CHAPTER 1

UNDERSTANDING THE ISSUES

1. (a) Product extension—manufacturer expands product lines in boating industry.
(b) Vertical forward—manufacturer buys distribution outlets
(c) Conglomerate—unrelated businesses
(d) Vertical backward—manufacturer acquires a supplier
(e) Vertical forward—an entertainment company acquires outlets for its products
(f) Market extension—companies providing the same services expand their geographic market

2. By accepting cash in exchange for the net assets of the company, the seller would have to recognize an immediate taxable gain. However, if the seller were to accept common stock of another corporation instead, the seller could construct the transaction as a tax-free reorganization. The seller could then account for the transaction as a tax-free exchange. The seller would not pay taxes until the shares received were sold.

3.

Identifiable assets (fair value)	$600,000
Deferred tax liability ($200,000 × 40%)	(80,000)
Net assets	$520,000
Goodwill	
Price paid	$850,000
Net assets	(520,000)
Goodwill	$330,000

4. (a) The net assets and goodwill will be recorded at their full fair value on the books of the parent on the date of acquisition.
(b) An investment account is recorded at the price paid for the interest.

5. Puncho will record the net assets at their fair value of $800,000 on its books. Also, Puncho will record goodwill of $100,000 ($900,000 – $800,000) resulting from the excess of the price paid over the fair value. Semos will record the removal of its net assets at their book values. Semos will record a gain on the sale of business of $500,000 ($900,000 – $400,000).

6. (a) Value Analysis:

Price paid	$800,000
Fair value of net assets	520,000
Goodwill	$280,000
Current assets (fair value)	$120,000
Land (fair value)	80,000
Building and equipment (fair value)	400,000
Customer list (fair value)	20,000
Liabilities (fair value)	(100,000)
Goodwill	280,000
Total	$800,000

(b) Value Analysis:

Price paid	$450,000
Fair value of net assets	520,000
Gain	$ (70,000)
Current assets (fair value)	$120,000
Land (fair value)	80,000
Building and equipment (fair value)	400,000
Customer list (fair value)	20,000
Liabilities (fair value)	(100,000)
Gain	(70,000)
Total	$450,000

7. The 2015 financial statements would be revised as they are included in the 2016–2015 comparative statements. The 2012 statements would be based on the new values. The adjustments would be:

(a) The equipment and building will be restated at $180,000 and $550,000 on the comparative 2015 and 2016 balance sheets.
(b) Originally, depreciation on the equipment is $40,000 ($200,000/5) per year. It will be recalculated as $36,000 ($180,000/5) per year. The adjustment for 2015 is for a half year. 2015 depreciation expense and accumulated depreciation will be restated at $18,000 instead of $20,000 for the half year. Depreciation expense for 2016 will be $36,000.

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(c) Originally, depreciation on the building is $25,000 ($500,000/20) per year. It will be recalculated as $27,500 ($550,000/20) per year. The adjustment for 2015 is for a half year. 2015 depreciation expense and accumulated depreciation will be restated at $13,750 instead of $12,500 for the half year. Depreciation expense for 2016 will be $27,500.

(d) Goodwill is reduced $30,000 on the comparative 2015 and 2016 balance sheets.

8.

Fair value of operating unit	$1,200,000
Book value including goodwill ..	1,250,000
Goodwill is impaired.	

Fair value of operating unit	$1,200,000
Fair value of net identifiable assets (excluding goodwill) ...	1,120,000
Recalculated goodwill	$ 80,000
Existing goodwill	200,000
Goodwill impairment loss	$ 120,000

9. (a) An estimated liability should have been recorded on the purchase date. Any difference between that estimate and the $100,000 paid would be recorded as a gain or loss on the liability already recorded.

(b) The estimated amount due would be recorded as a part of the purchase price and would result to a credit to paid-in capital, contingent share agreement. There would be no re-estimation of the amount.

(c) Since this agreement is based on issuance of additional shares based on a decrease in value, it is recorded as a liability based on the estimated value. On each reporting date, the liability would be re-estimated. Upon the settlement date, the liability would be extinguished by the issuance of the additional shares.

10. The two major differences are:

(a) Goodwill is $100,000. Under U.S. GAAP it would be impairment tested and possibly reduced in future periods. Under IFRS, it would be amortized over some number of future periods.

(b) Under U.S. GAAP, the stock issue costs would reduce the amount credited to paid in capital. Under IFRS, the issue costs would be expensed in the period incurred.

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EXERCISES

EXERCISE 1-1

	Account	Debit	Credit
(1)	Current Assets	85,000	
	Land	90,000	
	Building	300,000	
	Equipment	275,000	
	Goodwill	227,000	
	Liabilities		102,000
	Cash		875,000
	Expenses (acquisition costs)	15,000	
	Cash		15,000
(2)	Cash	875,000	
	Liabilities	100,000	
	Accumulated Depreciation—Building	200,000	
	Accumulated Depreciation—Equipment	100,000	
	Current Assets		80,000
	Land		70,000
	Building		450,000
	Equipment		300,000
	Gain on Sale of Business		375,000

Note: Seller does not receive the acquisition costs.

	Account	Debit	Credit
(3)	Investment in Crown Company	875,000	
	Cash		875,000
	Expenses (acquisition costs)	15,000	
	Cash		15,000

Note: At year-end, Crown would be consolidated with Barstow, as will be explained in Chapter 2.

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EXERCISE 1-2

Cash	100,000	
Inventory	270,000	
Equipment	220,000	
Land	180,000	
Buildings	300,000	
Goodwill*	515,000	
Discount on Bonds Payable	75,000	
Current Liabilities		80,000
Bonds Payable		500,000
Common Stock		60,000
Paid-In Capital in Excess of Par		1,020,000
Acquisition Expense	25,000	
Paid-In Capital in Excess of Par	10,000	
Cash		35,000

*Total consideration:		
Common stock (60,000 shares × $18)		$1,080,000
Less fair value of net assets acquired:		
Cash	$100,000	
Inventory	270,000	
Equipment	220,000	
Land	180,000	
Buildings	300,000	
Current liabilities	(80,000)	
Bonds payable	(425,000)	
Value of net identifiable assets acquired		565,000
Excess of total cost over fair value of net assets (goodwill)		$ 515,000

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EXERCISE 1-3

Accounts Receivable	100,000	
Inventory	210,000	
Equipment for Resale ($200,000 less 10%)	180,000	
Land	200,000	
Building	450,000	
R&D Project	90,000	
Customer List	210,650	
Goodwill*	879,350	
Current Liabilities		80,000
Bonds Payable		200,000
Warranty Liability		40,000
Common Stock		100,000
Paid-In Capital in Excess of Par		1,900,000
Totals	*2,320,000*	*2,320,000*

*Total consideration:		
Common stock (100,000 shares × $20)		$2,000,000
Less fair value of net assets acquired:		
Accounts receivable	$ 100,000	
Inventory	210,000	
Equipment for resale ($200,000 less 10%)	180,000	
Land	200,000	
Building	450,000	
R&D project	90,000	
Customer list ($100,000 payment discounted 3 years at 20%)	210,650*	
Current liabilities	(80,000)	
Bonds payable	(200,000)	
Estimated liability under warranty	(40,000)	
Value of net identifiable assets acquired		1,120,650
Excess of total cost over fair value of net assets (goodwill)		$ 879,350

*This amount is arrived at using table and would be 210,648 using financial calculator or Excel.

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EXERCISE 1-4

Account	Debit	Credit
Accounts Receivable	200,000	
Inventory	270,000	
Equipment	40,000	
Brand-Name Copyright	15,000	
Cash		160,000
Current Liabilities		80,000
Mortgage Payable		250,000
Gain on Acquisition*		35,000
Acquisition Expense	25,000	
Cash		25,000

*Total consideration:		
Cash		$160,000
Less fair value of net assets acquired:		
Accounts receivable	$ 200,000	
Inventory	270,000	
Equipment	40,000	
Brand-name copyright	15,000	
Current liabilities	(80,000)	
Mortgage payable	(250,000)	
Value of net identifiable assets acquired		195,000
Excess of total fair value over cost of net assets (gain)		$ (35,000)

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EXERCISE 1-5

(1) Adjustments:

Final value of manufacturing plant		$700,000
Provisional value of manufacturing plant		600,000
Total increase		$100,000

Depreciation adjustment:

Depreciation on final cost ($700,000/10 years)	$70,000	
Depreciation based on provisional cost ($600,000/10 years)	60,000	
Annual increase in depreciation	$10,000	
Adjustment for half year	$5,000	

Journal Entries:

Plant Assets	100,000	
Goodwill		100,000
Retained Earnings (increase depreciation for half year)	5,000	
Plant Assets (because they are shown net of depreciation)		5,000

(2)

Balance Sheet
December 31, 2015 (revised)

Current assets	$ 300,000	Current liabilities	$ 300,000
Equipment (net)	600,000	Bonds payable	500,000
Plant assets (net)	1,695,000	Common stock ($1 par)	50,000
Goodwill	200,000	Paid-in capital in excess of par	1,300,000
		Retained earnings	645,000
Total assets	$2,795,000	Total liabilities and equity	$2,795,000

Summary Income Statement
For Year Ended December 31, 2015 (revised)

Sales revenue		$800,000
Cost of goods sold		520,000
Gross profit		$280,000
Operating expenses	$150,000	
Depreciation expense	85,000	235,000
Net income		$ 45,000

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EXERCISE 1-6

Machine = $200,000

Deferred tax liability = $16,800

In this tax-free exchange, depreciation on $56,000 [($200,000 appraised value) – ($144,000* net book value)] of the machine's value is not deductible on future tax returns. The additional tax to be paid as a result of Lewison's inability to deduct the excess value assigned to the machine is $16,800 ($56,000 × 30%).

Goodwill = $800,000 – ($700,000 – $16,800)
= $116,800

*$180,000/10 yrs. × 2 prior years = $36,000 accumulated depreciation
$180,000 – $36,000 = $144,000 net book value

EXERCISE 1-7

Current Assets	100,000	
Equipment	200,000	
Building	270,000	
Deferred Tax Asset	90,000	
Goodwill*	350,000	
Current Liabilities		60,000
Cash		950,000

Price paid		$ 950,000
Less fair value of net assets:		
Current assets	$100,000	
Equipment	200,000	
Building	270,000	
Recorded (current) liabilities	(60,000)	510,000
Excess		$ 440,000
*Tax loss carryforward consideration:		
Deferred tax asset ($300,000 × 30%) = the value of the remaining carryforward		(90,000)
Goodwill		$ 350,000

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EXERCISE 1-8

		Dr.	Cr.
(1)	Estimated Liability for Contingent Consideration (original account)	40,000	
	Loss on Estimated Contingent Consideration	20,000	
	Cash		60,000

2 × (average income of $55,000* – $25,000) – (2 × $30,000)

* average of $50,000 and $60,000

Two years at $30,000 = $60,000 payment

		Dr.	Cr.
(2)	Paid in Capital, Contingent Share Agreement (original account)	40,000	
	Common stock, $1 par		12,000
	Paid-In Capital in Excess of Par		28,000

Value of amount due is $60,000 (2 × $30,000 for two years)
Divide $60,000 amount due by $5 value per share = 12,000 shares
No adjustment is made for the change in value.

		Dr.	Cr.
(3)	Estimated Liability for Contingent Consideration (original account)	40,000	
	Loss on Estimated Contingent Consideration	60,000	
	Common Stock, $1 par		20,000
	Paid-In Capital in Excess of Par		80,000

Deficiency [($6 – $5) × 100,000 shares]	$100,000
Divide by fair value	÷ $5
Added number of shares	20,000

EXERCISE 1-9

(1)	Purchase price	$600,000
	Fair value of net assets other than goodwill	400,000
	Goodwill	$200,000

The estimated value of the unit exceeds $600,000, confirming goodwill.

(2)	(a)	Estimated fair value of business unit	$520,000
		Book value of Anton net assets, including goodwill	$500,000

No impairment exists.

(b)	Estimated fair value of business unit	$400,000
	Book value of Anton net assets, including goodwill	$450,000

Goodwill is impaired.

Estimated fair value of business units	$400,000
Fair value of net assets, excluding goodwill	340,000
Remeasured amount of goodwill	$ 60,000
Existing goodwill	200,000
Impairment loss	$140,000

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APPENDIX EXERCISE

EXERCISE 1A-1

(1) Calculation of Earnings in Excess of Normal:

Average operating income:

2011	$ 90,000	
2012	110,000	
2013	120,000	
2014 (subtract $40,000)	100,000	
2015	130,000	
	$550,000 ÷ 5 years =	$110,000
Less normal return on assets at fair value:		
Accounts receivable	$100,000	
Inventory	125,000	
Land	100,000	
Building	300,000	
Equipment	250,000	
Fair value of total assets	$875,000	
Industry normal rate of return	× 12%	
Normal return on assets		105,000
Expected annual earnings in excess of normal		$ 5,000

(a) 5 × $5,000 = $25,000 Goodwill

(b) Capitalize the perpetual yearly earnings at 12%:

$$\text{Goodwill} = \frac{\text{Yearly Excess Earnings}}{\text{Capitalization Rate}}$$

$$= \frac{\$5{,}000}{0.12}$$

$$= \$41{,}667$$

(c) Present value of a $5,000 annuity capitalized at 16%. The correct present value factor is found in the "present value of an annuity of $1" table, at 16% for 5 periods. This factor multiplied by the $5,000 yearly excess earnings will result in the present value:

3.2743 × $5,000 = $16,372

(2) The goodwill recorded would be $15,000. The journal entry (not required) would be as follows:

Accounts Receivable	100,000	
Inventory	125,000	
Land	100,000	
Building	300,000	
Equipment	250,000	
Goodwill	15,000	
Cash		690,000
Total Liabilities		200,000

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PROBLEMS

PROBLEM 1-1

(1) Acquisition price $540,000

Total consideration:		
Cash		$540,000
Less fair value of net assets acquired:		
Accounts receivable	$ 79,000	
Inventory	98,000	
Other current assets	55,000	
Equipment	340,000	
Trademark	30,000	
In-process R&D	20,000	
Current liabilities	(125,000)	
Bonds payable	(100,000)	
Value of net identifiable assets acquired		397,000
Excess of total cost over fair value of net assets (goodwill)		$143,000

Journal Entry:		
Accounts Receivable	79,000	
Inventory	98,000	
Other Current Assets	55,000	
Equipment	340,000	
Trademark	30,000	
R&D	20,000	
Goodwill	143,000	
Cash		540,000
Current Liabilities		125,000
Bonds Payable		100,000
Dr. = Cr. Check Totals	*765,000*	*765,000*

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Problem 1-1, Concluded

(2) Acquisition price $350,000

Total consideration:		
Cash		$350,000
Less fair value of net assets acquired:		
Accounts receivable	$ 79,000	
Inventory	98,000	
Other current assets	55,000	
Equipment	340,000	
Trademark	30,000	
In-process R&D	20,000	
Current liabilities	(125,000)	
Bonds payable	(100,000)	
Value of net identifiable assets acquired		397,000
Excess of fair value of net assets over cost (gain)		$ (47,000)

Journal Entry:

Accounts Receivable	79,000	
Inventory	98,000	
Other Current Assets	55,000	
Equipment	340,000	
Trademark	30,000	
R&D	20,000	
Gain on Business Acquisition		47,000
Cash		350,000
Current Liabilities		125,000
Bonds Payable		100,000
Dr. = Cr. Check Totals	*622,000*	*622,000*

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PROBLEM 1-2

Total consideration for Vicker:		
Common stock (30,000 shares × $40)		$1,200,000
Less fair value of net assets acquired:		
Accounts receivable	$ 200,000	
Inventory	190,000	
Land	300,000	
Buildings	450,000	
Current liabilities	(160,000)	
Bonds payable	(90,000)	
Value of net identifiable assets acquired		890,000
Excess of total cost over fair value of net assets (goodwill)		$ 310,000

Bar entry to record the purchase of Vicker:		
Accounts Receivable	200,000	
Inventory	190,000	
Land	300,000	
Buildings	450,000	
Discount on Bonds Payable	10,000	
Goodwill	310,000	
Current Liabilities		160,000
Bonds Payable		100,000
Common Stock (30,000 shares × $10 par)		300,000
Paid-In Capital in Excess of Par		900,000
Dr. = Cr. Check Totals	*1,460,000*	*1,460,000*

Acquisition Expense	5,000	
Cash		5,000

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Problem 1-2, Concluded

Total consideration for Kendal:		
Common stock (15,000 shares × $40)		$600,000
Less fair value of net assets acquired:		
Accounts receivable	$ 80,000	
Inventory	100,000	
Land	80,000	
Buildings	400,000	
Current liabilities	(55,000)	
Bonds payable	(95,000)	
Value of net identifiable assets acquired		510,000
Excess of total cost over fair value of net assets (goodwill)		$ 90,000

Bar entry to record the purchase of Kendal:		
Accounts Receivable	80,000	
Inventory	100,000	
Land	80,000	
Buildings	400,000	
Discount on Bonds Payable	5,000	
Goodwill	90,000	
Current Liabilities		55,000
Bonds Payable		100,000
Common Stock (15,000 shares × $10 par)		150,000
Paid-In Capital in Excess of Par		450,000
Dr. = Cr. Check Totals	*755,000*	*755,000*

Acquisition Expense	4,000	
Cash		4,000

Paid-In Capital in Excess of Par	15,000	
Cash		15,000
To record issue and acquisition costs.		

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PROBLEM 1-3

(1) Total consideration for Yount:

Cash		$730,000
Less fair value of net assets acquired:		
Cash equivalents	$ 100,000	
Accounts receivable	120,000	
Inventory	70,000	
Depreciable fixed assets	400,000	
Current liabilities	(30,000)	
Long-term liabilities	(165,000)	
Value of net identifiable assets acquired		495,000
Excess of total cost over fair value of net assets (goodwill)		$235,000

Acquisition entry:

Cash Equivalents	100,000	
Accounts Receivable	120,000	
Inventory	70,000	
Depreciable Fixed Assets	400,000	
Goodwill	235,000	
Current Liabilities		30,000
Long-Term Liabilities		165,000
Cash		730,000
Dr. = Cr. Check Totals	*925,000*	*925,000*

Acquisition Expense	20,000	
Cash		20,000

(2) Pro Forma Income:

	Combined Income
Sales	$ 200,000
Less:	
Cost of goods sold ($120,000 + $20,000 additional for inventory valuation)	(140,000)
Other expenses	(25,000)
Depreciation (1/20 of $400,000 market value)	(20,000)
Net income	$ 15,000

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PROBLEM 1-4

(1) $500,000 consideration

Total consideration for Williams:		
Common stock (20,000 shares × $25)		$500,000
Less fair value of net assets acquired:		
Accounts receivable	$ 50,000	
Inventory	250,000	
Land	40,000	
Building	120,000	
Accounts payable	(40,000)	
Value of net identifiable assets acquired		420,000
Excess of total cost over fair value of net assets (goodwill)		$ 80,000

Kiln Corporation journal entries:		
Accounts Receivable	50,000	
Inventory	250,000	
Land	40,000	
Building	120,000	
Goodwill	80,000	
Accounts Payable		40,000
Common Stock		200,000
Paid-In Capital in Excess of Par		300,000
Dr. = Cr. Check Totals	*540,000*	*540,000*

(2) $385,000 consideration

Total consideration for Williams:		
Cash		$385,000
Less fair value of net assets acquired:		
Accounts receivable	$ 50,000	
Inventory	250,000	
Land	40,000	
Building	120,000	
Accounts payable	(40,000)	
Value of net identifiable assets acquired		420,000
Excess of fair value of net assets over cost (gain)		$ (35,000)

Kiln Corporation journal entries:		
Accounts Receivable	50,000	
Inventory	250,000	
Land	40,000	
Building	120,000	
Gain on Acquisition		35,000
Accounts Payable		40,000
Cash		385,000
Dr. = Cr. Check Totals	*460,000*	*460,000*

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PROBLEM 1-5

Total consideration for Jack:		
Common stock (18,000 shares × $270)		$4,860,000
Less fair value of net assets acquired:		
Investments	$ 400,500	
Accounts receivable	925,000	
Inventory	1,200,000	
Prepaid insurance	18,000	
Land	70,000	
Machinery and equipment ($1,473,500 × 1.3)	1,915,550	
Current liabilities	(1,475,000)	
Value of net identifiable assets acquired		3,054,050
Excess of total cost over fair value of net assets (goodwill)		$1,805,950

Journal Entry:

Investments	400,500	
Accounts Receivable	925,000	
Inventory	1,200,000	
Prepaid Insurance	18,000	
Land	70,000	
Machinery and Equipment	1,915,550	
Goodwill	1,805,950	
Current Liabilities		1,475,000
Common Stock (18,000 × $10)		180,000
Paid-In Capital in Excess of Par [(18,000 × $270) – $180,000]		4,680,000
Dr. = Cr. Check Totals	*6,335,000*	*6,335,000*

Acquisition Expense	12,000	
Cash		12,000

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PROBLEM 1-6

Total consideration for Sylvester:		
Cash		$580,000
Less fair value of net assets acquired:		
Notes receivable	$ 24,000	
Accounts receivable	56,000	
Inventory	30,000	
Other current assets	15,000	
Investments	63,000	
Land	55,000	
Building	275,000	
Equipment	426,000	
Patents	20,000	
Trade names	15,000	
Accounts payable	(45,000)	
Payroll and benefit-related liabilities—Current	(12,500)	
Debt maturing in one year	(10,000)	
Long-term debt	(248,000)	
Payroll and benefit-related liabilities—Long-Term	(156,000)	
Value of net identifiable assets acquired		507,500
Excess of total cost over fair value of net assets (goodwill)		$ 72,500

Journal Entry:

Notes Receivable	24,000	
Accounts Receivable	56,000	
Inventory	30,000	
Other Current Assets	15,000	
Investments	63,000	
Land	55,000	
Building	275,000	
Equipment	426,000	
Patents	20,000	
Trade Names	15,000	
Goodwill	72,500	
Accounts Payable		45,000
Payroll and Benefit-Related Liabilities—Current		12,500
Debt Maturing in One Year		10,000
Long-Term Debt		248,000
Payroll and Benefit-Related Liabilities—Long-Term		156,000
Cash		580,000
Dr. = Cr. Check Totals	*1,051,500*	*1,051,500*

Acquisition Expense	20,000	
Cash		20,000

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PROBLEM 1-7

(1) Total consideration for Sambo:

Cash		$225,000
Stock issued (15,000 shares × $20)		300,000
Contingent liability ($50,000 × 60%)		30,000
Total consideration		$555,000
Less fair value of net assets acquired:		
Notes receivable	$ 33,000	
Inventory	80,000	
Prepaid expenses	15,000	
Investments	55,000	
Land	90,000	
Buildings	170,000	
Equipment	250,000	
Vehicles	25,000	
Franchise	70,000	
Accounts payable	(63,000)	
Taxes payable	(15,000)	
Interest payable	(3,000)	
Bonds payable	(220,000)	
Value of net identifiable assets acquired		487,000
Excess of total cost over fair value of net assets (goodwill)		$ 68,000

Journal Entry:

Notes Receivable	33,000	
Inventory	80,000	
Prepaid Expenses	15,000	
Investments	55,000	
Discount on Bonds Payable	30,000	
Land	90,000	
Buildings	170,000	
Equipment	250,000	
Vehicles	25,000	
Franchise	70,000	
Goodwill	68,000	
Accounts Payable		63,000
Taxes Payable		15,000
Interest Payable		3,000
Bonds Payable		250,000
Cash		225,000
Common Stock (15,000 shares × $2)		30,000
Paid-In Capital in Excess of Par		270,000
Estimated Contingent Liability		30,000
Dr. = Cr. Check Totals	*886,000*	*886,000*

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Problem 1-7, Concluded

(2) Revised estimate of contingent payment ($50,000 × 90%)	$45,000	
Original estimate ($50,000 × 60%)	30,000	
Net increase	$15,000	
Journal Entry:		
Loss on Estimated Contingent Liability	15,000	
Estimated Contingent Liability		15,000

PROBLEM 1-8

Total consideration for Heinrich:		
Cash		$150,000
Less fair value of net assets acquired:		
Accounts receivable	$ 90,000	
Inventory	30,000	
Other current assets	8,000	
Equipment	80,000	
Vehicles	50,000	
Mailing list	10,000	
Accounts payable	(56,000)	
Accrued liabilities	(14,000)	
Notes payable	(30,000)	
Value of net identifiable assets acquired		168,000
Excess of fair value of net assets over price paid (gain)		$ (18,000)

Journal Entry:		
Accounts Receivable	90,000	
Inventory	30,000	
Other Current Assets	8,000	
Equipment	80,000	
Vehicles	50,000	
Mailing List	10,000	
Accounts Payable		56,000
Accrued Liabilities		14,000
Notes Payable		30,000
Gain on Acquisition of Business		18,000
Cash		150,000
Dr. = Cr. Check Totals	*268,000*	*268,000*

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PROBLEM 1-9

(1)

Reported Income for 2015
Combined Income Statement
For the Period Ending December 31, 2015

Sales revenue		$620,000
Cost of goods sold		223,000
Gross profit		$397,000
Selling expense	$140,000	
Administrative expenses	172,500	
Depreciation expense	20,550	
Amortization expense	10,600	343,650
Income from operations		$ 53,350
Other income and expenses		9,000
Income before taxes		$ 62,350
Provision for income taxes		18,705
Net income		$ 43,645

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Problem 1-9, Continued

Name of Acquiring Company: Faber Enterprises
Name of Acquired Company: Ann's Tool Company
Income Statement
For the Year Ending December 31, 2015
(Tax rate expressed as 0.3 for 30%)

Income Statement Accounts	Faber Enterprises	6 Mo. Ann's Tool Co.		Adjustments Debit		Adjustments Credit	Combined Income Statement	
Sales Revenue	(550,000)	(70,000)						(620,000)
Cost of Goods Sold	200,000	25,000			(1)	2,000		223,000
Gross Profit	(350,000)	(45,000)						(397,000)
Selling Expenses	125,000	15,000					140,000	
Administrative Expenses	150,000	22,500					172,500	
Depreciation Expense—Faber	13,800						13,800	
Depreciation Expense—Ann's Tool		3,750	(2)	3,000			6,750	
Amortization Expense—Faber	5,600						5,600	
Amortization Expense—Ann's Tool		1,000	(3)	4,000			5,000	
Total Operating Expenses	294,400	42,250						343,650
Operating Income	(55,600)	(2,750)						(53,350)
Nonoperating Revenues and Expenses:								
Interest Expense		2,000					2,000	
Interest Income	(7,000)						(7,000)	
Dividend Income	(4,000)						(4,000)	
Total Nonoperating Revenues and Expenses								(9,000)
Income Before Taxes	(66,600)	(750)		7,000		2,000		(62,350)
Provision for Income Taxes (30%)	19,980	225						18,705
Net Income	(46,620)	(525)						(43,645)

(1) Reduce (sold) inventory to fair value.

(2) New depreciation:

Building, 1/2($125,000/25 years)	2,500
Equipment, ½($56,000/8 years)	3,500
Trucks, ½($3,000/2 years)	750
Total new depreciation	6,750
Recorded depreciation	3,750
Adjustment	3,000

(3) New amortization:

Patent, (1/2($18,000/6 years)	1,500
Computer software, ½($10,000/2years)	2,500
Copyright, ½($20,000/10 years)	1,000
Total new amortization	5,000
Recorded amortization	1,000
Adjustment	4,000

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Problem 1-9, Concluded

(2) Pro forma disclosure for 2015 as if acquisition occurred at the start of the year:

Sales revenue ($550,000 + $140,000)	$ 690,000
Net income	$ 39,270
Calculation of net income:	
Reported net incomes before tax ($66,600 + $1,500)	$ 68,100
Inventory adjustment	2,000
Old Ann depreciation and amortization ($7,500 + $2,000)	9,500
New Ann amortization and depreciation	(23,500)*
Adjusted income before tax	$ 56,100
Tax provision (30%)	(16,830)
Net income	$ 39,270

*($2,500 + $3,500 + $750 + $1,500 + $2,500 + $1,000) = $11,750 × 2 = $23,500

PROBLEM 1-10

Part A1

Total consideration for Iris:		
Common stock (10,000 shares × $27)		$270,000
Less fair value of net assets acquired:		
Accounts receivable	$ 15,000	
Inventory	40,000	
Prepaid expenses	12,000	
Investments	33,000	
Land	40,000	
Building	85,000	
Equipment	50,000	
Patent	12,000	
Copyright	26,000	
Accounts payable	(22,000)	
Interest payable	(2,000)	
Notes payable	(40,000)	
Value of net identifiable assets acquired		249,000
Excess of total cost over fair value of net assets (goodwill)		$ 21,000

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Problem 1-10, Continued

Journal Entry:

Account	Dr.	Cr.
Accounts Receivable	15,000	
Inventory	40,000	
Prepaid Expenses	12,000	
Investments	33,000	
Land	40,000	
Building	85,000	
Equipment	50,000	
Patent	12,000	
Copyright	26,000	
Goodwill	21,000	
Accounts Payable		22,000
Interest Payable		2,000
Notes Payable		40,000
Common Stock (10,000 shares × $5 par)		50,000
Paid-In Capital in Excess of Par ($270,000 – $50,000)		220,000
Dr. = Cr. Check Totals	*334,000*	*334,000*

Account	Dr.	Cr.
Acquisition Expense	10,000	
Cash		10,000

Part A2

Summary disclosure:

Sales revenue	$475,000
Net income	$28,920

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Problem 1-10, Concluded

Worksheet for
Pro Forma Income Statement
For the Year Ending December 31, 2016
(Tax rate expressed as 0.4 for 40%)

Income Statement Accounts	Garman International	Iris Company		Adjustments Debit		Adjustments Credit	Pro Forma Combined Income Statement	
Sales Revenue	(350,000)	(125,000)						(475,000)
Cost of Goods Sold	147,000	55,000	(3)	2,000				204,000
Gross Profit	(203,000)	(70,000)						(271,000)
Selling Expenses	100,000	20,000					120,000	
Administrative Expenses	50,000	30,000					80,000	
Acquisition Expense			(4)	10,000			10,000	
Depreciation Expense—Garman	12,500						12,500	
Depreciation Expense—Iris		8,600	(1)	400			9,000	
Amortization Expense—Garman	1,000						1,000	
Amortization Expense—Iris		3,900			(2)	100	3,800	
Total Operating Expenses	163,500	62,500						236,300
Operating Income	(39,500)	(7,500)						(34,700)
Nonoperating Revenues and Expenses:								
Interest Expense		3,000					3,000	
Investment Income	(12,000)	(4,500)					(16,500)	
Total Nonoperating Revenues and Expenses								(13,500)
Income Before Taxes	(51,500)	(9,000)		12,400		100		(48,200)
Provision for Income Taxes (40%)	20,600	3,600						19,280
Net Income	(30,900)	(5,400)						(28,920)

(1) Adjust depreciation as follows:

New amounts:	
Building	$4,000
Equipment	5,000
Total new	$9,000
Recorded	8,600
Adjustment	$ 400

(2) Adjust amortization as follows:

New amounts:	
Patent	$1,200
Copyright	2,600
Total new	$3,800
Recorded	3,900
Adjustment	$ (100)

(3) Increase cost of goods sold to reflect fair value of beginning inventory.

(4) Expense acquisition costs.

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PROBLEM 1-11

Current Assets	100,000	
Assets Under Operating Leases (fair)	580,000	
Net Investment in Direct Financing Leases*	710,605	
Leased Equipment Under Capital Lease (fair)	60,000	
Buildings (fair)	400,000	
Land (fair)	100,000	
Research & Development (fair)	200,000	
Goodwill‡	382,678	
Current Liabilities		150,000
Obligation Under Capital Lease of Equipment**		33,283
Estimated Liabilities Under Lawsuit (estimate)		50,000
Cash		2,300,000

*Recorded net investment in direct financing leases		$730,000
Less adjustment for $50,000 per year lease:		
Present value of payments of $50,000 per year for 5 years at 8%: $50,000 × 3.9927	$ 199,635	
Present value of payments of $50,000 per year for 5 years at 12%: $50,000 × 3.6048	(180,240)***	19,395
		$710,605

**Present value of 5 payments of $9,233 at 12%: $9,233 × 3.6048 = $33,283
***PV amounts are based on tables at the end of text. The use of a financial calculator or Excel will result in a minor (under $2) difference.

‡Cash	$2,300,000
Value assigned to identifiable net assets	1,917,322
Goodwill	$ 382,678

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PROBLEM 1-12

Account	Dr.	Cr.
Current Assets	150,000	
Equipment ($150,000 increase)	350,000	
Land and Buildings	250,000	
Deferred Tax Asset	54,000	
Goodwill*	91,000	
Bonds Payable		200,000
Deferred Tax Liability		45,000
Common Stock ($10 par)		100,000
Paid-In Capital in Excess of Par ($650,000 – $100,000 par)		550,000
Dr. = Cr. Check Totals	*895,000*	*895,000*

*Price paid (10,000 shares × $65 fair value)		$650,000
Fair value of net assets:		
Current assets	$ 150,000	
Equipment	350,000	
Deferred tax liability [30% × ($350,000 – $200,000)] from deferred increase in equipment value	(45,000)	
Land and buildings	250,000	
Bonds payable	(200,000)	
Deferred tax asset (30% × $180,000) from carryover losses	54,000	559,000
Excess attributable to goodwill (net of deferred tax liability)		$ 91,000

Account	Dr.	Cr.
Acquisition Expense	10,000	
Cash		10,000

Account	Dr.	Cr.
Paid-In Capital in Excess of Par	3,000	
Cash		3,000

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PROBLEM 1-13

(1) Total consideration for Weber:

Common stock (20,000 shares × $60 + $20,000 contingency)		$1,220,000
Less fair value of net assets acquired:		
Cash	$ 30,000	
Accounts receivable	60,000	
Investment in marketable securities	150,000	
Land	450,000	
Buildings	450,000	
Equipment	600,000	
Accounts payable	(120,000)	
Income tax payable	(190,000)	
Value of net identifiable assets acquired		1,430,000
Excess of fair value of net assets over cost (gain)		$ (210,000)

Journal Entry:

Cash	30,000	
Accounts Receivable	60,000	
Investment in Marketable Securities	150,000	
Land	450,000	
Buildings	450,000	
Equipment	600,000	
Accounts Payable		120,000
Income Tax Payable		190,000
Gain on Acquisition		210,000
Common Stock ($2 × 20,000 shares)		40,000
Paid in capital, contingent consideration		20,000
Paid-In Capital in Excess of Par ($1,200,000 – $40,000)		1,160,000
Dr. = Cr. Check Totals	*1,740,000*	*1,740,000*

(2) Entry to record contingent consideration:

Paid-in capital, contingent consideration	20,000	
Common Stock (870 shares × $2)		1,740
Paid-In Capital in Excess of Par ($50,000 - $1,740)		18,260

Amount of consideration = deficiency in price /share price:

$2.50 × 20,000 shares =	$50,000
Divide by share price	$57.50
Shares issued	870

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APPENDIX PROBLEM

PROBLEM 1A-1

(1) Bonds:

Present value of interest payments for 5 years at 8%, $27,000 × 3.9927	$107,803
Present value of principal due in 5 years at 8%, $300,000 × 0.6806	204,180*
Present value of bonds	$311,983

Goodwill:

Expected return ($120,000 + $140,000 + $150,000 + $160,000 + $180,000) ÷ 5	$150,000
Normal return on assets ($150,000 + $200,000 + $100,000 + $600,000) × 10%	105,000
Profit in excess of normal return	$ 45,000
Present value of excess of normal return for 5 years at 16%, $45,000 × 3.2743	$147,344

*PV amounts are based on tables at the end of text. The use of a financial calculator or Excel will result in a minor (under $2) difference.

(2)

Cash and Receivables	150,000	
Inventory	200,000	
Land	100,000	
Building	600,000	
Goodwill	147,344	
Current Liabilities		120,000
9% Bonds Payable		300,000
Premium on Bonds Payable		11,983
Cash		765,361

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CASES

CASE 1-1

Part A

Confirmation:

Building:	
Payment	$80,000
n	20
Rate	0.14
Present value	$529,850
Land (20 acres × $10,000)	(200,000)
Balance, building	$329,850
Patent:	
Payment	$40,000
n	4
Rate	0.2
Present value	$103,549
Mortgage payable:	
Payment	$50,000
n	5
Rate	0.07
Present value	$205,010

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Case 1-1, Continued

Part B

(1) Discounted cash flows:

Period	Operating Capital	Salvage/ (Capital Expenditures)	Total
1	150,000		150,000
2	165,000		165,000
3	181,500		181,500
4	199,650		199,650
5	219,615	(100,000)	119,615
6	219,615		219,615
7	219,615		219,615
8	219,615		219,615
9	219,615		219,615
10	219,615	(120,000)	99,615
11	219,615		219,615
12	219,615		219,615
13	219,615		219,615
14	219,615		219,615
15	219,615	(130,000)	89,615
16	219,615		219,615
17	219,615		219,615
18	219,615		219,615
19	219,615		219,615
20	219,615	300,000	519,615

Rate	0.12
NPV	1,406,855

(2) Fair value comparison:

NPV of cash flows	$1,406,855
Total paid price for net assets	1,300,000
Excess of fair value	$ 106,855

(3) Entry to record acquisition:

Account	Debit	Credit
Cash Equivalents	80,000	
Inventory	150,000	
Accounts Receivable	180,000	
Land	200,000	
Building	329,850	
Equipment	220,000	
Patent	103,550	
Goodwill	361,610	
Current Liabilities		120,000
Mortgage Payable		205,010
Cash		1,300,000
Dr. = Cr. Check Totals	*1,625,010*	*1,625,010*

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Case 1-1, Concluded

Part C

Impairment test:

Implied fair value of Frontier	$1,200,000
Book value, including goodwill	1,300,000

Book value exceeds implied fair value; goodwill is impaired.

Impairment adjustment:

Implied fair value of Frontier	$1,200,000
Fair value of net identifiable assets (without goodwill)	1,020,000
Implied remaining goodwill	$ 180,000
Recorded goodwill	(361,610)
Required adjustment	$ (181,610)

Goodwill Impairment Loss	181,610	
Goodwill		181,610

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CASE 1-2

1. The acquisition would be qualified as horizontal.

2. The total price paid and its assignment are as follows:

Cash (79.2 million shares × $30)		$2,376,000,000
Stock issued (59 million shares × $32.25)		1,902,750,000
Total consideration		$4,278,750,000
Less fair value of net assets acquired:		
Cash and cash equivalents	$ 105,000,000	
Receivables	141,000,000	
Capitalized film costs	269,000,000	
Intangible assets	3,140,000,000	
Accounts payable	(325,000,000)	
Other liabilities	(83,000,000)	
Deferred income tax liability	(1,121,000,000)	
Value of net identifiable assets acquired		2,126,000,000
Excess of total cost over fair value of net assets (goodwill)		$2,152,750,000

3. Journal Entry:

	Dr.	Cr.
Cash and Cash Equivalents	105,000,000	
Receivables	141,000,000	
Capitalized Film Costs	269,000,000	
Intangible Assets	3,140,000,000	
Goodwill	2,152,750,000	
Accounts Payable		325,000,000
Other Liabilities		83,000,000
Deferred Income Tax Liability		1,121,000,000
Common Stock, par value (59,000,000 × $0.01)		590,000
Paid-In Capital in Excess of Par ($1,902,750,000 – $590,000 par)		1,902,160,000
Cash		2,376,000,000
Dr. = Cr. Check Totals	*5,807,750,000*	*5,807,750,000*

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