Business Combinations: America's Most Popular Business Activity, Bringing an End to the Controversy

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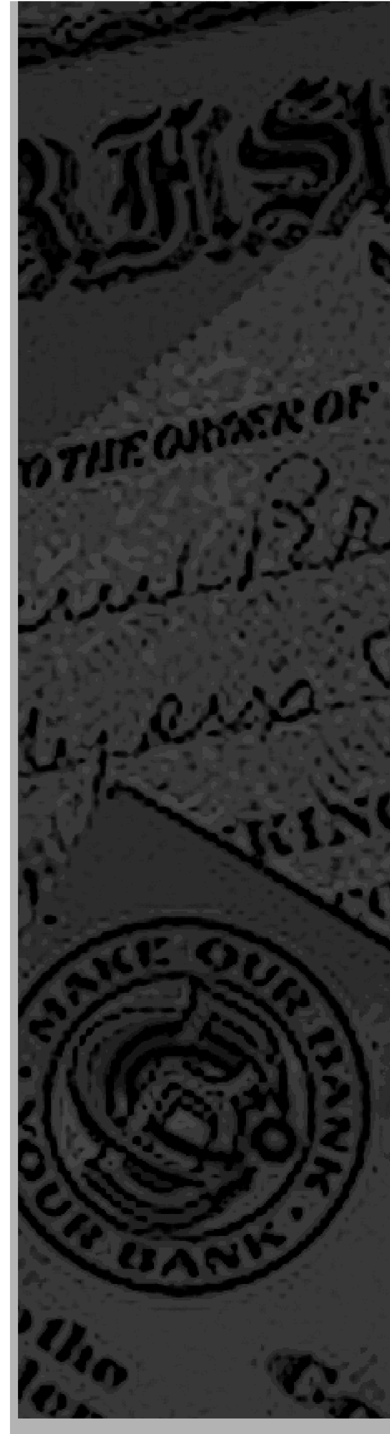


"There are few areas of accounting that need improvement more than the accounting for business combinations. The current accounting literature allows two economically similar business combinations to be accounted for using different accounting methods that produce dramatically different financial results, which is confusing to investors."

Edmund L. Jenkins, Chairman of the Financial Accounting Standards Board
Testimony before the U.S. House of Representatives, May 4, 2000

Learning Objectives

When you have completed this chapter, you should be able to

1. **Describe the major economic advantages of business combinations.**
2. **Differentiate between a purchase of assets and the purchase of a controlling interest of a company in terms of accounting procedures.**
3. **Demonstrate an understanding of the major difference between purchase and pooling of interests accounting.**
4. **Allocate the purchase cost to the assets and liabilities of the acquired company.**
5. **Account for assets and liabilities included in a business combination that involves goodwill.**
6. **Account for acquired assets and liabilities subsequent to a purchase, and apply impairment testing to goodwill.**
7. **Use zone analysis to account for purchases made at a price below the fair value of the company's net assets.**
8. **Explain the special issues that may arise in a purchase, and show how to account for them.**
9. **Be aware of transition rules for the use of pooling of interests and the procedures for existing goodwill.**
10. **(Appendix A) Estimate the value of goodwill.**
11. **(Appendix B) Explain the formerly used criteria that a business combination must meet to qualify as a pooling of interests.**
12. **(Appendix B) Record a pooling of interests acquisition, including the transfer of equity to the surviving company.**

Business combinations have been a common business transaction since the start of commercial activity. The concept is simple: A business combination is the group acquisition of all of a company's assets at a single price. *Business combinations* is a comprehensive term covering all acquisitions of one firm by another. Business combinations can be further categorized as either mergers or consolidations. The term *merger* applies when an existing company acquires another company and combines that company's operations with its own. The term *consolidation* applies when two or more previously separate firms merge into one new, continuing company. Business combinations make headlines not only in the business press but also in the local newspapers of the communities where the participating companies are located. While investors may delight in the price received for their interest, employees become concerned about continued employment, and local citizens worry about a possible relocation of the business.

The popularity of business combinations has steadily increased over the last decade. From 1991 to 2000, there has been over a 100% increase in the number of business combinations and nearly a 1,100% increase in the value of the transactions. Exhibit 1-1 includes the Merger Completion Record covering 1991 through 2000. The increase in this activity has fueled accounting concerns including:

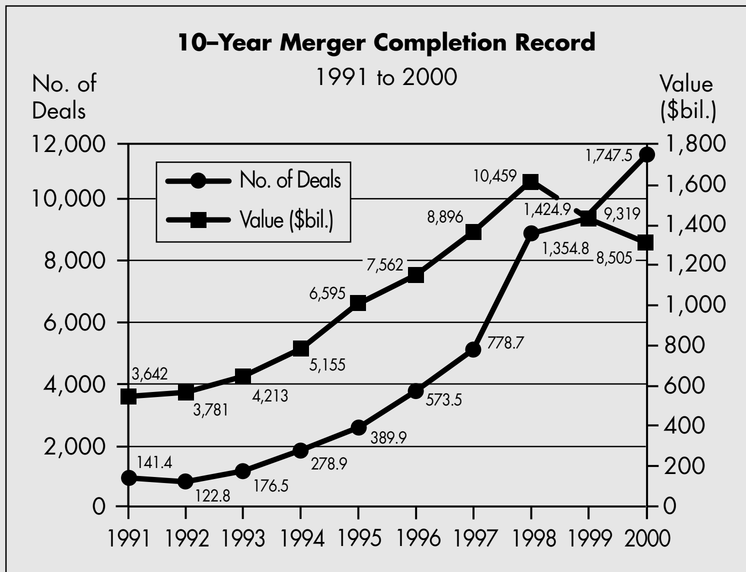
- *The use of two separate and distinct accounting models prior to 2001. Purchase accounting* records all accounts of the acquired company at fair (market-based) value. The *pooling-of-interests method*, which was allowed until July 2001, records all accounts of the acquired firm at their existing book values. It is not uncommon for companies to have a total fair value well in excess of twice the book value. The difference in the methods creates a huge variance in balance sheets and in the depreciation and amortization charges of periods after the combination.
- *Allegations of "precombination beautification."* These are adjustments made to a target company's (i.e., the firm to be acquired) financial statements to make the company look more valuable as a takeover candidate. This includes arranging in advance to meet the prior pooling requirements or making substantial write-offs to enhance postacquisition income. In the fall of 1999, there

Exhibit 1-1
Merger Completion Record 1991–2000

10-Year Merger Completion Record 1991 to 2000

Year	No. of Deals	% Change	Value ($bil.)	% Change
1991	3,642	—	$141.4	—
1992	3,781	3.8%	122.8	−13.2%
1993	4,213	11.4	176.5	43.7
1994	5,155	22.4	278.9	58.0
1995	6,595	27.9	389.9	39.8
1996	7,562	14.7	573.5	47.1
1997	8,896	17.6	778.7	35.8
1998	10,459	17.5	1,354.8	74.0
1999	9,319	−10.9	1,424.9	5.2
2000	8,505	−8.7	1,747.5	22.6

Source: Mergers and Acquisitions Alamanac, February 2001, p. 23.



were allegations that Tyco International arranged to have acquired companies take major write-downs before being acquired by Tyco. This concern caused a major decline in the value of Tyco shares and led to stockholder suits against the company.

- *Questions about the value assigned to the assets of an acquired company.* It has become common practice to record tangible assets at fair value. However, any amount in excess of the fair value was often treated as goodwill and amortized over a period of up to 40 years. A concern has been raised that the price paid could be attributed to specific intangible assets and that those assets, as well as goodwill, could have far shorter lives than 40 years. Also at issue was the fact that goodwill does not experience a straight-line, steady decline in value. Instead, it may have permanent value or may suffer a sudden and drastic decline in value upon the occurrence of certain events. Finally, in 2001, impairment testing and adjustment replaced amortization of goodwill.

Economic Advantages of Combinations

objective: **1**

Describe the major economic advantages of business combinations.

Business combinations are typically viewed as a way to jump-start economies of scale. Savings may result from the elimination of duplicative assets. Perhaps both companies will utilize common facilities and share fixed costs. There may be further economies as one management team replaces two separate sets of managers. It may be possible to better coordinate production, marketing, and administrative actions.

Horizontal combinations involve those where competitors serving similar functions hope to economize by combining those functions, such as the SBC acquisition of Ameritech Corporation. The following comments from the 1999 Annual Report of SBC Communications Inc. refer to its acquisition of Ameritech Corporation:

> *We grew our customer base significantly through the acquisition of Ameritech Corporation, which made us the local communications provider to about 53 million American homes and businesses. Being the incumbent provider is a huge advantage in a marketplace where customers increasingly look to one company to provide all their communications needs. This much larger customer base gives us the scope to achieve significant merger synergies and expand to 30 new major U.S. markets within the next two years.*[1]

Vertical combinations are the combinations of companies that were at different levels within the marketing chain. An example would be the acquisition of a food distribution company by a restaurant chain. The intended benefit of the vertical combination is the closer coordination of different levels of activity in a given industry. Recently, manufacturers have purchased retail dealers to control the distribution of their products. For example, the major automakers have been actively acquiring auto dealerships.

Conglomerates are combinations of dissimilar businesses. A company may want to diversify by entering a new industry. The purchase of Nabisco Holdings Corporation, a food product company, by Philip Morris, a tobacco company, was just such a diversification.

Tax Advantages of Combinations

Perhaps the most universal economic benefit in business combinations is a possible tax advantage. The owners of a small business, whether sole proprietors, partners, or shareholders, may wish to retire from active management of the company. If they were to sell their interest for cash or accept debt instruments, they would have an immediate taxable gain. If, however, they accept the common stock of another corporation in exchange for their interest and carefully craft the transaction as a "tax-free reorganization," they may account for the transaction as a tax-free exchange. No taxes are paid until the shareholders sell the shares received in the business combination. The

1 SBC Communications Inc. Annual Report 1999, p. 2, San Antonio, Texas, 2000.

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shareholder records the shares received (for tax purposes) at the book value of the shares exchanged for the new shares. For example, SBC Communications Inc. informed Ameritech investors that they would receive 1.136 SBC shares per share of Ameritech stock owned. The SBC Web site (*http://www.sbc.com/Investor/Shareholder/AIT*) has information that explains the tax-free nature of the exchange to Ameritech stockholders and helps them to calculate their new cost basis.

Further tax advantages exist when the target company has reported losses on its tax returns in prior periods. Section 172 (b) of the Internal Revenue Code provides that operating losses can be carried back two years to obtain a refund of taxes paid in previous years. Should the loss not be offset by income in the two prior years, the loss may be carried forward up to 20 years to offset future taxable income, thus eliminating or reducing income taxes that would otherwise be payable. These loss maneuvers have little or no value to a target company that has not had income in the two prior years and does not expect profitable operations in the near future. However, tax losses are transferable in a business combination. To an acquiring company that has a profit in the current year and/or expects profitable periods in the future, the tax losses of a target company may have real value. That value, viewed as an asset by the acquiring company, will be reflected in the price paid. However, the acquiring company must exercise caution in anticipating the benefits of tax loss carryovers. The realization of the tax benefits may be denied if it can be shown that the primary motivation for the combination was the transfer of the tax loss benefit.

A tax benefit may also be available in a subsequent period as a single consolidated tax return is filed by the single remaining corporation. The losses of one of the affiliated companies can be used to offset the net income of another affiliated company to lessen the taxes that would otherwise be paid by the profitable company. In some cases, it may be disadvantageous to file as a consolidated company. Companies with low incomes may fare better by being taxed separately due to the progressive income tax rate structure. The marginal tax rate of each company may be lower than that resulting when the incomes of the two companies are combined.[2]

REFLECTION

- Business combinations may have economic advantages for a firm desiring to expand horizontally or vertically or may be a means of diversifying risk by purchasing dissimilar businesses.
- Potential sellers may be motivated by the tax advantages available to them in a business combination.

objective: **2**

Differentiate between a purchase of assets and the purchase of a controlling interest of a company in terms of accounting procedures.

Obtaining Control

Control of another company may be achieved by either acquiring the assets of the target company or acquiring a controlling interest in the target company's voting common stock. In an acquisition of assets, *all* of the company's assets are acquired *directly* from the company. In most cases, existing liabilities of the acquired company also are assumed. When assets are acquired and liabilities are assumed, we refer to the transaction as an acquisition of "net assets." Payment could be made in cash, exchanged property, or issuance of either debt or equity securities. It is common to issue securities, since this avoids depleting cash or other assets that may be needed in future operations. Legally, a *statutory consolidation* refers to the combining of two or more previously inde-

2 See Chapter 6, "Cash Flow, EPS, Taxation, and Unconsolidated Investments," pp. 6-13 to 6-22.

pendent legal entities into one new legal entity. The previous companies are dissolved and are then replaced by a single continuing company. A *statutory merger* refers to the absorption of one or more former legal entities by another company that continues as the sole surviving legal entity. The absorbed company ceases to exist as a legal entity but may continue as a division of the surviving company.

In a *stock acquisition*, a controlling interest (typically, more than 50%) of another company's voting common stock is acquired. The company making the acquisition is termed the *parent*, and the company acquired is termed a *subsidiary*. Both the parent and the subsidiary remain separate legal entities and maintain their own financial records and statements. However, for external financial reporting purposes, the companies usually will combine their individual financial statements into a single set of consolidated statements. Thus, a consolidation may refer to a statutory combination or, more commonly, to the consolidated statements of a parent and its subsidiary.

There may be several advantages to obtaining control by purchasing a controlling interest in stock. Most obvious is that the total cost is lower, since only a controlling interest in the assets, and not the total assets, must be acquired. In addition, control through stock ownership may be simpler to achieve, since no formal negotiations or transactions with the acquired company's management are necessary. Further advantages may result from maintaining the separate legal identity of the former company. First of all, risk is lowered because the legal liability of any one corporation is limited to its own assets. Secondly, separate legal entities may be desirable when only one of the companies is subject to government control. Lastly, there may be tax advantages resulting from the preservation of the legal entities.

Stock acquisitions are said to be "friendly" when the stockholders of the target corporation, as a group, decide to sell or exchange their shares. In such a case, an offer may be made to the board of directors by the acquiring company. If the directors approve, they will recommend acceptance of the offer to the shareholders, who are likely to approve the transaction. Often, a two-thirds vote is required. Once approval is gained, the exchange of shares will be made with the individual shareholders. If the shareholders decline the offer, or if no offer is made, the acquiring company may deal directly with individual shareholders in an attempt to secure a controlling interest. Frequently, the acquiring company may make a formal *tender offer*. The tender offer typically will be published in newspapers and will offer a greater-than-market price for shares made available by a stated date. The acquiring company may reserve the right to withdraw the offer if an insufficient number of shares are made available to it. Where management and/or a significant number of shareholders oppose the purchase of the company by the intended buyer, the acquisition is viewed as *hostile*. Unfriendly offers are so common that several standard defensive mechanisms have evolved. Following are the common terms used to describe these defensive moves:

Greenmail. The target company may pay a premium price ("greenmail") to purchase treasury shares. It may either buy shares already owned by a potential acquiring company or purchase shares from a current owner who, it is feared, would sell to the acquiring company. The price paid for these shares in excess of their market price may not be deducted from stockholders' equity; instead, it is expensed.[3]

White Knight. The target company locates a different company to acquire a controlling interest. This could occur when the original acquiring company is in a similar industry and it is feared that current management of the target company would be displaced. The replacement acquiring company, the "white knight," might be in a different industry and could be expected to keep current management intact.

Poison Pill. The "poison pill" involves the issuance of stock rights to existing shareholders to purchase additional shares at a price far below fair value. However, the rights are exercisable

3 Financial Accounting Standards Board, FASB Technical Bulletin, Nos. 85 and 86, *Accounting for a Purchase of Treasury Shares at a Price Significantly in Excess of the Current Market Price of the Shares* and the *Income Statement Classification of Costs Incurred in Defending Against a Takeover Attempt* (Stamford, CT, 1985).

only when an acquiring company purchases or makes a bid to purchase a stated number of shares. The effect of the options is to substantially raise the cost to the acquiring company. If the attempt fails, there is at least a greater gain for the original shareholders.

Selling the Crown Jewels. This approach has the management of the target company selling vital assets (the "crown jewels") of the target company to others to make the company less attractive to the acquiring company.

Leveraged Buyouts. The management of the existing target company attempts to purchase a controlling interest in that company. Often, substantial debt will be incurred to raise the funds needed to purchase the stock, hence the term "leveraged buyout." When bonds are sold to provide this financing, the bonds may be referred to as "junk bonds," since they are often high-interest and high-risk due to the high debt-to-equity ratio of the resulting corporation.

Further protection against takeovers is offered by federal and state law. The Clayton Act of 1914 (section 7) is a federal law that prohibits business combinations in which "the effect of such acquisition may be substantially to lessen competition or to tend to create a monopoly." The Williams Act of 1968 is a federal law that regulates tender offers; it is enforced by the SEC. Several states also have enacted laws to discourage hostile takeovers. These laws are motivated, in part, by the fear of losing employment and taxes.

Accounting Ramifications of Control

When control is achieved through an asset acquisition, the acquiring company records on its books the assets and assumed liabilities of the acquired company. From the acquisition date on, all transactions of both the acquiring and acquired company are recorded in one combined set of accounts. The only new skill one needs to master is the proper recording of the acquisition when it occurs. **Once the initial acquisition is properly recorded, subsequent accounting procedures are the same as for any single accounting entity.** Combined statements of the new, larger company for periods following the combination are automatic.

Accounting procedures are more involved when control is achieved through a stock acquisition. The controlling company, the parent, will record only an investment account to reflect its interest in the controlled company, the subsidiary. Both the parent and the subsidiary remain separate legal entities with their own separate sets of accounts and separate financial statements. Accounting theory holds that where one company has effective control over another, there is only one economic entity, and there should be only one set of financial statements that combines the activities of the entities under common control. The accountant will prepare a worksheet, referred to as the *consolidated worksheet*, that starts with the separate accounts of the parent and the subsidiary. Various adjustments and eliminations will be made on this worksheet to merge the separate accounts of the two companies into a single set of financial statements, which are called *consolidated statements*.

This chapter discusses business combinations resulting from asset acquisitions, since the accounting principles are more easily understood in this context. The principles developed are applied directly to stock acquisitions that are presented in the chapters that follow.

REFLECTION

- Control of another company is gained by either acquiring all of that firm's assets (and usually its liabilities) or by purchasing a controlling interest in that company's voting common stock.
- Control through an acquisition of assets requires the correct initial recording of the purchase. Combined statements for future periods are automatically produced.

Purchase versus Pooling

objective:3

Demonstrate an understanding of the major difference between purchase and pooling of interests accounting.

Prior to the issuance of FASB Statement No. 141,[4] in 2001, there were two methods available to record the acquisition of a company. The primary method, applicable to most acquisitions, was the purchase method. Purchase accounting recorded all assets and liabilities at their estimated fair values. When the price exceeded the sum of the fair values for individual, identifiable assets, the excess was attributed to goodwill. Prior to July 2001, goodwill was amortized up to 40 years. With the issuance of FASB Statement No. 142,[5] goodwill is no longer amortized. It is now tested for, and, if necessary, adjusted for impairment. Under the pooling method, all assets and liabilities were transferred to the acquiring company at existing book values, and no goodwill could be created.

Purchase and pooling were not meant to be alternative methods available for any acquisition. It was intended that pooling would apply only to a "merger of equals." Toward this objective, in 1970, *APB Opinion No. 16*[6] restricted the use of pooling to transactions that met a strict set of criteria, which are covered in detail in Appendix B at the end of this chapter. The most important of the criteria required that 90% of the acquired firm's common stock shares be received in exchange for the acquiring company's common stock. All shareholders had to be treated equally in the distribution of shares. Over time, many business combinations were "managed" so that they would meet the pooling criteria. This meant that the acquiring company would receive the more favorable accounting treatment. Several perceived advantages led firms to try to use the pooling method. Below is a summary of the major differences between pooling and purchases.

Differences in Accounting	Pooling Advantage
Asset valuation: Under purchase accounting, assets are recorded at fair value, and goodwill may be recorded. Under pooling, assets were recorded at existing book value (which is generally lower than fair value), and no goodwill was created.	◆ Reported income is higher because depreciation expense is lower and there was no new goodwill amortization. (Goodwill was amortized over 40 years or less prior to FASB Statement No. 142.) ◆ Return on assets is greater as a higher income is divided by a lower asset base.
Current-year income: Under purchase accounting, the acquired firm's income is added to the acquiring firm's income statement starting on the purchase date. Under pooling, the acquired firm's income was added as of the first day of the reporting period (no matter when the acquisition occurs).	◆ Assuming that the acquired firm is profitable, the acquiring firm was able to include the acquired firm's income, along with its own, for the entire year even if the pooling occurred on the last day of the reporting period.
Retained earnings: In a purchase, the acquired firm's retained earnings cannot be added to that of the purchasing company. Under pooling, the retained earnings of the acquired firm were added to that of the acquiring firm (with some rare exceptions).	◆ There was an instant increase in retained earnings, which made prior periods look more profitable. ◆ Prior-year income statements were retroactively combined; thus, the acquiring firm "pulled in" the income of the acquired firm in its prior-year statements.
Direct acquisition costs: In a purchase, these costs are added to the cost of the company purchased. They are typically included in goodwill, which used to increase goodwill amortization in later periods. Now these costs could increase impairment losses in future periods. In a pooling, these costs were expensed in the period of the purchase.	◆ Income could have been higher in later periods, since there was no amortization of these costs. *However*, pooling income was decreased in the period of the acquisition, since these costs were expensed in the period of acquisition.

(continued)

4 FASB Statement No. 141, *Business Combinations* (Norwalk, CT: Financial Accounting Standards Board, June 2001).
5 FASB Statement No. 142, *Goodwill and Other Intangible Assets* (Norwalk, CT: Financial Accounting Standards Board, June 2001).
6 Accounting Principles Board Opinion No. 16, *Business Combinations* (New York: American Institute of Certified Public Accountants, 1970).

Differences in Accounting	Pooling Advantage
Total equity: In a purchase, the fair value of the shares issued to pay for the purchase must be added to the equity of the acquiring firm. In a pooling, the book value of the acquired firm's equity was assigned to the shares issued by the acquiring firm.	◆ Total equity was usually lower. Return on equity was greater, since a higher income was divided by a lower equity amount.

The financial statement advantages incurred by the pooling method and the increased "gaming" to use the pooling method led to its elimination in July 2001 with the issuance of FASB Statement No. 141. The FASB held that fair values should be used in all combinations. The lack of comparability due to financial statement distortions, which resulted from companies using alternative methods, could no longer be tolerated. Even before the statement was issued, companies were reluctant to use pooling. In the fall of 1999, Tyco International was criticized for stimulating earnings growth through the use of the pooling method. This precipitated a significant decline in the value of Tyco's shares. Tyco later announced that it would no longer acquire companies as a pooling of interests.

Some foreign countries still allow the use of the pooling method when similar-size firms combine; it is difficult to determine the buyer versus the seller in such cases. There were, of course, many combinations in the United States, prior to July 2001, that used the pooling method. Additional information about pooling of interests is covered in Appendix B of this chapter. Those who desire a complete knowledge of former pooling procedures should obtain a copy of the 7th edition of this text.

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REFLECTION

- Purchase and pooling created very different account values and caused significant differences in income.
- Pooling generally resulted in more favorable income statements in periods following the combination.
- Pooling accounting will no longer be allowed in the future.

objective:4

Allocate the purchase cost to the assets and liabilities of the acquired company.

Valuation under the Purchase Method

The purchase of another business is viewed as a group purchase of assets. In most cases, the purchasing firm assumes the liabilities of the acquired company. This means that the purchaser will record the liabilities on its books and pay them as they become due. Where liabilities are assumed, the purchase is termed a *purchase of net assets*.

All assets acquired and liabilities assumed are to be recorded at individually determined fair values. *Fair value* is the amount that the asset or liability could be bought or sold for in a current, normal (nonforced) sale between willing parties. The preferred measure is quoted fair value, where an active market for the item exists. When there is not an active market, independent appraisals, discounted cash flow analysis, and other types of valuations are used to determine fair values. The list of assets includes intangible assets that may or may not be recorded on the selling company's books. If the price paid for the entire company exceeds the values assigned to individually identifiable net assets, the remaining balance is recorded as goodwill.

Assigning Value to Assets and Liabilities

The allocation of value begins by determining the fair value of tangible assets, including accounts such as receivables, inventory, investments, and fixed assets. Fair values are also established for liabilities. Typically, current liabilities are recorded at book value, since this tends to approximate fair value. However, long-term liabilities may have fair values at variance with recorded book value due to changes in interest rates.

The next step is to identify and value intangible assets. In order to record an intangible asset, the intangible must meet the general requirements to be recognized as an asset under FASB Conceptual Statements Nos. 5 and 6. An asset must have "probable future economic benefits defined or controlled by a particular entity as a result of past transactions and events."[7] In addition, the attributes must be able to be reliably measured.[8] FASB Statement No. 141 further requires that an intangible asset meet one of the two following criteria:[9]

- Contractual or other legal rights assure control over future economic benefits. This includes rights that cannot be separated or transferred individually apart from other assets. For example, the Pepsi trademark could have a separate value even though, in reality, it could not be separated from the recipe and production process.
- The asset can be separated or divided so that it can be sold, exchanged, licensed, rented, or transferred. This does not require that a market for the asset currently exists. An intangible asset meets this test even if it could only be sold, exchanged, licensed, rented, or transferred with a group of other related assets or liabilities. For example, a client list of a service firm might have little value without the transfer of the company name in the same transaction.

Exhibit 1-2 contains examples of intangible assets that meet the criteria for recognition apart from goodwill.[10]

One of the intangible assets identified may be research and development (R&D). Value is assigned to R&D as though it was an asset, but the amount is usually expensed in the period of the purchase. The only case in which R&D can be treated as an asset and not immediately expensed is when there are R&D assets with multiple future uses.[11] Multiple-use R&D is later allocated to benefiting projects. A major purchase of R&D occurred in 1995 when IBM purchased Lotus Development Corporation for $2.9 billion. A $1.84 billion amount was assigned to R&D, which was immediately expensed. Imagine telling stockholders that it was prudent to buy this expense!

Recording Goodwill

When the price paid for a business exceeds the sum of the values assigned to identifiable assets, including intangible assets, the excess price is recorded as goodwill. Goodwill cannot be recorded unless the price paid for a company exceeds the total fair values assigned to all identifiable assets, net of liabilities assumed. Goodwill reflects intangible assets that could not be measured separately. It also includes the future benefits from other factors, such as excess earnings ability and achieving economies of scale. In this sense, goodwill is a residual value used to account for the price paid that cannot be assigned to other assets.

Prior to establishing the final price to be paid for a company, the buyer may want to estimate the value of goodwill attributable to anticipated excess earnings. Estimating the amount by which

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7 Statement of Financial Accounting Concepts No. 6, *Elements of Financial Statements* (Stamford, CT: Financial Accounting Standards Board, December 1985) par. 25.

8 Statement of Financial Accounting Concepts No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises* (Stamford, CT: Financial Accounting Standards Board, December 1984) par. 63.

9 FASB Statement No. 141, *Business Combinations* (Norwalk, CT: Financial Accounting Standards Board, June 2001) par. 39.

10 Ibid., par. A14.

11 Financial Accounting Standards Board Interpretation No. 4, *Applicability of FASB Statement No. 2 to Business Combinations* (Stamford, CT: Financial Accounting Standards Board, 1975).

Exhibit 1-2
Examples of Intangibles

Examples of Intangibles	Meet the Contractual-Legal Criterion*	Meet the Separability Criterion
Marketing—related intangible assets:		
Trademarks, tradenames	X	
Service marks, collective marks, certification marks	X	
Trade dress (unique color, shape, or package design)	X	
Newspaper mastheads	X	
Internet domain names	X	
Noncompetition agreements	X	
Customer-related intangible assets:		
Customer lists		X
Order or production backlog	X	
Customer contracts and related customer relationships	X	
Noncontractual customer relationships		X
Artistic-related intangible assets:		
Plays, operas, ballets	X	
Books, magazines, newspapers, other literary works	X	
Musical works such as compositions, song lyrics, advertising jingles	X	
Pictures, photographs	X	
Video and audiovisual material, including motion pictures, music videos, television programs	X	
Contract-based intangible assets:		
Licensing, royalty, standstill agreements	X	
Advertising, construction, management, service or supply contracts	X	
Lease agreements	X	
Construction permits	X	
Franchise agreements	X	
Operating and broadcast rights	X	
Use rights such as drilling, water, air, mineral, timber cutting, and route authorities	X	
Servicing contracts, such as mortgage servicing contracts	X	
Employment contracts	X	
Technology-based intangible assets:		
Patented technology	X	
Computer software and mask work	X	
Unpatented technology		X
Databases, including title plants		X
Trade secrets, such as formulas, processes, and recipes.	X	

*Some intangibles listed may also meet the separability criterion.

future income exceeds the amount considered normal for the industry can provide a reasonable value. The expected excess future income may be valued by multiplying it by the number of years it is expected to occur or by discounting the excess incomes to their present value. Appendix A, at the end of this chapter, includes methods for estimating goodwill. In the final recording of goodwill, any estimate made becomes irrelevant. **Recorded goodwill is the excess of the price paid over the values assigned to all other net identifiable assets.**

REFLECTION

- Under the purchase method, assets and liabilities generally are recorded at fair value.
- Identifiable intangible assets are included in the assets recorded at fair value.
- Goodwill is the excess of the price paid over the amount assigned to identifiable net assets.

Recording a Purchase with Goodwill

objective:5

Account for assets and liabilities included in a business combination that involves goodwill.

When the purchase of an existing company is being considered, a thorough appraisal should be made to determine the fair value of the company's assets and liabilities. A complete appraisal will usually precede negotiations over the price to be paid. Generally, the prospective purchaser will seek the seller's permission to conduct a preacquisition audit. The audit will determine whether all assets and liabilities are properly recorded. The purchaser knows that, while book values may be indicative of the fair values of most current assets, they seldom represent a reasonable fair value for fixed and intangible assets. Even among current assets, an inventory valued on a LIFO basis has value unrelated to fair value. Fixed and intangible assets are recorded at historical cost less an arbitrary estimate of accumulated depreciation or amortization, which has little to do with fair value. Intangible assets, such as customer lists, brand names, and favorable lease agreements, may exist yet not be recorded. Some liabilities may not be recorded at an amount that represents fair value because the fair value of liabilities changes as interest rates change.

The company being purchased may have goodwill on its books (arising from a prior purchase of another company). **Existing goodwill is assigned no value in a purchase.** The only goodwill recorded is that caused by the current purchase.

Acknowledging the limitations of (and for some assets, the absence of) recorded book values, the purchaser will typically engage an independent consultant to estimate the fair value of the individual assets to be acquired and the liabilities to be assumed. These estimates of fair value are of primary consideration when determining the price to be paid for the entire company.

To illustrate, assume that Acquisitions Inc. is considering the purchase of Johnson Company. The audited balance sheet on the date of purchase, December 31, 20X1, is as follows:

Johnson Company
Balance Sheet
December 31, 20X1

Assets			Liabilities and Equity		
Current assets:					
Accounts receivable	$28,000		Current liabilities	$ 5,000	
Inventory	40,000		Bonds payable	20,000	
Total current assets		$ 68,000	Total liabilities		$ 25,000

(continued)

Assets			Liabilities and Equity		
Long-term assets:					
Land	$10,000				
Buildings (net)	40,000		Stockholders' equity		
Equipment (net)	20,000		Common stock, $1 par	$ 1,000	
Patent (net)	15,000		Paid-in capital in excess of par . .	59,000	
Goodwill (existing)	20,000		Retained earnings	88,000	
Total long-term assets		105,000	Total stockholders' equity		148,000
Total assets		$173,000	Total liabilities and equity		$173,000

The accountant will proceed to secure fair values and might prepare a fair value balance sheet, as follows, for Johnson Company:

Johnson Company
Fair Values
December 31, 20X1

Assets	Book Value	Fair Value	Liabilities and Equity	Book Value	Fair Value
Current assets:					
Accounts receivable	$ 28,000	$ 28,000	Current liabilities	$ 5,000	$ 5,000
Inventory	40,000	45,000	Bonds payable	20,000	21,000
Total current assets	$ 68,000	$ 73,000	Total liabilities	$ 25,000	$ 26,000
Long-lived assets:					
Land	$ 10,000	$ 50,000			
Buildings (net)	40,000	80,000			
Equipment (net)	20,000	50,000			
Patent (net)	15,000	30,000			
Brand-name copyright* . . .	—	**40,000**			
Goodwill (preexisting)	20,000				
Total long-lived assets	$105,000	$250,000	Value of net assets		
Total assets	$173,000	$323,000	(assets − liabilities)	$148,000	$297,000

*Previously unrecorded assets.

Let us assume that the price to be paid to the seller for the net assets is $350,000. Direct acquisition costs of $10,000 are added to the purchase price (see page 1-13). The total price paid is $360,000. Prior to the issuance of FASB Statement No. 141, it would have been common to seek fair value for only the existing recorded accounts and to treat any price paid in excess of their total as goodwill. In the above example, the fair value of the net recorded assets (without the copyright) is $257,000 ($297,000 net assets − $40,000 copyright). The remaining price of $103,000 ($360,000 price − $257,000) could have been recorded as goodwill. But under FASB Statement No. 141, goodwill exists only to the extent that the price paid exceeds the fair values assigned to all identifiable assets including intangible assets that may not have existed on the books of the selling company. Notice that the sum of the fair values assigned to identifiable net assets is **$297,000** ($323,000 assets − $26,000 liabilities). Thus, at a price of $360,000, **goodwill would be recorded at $63,000,** the excess of the $360,000 total price over the $297,000 assigned to all net assets, including identifiable intangible assets, at fair value.

Entry to Record the Purchase

Assume that Acquisitions Inc. has agreed to pay $350,000 to Johnson Company for its net assets. Payment could be made in cash or by issuing bonds or stocks to Johnson's shareholders. For our

initial analysis, we will assume that \$350,000 cash is paid to Johnson Company and that another \$10,000 is paid to independent attorneys and accountants for direct acquisition costs. The journal entry to record the purchase would be as follows:

Account	Dr.	Cr.
Accounts Receivable	28,000	
Inventory	45,000	
Land	50,000	
Building	80,000	
Equipment	50,000	
Patent	30,000	
Brand-Name Copyright	40,000	
Goodwill (based on current purchase)	**63,000**	
Current Liabilities		5,000
Bonds Payable		20,000
Premium on Bonds Payable		1,000
Cash (for direct acquisition costs)		10,000
Cash (payment to Johnson Company)		350,000
Dr. = Cr. Check Totals	*386,000*	*386,000*

Note that all fixed and intangible assets are recorded at their estimated fair value, with no allowance for accumulated depreciation or amortization. Any adjustment of bonds payable is accomplished using a premium (in this case) or discount account. This is done to maintain a record of the legal face value.

The more common method of payment is for the purchaser to issue additional shares of its common stock. This preserves both cash and future lending ability. Let us assume that Acquisitions Inc. will issue \$1 par value shares with a fair value of \$50 per share. Acquisitions Inc. would have to issue 7,000 shares (\$350,000/\$50 per share). The journal entry to record the purchase follows. Note that the only difference between this and the preceding entry is the replacement of the credit to cash (for the payment to Johnson) with a credit to the buyers' paid-in equity accounts.

Account	Dr.	Cr.
Accounts Receivable	28,000	
Inventory	45,000	
Land	50,000	
Building	80,000	
Equipment	50,000	
Patent	30,000	
Brand-Name Copyright	40,000	
Goodwill	**63,000**	
Current Liabilities		5,000
Bonds Payable		20,000
Premium on Bonds Payable		1,000
Cash (for direct acquisition costs)		10,000
Common Stock (\$1 par, 7,000 shares)		7,000
Paid-In Capital in Excess of Par (\$350,000 − \$7,000 par)		343,000
Dr. = Cr. Check Totals	*386,000*	*386,000*

Issue costs resulting from the issuance of stock as consideration given in a purchase arrangement are not included in the cost of the company purchased. Instead, issue costs are subtracted from the amount assigned to the stock issued. Issue costs could always be recorded in a separate entry so that there is no opportunity to confuse them with the price paid for the company purchased. If the issue costs were \$5,000 in the above example, the added entry would be as follows:

Account	Dr.	Cr.
Paid-In Capital in Excess of Par (reduced for issue costs)	5,000	
Cash (for payment of issue costs)		5,000

Required Disclosure

For the period in which a purchase occurs, a schedule must be presented in the notes to the statements that discloses the fair value to the accounts of the company purchased. The schedule would be prepared as follows for the purchase of Johnson Company:

Schedule of Book and Assigned Values
Johnson Company Purchase
December 31, 20X1

Accounts	Assigned Value
Accounts Receivable	$ 28,000
Inventory	45,000
Land	50,000
Building	80,000
Equipment	50,000
Patent	30,000
Brand-Name Copyright	40,000
Goodwill	63,000
Current Liabilities	(5,000)
Bonds Payable	(20,000)
Premium on Bonds Payable	(1,000)
Net assets acquired	**$360,000**

The following additional information must be included in the notes to the financial statements of the acquiring company in the period the purchase occurs:

1. Name and description of the firm purchased and the percentage of voting shares purchased.
2. The primary reason for the purchase and the factors that led to the price if goodwill is recorded.
3. The portion of the financial reporting period for which the results of the purchased firm are included.
4. The cost of the company purchased and, if stock was issued as payment, the value assigned to the shares including a description of how the value per share was determined.
5. Disclosure of contingent payment agreements, options, or commitments included in the purchase agreement and the accounting methods that would be used if the contingency occurs.
6. The amount of in-process R&D purchased and written off during the period.
7. Disclosures as to any purchase price allocation that has not been finalized and an explanation as to why it has not been completed. In subsequent periods, any adjustment to the allocation is to be disclosed.

When the amount of goodwill recorded is significant with respect to other assets acquired, disclosure is also required as to:

1. The amount of goodwill related to each reporting segment (under FASB Statement No. 131).
2. The amount of acquired goodwill that is tax deductible.

Pro Forma Income Disclosures. Pro forma income disclosure is also required in the period in which the purchase occurs. The disclosure seeks to provide consistency over the current and prior periods by showing what the income would have been had the purchase occurred at the *start of the prior accounting period*. The following pro forma disclosures are made:

1. Results of operations for the current period as if the purchase occurred at the beginning of the period (unless the purchase was at or near the beginning of the period).
2. Results of operations for the immediately prior period if comparative statements are issued.

The statements themselves are not adjusted. The footnote must include, at a minimum, revenue, income before extraordinary items and cumulative effect of accounting changes, net income

and earnings per share. This disclosure would include the impact of the values assigned to accounts in the purchase transaction. Exhibit 1-3 presents the disclosure for business combinations for 2000 from the 2000 Annual Report of Quest Diagnostics Inc.

Exhibit 1-3
Quest Diagnostics Incorporated and Subsidiaries
Notes to Consolidated Financial Statements
(dollars in thousands unless otherwise indicated)

3. Acquisition of SmithKline Beecham's Clinical Laboratory Testing Business

On August 16, 1999, the Company completed the acquisition of SmithKline Beecham Clinical Laboratories, Inc. ("SBCL") which operated the clinical laboratory business of SmithKline Beecham plc ("SmithKline Beecham"). The original purchase price of approximately $1.3 billion was paid through the issuance of 12,564,336 shares of common stock of the Company (valued at $260.7 million), representing approximately 29% of the Company's then outstanding common stock, and the payment of $1.025 billion in cash, including $20 million under a non-competition agreement between the Company and SmithKline Beecham. At the closing of the acquisition, the Company used existing cash and borrowings under a new senior secured credit facility (the "Credit Agreement") to fund the cash purchase price and related transaction costs of the acquisition, and to repay the entire amount outstanding under its then existing credit agreement. The acquisition of SBCL was accounted for under the purchase method of accounting. The historical financial statements of Quest Diagnostics include the results of operations of SBCL subsequent to the closing of the acquisition.

Under the terms of the acquisition agreements, Quest Diagnostics acquired SmithKline Beecham's clinical laboratory testing business including its domestic and foreign clinical testing operations, clinical trials testing, corporate health services, and laboratory information products businesses. SmithKline Beecham's national testing and service network consisted of regional laboratories, specialty testing operations and its National Esoteric Testing Center, as well as a number of rapid-turnaround or "stat" laboratories, and patient service centers. In addition, SmithKline Beecham and Quest Diagnostics entered into a long-term contract under which Quest Diagnostics is the primary provider of testing to support SmithKline Beecham's clinical trials testing requirements worldwide. As part of the acquisition agreements, Quest Diagnostics granted SmithKline Beecham certain non-exclusive rights and access to use Quest Diagnostics' proprietary clinical laboratory information database. Under the acquisition agreements, SmithKline Beecham has agreed to indemnify Quest Diagnostics, on an after tax basis, against certain matters primarily related to taxes and billing and professional liability claims.

Under the terms of a stockholder agreement, SmithKline Beecham has the right to designate two nominees to Quest Diagnostics' Board of Directors as long as SmithKline Beecham owns at least 20% of the outstanding common stock. As long as SmithKline Beecham owns at least 10% but less than 20% of the outstanding common stock, it will have the right to designate one nominee. Quest Diagnostics' Board of Directors was expanded to nine directors following the closing of the acquisition. The stockholder agreement also imposes limitations on the right of SmithKline Beecham to sell or vote its shares and prohibits SmithKline Beecham from purchasing in excess of 29.5% of the outstanding common stock of Quest Diagnostics.

As of December 31, 2000 and 1999, the Company had recorded approximately $820 million and $950 million, respectively, of goodwill in conjunction with the SBCL acquisition, representing acquisition cost in excess of the fair value of net tangible assets acquired, which is amortized on the straight-line basis over forty years. The amount paid under the non-compete agreement is amortized on the straight-line basis over five years.

The SBCL acquisition agreements included a provision for a reduction in the purchase price paid by Quest Diagnostics in the event that the combined balance sheet of SBCL indicated that the net assets acquired, as of the acquisition date, were below a prescribed level. On October 11, 2000, the purchase price adjustment was finalized with the result that SmithKline Beecham owed Quest Diagnostics $98.6 million. This amount was offset by $3.6 million separately owed

(continued)

Exhibit 1-3 *(Continued)*

by Quest Diagnostics to SmithKline Beecham, resulting in a net payment by SmithKline Beecham of $95.0 million. The purchase price adjustment was recorded in the Company's financial statements in the fourth quarter of 2000 as a reduction in the amount of goodwill recorded in conjunction with the SBCL acquisition.

The remaining components of the purchase price allocation relating to the SBCL acquisition were finalized during the third quarter of 2000. The resulting adjustments to the SBCL purchase price allocation primarily related to an increase in deferred tax assets acquired, the sale of certain assets of SBCL at fair value to unconsolidated joint ventures of Quest Diagnostics and an increase in accrued liabilities for costs related to pre-acquisition periods. As a result of these adjustments, the Company reduced the amount of goodwill recorded in conjunction with the SBCL acquisition by approximately $35 million during the third quarter of 2000.

Pro Forma Combined Financial Information (Unaudited)

The following pro forma combined financial information for the years ended December 31, 1999 and 1998 assumes that the SBCL acquisition and borrowings under the new credit facility were effected on January 1, 1998. In connection with finalizing the purchase price adjustment with SmithKline Beecham, Quest Diagnostics filed a current report on Form 8-K on October 31, 2000 with the Securities and Exchange Commission to revise and update certain pro forma combined financial information previously reported by the Company (1) to reflect the restated historical financial statements of SBCL prepared in conjunction with finalizing the purchase price adjustment provided for in the SBCL acquisition agreements, as described above, (2) to reflect the reduction in the purchase price of the SBCL acquisition, (3) to reflect the completion of the purchase price allocation and (4) to revise other adjustments that had been reflected in the previously reported pro forma combined financial information. The unaudited pro forma combined financial information included in this Form 10-K reflects the revised pro forma combined financial information included in the Form 8-K referred to above.

None of the adjustments, resulting from the reduction in the SBCL purchase price or the completion of the purchase price allocation, had any impact on the Company's previously reported historical financial statements.

The unaudited pro forma combined financial information is presented for illustrative purposes only to assist in analyzing the financial implications of the SBCL acquisition and borrowings under the Credit Agreement. The unaudited pro forma combined financial information may not be indicative of the combined financial results of operations that would have been realized had Quest Diagnostics and SBCL been a single entity during the periods presented. In addition, the unaudited pro forma combined financial information is not necessarily indicative of the future results that the combined company will experience.

Significant pro forma adjustments reflected in the unaudited pro forma combined financial information include reductions in employee benefit costs and general corporate overhead allocated to the historical results of SBCL by SmithKline Beecham, offset by an increase in net interest expense to reflect the Company's new credit facility which was used to finance the SBCL acquisition. Amortization of the goodwill, which accounts for a majority of the acquired intangible assets, is calculated on the straight-line basis over forty years. Income taxes have been adjusted for the estimated income tax impact of the pro forma adjustments at the incremental tax rate of 40%. A significant portion of the intangible assets acquired in the SBCL acquisition is not deductible for tax purposes, which has the overall impact of increasing the effective tax rate.

Both basic and diluted weighted average common shares outstanding have been presented on a pro forma basis giving effect to the shares issued to SmithKline Beecham and the shares granted at closing to employees. Potentially dilutive common shares primarily represent stock options. During periods in which net income available for common stockholders is a loss, diluted weighted average common shares outstanding will equal basic weighted average common shares outstanding, since under these circumstances, the incremental shares would have an anti-dilutive effect.

Unaudited pro forma combined financial information for the years ended December 31, 1999 and 1998 was as follows (in thousands, except per-share data):

Exhibit 1-3 *(Concluded)*

	1999	1998
Net revenues	$3,294,810	$3,021,631
Income (loss) before extraordinary loss	(33,539)	50,209
Net income (loss)	(35,678)	50,209
Basic earnings (loss) per common share:		
Income (loss) before extraordinary loss	$ (0.78)	$ 1.16
Net income (loss)	$ (0.83)	$ 1.16
Weighted average common shares outstanding—basic	43,345	43,031
Diluted earnings (loss) per common share:		
Income (loss) before extraordinary loss	$ (0.78)	$ 1.15
Net income (loss)	$ (0.83)	$ 1.15
Weighted average common shares outstanding—diluted	43,345	43,440

Source: Quest Diagnostics Inc. 10-K 2000-12-31. This disclosure originally appeared in the Quest Diagnostics Inc. 1999 Annual Report and was presented again for comparative purposes in the 2000 Annual Report.

Accounting for the Purchase by the Selling Company

The goodwill recorded by the buyer is not tied to the gain (or loss) recorded by the seller. The seller records the removal of net assets at their book values. The excess of the price received by the seller ($350,000[12]) over the sum of the net asset book values ($173,000 assets − $25,000 liabilities) is recorded as a gain on the sale. In this case, the gain is $202,000. The entry on Johnson's books would be as follows:

Investment in Acquisitions Inc. Stock	350,000	
Current Liabilities	5,000	
Bonds Payable	20,000	
Accounts Receivable		28,000
Inventory		40,000
Land		10,000
Buildings (net)		40,000
Equipment (net)		20,000
Patent (net)		15,000
Goodwill (preexisting)		20,000
Gain on Sale of Business		202,000
Dr. = Cr. Check Totals	*375,000*	*375,000*

The only remaining asset of Johnson Company is cash. Johnson would typically distribute the stock received to its shareholders and cease operations.

12 Remember that the $10,000 in direct acquisition costs is paid by the purchaser to a third party, not to the seller.

REFLECTION

- The buyer records all accounts, including identifiable intangible assets, at fair value.
- Existing book values, including existing goodwill, do not affect the amount assigned to accounts.
- In the period of the purchase, the amounts assigned to accounts must be disclosed.
- The entry of the seller is based on book values and records a gain for the excess of the price over the net book value of the assets transferred.

Accounting for the Acquired Assets and Liabilities after the Purchase

objective: **6**

Account for acquired assets and liabilities subsequent to a purchase, and apply impairment testing to goodwill.

Normal depreciation and amortization procedures are applied to the newly acquired identifiable tangible assets and to the liabilities. FASB Statement No. 142 requires special amortization and impairment procedures for intangible assets. Goodwill is not subject to amortization but has unique impairment testing procedures.

Tangible Assets and All Liabilities

All tangible asset accounts are considered newly acquired and are accounted for based on their assigned values and, when applicable, anticipated lives. The accounting procedures for the acquired tangible accounts are as follows:

Inventory—Maintained at assigned fair value until sold. Upon sale, the fair value is assigned to the cost of goods sold.

Receivables—Accounts and notes receivable may be adjusted to a lower amount by using an allowance for bad debts. Once created, the allowance is accounted for in the normal manner. Adjustments to notes receivable and other debt investments may be necessary due to a change in interest rates. An adjustment to reflect a change in interest rates is amortized as a premium or discount over the remaining term of the investment.

Equity Investments—They are adjusted to a new fair value that will be their cost for all subsequent fair value adjustments and sales.

Fixed Assets—These are fixed assets used by the business, such as land, buildings, and equipment. Except for land, depreciation will be calculated on the newly assigned value, using the newly estimated salvage value and remaining life. Any appropriate depreciation method may be used. Long-lived assets are also subject to impairment testing under FASB Statement No. 121. Impairment testing requires that assets, or groups of assets, be tested for future cash flows upon the occurrence of certain events that could suggest a decline in value. When the anticipated, undiscounted, future cash flows are less than carrying value, the assets are adjusted down to their fair value.[13]

Liabilities—Current liabilities are adjusted to fair value and are paid at that amount. Long-term liabilities are recorded at their legal face value, and a premium or discount is recorded and then amortized over the life of the liability.

13 FASB Statement No. 121, *Impairment Testing of Long-lived Assets and for Long-lived Assets to be Disposed of* (Norwalk, CT: Financial Accounting Standards Board, 1995) par. 4–11.

Separately Identified Intangible Assets

Intangible assets with a determinable life are to be amortized over their useful economic lives. Where a residual value at the end of the economic life can be estimated, it is subtracted from the amount to be amortized. There is no maximum amortization period. The amortization method should reflect the pattern of benefits conveyed by the asset, but if the pattern cannot be reliably determined, the straight-line method is to be used. As with other long-lived assets, intangible assets are subject to normal asset impairment testing under FASB Statement No. 121.

In the period that the purchase occurs, there must be a footnote disclosure of the following information if intangible assets were a material amount of the price paid:

- For intangible assets subject to amortization, disclose the following:
  1. The total amount assigned to intangible assets and the amounts assigned to each major class of intangible assets.
  2. The amount of any significant residual values in total and by major classes of intangible assets.
  3. The weighted average amortization period applicable to all intangible assets and to major classes of intangible assets.
- For intangible assets not subject to amortization, disclose the total amount assigned to these assets and to each major class of such intangible assets.

FASB Statement No. 142 states that "If no legal, regulatory, contractual, competitive, economic, or other factors limit the useful life of the intangible asset to the reporting entity, the useful life of the asset shall be considered to be indefinite."[14]

Intangible assets with indefinite economic lives are not amortized until a determinable life can be established. An indefinite economic life is not synonymous with an infinite life; rather, it means that the life extends beyond the foreseeable horizon. Intangible assets not subject to amortization are subject to separate impairment testing on an annual basis or on an interim basis if it appears that impairment has occurred. An impairment loss is recorded if the fair value of the intangible asset is less than the book value.

The notes to each period's financial statements must include total carrying amounts and cumulative amortization for each major class of identifiable intangible asset subject to amortization. Amortization expense must also be disclosed for the period. The notes must also include the estimated annual amortization expense for each of the next five fiscal periods.

Example of Future Effects

At the time of the purchase, amortization procedures will be determined for all assets and liabilities acquired. Let us assume that Acquisitions Inc. adopted the following amortization policies for the assets and liabilities acquired in the purchase of Johnson Company. [The asterisk (*) identifies an adjustment that applies only to the year following the purchase.]

Accounts	Assigned Value	Amortization Procedure	Amortization Amount
Accounts receivable	$ 28,000	None	
Inventory	45,000	Sold during the first year	$45,000*
Land	50,000	Not amortized; realized when sold	
Building	80,000	$0 salvage, 20 years, straight-line	4,000
Equipment	50,000	$10,000 salvage, 5 years, straight-line	8,000
Patent	30,000	No salvage, 4-year estimated useful life, straight-line	7,500

(continued)

14 FASB Statement No. 142, *Goodwill and Other Intangible Assets*, par. 11.

Accounts	Assigned Value	Amortization Procedure	Amortization Amount
Brand-name copyright . . .	40,000	No salvage, 10-year estimated useful life, straight-line	4,000
Goodwill	63,000	No amortization (will be subject to impairment procedures)	
Current liabilities	(5,000)	None	
Notes payable	(21,000)	$1,000 premium amortized over 5 years straight-line, reduces interest expense	(200)
Net assets acquired . .	**$360,000**		

Acquisitions Inc. might also do a pro forma analysis of what the impact of the purchase will be on future income. Future financial statements will be based on the combined transactions of both companies. There will no longer be separate accounts maintained for each of the former companies. Thus, all of the above adjustments will be included in the accounts of Acquisitions Inc.

Acquisitions Inc.
Pro Forma Income Statement
For the Year Ending December 31, 20X2

Adjustments Necessary Due to Purchase of Johnson Company		
Sales revenue		$350,000
Less: Cost of goods sold (includes $45,000 Johnson inventory)		130,000
Gross profit		$220,000
Selling expenses (includes $4,000, copyright amortization)	$44,000	
Administrative expenses (includes $5,000, employee training amortization)	63,000	
Depreciation—building (includes $4,000, Johnson building)	25,000	
Depreciation—equipment (includes $8,000, Johnson equipment)	18,000	
Patent amortization (for Johnson patents)	7,500	
Total operating expenses		157,500
Operating income		$ 62,500
Less: Interest expense (minus $200 premium amortization)		9,800
Income before taxes		$ 52,700
Provision for income tax (40%)		(21,080)
Net income		$ 31,620

Goodwill Impairment

Goodwill is not amortized but is subject to separate and distinct impairment procedures. Five specific concerns need to be addressed:

1. Goodwill must be allocated to reporting units if the purchased company contains more than one reporting unit.
2. A reporting unit valuation plan must be established within one year of a purchase. This sets forth the procedures that will be used to measure the fair value of reporting units in future periods.
3. Impairment testing is normally done on an annual basis. There are, however, exceptions to annual testing and some cases where testing may be required *between* annual testing dates.
4. The procedure for determining if impairment has occurred must be established.
5. The procedure for determining the amount of the impairment loss, which is also the decrease in the goodwill amount recorded, must be established.