FA Module 17: Business combinations (overview 4th edition)

(The attached PDF file has better formatting.)

(Readings from the fourth 4th edition of the Robinson text.)

Reading: chapter 13 §5 business combinations, *excluding* sub-sections

- 5.3.4. Goodwill Impairment
- 5.4. Financial Statement Presentation Subsequent to the Business Combination
- 5.5. Variable Interest and Special Purpose Entities and Example 11 Receivables Securitization
- 5.6. Additional issues in business combinations that impair comparability

The pooling of interests has not been used for many years. The textbook mentions it because it still affects the financial statements of some firms. The final exam problems do not test pooling of interests.

Contingent liabilities are relevant in some scenarios but are not important for most financial accounting.

Business combinations where the investor has control over the investee (often measured at 50% or more of the voting shares) require consolidated financial statements, with the fair values of the investee's assets and liabilities added to the book values of the investor's assets and liabilities.

The excess of the purchase price over the fair values of the investee's identifiable assets and liabilities is recognized as goodwill on the investor's balance sheet. The textbook gives two goodwill methods (partial and full goodwill), with their effects on shareholders' equity and financial ratios.

The portion of the investee not purchased by the investor is non-controlling (minority) interest, which differs for the full goodwill method vs the partial goodwill method. The final exam problems test full goodwill, partial goodwill, and the non-controlling (minority) interests for each.

The textbook explains the differences between mergers, acquisitions, consolidations, and special purpose entities (called variable interest entities by IFRS). Special purpose entities are used by many firms for leased assets, securitization of assets, and structured securities. Some large insurers and reinsurers use special purpose entities to issue catastrophe bonds. These subjects are not tested on the final exam.

Final exam problems give book values and fair values of the investor's and the investee's assets and liabilities for a less than 100% consolidation and derive

- the consolidated financial statements
- the goodwill asset (partial and full)
- the non-controlling (minority) interest

Example 6 Recognition and Measurement of Goodwill shows the computation of partial goodwill and full goodwill for the simplest case. Partial goodwill is the portion of full goodwill held by the reporting entity.

Example 7 Acquisition Method Post-Combination Balance Sheet is more similar to the final exam problems. Knowing when to use book values vs fair values is critical.

The excess purchase price is the cash paid minus the book value of the acquiree's net assets. Stocks are cash equivalents, since they are readily sold at fair value (market value). The excess purchase price uses the fair value of the new shares issued, not their book values. The textbook says: "Franklin's post-merger financial statement reflects in stockholders' equity the stock issued by Franklin to acquire Jefferson. Franklin issues stock with a par value of €1,000,000; however, the stock is measured at fair value under both IFRS and US GAAP. Therefore, the consideration exchanged is 1,000,000 shares at market value of €15, or €15,000,000. Prior to the transaction, Franklin had 5,000,000 shares of €1 par stock outstanding (€5,000,000). The combined entity reflects the Franklin capital stock outstanding of €6,000,000 (€5,000,000 plus the additional 1,000,000 shares of €1 par stock issued to effect the transaction). Franklin's additional paid in capital of €6,000,000 is increased by the €14,000,000 additional paid in capital from the issuance of the 1,000,000 shares (€15,000,000 less par value of €1,000,000) for a total of €20,000,000. At the acquisition date, only the acquirer's retained earnings are carried to the combined entity. Earnings of the target are included on the consolidated income statement and retained earnings only in post-acquisition periods."

The excess purchase price is split between the fair value allocated to identifiable net assets and goodwill. The acquiree's identifiable net assets are listed at fair value on the acquirer's balance sheet and combined with the book values of the acquirer's assets. The textbook says: "Assets and liabilities are combined using book values of Franklin plus fair values for the assets and liabilities acquired from Jefferson. For example, the book value of Franklin's inventory (€12,000,000) is added to the fair value of inventory acquired from Jefferson (€3,000,000) for a combined inventory of €15,000,000. Long-term debt has a book value of €16,000,000 on Franklin's pre-acquisition statements, and Jefferson's fair value of debt is €1,800,000. The combined long-term debt is recorded as €17,800,000" and "Under the acquisition method, amortization/depreciation is based on historical cost of Franklin's assets and the fair value of Jefferson's assets. Using Example 7, as Jefferson's acquired inventory is sold, the cost of goods sold would be €1,300,000 higher and depreciation on PP&E would be €2,000,000 higher over the life of the asset than if the companies had not combined." Note that the excess of fair value over book value for some assets is amortized over time.

Example 7 is easy because the acquirer buys all the shares of the acquire, so full goodwill equals partial goodwill. Example 8 Non-controlling Asset Valuation uses a 90% acquisition. Some procedures seem strange at first, so read carefully the explanations, especially: "Under the acquisition method (IFRS and US GAAP), as long as the parent has control over the subsidiary (i.e., regardless of whether the parent had purchased 51% or 100% of the subsidiary's stock), it would include 100% of the subsidiary's assets and liabilities at fair value on the consolidated balance sheet. Therefore, PP&E on the consolidated balance sheet would be valued at €390,000." The parent controls the subsidiary, so all the subsidiary's assets are on the parent's balance sheet. The parent does not fully own all these assets, so it has an offsetting liability for non-controlling (minority) interests.

The parent's equity is the same whether it uses the full goodwill method or the partial goodwill method, so

full goodwill – full goodwill non-controlling (minority) interests
= partial goodwill – partial goodwill non-controlling (minority) interests.

Verify this relation in Example 8 Non-controlling Asset Valuation. The four accounting entries in the relation above are computed in the Solution to 2 (full goodwill method) and Solution to 3 (partial goodwill method).

Review the practice exam questions for this module on the discussion forum. These problems are based directly on the examples in the textbook.