

Business Combination

Patriani Wahyu Dewanti, S.E., M.Acc.

Accounting Department

Faculty of Economics

Yogyakarta State University





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



CREATING BUSINESS ENTITIES

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:

<u>Item</u>	<u>Cost</u>	<u>Book Value</u>
Cash		\$ 70,000
Inventory	\$ 50,000	50,000
Land	75,000	75,000
Building	100,000	80,000
Equipment	250,000	160,000
		<u>\$435,000</u>



(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.

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

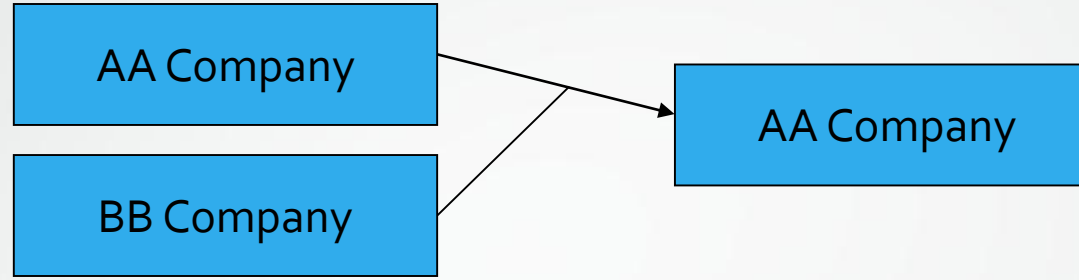
(2)	Cash	70,000	
	Inventory	50,000	
	Land	75,000	
	Building	100,000	
	Equipment	250,000	
	Accumulated Depreciation		110,000
	Common Stock, \$2 par		200,000
	Additional Paid-In Capital		235,000

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

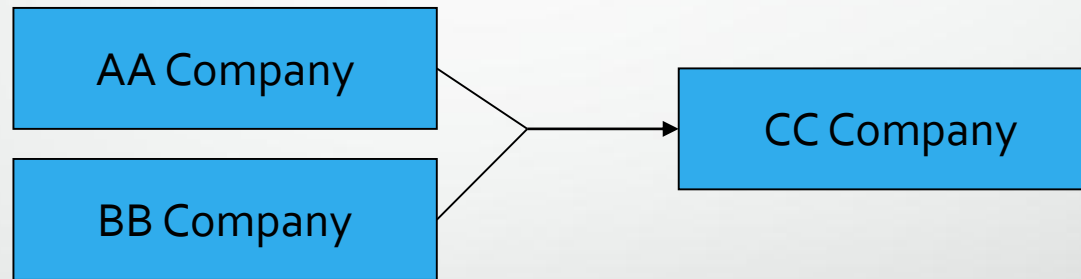


FORM OF BUSINESS COMBINATIONS

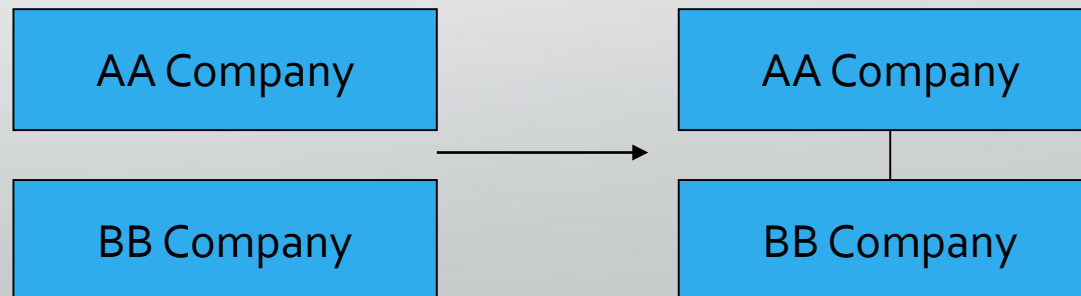
BUSINESS COMBINATIONS



(a) Statutory Merger



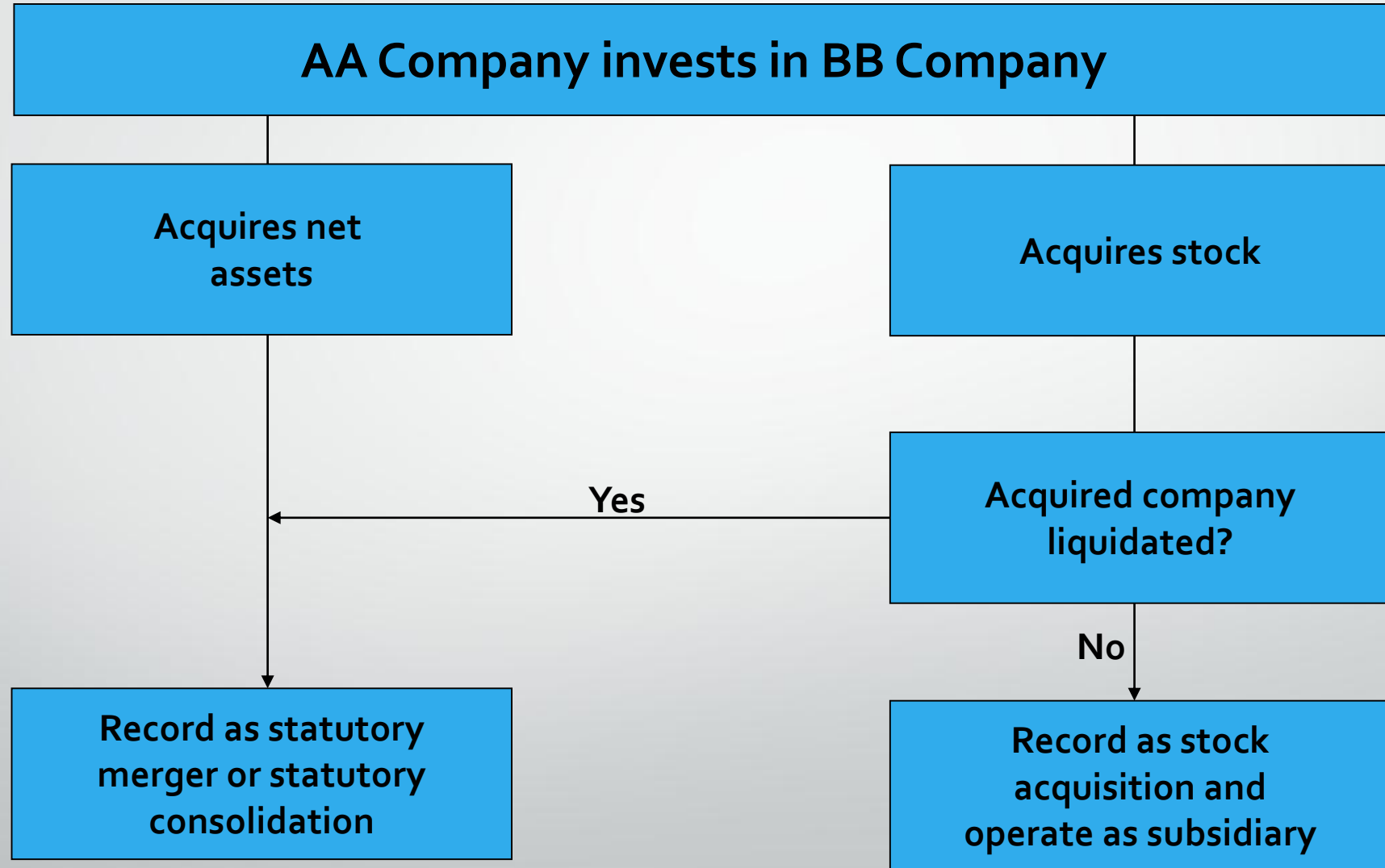
(b) Statutory Consolidation



(c) Stock Acquisition



Determining the Type of Business Combination





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



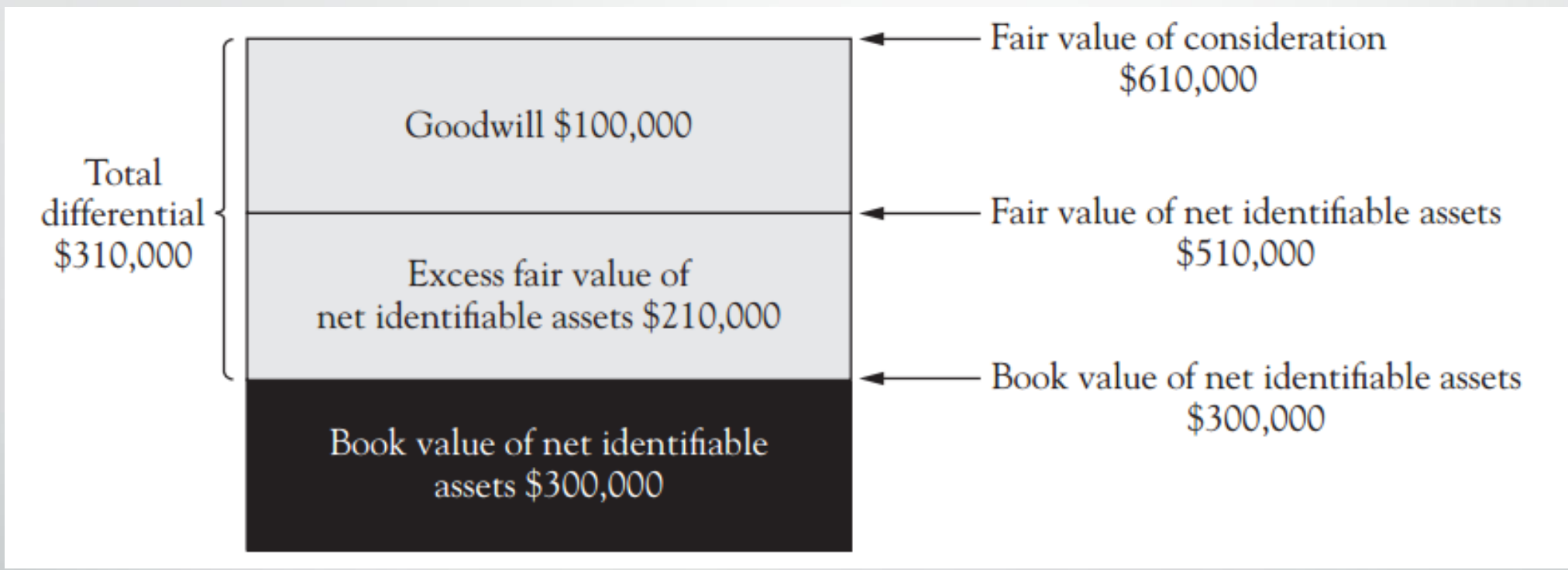
Valuation of Business Entities

- 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

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





(3)	Acquisition Expense	40,000	
	Cash		40,000

Record costs related to acquisition of Sharp Company.

(4)	Deferred Stock Issue Costs	25,000	
	Cash		25,000

Record costs related to issuance of common stock.

(5)	Cash and Receivables	45,000	
	Inventory	75,000	
	Land	70,000	
	Buildings and Equipment	350,000	
	Patent	80,000	
	Goodwill	100,000	
	Current Liabilities		110,000
	Common Stock		100,000
	Additional Paid-In Capital		485,000
	Deferred Stock Issue Costs		25,000

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

Item	Carrying Amount	Fair Value
Cash and receivables	\$ 50,000	\$ 50,000
Inventory	80,000	90,000
Equipment	120,000	150,000
Goodwill	100,000	
Total assets	\$350,000	\$290,000
Current payables	(10,000)	(10,000)
Net assets	<u>\$340,000</u>	<u>\$280,000</u>

(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

(9)	Acquisition Expense	40,000	
	Deferred Stock Issue Costs	25,000	
	Cash		65,000

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

(10)	Investment in Sharp Stock	610,000	
	Common Stock		100,000
	Additional Paid-In Capital		485,000
	Deferred Stock Issue Costs		25,000

Record acquisition of Sharp Company stock.



Financial Reporting Subsequent to a Business Combination

	20X0	20X1
Point Corporation:		
Separate income (excluding any income from Sharp)	\$300,000	\$300,000
Shares outstanding, December 31	30,000	40,000
Sharp Company:		
Net income	\$ 60,000	\$ 60,000

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