Advanced Accounting 7th edition Jeter Solutions Manual

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CHAPTER 2

Note: The letter A indicated for a question, exercise, or problem means that the question, exercise, or problem relates to a chapter appendix.

ANSWERS TO QUESTIONS

1(J). At the acquisition date, the fair value of the contingent consideration must be recorded on the parent's books regardless of whether stock or cash is used to settle the earnout. Whether contingent consideration (based on stock issuance) is classified as a liability or as equity depends on the characteristics of the earnout. Earnouts that are settled with a fixed number of shares will be classified as equity if the earnout target is based solely on the buyer's operations (which includes the operations of the acquired company) and cannot be based on any external index or comparisons with other companies or industries. If the earnout is settled with a variable number of shares, equity classification is possible if the earnout is based on the parent's stock price. However, if the number of shares offered in the earnout is inversely related to the parent's stock price, the earnout would be classified as a liability. Very few earnouts using stock will qualify for equity classification.

Changes in the value of stock earnouts classified as a liability will be reflected in earnings, while changes in the value of the stock earnouts classified as equity are not remeasured. .

2. 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.

3. 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 as follows. In the first step, known as the qualitative test, the firm must evaluate relevant events or circumstances concerning the value of a reporting unit. If it is deemed more likely than not that the fair value of the reporting unit is less than its carrying value, the company proceeds to the quantitative test. Otherwise, goodwill is not impaired. If it is deemed more likely than not that the fair value of the reporting unit is less than its carrying value, the company must proceed to the quantitative test. In this test, 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 goodwill is considered impaired. The amount of goodwill impairment is the lesser of the carrying value of goodwill or the excess of the carrying value of the reporting unit over its fair value.

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 writedown).

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.

ANSWERS TO ANALYZING FINANCIAL STATEMENTS EXERCISES

AFS2-1 Tesla Acquires SolarCity (2016).

Questions:

Part A: Assuming this were treated as an asset acquisition (business combination), prepare the journal entry on Tesla's books to record the acquisition.

Cash	$213,523	
Accounts Receivable	74,619	
Inventory	191,878	
Solar energy systems	5,781,496	
Property, plant and equipment	1,056,312	
Intangible assets	356,510	
Prepaid expenses	199,864	
Other assets	638,908	
Accounts payable		230,078
Accrued liabilities		238,590
Debt		3,525,130
Deferred revenues		271,128
Other liabilities		950,423
Noncontrolling interest on SolarCity's books		1,063,057
Bargain gain		88,727
Common stock (11,124.497)($.001)		11
Paid in capital		2,145,989

The noncontrolling interest on SolarCity's books represents the amount of net assets on SolarCity's books that they don't own from prior acquisitions where they purchased less than 100% ownership.

Part B: What was the reason Tesla was able to acquire SolarCity for a bargain?

The primary factor contributing to the gain relates to the change in the overall price of our common stock from the time that the Merger Agreement was executed on July 31, 2016 to the acquisition date. During this time, our stock price decreased from $230.01 to $185.04, which in turn reduced the fair value of the consideration.

Part C

a. What is the journal entry to record the measurement period adjustment?

Loss on acquisition*	**57,746**	
Other assets		**11,571**

Accrued liabilities	**46,175**

*** $88,727-30,981**

b. How is the bargain gain reported in 2016 and 2017?

In 2016, there was a bargain gain of $88,727
In 2017, there was a loss of $57,746 because of the measurement period adjustment which is recognized in the period estimates are finalized.

AFS2-1 eBay acquires Skype

(A) Goodwill computation

Acquisition price	$ 2,593	million
Net tangible and intangible assets	262	million
Goodwill	$ 2,331	million

(B) Factors used to determine in the contingent consideration is part of the exchange or not. (FASB ASC paragraphs 805-10-55-24 and 25)

The acquirer should consider the following if the contingent payments are made to employees or selling shareholders.

1. Is the selling shareholder a continuing employee? If the contingent payment is canceled if the employee's employment is terminated, then the consideration might be post-acquisition compensation for services.
2. If the selling shareholder is a continuing employee and the period of required continuing employment is longer than the contingent payment period, the contingent payments might, in substance, be compensation.
3. If the selling shareholder is a continuing employee and the employee's compensation is reasonable in comparison to other key employees, the contingent payment may indicate additional consideration rather than compensation.
4. If the contingent payment for non-employees is less than the contingent payments for continuing employees, the additional contingent payments for employees may indicated compensation rather than additional consideration.

(C) It is not clear why eBay would settle the earnout for $530.3 million when the conditions for having to make the additional contingent payments (up to $1.3 billion) were probably not going to be met. Under current GAAP, if the amount of the contingent payment exceeded the previously expected amount, the difference is reflected in earnings. Under the rules in effect for the Skype transaction the contingent payment was simply an adjustment of goodwill. Because eBay was settling the earnout for approximately a third of the total potential payments indicates that Skype was not performing well. Notice that eBay wrote down$1.39 billion in goodwill at the same time. One potential reason that eBay might have agreed to the payment is that the former CEO of Skype was stepping down and the contingent payment may have been incentive for him to step down. In addition, the earnout may have prevented eBay from selling Skype.

AFS2-2 eBay Sells Skype	As Reported			Adjustments			Adjusted		
eBay's Income Statement	2007	2008	2009	2007	2008	2009	2007	2008	2009
Net revenues	$7,672,329	$8,541,261	$8,727,362	-364,564	-550,841	-620,403	$7,307,765	$7,990,420	$8,106,959
Cost of net revenues	1,762,972	2,228,069	2,479,762	-337,338	-434,588	-462,701	1,425,634	1,793,481	2,017,061
Gross profit	5,909,357	6,313,192	6,247,600	(27,226)	(116,253)	(157,702)	5,882,131	6,196,939	6,089,898
Operating expenses:									
Sales and marketing	1,882,810	1,881,551	1,885,677				1,882,810	1,881,551	1,885,677
Product development	619,727	725,600	803,070				619,727	725,600	803,070
General & administrative	904,681	998,871	1,418,389			(343,200)	904,681	998,871	1,075,189
Provision for trans. & loan losses	293,917	347,453	382,825				293,917	347,453	382,825
Amortization of acquired intangible assets	204,104	234,916	262,686				204,104	234,916	262,686
Restructuring		49,119	38,187				-	49,119	38,187
Impairment of goodwill	1,390,938			(1,390,938)			-	-	-
Total operating expenses	5,296,177	4,237,510	4,790,834	(1,390,938)		(343,200)	3,905,239	4,237,510	4,447,634
Income from operations	613,180	2,075,682	1,456,766	1,363,712	(116,253)	185,498	1,976,892	1,959,429	1,642,264
Interest and other income	137,671	107,882	1,422,385			(1,400,000)	137,671	107,882	22,385
Income before income taxes	750,851	2,183,564	2,879,151	1,363,712	(116,253)	(1,214,502)	2,114,563	2,067,311	1,664,649
Provision for income taxes	(402,600)	(404,090)	(490,054)						
Net income	$348,251	$1,779,474	$2,389,097						

Ratios	2007	2008	2009				2007	2008	2009
Gross Margin Percentage	77.0%	73.9%	71.6%	7.5%	21.1%	25.4%	80.5%	77.6%	75.1%
Operating Margin Percentage	8.0%	24.3%	16.7%				27.1%	24.5%	20.3%
Income before taxes %	9.8%	25.6%	33.0%				28.9%	25.9%	20.5%

There are four adjustments to eliminate the effect of Skype from eBay's books. First, we eliminate the revenues and the direct expenses from each year. We eliminated 100% of Skype's revenues and direct expenses disclosed in the footnotes in 2009 because it was not clear from the disclosure whether those amounts were the amounts included on eBay's statements or whether they were for the entire year. An acceptable solution would be to eliminate 11.5/12 or 95.8%. Second, the impairment of goodwill was added back in 2007. Third, the gain on the sale of $1.4 million was subtracted from interest and other income in 2009. And finally, the charge from the legal settlement was added back (or subtracted from costs) in 2009.

Performance: Including Skype, eBay's gross margin declined from 77% to 71.6%. Without Skype, the gross margin still declined, but the decline was smaller (80.5% to 75.1%). Including Skype, income before taxes showed a rather large increase in absolute dollars increasing to $2,879,151 from $648,251 (283% increase). After Skype is eliminated we find a decreasing trend from $2,114,563 to 1,664,649 (a 21.3% decline). A similar trend exists for the income before tax as a percentage of revenues. The unadjusted percentage increased from 9.8% to 33% while the adjusted percentage decreased from 28.9% to 20.5%. The most interesting aspect of the numbers is that eBay recorded an impairment charge of $1.4 million in 2007 and then in 2009 recorded an $1.4 million gain on the sale.

AFS2-3 Measurement Period Adjustments and Contingent Consideration

A. The measurement period adjustment was made at the end of the year. FASB ASC Topic 805.30.35.1 states that some changes in the fair value of contingent consideration that the acquirer recognizes after the acquisition date may be the result of additional information about facts and circumstances that existed at the acquisition date that the acquirer obtained after that date. Such changes are measurement period adjustments. However, changes resulting from events after the acquisition date, such as meeting an earnings target, reaching a specified share price, or reaching a milestone on a research and development project, are not measurement period adjustments. The company in the problem did not use a measurement adjustment correctly because they state that 'the initial terms of the agreement have not been met.' This is clearly an event that occurred after the date of the acquisition. The company should write down the contingent consideration liability to zero and recognize a gain on revaluation. Note that the English was not corrected in the footnote. They meant to write 'the initial terms of the agreement have not been met,' but they wrote 'have not be met'. Does this provide confidence to the user that the numbers presented are correct?

B. The company is silent on the impairment of the intangible assets acquired.

What the company should have recorded:

	Contingent consideration	367,500	
	Gain on revaluing (IS)		367,500
	Impairment loss (IS)	577,500	
	Intellectual property		577,500

<u>What the company actually recorded:</u>

Acquisition Date	Intellectual property	577,500	
	Common stock and PIC		210,000
	Contingent consideration		367,500
Measurement Period Adjustment	Contingent consideration	376,500	
	Goodwill	210,000	
	Intellectual property		577,500
Impairment	Impairment loss (IS)	210,000	
	Goodwill		210,000

C. Although the overall impact on net income is the same (a reduction of net income of $210,000), the company is supposed to estimate the fair value of the contingent consideration each quarter and record the change in income. Using measurement period adjustments to 're-write' history after events occur gives a potentially misleading impression on the performance of the acquisition. Measurement period adjustments are intended to adjust estimation made on the date of acquisition related to better information about circumstances that existed on the date of acquisition, rather than circumstances that arose subsequent to acquisition.

AFS2-4 Emdeon Inc. Acquisition of FVTech (Contingent Consideration)

1. Sellers often keep the cash on the date of the acquisition. Thus, they have incentives to delay payments on debt and to attempt to collect receivables in advance. Including a working capital arrangement helps to mitigate these incentive problems.

2. Contingent consideration is often used to help the acquirer and the acquiree to agree on a selling price. The seller believes the company is worth more because of anticipated future performance and the acquirer unsure about the exact future performance. However, the acquirer is more willing to pay more

for an acquisition if the future performance exceeds some critical level or if certain milestones are met (such as regulatory approval of a drug patent).

The total potential contingent consideration offered is $40,000; thus the total potential consideration offered is $60,303 ($20,005 cash, $58 working capital settlement, and $40,000 of contingent consideration). Maximum contingent consideration to total potential consideration offered is 66.3 percent. The fair value of contingent consideration on the date of acquisition is $14,910 is 37.3 percent of the maximum potential contingent consideration offered ($14,910/$40,000). The fair value of contingent consideration on the date of acquisition is 42.6 percent of the total consideration offered on the date of acquisition ($14,910/$34,973)/

3. Schedule of changes in fair value for contingent consideration

		After Measurement Period Adjustment		
	1st Qtr	2nd Qtr	3rd Qtr	4th Qtr
Fair value of contingent consideration				
Beginning of quarter (or DOA)	14,910	13,850	13,850	13,850
Fair value at the end of quarter	15,200	13,210	11,580	7,170
Total change in fair value	(290)	640	2,270	6,680
Previous years (gain) and losses		290	(930)	(2,270)
Loss on change in fair value	290			
(Gain) on change in fair value	______	(930)	(1,340)	(4,410)
Totals	- 0 -	- 0 -	- 0 -	- 0-

4. Given that the fair value of the contingent consideration has been decreasing, it becomes less likely that any contingent consideration will be paid. If not, reducing the liability for contingent consideration will result in future gains recorded on the books (In theory, this partially offsets the expected lower earnings.) Gains on reduction in the contingent consideration liability can signal future goodwill impairments.

AFS2-5 Emdeon Inc. Acquisition of FVTech (Contingent Consideration)

1. The company did reassess the fair value estimates of the identifiable net assets but did not provide an adequate description that the transaction resulted in a gain. The company merely restated the definition of a bargain gain (i.e. that the transaction resulted in an excess of the value of the net assets acquired over the purchase price).

2. A bargain purchase might happen, for example, in a business combination that is a forced sale in which the seller is acting under compulsion. Also, sometimes the seller needs quick access to funds and perhaps the number of buyers is limited (such as a bank with weak performance). The FASB has struggled over time with bargain purchases because the FASB believes that the number of bargains should be very small.

3.

Current Assets	24,910	
Property, Plant, and Equipment	491	
Due from Securitization	108,554	
Identifiable intangible assets	67,200	
Current Liabilities		8,500
Deferred taxes		12,527
Cash		158,901
Gain on bargain purchase		21,227

ANSWERS TO EXERCISES

Exercise 2-1

Part A	Receivables	228,000	
	Inventory	396,000	
	Plant and Equipment	540,000	
	Land	660,000	
	Goodwill ($2,154,000 - $1,824,000)	330,000	
	Liabilities		594,000
	Cash		1,560,000
Part B	Receivables	228,000	
	Inventory	396,000	
	Plant and Equipment	540,000	
	Land	660,000	
	Liabilities		594,000
	Cash		990,000
	Gain on Business Combination ($1,230,000 - $990,000)		240,000

Exercise 2-2

Cash	$680,000
Receivables	720,000
Inventories	2,240,000
Plant and Equipment (net) ($3,840,000 + $720,000)	4,560,000
Goodwill	120,000
Total Assets	$8,320,000
Liabilities	1,520,000
Common Stock, $16 par ($3,440,000 + (.50 × $800,000))	3,840,000
Other Contributed Capital ($400,000 + $800,000)	1,200,000
Retained Earnings	1,760,000
Total Equities	$8,320,000

Entries on Petrello Company's books would be:

Cash	200,000	
Receivables	240,000	
Inventory	240,000	
Plant and Equipment	720,000	
Goodwill *	120,000	
Liabilities		320,000
Common Stock (25,000 × $16)		400,000
Other Contributed Capital ($48 - $16) × 25,000		800,000

* ($48 × 25,000) – [($1,480,000 – ($800,000 – $720,000) – $320,000]
= $1,200,000 – [$1,480,000 – $80,000 – $320,000] = $1,200,000 – $1,080,000 = $120,000

Exercise 2-3

Accounts Receivable	231,000	
Inventory	330,000	
Land	550,000	
Buildings and Equipment	1,144,000	
Goodwill	848,000	
Allowance for Uncollectible Accounts ($231,000 - $198,000)		33,000
Current Liabilities		275,000
Bonds Payable		450,000
Premium on Bonds Payable ($495,000 - $450,000)		45,000
Preferred Stock (15,000 × $100)		1,500,000
Common Stock (30,000 × $10)		300,000
Other Contributed Capital ($25 - $10) × 30,000		450,000
Cash		50,000

Cost paid ($1,500,000 + $750,000 + $50,000) =	$2,300,000
Fair value of net assets (198,000 + 330,000 + 550,000 + 1,144,000 – 275,000 – 495,000) =	1,452,000
Goodwill =	$848,000

Exercise 2-4

Cash	96,000	
Receivables	55,200	
Inventory	126,000	
Land	198,000	
Plant and Equipment	466,800	
Goodwill*	137,450	
Accounts Payable		44,400
Bonds Payable		480,000
Premium on Bonds Payable**		45,050
Cash		510,000

** Present value of maturity value, 12 periods @ 4%:	0.6246 × $480,000 =	$299,808
Present value of interest annuity, 12 periods @ 4%:	9.38507 × $24,000 =	225,242
Total present value		525,050
Par value		480,000
Premium on bonds payable		$ 45,050

*Cash paid		$510,000
Less: Book value of net assets acquired ($897,600 – $44,400 – $480,000)		(373,200)
Excess of cash paid over book value		136,800
Increase in inventory to fair value	(15,600)	
Increase in land to fair value	(28,800)	
Increase in bond to fair value	45,050	
Total increase in net assets to fair value		650
Goodwill		$137,450

Exercise 2-5

Part A	Current Assets	960,000	
	Plant and Equipment	1,440,000	
	Goodwill	120,000	
	Liabilities		216,000
	Cash		2,160,000
	Liability for Contingent Consideration		144,000
Part B	Loss on change in Fair Value of Contingent Consideration	56,000	
	Liability for Contingent Consideration		56,000
Part C	Liability for Contingent Consideration	200,000	
	Gain on change in Fair Value of Contingent Consideration		200,000

Exercise 2-6

Part A	Current Assets	960,000	
	Plant and Equipment	1,440,000	
	Goodwill	176,000	
	Liabilities		216,000
	Cash		2,160,000
	Paid-in-Capital - Contingent Consideration		200,000
Part B	Paid-in-Capital – Contingent Consideration	200,000	
	Common Stock ($10 × 10,000)		100,000
	Paid in Capital – Common Stock		100,000

Platz Company does not adjust the original amount recorded as equity.

Exercise 2-7

1. (c)	Cost (8,000 shares @ $30)	$240,000
	Fair value of net assets acquired	228,800
	Excess of cost over fair value (goodwill)	$ 11,200
2. (c)	Cost (8,000 shares @ $30)	$240,000
	Fair value of net assets acquired ($90,000 + $242,000 – $56,000)	276,000
	Excess of fair value over cost (gain)	$ 36,000

Exercise 2-8

Current Assets	362,000	
Long-term Assets ($1,890,000 + $20,000) + ($98,000 + $5,000)	2,013,000	
Goodwill *	395,000	
Liabilities		119,000
Long-term Debt		491,000
Common Stock (144,000 × $5)		720,000
Other Contributed Capital (144,000 × ($15 - $5))		1,440,000

* (144,000 × $15) – [$362,000 + $2,013,000 – ($119,000 + $491,000)] = $395,000

Total shares issued $\left(\frac{\$700{,}000}{\$5} + \frac{\$20{,}000}{\$5}\right) = 144{,}000$

Fair value of stock issued (144,000 × $15) = $2,160,000

Exercise 2-9

Case A

Cost (Purchase Price)	$130,000
Less: Fair Value of Net Assets	120,000
Goodwill	$ 10,000

Case B

Cost (Purchase Price)	$110,000
Less: Fair Value of Net Assets	90,000
Goodwill	$ 20,000

Case C

Cost (Purchase Price)	$15,000
Less: Fair Value of Net Assets	20,000
Gain	($ 5,000)

	Assets			Liabilities	Retained Earnings (Gain)
	Goodwill	Current Assets	Long-Lived Assets		
Case A	$10,000	$20,000	$130,000	$30,000	0
Case B	20,000	30,000	80,000	20,000	0
Case C	0	20,000	40,000	40,000	5,000

Exercise 2-10

Part A.

2019: **Quantitative Test:**

Fair value of the reporting unit		$400,000
Carrying value of unit:		
Carrying value of identifiable net assets	$330,000	
Carrying value of goodwill ($450,000 - $375,000)	75,000	
		405,000
Excess of carrying value over fair value		$ 5,000

Goodwill impairment is the lower of:

Recorded value of goodwill ($450,000 - $375,000)	75,000	
Excess of carrying value over fair value		5,000

2019 goodwill impairment is $5,000

2020: **Step 1**:

Fair value of the reporting unit		$400,000
Carrying value of unit:		
Carrying value of identifiable net assets	$320,000	
Carrying value of goodwill ($75,000 - $5,000)	70,000	
		390,000
Excess of fair value over carrying value		$ 10,000

Since the fair value is greater than the carrying value, there is no goodwill impairment.

2021: **Step 1**:

Fair value of the reporting unit		$350,000
Carrying value of unit:		
Carrying value of identifiable net assets	$300,000	
Carrying value of goodwill ($75,000 - $5,000)	70,000	
		370,000
Excess of carrying value over fair value		$ 20,000

Goodwill impairment is the lower of:

Recorded value of goodwill ($450,000 - $375,000-5,000)	70,000
Excess of carrying value over fair value	20,000

2021 goodwill impairment is $20,000

Part B.

2019:	Impairment Loss—Goodwill	5,000	
	Goodwill		5,000
2020:	No entry		
2021:	Impairment Loss—Goodwill	20,000	
	Goodwill		20,000

Part C.

SFAS No. 142 specifies the presentation of goodwill in the balance sheet and income statement (if impairment occurs) as follows:

- The aggregate amount of goodwill should be a separate line item in the balance sheet.
- The aggregate amount of losses from goodwill impairment should be shown as a separate line item in the operating section of the income statement unless some of the impairment is associated with a discontinued operation (in which case it is shown net-of-tax in the discontinued operation section).

Part D.

In a period in which an impairment loss occurs, *SFAS No. 142* mandates the following disclosures in the notes:

(1) A description of the facts and circumstances leading to the impairment;
(2) The amount of the impairment loss and the method of determining the fair value of the reporting unit;
(3) The nature and amounts of any adjustments made to impairment estimates from earlier periods, if significant.

Part E.(optional)

2019: **Step 1**:

Fair value of the reporting unit		$400,000
Carrying value of unit:		
Carrying value of identifiable net assets	$330,000	
Carrying value of goodwill ($450,000 - $375,000)	75,000	
		405,000
Excess of carrying value over fair value		$ 5,000

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

Step 2:

Fair value of the reporting unit		$400,000
Fair value of identifiable net assets		340,000
Implied value of goodwill		60,000
Recorded value of goodwill ($450,000 - $375,000)		75,000
Impairment loss		$ 15,000

2020: **Step 1**:

Fair value of the reporting unit		$400,000
Carrying value of unit:		
Carrying value of identifiable net assets	$320,000	
Carrying value of goodwill ($75,000 - $15,000)	60,000	
		380,000
Excess of fair value over carrying value		$ 20,000

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

2021: **Step 1**:	Fair value of the reporting unit		$350,000
	Carrying value of unit:		
	Carrying value of identifiable net assets	$300,000	
	Carrying value of goodwill ($75,000 - $15,000)	60,000	
			360,000
	Excess of carrying value over fair value		$ 10,000

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

Step 2:	Fair value of the reporting unit	$350,000
	Fair value of identifiable net assets	325,000
	Implied value of goodwill	25,000
	Recorded value of goodwill ($75,000 - $15,000)	60,000
	Impairment loss	$ 35,000

Exercise 2-11

a. Fair Value of Identifiable Net Assets

Book values $500,000 – $100,000 =	$400,000
Write up of Inventory and Equipment:	
($20,000 + $30,000) =	50,000
Purchase price above which goodwill would result	$450,000

b. Equipment would not be written down, regardless of the purchase price, unless it was reviewed and determined to be overvalued originally.
c. A gain would be shown if the purchase price was below $450,000.
d. Anything below $450,000 is technically considered a bargain.
e. Goodwill would be $50,000 at a purchase price of $500,000 or ($450,000 + $50,000).

Exercise 2-12A

Cash	20,000	
Accounts Receivable	112,000	
Inventory	134,000	
Land	55,000	
Plant Assets	463,000	
Discount on Bonds Payable	20,000	
Goodwill*	127,200	
Allowance for Uncollectible Accounts		10,000
Accounts Payable		54,000
Bonds Payable		200,000
Deferred Income Tax Liability		67,200
Cash		600,000

Cost of acquisition	$600,000
Book value of net assets acquired ($80,000 + $132,000 + $160,000)	372,000
Difference between cost and book value	228,000
Allocated to:	
Increase inventory, land, and plant assets to fair value ($52,000 + $25,000 + $71,000)	(148,000)
Decrease bonds payable to fair value	(20,000)
Establish deferred income tax liability ($168,000 × 40%)	67,200
Balance assigned to goodwill	$127,200

ANSWERS TO ASC (Accounting Standards Codification) EXERCISES

ASC2-1 **Presentation** Does current GAAP require that the information on the income statement be reported in chronological order with the most recent year listed first, or is the reverse order acceptable as well?

Alternative one:
Step 1: In the search box on the home page, enter ‘chronological order’.
Step 2: Two results are obtained.

Alternative two:
Step 1: Use the drop-down menus under the ‘presentation’ general topic on the homepage and choose ‘Presentation of financial statements’; then under the second drop-down menu, choose ’10-overall’.

Step 2: Click on the 'Expand' option and scroll through the topics looking for 'chronological order'. The very last line is SAB Topic 11.E Chronological Ordering of Data.

FASB ASC 205-10-S99-9 under SEC guidance indicates that the SEC staff have not preference in what order the data are presented (e.g., the most current data displayed first, etc.) as long as all schedules in the report are ordered in the same chronological order.

ASC2-2 **General Principles** In the 1990s, the pooling of interest method was a preferred method of accounting for consolidations by many managers because of the creation of instant earnings if the acquisition occurred late in the year. Can the firms that used pooling of interest in the 1990s continue to use the method for those earlier consolidations, or were they required to adopt the new standards for previous business combinations retroactively?

This issue is related to whether the rules for pooling of interest have been grandfathered or not.
Alternative one:
Step 1: Below the search box on the home page, click on 'advanced search.' Enter 'Pooling of interests' in the text/keyword box and click on exact phrase.
Step 2: Three results are obtained and the first alternative is the correct answer.

Alternative two:
Step 1: Use the drop-down menus under the 'General Principles' general topic on the homepage and choose 'Generally Accepted Accounting Principles'; then under the second drop-down menu, choose '10-overall'.
Step 2: Section 70 is always the section for grandfathered guidance.

FASB ASC subparagraph 105-10-70-2(a) lists pooling of interests is listed as a grandfathered method.

ASC2-3 **Glossary** What instruments qualify as cash equivalents?

On the Codification homepage, click on 'Master Glossary' in the left-hand column. In the 'glossary term quick find' menu type 'cash equivalent' and hit return.

Cash equivalents are short-term, highly liquid investments that have both of the following characteristics:

a. Readily convertible to known amounts of cash
b. So near their maturity that they present insignificant risk of changes in value because of changes in interest rates.

ASC2-4 **Overview** If guidance for a transaction is not specifically addressed in the Codification, what is the appropriate procedure to follow in identifying the proper accounting?

The topic that established the Codification as authoritative GAAP is Topic 105.
Step 1: Use the drop-down menus under the 'General Principles' general topic on the homepage and choose 'Generally Accepted Accounting Principles'; then under the second drop-down menu, choose '10-overall'.
Step 2: click on the red 'Join all Sections' button. Scroll through the paragraphs.

FASB ASC paragraph 105-10-05-2 states that if the guidance for a transaction or event is not specified within a source of authoritative GAAP for that entity, an entity shall first consider accounting principles for similar transactions or events within a source of authoritative GAAP for that entity and then consider nonauthoritative guidance from other sources.

ASC2-5 General List all the topics found under General Topic 200—Presentation (*Hint:*There are 15 topics).

Presentation

205 Presentation of Financial Statements
210 Balance Sheet
215 Statement of Shareholder Equity
220 Comprehensive Income
225 Income Statement

230 Statement of Cash Flows
235 Notes to Financial Statements
250 Accounting Changes and Error Corrections
255 Changing Prices
260 Earnings Per Share

270 Interim Reporting
272 Limited Liability Entities
274 Personal Financial Statements
275 Risks and Uncertainties
280 Segment Reporting

ASC2-6 Cross-Reference The rules providing accounting guidance on subsequent events were originally listed in *FASB Statement No. 165*. Where is this information located in the Codification? List all the topics and subtopics in the Codification where this information can be found (i.e., ASC XXX-XX).

Step 1: Choose the cross reference tab on the opening page of the Codification.
Step 2: Use the 'By Standard' drop down menu. Choose FAS as the standard type and 165 as the standard number. Click on 'Generate Report.'

FASB ASC subtopic 855-10 [, Subsequent Events – Overall]

ASC2-7 Overview Distinguish between an asset acquisition and the acquisition of a business.

This is a more difficult issue to find.
Alternative one:
Step 1: Below the search box on the home page, click on 'advanced search.' Enter 'asset acquisition' in the text/keyword box and click on exact phrase.
Step 2: Sixteen results are obtained. You can narrow the search by clicking on 'business combinations' in the Narrow by related term section. Then, notice that the section on 'related issues' seems to be where acquisition of assets rather than a business is located.

FASB ASC paragraph 805-50-05-3 states that the guidance in the 'acquisition of assets rather than a business' subsections address transactions in which the assets acquired and liabilities assumed do not constitute a business. A business is considered 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.

Alternative two:

Step 1: Use the drop-down menus under the 'Broad Transactions' general topic on the homepage and choose 'Business Combinations'; then under the second drop-down menu, choose '10-overall'. Expand the sections. Since nothing is listed related to the search, go to the scope section (805-10-15). FASB ASC subparagraph 805-10-15-4(b) tells you the scope of section 10 does not cover asset acquisitions.
Step 2: Go back and search for 'asset acquisition.

ASC2-8 Measurement GAAP requires that firms test for goodwill impairment on an annual basis. One reporting unit performs the impairment test during January while a second reporting unit performs the impairment test during July. If the firm reports annual results on a calendar basis, is this acceptable under GAAP?

This can be a difficult issue to find depending on the student's knowledge of goodwill. If a general search is used with the term 'goodwill impairment' the correct section can be found. The student must be aware that 'subsequent measurement' would be related to impairment testing of goodwill since impairment tests are subsequent measurements of goodwill. However, since the correct paragraph is paragraph 28, a lot of scrolling is needed.

Alternative two
Step 1: Use the drop-down menus under the 'Assets' general topic on the homepage and choose '350 – Intangibles-Goodwill and other'; then under the second drop-down menu, choose '20-Goodwill'. Expand the sections. Since nothing is listed related to the search, go to the scope section (805-10-15). FASB ASC subparagraph 805-10-15-4(b) tells you the scope of section 10 does not cover asset acquisitions.
Step 2: click on subsequent measurement and click on 'expand' topics. One of the topics is 'when to test goodwill impairment'.

FASB ASC paragraph 350-20-35-28 states that different reporting units may be tested for impairment at different times.

ANSWERS TO PROBLEMS

Problem 2-1

Current Assets	85,000	
Plant and Equipment	150,000	
Goodwill*	100,000	
Liabilities		35,000
Common Stock [(20,000 shares @ $10/share)]		200,000
Other Contributed Capital [(20,000 × ($15 – $10))]		100,000

Acquisition Costs Expense	20,000	
Cash		20,000
Other Contributed Capital	6,000	
Cash		6,000
To record the direct acquisition costs and stock issue costs		

* Goodwill = Excess of Consideration of $335,000 (stock valued at $300,000 plus debt assumed of $35,000) over Fair Value of Identifiable Assets of $235,000 (total assets of $225,000 plus PPE fair value adjustment of $10,000)

Problem 2-2

Acme Company
Balance Sheet
October 1, 2019
(000)

Part A.

Assets (except goodwill) ($3,900 + $9,000 + $1,300)		$14,200
Goodwill (1)		1,160
Total Assets		$15,360
Liabilities ($2,030 + $2,200 + $260)		$4,490
Common Stock (180 × $20) + $2,000		5,600
Other Contributed Capital (180 × ($50 – $20))		5,400
Retained Earnings		(130)
Total Liabilities and Equity		$15,360

(1) Cost (180 × $50)		$9,000
Fair value of net assets acquired:		
Fair value of assets of Baltic and Colt	$10,300	
Less liabilities assumed	2,460	7,840
Goodwill		$1,160

Problem 2-2 (continued)

Part B. (using the new simplified goodwill impairment rules)

Baltic

2020: **Step1**: Fair value of the reporting unit		$6,500,000
Carrying value of unit:		
Carrying value of identifiable net assets	6,340,000	
Carrying value of goodwill	200,000*	
Total carrying value		6,540,000
Excess of carrying value over fair value		40,000

*[(140,000 x $50) – ($9,000,000 – $2,200,000)]

The excess of carrying value over fair value means goodwill is impaired. The amount of goodwill impairment is the lower of:

Recorded value of goodwill	200,000
Excess of carrying value over fair value	$ 40,000

For 2020, Baltic would impair goodwill of $40,000

Colt

2020: **Step1**: Fair value of the reporting unit		$1,900,000
Carrying value of unit:		
Carrying value of identifiable net assets	$1,200,000	
Carrying value of goodwill	960,000*	
Total carrying value		2,160,000
Excess of carrying value over fair value		260,000

*[(40,000 x $50) – ($1,300,000 – $260,000)]

The excess of carrying value over fair value means goodwill is impaired. The amount of goodwill impairment is the lower of:

Recorded value of goodwill	960,000
Excess of carrying value over fair value	260,000

For 2020, Colt would impair goodwill of $260,000

Total impairment loss is $300,000.

Journal entry:

Impairment Loss	$300,000	
Goodwill		$300,000

Problem 2-2 (continued)

Part B. (using the former two-step approach to determine goodwill impairment)

Baltic

2020: **Step1**: Fair value of the reporting unit			$6,500,000
Carrying value of unit:			
Carrying value of identifiable net assets	6,340,000		
Carrying value of goodwill	200,000*		
Total carrying value		6,540,000	

*[(140,000 x $50) – ($9,000,000 – $2,200,000)]

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

Step 2: Fair value of the reporting unit	$6,500,000
Fair value of identifiable net assets	6,350,000
Implied value of goodwill	150,000
Recorded value of goodwill	200,000
Impairment loss	$ 50,000

(because $150,000 < $200,000)

Colt

2020: **Step1**: Fair value of the reporting unit			$1,900,000
Carrying value of unit:			
Carrying value of identifiable net assets	$1,200,000		
Carrying value of goodwill	960,000*		
Total carrying value		2,160,000	

*[(40,000 x $50) – ($1,300,000 – $260,000)]

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

Step 2: Fair value of the reporting unit	$1,900,000
Fair value of identifiable net assets	1,000,000
Implied value of goodwill	900,000
Recorded value of goodwill	960,000
Impairment loss	$ 60,000

(because $900,000 < $960,000)

Total impairment loss is $110,000.

Journal entry:

Impairment Loss	$110,000	
Goodwill		$110,000

Problem 2-3

Present value of maturity value, 20 periods @ 6%:	0.3118 × $600,000 =	$187,080
Present value of interest annuity, 20 periods @ 6%:	11.46992 × $30,000 =	344,098
Total Present value		531,178
Par value		600,000
Discount on bonds payable		$68,822

Cash	114,000	
Accounts Receivable	135,000	
Inventory	310,000	
Land	315,000	
Buildings	54,900	
Equipment	39,450	
Bond Discount ($40,000 + $68,822)	108,822	
Current Liabilities		95,300
Bonds Payable ($300,000 + $600,000)		900,000
Gain on Purchase of Business		81,872

Computation of Excess of Net Assets Received Over Cost

Cost (Purchase Price) ($531,178 plus liabilities assumed of $95,300 and $260,000)	$886,478
Less: Total fair value of assets received	$968,350
Excess of fair value of net assets over cost	($ 81,872)

Problem 2-4

Part A January 1, 2019

Accounts Receivable	72,000	
Inventory	99,000	
Land	162,000	
Buildings	450,000	
Equipment	288,000	
Goodwill*	19,000	
Allowance for Uncollectible Accounts		7,000
Accounts Payable		83,000
Note Payable		180,000
Cash		720,000
Liability for Contingent Consideration		100,000

*Computation of Goodwill

Consideration paid ($720,000 + $100,000)	$820,000
Total fair value of net assets acquired ($1,064,000 - $263,000)	801,000
Goodwill	$ 19,000

Problem 2-4 (continued)

Part B January 2, 2019

Loss on Change in Fair Value of Contingent Consideration	20,000	
Liability for Contingent Consideration		20,000

Part C January 2, 2020

Liability for Contingent Consideration	120,000	
Gain from Change in Fair Value of Contingent Consideration		120,000

Problem 2-5

Pepper Company
Pro Forma Balance Sheet
Giving Effect to Proposed Issue of Common Stock and Note Payable for
All of the Common Stock of Salt Company under Purchase Accounting
December 31, 2018

	Audited Balance Sheet	Adjustments	Pro Forma Balance Sheet
Cash	$180,000	405,000	$585,000
Receivables	230,000	(60,000) 117,000	287,000
Inventories	231,400	134,000	365,400
Plant Assets	1,236,500	905,000 (1)	2,141,500
Goodwill		181,500	181,500
Total Assets	$1,877,900		$3,560,400
Accounts Payable	$255,900	(60,000) 180,000	$375,900
Notes Payable, 8%	0	300,000	300,000
Mortgage Payable	180,000	152,500	332,500
Common Stock, $20 par	900,000	600,000	1,500,000
Additional Paid-in Capital	270,000	510,000 (2)	780,000
Retained Earnings	272,000		272,000
Total Liabilities and Equity	$1,877,900		$3,560,400

Problem 2-5 (continued)

Change in Cash	
Cash from stock issue ($37 × 30,000)	$1,110,000
Less: Cash paid for acquisition	(800,000)
Plus: Cash acquired in acquisition	95,000
Total change in cash	$ 405,000

Goodwill:	
Cost of acquisition	$1,100,000
Net assets acquired ($340,000 + $179,500 + $184,000)	703,500
Excess cost over net assets acquired	$396,500
Assigned to plant assets	215,000
Goodwill	$ 181,500

(1) $690,000 + $215,000 (2) ($37 - $20) × 30,000

Problem 2-6

Ping Company
Pro Forma Income Statement for the Year 2019
Assuming a Merger of Ping Company and Spalding Company

Sales (1)		$6,345,972
Cost of goods sold:		
Fixed Costs (2)	$824,706	
Variable Costs (3)	2,464,095	3,288,801
Gross Margin		3,057,171
Selling Expenses (4)	$785,910	
Other Expenses (5)	319,310	1,105,220
Net Income		$1,951,951

$$\frac{\$1{,}951{,}951 - (\$952{,}640 + \$499{,}900)}{0.20} = \frac{\$499{,}411}{0.20} = \$2{,}497{,}055$$

Since $2,497,055 is greater than $1,800,000 Ping should buy Spalding.

(1) $3,510,100 + $2,365,800 = $5,875,900 × 1.2 × .9 = $6,345,972

(2) ($1,752,360 × .30) + ($1,423,800 × .30 × .70) = $824,706

(3) $\$1{,}752{,}360 \times .70 \times \frac{\$5{,}875{,}900 \times 1.2}{\$3{,}510{,}100} =$ $2,464,095

(4) ($632,500 + $292,100) × .85 = $785,910

(5) $172,600 × 1.85 = $319,310

Problem 2-7A

Part A

Receivables		125,000	
Inventory		195,000	
Land		120,000	
Plant Assets		567,000	
Patents		200,000	
Deferred Tax Asset ($60,000 x 35%)		21,000	
Goodwill*		154,775	
	Current Liabilities		89,500
	Bonds Payable		300,000
	Premium on Bonds Payable		60,000
	Deferred Tax Liability		93,275
	Common Stock (30,000 × $2)		60,000
	Other Contributed Capital (30,000 × $26)		780,000

Cost of acquisition (30,000 × $28)		$840,000
Book value of net assets acquired ($120,000 + $164,000 + $267,000)		551,000
Difference between cost and book value		289,000
Allocated to:		
	Increase inventory, land, plant assets, and patents to fair value	(266,500)
	Deferred income tax liability (35% × $266,500)	93,275
	Increase bonds payable to fair value	60,000
	Deferred income tax asset (35% × $60,000)	(21,000)
	Balance assigned to goodwill	$154,775

Part B

Income Tax Expense (Balancing amount)		148,006	
Deferred Tax Liability ($51,125 × 35%)*		17,894	
	Deferred Tax Asset ($6,000 × 35%)		2,100
	Income Tax Payable ($468,000 × 35%)		163,800

* Inventory: $28,000

Plant Assets, $\frac{\$100,000}{10}$ 10,000

Patents, $\frac{\$105,000}{8}$ 13,125

Total $51,125