Business Combination

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THE DEVELOPMENT OF COMPLEX BUSINESS STRUCTURES

Enterprise expansion as a means of survival and profitability

- Size often allows economies of scale
- New earning potential
- Earnings stability through diversification
- Management rewards for bigger company size
- Prestige associated with company size
Organizational Structure and Business Objectives

• A **subsidiary** is a corporation that is controlled by another corporation, referred to as a parent company, usually through majority ownership of its common stock.

• Because a subsidiary is a separate legal entity, the parent’s risk associated with the subsidiary’s activities is limited.
Organizational Structure, Acquisitions, and Ethical Considerations

• Manipulation of financial reporting
  • Usage of subsidiaries or other entities to borrow money without reporting the debt on their balance sheets
  • Using special entities to manipulate profits
  • Manipulation of accounting for mergers and acquisitions
    • Pooling-of-interests
BUSINESS EXPANSION AND FORMS OF ORGANIZATIONAL STRUCTURE

Expansion from within: New subsidiaries or entities such as partnerships, joint ventures, or special entities

• Motivating factors:
  • Helps establish clear lines of control and facilitate the evaluation of operating results
  • Special tax incentives
  • Regulatory reasons
  • Protection from legal liability
  • Disposing of a portion of existing operations
Expansion through business combinations

- Entry into new product areas or geographic regions by acquiring or combining with other companies
- A **business combination** occurs when “... an acquirer obtains control of one or more businesses”
- The concept of control relates to the ability to direct policies and management
• Traditional view - Control is gained by acquiring a majority of the company’s common stock
• However, it is possible to gain control with less than majority ownership or with no ownership at all
  • Informal arrangements
  • Formal agreements
ORGANIZATIONAL STRUCTURE AND FINANCIAL REPORTING

1. **Merger** - A business combination in which the acquired company’s assets and liabilities are combined with those of the acquiring company results in no additional organizational components.

2. **Controlling ownership** - A business combination in which the acquired company remains as a separate legal entity with a majority of its common stock owned by the purchasing company leads to a parent–subsidiary relationship.
   - Accounting standards normally require consolidated financial statements.

3. **Noncontrolling ownership** - The purchase of a less-than-majority interest in another corporation does not usually result in a business combination or controlling situation.

4. **Other beneficial interest** - One company may have a beneficial interest in another entity even without a direct ownership interest.
As an illustration of a created entity, assume that Allen Company creates a subsidiary, Blaine Company, and transfers the following assets to Blaine in exchange for all 100,000 shares of Blaine’s $2 par common stock:

<table>
<thead>
<tr>
<th>Item</th>
<th>Cost</th>
<th>Book Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 70,000</td>
<td>$ 70,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>$ 50,000</td>
<td>50,000</td>
</tr>
<tr>
<td>Land</td>
<td>75,000</td>
<td>75,000</td>
</tr>
<tr>
<td>Building</td>
<td>100,000</td>
<td>80,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>250,000</td>
<td>160,000</td>
</tr>
</tbody>
</table>

$435,000
(1) **Investment in Blaine Company Common Stock** 435,000
Accumulated Depreciation* 110,000
  - Cash 70,000
  - Inventory 50,000
  - Land 75,000
  - Building 100,000
  - Equipment 250,000

Record the creation of Blaine Company.

*\$110,000 = (\$100,000 - \$80,000) + (\$250,000 - \$160,000)*

(2) **Cash** 70,000
**Inventory** 50,000
**Land** 75,000
**Building** 100,000
**Equipment** 250,000
  - Accumulated Depreciation 110,000
  - Common Stock, $2 par 200,000
  - Additional Paid-In Capital 235,000

Record the receipt of assets and the issuance of $2 par common stock.
BUSINESS COMBINATIONS

(a) Statutory Merger

AA Company
AA Company
BB Company
CC Company

(b) Statutory Consolidation

AA Company
BB Company
AA Company

(c) Stock Acquisition

AA Company
BB Company
Determining the Type of Business Combination

AA Company invests in BB Company

- Acquires net assets
  - Record as statutory merger or statutory consolidation

- Acquires stock
  - Acquired company liquidated?
    - Yes
    - No
      - Record as stock acquisition and operate as subsidiary
Methods of Effecting Business Combinations

• Acquisition of assets
  • Statutory Merger
  • Statutory Consolidation

• Acquisition of stock
  • A majority of the outstanding voting shares usually is required unless other factors lead to the acquirer gaining control
  • Noncontrolling interest: The total of the shares of an acquired company not held by the controlling shareholder

• Acquisition by other means
Valuation of Business Entities

- Value of individual assets and liabilities
  - Value determined by appraisal

- Value of potential earnings
  - “Going-concern value” based on:
    - A multiple of current earnings.
    - Present value of the anticipated future net cash flows generated by the company.

- Valuation of consideration exchanged
# ACCOUNTING FOR BUSINESS COMBINATION

<table>
<thead>
<tr>
<th>Assets, Liabilities and Equities</th>
<th>Book Value</th>
<th>Fair Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash &amp; Receivables</td>
<td>$ 45,000</td>
<td>$ 45,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>65,000</td>
<td>75,000</td>
</tr>
<tr>
<td>Land</td>
<td>40,000</td>
<td>70,000</td>
</tr>
<tr>
<td>Buildings &amp; Equipment</td>
<td>400,000</td>
<td>350,000</td>
</tr>
<tr>
<td>Accumulated Depreciation</td>
<td>(150,000)</td>
<td></td>
</tr>
<tr>
<td>Patent</td>
<td></td>
<td>80,000</td>
</tr>
<tr>
<td>Total Assets</td>
<td>$400,000</td>
<td>$620,000</td>
</tr>
<tr>
<td>Current Liabilities</td>
<td>$100,000</td>
<td>110,000</td>
</tr>
<tr>
<td>Common Stock ($5 par)</td>
<td>100,000</td>
<td></td>
</tr>
<tr>
<td>Additional Paid-In Capital</td>
<td>50,000</td>
<td></td>
</tr>
<tr>
<td>Retained Earnings</td>
<td>150,000</td>
<td></td>
</tr>
<tr>
<td>Total Liabilities &amp; Equities</td>
<td>$400,000</td>
<td></td>
</tr>
<tr>
<td>Fair Value of Net Assets</td>
<td></td>
<td>$510,000</td>
</tr>
</tbody>
</table>
Total differential $310,000

- Goodwill $100,000
- Excess fair value of net identifiable assets $210,000
- Book value of net identifiable assets $300,000

- Fair value of consideration $610,000
- Fair value of net identifiable assets $510,000
- Book value of net identifiable assets $300,000
(3)  
<table>
<thead>
<tr>
<th>Acquisition Expense</th>
<th>40,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>40,000</td>
</tr>
</tbody>
</table>

Record costs related to acquisition of Sharp Company.

(4)  
<table>
<thead>
<tr>
<th>Deferred Stock Issue Costs</th>
<th>25,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>25,000</td>
</tr>
</tbody>
</table>

Record costs related to issuance of common stock.

(5)  
<table>
<thead>
<tr>
<th>Cash and Receivables</th>
<th>45,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory</td>
<td>75,000</td>
</tr>
<tr>
<td>Land</td>
<td>70,000</td>
</tr>
<tr>
<td>Buildings and Equipment</td>
<td>350,000</td>
</tr>
<tr>
<td>Patent</td>
<td>80,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>100,000</td>
</tr>
</tbody>
</table>

Record acquisition of Sharp Company.
Entries Recorded by Acquired Company

(6) Investment in Point Stock 610,000
Current Liabilities 100,000
Accumulated Depreciation 150,000
   Cash and Receivables 45,000
   Inventory 65,000
   Land 40,000
   Buildings and Equipment 400,000
   Gain on Sale of Net Assets 310,000

Record transfer of assets to Point Corporation.

(7) Common Stock 100,000
Additional Paid-In Capital 50,000
Retained Earnings 150,000
Gain on Sale of Net Assets 310,000
   Investment in Point Stock 610,000

Record distribution of Point Corporation stock.
Subsequent Accounting for Goodwill by Acquirer

<table>
<thead>
<tr>
<th>Item</th>
<th>Carrying Amount</th>
<th>Fair Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash and receivables</td>
<td>$50,000</td>
<td>$50,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>80,000</td>
<td>90,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>120,000</td>
<td>150,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>100,000</td>
<td></td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td><strong>$350,000</strong></td>
<td><strong>$290,000</strong></td>
</tr>
<tr>
<td><strong>Current payables</strong></td>
<td><strong>(10,000)</strong></td>
<td><strong>(10,000)</strong></td>
</tr>
<tr>
<td><strong>Net assets</strong></td>
<td><strong>$340,000</strong></td>
<td><strong>$280,000</strong></td>
</tr>
</tbody>
</table>

(8) Cash and Receivables 45,000
Inventory 75,000
Land 70,000
Buildings and Equipment 350,000
Patent 80,000
Cash 500,000
Current Liabilities 110,000
Gain on Bargain Purchase of Sharp Company 10,000

Record acquisition of Sharp Company.
Combination Effected through Acquisition of Stock

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>(9)</td>
<td>Acquisition Expense</td>
</tr>
<tr>
<td></td>
<td>Deferred Stock Issue Costs</td>
</tr>
<tr>
<td></td>
<td>Cash</td>
</tr>
</tbody>
</table>

Record merger and stock issue costs related to acquisition of Sharp Company.

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>(10)</td>
<td>Investment in Sharp Stock</td>
</tr>
<tr>
<td></td>
<td>Common Stock</td>
</tr>
<tr>
<td></td>
<td>Additional Paid-In Capital</td>
</tr>
<tr>
<td></td>
<td>Deferred Stock Issue Costs</td>
</tr>
</tbody>
</table>

Record acquisition of Sharp Company stock.
Financial Reporting Subsequent to a Business Combination

<table>
<thead>
<tr>
<th></th>
<th>20X0</th>
<th>20X1</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Point Corporation:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Separate income (excluding any income from Sharp)</td>
<td>$300,000</td>
<td>$300,000</td>
</tr>
<tr>
<td>Shares outstanding, December 31</td>
<td>30,000</td>
<td>40,000</td>
</tr>
<tr>
<td><strong>Sharp Company:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net income</td>
<td>$ 60,000</td>
<td>$ 60,000</td>
</tr>
</tbody>
</table>

**20X0:**
- Net Income                    $300,000
- Earnings per Share ($300,000/30,000 shares) $10.00

**20X1:**
- Net Income ($300,000 + $60,000) $360,000
- Earnings per Share ($360,000/40,000 shares) $9.00
THANK YOU