

## **Chapter 2**

### **Accounting for Business Combinations**

#### *Multiple Choice*

1. SFAS 141R requires that all business combinations be accounted for using
  - a. the pooling of interests method.
  - b. the acquisition method.
  - c. either the acquisition or the pooling of interests methods.
  - d. neither the acquisition nor the pooling of interests methods.
  
2. Under the acquisition method, if the fair values of identifiable net assets exceed the value implied by the purchase price of the acquired company, the excess should be
  - a. accounted for as goodwill.
  - b. allocated to reduce current and long-lived assets.
  - c. allocated to reduce current assets and classify any remainder as an extraordinary gain.
  - d. allocated to reduce any previously recorded goodwill and classify any remainder as an ordinary gain.
  
3. In a period in which an impairment loss occurs, SFAS No. 142 requires each of the following note disclosures except
  - a. a description of the facts and circumstances leading to the impairment.
  - b. the amount of goodwill by reporting segment.
  - c. the method of determining the fair value of the reporting unit.
  - d. the amounts of any adjustments made to impairment estimates from earlier periods, if significant.
  
4. Once a reporting unit is determined to have a fair value below its carrying value, the goodwill impairment loss is computed by comparing the
  - a. fair value of the reporting unit and the fair value of the identifiable net assets.
  - b. carrying value of the goodwill to its implied fair value.
  - c. fair value of the reporting unit to its carrying amount (goodwill included).
  - d. carrying value of the reporting unit to the fair value of the identifiable net assets.
  
5. SFAS 141R requires that the acquirer disclose each of the following for each material business combination except the
  - a. name and a description of the acquiree.
  - b. percentage of voting equity instruments acquired.
  - c. fair value of the consideration transferred.
  - d. Each of the above is a required disclosure
  
6. In a leveraged buyout, the portion of the net assets of the new corporation provided by the management group is recorded at
  - a. appraisal value.
  - b. book value.
  - c. fair value.
  - d. lower of cost or market.

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7. When the acquisition price of an acquired firm is less than the fair value of the identifiable net assets, all of the following are recorded at fair value except
- Assumed liabilities.
  - Current assets.
  - Long-lived assets.
  - Each of the above is recorded at fair value.
8. Under SFAS 141R,
- both direct and indirect costs are to be capitalized.
  - both direct and indirect costs are to be expensed.
  - direct costs are to be capitalized and indirect costs are to be expensed.
  - indirect costs are to be capitalized and direct costs are to be expensed.
9. A business combination is accounted for properly as an acquisition. Which of the following expenses related to effecting the business combination should enter into the determination of net income of the combined corporation for the period in which the expenses are incurred?

	<u>Security issue costs</u>	<u>Overhead allocated to the merger</u>
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

10. In a business combination, which of the following costs are assigned to the valuation of the security?

	<u>Professional or consulting fees</u>	<u>Security issue costs</u>
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

11. Par Company and Sub Company were combined in an acquisition transaction. Par was able to acquire Sub at a bargain price. The sum of the fair values of identifiable assets acquired less the fair value of liabilities assumed exceeded the cost to Par. After eliminating previously recorded goodwill, there was still some "negative goodwill." Proper accounting treatment by Par is to report the amount as
- paid-in capital.
  - a deferred credit, which is amortized.
  - an ordinary gain.
  - an extraordinary gain.
12. With an acquisition, direct and indirect expenses are
- expensed in the period incurred.
  - capitalized and amortized over a discretionary period.
  - considered a part of the total cost of the acquired company.
  - charged to retained earnings when incurred.

13. In a business combination accounted for as an acquisition, how should the excess of fair value of net assets acquired over the consideration paid be treated?
- Amortized as a credit to income over a period not to exceed forty years.
  - Amortized as a charge to expense over a period not to exceed forty years.
  - Amortized directly to retained earnings over a period not to exceed forty years.
  - Recorded as an ordinary gain.
14. P Corporation issued 10,000 shares of common stock with a fair value of \$25 per share for all the outstanding common stock of S Company in a business combination properly accounted for as an acquisition. The fair value of S Company's net assets on that date was \$220,000. P Company also agreed to issue an additional 2,000 shares of common stock with a fair value of \$50,000 to the former stockholders of S Company as an earnings contingency. Assuming that the contingency is expected to be met, the \$50,000 fair value of the additional shares to be issued should be treated as a(n)
- decrease in noncurrent liabilities of S Company that were assumed by P Company.
  - decrease in consolidated retained earnings.
  - increase in consolidated goodwill.
  - decrease in consolidated other contributed capital.
15. On February 5, Pryor Corporation paid \$1,600,000 for all the issued and outstanding common stock of Shaw, Inc., in a transaction properly accounted for as an acquisition. The book values and fair values of Shaw's assets and liabilities on February 5 were as follows

	<u>Book Value</u>	<u>Fair Value</u>
Cash	\$ 160,000	\$ 160,000
Receivables (net)	180,000	180,000
Inventory	315,000	300,000
Plant and equipment (net)	820,000	920,000
Liabilities	<u>(350,000)</u>	<u>(350,000)</u>
Net assets	<u>\$1,125,000</u>	<u>\$1,210,000</u>

What is the amount of goodwill resulting from the business combination?

- \$-0-
  - \$475,000.
  - \$85,000.
  - \$390,000.
16. P Company purchased the net assets of S Company for \$225,000. On the date of P's purchase, S Company had no investments in marketable securities and \$30,000 (book and fair value) of liabilities. The fair values of S Company's assets, when acquired, were

Current assets	\$ 120,000
Noncurrent assets	<u>180,000</u>
Total	\$300,000

How should the \$45,000 difference between the fair value of the net assets acquired (\$270,000) and the consideration paid (\$225,000) be accounted for by P Company?

- The noncurrent assets should be recorded at \$ 135,000.
- The \$45,000 difference should be credited to retained earnings.
- The current assets should be recorded at \$102,000, and the noncurrent assets should be recorded at \$153,000.
- An ordinary gain of \$45,000 should be recorded.

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17. If the value implied by the purchase price of an acquired company exceeds the fair values of identifiable net assets, the excess should be
- allocated to reduce any previously recorded goodwill and classify any remainder as an ordinary gain.
  - allocated to reduce current and long-lived assets.
  - allocated to reduce long-lived assets.
  - accounted for as goodwill.
18. P Co. issued 5,000 shares of its common stock, valued at \$200,000, to the former shareholders of S Company two years after S Company was acquired in an all-stock transaction. The additional shares were issued because P Company agreed to issue additional shares of common stock if the average post combination earnings over the next two years exceeded \$500,000. P Company will treat the issuance of the additional shares as a (decrease in)
- consolidated retained earnings.
  - consolidated goodwill.
  - consolidated paid-in capital.
  - non-current liabilities of S Company assumed by P Company.
19. In a business combination in which the total fair value of the identifiable assets acquired over liabilities assumed is greater than the consideration paid, the excess fair value is:
- classified as an extraordinary gain.
  - allocated first to eliminate any previously recorded goodwill, and any remaining excess over the consideration paid is classified as an ordinary gain.
  - allocated first to reduce proportionately non-current assets then to non-monetary current assets, and any remaining excess over cost is classified as a deferred credit.
  - allocated first to reduce proportionately non-current, depreciable assets to zero, and any remaining excess over cost is classified as a deferred credit.
20. The first step in determining goodwill impairment involves comparing the
- implied value of a reporting unit to its carrying amount (goodwill excluded).
  - fair value of a reporting unit to its carrying amount (goodwill excluded).
  - implied value of a reporting unit to its carrying amount (goodwill included).
  - fair value of a reporting unit to its carrying amount (goodwill included).
21. If an impairment loss is recorded on previously recognized goodwill due to the transitional goodwill impairment test, the loss should be treated as a(n):
- loss from a change in accounting principles.
  - extraordinary loss
  - loss from continuing operations.
  - loss from discontinuing operations.
22. P Company acquires all of the voting stock of S Company for \$930,000 cash. The book values of S Company's assets are \$800,000, but the fair values are \$840,000 because land has a fair value above its book value. Goodwill from the combination is computed as:
- \$130,000.
  - \$90,000.
  - \$40,000.
  - \$0.

23. Under SFAS 141R, what value of the assets and liabilities are reflected in the financial statements on the acquisition date of a business combination?
- a. Carrying value
  - b. Fair value
  - c. Book value
  - d. Average value

**Use the following information to answer questions 24 & 25.**

Pratt Company issued 24,000 shares of its \$20 par value common stock for the net assets of Sele Company in business combination under which Sele Company will be merged into Pratt Company. On the date of the combination, Pratt Company common stock had a fair value of \$30 per share. Balance sheets for Pratt Company and Sele Company immediately prior to the combination were as follows:

	Pratt	Sele
Current Assets	\$1,314,000	\$192,000
Plant and Equipment (net)	<u>1,725,000</u>	<u>408,000</u>
Total	<u>\$3,039,000</u>	<u>\$600,000</u>
Liabilities	\$ 900,000	\$150,000
Common Stock, \$20 par value	1,650,000	240,000
Other Contributed Capital	218,000	60,000
Retained Earnings	<u>271,000</u>	<u>150,000</u>
Total	<u>\$3,039,000</u>	<u>\$600,000</u>

24. If the business combination is treated as an acquisition and Sele Company's net assets have a fair value of \$686,400, Pratt Company's balance sheet immediately after the combination will include goodwill of
- a. \$30,600.
  - b. \$38,400.
  - c. \$33,600.
  - d. \$56,400.
25. If the business combination is treated as an acquisition and the fair value of Sele Company's current assets is \$270,000, its plant and equipment is \$726,000, and its liabilities are \$168,000, Pratt Company's financial statements immediately after the combination will include
- a. Negative goodwill of \$108,000.
  - b. Plant and equipment of \$2,451,000.
  - c. Plant and equipment of \$2,343,000.
  - d. An ordinary gain of \$108,000.

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26. On May 1, 2011, the Phil Company paid \$1,200,000 for 80% of the outstanding common stock of Sage Corporation in a transaction properly accounted for as an acquisition. The recorded assets and liabilities of Sage Corporation on May 1, 2011, follow:

Cash	\$100,000
Inventory	200,000
Property & equipment (Net of accumulated depreciation)	800,000
Liabilities	(160,000)

On May 1, 2011, it was determined that the inventory of Sage had a fair value of \$220,000 and the property and equipment (net) has a fair value of \$1,200,000. What is the amount of goodwill resulting from the business combination?

- \$0.
- \$112,000.
- \$140,000.
- \$28,000.

**Use the following information to answer questions 27 & 28.**

Posch Company issued 12,000 shares of its \$20 par value common stock for the net assets of Sato Company in a business combination under which Sato Company will be merged into Posch Company. On the date of the combination, Posch Company common stock had a fair value of \$30 per share. Balance sheets for Posch Company and Sato Company immediately prior to the combination were as follows:

	<u>Posch</u>	<u>Sato</u>
Current Assets	\$ 657,000	\$ 96,000
Plant and Equipment (net)	<u>863,000</u>	<u>204,000</u>
Total	<u>\$1,520,000</u>	<u>\$300,000</u>
Liabilities	\$ 450,000	\$ 75,000
Common Stock, \$20 par value	825,000	120,000
Other Contributed Capital	109,000	30,000
Retained Earnings	<u>136,000</u>	<u>75,000</u>
Total	<u>\$1,520,000</u>	<u>\$300,000</u>

27. If the business combination is treated as an acquisition and Sato Company's net assets have a fair value of \$343,200, Posch Company's balance sheet immediately after the combination will include goodwill of
- \$15,300.
  - \$19,200.
  - \$16,800.
  - \$28,200.
28. If the business combination is treated as an acquisition and the fair value of Sato Company's current assets is \$135,000, its plant and equipment is \$363,000, and its liabilities are \$84,000, Posch Company's financial statements immediately after the combination will include
- Negative goodwill of \$54,000.
  - Plant and equipment of \$1,226,000.
  - Plant and equipment of \$1,172,000.
  - An ordinary gain of \$54,000.

29. Following its acquisition of the net assets of Sandy Company, Potter Company assigned goodwill of \$60,000 to one of the reporting divisions. Information for this division follows:

	<u>Carrying Amount</u>	<u>Fair Value</u>
Cash	\$ 20,000	\$20,000
Inventory	35,000	40,000
Equipment	125,000	160,000
Goodwill	60,000	
Accounts Payable	30,000	30,000

Based on the preceding information, what amount of goodwill will be reported for this division if its fair value is determined to be \$200,000?

- a. \$0
  - b. \$60,000
  - c. \$30,000
  - d. \$10,000
30. The fair value of net identifiable assets exclusive of goodwill of a reporting unit of X Company is \$300,000. On X Company's books, the carrying value of this reporting unit's net assets is \$350,000, including \$60,000 goodwill. If the fair value of the reporting unit is \$335,000, what amount of goodwill impairment will be recognized for this unit?
- a. \$0
  - b. \$10,000
  - c. \$25,000
  - d. \$35,000
31. The fair value of net identifiable assets of a reporting unit exclusive of goodwill of Y Company is \$270,000. The carrying value of the reporting unit's net assets on Y Company's books is \$320,000, including \$50,000 goodwill. If the reported goodwill impairment for the unit is \$10,000, what would be the fair value of the reporting unit?
- a. \$320,000
  - b. \$310,000
  - c. \$270,000
  - d. \$290,000

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32. Potter Corporation acquired Sims Company through an exchange of common shares. All of Sims' assets and liabilities were immediately transferred to Potter. Potter Company's common stock was trading at \$20 per share at the time of exchange. The following selected information is also available:

	<u>Potter Company</u>	
	<i>Before Acquisition</i>	<i>After Acquisition</i>
<i>Par value of shares outstanding</i>	\$200,000	\$250,000
<i>Additional Paid in Capital</i>	350,000	550,000

What number of shares was issued at the time of the exchange?

- a. 5,000
- b. 17,500
- c. 12,500
- d. 10,000



*Problems*

2-1 Balance sheet information for Seitz Corporation at January 1, 2011, is summarized as follows:

Current assets	\$ 920,000	Liabilities	\$ 1,200,000
Plant assets	1,800,000	Capital stock \$10 par	800,000
		Retained earnings	<u>720,000</u>
	<u>\$2,720,000</u>		<u>\$ 2,720,000</u>

Seitz's assets and liabilities are fairly valued except for plant assets that are undervalued by \$200,000. On January 2, 2011, Pell Corporation issues 80,000 shares of its \$10 par value common stock for all of Seitz's net assets and Seitz is dissolved. Market quotations for the two stocks on this date are:

Pell common: \$28

Seitz common: \$19

Pell pays the following fees and costs in connection with the combination:

Finder's fee	\$10,000
Costs of registering and issuing stock	5,000
Legal and accounting fees	6,000

**Required:**

- A. Calculate Pell's investment cost of Seitz Corporation.
- B. Calculate any goodwill from the business combination.

2-2 Peterson Corporation purchased the net assets of Scarberry Corporation on January 2, 2011 for \$560,000 and also paid \$20,000 in direct acquisition costs. Scarberry's balance sheet on January 1, 2011 was as follows:

Accounts receivable-net	\$ 180,000	Current liabilities	\$ 70,000
Inventory	360,000	Long term debt	160,000
Land	40,000	Common stock (\$1 par)	20,000
Building-net	60,000	Paid-in capital	430,000
Equipment-net	<u>80,000</u>	Retained earnings	<u>40,000</u>
Total assets	<u>\$ 720,000</u>	Total liab. & equity	<u>\$ 720,000</u>

Fair values agree with book values except for inventory, land, and equipment, which have fair values of \$400,000, \$50,000 and \$70,000, respectively. Scarberry has patent rights valued at \$20,000.

**Required:**

- A. Prepare Peterson's general journal entry for the cash purchase of Scarberry's net assets.
- B. Assume Peterson Corporation purchased the net assets of Scarberry Corporation for \$500,000 rather than \$560,000, prepare the general journal entry.

2-10 **Test Bank to Accompany Jeter and Chaney Advanced Accounting**

2-3 Pyle Company acquired the assets (except cash) and assumed the liabilities of Sand Company on January 1, 2011, paying \$2,600,000 cash. Immediately prior to the acquisition, Sand Company's balance sheet was as follows:

	<u>BOOK VALUE</u>	<u>FAIR VALUE</u>
Accounts receivable (net)	\$ 240,000	\$ 220,000
Inventory	290,000	320,000
Land	960,000	1,508,000
Buildings (net)	<u>1,020,000</u>	<u>1,392,000</u>
Total	<u>\$2,510,000</u>	<u>\$3,440,000</u>
Accounts payable	\$ 270,000	\$ 270,000
Note payable	600,000	600,000
Common stock, \$5 par	420,000	
Other contributed capital	640,000	
Retained earnings	<u>580,000</u>	
Total	<u>\$2,510,000</u>	

Pyle Company agreed to pay Sand Company's former stockholders \$200,000 cash in 2012 if post-combination earnings of the combined company reached \$1,000,000 during 2011.

**Required:**

- A. Prepare the journal entry necessary for Pyle Company to record the acquisition on January 1, 2011. It is expected that the earnings target is likely to be met.
- B. Prepare the journal entry necessary for Pyle Company in 2012 assuming the earnings contingency was not met.

2-4 Condensed balance sheets for Payne Company and Sigle Company on January 1, 2011 are as follows:

	<u>Payne</u>	<u>Sigle</u>
Current Assets	\$ 440,000	\$200,000
Plant and Equipment (net)	<u>1,080,000</u>	<u>340,000</u>
Total Assets	<u>\$1,520,000</u>	<u>\$540,000</u>
Total Liabilities	\$ 230,000	\$ 80,000
Common Stock, \$10 par value	840,000	240,000
Other Contributed Capital	300,000	130,000
Retained Earnings	<u>150,000</u>	<u>90,000</u>
Total Equities	<u>\$1,520,000</u>	<u>\$540,000</u>

On January 1, 2011 the stockholders of Payne and Sigle agreed to a consolidation whereby a new corporation, Lawson Company, would be formed to consolidate Payne and Sigle. Lawson Company issued 70,000 shares of its \$20 par value common stock for the net assets of Payne and Sigle. On the date of consolidation, the fair values of Payne's and Sigle's current assets and liabilities were equal to their book values. The fair value of plant and equipment for each company was: Payne, \$1,270,000; Sigle, \$360,000.

An investment banking house estimated that the fair value of Lawson Company's common stock was \$35 per share. Payne will incur \$45,000 of direct acquisition costs and \$15,000 in stock issue costs.

**Required:**

Prepare the journal entries to record the consolidation on the books of Lawson Company assuming that the consolidation is accounted for as an acquisition.

2-5 The stockholders' equities of P Corporation and S Corporation were as follows on January 1, 2011:

	<u>P Corp.</u>	<u>S Corp.</u>
Common Stock, \$1 par	\$1,000,000	\$ 600,000
Other Contributed Capital	2,800,000	1,100,000
Retained Earnings	<u>600,000</u>	<u>340,000</u>
Total Stockholders' Equity	<u>\$4,400,000</u>	<u>\$2,040,000</u>

On January 2, 2011 P Corp. issued 100,000 of its shares with a market value of \$14 per share in exchange for all of S's shares, and S Corp. was dissolved. P Corp. paid \$10,000 to register and issue the new common shares.

**Required:**

Prepare the stockholders' equity section of P Corp. balance sheet after the business combination on January 2, 2011.

2-6 The managers of Petty Company own 10,000 of its 100,000 outstanding common shares. Swann Company is formed by the managers of Petty Company to take over Petty Company in a leveraged buyout. The managers contribute their shares in Petty Company and Swann Company then borrows \$675,000 to purchase the remaining 90,000 shares of Petty Company for \$600,000; the remaining \$75,000 is used for working capital. Petty Company is then merged into Swann Company effective January 1, 2011. Data relevant to Petty Company immediately prior to the leveraged buyout follow:

	<u>Book Value</u>	<u>Fair Value</u>
Current Assets	\$ 90,000	\$ 90,000
Plant Assets	255,000	525,000
Liabilities	<u>(45,000)</u>	<u>(45,000)</u>
Stockholders' Equity	<u>\$300,000</u>	<u>\$570,000</u>

**Required:**

- A. Prepare journal entries on Swann Company's books to reflect the effects of the leveraged buyout.
- B. Determine the balance of each of the following immediately after the merger:
  1. Current Assets
  2. Plant Assets
  3. Note Payable
  4. Common Stock

## 2-12 Test Bank to Accompany Jeter and Chaney Advanced Accounting

- 2-7 On January 1, 2010, Presley Company acquired the net assets of Sill Company for \$1,580,000 cash. The fair value of Sill's identifiable net assets was \$1,310,000 on his date. Presley Company decided to measure goodwill impairment using the present value of future cash flows to estimate the fair value of the reporting unit (Sill). The information for these subsequent years is as follows:

<i>Year</i>	<i>Present value of Future Cash Flows</i>	<i>Carrying value of Sill's Identifiable Net Assets*</i>	<i>Fair Value Sill's Identifiable Net Assets</i>
2011	\$1,400,000	\$1,160,000	\$1,190,000
2012	\$1,400,000	\$1,120,000	\$1,210,000

\* Identifiable net assets do not include goodwill.

### Required:

- A: For each year determine the amount of goodwill impairment, if any.  
 B: Prepare the journal entries needed each year to record the goodwill impairment (if any) on Presley's books.
- 2-8 The following balance sheets were reported on January 1, 2011, for Piper Company and Sieler Company:

	<u>Piper</u>	<u>Sieler</u>
Cash	\$ 150,000	\$ 30,000
Inventory	450,000	150,000
Equipment (net)	<u>1,320,000</u>	<u>570,000</u>
Total	<u>\$1,920,000</u>	<u>\$750,000</u>
Total liabilities	\$ 450,000	\$150,000
Common stock, \$20 par value	600,000	300,000
Other contributed capital	375,000	105,000
Retained earnings	<u>495,000</u>	<u>195,000</u>
Total	<u>\$1,920,000</u>	<u>\$750,000</u>

### Required:

Appraisals reveal that the inventory has a fair value \$180,000, and the equipment has a current value of \$615,000. The book value and fair value of liabilities are the same. Assuming that Piper Company wishes to acquire Sieler for cash in an asset acquisition, determine the following cutoff amounts:

- The purchase price above which Piper would record goodwill.
- The purchase price at which Piper would record a \$50,000 gain.
- The purchase price below which Piper would obtain a "bargain."
- The purchase price at which Piper would record \$75,000 of goodwill.

### Short Answer

- SFAS No. 142 requires that goodwill impairment be tested annually for each reporting unit. Discuss the necessary steps of the goodwill impairment test.

2. Briefly describe the different treatment under SFAS 141 vs. SFAS 141R for the following issues:
  - a. Business definition
  - b. Acquisitions costs
  - c. In-process R&D
  - d. Contingent consideration

### Short Answer Questions from the Textbook

1. When contingent consideration in an acquisition is based on security prices, how should this contingency be reflected on the acquisition date? If the estimate changes during the measurement period, how is this handled? If the estimate changes after the end of the measurement period, how is this adjustment handled? Why?
2. What are pro forma financial statements? What is their purpose?
3. How would a company determine whether goodwill has been impaired?
4. AOL announced that because of an accounting change (FASB Statements Nos. 141R [ASC 805] and 142 [ASC 350]), earnings would be increasing 2002, Veritas Software Corporation's CFO resigned after claiming to have an MBA from Stanford University. On the other hand, Bausch & Lomb Inc.'s board refused the CEO's offer to resign following a questionable claim to have an MBA. Suppose you have been retained by the board of a company where the CEO has 'overstated' credentials. This company has a code of ethics and conduct which over the next 25 years by \$5.9 billion a year. What change(s) required by FASB (in SFAS Nos. 141R and 142) resulted in an increase in AOL's in-come? Would you expect this increase in earnings to have a positive impact on AOL's stock price? Why or why not?

### Business Ethics Question from Textbook

There have been several recent cases of a CEO or CFO resigning or being ousted for misrepresenting academic credentials. For instance, during February 2006, the CEO of RadioShack resigned by 'mutual agreement' for inflating his educational background. During states that the employee should always do "the right thing." (a) What is the board of directors' responsibility in such matters? (b) What arguments would you make to ask the CEO to resign? What damage might be caused if the decision is made to retain the current CEO?

2-14 Test Bank to Accompany Jeter and Chaney Advanced Accounting

**ANSWER KEY**

*Multiple Choice*

- |      |       |       |       |
|------|-------|-------|-------|
| 1. b | 10. c | 19. b | 28. d |
| 2. d | 11. c | 20. d | 29. d |
| 3. b | 12. a | 21. a | 30. c |
| 4. b | 13. d | 22. b | 31. b |
| 5. d | 14. c | 23. b | 32. c |
| 6. b | 15. d | 24. c |       |
| 7. d | 16. d | 25. d |       |
| 8. b | 17. d | 26. c |       |
| 9. c | 18. c | 27. c |       |

*Problems*

2-1 A. FMV of shares issued by Pell (80,000 sh × \$28) = \$2,240,000

B. Investment cost from Part A \$2,240,000  
 Less: Fair value of Seitz's net assets (\$2,720,000+\$200,000-\$1,200,000) 1,720,000  
 Goodwill from investment \$ 520,000

2-2 A. Accounts Receivable 180,000  
 Inventory 400,000  
 Land 50,000  
 Building 60,000  
 Equipment 70,000  
 Patent 20,000  
 Goodwill 10,000  
 Acquisition Expense 20,000  
     Current Liabilities 70,000  
     Long-term Debt 160,000  
     Cash 580,000

B. Acquisition Expense 20,000  
 Accounts Receivable 180,000  
 Inventory 400,000  
 Land 50,000  
 Building 60,000  
 Equipment 70,000  
 Patent 20,000  
     Current Liabilities 70,000  
     Long-term Debt 160,000  
     Cash 520,000  
     Gain on Acquisition 50,000

2-3	A.	Accounts Receivable	240,000	
		Inventory	320,000	
		Land	1,508,000	
		Buildings	1,392,000	
		Goodwill	30,000	
		Allowance for Uncollectible Accounts		20,000
		Accounts Payable		270,000
		Note Payable		600,000
		Cash		2,600,000
		Goodwill	200,000	
		Liability for Contingent Consideration		200,000
		Cost of acquisition	\$2,600,000	
		Fair value of net assets acquired		
		(\$3,440,000 – \$870,000)	<u>2,570,000</u>	
		Goodwill	<u>\$ 30,000</u>	
	B.	Liability for Contingent Consideration	200,000	
		Income from Change in Estimate		200,000
2-4		Current Assets (\$440,000 + \$200,000)	640,000	
		Plant and Equipment (\$1,270,000 + \$360,000)	1,630,000	
		Goodwill	490,000	
		Liabilities (\$230,000 + \$80,000)		310,000
		Common Stock		
		(70,000 shares @ \$20/share)		1,400,000
		Other Contributed Capital		
		(70,000 × (\$35 – \$20))		1,050,000
		Acquisition Expense	45,000	
		Cash		45,000
		Other Contributed Capital	15,000	
		Cash		15,000
2-5		Stockholders' Equity:		
		Common Stock, \$1 par	\$1,100,000	
		Other Contributed Capital	4,090,000	[\$2,800,000 + (100,000 × \$13) – \$10,000]
		Retained Earnings	<u>600,000</u>	
		Total stockholders' Equity	<u>\$ 5,790,000</u>	

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2-6	A		
	Investment in Petty Company (\$300,000 × .10)	30,000	
	Common Stock		30,000
	Cash	675,000	
	Note Payable		675,000
	Investment in Petty Company	600,000	
	Cash		600,000
	Current Assets	90,000	
	Plant Assets (1)	498,000	
	Goodwill (2)	87,000	
	Liabilities		45,000
	Investment in Petty		630,000

(1)  $\$255,000 + [.90 \times (\$525,000 - \$255,000)] = \$498,000$

(2)	Cost of shares	\$600,000
	Book value of net assets (.90 × \$300,000) =	<u>270,000</u>
	Difference between cost and book value	\$330,000
	Allocated to:	
	Plant assets (.90 × (\$525,000 – \$255,000)) =	<u>243,000</u>
	Goodwill	<u>87,000</u>

B		
1.	Current Assets (\$90,000 + \$75,000)	165,000
2.	Plant Assets (\$255,000 + \$243,000)	498,000
3.	Note Payable	675,000
4.	Common Stock	30,000

2-7	A.		
	2011: <b>Step 1:</b> Fair value of the reporting unit		\$1,400,000
	<u>Carrying value of unit:</u>		
	Carrying value of identifiable net assets	\$1,160,000	
	Carrying value of goodwill (\$1,580,000 – \$1,310,000)	<u>270,000</u>	
			<u>1,430,000</u>
	Excess of carrying value over fair value		<u>\$30,000</u>

The excess of carrying value over fair value means that step 2 is required.

	<b>Step 2:</b> Fair value of the reporting unit		\$1,400,000
	Fair value of identifiable net assets		<u>1,190,000</u>
	Implied value of goodwill		210,000
	Recorded value of goodwill (\$1,580,000 – \$1,310,000)		<u>270,000</u>
	Impairment loss		<u>\$60,000</u>



2012:	<b>Step 1:</b> Fair value of the reporting unit		\$1,400,000
	<u>Carrying value of unit:</u>		
	Carrying value of identifiable net assets	\$1,120,000	
	Carrying value of goodwill (\$270,000 – \$40,000)	<u>230,000</u>	
			<u>1,350,000</u>
	Excess of Fair value over Carrying value		<u>\$ 50,000</u>

The excess of fair value over carrying value means that step 2 is **not** required.

B.			
2011:	Impairment Loss—Goodwill	60,000	
	Goodwill		60,000
2012:	No entry		

- 2-8 a. Fair Value of Identifiable Net Assets
- |  |                  |
|--|------------------|
| Book values \$750,000 – \$150,000 =              | \$600,000        |
| Write up of Inventory and Equipment:             |                  |
| (\$30,000 + \$45,000) =                          | <u>75,000</u>    |
| Purchase price above which goodwill would result | <u>\$675,000</u> |
- b. Any existing goodwill would be eliminated before recording a gain:  
\$675,000 Fair Value of Identifiable Net Assets – \$50,000 Gain = \$625,000.
- c. Anything below \$675,000 is technically considered a bargain.
- d. Goodwill would be \$75,000 at a purchase price of \$750,000 or (\$675,000 + \$75,000).

*Short Answer*

- In the first step of the goodwill impairment test, the fair value of the reporting unit is compared to its carrying amount. If the fair value is less than the carrying amount, then the carrying value of the goodwill is compared to its implied fair value. A loss is recognized when the carrying value of goodwill is higher than its fair value.

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2.

Issue	SFAS No. 141	SFAS No. 141R
Acquisitions costs	Capitalize the costs.	Expense as incurred.
In-process R&D	Included as part of purchase price, but then immediately expensed.	Included as part of purchase price, treated as an asset.
Contingent consideration	Record when determinable and reflect subsequent changes in the purchase price.	Record at fair value on the acquisition date with subsequent changes recorded on the income statement.
Business definition	A business is defined as a self-sustaining integrated set of activities and assets conducted and managed for the purpose of providing a return to investors. The definition would exclude early-stage development entities.	A business or a group of assets no longer must be self-sustaining. The business or group of assets must be capable of generating a revenue stream. This definition would include early-stage development entities.

### Short Answer Questions from the Textbook Solutions

- At the acquisition date, the information available (and through the end of the measurement period) is used to estimate the expected total consideration at fair value. If the subsequent stock issue valuation differs from this assessment, the *Exposure Draft (SFAS 1204-001)* expected to replace *FASB Statement No. 141R* specifies that equity should not be adjusted. The reason is that the valuation was determined at the date of the exchange, and thus the impact on the firm's equity was measured at that point based on the best information available then.
- Pro forma financial statements (sometimes referred to as "as if" statements) are financial statements that are prepared to show the effect of planned or contemplated transactions.
- For purposes of the goodwill impairment test, all goodwill must be assigned to a reporting unit. Goodwill impairment for each reporting unit should be tested in a two-step process. In the first step, the fair value of a reporting unit is compared to its carrying amount (goodwill included) at the date of the periodic review. The fair value of the unit may be based on quoted market prices, prices of comparable businesses, or a present value or other valuation technique. If the fair value at the review date is less than the carrying amount, then the second step is necessary. In the second step, the carrying value of the goodwill is compared to its implied fair value. (The calculation of the implied fair value of goodwill used in the impairment test is similar to the method illustrated throughout this chapter for valuing the goodwill at the date of the combination.)

4. The expected increase was due to the elimination of goodwill amortization expense. However, the impairment loss under the new rules was potentially larger than a periodic amortization charge, and this is in fact what materialized within the first year after adoption (a large impairment loss). If there was any initial stock price impact from elimination of goodwill amortization, it was only a short-term or momentum effect. Another issue is how the stock market responds to the goodwill impairment charge. Some users claim that this charge is a non-cash charge and should be disregarded by the market. However, others argue that the charge is an admission that the price paid was too high, and might result in a stock price decline (unless the market had already adjusted for this overpayment prior to the actual write down).

**ANSWERS TO BUSINESS ETHICS CASE**

a and b. The board has responsibility to look into anything that might suggest malfeasance or inappropriate conduct. Such incidents might suggest broader problems with integrity, honesty, and judgment. In other words, can you trust any reports from the CEO? If the CEO is not fired, does this send a message to other employees that ethical lapses are okay? Employees might feel that top executives are treated differently.