Chapter 1

BUSINESS COMBINATIONS

Answers to Questions

1 According to IFRS 3, business combination is a process where a business entity acquires one or more other business entities. A business is defined as "an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants". This shows that a business entity should have three characteristics: (1) an input, which is a set of activities and assets, (2) a process, which is managing and conducting the input, and (3) an output, which is the return from conducting the process.
For example, a business purchased a factory; normally this should be an acquisition of assets, however, if by purchasing the factory, the entity also hiring its management and workers of that certain factory this should be a business combination. The factory itself acted as an input, while the management and workers are a part of the process, and the products produced or any other economic benefits such as cost reduction is the output. This transaction is now a business combination.

2 The dissolution of all but one of the separate legal entities is *not* necessary for a business combination. An example of one form of business combination in which the separate legal entities are not dissolved is when one corporation becomes a subsidiary of another. In the case of a parent-subsidiary relationship, each combining company continues to exist as a separate legal entity even though both companies are under the control of a single management team.

3 A business combination occurs when two or more previously separate and independent companies are brought under the control of a single management team. Merger and consolidation in a generic sense are frequently used as synonyms for the term *business combination*. In a technical sense, however, a *merger* is a type of business combination in which all but one of the combining entities are dissolved and a *consolidation* is a type of business combination in which a new corporation is formed to take over the assets of two or more previously separate companies and all of the combining companies are dissolved.

4 In August 1999, FASB issued a report to eliminate the pooling of interest method because of the following reasons: (1) pooling provides less relevant information to statement users, (2) pooling ignores economic value exchanged in the transaction and makes subsequent performance evaluation impossible and (3) comparing firms using the alternative methods is difficult for investors.

The above problems occurred because the pooling interest method uses historical book value rather than the fair value to recognize the net assets at the transaction date.

5 In a business combination, goodwill is the excess of investment cost over the fair value of the investee's identifiable net assets. Under the GAAP and IFRS, goodwill arising from a business combination should be recorded as an asset. Goodwill should not be amortized because it has indefinite useful life, rather, it should be tested for any impairment at least annually.

SOLUTIONS TO EXERCISES

Solution E1-1

1 a
2 b
3 a
4 c

Solution E1-2 [AICPA adapted]

1 **a**
Plant and equipment should be recorded at the $220,000 fair value.

2 c

Investment cost		$1,600,000
Less: Fair value of net assets		
Cash	$ 160,000	
Inventory	380,000	
Property and equipment — net	1,120,000	
Liabilities	(360,000)	1,300,000
Goodwill		$ 300,000

Solution E1-3

Additional Capital — PT Pratama Tbk Corporation on March 10

Excess of fair value over par value of each share: $40 - $20 = $20

Additional paid-in capital from stocks issuance [1,000,000 shares x $20]	$20,000,000
Less: cost of registering and issuing, printing and delivering the shares [$200,000 + $50,000 + $20,000]	$270,000
Additional paid-in capital that should be recorded	$19,730,000

Solution E1-4

Goodwill/Gain – Summer Inc.

Fair value of Summer Inc.'s net assets on July 1 [$ 12,000 + $15,000 + $32,000 +$40,000 - $15,000 – $25,000]	$59,000,000	
Less: purchase price to acquire Summer Inc.		$50,000,000
Gain from bargain purchase (Fair value of Summer Inc.'s net assets exceeded the purchase price)		$9,000,000

Solution E1-5

Journal entries on the books of Pan Corporation to record merger with Sis Corporation

Accounts payable		2,500
Unearned revenues	400	
Interest payable		100
Notes payable		7,000
Bonds payable		10,000
Recognized liabilities		$20,000

Note: assets and liabilities in business combinations are recorded at fair value instead of book value.

SOLUTIONS TO PROBLEMS

Solution P1-1

Investment in Sung Ltd (+A)	11,000,000	
Common stock, $10 par (+SE)		5,000,000
Additional paid-in capital (+SE)		5,000,000
Cash (-A)		1,000,000

To record issuance of 500,000 shares of $10 par common stock plus $1,000,000 cash in a business combination with Sung Ltd.

Cash (+A)	2,000,000	
Trade receivables (+A)	800,000	
Inventories (+A)	3,000,000	
Prepaid expenses (+A)	1,000,000	
Land (+A)	6,800,000	
Building-net (+A)	10,100,000	
Equipment-net (+A)	3,000,000	
Trade payable (+L)		1,500,000
Notes payable (+L)		4,600,000
Bonds payable (+L)		7,100,000
Investment in Sung Ltd (-A)		11,000,000
Gain from Bargain Purchase (Ga, +SE)	2,500,000	

To assign the cost of Sung Ltd to identifiable assets acquired and liabilities assumed on the basis of their fair values and to recognize the gain from a bargain purchase.

Solution P1-2

Preliminary computations	
Additional paid-in capital from additional stock issuance [200,000 shares x $10]	$2,000,000
Common stock, $10 par from additional stock issuance [$10,000,000 - $2,000,000]	$8,000,000
Purchase price: Cost of investment in Carlos SA	$10,000,000
Less: Fair value of Carlos SA at December 31 [$1,000,000 + $12,000,000 +$13,000,000 - $4,000,000 - $13,000,000]	$9,000,000
Excess of purchase price over fair value (goodwill)	$1,000,000

Jose SA
Balance Sheet
At December 31 (After the Business Combination)

Assets	
Current assets	
Cash [$2,000,000 + $1,000,000]	$3,000,000
Other current assets [$13,000,000 + $12,000,000]	$25,000,000
Plant assets [$15,000,000 + $13,000,000]	$28,000,000
Goodwill	$ 1,000,000
Total assets	$57,000,000
Liabilities and Stockholders' Equity	
Liabilities	
Current liabilities [$5,000,000 + $4,000,000]	$ 9,000,000
Other liabilities [$12,000,000 + $13,000,000]	$25,000,000
Stockholders' equity	
Additional paid-in capital	$2,000,000
Common stock, $10 par ($10,000,000 +$8,000,000)	$18,000,000
Retained earnings	$3,000,000
Total liabilities and stockholders' equity	$57,000,000

Solution P1-3

Par issues 25,000 shares of stock for Sin's outstanding shares

1a

		Debit	Credit
	Investment in Sin	1,500,000	
	Capital stock, $10 par		250,000
	Additional paid-in capital		1,250,000
	To record issuance of 25,000, $10 par shares with a market price of $60 per share in a business combination with Sin.		
	Investment expenses	60,000	
	Additional paid-in capital	40,000	
	Cash		100,000
	To record costs of combination in a business combination with Sin.		
	Cash	20,000	
	Inventories	120,000	
	Other current assets	200,000	
	Land	200,000	
	Plant and equipment — net	700,000	
	Goodwill	360,000	
	Liabilities		100,000
	Investment in Sin		1,500,000

To assign investment cost to identifiable assets and liabilities according to their fair values and the remainder to goodwill. Goodwill is computed: $1,500,000 cost - $1,140,000 fair value of net assets acquired.

1b

Par Corporation
Balance Sheet
January 2, 2011
(after business combination)

Assets	
Cash [$240,000 + $20,000 - $100,000]	$ 160,000
Inventories [$100,000 + $120,000]	220,000
Other current assets [$200,000 + $200,000]	400,000
Land [$160,000 + $200,000]	360,000
Plant and equipment — net [$1,300,000 + $700,000]	2,000,000
Goodwill	360,000
Total assets	$3,500,000
Liabilities and Stockholders' Equity	
Liabilities [$400,000 + $100,000]	$ 500,000
Capital stock, $10 par [$1,000,000 + $250,000]	1,250,000
Additional paid-in capital [$400,000 + $1,250,000 - $40,000]	1,610,000
Retained earnings (subtract $60,000 direct costs)	140,000
Total liabilities and stockholders' equity	$3,500,000

Solution P1-3 (continued)

Par issues 15,000 shares of stock for Sin's outstanding shares

2a

Investment in Sin (15,000 shares × $60)	900,000	
Capital stock, $10 par		150,000
Additional paid-in capital		750,000
To record issuance of 15,000, $10 par common shares with a market price of $60 per share.		
Investment expense	60,000	
Additional paid-in capital	40,000	
Cash		100,000
To record costs of combination in the acquisition of Sin.		
Cash	20,000	
Inventories	120,000	
Other current assets	200,000	
Land	200,000	
Plant and equipment — net	700,000	
Liabilities		100,000
Investment in Sin		900,000
Gain on bargain purchase		240,000
To record Sin's net assets at fair values and the gain on the bargain purchase.		

Fair value of net assets acquired	$1,140,000
Investment cost (Fair value of consideration)	900,000
Gain on Bargain Purchase	$ 240,000

2b

Par Corporation
Balance Sheet
January 2, 2011
(after business combination)

Assets	
Cash [$240,000 + $20,000 - $100,000]	$ 160,000
Inventories [$100,000 + $120,000]	220,000
Other current assets [$200,000 + $200,000]	400,000
Land [$160,000 + $200,000]	360,000
Plant and equipment — net [$1,300,000 + $700,000]	2,000,000
Total assets	$3,140,000
Liabilities and stockholders' equity	
Liabilities [$400,000 + $100,000]	$ 500,000
Capital stock, $10 par [$1,000,000 + $150,000]	1,150,000
Additional paid-in capital [$400,000 + $750,000 - $40,000]	1,110,000
Retained earnings (subtract $60,000 direct costs and add $240,000 Gain from bargain purchase)	380,000
Total liabilities and stockholders' equity	$3,140,000

Solution P1-4

1 *Schedule to allocate investment cost to assets and liabilities*

Investment cost (fair value), January 1	$300,000
Fair value acquired from Sun ($360,000 × 100%)	360,000
Excess fair value over cost (bargain purchase gain)	$ 60,000

Allocation:

	Allocation
Cash	$ 10,000
Receivables — net	20,000
Inventories	30,000
Land	100,000
Buildings — net	150,000
Equipment — net	150,000
Accounts payable	(30,000)
Other liabilities	(70,000)
Gain on bargain purchase	(60,000)
Totals	$ 300,000

2

Pub Corporation
Balance Sheet
at January 1, 2011
(after combination)

Assets		*Liabilities*	
Cash	$ 25,000	Accounts payable	$ 120,000
Receivables — net	60,000	Note payable (5 years)	200,000
Inventories	150,000	Other liabilities	170,000
Land	145,000	Liabilities	490,000
Buildings — net	350,000		
Equipment — net	330,000	*Stockholders' Equity*	
		Capital stock, $10 par	300,000
		Other paid-in capital	100,000
		Retained earnings*	170,000
		Stockholders' equity	570,000
Total assets	$1,060,000	Total equities	$1,060,000

* Retained earnings reflects the $60,000 gain on the bargain purchase.

Solution P1-5

1 *Journal entries to record the acquisition of Saw Corporation*

Investment in Saw	5,000,000	
Capital stock, $10 par		1,000,000
Other paid-in capital		3,000,000
Cash		1,000,000
To record acquisition of Saw for 100,000 shares of common stock and $1,000,000 cash.		
Investment expense	200,000	
Other paid-in capital	100,000	
Cash		300,000
To record payment of costs to register and issue the shares of stock ($100,000) and other costs of combination ($200,000).		
Cash	480,000	
Accounts receivable	720,000	
Notes receivable	600,000	
Inventories	1,000,000	
Other current assets	400,000	
Land	400,000	
Buildings	2,400,000	
Equipment	1,200,000	
Accounts payable		600,000
Mortgage payable, 10%		1,200,000
Investment in Saw		5,000,000
Gain on bargain purchase		400,000
To record the net assets of Saw at fair value and the gain on the bargain purchase.		

Gain on Bargain Purchase Calculation

Acquisition price	$5,000,000
Fair value of net assets acquired	5,400,000
Gain on bargain purchase	$ 400,000

Solution P1-5 (continued)

2

Pat Corporation
Balance Sheet
at January 2, 2011
(after business combination)

Assets		
Current Assets		
Cash	$ 5,180,000	
Accounts receivable — net	3,320,000	
Notes receivable — net	3,600,000	
Inventories	6,000,000	
Other current assets	1,800,000	$19,900,000
Plant Assets		
Land	$ 4,400,000	
Buildings — net	20,400,000	
Equipment — net	21,200,000	46,000,000
Total assets		$65,900,000
Liabilities and Stockholders' Equity		
Liabilities		
Accounts payable	$ 2,600,000	
Mortgage payable, 10%	11,200,000	$13,800,000
Stockholders' Equity		
Capital stock, $10 par	$21,000,000	
Other paid-in capital	18,900,000	
Retained earnings*	12,200,000	52,100,000
Total liabilities and stockholders' equity		$65,900,000

* Subtract $200,000 direct combination costs and add $400,000 gain on bargain purchase.