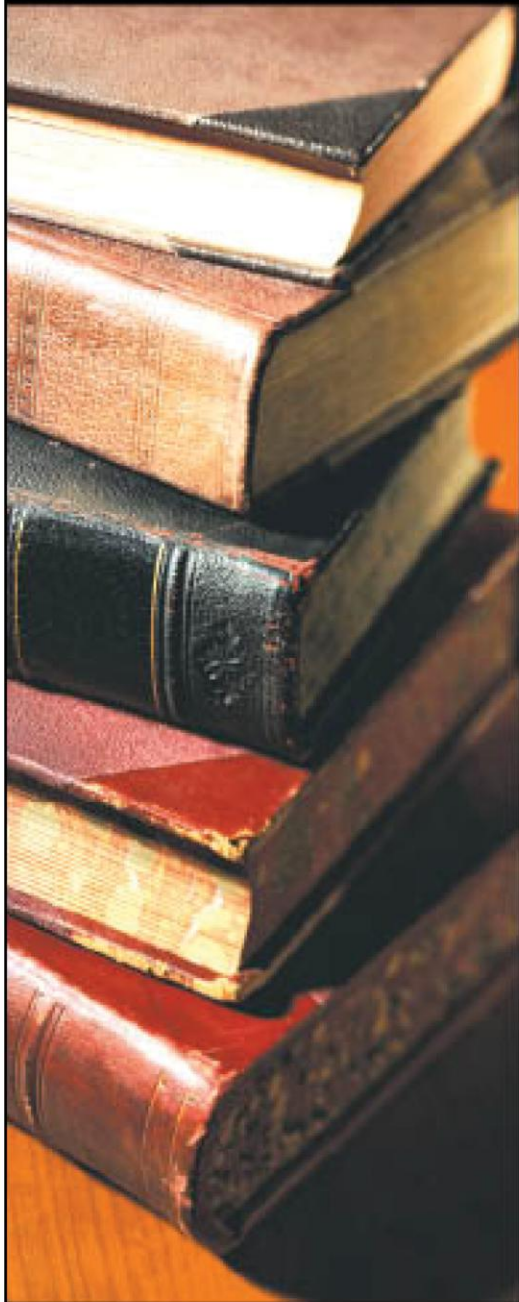


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## **Business Combinations and Consolidated Financial Reporting**

Course #6660/QAS6660

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# Business Combinations and Consolidated Financial Reporting (Course #6660/QAS6660)

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# Chapter 1: Business Combinations

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## Learning Objectives:

After completing this chapter, you should be able to:

- Account and report for a business combination using the purchase method
- Record preacquisition contingencies during the allocation period as a cost element of the investment
- Explain tax considerations when using the purchase method

Business combinations in the form of mergers and acquisitions of business entities occur when companies choose to combine (rather than grow internally) to take advantage of cost efficiencies or transform their businesses to the next level. The result of a business combination is that the combined company may have additional product offerings, greater geographic presence, increased market share, as well as control over all sources of production and product distribution (vertical integration). The accountant is frequently called upon to advise management of the impact of proposed combinations, as well as to prepare consolidated financial statements for completed transactions. Knowledge of the emerging accounting rules in this area is critical in supporting both functions.

## REVIEW

The degree to which one corporation (investor) acquires an interest in the common stock of another corporation (investee) generally determines the accounting treatment for the investment subsequent to acquisition. The classification of such investments depends on the percentage of the investee voting stock that is held by the investor:

1. Holdings of less than 20 percent (**fair value method**)—investor has passive interest.
2. Holdings between 20 percent and 50 percent (**equity method**)—investor has significant influence.
3. Holdings of more than 50 percent (**consolidated statements**)—investor has controlling interest.

Exhibit 1-1 lists these levels of interest or influence and the corresponding valuation and reporting method that companies must apply to the investment.

### Exhibit 1-1: Three Levels of Influence and Accounting Methods

Percentage of Ownership	0% <-----> 20%	20% <-----> 50%	50 <-----> 100%
<b>Level of Influence</b>	Little or None	Significant	Control
<b>Valuation Method</b>	Fair Value Method	Equity Method	Consolidation

## BACKGROUND

For many years, GAAP permitted business combinations to be structured as either a pooling of interests or as a purchase of one corporation by the other. Historically, much of the controversy concerning accounting requirements for business combinations involved the pooling of interests method. Because a pooling received favorable accounting treatment (among other things, assets and liabilities did not have to be remeasured to fair value), businesses had a strong incentive to structure any combination as a pooling. **In 2001, the FASB ended the use of pooling-of-interests accounting for all new combinations.**

With the exception of the elimination of pooling of interests for new acquisitions (in 2001) and the required consolidation of variable interest entities (revised in 2003), the accounting rules for business combinations and consolidations remained largely unchanged for over 50 years until December 2007, when the Financial Accounting Standards Board (FASB), after many years of deliberation, simultaneously issued two new standards reflected in the Codification as ASC 805, *Business Combinations*, and ASC 810, *Consolidation*. These statements, which require prospective treatment for **new business combinations having fiscal years beginning after December 15, 2008**, mandate what is referred to as the *acquisition method*. Moreover, **the purchase method of accounting will no longer be permitted for acquisitions closed after the effective date of the new rules.**

A critical distinction is that the new rules abandon the historical cost-based structure of accounting for acquisitions at the price paid and require that consolidation of the acquiree is at “business fair value.” As retroactive adoption of the new standards is not permitted, mergers completed before the effective date must continue to be treated in accordance with the accounting standards that were in effect at the date of the original business combination. Therefore, there will continue to be many mergers that will be “grandfathered” under the accounting rules in existence at the dates they were completed (i.e., purchase method and pooling of interests method).

This chapter and Chapter 2, *Consolidated Financial Reporting*, emphasize both the theory and practice relating to the new standards (i.e., the **acquisition method**). However, since preexisting accounting methods (e.g., poolings and purchase method) will continue to be used for transactions closed before the effective dates of ASC 805 and ASC 810, a comparison of old and new rules prepare practitioners for dealing with the variety of practices they will encounter at their clients or employers.

## RELEVANT ACCOUNTING PRONOUNCEMENTS

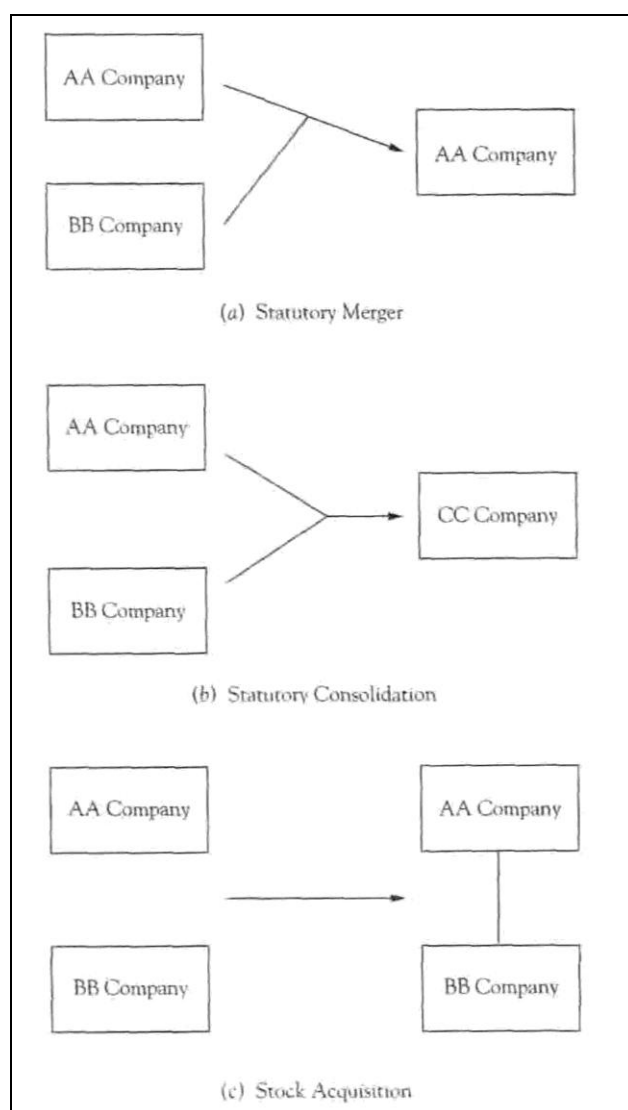
Business combinations are accounted for in accordance with ASC 805, ASC 350, *Intangibles—Goodwill and Other*, and ASC 810. Applicable Emerging Issues Task Force bulletins have been incorporated in the above Codification sections.

## FORMS OF BUSINESS COMBINATIONS

In practice, there generally are three forms of business combinations. Deciding on the appropriate form to use is driven by a combination of legal, tax, regulatory, marketing, and operational issues. Exhibit 1-2 illustrates the three primary legal forms of business combinations. These business combinations are as follows:

1. *Statutory merger*: The acquirer purchases either the net assets of the target company or acquires the stock of the target (acquiree) company; in either case, the acquiree company is dissolved, as the acquirer brings the assets and liabilities of the acquiree on its books and cancels the stock of the acquiree.
2. *Statutory consolidation*: A new company is formed by the combination of two or more companies; the previous companies no longer exist but may become operating divisions of the new company.
3. *Stock acquisition*: The acquirer purchases the stock or net assets of the acquiree and operates it as a direct (wholly or majority owned) subsidiary of the acquirer (the parent). Unlike a statutory merger and statutory consolidation, there is a need to consolidate the accounts of the parent and subsidiary into a consolidated economic entity. Effective with ASC 805 and ASC 810, the *acquisition method* is the required method to account for business combinations having a closing date in fiscal periods beginning after December 15, 2008.

### Exhibit 1-2: Types of Business Combinations



## THE ACQUISITION METHOD

The acquisition method requires that the acquired company be reported in consolidation at business fair value. Acquiree assets and liabilities along with the fair value of unrecorded acquiree intangible assets will be reported in consolidation at fair value. The acquiree accounting records will continue to maintain the carrying values using the basis of accounting that was in existence prior to the acquisition. Fair value consolidation adjustments will be prepared on a worksheet used to effect the business combination and generally will not be posted to either the parent or subsidiary accounting records (for exceptions, see the discussion of push down accounting). Goodwill is recorded where the fair value of consideration transferred plus any fair value of the noncontrolling (minority) interest in the acquiree exceeds the fair value of net assets acquired.

When the fair value of consideration transferred plus any fair value of the noncontrolling (minority) interest in the acquiree is less than the fair value of net assets acquired, a gain from bargain purchase is recorded on the consolidated income statement in the accounting period that the acquisition takes place.

## ACCOUNTING AND REPORTING UNDER THE ACQUISITION METHOD

Accounting for the three forms of business combinations (i.e., statutory merger, statutory consolidation, and acquisition) under the new accounting rules (ASC 805 and ASC 810) is discussed below, followed by a comparison of the new accounting rules with the “grandfathered” previous accounting rules and ASC 810-10-10). The “grandfathered” rules do not appear in the Codification, but continue to be applicable to acquisitions completed on or before December 15, 2008.

### Statutory Merger

Statutory mergers can be structured in one of two ways:

1. The acquirer purchases the assets and liabilities of the acquiree and dissolves the acquiree:
  - a. The assets and liabilities, as well as any unrecorded intangibles of the acquiree are recorded at fair value directly on the acquirer’s books.
  - b. Any excess of fair value of consideration transferred (generally the purchase price) over the fair values of the net assets (and intangibles) acquired is recorded as goodwill (where there is a purchase of 100% of acquiree stock).
  - c. If acquiree fair values are greater than the consideration transferred, a gain on bargain purchase occurs.
  - d. None of acquiree equity will appear on the consolidated financial statements.
2. The acquirer purchases the stock of the acquiree (debit investment in acquiree, credit cash, debt, or stock of the acquirer) and dissolves the acquiree:
  - a. Records the net assets on the books of the acquirer at fair value as in 1 above.

### Example

ABC Corporation pays \$10 million to acquire 100% ownership of XYZ Corporation in a transaction that will be treated as a statutory merger. The purchase price equals business fair value. The fair value of XYZ assets is \$15 million and the fair value of XYZ liabilities is \$5 million. The accounting entries on ABC Corporation are as follows:

1. Dr. Investment in XYZ Corporation	\$10 million	
Cr. Cash or other form of payment		\$10 million
2. Dr. Assets (from XYZ)	\$15 million	
Cr. Liabilities (from XYZ)		\$ 5 million
Cr. Investment in XYZ Corp		\$10 million

XYZ Corporation will then liquidate (debit liabilities and equity, credit assets) and cease to exist.

### Statutory Consolidation

In this transaction, the acquirer and acquiree company merge to form a new company. Under the acquisition method, the new company records the assets, liabilities, and previously unrecorded intangibles of the acquirer and acquiree at fair value. The new company then cancels the common stock of the predecessor companies, which go out of existence.

#### Example

Rim Company and Boyce Company agree to combine in a statutory consolidation. It is agreed that a new company, Weston Incorporated, will be the successor company and receive the net assets of Rim and Boyce. Under the acquisition method, Weston will record, at fair value, the net assets of Rim and Boyce. Any excess of consideration transferred to the owners of Rim and Boyce over the fair value of net assets acquired will be reported as goodwill by Weston.

### Acquisition

The acquiree will be operated as a subsidiary of the acquirer. The assets, liabilities, and stockholders' equity of both companies will continue to be recorded using the same basis of accounting that was used previously. Consolidated financial statements will be prepared using the worksheet techniques described more fully in the next chapter, *Consolidated Financial Reporting*. Briefly, the carrying amounts (book values) from the parent and subsidiary will be subtotaled and the appropriate elimination entries for intercompany transactions will be posted to the worksheet along with the acquiree fair value adjustments and elimination of subsidiary capital accounts and previously calculated acquiree goodwill. These are illustrated in the next chapter. Acquiree intangible assets and goodwill are treated identically for each of the three business combinations (i.e., statutory merger, statutory consolidation, and acquisition), as discussed below.

### Treatment of Intangible Assets

Acquiree intangible assets are recorded in the consolidated financial statements at fair value as of the *date of acquisition*, even if not previously recorded on the acquiree books. A common example is the fair value of customer lists that must be appraised based on the size, profitability, and expected longevity of the customer relationship. Other purchased intangibles are included in investment cost only if contractual in nature (e.g., patents, copyrights, trademarks) or separable (i.e., are capable of alternative future use).



## Definition of Goodwill under the Acquisition Method

Goodwill is defined as: (the fair value of consideration transferred + the fair value of any noncontrolling interest in the acquiree + the fair value of any previously held equity interest in the acquiree) - the fair value of net assets acquired.

### Example 1

On July 1, 2X13, Jeffries Incorporated issues 40,000 shares of its common stock in exchange for an initial acquisition of 80% of Bromard's outstanding shares. The aggregate fair value of the shares issued is \$4,000,000 (\$100 per share). It is determined by independent appraisal that the remaining 20% of Bromard has a fair value of \$800,000. It is also determined that the fair value of 100% of the Bromard's net assets at date of acquisition is \$4,200,000. What is the goodwill?

### Solution

Goodwill = Fair value of consideration transferred (\$4,000,000) + fair value of noncontrolling interest (\$800,000) + fair value of previously held equity interest (0) - fair value of net assets acquired (\$4,200,000) = \$600,000

### Example 2

Same facts as above, but the fair value of Bromard's net assets at date of acquisition is \$5,000,000.

### Solution

In this second example, there is a \$200,000 excess of fair value of net assets acquired over fair value of consideration transferred + the fair value of the noncontrolling interest. The result is a \$200,000 gain on the bargain purchase that is recognized in the consolidated income statement in the period of acquisition.

## Treatment of Goodwill

Amortization of goodwill is *no longer* allowed. Goodwill recorded in consolidation is subject to an annual impairment test. This test is applied to the business segments of the consolidated entity based on the following steps:

1. If the fair value of the business segment is less than the carrying value, including goodwill, proceed to step 2. If the carrying value of the business segment is zero or negative, it will still be necessary to perform step 2 of the goodwill impairment test if there are adverse qualitative factors indicating impairment may exist. Such factors may include an adverse change in legal factors or business climate, an adverse action or assessment by a regulator, unanticipated competition, a loss of key personnel, a more likely than not expectation that a reporting unit (or significant portion) will be sold or disposed of, impairment of a long lived asset within the reporting unit or recognition of an impairment loss in a subsidiary that is a component of the reporting unit. Note that the above guidance (for business segments with zero or negative carrying value) was adopted in late 2010 *and is effective for fiscal years beginning after December 15, 2011*. It is particularly targeted at companies with a single (or very few) business segments that were previously able to avoid performing step 2, below of the impairment test. (ASC 350-20-35-8A)

2. If the implied value of goodwill of the business segment is greater than the carrying value of goodwill, goodwill impairment is recognized equal to the shortfall (Dr. Goodwill Impairment Loss, Cr. Goodwill). If it is not, there is no goodwill impairment.

The following example illustrates this test:

### Example

Adams Company has \$70,000,000 in goodwill associated with its acquisition one year ago of Baker Company. Adams is required to test for impairment using the following steps:

1. At date of acquisition, goodwill is assigned to each of Adam's business segments; in this example, Adams has three divisions comprising its business segments, with book values excluding goodwill of: Division A—\$60 million, Division B—\$220 million, Division C—\$180 million. The goodwill assigned to the three divisions is \$20 million, \$30 million and \$20 million, respectively.
2. The book value (net assets) of each division inclusive of the allocated goodwill (from step 1) is compared to the fair value of each division; that is, the theoretical price at which the division could be sold. The fair values of the three divisions are \$90 million, \$200 million, and \$300 million, respectively. (Note that these amounts may be determined by consultation with an expert in the field of mergers and acquisitions.)
3. If the fair value of each division is greater than the book value inclusive of goodwill, no further testing is required and there is no goodwill impairment. If the fair value of any division is less than the book value inclusive of goodwill, proceed to step 4 for that division. In this problem, the fair value of the individual net assets of Division B is given at \$180 million.
4. Compute the implied value of goodwill. This is equal to the fair value of the division (price at which it could be sold) minus the fair value of the specific net assets of the division. If the implied value of goodwill is less than the book value of goodwill, the difference must be written off as an impairment loss on goodwill. If the implied value of goodwill is greater than the book value of goodwill, no impairment has taken place.

### Solution

(\$ millions)

	<i>Book Value (without Goodwill)</i>	<i>Goodwill</i>	<i>Book Value (with Goodwill)</i>	<i>Fair Value</i>	<i>Further Testing</i>
Division A	60	20	80	90	No
Division B	220	30	250	200	Yes
Division C	180	20	200	300	No
Total	460	70	530	590	

Following the above rules, Division B requires further testing, as its fair value is less than the book value of net assets inclusive of goodwill.

Fair value of Division B (per above)		200	
Fair value of individual net assets of Division B		180	
Implied value of goodwill		20	
Book value of goodwill		30	
Writedown of goodwill		10	
Journal entry:			
	Dr. Impairment Loss on Goodwill	\$10 million	
	Cr. Goodwill		\$10 million

Note that when a previously acquired subsidiary is sold, any remaining goodwill must be reduced to zero as part of the calculation of the gain or loss on sale.

**Note:** The cost of developing, maintaining, or restoring intangible assets that (1) are not specifically identifiable, (2) have indeterminate lives, or (3) are inherent in a continuing business and related to an enterprise as a whole should be expensed as incurred.

### Income Statement Reporting

Under the *acquisition method*, income and expenses of the acquiree are recognized prospectively beginning from the date of acquisition. Under the acquisition method, preacquisition income (income earned by the acquiree before the effective date of the transaction) is **not** reported on the consolidated financial statements. **Note:** This represents a **departure** from the *purchase method*, where preacquisition earnings of the acquiree were deducted from full-year consolidated earnings on the income statement.

### Direct Combination Costs and Stock Issuance Costs

Direct combination costs associated with completing the business combination (e.g., legal, accounting, consulting, appraisals, and finders fees) is treated as an operating expense under the acquisition method. When the acquirer issues stock in conjunction with a business combination, any stock issuance costs, such as underwriter costs and exchange fees, are treated as a reduction (debit) to Additional Paid in Capital.

According to **Accounting Standards Update** (ASU) No. 2010-22 (August 2010), *Accounting for Various Topics*, fees to an investment banker for underwriting services related to a business combination or purchase of an asset should be allocated between acquisition-related services and debt issue costs based on fair value.

### Restructuring Costs

It is common to find that shortly after the announcement of an acquisition, the acquirer will establish a provision for restructuring costs, as well as announce anticipated savings. The restructuring cost can be recognized as part of the Investment in Subsidiary if certain conditions are met. These conditions are similar to the criteria for recognition of a liability if no acquisition had taken place; that is, a formal plan of restructuring needs to have the approval of the Board of Directors of the acquirer. If these conditions are not met, restructuring costs will need to be expensed.

## Preacquisition Contingencies

Under ASC 805, contractual preacquisition contingencies of the acquiree must always be measured at acquisition date fair value, resulting in either an increase or decrease to the debit to the acquirer's investment account. Noncontractual contingencies such as outstanding acquiree litigation are recorded at acquisition date fair value only when they meet the "more likely than not" criteria for definition of an asset or liability.

## Contingent Consideration

This consideration relates to an additional amount paid by the acquirer to the shareholders of the acquiree if certain conditions are met. Most commonly, this relates to whether the acquiree is able to meet future earnings targets specified in the merger agreement. Under the acquisition method, such "earn-outs" or other forms of contingent consideration are recorded at fair value as part of the debit to the investment account at the acquisition date. Subsequent changes in the fair value of contingent consideration are recorded in earnings and not as an adjustment of investment cost. An exception is when the contingent consideration qualifies as equity, there is no subsequent adjustment to fair value.

Subsequent adjustments under the acquisition method will require revision of prior period previously issued financial statements.

## Push Down Accounting

While the FASB has given extensive guidance on how consolidated financial statements should be prepared to reflect a business combination, less attention has been given to how an acquired subsidiary reflects assets and liabilities on its books. One view is that the subsidiary should maintain its previous basis of recording, be that historical cost, market value, or other basis of accounting. According to that view, all fair value adjustments to prepare consolidated financial statements would appear on a worksheet only, and not be posted to the subsidiary's general ledger.

Under the alternative view, the change in ownership resulting from the acquisition of the subsidiary results in a new measurement basis for that company. That measurement basis is fair value and the balances on the subsidiary's general ledger are adjusted to fair value. This eliminates the need for certain consolidation worksheet adjustments, as these are now made directly to the affected accounts on the subsidiary's books. This view is referred to as *push down accounting*.

The differences in the two views becomes important if the subsidiary issues separate GAAP financial statements, which could be required if the subsidiary issues stock or requires a loan. The SEC, which governs reporting by publicly held companies, has, in ASC 805, *Business Combinations: Related Issues* (ASC 805-50-S99) and ASC 805-50-S99, indicated that push down accounting should be used in separately issued financial statements of a subsidiary when that subsidiary is "substantially wholly owned" (i.e., generally, greater than 95% ownership). The rationale is that if the subsidiary were merged into the parent as a statutory merger, the accounting basis for acquired assets and liabilities would be fair value under the acquisition method and that the basis of accounting should not be different when the parent decides to maintain the existence of the subsidiary.

## Contrast of Acquisition Method with Purchase and Pooling of Interest Methods

Prior to the effective dates of ASC 805 and ASC 810, previously completed business combinations were accounted for under the purchase method or the pooling of interest method. Since the new rules are grandfathered, those business combinations will continue to be accounted for under the rules that were in place at the time the transaction closed. A listing of the main points of each method is as follows:

- *Acquisition method (effective for new acquisitions by acquirers having fiscal years beginning after December 15, 2008):*
  - Focus is on fair value of the acquired entity.
  - Direct combination costs are expensed.
  - Stock issuance costs are treated as a reduction of Additional Paid in Capital.
  - Bargain purchase is treated as income to the acquirer.
  - Fair value of contingent consideration at acquisition date is considered part of the fair value of the acquired entity.
  - Subsequent resolution of contingent consideration at a value different from that recorded at acquisition date is run through the income statement.
  - Acquiree in process research and development costs and other purchased intangibles are recorded at fair value at acquisition date.
  - Preacquisition contingencies that are resolved after the acquisition closing date are expensed.
  - Acquiree assets and liabilities are reported in the consolidated entity at fair value.
- *Purchase method (effective for acquisitions closed prior to December 15, 2008, that have been accounted for under the purchase method):*
  - Acquisitions continue to be accounted for under the purchase method.
  - Focus is on historical cost of the acquisition (i.e., the price paid to acquire an entity).
  - Direct combination costs are capitalized as part of the investment cost.
  - Stock issuance costs are treated as a reduction of Additional Paid in Capital.
  - Bargain purchase results in a proportional reduction of noncurrent assets of the acquiree with any excess treated as an extraordinary gain.
  - Contingent consideration is not recorded as part of acquisition cost until it is subsequently resolved. (**Note:** If the resolution of the contingency requires an additional payment to be made by the acquirer, that payment will either increase goodwill or lessen the reduction to noncurrent assets in the case of a bargain purchase.)
  - Acquiree in process research and development costs are included in acquisition cost only where considered either technologically feasible or subject to alternative future use.
  - Assets and liabilities of the acquiree are reported at fair value, subject to any reduction in acquiree noncurrent assets due to a bargain purchase.
- *Pooling of interest method (effective for acquisitions completed prior to June 30, 2001, assuming they met all 12 of the specific criteria in existence at that time):*
  - Acquisitions will continue to be consolidated under this method, until the entities are sold, closed, or otherwise disposed of.
  - Assets and liabilities are consolidated at their book values.
  - There are no adjustments to either the balance sheet (fair value allocations) or the income statement (amortization of fair value adjustments).

- Income and expense of the acquiree are reported retrospectively; that is, they are retroactively restated for all periods presented.

Exhibit 1-3 presents the main differences between the acquisition and purchase methods of accounting.

**Exhibit 1-3: Acquisition Method vs. Purchase Method**

	<b><i>New Rules (Acquisition Method) ASC 805; ASC 810</i></b>	<b><i>Old Rules (Purchase Method) ASC 805; ASC 810</i></b>
<i>Focus</i>	Fair value of entity acquired, referred to as “business fair value”	Historical cost; i.e., price paid to acquire the entity
<i>Direct combination costs</i>	Expensed	Treated as part of cost of acquisition
<i>Bargain purchase</i>	Recognize as income on transaction closing date	Reduce noncurrent assets proportionately; any excess is extraordinary gain
<i>Stock issuance costs</i>	Decrease (debit) to Additional Paid In Capital	Same
<i>Contingent consideration</i>	Recorded at fair value at transaction closing date; subsequent changes in fair value recorded in income statement	Not recorded as part of acquisition cost until contingency is resolved. This will result in additional goodwill or less reduction to noncurrent assets (bargain purchase)
<i>In process research and development costs</i>	Capitalize at fair value as intangible assets, subject to impairment testing or amortization	Expensed
<i>Preacquisition contingencies</i>	Contractual contingencies recorded at fair value; noncontractual contingencies recorded at fair value if they meet “more likely than not” criteria for definition of an asset or liability	Not recorded unless ASC 450 criteria are met (i.e., probable and reasonably estimable)
<i>Valuation of equity issued</i>	Fair value at transaction closing date	Fair value at the date the acquisition is announced
<i>Other intangible assets</i>	Recorded at fair value	Recorded as part of investment cost if meeting contractual criteria (e.g., patents) or separability (e.g., technology)

## Steps to Accounting under the Acquisition Method

The following steps are taken in accounting for a business combination under the acquisition method:

1. Assets and liabilities of the acquired business are recorded at fair market value as follows: Trading securities are at market value. Receivables are recorded at the discounted present value of amounts to be received using current interest rates, less allowance for bad debts and collection costs. Raw materials are recorded at current replacement cost. Work in process is recorded at estimated net realizable value of finished goods less the costs to complete and the profit allowance. Finished goods are recorded at estimated net realizable value less a reasonable profit allowance (lower limit). Fixed assets to be used in the business are recorded at replacement cost. If the fixed assets are to be sold, they are recorded at fair value less cost to sell. Intangibles and other assets are recognized at appraised values. Any duplicate assets that are to be disposed of are recorded at estimated net salvage value. If there is no net salvage value, a zero valuation is assigned. Liabilities are typically recorded at the discounted present value of amounts to be paid based on current interest rates.
2. The excess of the fair value of consideration transferred over the fair value of net assets acquired is assigned to goodwill, which is subject to an annual impairment test.
3. Goodwill previously recorded by the acquiree is not brought forward.
4. The excess of the fair value of net assets received over the fair value of consideration transferred is recorded as a gain on bargain purchases.
5. None of the stockholders' equity accounts of the acquired company is shown on the acquirer's books or in the consolidated financial statements.
6. Net income of the acquired business is recognized from the acquisition date to year-end.
7. Direct costs of the acquisition (e.g., legal, accounting, consulting, engineering evaluation, appraisal, and finders' fees) are expensed. Indirect and general costs (internal costs) are also expensed as incurred. If the acquirer pays fees to an investment banker for advice and assistance, such costs must be expensed. The costs of registering and issuing any debt or equity securities to effect the combination are accounted for as any other issue cost; that is, the issuance cost for debt is deferred and amortized over the term of the debt using the interest method, and the cost of issuing stock (e.g., underwriting fees) is a reduction of additional paid-in-capital. Liabilities and commitments for the costs of closing an acquired company's plant are considered direct costs of the acquisition and are expensed. However, the costs of closing a duplicate plant of the acquirer are not part of the acquisition cost.

According to ASC 805-20-55-51, termination or employee relocation costs arising because of a business combination should be accrued when the combination is consummated.

A purchase of stock appreciation rights (awards) or stock options by an acquired company related to a business combination should be accounted for as compensation expense rather than as an element of acquisition cost by the acquirer.

If debt securities are issued in the acquisition, they should be recorded at their fair value based on the present value of the debt payments discounted at the market interest rate. Any difference between face value and present value is recorded as discount or premium on the debt.

In determining the fair value of securities issued in a business combination, consideration should be given to the quantity issued, price variability, and issue costs.

There is a step-by-step acquisition process to be followed:

- If control is not achieved on the initial purchase, the subsidiary is not included in consolidation until control has been achieved.
- After the parent owns more than 50% of the subsidiary, a retroactive adjustment is required, including the subsidiary's profits in consolidated retained earnings, in a step-by-step manner starting with the original investment.
- The subsidiary's profits are included in ownership years at the applicable percentage owned.

### Example

On October 31, 2X13, Kravis Company bought for cash at \$10 per share all 300,000 of Hartman's outstanding common stock. It is agreed that the purchase price equals business fair value. At October 31, 2X13, Hartman's balance sheet showed a book value of net assets of \$2,500,000. At that date, the fair value of Hartman's fixed assets exceeded its book value by \$300,000. In the October 31, 2X13 consolidated balance sheet, Kravis reports goodwill of \$200,000, computed as follows:

Fair value of consideration transferred (\$10x300,000 shares)	\$3,000,000
Book value of net assets acquired	2,500,000
Excess of cost over book value	<u>\$ 500,000</u>
Excess of fair value over book value of fixed assets	300,000
Goodwill	<u>\$ 200,000</u>

### Example

ABC Co. purchases 100% interest in common stock of DEF Co. for \$1,800,000. The journal entry to reflect the initial investment is:

Investment in DEF Company	1,800,000	
Cash		1,800,000

### Example

Moses Company bought 100% of Rolo Company in a business combination on September 30, 2X13. During 2X13, Moses declared dividends of \$20,000 per quarter, and Rolo declared quarterly dividends of \$5,000. The dividends declared to be reported in December 31, 2X13, consolidated retained earnings under the acquisition method are \$80,000 (those paid by Moses only). The dividends paid by Rolo go to Moses and are eliminated in consolidation.



## Example

On June 30, 2X12, Harris Company exchanged 300,000 shares of its \$10 par value common stock for all of Blake Company's common stock. The fair market value of Harris Company's common stock issued equals the carrying value of Blake's net assets. Both entities will continue their separate businesses and operations. The following data are presented:

	<i>Harris</i>	<i>Blake</i>
Retained earnings—12/31/2X11	\$3,000,000	\$900,000
Dividends paid—4/1/2X12	700,000	
Net income—1/1/2X12 to 6/30/2X12	850,000	250,000

If the acquisition method was used, the balance in retained earnings to be presented by the Harris Company in its June 30, 2X12, consolidated balance sheet would be based on the parent's retained earnings as follows:

Balance, 12/31/2X11	\$3,000,000
Net income—1/1/2X12-6/30/2X12	850,000
Dividends paid—4/1/2X12	(700,000)
Retained earnings—6/30/2X12	<u>\$3,150,000</u>

Earnings of Blake Company prior to the acquisition date are not included in consolidated retained earnings.

If there is an exchange by a partly owned subsidiary of its common stock for the voting common stock of the parent company, this *downstream merger* transaction is treated as a purchase.

## Example

### Business Combination Accounted for under the Acquisition Method

ABC Company issues 50,000 shares on December 1, 2X13, to acquire all of XYZ Company's outstanding shares. This transaction will be accounted for under the acquisition method, with XYZ Company becoming a 100%-owned subsidiary of ABC Company.

ABC Company	
Shares issued to acquire XYZ Company:	50,000
Par value:	\$ 3
Fair value:	\$ 10
XYZ Company	
Total shares outstanding:	10,000
Par value:	\$ 10

## OUT-OF-POCKET COSTS OF BUSINESS COMBINATION

Legal fees related to business combination:	\$35,000
SEC stock registration related costs:	<u>\$15,000</u>
Total:	<u><u>\$50,000</u></u>

ABC Company and XYZ Company Separate Balance Sheets (prior to combination)  
As of Dec. 31, 2X13

	<i>ABC Company</i>	<i>XYZ Company</i>
<b>ASSETS</b>		
Current assets	900,000	135,000
Property, plant, and equipment (net)	2,500,000	400,000
Other assets	-	35,000
Total Assets	<u>3,400,000</u>	<u>570,000</u>
<b>LIABILITIES &amp; EQUITY</b>		
Current liabilities	500,000	120,000
Long-term liabilities	1,200,000	200,000
Common stock, ABC Company	900,000	
Common stock, XYZ Company		100,000
Paid-in-capital	300,000	50,000
Retained earnings	500,000	100,000
Total liabilities and equity	<u>3,400,000</u>	<u>570,000</u>

It is assumed that there were no intercompany transactions prior to the business combination. Moreover, there were no contingent considerations related to this combination. The effect of income taxes is disregarded in this example.

ABC will record its investment in XYZ as follows:

12/31/2X13	Investment in XYZ Company	500,000	
	Common stock		150,000
	Additional Paid-in-capital		350,000

To record issuance of ABC shares in exchange for all of XYZ shares in a purchase type business combination.

12/31/2X13	Operating expenses	35,000	
	Additional Paid-in-capital	15,000	
	Cash		50,000

To record direct combination costs and stock issuance costs.

The fair value for XYZ Company's assets and liabilities differs from the carrying amount at the date of acquisition as follows:

	<i>Carrying Amount</i>	<i>Fair Value</i>
Inventory (part of current assets)	100,000	125,000
Plant assets	400,000	550,000
Long-term liabilities	200,000	170,000

Thus, XYZ's assets and liabilities in terms of fair values are as follows:

<b>ASSETS</b>			
Current assets		160,000*	
Property, plant, and equipment (net)		550,000	
Other assets		35,000	
Total assets			745,000
<b>LIABILITIES</b>			
Current liabilities		120,000	
Long-term liabilities		170,000	
Total liabilities			290,000
Fair value of XYZ			455,000
*[135,000+(125,000-100,000)]			

The Goodwill generated by the acquisition may be calculated as follows:

ABC's total investment in XYZ	500,000
Less: fair value of XYZ	455,000
Goodwill	45,000

ABC Company and Subsidiary Consolidated Balance Sheet As of Dec. 31, 2X13

	ABC Company	XYZ Company	Eliminations Increases (Decreases)	Consolidated
<b>ASSETS</b>				
Current assets	850,000	135,000	25,000	1,010,000
Investment in XYZ	500,000		(500,000)	-
Property, plant, and equipment (net)	2,500,000	400,000	150,000	3,050,000
Other assets		35,000	-	35,000
Goodwill			45,000	45,000
Total assets	<u>3,850,000</u>	<u>570,000</u>	<u>(280,000)</u>	<u>4,140,000</u>
<b>LIABILITIES &amp; EQUITY</b>				
Current liabilities	500,000	120,000		620,000
Long-term liabilities	1,200,000	200,000	(30,000)	1,370,000
Common stock, ABC Company	1,050,000			1,050,000
Common stock, XYZ Company		100,000	(100,000)	-
Additional Paid-in capital	635,000	50,000	(50,000)	635,000
Retained earnings	<u>465,000*</u>	<u>100,000</u>	<u>(100,000)</u>	<u>500,000</u>
Total liabilities and equity	<u>3,850,000</u>	<u>570,000</u>	<u>(280,000)</u>	<u>4,140,000</u>

\* 500,000-35,000 direct combination costs.

## **RESEARCH AND DEVELOPMENT COSTS ACQUIRED AS PART OF A BUSINESS COMBINATION**

ASC 805-20-30 requires that research and development assets acquired in a business combination of a business be initially recognized and measured at fair value, even if those assets do not have alternative future use. Subsequent to initial recording, such research and development costs are subject to the annual impairment review prescribed under ASC 350. The scope of this accounting extends to all acquired or purchased tangible and intangible assets resulting from research and development activities, including patents, blueprints, formulas, and designs for new products and processes. It also includes materials and supplies, and equipment and facilities used by the acquiree in its research and development activities.

### **Income Taxes**

For business combinations occurring after the effective date of this statement, the acquiring company shall recognize a deferred tax asset or liability associated with temporary differences between the assigned value on the books and the tax bases of net assets acquired, in accordance with ASC 805-740-05-1. The acquirer shall also account for potential tax effects of temporary differences, carryforwards, and any income tax uncertainties of the acquiree in accordance with ASC 740-10.

For business transactions occurring before the effective date of the Statement, the acquirer shall not adjust the accounting for prior business combinations for previously recognized changes in acquired tax uncertainties or previously recognized changes in the valuation allowance for acquired deferred tax assets.

### **Disclosures**

For each acquisition that occurs during the reporting period or after the reporting period but before financial statements are issued, the acquirer must disclose:

1. Name and description of the acquiree.
2. Acquisition date.
3. Percentage of voting interest acquired.
4. Rationale for the business combination and how the acquirer obtained control of the acquiree.
5. Qualitative factors supporting any goodwill from the transaction (e.g., expected synergies from combined operations or description of intangible assets not qualifying for separate recognition).
6. Fair value of total consideration transferred, as well as fair value of each component.
7. Amount and description of any contingent consideration, as well as a discussion of the circumstances in which payment will be made; also included should be a range of possible outcomes or, if a range cannot be estimated, the reasons why.
8. Amounts recognized at the acquisition date for each major class of assets acquired and liabilities assumed.
9. Nature of recognized and unrecognized contingencies along with a range of possible outcomes.
10. Total goodwill expected to be deducted for tax purposes.

11. If acquirer is required to disclose segment information, the amount of goodwill by reportable segment (this information will be used in the goodwill impairment test).
12. Where acquirer and acquiree have previously had a business relationship, any amounts that are not part of the exchange in the business combination between the acquirer and acquiree should be identified.
13. Any acquisition-related costs and, where reported in the financial statements, that is, expense, reduction of paid in capital, or other category.
14. For any bargain purchase, the amount of the gain included in the consolidated income statement and the reason why the business combination resulted in a gain.
15. Fair value of any noncontrolling interest and valuation techniques used to measure fair value.
16. For step acquisitions, the fair value and valuation technique of any equity interest held immediately prior to the acquisition date and the amount of gain or loss recognized as a result of remeasuring to fair value.
17. For public companies, the amount of revenue and earnings subsequent to the acquisition date, reported in the consolidated income statement.

As clarified by **Accounting Standards Update (ASU)** No. 2010-29 in December 2010, supplemental pro forma information shows revenue and earnings of the acquiree as though the business combination occurred as of the beginning of the comparable annual reporting period. For example, if a calendar year-end company completed a business combination in April 2X13, disclosures would be provided as if the business combination occurred as of January 1, 2X13. In addition, disclosure is required of any material nonrecurring transactions included in the pro forma adjustments.

Exhibit 1-4 presents recent disclosures of three companies' (Humana, Johnson Controls, and Schlumberger NV) acquisitions.

#### **Exhibit 1-4**

#### **Humana 2010 Annual Report**

#### **3. Acquisitions**

On December 21, 2010, we acquired Concentra Inc., or Concentra, a health care company based in Addison, Texas, for cash consideration of \$804.7 million. Through its affiliated clinicians, Concentra delivers occupational medicine, urgent care, physical therapy, and wellness services to workers and the general public through its operation of medical centers and worksite medical facilities. The Concentra acquisition provides entry into the primary care space on a national scale, offering additional means for achieving health and wellness solutions and providing an expandable platform for growth with a management team experienced in physician asset management and alternate site care. The preliminary fair values of Concentra's assets acquired and liabilities assumed at the date of the acquisition are summarized as follows:

<i>(in thousands)</i>	<i>Concentra</i>
Cash and cash equivalents	\$ 21,317
Receivables	108,571
Other current assets	20,589
Property and equipment	131,837
Goodwill	531,372
Other intangible assets	188,000
Other long-term assets	12,935
Total assets acquired	1,014,621
Current liabilities	(100,091)
Other long-term liabilities	(109,811)
Total liabilities assumed	(209,902)
Net assets acquired	\$ 804,719

The other intangible assets, which primarily consist of customer relationships and trade name, have a weighted average useful life of 13.7 years. Approximately \$57.9 million of the acquired goodwill is deductible for tax purposes. The purchase price allocation is preliminary, subject to completion of valuation analyses, including, for example, refining assumptions used to calculate the fair value of other intangible assets. The purchase agreement contains provisions under which there may be future consideration paid or received related to the subsequent determination of working capital that existed at the acquisition date. Any payments or receipts for provisional amounts for working capital will be recorded as an adjustment to goodwill when paid or received.

The results of operations and financial condition of Concentra have been included in our consolidated statements of income and consolidated balance sheets from the acquisition date. In connection with the acquisition, we recognized approximately \$14.9 million of acquisition-related costs, primarily banker and other professional fees, in selling, general and administrative expense. The pro forma financial information assuming the acquisition had occurred as of January 1, 2009 was not material to our results of operations.

On October 31, 2008, we acquired PHP Companies, Inc. (d/b/a Cariten Healthcare), or Cariten, for cash consideration of approximately \$291.0 million, including the payment of \$34.9 million during 2010 to settle a purchase price contingency. The Cariten acquisition increased our commercial fully-insured and ASO presence as well as our Medicare HMO presence in eastern Tennessee. During 2009, we continued our review of the fair value estimate of certain other intangible and net tangible assets acquired. This review resulted in a decrease of \$27.1 million in the fair value of other intangible assets, primarily related to the fair value assigned to the customer contracts acquired. There was a corresponding adjustment to goodwill and deferred income taxes. The total consideration paid exceeded our estimated fair value of the net tangible assets acquired by approximately \$145.8 million of which we allocated \$52.3 million to other intangible assets and \$93.5 million to goodwill. The other intangible assets, which primarily consist of customer contracts, have a weighted-average useful life of 11.6 years. The acquired goodwill is not deductible for tax purposes.

On August 29, 2008, we acquired Metcare Health Plans, Inc., or Metcare, for cash consideration of approximately \$14.9 million. The acquisition expanded our Medicare HMO membership in central Florida.

On May 22, 2008, we acquired OSF Health Plans, Inc., or OSF, a managed care company serving both Medicare and commercial members in central Illinois, for cash consideration of approximately \$87.3 million, including the payment of \$3.3 million during 2009 to settle a purchase price contingency. This acquisition expanded our presence in Illinois, broadening our ability to serve multi-location employers with a wider range of products including our specialty offerings. The total consideration paid exceeded our estimated fair value of the net tangible assets acquired by approximately \$31.1 million of which we allocated \$10.1 million to other intangible assets and \$21.0 million to goodwill. The other intangible assets, which primarily consist of customer contracts, have a weighted-average useful life of 9.9 years. The acquired goodwill is not deductible for tax purposes.

On April 30, 2008, we acquired UnitedHealth Group's Las Vegas, Nevada individual SecureHorizons Medicare Advantage HMO business, or SecureHorizons, for cash consideration of approximately \$185.3 million, plus subsidiary capital and surplus requirements of \$40 million. The acquisition expanded our presence in the Las Vegas market. The total consideration paid exceeded our estimated fair value of the net tangible assets acquired by approximately \$185.3 million of which we allocated \$69.3 million to other intangible assets and \$116.0 million to goodwill. The other intangible assets, which primarily consist of customer contracts, have a weighted-average useful life of 10.9 years. The acquired goodwill is not deductible for tax purposes.

The purchase agreements for certain of the acquisitions discussed above occurring prior to January 1, 2009 contain provisions under which there may be future contingent consideration paid or received primarily associated with balance sheet settlements. Any contingent consideration paid or received will be recorded as an adjustment to goodwill when the contingencies are resolved. We do not expect these adjustments to be material.

The results of operations and financial condition of Cariten, Metcare, OSF, and SecureHorizons have been included in our consolidated statements of income and consolidated balance sheets since the acquisition dates.

## **Johnson Controls 2010 Annual Report**

### **2. Acquisitions**

In July 2010, the Company acquired an additional 40% of a power solutions Korean joint venture. The acquisition increased the Company's ownership percentage to 90%. The remaining 10% was acquired by the local management team. The Company paid approximately \$86 million (excluding cash acquired of \$57 million) for the additional ownership percentage and incurred approximately \$10 million of acquisition costs and related purchase accounting adjustments. As a result of the acquisition, the Company recorded a non-cash gain of \$47 million within power solutions equity income to adjust the Company's existing equity investment in the Korean joint venture to fair value. Goodwill of \$51 million was recorded as part of the transaction. The purchase price allocation may be subsequently adjusted to reflect final valuation studies.

Also during fiscal 2010, the Company completed three acquisitions for a combined purchase price of \$35 million, of which \$32 million was paid as of September 30, 2010.

The acquisitions in the aggregate were not material to the Company's consolidated financial statements. In connection with the acquisitions, the Company recorded goodwill of \$9 million. The purchase price allocation may be subsequently adjusted to reflect final valuation studies.

During fiscal 2009, the Company completed four acquisitions for a combined purchase price of \$43 million, of which \$38 million was paid in the twelve months ended September 30, 2009. None of the acquisitions were material to the Company's consolidated financial statements. In connection with these acquisitions, the Company recorded goodwill of \$30 million, of which \$26 million was recorded during fiscal 2009.

In July 2008, the Company formed a joint venture to acquire the interior product assets of Plastech Engineered Products, Inc. (Plastech). Plastech filed for bankruptcy in February 2008. The Company owns 70% of the newly formed entity and certain Plastech term lenders hold the remaining noncontrolling interest. The Company contributed cash and injection molding plants to the new entity with a fair value of \$262 million. The lenders contributed their rights to receive Plastech's interiors business obtained in exchange for certain Plastech debt. The combined equity in the new entity was approximately \$375 million. Goodwill of \$199 million was recorded as part of the transaction. In the third quarter of fiscal 2009, the Company finalized valuations associated with the acquisition and recorded a \$21 million increase to goodwill.

Also in fiscal 2008, the Company completed seven additional acquisitions for a combined purchase price of \$108 million, none of which were material to the Company's consolidated financial statements. In connection with these acquisitions, the Company recorded goodwill of \$66 million.

## **Schlumberger NV 2010 Annual Report**

### **4. Acquisitions**

#### *Merger with Smith International, Inc.*

On August 27, 2010, Schlumberger acquired all of the outstanding shares of Smith, a leading supplier of premium products and services to the oil and gas exploration and production industry. The merger brings together the complementary drilling and measurements technologies and expertise of Schlumberger and Smith in order to facilitate the engineering of complete drilling systems which optimize all of the components of the drill string. Such systems will enable Schlumberger's customers to achieve improved drilling efficiency, better well placement and increased wellbore assurance as they face increasingly more challenging environments. In addition, Schlumberger's geographic footprint will facilitate the extension of joint offerings on a worldwide basis.

Under the terms of the merger agreement, Smith became a wholly-owned subsidiary of Schlumberger. Each share of Smith common stock issued and outstanding immediately prior to the effective time of the merger was converted into the right to receive 0.6966 shares of Schlumberger common stock, with cash paid in lieu of fractional shares.



At the effective time of the merger, each outstanding option to purchase Smith common stock was converted pursuant to the merger agreement into a stock option to acquire shares of Schlumberger common stock on the same terms and conditions as were in effect immediately prior to the completion of the merger. The number of shares of Schlumberger common stock underlying each converted Smith stock option was determined by multiplying the number of Smith stock options by the 0.6966 exchange ratio, and rounding down to the nearest whole share. The exercise price per share of each converted Smith stock option was determined by dividing the per share exercise price of such stock option by the 0.6966 exchange ratio, and rounded up to the nearest whole cent. Smith stock options, whether or not then vested and exercisable, became fully vested and exercisable and assumed by Schlumberger at the effective date of the merger in accordance with preexisting change-in-control provisions. Smith stock options were converted into 0.6 million of Schlumberger stock options.

At the effective time of the merger, Smith restricted stock units, whether or not then vested, became fully vested (except for grants between the date of the merger agreement and closing, which were not significant and did not automatically vest) and were converted into shares of Schlumberger common stock in connection with the merger, determined by multiplying the number of shares of Smith common stock subject to each award by the 0.6966 exchange ratio, rounded to the nearest whole share (assuming, in the case of performance-based Smith restricted stock unit awards, the deemed attainment of the performance goals under the award at the target level).

#### *Calculation of Consideration Transferred*

The following details the fair value of the consideration transferred to effect the merger with Smith:

*(stated in millions, except exchange ratio and per share amounts)*

Number of shares of Smith common stock outstanding as of the acquisition date	248
Number of Smith unvested restricted stock units outstanding as of the acquisition date	4
	<u>252</u>
Multiplied by the exchange ratio	x 0.6966
Equivalent Schlumberger shares of common stock issued	176
Schlumberger closing stock price on August 27, 2010	\$ 55.76
Common stock equity consideration	\$ 9,812
Fair value of Schlumberger equivalent stock options issued	\$ 16
Total fair value of the consideration transferred	<u>\$ 9,828</u>

*Certain amounts reflect rounding adjustments*

#### *Preliminary Allocation of Consideration Transferred to Net Assets Acquired*

The following amounts represent the preliminary estimates of the fair value of identifiable assets acquired and liabilities assumed in the merger. The final determination of fair value for certain assets and liabilities will be completed as soon as the information necessary to complete the analysis is obtained. These amounts will be finalized as soon as possible, but no later than one year from the acquisition date.

*(stated in millions)*

Cash	\$ 399
Accounts receivable	1,831
Inventory <sup>(1)</sup>	2,013
Fixed assets	2,017
Intangible assets:	
Trade names (weighted-average life of 25 years)	1,560
Technology (weighted-average life of 16 years)	1,170
Customer relationships (weighted average life of 23 years)	1,360
Other assets	429
Accounts payable and accrued liabilities	(1,460)
Long-term debt <sup>(2)</sup>	(2,141)
Deferred taxes <sup>(3)</sup>	(1,936)
Other liabilities	(528)
sub-total	\$ 4,714
Less:	
Investment in M-I SWACO <sup>(4)</sup>	(1,429)
Noncontrolling interests	(111)
Total identifiable net assets	\$ 3,174
Gain on investment in M-I SWACO <sup>(4)</sup>	(1,238)
Goodwill <sup>(5)</sup>	7,892
Total consideration transferred	\$ 9,828

<sup>(1)</sup> Schlumberger recorded an adjustment of approximately \$155 million to write-up the acquired inventory to its estimated fair value. Schlumberger's cost of revenue reflected this increased valuation as this inventory was sold. Accordingly, Schlumberger's margins were temporarily reduced in the initial periods subsequent to the merger.

<sup>(2)</sup> In connection with the merger, Schlumberger assumed all of the debt obligations of Smith including its long-term fixed rate notes consisting of the following: \$220 million 6.75% Senior Notes due 2011, \$300 million 8.625% Senior Notes due 2014, \$275 million 6.00% Senior Notes due 2016 and \$700 million 9.75% Senior Notes due 2019. Schlumberger recorded a \$417 million adjustment to increase the carrying amount of these notes to their estimated fair value. This adjustment will be amortized as a reduction of interest expense over the remaining term of the respective obligations.

<sup>(3)</sup> In connection with the acquisition accounting, Schlumberger provided deferred taxes related to, among other items, the estimated fair value adjustments for acquired inventory, intangible assets and assumed debt obligations. Included in the provisions for deferred taxes are amounts relating to the outside basis difference associated with shares in certain Smith non-US subsidiaries for which no taxes have previously been provided. Schlumberger expects to reverse the outside basis difference primarily through the reorganization of those subsidiaries as well as through repatriating earnings in lieu of permanently reinvesting them. In this regard, Schlumberger is in the process of assessing certain factors that impact the ultimate amount of deferred taxes to be recorded. The amount of deferred taxes recorded will likely be revised after this assessment is completed. Any revision to the amount of deferred taxes recorded will impact the amount of goodwill recorded.

<sup>(4)</sup> Prior to the completion of the merger, Smith and Schlumberger operated M-I SWACO, a drilling fluids joint venture that was 40% owned by Schlumberger and 60% owned by Smith. Effective at the closing of the merger, M-I SWACO is now owned 100% by Schlumberger. As a result of obtaining control of this joint venture, Schlumberger was

required under generally accepted accounting principles to remeasure its previously held equity interest in the joint venture at its merger-date fair value and recognize the resulting pretax gain of \$1.3 billion (\$1.2 billion after-tax) in earnings. This gain is classified as *Gain on Investment in M-I SWACO* in the *Consolidated Statement of Income*. Prior to acquiring Smith, Schlumberger recorded income relating to this venture using the equity method of accounting. The carrying value of Schlumberger's investment in the joint venture on December 31, 2009 was \$1.4 billion, and was included within *Investments in Affiliated Companies* on the *Consolidated Balance Sheet*. Schlumberger's equity income from this joint venture was \$78 million in 2010 (representing the period from January 1, 2010 to August 27, 2010), \$131 million in 2009 and \$210 million in 2008. Schlumberger received cash distributions from the joint venture of \$50 million in 2010, \$106 million in 2009 and \$57 million in 2008.

- <sup>(5)</sup> The goodwill recognized is primarily attributable to expected synergies that will result from combining the operations of Schlumberger and Smith as well as intangible assets that do not qualify for separate recognition. Approximately \$0.2 billion of the goodwill is deductible for income tax purposes.

#### *Acquisition of Geoservices*

On April 23, 2010, Schlumberger completed the acquisition of Geoservices, a privately owned oilfield services company specializing in mud logging, slickline and production surveillance operations, for \$915 million in cash.

The purchase price has been allocated to the net assets acquired upon their estimated fair values as follows:

<i>(stated in millions)</i>	
Cash	\$ 26
Other assets	184
Fixed assets	90
Goodwill	599
Intangible assets	377
Long-term debt	(145)
Deferred tax liabilities	(64)
Other liabilities	(152)
	\$ 915

The long-term debt was repaid at the time of closing.

Intangible assets recorded in connection with this transaction, which primarily relate to customer relationships, will be amortized over a weighted average period of approximately 17 years. The amount allocated to goodwill represents the excess of the purchase price over the fair value of the net assets acquired and is not tax deductible for income tax purposes.

#### *Other Acquisitions*

Schlumberger has made other acquisitions and minority investments, none of which were significant on an individual basis, for cash payments, net of cash acquired, of \$212 million during 2010, \$514 million during 2009, and \$345 million during 2008.

### Supplemental Pro Forma Data

Smith's results of operations have been included in Schlumberger's financial statements for periods subsequent to the effective date of the merger. Smith contributed revenues of \$3.3 billion and net income of \$160 million (including the recurring effects of purchase accounting) to Schlumberger for the period from the closing of the merger through December 31, 2010. The following unaudited supplemental pro forma data ("pro forma data") presents consolidated information as if the merger with Smith and the acquisition of Geoservices had been completed on January 1, 2009:

<i>(stated in millions, except per share data)</i>	2010	2009
Revenue	\$ 33,468	\$ 31,182
Net income	\$ 3,376	\$ 3,271
Net income attributable to Schlumberger	\$ 3,370	\$ 3,244
Diluted earnings per share	\$ 2.44	\$ 2.34

The pro forma data was prepared based on the historical financial information of Schlumberger, Smith and Geoservices and has been adjusted to give effect to pro forma adjustments that are (i) directly attributable to the transactions, (ii) factually supportable and (iii) expected to have a continuing impact on the combined results. The pro forma data is not necessarily indicative of what Schlumberger's results of operations actually would have been had the transactions been completed on January 1, 2009. Additionally, the pro forma data does not purport to project the future results of operations of the combined company nor do they reflect the expected realization of synergies associated with the transactions. The pro forma data reflects the application of the following adjustments:

- Elimination of the gain resulting from Schlumberger's remeasurement of its previously held 40% equity interest in M-I SWACO, which is considered non-recurring.
- Additional depreciation and amortization expense associated with fair value adjustments to acquired identifiable intangible assets and property, plant and equipment.
- Elimination of charges incurred in 2010 related to the fair value adjustments to Smith's inventory that has been sold as they will not have a long-term continuing impact.
- Reductions in interest expense as a result of increasing the carrying value of acquired debt obligations to its estimated fair value.
- Elimination of transaction costs incurred in 2010 that are directly related to the transactions, and do not have a continuing impact on the combined company's operating results.
- The issuance of 176 million of shares of Schlumberger common stock.

Included in the 2010 and 2009 pro forma net income attributable to Schlumberger and diluted earnings per share presented above are the following significant charges and credits:

	2010		2009	
	Net Income Impact	Diluted EPS Impact*	Net Income Impact	Diluted EPS Impact
<i>(stated in millions, except per share data)</i>				
Severance and other <sup>(1)</sup>	\$ 77	\$ 0.06	\$ 85	\$ 0.06
Impairment relating to WesternGeco's first generation Q-Land acquisition system <sup>(1)</sup>	71	0.05	-	-
Other WesternGeco-related charges <sup>(1)</sup>	63	0.05	-	-
Impact of elimination of tax deduction related to Medicare Part D subsidy <sup>(1)</sup>	40	0.03	-	-
Mexico restructuring <sup>(1)</sup>	36	0.03	-	-
Venezuelan currency-related losses <sup>(2)</sup>	35	0.03	-	-
Repurchase of bonds <sup>(1)</sup>	37	0.03	-	-
Gain on remeasurement of investment in @Balance <sup>(2)</sup>	(18)	(0.01)	-	-
Postretirement benefits curtailment <sup>(1)</sup>	-	-	122	0.09
Employee severance <sup>(2)</sup>	-	-	32	0.02
	<b>\$ 341</b>	<b>\$ 0.25</b>	<b>\$ 239</b>	<b>\$ 0.17</b>

\* Does not add due to rounding

<sup>(1)</sup> Relates to Schlumberger's historical operations and is more fully described in Note 3 - *Charges and Credits*.

<sup>(2)</sup> Relates to Smith's historical operations.

## Chapter 1 – Review Questions

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*The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.*

*We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.*

1. For the past several years, Mozza Company has invested in the common stock of Chedd Company. As of July 1, 2001, Mozza owned approximately 13% of the total of Chedd's outstanding voting common stock. Recently, management of the two companies have discussed a possible combination of the two entities. However, no public announcement has been made, and no notice to owners has been given. The resulting business combination would be accounted for under the \_\_\_\_\_ method.
  - a) pooling of interests
  - b) acquisition
  - c) part acquisition, part pooling
  - d) joint venture
2. A business combination in which the surviving entity is not one of the two combining entities is a(n):
  - a) investment in stock
  - b) statutory consolidation
  - c) statutory merger
  - d) stock acquisition
3. To effect a business combination, Proper Co. acquired all the outstanding common shares of Scapula Co., a business entity, for cash equal to the carrying amount of Scapula's net assets. The carrying amounts of Scapula's assets and liabilities approximated their fair values at the acquisition date, except that the carrying amount of its building was more than fair value. In preparing Proper's year-end consolidated income statement, what is the effect of recording the assets acquired and liabilities assumed at fair value, and should goodwill amortization be recognized:

<u>Depreciation Expense</u>	<u>Goodwill Amortization</u>
a) Lower	Yes
b) Higher	Yes
c) Lower	No
d) Higher	No

4. If the acquiring company pays \$5 per share for 100,000 shares of acquired company voting stock in exchange for assets with a fair value of \$500,000 and liabilities at a fair value of \$25,000, what is the amount of goodwill recognized by the acquiring company:
- a) \$500,000
  - b) \$475,000
  - c) \$25,000
  - d) \$0
5. At what value should an accountant record a preacquisition contingency:
- a) fair value
  - b) cost
  - c) tax basis
  - d) present value
6. When there is a difference between the book and tax basis of an acquired company, the difference is:
- a) a permanent difference
  - b) usually immaterial and not recognized
  - c) a temporary difference
  - d) written off as an expense
7. If the acquiring company determines that a \$500,000 difference exists between the book and tax bases (book basis > tax basis) and the company's tax rate is 40 percent, what is the amount of the deferred tax liability:
- a) a deferred tax asset of \$200,000 results
  - b) a deferred tax asset results when there is a difference between fair value and tax basis
  - c) a deferred tax liability amounting to \$200,000
  - d) 0
8. In the period when a material business combination occurs, what supplemental information should be disclosed on a pro forma basis in the notes to the financial statements of a combined entity that is a public business enterprise:
- a) contingent payments, options, or commitments specified in the acquisition agreement
  - b) if comparative statements are presented, the results of operations for all periods reported as though the combination had been completed at the beginning of the earliest period
  - c) if comparative financial statements are presented, the results of operations for the comparable prior period as though the combination had been completed at the beginning of that period
  - d) the period for which the results of operations of the acquired entity are included in the income statement of the combined entity

## Chapter 1 – Solutions and Suggested Responses

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1. A: Incorrect. The pooling-of-interests method may not be used to account for a business combination initiated after June 30, 2001.

**B: Correct.** A business combination is an entity's acquisition of (1) net assets constituting a business or (2) controlling equity interests of one or more other entities. A business combination initiated after June 30, 2001 (and after December 15, 2008) must be accounted for using the *acquisition method*.

C: Incorrect. Accounting for a business combination as part purchase and part pooling is not allowed.

D: Incorrect. A joint venture does not meet the definition of a business combination.

(See page 1-2 of the course material.)

2. A: Incorrect. An investment in stock is not always associated with a business combination.

**B: Correct.** In a statutory consolidation, the combining entities are dissolved, and the assets and liabilities of the combining entities are used to create a new legal entity. A new company is formed by the combination of two or more companies; the previous companies no longer exist but may become operating divisions of the new company.

C: Incorrect. In a statutory merger, the acquirer purchases either the net assets of the target company or acquires the stock of the target (acquiree) company; in either case, the acquiree company is dissolved, as the acquirer brings the assets and liabilities of the acquiree on its books and cancels the stock of the acquiree.

D: Incorrect. In a stock acquisition, the acquirer purchases the stock or net assets of the acquiree and operates it as a direct (wholly or majority owned) subsidiary of the acquirer (the parent). Unlike a statutory merger and statutory consolidation, there is a need to consolidate the accounts of the parent and subsidiary into a consolidated economic entity.

(See page 1-3 of the course material.)



3. A: Incorrect. Goodwill will be recognized but not amortized.

B: Incorrect. Depreciation will decrease, and goodwill will be recognized but not amortized.

**C: Correct.** A business combination is accounted for as an acquisition. Under the *acquisition method*, the entry recording the transaction is based on the fair values exchanged. Accordingly, the identifiable assets acquired and liabilities assumed ordinarily are recorded at their acquisition-date fair values. The differences between those fair values and carrying amounts will affect net income when related expenses are incurred. The effect of recording the building at fair value in the consolidated balance sheet instead of its higher carrying amount on Scapula's books will be to decrease future depreciation. Goodwill is defined as: (the fair value of consideration transferred + the fair value of any noncontrolling interest in the acquiree + the fair value of any previously held equity interest in the acquiree) - the fair value of net assets acquired. Thus, Proper recognizes goodwill for the excess of the cash paid over the fair value of the net assets acquired (given an acquisition of 100% of Scapula's common shares). This amount will be tested for impairment, not amortized.

D: Incorrect. Depreciation will decrease.

(See page 1-6 of the course material.)

4. A: Incorrect. This is the amount of the fair value of the assets of the acquired company and the amount the acquiring company paid for the assets.

B: Incorrect. This is the net of the fair value of the assets less the liabilities.

**C: Correct.** Goodwill = Fair value of consideration transferred (\$500,000) + fair value of noncontrolling interest (0) + fair value of previously held equity interest (0) - fair value of net assets acquired (\$475,000) = \$25,000, where the fair value of net assets acquired is \$475,000 (\$500,000 - \$25,000).

D: Incorrect. Since the amount given exceeds the net fair value of the assets and liabilities received, there has to be goodwill.

(See page 1-6 of the course material.)

5. **A: Correct.** Under ASC 805, contractual preacquisition contingencies of the acquiree must always be measured at acquisition date fair value, resulting in either an increase or decrease to the debit to the acquirer's investment account. Noncontractual contingencies such as outstanding acquiree litigation are recorded at acquisition date fair value only when they meet the "more likely than not" criteria for definition of an asset or liability.

B: Incorrect. Cost isn't what something is worth at the time of the acquisition. It may be worth more or less than the actual cost because of the time change or other developments.

C: Incorrect. Tax basis doesn't mean it is worth amount.

D: Incorrect. Present value may have already had depreciation or additional costs charged to it.

(See page 1-9 of the course material.)

6. A: Incorrect. The difference, in time is done away with so the difference is not permanent.

B: Incorrect. Whether immaterial or not the difference is always recognized and accounted for.

**C: Correct.** The difference is temporary and will disappear in future accounting periods.

D: Incorrect. It is not allowable to right of the difference as an expense.

(See page 1-17 of the course material.)

7. A: Incorrect. The question states "what is the amount of the deferred liability" and not the amount of the deferred tax asset.

B: Incorrect. A deferred tax liability results when (book basis > tax basis).

**C: Correct.** A deferred tax liability of \$200,000 results (40% x \$500,000 difference).

D: Incorrect. A zero results when book base equals tax base.

(See page 1-17 of the course material.)

8. A: Incorrect. Contingent payments, options, or commitments specified in the acquisition agreement are already required disclosures of actual data and therefore cannot be supplemental information.

B: Incorrect. This type of disclosure would only be required for the comparable prior period.

**C: Correct.** As clarified by **Accounting Standards Update (ASU)** No. 2010-29 in December 2010, supplemental pro forma information shows revenue and earnings of the acquiree as though the business combination occurred as of the beginning of the comparable annual reporting period. For example, if a calendar year-end company completed a business combination in April 2X13, disclosures would be provided as if the business combination occurred as of January 1, 2X13. In addition, disclosure is required of any material nonrecurring transactions included in the pro forma adjustments. However, pro forma disclosures for nonpublic entities are not required.

D: Incorrect. This type of disclosure is already a required disclosure of actual data and therefore cannot be supplemental information.

(See page 1-18 of the course material.)

## Chapter 2: Consolidated Financial Reporting

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### Learning Objectives:

After completing this section, you should be able to:

- Explain when consolidation is appropriate
- Prepare eliminating entries
- Account for minority interest
- Explain how consolidation is reported and disclosed
- Prepare a combined financial statement

Consolidated financial statements present the financial position, operating results, and cash flows of the single economic entity comprised of a parent and one or more subsidiaries or variable interest entities that they control. Consolidated financial statements are believed to be more useful to users of financial information than the financial statements of individual companies that are related by ownership. Consolidated financial reporting is required when one entity owns, directly or indirectly, more than 50% of the outstanding voting interests of another entity. However, a majority-owned subsidiary is not consolidated if control does not rest with the majority owner.

Traditionally, consolidation takes place when the parent controls greater than 50% of the voting common shares of its subsidiary; however, the FASB has acknowledged that where control is exercised through contractual arrangements (known as *variable interest*) rather than direct ownership, consolidation is also required. Conversely, there are limited exceptions when majority owned subsidiaries are not consolidated.

This chapter is not applicable to a statutory merger, where an acquirer liquidates an acquiree and combines the acquiree's operations with that of the acquirer; or a statutory consolidation, where both the acquirer and acquiree company are liquidated and a new company is formed. Both of these are covered in the previous chapter, *Business Combinations*.

This chapter explains the worksheet techniques used to consolidate a parent with one or more of its subsidiaries to achieve consolidated financial statements presented in accordance with GAAP. As discussed in the previous chapter, the **newly adopted acquisition method** will be emphasized in the examples, with comments made as to the differences between the acquisition and the “grandfathered” purchase and pooling of interests methods of accounting. It should be assumed that the parent company accounts for its investment in its consolidated subsidiaries using the equity method of accounting. It is important to note that when the parent accounts for its investment in its subsidiaries using a method other than the equity method (such as cost or partial equity method), the consolidated results will be identical. What will differ is the consolidation worksheet entries used to achieve the consolidated results.

### RELEVANT AUTHORITATIVE PRONOUNCEMENTS

The major authoritative pronouncements governing consolidated financial statements are ASC 805 and ASC 810. Relevant FASB Emerging Issues Task Force conclusions have been incorporated into ASC 805 and 810. The following discussion incorporates the most recent guidance.

According to **Accounting Standards Update (ASU) No. 2010-02** (January 2010) (ASC 810, *Consolidation*), *Accounting and Reporting for Decreases in Ownership of a Subsidiary—a Scope Clarification*, a deconsolidation of a subsidiary by a parent is when the parent no longer has a controlling financial interest. An ensuing gain or loss is recognized by the parent. In addition, a change in a parent's ownership interest is treated as an equity transaction. As a result, gain or loss is not recorded. (ASC 810-10-40-4 and 40-5)

A parent's ownership changes if it buys, sells, or reacquires shares in the subsidiary. (ASC 810-10-45-22) A deconsolidation should include disclosure of the nature of activities, any related-party transaction, valuation method to determine fair value, fair value inputs, and resulting gain or loss. (ASC 810-10-50-1B)

Disclosure for a business combination includes the date of purchase, identification and description of the acquiree, percentage of ownership bought, way in which control of the targeted company occurred, accounting treatment for the combination, reasons for the combination, transaction description, issuance costs, information if the combination occurred in stages, fair value measurements, acquisition costs, valuation method, acquiree's profit after the purchase date, and profit for the combined company for a comparable previous period. (ASC 805, *Business Combinations*) (ASC 805-10-50-2)

## **EXCEPTIONS TO CONSOLIDATION OF MAJORITY OWNED SUBSIDIARIES**

The usual condition for consolidation is ownership of a controlling financial interest, which is generally evidenced by direct ownership of greater than 50% of the outstanding voting shares of another company. However, over the years many companies excluded from consolidation certain “nonhomogeneous” subsidiary operations that were different in character than the parent. Consolidation is required even where the business activities of the parent and subsidiary significantly differ. However, the FASB in that statement did not address the practice of not consolidating subsidiaries, where control is likely to be temporary, for instance, when a subsidiary is in a legal reorganization under bankruptcy laws. Therefore, not consolidating subsidiaries where control is considered to be temporary continues to be acceptable.

Additionally, if a subsidiary operates under foreign exchange restrictions that are so severe that they hamper the ability of the parent to control the timing of subsidiary dividends, then consolidation is not appropriate. If one of these exceptions to consolidations applies, the parent should account for its investment in its unconsolidated subsidiary by the equity method.

## **STEPS TO ACHIEVE CONSOLIDATION**

Under the acquisition, purchase, and pooling of interests methods, a consolidation worksheet is used to make the appropriate adjustments (discussed below) to report combined results of the parent and its subsidiaries in consolidated financial statements in accordance with the accounting rules in effect at the date the acquisition was completed. The worksheet consists of columns for the book values of the parent and subsidiaries, a column for worksheet adjustments, and a final column for consolidated totals. Figures for the parent and subsidiaries come from the final U.S. GAAP financial statements and use the accounting basis appropriate for transactions recorded on their

individual books (e.g., historical cost or fair value). The parent's figures will include the balance for its Investment in Subsidiaries account along with equity earnings (when the equity method is used) and dividends received.

Eleven types of worksheet entries that may be appropriate, depending on the circumstances, are illustrated and discussed below. Worksheet entries are *not* posted to the general ledgers of either the parent or subsidiary companies (with the limited exception of push down accounting). While the parent does have the choice of accounting for its investment using the equity, cost, or partial equity methods, the consolidated results will be identical. Therefore, subsidiary earnings will be included as part of consolidated retained earnings.

A critical consolidation principle is that intercompany transactions between a parent and its consolidated subsidiaries must be eliminated in consolidation. The reason is that such transactions are not considered "arm's length" or subject to independent pricing because they take place within the same economic entity. The result is that intercompany loans and borrowings, as well as dividends and intercompany sales, purchases, and unrealized gains on inventory transfers between parent and subsidiary must be eliminated. These are illustrated in the consolidation entries discussed below.

## **CONSOLIDATION WORKSHEET ENTRIES AND EXAMPLES**

Consolidated financial statements consist of combining parent and subsidiary accounts and eliminating intercompany balances and transactions. Thus, all gains and losses on transactions between the parent and subsidiaries, or between subsidiaries, must be eliminated.

Intercompany eliminations include those for intercompany payables and receivables, advances, investments, and profits. The existence of a noncontrolling (minority) interest in a subsidiary does not affect the amount of intercompany profit to be eliminated. That is, the entire intercompany profit should be eliminated, not just the portion related to the controlling interest. In the case of certain regulated companies, intercompany profits do not need elimination to the degree that the profit constitutes a reasonable return on investment. Subsidiary investment in the parent's shares is not considered outstanding stock in the consolidated balance sheet.

Intercompany sales and purchases require elimination because revenue and expenses are not realized for consolidated purposes until the inventory is sold to outsiders. The elimination of intercompany profits will result in inventory being valued at cost on the consolidated balance sheet and is accomplished as indicated in the following discussion.

Intercompany profits in ending inventory are eliminated by crediting inventory and debiting cost of sales or retained earnings (if books are closed). Further, cost of sales and beginning retained earnings must be adjusted for intercompany profit in beginning inventory resulting from intercompany transactions in the prior year. Unless intercompany profits in inventories are eliminated, consolidated net income and ending inventory will be misstated.

If merchandise, including an intercompany profit, is reduced from the intercompany transfer price to market value and the reduction equals or exceeds the intercompany inventory profit, there is no need for a deferral of profit entry in consolidation. For

example, if merchandise costing one affiliate \$15,000 is sold to another affiliate for \$18,000, who reduces it to market value of \$16,500, the consolidated workpaper adjustment for unrealized intercompany profits should be only \$1,500.

Following is a description of the most common consolidation worksheet entries to properly present consolidated financial statements in accordance with GAAP. As noted previously, these entries are not posted to the individual books of the parent or subsidiary, with the limited exception of when push down accounting (discussed later) is applicable. These entries are subsequently used in the illustrative examples. The descriptions that follow assume consolidation subsequent to the year of acquisition:

1. Elimination of subsidiary capital as of January 1 of the year of reporting against the parent's investment account balance.  
Dr. Common stock (sub)  
Dr. Additional paid in capital (sub)  
Dr. Retained earnings (sub)  
    Cr. Investment in subsidiary (parent)
2. Recording of unamortized fair value adjustments and goodwill as of January 1 of the year of reporting.  
Dr. Fixed assets  
Dr. Inventory  
Dr. Intangible assets  
Dr. Goodwill  
    Cr. Investment in subsidiary  
(Assumes fair value of acquiree assets exceed carrying value at date of acquisition.)
3. Elimination of subsidiary net income against equity earnings recorded by the parent (assumes parent company accounts for its investment in its subsidiary using the equity method). This entry assumes that the subsidiary has positive net income. The entry would be reversed if the subsidiary had a net loss.  
Dr. Equity income  
    Cr. Investment in subsidiary
4. Elimination of dividends paid by the subsidiary to the parent (assumes parent uses the equity method). This is an intercompany transaction within the economic entity of the parent and its subsidiary.  
Dr. Investment in subsidiary  
    Cr. Dividends paid
5. Recording of excess amortization on the fair value adjustments (entry 2) as applicable (e.g., applies to excess of fair value over book value of depreciable fixed assets at date of acquisition). Note that this entry would be reversed if the fair value was less than the book value at the date of acquisition.  
Dr. Amortization expense  
    Cr. Accumulated amortization-fixed assets
6. Elimination of intercompany receivables and payables (intercompany debt).  
Dr. Payable from sub/parent  
    Cr. Receivable from sub/parent
7. Elimination of interest income and expense on intercompany debt.  
Dr. Interest income  
    Cr. Interest expense

8. Elimination of intercompany sales and purchases between the parent and subsidiary.  
Dr. Sales  
    Cr. Cost of goods sold (purchases)
9. Elimination of intercompany profit on sale of inventory between the parent and subsidiary (in year of intercompany sale to the extent the inventory has not been sold to third parties).  
Dr. Cost of goods sold  
    Cr. Ending inventory
10. Elimination of intercompany purchases and sales.  
Dr. Sales  
    Cr. Purchases
11. Elimination of intercompany profit on unsold inventory, subsequent to the year of sale, when the ending inventory of the prior period becomes the beginning inventory of the current period.  
Dr. Beginning inventory  
    Cr. Cost of goods sold

### Example

Information from the individual and consolidated income statements and balance sheets of Hand Inc. and its subsidiary, Foot Company, for the year ended December 31, 2X12, and as of the year then ended are as follows:

	<i>Hand</i>	<i>Foot</i>	<i>Consolidated</i>
<b><i>INCOME STATEMENT ACCOUNTS</i></b>			
Revenues	\$200,000	\$140,000	\$308,000
Cost of goods sold	<u>150,000</u>	<u>110,000</u>	<u>231,000</u>
Gross profit	\$ 50,000	\$ 30,000	\$ 77,000
<b><i>BALANCE SHEET ACCOUNTS</i></b>			
Accounts receivable	\$ 26,000	\$ 19,000	\$ 39,000
Inventory	30,000	25,000	52,000
<b><i>ADDITIONAL DATA</i></b>			
During 2X12, Hand sold goods to Foot at the same markup on cost that Hand uses for all of its sales.			

The following questions relate to the aforementioned data:

- What was the amount of intercompany sales from Hand to Foot during 2X12?
- What was the amount of Foot's payable to Hand for intercompany sales?
- In Hand's consolidated worksheet, what amount of unrealized intercompany profit was eliminated?

GAAP requires that in the preparation of consolidated financial statements, all intercompany transactions must be eliminated so that only those transactions between the consolidated entity and its outside parties are included in the financial statements.



The amount of intercompany sales from Hand to Foot must be ascertained from Hand's revenue, Foot's revenue, and consolidated revenues. Hand's revenue, it should be noted, includes intercompany sales to Foot. That is, part of the Hand's \$200,000 includes sales that were made to Foot. The \$308,000 of consolidated revenues represents the amount that has already been reduced for intercompany sales. Therefore, the amount of intercompany sales may be computed as follows:

Total combined revenues of Hand and Foot (\$200,000 + 140,000)	\$340,000
Less: consolidated revenues	<u>308,000</u>
Intercompany sales for 2X12	<u>\$ 32,000</u>

The worksheet entry to eliminate this in consolidation is:

Dr. Sales (revenues)	32,000	
Cr. Purchases (cost of goods sold)		32,000

In computing the amount of Foot's payable to Hand, the consolidated balance sheet should include only those amounts due to or from those outside the consolidated entity. The computation, therefore, of Foot's payable to Hand may be computed as follows:

Total combined accounts receivable of Hand and Foot (\$26,000 + 19,000)	\$45,000
Less: consolidated receivables	<u>39,000</u>
Foot's payable to Hand for intercompany sales	<u>\$ 6,000</u>

Finally, with respect to the inventory purchased by one member of the consolidated group from another, from the perspective of consolidated entity, the inventory must be stated at historical cost. That is, the difference between the selling price of the inventory and its historical cost at the date of consolidated financial statements should be considered unrealized intercompany profit and eliminated in consolidation. Thus, the following computation must be made to determine the unrealized intercompany (gross) profit in inventory that was eliminated:

Total combined inventory of Hand and Foot (\$30,000 + \$25,000)	\$55,000
Less: consolidated inventory	<u>52,000</u>
Unrealized intercompany (gross) profit in ending inventory that was eliminated	<u>\$ 3,000</u>

This unrealized gain is eliminated by the following worksheet entry:

Dr. Cost of goods sold	3,000	
Cr. Ending inventory		3,000

Profits or losses on sales or purchases before an affiliation are not adjusted in consolidation.

## Example

### Intercompany Sale of Inventory

Page Company purchased inventory from its wholly owned subsidiary, Sage Company, during year ended December 31, 2X13, as follows:

	<i>Selling Price</i>	<i>Cost</i>	<i>Gross Profit</i>
Beginning inventory	400,000	320,000	80,000
Purchases	700,000	560,000	140,000
Ending inventory	<u>300,000</u>	<u>240,000</u>	<u>60,000</u>
Cost of goods sold	<u>800,000</u>	<u>640,000</u>	<u>160,000</u>

The worksheet entry to eliminate intercompany profits is as follows:

Dr. Retained earnings—Page	80,000	
Dr. Intercompany sales—Page	700,000	
Cr. Intercompany cost of goods sold—Page		560,000
Cr. Cost of goods sold—Page		160,000
Cr. Inventories—Sage		60,000

All intercompany receivables, payables, notes, and advances are eliminated for the purposes of consolidation. An illustrative entry is:

Dr. Accounts (notes) payable	xx	
Cr. Accounts (notes) receivable		xx

If the balance sheet includes discounted receivables from another affiliate, it must be eliminated by debiting discounted receivables and crediting receivables. As to notes receivable, where the holder of an intercompany note has discounted the instrument with an outsider, the contingent liability for notes receivable discounted is considered a primary liability.

When an intercompany sale/purchase of a fixed asset occurs, such assets remain within the consolidated group. Intercompany profits on the sale and/or acquisition of fixed assets between affiliates are eliminated in consolidation so as to reflect the carrying value of the fixed assets at cost to the consolidated group. A similar adjustment for intercompany profit is made for depreciable and nondepreciable long-lived assets. An adjustment must also be made for any depreciation recorded on the intercompany profit so that depreciation is adjusted based on cost of the asset to the consolidated entity. Illustrative entries follow:

In the year a fixed asset is sold at a gain, the worksheet elimination entry is:

Dr. Accumulated depreciation	
Dr. Gain on sale	
Cr. Fixed asset	
Cr. Depreciation expense	

In the years after sale, the elimination entry would be:

Dr. Retained earnings (beginning)  
Dr. Accumulated depreciation  
    Cr. Fixed asset  
    Cr. Depreciation expense

This elimination is cumulative until the asset is fully depreciated.

### Example

#### Intercompany Sale of Equipment

A parent had equipment (original purchase price \$60,000, accumulated depreciation of \$30,000) with a five-year remaining life. The parent sold the equipment to its subsidiary for \$40,000. The parent's journal entry for the sale was:

Dr. Cash	40,000	
Dr. Accumulated depreciation	30,000	
Cr. Equipment		60,000
Cr. Gain on sale of equipment		10,000

The subsidiary recorded its purchase as:

Dr. Equipment	40,000	
Cr. Cash		40,000

The subsidiary will record depreciation expense each year at \$8,000 (\$40,000/5 years).

The gain on sale of \$10,000 must be eliminated along with the difference in depreciation of \$2,000 (\$8,000 - \$6,000). The \$6,000 in depreciation is based on a \$30,000 carrying value.

The elimination entry is:

Dr. Gain on sale of equipment	10,000	
Dr. Accumulated depreciation	2,000	
Cr. Depreciation expense		2,000
Cr. Equipment		10,000

The depreciation adjustment will be required at each year-end over the life of the asset.

In subsequent years, the debit to gain on sale instead will be to retained earnings for an amount that is reduced by the accumulated excess amortization.

An affiliate experiencing an intercompany profit on the sale of a long-lived asset to another affiliate may have to pay income taxes on that gain. In this instance, the intercompany profit on the sale should be reduced by the tax effect in making the consolidated adjusting entry.

“Intercompany bonds” (parent issues bonds to third parties and subsidiary purchases bonds in the open market) bought by an affiliate are considered as being retired in the year of purchase. In other words, intercompany bonds (along with any premium or discount) are eliminated and treated as if the bonds were retired in exchange for the investment. A resulting gain or loss is recognized in the consolidated income statement. The gain or loss is allocated between the consolidated (parent) interest and the noncontrolling (minority) interest in transactions where a parent holds bonds of a partially owned subsidiary or where one subsidiary holds bonds of another subsidiary.

An illustrative entry to eliminate an intercompany transaction in bonds follows:

Dr. Bonds payable	xx	
Dr. Discount on bonds	xx	
Dr. Loss on retirement of bonds	xx	
Cr. Investment in bonds		xx

### Example

A parent buys \$40,000 face value 10% bonds from a 100%-owned subsidiary for \$39,000. This amount equals the book value on the subsidiary's books. The following entry is recorded on the parent's investor's books:

Dr. Investment in bonds	39,000	
Cr. Cash		39,000

The subsidiary makes the following entry on issuance:

Dr. Cash	39,000	
Dr. Discount on bonds payable	1,000	
Cr. Bonds payable		40,000

The consolidation worksheet entry is:

Dr. Bonds payable	40,000	
Cr. Discount on bonds payable		1,000
Cr. Investment in bonds		39,000

An intercompany gain or loss on bonds does not occur if the acquisition price is the same as the book value of the bonds on the affiliated issuer's records (as in the above example).

In order for an affiliated investor to recognize a gain or loss on intercompany bondholdings, the following must exist:

- The bonds are sold outside of the affiliated group.
- The price paid differs from the carrying value of the affiliated issuer.
- The bonds are outstanding.

Intercompany dividends are eliminated in consolidation. Consolidated retained earnings should include the accumulated earnings of the consolidated group arising after acquisition that have not been distributed to stockholders of the parent company.

## Comprehensive Consolidation Problem—Acquisition Method

An example of a comprehensive consolidation problem using the acquisition method is illustrated below involving Broad Company, the acquirer, and Romaro Company, the acquiree. A solution is included in the form of a consolidation worksheet.

### Example

#### Comprehensive Consolidation Problem

On January 1, 2X13, Broad Company purchases 100% of the voting common shares of Romaro Company. Broad uses the equity method to account for its investment in Romaro. At the acquisition date, \$81,000 of the purchase price was attributed to land that had a fair value in excess of the carrying value on Romaro's books. In addition, \$45,000 of the purchase price was attributed to equipment that had a fair value in excess of the carrying value on Romaro's books. At acquisition date, the equipment had a remaining useful life of 10 years. It is assumed that the consideration transferred by Broad to acquire Romaro was equal to the business fair value and that the business fair value exceeded the fair value of net assets acquired at the acquisition date by \$54,000.

It is now December 31, 2X13, and consolidated financial statements need to be prepared. At the financial statement date, Romaro has borrowed \$100,000 from Broad Company, without interest. This acquisition was completed subsequent to the effective date of ASC 805 and the acquisition method must be used.

The following are the applicable income statement and balance sheet accounts for Broad and Romaro at December 31, 2X13:

*(\$ thousands)*

	<i>Broad</i>	<i>Romaro</i>
Sales	1,057	324
Less: Cost of goods sold	495	81
Equity earnings—Romaro	121	-
Depreciation and amortization	155	117
Net income	<u>528</u>	<u>126</u>
Current assets	358	286
Investment in Romaro	895	-
Land	396	149
Equipment	274	377
Buildings	483	257
Due from Romaro	100	-
Goodwill	-	-
Total assets	<u>2,506</u>	<u>1,069</u>
Accounts payable	400	92
Due to parent		100
Other liabilities	356	139
Total liabilities	<u>756</u>	<u>331</u>
Common stock @ par	24	15
Additional paid in capital	200	138

Retained earnings	1,526	585
Total stockholders' equity	<u>1,750</u>	<u>738</u>
Total liabilities and stockholders' equity	<u>2,506</u>	<u>1,069</u>

**Statement of Retained Earnings**

	<i>Broad</i>	<i>Romaro</i>
Retained earnings, January 1, 2X13	1,275	558
Add net income	528	126
Less dividends paid	<u>277</u>	<u>99</u>
Retained earnings, December 31, 2X13	1,526	585

**Required:** Prepare a consolidation worksheet as of December 31, 2X13, with all appropriate elimination entries.

**Analysis:** In this problem, the original acquisition cost is not provided, but both the fair value adjustments and goodwill as of the acquisition date is provided. It is necessary to roll forward the fair value adjustments to obtain the unamortized fair value adjustments as of January 1 of the year of reporting (2X13). The only fair value adjustment that requires this calculation is equipment (a depreciable asset). The accumulated amortization of the fair value adjustment as of January 1, 2X13 (4 years after acquisition date), is \$18,000 ( $\$4,500 \times 4$ ). The \$18,000 is deducted from the fair value adjustment at the acquisition date (\$45,000) to arrive at the unamortized fair value adjustment at January 1, 2X13, of \$27,000. The \$27,000 is used in the second consolidation entry. The following consolidation entries follow the outline previously given of the required adjustments (all entries are in \$ thousands):

1. Dr. Retained earnings—Romaro January 1, 2X13	558	
Dr. Common stock—Romaro	15	
Dr. Additional paid in capital	138	
Cr. Investment in Romaro		711

To eliminate the stockholders' equity of the subsidiary against the parent's investment account, to allow the amortized fair value of net assets to flow through in consolidation.

2. Dr. Goodwill	54	
Dr. Land	81	
Dr. Equipment	27	
Cr. Investment in Romaro		162

To recognize goodwill as of the date of acquisition (no subsequent impairment has taken place) and recognize the unamortized fair value adjustments as of January 1 of the year of reporting.

3. Dr. Equity earnings—Romaro	121	
Cr. Investment in Romaro		121

To reverse the equity income accrued by Broad to allow the revenue and expense of Romaro to flow through in consolidation. If this entry were not made, the earnings of Romaro would be double counted. The difference between the net income of Romaro and the equity earnings of Broad relates to the annual excess amortization recorded by Broad under the equity method.

4. Dr. Investment in Romaro	99	
Cr. Dividends paid		99

To eliminate the dividends paid by Romaro to its parent (Broad), an intercompany transaction within the same economic entity. This entry is the reverse of what was recorded by Broad when it received the dividend from Romaro, as Broad is using the equity method of accounting for its investment in its wholly owned subsidiary.

5. Dr. Amortization of fair value adjustment— equipment	5 (rounded)	
Cr. Accumulated amortization—equipment		5 (rounded)

To record current-year amortization of the fair value adjustment related to equipment.

6. Dr. Due to Broad	100	
Cr. Due from Romaro		100

To eliminate intercompany receivables and payables.

The above entries are posted to the consolidation worksheet.

### Solution

#### Consolidation Worksheet December 31, 2X13

(\$ thousands)

			<i>Worksheet Entries</i>		<i>Consolidated</i>
	<i>Broad</i>	<i>Romaro</i>	<i>(see note)</i>		<i>Totals</i>
			<i>Dr.</i>	<i>Cr.</i>	
Sales	1,057 cr.	324 cr.			1,381 cr.
Less: Cost of goods sold	495 dr.	81 dr.			576 dr.
Equity earnings— Romaro	121 cr.		121(3)		
Depreciation/ amortization	<u>155 dr.</u>	<u>117 dr.</u>	<u>5(5)</u>		<u>277 dr.</u>
Net income	<u>528 cr.</u>	<u>126 cr.</u>	<u>126 dr.</u>		<u>528 cr.</u>
Current assets	358 dr.	286 dr.			644 dr.
Investment in Romaro	895 dr.		99(4)	162(2) 711(1) 121(3)	-
Land	396 dr.	149 dr.	81(2)		626 dr.
Equipment	274 dr.	377 dr.	27(2)	5(5)	673 dr.
Building	483 dr.	257 dr.			740 dr.

Due from Romaro	100 dr.		100(6)	-
Goodwill			54(2)	54 dr.
Total assets	<u>2,506 dr.</u>	<u>1,069 dr.</u>		<u>2,737 dr.</u>
Accounts payable	400 cr.	92 cr.		492 cr.
Due to parent		100 cr.	100(6)	-
Other liabilities	<u>356 cr.</u>	<u>139 cr.</u>		<u>495 cr.</u>
Total liabilities	<u>756 cr.</u>	<u>331 cr.</u>		<u>987 cr.</u>
Common stock @ par	24 cr.	15 cr.	15(1)	24 cr.
Additional paid in capital	200 cr.	138 cr.	138(1)	200 cr.
Retained earnings	<u>1,526 cr.</u>	<u>585 cr.</u>		<u>1,526 cr.</u>
Total stockholders' equity	<u>1,750 cr.</u>	<u>646 cr.</u>		<u>1,750 cr.</u>
Total liabilities and stockholders' equity	<u>2,506 cr.</u>	<u>1,069 cr.</u>		<u>2,737 cr.</u>
Retained earnings, January 1, 2X13	1,275 cr.	558 cr.	558(1)	1,275 cr.
Add: Net income	528 cr.	126 cr.		528 cr.
Subtract: Dividends paid	277 dr.	99 dr.	99(4)	277 dr.
Retained earnings, December 31, 2X13	1,526 cr.	585 cr.		1,526 cr.

**Note:** Numbers in parenthesis in the worksheet entries columns correspond with the entries immediately preceding this page.

### CONSOLIDATION OF NONCONTROLLING (MINORITY) INTERESTS

Noncontrolling interest (also referred to as *minority interest*) represents the portion of a subsidiary's equity that is not owned directly or indirectly by the parent. Noncontrolling interest has three implications:

1. Noncontrolling shareholders have an interest in the equity (net assets) of the subsidiary, which must be clearly identified and presented within stockholders' equity in the consolidated financial statements, but separate from the parent's equity. Prior to the adoption of ASC 810, the interest of the minority shareholders was sometimes reflected in the "mezzanine" section of the balance sheet, between liabilities and stockholders' equity, **which is no longer acceptable**.
2. Noncontrolling shareholders have an interest in the net income of the subsidiary, which is separately reported on the face of the income statement apart from the earnings associated with the controlling interest (parent). On consolidated working papers, a subsidiary's net income is allocated between the noncontrolling (minority) interest share and the parent's share.
3. Noncontrolling shareholders have an interest in any dividends paid by the subsidiary.

The following example illustrates the application of these concepts.



## Example

On January 2, 2X13, Suz Company purchased 75% of the Levita Company's outstanding common stock. Selected balance sheet data at December 31, 2X13, follow:

	<i>Suz</i>	<i>Levita</i>
Total assets	<u>\$210,000</u>	<u>\$90,000</u>
Liabilities	\$ 60,000	\$30,000
Common stock	50,000	25,000
Retained earnings	<u>\$100,000</u>	<u>\$35,000</u>
	<u>\$210,000</u>	<u>\$90,000</u>

During 2X13, Suz and Levita paid cash dividends of \$12,500 and \$2,500, respectively, to their shareholders. There were no other intercompany transactions.

The following questions relate to the data just presented:

- In Suz's December 31, 2X13, consolidated balance sheet, what amount should be reported as noncontrolling (minority) interests in net assets?
- What amount should Suz report as dividends paid on its December 31, 2X13, consolidated statements of retained earnings?
- In its December 31, 2X13, consolidated balance sheet, what amount should Suz report as common stock?

The noncontrolling (minority) interest represents the portion of total stockholders' equity owned by investors in a subsidiary who are not part of the controlling interest. That is, they are not part of the parent entity. The noncontrolling (minority) interest is computed by referring to the stockholders' equity accounts of the subsidiary standing alone. Any adjustments made for consolidated financial statements are ignored in this calculation. Examination of the data given in the illustration enumerated previously indicates that the noncontrolling (minority) interest in Levita's net assets at December 31, 2X13, is \$15,000. This amount is computed by multiplying Levita's net assets (\$60,000) by the portion of Levita's stock (25%) that is not owned by the parent company (Suz Company). The computation is as follows:

$$(\$25,000 + \$35,000) \times 25\% = \$15,000$$

When a business combination is accounted for under the acquisition method, any preacquisition dividends are not adjusted. Only those transactions of the subsidiary subsequent to the date of the purchase are presented in the consolidated financial statements. Thus, any dividends paid by the subsidiary to the parent should be eliminated in preparing the consolidated financial statements. In general, all dividends paid to minority shareholders of the subsidiary should be accounted for as a reduction of the minority interest in the subsidiary's net assets. In this illustration, Suz should report dividends as \$12,500 in its December 31, 2X13, consolidated statement of retained earnings. This is the amount Suz paid to its shareholders that year.

In the preparation of Suz's consolidated balance sheet, the entire stockholders' equity of the subsidiary must be eliminated. Thus, Suz's December 31, 2X13, balance sheet should report common stock as \$50,000.

When consolidated financial statements are presented, 100% of the assets, liabilities, revenue, and expenses and the revenue and expenses in the income statement of the subsidiary are shown. Therefore, a contra must be presented for the part of these financial statement items not belonging to the parent. In the balance sheet, the contra for the noncontrolling (minority) interest in consolidated net assets based on the minority's percentage ownership in the net assets of the subsidiary must be presented. If a debit balance for the noncontrolling (minority) interest arises, it may be shown as a deduction to stockholders' equity or a reduction to the parent's retained earnings.

Retained earnings of the consolidated entity at the acquisition date consist solely of the retained earnings of the parent (since the consolidated entity does not include any equity amounts of the subsidiary). Retained earnings of the consolidated entity at the reporting date consist of acquisition-date retained earnings, plus the parent's net income for the year (which includes its proportionate share of the subsidiary's net income), minus consolidated dividends paid.

There are acceptable alternative presentations to presenting noncontrolling (minority) interests in the balance sheet. Noncontrolling (minority) interest may be shown as a part of stockholders' equity but segregated from the equity of the controlling interest. This presentation is as follows:

<i>STOCKHOLDERS' EQUITY</i>	
Controlling interests:	
Common stock	\$100,000
Retained earnings	800,000
Noncontrolling interests	70,000
Total	\$970,000

In the consolidated income statement, noncontrolling (minority) interests are presented as a deduction (expense) if there is a consolidated profit. If there is a consolidated net loss, the noncontrolling (minority) interest will be an income item because the noncontrolling (minority) interest would decrease the consolidated loss. The noncontrolling (minority) interest is calculated by multiplying the subsidiary's profit (after elimination of intercompany profits) by the percentage of the subsidiary's stock held by the noncontrolling (minority) interest. **The noncontrolling (minority) interest may be presented in the income statement as a separate item, if material, after consolidated net income.**

This consolidated income statement presentation is illustrated below for a 30% noncontrolling interest in XYZ:

Revenues	\$5,000,000
Expenses	(4,000,000)
Income from continuing operations, pretax	1,000,000
Income tax expense	(400,000)
Income from continuing operations, net of tax	600,000
Discontinued operations, net of tax	(100,000)
Net income	500,000
Less: Net income attributable to noncontrolling interest	(150,000)
Net income attributable to XYZ	350,000

Losses may be incurred by the subsidiary, with their concurrent negative financial effects on noncontrolling interest. If the noncontrolling interest in subsidiary net assets has been reduced to zero because of losses, the noncontrolling interest will continue to be charged for its share of additional losses, even if that results in a deficit balance in the noncontrolling interest account. This represents a change from prior practice and is mandated by ASC 810-10-65-10.

Noncontrolling (minority) interests do not affect the adjustment for unrealized intercompany profits in inventories. However, consolidated profit and noncontrolling (minority) interests in the net income of a subsidiary are affected by the adjustment because the change in beginning or ending inventory of a partly owned subsidiary does impact net income determination.

**Note:** When performing a consolidation, if the balance sheet does *not* balance, it is usually because of the noncontrolling interest, as these amounts do not appear on the companies' general ledgers.

## **CONTRAST OF ACQUISITION AND PURCHASE METHODS FOR NONCONTROLLING (MINORITY) INTERESTS**

The following terminology is mentioned in ASC 805 and ASC 810 as it relates to various aspects of the treatment of noncontrolling (minority) interest:

### *The Acquisition Method:*

- **Control Premium:** Represents extra dollars paid to acquire control; remainder of shares sell at a lower price.
  - $\text{Business Fair Value} = \text{FV of Controlling Interests} + \text{FV of Noncontrolling Interest}$
  - $\text{Goodwill} = \text{Total Business Fair Value} - \text{FV of Net Assets Acquired}$
- **Step Acquisition:**
  - If the parent held a noncontrolling interest prior to obtaining control, remeasure the noncontrolling interest at fair value and calculate the gain or loss that will appear on the income statement.
  - If the parent had control prior to the acquisition of additional shares, remeasure the noncontrolling interest at fair value and treat the acquisition as an equity transaction (debit or credit to additional paid in capital).
- **Sale of Subsidiary Shares:** Establish a cost basis of shares sold (first in, first out [FIFO], specific identification, and weighted average cost are acceptable cost flow assumptions).
  - If control is maintained after the sale, treat the sale as a capital transaction (difference between proceeds received and cost of shares sold is a debit or credit to additional paid in capital).
  - If control is not maintained after the sale, calculate the gain or loss reported in earnings.
- **Preacquisition Income:** Report revenue and expense subsequent to the date of acquisition (separately show 100% of postacquisition revenue and expense less the noncontrolling interest share of net income).
- **Presentation of Noncontrolling Interest on Balance Sheet:** This should be reported in stockholders' equity.

*The Purchase Method:*

- *Control Premium:* Not discussed. Report noncontrolling interest as a percentage of subsidiary net assets (parent company method).
- *Step Acquisition:* Each step requires separate fair value allocations and amortization (cost accumulation), potentially resulting in several layers of goodwill.
- *Sale of Subsidiary Shares:*
  - Establish a cost basis of shares sold (FIFO, specific identification, and weighted average cost are acceptable cost flow assumptions).
  - Gain or loss reported on the income statement; there is no distinction between whether control is maintained after the sale.
- *Preacquisition Income:* For acquisitions after January 1, report full-year revenue and expense and deduct “preacquisition net income” for the months not owned.
- *Presentation of Noncontrolling Interest on Balance Sheet:* Prior rules did not mandate the presentation. Noncontrolling interest on the balance sheet was reported in liabilities, between liabilities and stockholders' equity (known as the “mezzanine section”), or in stockholders' equity.

Exhibit 2-1 contrasts the new acquisition method rules with the grandfathered old rules for the purchase and pooling of interests methods.

**Exhibit 2-1: Noncontrolling Interests—New Rules vs. Old Rules**

	<b>ASC 805 and ASC 810 (Acquisition Method)</b>	<b>Old Rules (Purchase Method) (Not in Codification)</b>
<i>Control Premium</i>	Represents extra dollars (above fair value of acquiree stock) to obtain control. Used in determining business fair value and goodwill.	Not discussed. Noncontrolling interest on balance sheet reported as percentage of book value of subsidiary net assets.
<i>Step Acquisitions</i>	There are two possible treatments for additional purchases (steps): 1. If the parent held noncontrolling interest (NCI) and now obtains control, remeasure NCI at fair value with gain or loss in earnings. 2. If the parent had control and acquires additional shares, treat as an equity transaction with an increase or decrease in additional paid in capital.	Each additional purchase (step) requires separate fair value allocations and amortization. This is referred to as the <i>cost accumulation method</i> and results in several layers of goodwill.

<i>Sale of Subsidiary Shares</i>	1. Establish a cost basis of shares sold (e.g., FIFO, specific identification, weighted average). 2. Determine if control is maintained after the sale: a. If control is maintained, treat the sale as an equity transaction (increase or decrease in additional paid in capital). b. If control is not maintained, calculate the gain or loss in earnings. As clarified in 2010 by a revision to ASC 810-10-65, (a) and (b) are applied as long as there is no other conflicting GAAP.	First establish the cost basis of shares sold (i.e., FIFO, specific identification, weighted average) and then calculate gain or loss on the sale to be reported in earnings. There is no distinction as to whether control is maintained after the sale.
<i>Preacquisition Income (acquiree earnings prior to business combination)</i>	Not reflected in consolidated financial statements.	In the year of the acquisition, show 100% of full-year acquiree income and expense and deduct preacquisition income for the months not owned.

## **SPIN-OFFS**

A parent may transfer a wholly or partly owned subsidiary or an investee to the entity's stockholders. The accounting for a spin-off varies with the percentage of the company that is owned. If ownership is minor (e.g., 20%), the transfer is considered a dividend in kind (property dividend) and is accounted for at the fair value of the shares in the investee transferred. If the spin-off is for a majority or wholly owned subsidiary, the impact is to remove its operations from the former parent and to vest them with the parent's stockholders. This transaction is clearly a spin-off of substance. Such a spinoff is accounted for at the recorded book values of the net assets transferred. The profit of the subsidiary to be disposed should be included in the parent's earnings up to the actual date of spin-off.

## **CONSOLIDATION REPORTING—OTHER TOPICS**

If a subsidiary holds shares in the parent, the shares should not be reported as outstanding stock in the consolidated balance sheet but rather treasury shares to be deducted from consolidated stockholders' equity.

If an investment in subsidiary is sold during the year, the parent should include in its income statement its percentage interest in the subsidiary's profits up to the disposal date and any gain or loss on sale.

Consolidation is still allowed without adjustments if the parent and subsidiary have fiscal year-ends of three months or less apart. The parent's fiscal year results are added to the subsidiary's fiscal year results. There should be footnote disclosure of significant occurrences during the intervening time period.

There are situations in which parent company statements are required in addition to consolidated statements so as to provide information to lenders, suppliers, and preferred stockholders. In such cases, dual columns are warranted: one column for the parent and the other for the subsidiary. Alternatively, separate “parent company only” financial statements may be presented.

## TAXES

There is a deferral of income taxes on any intercompany profits if the asset remains within the consolidated group. If consolidated tax returns are prepared, no adjustment is required for deferred income taxes because the intercompany profits are eliminated in deriving the consolidated tax liability.

Consolidated income tax expense may be recorded on the parent's books or allocated among the affiliates so each affiliate will recognize its share of consolidated income tax expense on its own books. However, if affiliates issue their own separate financial statements in addition to consolidated statements being prepared, the income tax expense must be allocated to the affiliates.

If the parent and subsidiary prepare separate tax returns instead of a consolidated tax return, the parent or a subsidiary may include in its accounts income taxes paid on intercompany profits. In this case, the taxes should be deferred or the intercompany profits that have been eliminated in consolidation reduced.

### Example

A subsidiary sells inventory costing \$200,000 to its parent and records a \$50,000 profit on the transaction. All of this inventory remains with the parent through year-end. The subsidiary files a separate tax return from its parent and pays \$15,000 in income taxes from the transaction. If consolidated financial statements were prepared, the following consolidating (worksheet) entries are required:

Dr. Sales	250,000	
Cr. Cost of goods sold (purchases)		250,000
<i>To eliminate intercompany sales and purchases.</i>		
Dr. Cost of goods sold	50,000	
Cr. Inventory		50,000
<i>To eliminate profit on intercompany sale.</i>		
Deferred income tax asset	15,000	
Income tax expense		15,000
<i>To defer tax expense on intercompany profits eliminated in consolidation.</i>		

## ACCOUNTING FOR TRANSFERS OF FINANCIAL ASSETS (ASC 860)

This topic deals with appropriate accounting recognition by a transferor (seller) for transfers of financial assets. The principal issue is whether a sale or a collateralized borrowing is recognized by the transferor at the date of transfer. The answer is critical when a sale occurs, a gain or loss is recognized, and the assets in question are removed from the books of the transferor. Recognition of a sale and profit increases the return on assets (net income/average assets) ratio of the transferor and will reduce the leverage (debt/equity) ratio, which is generally considered a desired result. If the criteria

for sales accounting are not met, no gain or loss is recognized and the assets stay on the transferor's balance sheet along with a borrowing. This will increase the leverage ratio, and potentially place the transferor in violation of debt covenants.

### **Accounting Treatment**

As a general principle, when a transferor has no continuing involvement with both the transferred financial assets and the transferee, sales treatment with recognition of gain or loss on a sale, along with removing the assets from the transferor's balance sheet, is appropriate.

However, there are situations where the transferor will have some continuing involvement with the transferred financial assets and/or the transferee. Examples of situations include transferor servicing, recourse or guarantee arrangements, agreements to purchase or redeem the transferred financial assets, options written (sold) or held, pledges of collateral, and possible retained transferor beneficial interests in the transferred financial assets. Each of the above situations raises questions as to whether the transferor should account for the transfers as sales or as secured borrowings.

ASC 860 provides specific guidance on transactions that fall into the categories of securitizations, factoring, transfers of receivables with recourse, securities lending transactions, repurchase agreements, loan participations, and banker's acceptances. A brief description of the most common of these structures and a summary of accounting guidance follows.

*Securitizations.* Beneficial interests in a portfolio of financial assets, such as mortgage or auto loans, or trade or credit card receivables, are transferred (sold) by the transferor to a trust. The trust will securitize the pool of assets and pass through the interest and principal collected to investors, who have purchased a portion of the pool of assets. (Note that the transferor may have been the originator of these assets or acquired them from another entity.) There may be several classes of investors who are entitled to differing cash flows generated from these assets. In some instances, a "turbo provision" provides that cash received during the amortization period of the securitization is paid to one class of investors before any cash is available for repayment to other investors. The transferor may have the right, under certain conditions and with trustee approval, to withdraw receivables from the pool of securitized receivables.

*Factoring.* Factoring arrangements are discussed in sections 3.08 and 3.09.

*Transfers of receivables with recourse.* One or more entire receivables are transferred, where the transferor provides the transferee (buyer) with full or limited recourse. If there is a payment default by the obligor of the receivables, the transferor is required, as specified by the terms of the arrangement, to make full or limited payment to the transferee, or repurchase the receivables sold.

*Repurchase agreements.* Repurchase agreements are discussed in sections 17.28 and 17.29.

*Participating interests.* To be eligible for sale accounting (described in the next paragraph), GAAP requires that an entire financial asset cannot be divided into component parts (e.g., interest and principal on a receivable) unless it meets the

definition of a *participating interest*. The definition of the term participating interest will be incorporated in ASC 860-10-40-6A and represents a proportionate (pro rata) ownership interest in an entire financial asset. Cash flows received from the entire financial asset are divided proportionately among participating interest holders. No participating interest holder's interest may be subordinated to the interest of another participating interest holder; and participating interest holders are not permitted to have recourse to the transferor.

*Accounting.* A transfer of an entire financial asset, a group of entire financial assets, or a participating interest in an entire financial asset in which the transferor surrenders control over those financial assets shall be accounted for as a sale if all of the following conditions are met (ASC 860-10-40-5):

1. The financial assets have been “isolated” (put out of reach) from the transferor and its creditors.
2. The transferee has the right to pledge or exchange the transferred financial assets with no conditions constraining the transferee (or third-party holder of its beneficial interest) from taking advantage of these rights.
3. The transferor or its consolidated affiliates does not maintain effective control of those financial assets. Effective control exists if (a) there is an agreement that obligates the transferor to repurchase or redeem the financial assets before their maturity or (b) there is an agreement that permits the transferee to require the transferor to repurchase the transferred assets at a price so favorable to the transferee that it is probable that the repurchase will take place.
4. Derecognition of a transferred financial asset (treatment as a sale by the transferor) is appropriate only where there is reasonable assurance that the transferred financial is beyond the reach of the bankruptcy trustee of the transferor.

The following are examples of the application of the above criteria.

1. If the transferor and transferee are related by majority ownership, treatment as a sale in the consolidated financial statements is not permitted (this is an intercompany transaction).
2. A transfer of receivables in their entirety with recourse shall be accounted for as a sale, with the proceeds of the sale reduced by the fair value of the recourse obligation (see Example 1, below).
3. If the transferor has the power to require the return of transferred financial assets from the transferee through a repurchase agreement or call option (option to purchase given by the transferee to the transferor), sales treatment is not permitted. However, “cash settled call options,” where the receivable is not returned to the transferor, do not preclude sales treatment. Additionally, a call option embedded by the issuer of a callable bond would not result in the transferor maintaining effective control. A put option (option to sell) written (sold) to the transferee generally does not provide the transferor with effective control over the transferred financial asset and does not create issues as to recognition of sale by the transferor. An exception would be a put option written on a not-readily-obtainable asset that may benefit the transferor and constrain the transferee if the option is “deep in the money” when written, as it is probable that the transferee will exercise it.



4. If a transferor imposes restrictions on the ability of a transferee to pledge or exchange the transferred financial assets, where that restriction provides more than a trivial benefit to the transferor, the transaction cannot be treated by the transferor as a sale. On the other hand, a transferor's right of first refusal if the transferee chooses to sell the asset does not jeopardize sales accounting by the transferor, as it cannot compel the transferee to sell the asset. A right by the transferor to reclaim specific transferred financial assets by paying their fair value when reclaimed does not maintain effective control and thus sales treatment is appropriate assuming the other above conditions are met. Any retained beneficial interest in a transferred financial asset should initially be recognized at fair value.
5. In a loan participation, the lead bank (transferor) allows the participating bank to resell the asset, but the transferor may retain the right to call (purchase) the asset at any time from whoever holds it, and can enforce the call option by withholding the flow of interest at the call date. This transferor-imposed restriction provides more than a trivial benefit to the transferor, and sale accounting is not appropriate.

ASC 860 has eliminated the previous concept of "qualifying special purpose entities" and now requires that all SPEs be analyzed for consolidation using ASC 810.

If the transferee is consolidated by the transferor, then even if the criteria under *Accounting* above are met, the transferred assets would not be treated as sold in the consolidated financial statements. However, the transferee may recognize the transferred assets in its separate entity financial statements and the transferor would recognize a sale in its separate entity financial statements.

Treatment as a sale or as collateralized financing is determined using the above guidance and is based on the facts and circumstances of the particular situation.

The following are the minimum disclosure requirements for transactions subject to these rules:

1. Explain the transferor's continuing involvement, if any, with the transferred financial asset.
2. Discuss the nature of any restriction on assets reported by an entity in its statement of financial position relating to a transferred financial asset.
3. Describe any servicing arrangements existing between the transferor or transferee, as well as the classification of servicing assets and servicing liabilities in the statement of financial condition.
4. For transfers treated as sales, indicate the impact on the entity's balance sheet, income statement, and statement of cash flows.
5. For transfers treated as secured borrowings, indicate the impact on the entity's balance sheet, income statement, and statement of cash flows.
6. Discuss any risks related to the transferred assets to which the transferor continues to be exposed after the transfer.

The above disclosures may be reported in aggregate form for similar transactions.

The effective date of ASC 860 is the beginning of each reporting entity's first annual reporting period beginning after November 15, 2009. A reporting entity is encouraged, but not required, to disclose comparative information for periods earlier than the effective date.

The following examples illustrate the principal requirements in this area.

### Example 1

ABC Corp., a financial institution, has originated \$10,000,000 of fixed rate, interest-bearing auto loans in its program with a major car dealer. To raise money, ABC sells the entire auto loan portfolio to an unrelated securitization entity and receives proceeds of \$10,800,000. ABC does not service the loans, nor does it restrict the ability of the securitization entity from pledging or selling the assets to investors or others. ABC does agree to provide a limited recourse obligation, meaning ABC agrees to repurchase delinquent loans up to 5% of the aggregate face amount. In addition, ABC agrees to provide a variable interest rate return to the securitization entity, in substance, making this a interest rate swap, that is, ABC receives the fixed rate on the auto loans and pays a variable interest rate to the securitization entity. Assume that on the reporting date, the fair value of this swap is \$300,000.

**Analysis:** This transaction qualifies as a sale, because the transferred financial assets are out of the effective control of ABC. ABC records the recourse obligation and the fair value of the interest rate swap along with the gain on sale.

Net Proceeds:		
Cash received		10,800,000
Plus interest rate swap asset		300,000
Less: recourse obligation		(500,000)
Net proceeds		10,600,000
Gain on Sale		
Net proceeds		10,600,000
Less: Carrying amount of loans sold		10,000,000
Gain on Sale		600,000
Journal Entry:		
Dr. Cash	10,800,000	
Dr. Interest Rate Swap	300,000	
Cr. Auto Loans		10,000,000
Cr. Recourse Obligation		500,000
Cr. Gain on Sale		600,000

### Example 2

XYZ has \$7,000,000 of accounts receivable arising from credit sales on its books. XYZ sells these assets to HIJ for \$7,100,000, but retains the right to repurchase the assets at the face value of \$7,000,000 at any date before the assets contractually mature.

**Analysis:** XYZ as transferor retains a call option on these receivables that provides “more than a trivial benefit” (the FASB's term) to them. Sale accounting is not permitted, as the transferred assets are not fully beyond the control of the transferor. The transaction is treated as a collateralized borrowing on the books of XYZ.

Journal Entry (XYZ):		
Dr. Cash	7,100,000	
Cr. Collateralized Borrowing		7,100,000

## VARIABLE INTEREST ENTITIES (VIEs)

In essence, a *variable interest entity (VIE)* is any legal structure (including, but not limited to, those previously described as special-purpose entities) with insufficient equity investment or whose equity investors lack one of the essential characteristics of financial control. When an entity becomes involved with a VIE, it must determine whether it is the primary beneficiary and therefore must consolidate the VIE. A primary beneficiary holds a variable interest(s) that will absorb a majority of the VIE's expected losses or receive a majority of its expected residual returns (or both).

Traditional criteria for consolidation have required the parent to have a controlling financial interest in its subsidiaries, typically in the form of voting common shares. In the 1990s, companies began to sponsor the formation of so-called *special purpose entities (SPEs)* to isolate certain assets and liabilities into separate legal entities so that investors and creditors of those entities could better understand the risks and require a lower return on those risks. Companies seeking to raise money for their operations may sponsor the creation of a SPE to which they sell assets for money. Companies often create SPEs for a single specific purpose, for example, to facilitate securitization of financial assets, support leasing activities or reduce risk through hedging, or for research and development, and reinsurance.

The SPE obtains money by issuing stock, borrowing, or selling assets to investors and passing through the proceeds to the sponsor company to pay for the assets purchased. The SPE is owned by shareholders unrelated to the sponsor and may use the assets as security for a collateralized borrowing. The principal question with these structures is the same as with ASC 860; that is, can the sponsor company record a sale of assets along with a gain or loss on a sale and remove the assets from its balance sheet or must the sponsor treat this structure as a collateralized borrowing?

The answer is that if the SPE structure meets the definition of a variable interest entity (VIE), a sponsor company that is a primary beneficiary must consolidate the VIE with its operations and thus cannot record a sale. However, if the SPE structure is not in the form of a VIE and if the transferor meets the requirements of ASC 860 and is not a primary beneficiary, sale accounting is appropriate. These accounting standards are meant to protect against the abusive practices of some companies, notably Enron, to not consolidate SPEs they controlled in substance, particularly when there was no substantial outside equity investors and when the sponsor guaranteed a minimum return to investors as well as agreeing to reimburse the SPE for any losses incurred.

The determination of whether a legal entity meets the definition of a VIE and whether the reporting unit meets the criteria of a primary beneficiary is made at the date that the reporting entity first becomes involved with the legal entity or later if events subsequent to the formation of the VIE now make the reporting unit a primary beneficiary.

In defining a VIE, the FASB clarified their replacement of a quantitative based risks and rewards approach to a more qualitative approach. (ASC 810-10-05-8) This qualitative approach relates to SPE structures, where equity investors lack sufficient equity capital to be able to finance SPE operations without additional subordinated financial support, or if holders of the equity investment in the entity, in the aggregate, lack any one of the following three characteristics:

1. The power to direct activities of the legal entity that most significantly impact economic performance, even if that power is not used. This power may exist despite the fact that the entity that has this ability lacks significant voting rights through stock ownership. It is possible that the power is shared among multiple unrelated parties. The reporting entity is responsible for identifying the party that directs the activities with the most significant impact on the VIE's economic performance. (ASC 810-10-25-38E)
2. The obligation to absorb expected losses of the legal entity, which may occur when there is a minimum return on invested capital provided to investors based on the legal entity's governing document. This condition may also exist when the voting rights of some investors are not proportional to their obligations to absorb expected losses.
3. The right to receive residual returns of the legal entity, including when this right is capped by the legal entity's governing document.

When one or a combination of the above conditions exists, someone other than the equity holders in the SPE will be the primary beneficiary of the risks and rewards of ownership. This may be the sponsor company or another company on whose behalf the sponsor created the SPE. In such cases, a controlling financial interest is achieved through contractual arrangements that do not involve ownership of voting equity interests. In addition, some SPEs do not have an independent governing board and may have activities that are limited by the articles of incorporation, partnership, or trust agreement. The reporting entity, in substance, may implicitly accept all the activities that the SPE is permitted to engage. The reporting entity that has the variable interests is required to assess whether it has a controlling financial interest in the SPE based on its ability to direct activities of the SPE and have the obligation to absorb losses of the SPE or receive benefits from the SPE that can be considered significant to the SPE's financial performance. (ASC 810-10-25-38A)

The reporting entity must also consider if it holds an implicit variable interest in the SPE. (ASC 810-10-25-54) Implicit variable interests commonly occur in leasing transactions among related parties and in other types of arrangements, where the reporting entity receives the variability of return on the SPE, irrespective of whether there is a contractual relationship between the parties. When a variability of return is given to the reporting entity, a controlling financial interest will exist.

Fees that are paid to a legal entity's decision makers or service provider are not considered variable interests if the fees are compensation for services provided, have the same seniority as other payables of the SPE, are considered customary compensation, and are insignificant to the SPE's overall performance. (ASC 810-10-55-37)

If a controlling financial interest exists, the reporting entity is considered the primary beneficiary and the SPE meets the criteria of being a VIE that must be consolidated with the reporting entity's operations. Thus, the assets, liabilities, and noncontrolling (minority) interests are consolidated at fair value and results of operations of the VIE must be included in the consolidated financial statements of the primary beneficiary. These rules are applied to the entire VIE and not to divisions, departments, branches, or pools of assets within the VIE. An exception exists when the activities of the VIE primarily relate to securitizations and the assets of the VIE can only be used to settle the obligations of that entity. In that case, the assets and liabilities of the VIE may be

measured at their unpaid principal balances (an alternative to fair value measurement). The primary beneficiary will still be required to recognize any other than temporary impairment in its investment, any needed allowance for credit losses, as well as accrued interest.

The requirement to determine the primary beneficiary is ongoing, although that assessment may change, depending on the facts and circumstances of how the VIE and the reporting entity treat their relationship. There are no longer any qualifying special purpose entities (QSPE) that are not subject to these standards. **QSPE designation was removed in ASC 860 in December 2009.**

The logic behind these rules is to prevent abuses, where some SPEs are designed to avoid having to report them in the consolidated financial statements of the primary beneficiary. Many VIEs do not have a governing board to make economic decisions on how these entities operate; instead, they rely on the direction of the primary beneficiary. Now all SPE structures that meet the definition of a VIE must be consolidated with the primary beneficiary's other operations.

SPEs are often created for a single specific purpose, for example, to facilitate securitization of financial assets and to support leasing activities, risk reduction through hedging, research and development, and reinsurance. Other entities having the same characteristics may also qualify as VIEs.

The initial measurement by a consolidating entity of the assets, liabilities, and noncontrolling interests of a VIE depend on whether the determination of their carrying value is practical. In this context, carrying value means the amounts that the assets, liabilities, and noncontrolling interests would be reported in the consolidated financial statements if the VIE rules described above had been in effect when the reporting entity first met the conditions of primary beneficiary. Under the acquisition method of accounting, this requires measurement at fair value as of the date the conditions of primary beneficiary are first met. However, if carrying values described above are not available and the activities of the VIE primarily relate to securitizations and the assets of the VIE can be used only to settle obligations of the entity, then the assets and liabilities of the VIE can be measured by the reporting entity at their unpaid principal balance.

The one significant exception is in regard to assets or liabilities transferred at inception by the primary beneficiary to the VIE. These are, in effect, intercompany transactions, which will be measured in the consolidated financial statements in the same manner as the intercompany transactions previously described (i.e., any intercompany profit on a transfer is eliminated in consolidation through a worksheet adjustment).

Any difference between the net amount added to the balance sheet of the consolidating entity and the book value of the VIE previously recognized by the reporting entity is treated as a cumulative effect adjustment to beginning retained earnings of the first year restated. (ASC 810-10-30-9) Once an entity has been designated as a VIE, that designation will not change unless there is a change in the underlying contractual relationship, a return of capital to other equity investors, a change in the nature of the activities of the VIE, or the consolidating entity loses its power to direct the activities of the VIE in a way that significantly impacts the entity's performance.

Note that in **Accounting Standards Update (ASU) 2010-10**, issued in February 2010, the FASB has chosen to defer for investment companies only, the consolidation requirements from ASC 810. The reason for the deferral is to allow *the International Accounting Standards Board (IASB)* and *FASB* sufficient time to issue joint consistent guidance on principal and agent relationships as part of their joint consolidation project.

### **Fair Value Option Relating to VIEs**

A reporting entity that is required to consolidate a VIE may elect to use the fair value option ASC 825-10 if the reporting entity elects that option for all financial assets and liabilities of the VIE.

### **Disclosure**

Disclosure is extensive and depends on whether the reporting entity is a primary beneficiary or nonprimary beneficiary of the VIE. (ASC 810-10-50-5A) A primary beneficiary of a VIE or a reporting entity that holds a variable interest in a VIE must disclose the following:

1. Qualitative and quantitative information about the reporting entity's involvement in the VIE, including, but not limited to, the nature, purpose, size and activities of the VIE, including how the VIE is financed.
2. The carrying amount and classification of consolidated assets that are collateral for the VIE's obligations.
3. Lack of recourse if creditors (or beneficial interest holders) of a consolidated VIE have no recourse to the general credit of the primary beneficiary.
4. Methodology, including assumptions and judgments made, to determine whether the reporting entity is the primary beneficiary.
5. Whether the conclusion has changed as to need to consolidate the VIE in the periods presented in the most recent financial statements.
6. Whether the reporting entity has provided financial or other support to the VIE during the periods presented, and if so, the amount, type and primary reasons such support has been given.

### **Notes:**

1. The above disclosures do not apply when the reporting entity holds both a majority of voting interests of a VIE (that is a business) and is also a primary beneficiary. Normal disclosure for consolidated entities applies.
2. In addition, the above disclosures are not required for VIEs created before December 31, 2003, where the reporting entity is unable to
  - a. Determine whether a legal entity is a VIE.
  - b. Determine whether the reporting entity is the VIE's primary beneficiary.
  - c. Perform the accounting required to consolidate the VIE when it has been determined it is the primary beneficiary. (ASC 810-10-15-17)

For VIEs created prior to December 31, 2003, meeting condition (2.) in the note above, the following disclosure is required:

1. Number of legal entities to which this applies and why the information required to apply the guidance is not available.
2. Nature, purpose, size (if available), and activities of the legal entities and the nature of the reporting entity's involvement with the legal entities.
3. Reporting entity's maximum exposure to loss because of its involvement with the legal entities.
4. Amount of income, expense, purchases, sales, or other measure of activity between the reporting entity and legal entities.

In addition to the four disclosure items above, a nonprimary beneficiary holder of an interest in a VIE is required to disclose:

1. The carrying amounts and classification of assets and liabilities in the reporting entity's balance sheet that relate to the reporting entity's variable interest in the VIE.
2. The reporting entity's maximum exposure to loss as a result of its involvement with the VIE and how that maximum exposure is determined. A description of the nature of the sources of the reporting entity's exposure to loss should be discussed.
3. A table that compares the book value of the VIE's assets and liabilities to the maximum loss exposure and the qualitative and quantitative factors that could require the reporting entity to provide financial support to the VIE.
4. Any liquidity arrangements, guarantees, or other commitments that may affect the fair value or risk of the reporting entity's VIE.
5. A description of all factors used to conclude that the power to direct activities influencing VIE performance is shared with other entities.

The footnote disclosures required above may be provided in more than one note to the financial statements as long as there is a cross reference to the other notes that contain the remaining required disclosures.

The effective date with respect to the variable interest entity amendments of ASC 810 are to be applied to the reporting entity's first annual reporting period beginning after November 15, 2009, and to interim periods within that first annual period.

Exhibit 2-2 shows Fluor's VIEs disclosure.

## **Exhibit 2-2**

### **Fluor 2007 Annual Report**

#### **Variable Interest Entities**

##### *National Roads Telecommunications Services ("NRTS") Project*

In 2005, the company's Industrial & Infrastructure segment was awarded a \$544 million project by a joint venture, GeneSYS Telecommunications Limited ("GeneSYS"), in which the company owns a 45 percent interest and HSBC Infrastructure Fund Management Limited owns a 55 percent interest. The project was entered into with the United

Kingdom Secretary of State for Transport (the “Highways Agency”) to design, build, maintain and finance a significant upgrade to the integrated transmission network throughout England's motorways. GeneSYS financed the engineering and construction (“E&C”) of the upgraded telecommunications infrastructure with approximately \$279 million of non-recourse debt (the “term loan facility”) from a consortium of lenders (the “Banks”) along with joint venture member equity contributions and subordinated debt which were financed during the construction period utilizing equity bridge loans from outside lenders. During September 2007, the joint venture members paid their required permanent financing commitments in the amount of \$44 million and were issued Subordinated Notes by GeneSYS. These funds were used by GeneSYS to repay the temporary construction term financing including the company's equity bridge loan. In early October 2007, the newly constructed network achieved operational status and was fully accepted by the Highways Agency on December 20, 2007, thereby concluding the E&C phase and entering the operations and maintenance phase of the project.

Based on a qualitative analysis of the variable interests of all parties involved at the formation of GeneSYS, under the provisions of FIN 46-R, the company was initially determined to be the primary beneficiary of the joint venture. The company's consolidated financial statements included the accounts of GeneSYS, and, accordingly, the non-recourse debt provided by the Banks from the inception of the venture. Effective October 1, 2007, the company no longer consolidates the accounts of GeneSYS because it is no longer the primary beneficiary of the joint venture.

FIN 46-R requires that the initial determination of whether an entity is a variable interest entity (“VIE”) shall be reconsidered under certain conditions. One of those conditions is when the entity's governing documents or contractual arrangements are changed in a manner that changes the characteristics or adequacy of the entity's equity investment at risk. Such an event occurred in September 2007 upon the infusion of capital by the joint venture members which resulted in permanent financing through issuance of Subordinated Notes by GeneSYS that replaced the temporary equity bridge loans that had been provided by outside lenders. This refinancing of temporary debt with permanent debt constituted a change in the governing documents of GeneSYS that required reconsideration of GeneSYS as a variable interest entity.

Based on the new capitalization structure of GeneSYS, the adequacy of the equity at risk in GeneSYS was evaluated and found to be inadequate to finance its operations without additional subordinated financial support. Accordingly, upon reconsideration, GeneSYS continues to be a variable interest entity. Because the company holds a variable interest in the entity through its equity and debt investments, a qualitative evaluation was undertaken to determine if it was the primary beneficiary. In this evaluation, the company considered all parties that have direct or implicit variable interests based on the contractual arrangements existing at the time of reconsideration. Based on this evaluation, the company has determined that it is no longer the primary beneficiary of GeneSYS. Accordingly, GeneSYS is not consolidated in the company's accounts at December 31, 2007 and is being accounted for on the equity method of accounting.

The company's maximum exposure to loss relating to its investment in GeneSYS is its aggregate \$20 million equity and debt investment plus any unremitted earnings. The term loan is an obligation of GeneSYS and will never be a debt repayment obligation of the company because it is non-recourse to the joint venture members.



### *Interstate 495 Capital Beltway Project*

In December 2007, the company was awarded the \$1.3 billion Interstate 495 Capital Beltway high-occupancy toll (“HOT”) lanes project in Virginia. The project is a public-private partnership between the Virginia Department of Transportation (“VDOT”) and Capital Beltway Express LLC, a joint venture in which the company has a ten percent interest and Transurban (USA) Inc. has a 90 percent interest (“Fluor-Transurban”). Under the agreement, VDOT will own and oversee the addition of traffic lanes, interchange improvements and construction of HOT lanes on 14 miles of the I-495 Capital Beltway in northern Virginia. Fluor-Transurban, as concessionaire, will develop, design, finance, construct, maintain and operate the improvements and HOT lanes under an 80 year concession agreement. The construction will be financed through grant funding from VDOT, non-recourse borrowings from issuance of public tax-exempt bonds, a nonrecourse loan from the Federal Transportation Infrastructure Finance Innovation Act (TIFIA) which is administered by the U.S. Department of Transportation and equity contributions from the joint venture members.

The construction of the improvements and HOT lanes will be performed by a construction joint venture in which the company has a 65 percent interest and Lane Construction has a 35 percent interest (“Fluor-Lane”). Transurban (USA) Inc. will perform the operations and maintenance upon completion of the improvements and commencement of operations of the toll lanes.

Fluor-Transurban has been determined to be a variable interest entity under the provisions of FIN 46-R. Pursuant to the requirements of the Interpretation, the company evaluated its interest in Fluor-Transurban including its project execution obligations and risks relating to its interest in Fluor-Lane and has determined based on a qualitative analysis that it is not the primary beneficiary of Fluor-Transurban. The company's maximum exposure to loss relating to its investment in Fluor-Transurban is its \$35 million aggregate equity investment commitment, of which \$9 million has been funded, plus any un-remitted earnings. The company will never have repayment obligations associated with any of the debt because it is non-recourse to the joint venture members. The company will account for its ownership interest in Fluor-Transurban on the equity method of accounting. The company will fully consolidate Fluor-Lane in its consolidated financial statements.

### **EFFECTIVE DATE**

**The accounting for noncontrolling interests (ASC 810-10-65-1A) is to be applied prospectively for fiscal years beginning on or after December 15, 2008.** Earlier adoption is prohibited. The presentation and disclosure requirements must be applied prospectively.

### **DISCLOSURES**

In addition to the presentation requirements previously discussed for noncontrolling interests on the face of the balance sheet and income statement, the following additional disclosures are required:

1. A reconciliation of total equity (net assets) attributable to the parent and noncontrolling interest. This reconciliation shall separately disclose, net income, transactions with owners, and each component of other comprehensive income.

2. In the notes to the consolidated financial statements, a separate schedule showing the impact of changes in the parent's ownership in a subsidiary.
3. For a subsidiary that is deconsolidated, the parent must disclose the gain or loss recognized at the time the subsidiary is no longer consolidated.

Disclosure is required on the financial statements or footnotes of the company's consolidation policy (e.g., composition of companies consolidated, intercompany transactions eliminated), on intervening events affecting financial position when the reporting periods of subsidiaries differ from that of the parent, on tax implications on the accounts, and on allocation methods (e.g., taxes among members of the consolidated group).

ASC 810-10-50-2 requires disclosure whenever a change is made to modify or eliminate the time lag (typically three months or less) used for recording results of consolidated entities or equity method investees having a different fiscal year-end.

Exhibit 2-3 presents excerpts from the annual report of Goodyear and General Electric.

### **Exhibit 2-3**

#### **Goodyear Tire and Rubber Company 2010 Annual Report**

##### **Note 21. Consolidating Financial Information**

Certain of our subsidiaries have guaranteed our obligations under the \$1.0 billion outstanding principal amount of 10.5% senior notes due 2016, the \$1.0 billion outstanding principal amount of 8.25% senior notes due 2020, and the \$282 million outstanding principal amount of 8.75% notes due 2020 (collectively, the "notes"). The following presents the condensed consolidating financial information separately for:

- (i) The Parent Company, the issuer of the guaranteed obligations;
- (ii) Guarantor subsidiaries, on a combined basis, as specified in the indentures related to Goodyear's obligations under the notes;
- (iii) Non-guarantor subsidiaries, on a combined basis;
- (iv) Consolidating entries and eliminations representing adjustments to (a) eliminate intercompany transactions between or among the Parent Company, the guarantor subsidiaries and the non-guarantor subsidiaries, (b) eliminate the investments in our subsidiaries, and (c) record consolidating entries; and
- (v) The Goodyear Tire & Rubber Company and Subsidiaries on a consolidated basis.

Each guarantor subsidiary is 100% owned by the Parent Company at the date of each balance sheet presented. The notes are fully and unconditionally guaranteed on a joint and several basis by each guarantor subsidiary. Each entity in the consolidating financial information follows the same accounting policies as described in the consolidated financial statements, except for the use by the Parent Company and guarantor subsidiaries of the equity method of accounting to reflect ownership interests in subsidiaries which are eliminated upon consolidation. Intercompany cash advances and loans made primarily for the purpose of short-term operating needs are included in cash flows from operating activities. Intercompany transactions reported as investing or financing activities include the sale of the capital stock of various subsidiaries and other capital transactions between members of the consolidated group.

**General Electric**  
**2008 Annual Report**

**Note 26. Intercompany Transactions**

Effects of transactions between related companies are eliminated and consist primarily of GECS dividend to GE; GE customer receivables sold to GECS; GECS services for trade receivables management and material procurement; buildings and equipment (including automobiles) leased by GE from GECS; information technology (IT) and other services sold to GECS by GE; aircraft engines manufactured by GE that are installed on aircraft purchased by GECS from third-party producers for lease to others; medical equipment manufactured by GE that is leased by GECS to others; and various investments, loans and allocations of GE corporate overhead costs.

These intercompany transactions are reported in the GE and GECS columns of our financial statements (and include customer receivables sold from GE to GECS), but are eliminated in deriving our Consolidated financial statements. The effects of these eliminations on our Consolidated cash flows from operating, investing and financing activities follow.

<i>December 31 (In millions)</i>	<i>2008</i>	<i>2007</i>	<i>2006</i>
<b>OPERATING</b>			
Sum of GE and GECS cash from operating activities—continuing operations	\$ 50,290	\$ 48,316	\$ 45,351
Elimination of GECS dividend to GE	(2,351)	(7,291)	(9,847)
Net decrease (increase) in GE customer receivables sold to GECS	90	(255)	2,036
Other reclassifications and eliminations	(188)	(828)	(956)
<b>Consolidated cash from operating activities—continuing operations</b>	<b>\$ 47,841</b>	<b>\$ 39,942</b>	<b>\$ 35,512</b>
<b>INVESTING</b>			
Sum of GE and GECS cash used for investing activities—continuing operations	\$ (39,615)	\$ (67,845)	\$ (54,132)
Net increase (decrease) in GE customer receivables sold to GECS	(90)	255	2,036
Other reclassifications and eliminations	(320)	1,202	1,223
<b>Consolidated cash used for investing activities—continuing operations</b>	<b>\$ (40,025)</b>	<b>\$ (66,388)</b>	<b>\$ (50,873)</b>
<b>FINANCING</b>			
Sum of GE and GECS cash used for investing activities—continuing operations	\$ 22,760	\$ 18,751	\$ 16,772
Elimination of short-term intercompany borrowings	(787)	1,950	(2,732)
Elimination of GECS dividend to GE	2,351	7,291	9,847
Other reclassifications and eliminations	316	99	(48)
<b>Consolidated cash from financing activities—continuing operations</b>	<b>\$ 24,640</b>	<b>\$ 28,091</b>	<b>\$ 23,839</b>

## COMBINED FINANCIAL STATEMENTS

Combined financial statements present the financial status and operating results of legally separate entities, related by common ownership, as if they were a single entity.

Consolidated financial statements are prepared when the parent has control over its affiliates. However, when control does not exist, combined financial statements are more suitable than consolidated statements. Examples of when combined statements should be prepared are when one stockholder owns a controlling interest in several related operating companies (brother-sister corporation), companies are under common management, subsidiaries are not consolidated when control does not exist, and combined statements are more meaningful than separate statements. For example, combined financial statements may be suitable for a combination of a partnership and a corporation that are commonly owned. Combined financial statements are appropriate when common management or common control exists for two or more entities not subject to consolidation.

Combined financial statements are prepared in a similar manner as consolidated statements. In other words, intercompany transactions and profits are eliminated. The calculation of combined net income is similar to the calculation for consolidated net income. Thus, combined net income should be recorded at the total of the net income reported by the combined entities, adjusted for any profits or losses from transactions between the combined entities. There is similar accounting treatment for noncontrolling (minority) interests, foreign operations, income taxes, and different fiscal periods among the combined group.

The major difference between combined and consolidated financial statements is that in the former none of the combining companies has an ownership interest in any of the other combining companies. The equity accounts of the combining companies are added. The equity section of the combined balance sheet incorporates the paid-in-capital accounts of the combining entities. However, there is only a single combined retained earnings account. Combined statements are unlike consolidation, in which the equity accounts are eliminated in a consolidation worksheet against the investment in subsidiaries held by the parent company.

## COMPREHENSIVE EXAMPLES AND APPLICATIONS— PURCHASE METHOD

**Note:** The following two problems are presented using the purchase method of accounting, which continues to be required for all acquisitions (not qualifying for poolings) completed prior to the effective dates of ASC 805 and ASC 810.

### Problem 1 (Use Exhibit 2-4)

On December 31, 2X12, Popular Corporation issued 21,040 shares of its \$1 par (current fair value \$10) common stock for *all* the outstanding common stock of Sky Company in a statutory merger. The business combination is recorded under the purchase method.

**Required:** Using the information given in Exhibit 2-4, prepare Popular Corporation's journal entries on December 31, 2X12, (a) to record the stock exchange, (b) to record payment of the out-of-pocket costs incurred in the merger with Sky Company, and (c) to record the merger with Sky Company.

## Exhibit 2-4: Purchase Combinations

Out-of-pocket costs of the business combination paid in cash by Popular on December 31, 2X12 were as follows:

Finder's and legal fees to business combination	\$10,450
Costs associated with SEC registration statement	14,550
Total out-of-pocket costs of business combination	<u>\$25,000</u>

Popular and Sky's modified balance sheets and current fair values (*prior* to the business combination) on December 31, 2X12 follow:

	<i>Popular Carrying Amounts</i>	<i>Sky Carrying Amounts</i>	<i>Sky Current Fair Values</i>	<i>Excess of Current Fair Value Over Book Value</i>
<b>ASSETS</b>				
Cash	\$40,000	\$20,000	\$20,000	\$0
Inventory	160,000	100,000	105,200	5,200
Other current assets	110,000	43,000	43,000	0
Plant assets (net)	<i>700,000</i>	<i>220,000</i>	<i>258,000</i>	<i>38,000</i>
Land	200,000	50,000	62,000	12,000
Building (economic life = 20 years)	260,000	120,000	136,000	16,000
Machinery (economic life = 5 years)	240,000	50,000	60,000	10,000
Patent (economic life = 6 years)	0	0	42,000	42,000
Goodwill (net)	<u>20,000</u>	<u>0</u>	?	?
Total assets	<u>\$1,030,000</u>	<u>\$383,000</u>		
<b>LIABILITIES &amp; STOCKHOLDERS' EQUITY</b>				
Current liabilities	\$ 20,000	\$ 3,200	\$ 3,200	\$0
Long-term liabilities	490,000	186,000	222,000	36,000
Common stock, \$1 par	200,000			
Common stock, \$5 par		80,000		
Additional paid-in- capital		110,000	47,000	
Retained earnings	<u>210,000</u>	<u>66,800</u>		
Total liabilities & stockholders' equity	<u>\$1,030,000</u>	<u>\$383,000</u>		

### Solution (Problem 1)

<b>(a) 12/31/2X12</b>			
Investment in Sky's common stock	210,400		
Common stock			21,040
Additional paid-in-capital			189,360
<b>(b) 12/31/2X12</b>			
Investment in Sky's common stock	10,450		
Additional paid-in-capital	14,550		
Cash			25,000
<b>(c) 12/31/2X12</b>			
Cash	20,000		
Inventories	105,200		
Other current assets	43,000		
Plant assets (note 1)	238,951		
Patent (note 1)	38,899		
Current liabilities			3,200
Long-term debt			186,000
Premium on long-term debt			36,000
Investment in Sky's common stock			220,850

Under precodification standard FAS-141 purchase accounting, a bargain purchase occurs when the purchase price (debit to investment account) is less than the fair value of net assets acquired. The bargain amount is used to reduce noncurrent assets (plant assets and patent in this example) proportionately with any excess treated as an extraordinary gain. The following table derives the amounts used to consolidate plant assets and patents:

<i>Noncurrent Asset</i>	<i>Fair Value</i>	<i>Percentage</i>	<i>Allocation of Bargain Purchase</i>	<i>Net Amount</i>
Plant assets	258,000	86%	(19,049)	238,951
Patent	42,000	14%	(3,101)	38,899
Total	300,000		(22,150)	277,850
Purchase price (210,400 + 10,450)				220,850
Fair value of net assets acquired				(243,000)
Bargain purchase amount				(22,150)

**Note:** If this transaction was accounted for under the acquisition method (ASC 805 (FAS-141R)), the finder's and legal fees of \$10,450 would be charged to acquisition expense. A gain on the bargain purchase would be recorded rather than the proportionate reduction of noncurrent assets.

### Problem 2 (Use Exhibits 2-4 and 2-5)

On December 31, 2X12, Popular Corporation issued 22,800 shares of its \$1 par (current fair value \$10) common stock to stockholders of Sky Company in exchange for 15,200 of the 16,000 outstanding shares of Sky's \$5 par common stock in a *purchase-type* business combination.

**Required:** Based on the information previously presented in Exhibit 2-4:

1. Prepare the elimination entries for the consolidated working paper on December 31, 2X12.
2. Prepare the journal entries Popular Corporation should make on its books (a) to record dividend declared by Sky Company on November 24, 2X13, (b) to record net income of Sky Company for the year ended December 31, 2X13, and (c) to amortize differences between current fair values and carrying amounts of Sky Company's identifiable net assets.
3. Prepare the elimination entries for the consolidated working paper on December 31, 2X13.
4. Complete the working paper for Consolidated Financial Statements (use Exhibit 2-5).

**Exhibit 2-5: Consolidation**

**POPULAR CORPORATION AND SUBSIDIARY Working  
Paper for Consolidated Financial Statements  
For Year Ended December 31, 2X13**

	Popular	Eliminations		Consolidated
		Sky	Dr.	
<b>INCOME STATEMENT</b>				
Revenue:				
Net sales	1,122,200	217,800		
Intercompany investment income	7,790			
Total revenue	<u>1,129,990</u>	<u>217,800</u>		
Costs and expenses:				
Cost of goods sold	785,000	140,000		
Operating expenses	111,390	25,800		
Interest and income taxes expense	142,000	34,000		
MI* in net income of subsidiary				
Total costs and expenses	<u>1,038,390</u>	<u>199,800</u>		
Net income	<u>\$91,600</u>	<u>\$18,000</u>		
<b>STATEMENT OF RETAINED EARNINGS</b>				
Retained earnings, beginning of year	210,000	66,800		
Net income	91,600	18,000		
Subtotal	<u>301,600</u>	<u>84,800</u>		
Dividends declared	<u>26,010</u>	<u>8,000</u>		
Retained earnings, end of year	<u>275,590</u>	<u>76,800</u>		
<b>BALANCE SHEET ASSETS</b>				

Inventories	172,200	110,000
Other current assets	133,000	52,000
Investment in Sky common stock	238,450	
Plant assets (net)	720,000	230,000
Patent (net)	0	0
Goodwill (net)	19,500	0
Total assets	<u>1,283,150</u>	<u>392,000</u>

**LIABILITIES AND STOCKHOLDERS' EQUITY**

Liabilities	484,110	188,200
Minority interest in net assets of subsidiary		
Common stock, \$2 par	211,400	
Common stock, \$10 par	0	80,000
Additional paid-in-capital	312,050	47,000
Retained earnings	<u>275,590</u>	<u>76,800</u>
Total liabilities & stockholders' equity	<u>1,283,150</u>	<u>392,000</u>

\* MI = minority interest.

**Solution (Problem 2)**

**(1) 12/31/2X12**

Investment in Sky's common stock	228,000	
Common stock		22,800
Additional paid-in-capital		205,200
Investment in Sky's common stock	10,450	
Additional paid-in-capital	14,550	
Cash		25,000
Common stock—Sky	80,000	
Additional paid-in-capital—Sky	47,000	
Retained earnings—Sky	66,800	
Inventories—Sky	5,200	
Plant assets—Sky	38,000	
Patent—Sky	42,000	
Goodwill—Popular	7,600	
Investment in Sky's common stock—Popular		238,450
Minority interest in net assets of subsidiary		12,150
Premium on long-term debts—Sky		36,000

**(2-a) 12/31/2X12**

Cash (8,000×95%)	7,600	
Investment in Sky's common stock		7,600

**(2-b)**

Investment in Sky's common stock (18,000×95%)	17,100	
Intercompany investment income		17,100

**(2-c)**

Intercompany investment income	9,310	
Investment in Sky's common stock		9,310



(3) 12/31/2X13

Common stock—Sky	80,000	
Additional paid-in-capital—Sky	47,000	
Retained earnings—Sky	66,800	
Inventories—Sky	5,200	
Plant assets—Sky	35,200	
Patent—Sky	35,000	
Goodwill—Popular	7,410	
Intercompany investment income—Popular	7,790	
Operating expenses—Sky	9,800	
Minority interest in net income of subsidiary	410	
Investment in Sky's common stock—Popular		238,450
Minority interest in net assets of subsidiary		12,160
Dividends declared—Sky		8,000
Premium on long-term debts—Sky		36,000

**POPULAR CORPORATION AND SUBSIDIARY**  
**Working Paper for Consolidated Financial Statements**  
**For Year Ended December 31, 2X13**

	Popular	Sky	Eliminations		Consolidated
			Dr.	Cr.	
<b>INCOME STATEMENT</b>					
Revenue:					
Net sales	1,122,200	217,800			1,340,000
Intercompany investment income	7,790		7,790		
Total revenue	<u>1,129,990</u>	<u>217,800</u>	<u>7,790</u>		<u>1,340,000</u>
Costs and expenses:					
Cost of goods sold	785,000	140,000			925,000
Operating expenses	111,390	25,800	9,800		146,990
Interest and income taxes expense	142,000	34,000			176,000
Noncontrolling (minority) interest in net income of subsidiary			410		410
Total costs and expenses	<u>1,038,390</u>	<u>199,800</u>	<u>10,210</u>		<u>1,248,400</u>
Net income	<u>91,600</u>	<u>18,000</u>	<u>18,000</u>		<u>91,600</u>

**STATEMENT OF RETAINED EARNINGS**

Retained earnings, beginning of year	210,000	66,800	66,800		210,000
Net income	91,600	18,000	18,000		91,600
Subtotal	<u>301,600</u>	<u>84,800</u>	<u>84,800</u>		<u>301,600</u>
Dividends declared	<u>26,010</u>	<u>8,000</u>		<u>8,000</u>	<u>26,010</u>
Retained earnings, end of year	<u>275,590</u>	<u>76,800</u>	<u>84,800</u>	<u>8,000</u>	<u>275,590</u>

**BALANCE SHEET ASSETS**

Inventories	172,200	110,000	5,200		287,400
Other current assets	133,000	52,000			185,000
Investment in Sky common stock	238,450			238,450	0
Plant assets (net)	720,000	230,000	35,200		985,200
Patent (net)	0	0	35,000		35,000
Goodwill (net)	19,500	0	7,410		26,910
Total assets	<u>1,283,150</u>	<u>392,000</u>	<u>82,810</u>	<u>238,450</u>	<u>1,519,510</u>

**LIABILITIES AND STOCKHOLDERS' EQUITY**

Liabilities	484,110	188,200		36,000	708,310
Noncontrolling (minority) interest in net assets of subsidiary				12,160	12,160
Common stock, \$2 par	211,400				211,400
Common stock, \$10 par	0	80,000	80,000		0
Additional paid-in-capital	312,050	47,000	47,000		312,050
Retained earnings	275,590	76,800	76,800		275,590
Total liabilities & stockholders' equity	<u>1,283,150</u>	<u>392,000</u>	<u>203,800</u>	<u>48,160</u>	<u>1,519,520</u>

Notes to Problem 2

1. Operating expenses worksheet adjustments totaling 9,800 consist of amortization of excess of fair value over book value (800 building; 2,000 machine; 7,000 patent).
2. Minority interest in net income of subsidiary is 5% (18,000 - 9,800) = 410. The 9,800 represents the amortization calculated in 1. above.
3. Amortization of difference between acquisition date fair values and carrying values is  $9,800 \times 95\% = 9,310$ .

## Chapter 2 – Review Questions

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*The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.*

*We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.*

1. Consolidated financial statements are typically prepared when one entity has a controlling financial interest in another unless:
  - a) the subsidiary is a finance entity
  - b) the fiscal year-ends of the two entities are more than 3 months apart
  - c) control does not rest with the majority owner(s)
  - d) the two entities are in unrelated industries, such as manufacturing and real estate
2. Primor, a manufacturer, owns 75% of the voting interests of Sublette, an investment firm. Sublette owns 60% of the voting interests of Minos, an insurer. In Primor's consolidated financial statements, should consolidation accounting or equity method accounting be used for Sublette and Minos:
  - a) consolidation used for Sublette and equity method used for Minos
  - b) consolidation used for both Sublette and Minos
  - c) equity method used for Sublette and consolidation used for Minos
  - d) equity method used for both Sublette and Minos
3. Shep Co. has a receivable from its parent, Pep Co. Should this receivable be separately reported in Shep's balance sheet and in Pep's consolidated balance sheet:

	<u>Shep's Balance Sheet</u>	<u>Pep's Consolidated Balance Sheet</u>
a) Yes		No
b) Yes		Yes
c) No		No
d) No		Yes

4. On January 1, Pathan Corp. acquired 80% of Samoa Corp.'s \$10 par common stock for \$975,000. The remaining 20% of this stock is held by NCI Co., an unrelated party. On the acquisition date for this business combination, the carrying amount of Samoa's net assets was \$1 million. The fair values of the assets acquired and liabilities assumed were the same as their carrying amounts on Samoa's balance sheet except for plant assets (net), the fair value of which was \$100,000 in excess of the carrying amount. The fair value of the noncontrolling interest is 20% of the fair value of the acquiree's net assets at the acquisition date. (No exceptions to the recognition or measurement principles apply.) For the year ended December 31, Samoa had net income of \$190,000 and paid cash dividends totaling \$125,000. In the December 31 consolidated balance sheet, the noncontrolling interest is reported at:
- a) \$200,000
  - b) \$213,000
  - c) \$220,000
  - d) \$233,000
5. A 70%-owned subsidiary declares and pays a cash dividend. What effect does the dividend have on the retained earnings and noncontrolling interest balances in the consolidated balance sheet:
- a) no effect on either retained earnings or the noncontrolling interest
  - b) no effect on retained earnings and a decrease in the noncontrolling interest
  - c) decreases in both retained earnings and the noncontrolling interest
  - d) a decrease in retained earnings and no effect on the noncontrolling interest
6. Perez, Inc. owns 80% of Senior, Inc. During the year just ended, Perez sold goods with a 40% gross profit to Senior. Senior sold all of these goods during the year. In its consolidated financial statements for the year, how should the summation of Perez and Senior income statement items be adjusted:
- a) sales and cost of goods sold should be reduced by the intraentity sales
  - b) sales and cost of goods sold should be reduced by 80% of the intraentity sales
  - c) net income should be reduced by 80% of the gross profit on intraentity sales
  - d) no adjustment is necessary
7. According to GAAP relative to consolidation of variable interest entities (VIEs):
- a) a not-for-profit organization may **not** be treated as a variable interest entity
  - b) a variable interest entity has an equity investment of more than 10% of its total assets
  - c) a variable interest entity is consolidated by its primary beneficiary when the beneficiary becomes involved with the entity
  - d) corporations may not be organized as variable interest entities

8. Combined statements may be used to present the results of operations of:

	<i>Entities under Common Management</i>	<i>Commonly Controlled Entities</i>
a)	No	Yes
b)	Yes	No
c)	No	No
d)	Yes	Yes

## Chapter 2 – Solutions and Suggested Responses

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1. A: Incorrect. The nature of the subsidiary's business is irrelevant.  
B: Incorrect. A difference in fiscal periods is irrelevant.  
**C: Correct.** Consolidated financial reporting is required when one entity owns, directly or indirectly, more than 50% of the outstanding voting interests of another entity. However, a majority-owned subsidiary is not consolidated if control does not rest with the majority owner.  
D: Incorrect. Whether the parent and subsidiary are in related industries is irrelevant.  
(See page 2-1 of the course material.)
  
2. A: Incorrect. Primor has a controlling interest in Minos as well.  
**B: Correct.** All entities in which a parent has a controlling financial interest through direct or indirect ownership of a majority voting interest ordinarily must be consolidated. However, a subsidiary is not consolidated when control does not rest with the majority owner. Primor has direct control of Sublette and indirect control of Minos and should consolidate both.  
C: Incorrect. Primor has a controlling interest in Sublette as well.  
D: Incorrect. Primor should consolidate both Sublette and Minos.  
(See page 2-1 of the course material.)
  
3. **A: Correct.** In a consolidated balance sheet, reciprocal balances, such as receivables and payables, between a parent and a consolidated subsidiary are eliminated in their entirety, regardless of the portion of the subsidiary's stock held by the parent. However, intraentity transactions should not be eliminated from the separate financial statements of the entities.  
B: Incorrect. The receivable should be eliminated from the consolidated statements.  
C: Incorrect. The receivable should be reported on the subsidiary's balance sheet.  
D: Incorrect. The receivable should be eliminated from the consolidated statements but not from the subsidiary's balance sheet.  
(See page 2-3 of the course material.)

4. A: Incorrect. This figure is the carrying amount of the noncontrolling interest on 1/1, assuming it equaled 20% of the carrying amount of the net assets.

B: Incorrect. The amount of \$213,000 is the noncontrolling interest measured at its carrying amount on 1/1, plus its share of net income, minus its share of dividends.

C: Incorrect. The amount of \$220,000 is the noncontrolling interest measured at fair value at 1/1.

**D: Correct.** A noncontrolling (minority) interest is the equity of a subsidiary not directly or indirectly attributable to the parent. Thus, the noncontrolling interest is equal to the 20% (100% - 80%) interest in Samoa not held by Pathan. The fair value of the noncontrolling interest at the acquisition date was \$220,000 [(\$1,000,000 carrying amount + \$100,000 undervalued plant assets) x 20%]. The noncontrolling interest to be reported at year end is calculated as follows:

Noncontrolling interest at 1/1	\$220,000
Noncontrolling interest in subsidiary's net income (\$190,000 x 20%)	38,000
Noncontrolling interest in subsidiary's dividends paid (\$125,000 x 20%)	<u>(25,000)</u>
Noncontrolling interest at 12/31	<u>\$233,000</u>

(See pages 2-13 to 2-14 of the course material.)

5. A: Incorrect. Cash dividends from a subsidiary decrease the noncontrolling interest.

**B: Correct.** The parent's investment in subsidiary, dividends, and the subsidiary's equity accounts, which include retained earnings, are among the eliminations in a consolidation. The equity (net assets) of the subsidiary not directly or indirectly attributable to the parent is reported separately as the noncontrolling interest. Consolidated retained earnings equals the accumulated earnings of the consolidated group not distributed to the owners of, or capitalized by, the parent. Thus, it equals the parent's retained earnings. Accordingly, the subsidiary's cash dividend reduces its retained earnings balance and the noncontrolling interest but not the consolidated retained earnings.

C: Incorrect. Cash dividends from a subsidiary have no effect on consolidated retained earnings but decrease the noncontrolling interest.

D: Incorrect. Cash dividends from a subsidiary have no effect on consolidated retained earnings.

(See pages 2-14 to 2-15 of the course material.)

6. **A: Correct.** Given that all of the goods were sold, no adjustment is necessary for intraentity profit in ending inventory. Accordingly, the parent's cost should be included in consolidated cost of goods sold, and the price received by the subsidiary should be included in consolidated sales. The required adjustment is to eliminate the sale recorded by the parent and the cost of goods sold recorded by the subsidiary.

B: Incorrect. The elimination is made without regard to the noncontrolling interest.

C: Incorrect. No profit should be eliminated. All of the goods sold to Senior have been resold.

D: Incorrect. Sales and cost of sales should be reduced.

(See page 2-19 of the course material.)

7. A: Incorrect. This interpretation applies to NPOs if they are used to avoid the requirements of the pronouncement.

B: Incorrect. An entity qualifies as a VIE if the equity at risk does not suffice to finance entity activities without additional subordinated financial support. An equity investment of less than 10% of total assets is usually considered to be insufficient. But a greater investment also may not suffice if, for example, assets or entity activities are high risk.

**C: Correct.** In essence, a variable interest entity (VIE) is any legal structure (including, but not limited to, those described as special-purpose entities) with insufficient equity investment or whose equity investors lack one of the essential characteristics of financial control. When an entity becomes involved with a VIE, it must determine whether it is the primary beneficiary and therefore must consolidate the VIE. A primary beneficiary holds a variable interest(s) that will absorb a majority of the VIE's expected losses or receive a majority of its expected residual returns (or both).

D: Incorrect. A VIE may take any form.

(See page 2-24 of the course material.)

8. A: Incorrect. Common management justifies use of combined statements.

B: Incorrect. Common control justifies use of combined statements.

C: Incorrect. Either common management or common control justifies use of combined statements.

**D: Correct.** Combined (as distinguished from consolidated) statements of commonly controlled entities may be more meaningful than separate statements. For example, combined statements may be used (1) to combine the statements of several entities with related operations when one individual owns a controlling financial interest in them or (2) to combine the statements of entities under common management.

(See page 2-33 of the course material.)



## Appendix: Annual Report References

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### **Carnival 2009 Annual Report Note 15—Acquisition**

In September 2007, we entered into an agreement with Orizonia Corporation, Spain's largest travel company, to operate Ibero, a Spanish cruise line, for an investment of \$403 million, which we funded with \$146 million of cash and \$257 million in proceeds that Ibero borrowed under a portion of our principal revolver. Orizonia contributed \$49 million of assets, principally trademarks and goodwill, for their 25% interest in the venture. Ibero operated two contemporary Spanish cruise ships in September 2007, the 834-passenger capacity Grand Voyager, and the 1,244-passenger capacity Grand Mistral, which were built in 2000 and 1999, respectively. For reporting purposes, we have included Ibero's results of operations within our consolidated financial results since September 1, 2007. The pro forma impact of including Ibero in our results as if the acquisition took place on December 1, 2006 has not been presented due to its immaterial effect.

The 2007 acquisition was accounted for as a business purchase combination using the purchase method of accounting. The purchase price was allocated to tangible and identifiable intangible assets acquired based on their estimated fair values at the acquisition date. The \$451 million purchase price was allocated as follows: \$254 million to ships, \$161 million to goodwill, \$35 million to trademarks and \$1 million to other. In July 2009, we purchased the remaining 25% interest in Ibero that we did not own for \$33 million, which approximated this minority interests' carrying value.

### **Sherwin-Williams 2009 Annual Report Note 2—Acquisitions**

All acquisitions have been accounted for as purchases and their results of operations have been included in the consolidated financial statements since the date of acquisition. During the first quarter of 2009, the Company acquired Altax Sp. zo.o. (Altax). Headquartered in Poznan, Poland, Altax is a leading innovator of protective woodcare coatings and serves multiple channels, including industrial, professional and DIY. Included in the Consumer Group, the acquisition provides a platform for further growth in Central Europe. The aggregate consideration paid for Altax was \$11,500, net of cash acquired, including the assumption of certain financial obligations. The acquisition resulted in the recognition of goodwill and intangible assets.

In December 2008, the Company acquired Euronavy-Tintas Maritimas e Industriais S.A. of Portugal (Euronavy). Headquartered in Lisbon, Portugal, Euronavy is a leading innovator of marine and protective coatings applied to ships, off shore platforms, storage tanks, steel, concrete and flooring. Included in the Global Finishes Group, the acquisition strengthens the Company's global platform of protective and marine coatings.

In September 2008, the Company purchased certain assets of the Wagman Primus Group, LP (Wagman). The acquired assets are related to imported raw materials of brushes and foreign manufactured applicators and allow greater flexibility and control in the importation of applicators and related products for the Consumer Group.

In July 2008, the Company acquired the liquid coatings subsidiaries of Inchem Holdings International Limited (Inchem). Headquartered in Singapore, Inchem produces coatings applied to wood and plastic products in Asia. These waterborne, solvent-based, and ultraviolet curable coatings are applied to furniture, cabinets, flooring and electronic products. The coatings are made and sold in China, Vietnam and Malaysia and distributed to 15 other Asian countries.

This acquisition strengthens the Global Finishes Group's product offering throughout Asia.

In February 2008, the Company acquired Becker Powder Coatings, Inc. (Becker), a subsidiary of Sweden-based AB Wilh. Headquartered in Columbus, Ohio, Becker produces powder coatings applied to appliances, metal furniture, fixtures, equipment and electronic products manufactured throughout North America. This acquisition strengthens Global Finishes Group's position in the powder coatings market.

The aggregate consideration paid for Euronavy, Inchem, Wagman and Becker was \$64,103, net of cash acquired, including acquisition costs and the assumption of certain financial obligations. The acquisitions resulted in the recognition of intangible assets. The Euronavy, Inchem and Becker acquisitions also resulted in the recognition of goodwill.

In October 2007, an indirect wholly owned subsidiary of the Company acquired the remaining 75 percent interest in Life Shield Engineered Systems LLC (Life Shield) by acquiring all of the outstanding membership interests. In late December 2007, the Company acquired substantially all the assets and business of Flex Recubrimientos, S.A. de C.V. and related companies (Flex group). The aggregate consideration paid in cash for these acquisitions was \$27,056 including costs of acquisition and the assumption of certain financial obligations. Life Shield is a start-up company that develops and manufactures blast and fragment mitigating systems and ballistic resistant systems that will expand the product offering in the Consumer Group. Flex group is a leading manufacturer and distributor of automotive after-market body fillers, putties, primers and other vehicle refinish products headquartered in Monterrey, Mexico. This acquisition will strengthen the Global Finishes Group's automotive refinish market position in Mexico. These acquisitions resulted in the recognition of goodwill. The acquisition of Flex group resulted in the recognition of identifiable intangible assets.

During the third quarter of 2007, the Company acquired substantially all of the stock of Pinturas Industriales S.A. (PISA), substantially all of the assets and business of Napko, S.A. de C.V. (Napko), the brand names, formulas and patents of the VHT<sup>®</sup> brand paint line (VHT), and 100 percent of the stock of Columbia Paint & Coatings Co. (Columbia) for an aggregate cash consideration of \$105,850, net of cash acquired, including costs of acquisition and the assumption of certain financial obligations. The acquisitions of Napko and Columbia resulted in the recognition of goodwill and all four acquisitions resulted in the recognition of identifiable intangible assets. Columbia, included in the Paint Stores Group, is a leading manufacturer and distributor of paints and coatings in the central and northwestern United States. Columbia services the professional painting contractor, builder and do-it-yourself markets through company-operated stores. Columbia was acquired to contribute to the Company's domestic controlled-distribution growth strategy. VHT, included in the Consumer Group, is the market leader in High Temperature coatings and premium aerosol products. VHT was acquired to broaden the

product offering in Consumer Group and add to its growth strategy. Napko, included in the Global Finishes Group, is a leading manufacturer and distributor of industrial maintenance coatings primarily for the government oil and power industries in Mexico primarily through company-operated branches. PISA, also included in the Global Finishes Group, provides industrial paint products in Uruguay to the wood protection and industrial maintenance market. Napko and PISA were acquired to support and broaden the Company's international growth strategy.

During the second quarter of 2007, the Company acquired substantially all of the assets and business of Nitco Paints Private Limited (Nitco) and 100 percent of the stock of M.A.

Bruder & Sons Incorporated (MAB) for an aggregate consideration in cash of \$149,508, net of cash acquired, including costs of acquisition and the assumption of certain financial obligations.

Both acquisitions resulted in the recognition of goodwill and identifiable intangible assets. MAB, included in the Paint Stores Group, is a leading manufacturer and distributor of paints and coatings in the eastern and southeastern portions of the United States. MAB services the professional painting contractor, builder and do-it-yourself markets through its own company-operated stores. MAB was acquired as part of the Company's domestic controlled-distribution growth strategy. Nitco, included in the Global Finishes Group, is a leading manufacturer and distributor, especially in western India, of exterior paints and coatings used in the construction of office buildings, high rise apartments, shopping malls, hospitals and schools. Nitco was acquired to support the Company's growth strategy into new international markets.

The following unaudited pro-forma summary presents consolidated financial information as if Altax, Euronavy, Wagman, Inchem, Becker, Flex group, Life Shield, Columbia, VHT, Napko, PISA, MAB and Nitco had been acquired at the beginning of each period presented. The unaudited pro-forma consolidated financial information does not necessarily reflect the actual results that would have occurred had the acquisitions taken place on January 1, 2007 or the future results of operations of the combined companies under ownership and operation of the Company.

	<b>2009</b>	<b>2008</b>	<b>2007</b>
Net sales	<b>\$7,094,519</b>	\$8,025,041	\$8,213,512
Net income	<b>435,470</b>	478,278	622,289
Net income per common share:			
Basic	<b>3.84</b>	4.09	4.89
Diluted	<b>3.77</b>	4.01	4.75

## **Baker Hughes 2008 Annual Report**

### **Note 3. Acquisitions**

In April 2008, we acquired two firms for our reservoir technology and consulting group—Gaffney, Cline & Associates (“GCA”) and GeoMechanics International (“GMI”)—for \$72 million in cash, including \$4 million of direct transaction costs and net of cash acquired of \$5 million. These firms provide consulting services related to reservoir engineering, technical and managerial advisory services and reservoir geomechanics. As a result of these acquisitions, we recorded \$43 million of goodwill and \$19 million of intangibles. Under the terms of the purchase agreements, we may be required to make additional

payments of up to approximately \$46 million based on the performance of the businesses during 2008, 2009 and 2010. During 2008, we made several other acquisitions having an aggregate purchase price of \$53 million, of which \$48 million was paid in cash. As a result of these acquisitions, we recorded \$2 million of goodwill and \$26 million of intangible assets through December 31, 2008.

In January 2006, we acquired Nova Technology Corporation (“Nova”) for \$55 million, net of cash acquired of \$3 million, plus assumed debt. Nova is a supplier of permanent monitoring, chemical injection systems, and multi-line services for deepwater and subsea oil and gas well applications. As a result of the acquisition, we recorded \$30 million of goodwill, \$24 million of intangible assets and assigned \$2 million to inprocess research and development.

For each of these acquisitions, the purchase price was allocated based on the fair value of the assets acquired and liabilities assumed using a discounted cash flow approach. Amounts related to in-process research and development were written off at the date of acquisition and are included in research and engineering expenses. Pro forma results of operations have not been presented individually or in the aggregate for these acquisitions because the effects of these acquisitions were not material to our consolidated financial statements.

## **Johnson & Johnson 2008 Annual Report**

### **17. Mergers, Acquisitions and Divestitures**

Certain businesses were acquired for \$1,214 million in cash and \$114 million of liabilities assumed during 2008. These acquisitions were accounted for by the purchase method and, accordingly, results of operations have been included in the financial statements from their respective dates of acquisition.

The 2008 acquisitions included: Amic AB, a privately held Swedish developer of in vitro diagnostic technologies for use in point-of-care and near-patient settings; Beijing Dabao Cosmetics Co., Ltd., a company that sells personal care brands in China; SurgRx, Inc., a privately held developer of the advanced bipolar tissue sealing system used in the ENSEAL® family of devices; HealthMedia, Inc., a privately held company that creates web based behavior change interventions; LGE Performance Systems, Inc., a privately held company known as Human Performance Institute™, which develops science-based training programs to improve employee engagement and productivity and Omrix Biopharmaceuticals, Inc., a fully integrated biopharmaceutical company that develops and markets biosurgical and immunotherapy products.

The excess of purchase price over the estimated fair value of tangible assets acquired amounted to \$891 million and has been assigned to identifiable intangible assets, with any residual recorded to goodwill. Approximately \$181 million has been identified as the value of IPR&D associated with the acquisitions of Omrix Biopharmaceuticals, Inc., Amic AB, SurgRx, Inc. and HealthMedia, Inc.

The IPR&D charge related to the acquisition of Omrix Biopharmaceuticals, Inc. was \$127 million and is associated with stand-alone and combination biosurgical technologies used to achieve hemostasis. The value of the IPR&D was calculated using cash flow projections discounted for the risk inherent in such projects. Probability of success factors ranging from 60-90% were used to reflect inherent clinical and

regulatory risk. The discount rate applied was 14%. As of the end of the 2008 fiscal year, 97.8% of the outstanding shares of Common Stock of Omrix Biopharmaceuticals, Inc. had been tendered by stockholders. Excluding shares that were tendered subject to guaranteed delivery procedures, 90.2% of the outstanding shares of Common Stock had been tendered. On December 30, 2008 the Company completed the acquisition of Omrix Biopharmaceuticals, Inc.

The IPR&D charge related to the acquisition of Amic AB was \$40 million and is associated with point-of-care device and 4CAST Chip technologies. The value of the IPR&D was calculated using cash flow projections discounted for the risk inherent in such projects. The discount rate applied was 20%.

The IPR&D charge related to the acquisition of SurgRx, Inc. was \$7 million and is associated with vessel cutting and sealing surgical devices. The value of the IPR&D was calculated using cash flow projections discounted for the risk inherent in such projects. Probability of success factors ranging from 90-95% were used to reflect inherent clinical and regulatory risk. The discount rate applied was 18%.

The IPR&D charge related to the acquisition of HealthMedia, Inc. was \$7 million and is associated primarily with process enhancements to software technology. The value of the IPR&D was calculated using cash flow projections discounted for the risk inherent in such projects. A probability of success factor of 90% was used to reflect inherent risk. The discount rate applied was 14%.

Certain businesses were acquired for \$1,388 million in cash and \$232 million of liabilities assumed during 2007. These acquisitions were accounted for by the purchase method and, accordingly, results of operations have been included in the financial statements from their respective dates of acquisition.

The 2007 acquisitions included: Conor Medsystems, Inc., a cardiovascular device company, with new drug delivery technology; Robert Reid, Inc., a Japanese orthopedic product distributor; and Maya's Mom, Inc., a social media company.

The excess of purchase price over the estimated fair value of tangible assets acquired amounted to \$636 million and has been assigned to identifiable intangible assets, with any residual recorded to goodwill. Approximately \$807 million has been identified as the value of IPR&D associated with the acquisition of Conor Medsystems, Inc.

The IPR&D charge related to the acquisition of Conor Medsystems, Inc. was \$807 million and is associated with research related to the discovery and application of the stent technology. The value of the IPR&D was calculated using cash flow projections discounted for the risk inherent in such projects. The discount rate applied was 19%.

Certain businesses were acquired for \$18.0 billion in cash and \$1.3 billion of liabilities assumed during 2006. These acquisitions were accounted for by the purchase method and, accordingly, results of operations have been included in the financial statements from their respective dates of acquisition except as noted below.

On December 20, 2006, the Company completed the acquisition of the Consumer Healthcare business of Pfizer Inc. for a purchase price of \$16.6 billion in cash. The operating results of the Consumer Healthcare business of Pfizer Inc. were reported in

the Company's financial statements beginning in 2007, as 2006 results subsequent to the acquisition date were not significant. In order to obtain regulatory approval of the transaction, the Company agreed to divest certain overlapping businesses. The Company completed the divestiture of the ZANTAC<sup>®</sup> product on December 20, 2006 and the divestitures of KAOPECTATE<sup>®</sup>, UNISOM<sup>®</sup>, CORTIZONE<sup>®</sup>, BALMEX<sup>®</sup> and ACT<sup>®</sup> products on January 2, 2007.

The following table provides pro forma results of operations for the fiscal year ended December 31, 2006, as if the Consumer Healthcare business of Pfizer Inc. had been acquired as of the beginning of the period presented. The pro forma results include the effect of divestitures and certain purchase accounting adjustments such as the estimated changes in depreciation and amortization expense on the acquired tangible and intangible assets. However, pro forma results do not include any anticipated cost savings or other effects of the planned integration of the Consumer Healthcare business of Pfizer Inc. Accordingly, such amounts are not necessarily indicative of the results if the acquisition had occurred on the dates indicated or which may occur in the future.

<i>(Unaudited)</i>	
<i>(Shares in millions except per share data)</i>	<i>Pro forma results Year ended December 31, 2006</i>
Net sales	\$57,115
Net earnings	\$10,770
Diluted net earnings per share	\$ 3.64

The IPR&D charge related to the acquisition of the Consumer Healthcare business of Pfizer Inc. was \$320 million on a pre-tax basis and \$217 million on an after-tax basis and is primarily associated with rights obtained to the switch of ZYRTEC<sup>®</sup> from U.S. prescription to over-the-counter status. The switch was approved by the FDA effective November 2007. The value of the IPR&D was calculated using cash flow projections discounted for the risk inherent in such projects. A probability of success factor of 95% was used to reflect inherent regulatory risk as of the acquisition date and the discount rate applied was 11%.

The Company completed the analysis of integration plans, pursuant to which the Company is incurring costs primarily related to the elimination of certain duplicate selling, general and administrative functions between the two companies in areas such as global business services, corporate staff and go-to-market support, as well as excess manufacturing capacity.

In addition to the acquisition of the Consumer Healthcare business of Pfizer Inc., 2006 acquisitions included: Animas Corporation, a leading maker of insulin infusion pumps and related products; Hand Innovations LLC, a privately held manufacturer of fracture fixation products for the upper extremities; Future Medical Systems S.A., a privately held company that primarily develops, manufactures and markets arthroscopic fluid management systems; Vascular Control Systems, Inc., a privately held company focused on developing medical devices to treat fibroids and to control bleeding in obstetric and gynecologic applications; Groupe Vendôme S.A., a privately held French marketer of adult and baby skin care products; ColBar LifeScience Ltd., a privately held company specializing in reconstructive medicine and tissue engineering and Ensure Medical, Inc., a privately held company that develops devices for postcatheterization closure of the femoral artery.

Excluding the acquisition of the Consumer Healthcare business of Pfizer Inc., the excess of purchase price over the estimated fair value of tangible assets acquired in 2006 amounted to \$1,209 million and has been assigned to identifiable intangible assets, with any residual recorded to goodwill. Approximately \$239 million has been identified as the value of IPR&D primarily associated with the acquisitions of Hand Innovations LLC, Future Medical Systems S.A., Vascular Control Systems, Inc., ColBar LifeScience Ltd. and Ensure Medical, Inc.

The IPR&D charge related to the acquisition of Hand Innovations LLC was \$22 million and is associated with fracture repair technologies. The value of the IPR&D was calculated using cash flow projections discounted for the risk inherent in such projects. Probability of success factors ranging from 38-95% were used to reflect inherent clinical and regulatory risk and the discount rate applied was 17%.

The IPR&D charge related to the acquisition of Future Medical Systems S.A. was \$15 million and is associated with the NEXTRA and DUO PUMP product technologies. The value of the IPR&D was calculated using cash flow projections discounted for the risk inherent in such projects. A probability of success factor of 90% for both technologies was used to reflect inherent clinical and regulatory risk and the discount rate applied was 22%.

The IPR&D charge related to the acquisition of Vascular Control Systems, Inc. was \$87 million and is associated with the FLOSTAT system technology. The value of the IPR&D was calculated using cash flow projections discounted for the risk inherent in such projects. A probability of success factor of 75% was used to reflect inherent clinical and regulatory risk and the discount rate applied was 21%.

The IPR&D charge related to the acquisition of ColBar LifeScience Ltd. was \$49 million and is associated with the EVOLENCE® family of products, which are biodegradable dermal fillers. The value of the IPR&D was calculated using cash flow projections discounted for the risk inherent in such projects. Probability of success factors ranging from 70-80% were used to reflect inherent clinical and regulatory risk and the discount rate applied was 21%.

The IPR&D charge related to the acquisition of Ensure Medical, Inc. was \$66 million and is associated with the femoral artery closure device. The value of the IPR&D was calculated using cash flow projections discounted for the risk inherent in such projects. A probability of success factor of 75% was used to reflect inherent clinical and regulatory risk and the discount rate applied was 22%.

With the exception of the Consumer Healthcare business of Pfizer Inc., supplemental pro forma information for 2008, 2007 and 2006 per SFAS No. 141, *Business Combinations*, and SFAS No. 142, *Goodwill and Other Intangible Assets*, is not provided, as the impact of the aforementioned acquisitions did not have a material effect on the Company's results of operations, cash flows or financial position.

With the exception of the divestiture of the Professional Wound Care business of Ethicon, Inc., which resulted in a gain of \$536 million before tax, and is recorded in other (income) expense, net, in 2008, divestitures in 2008, 2007 and 2006 did not have a material effect on the Company's results of operations, cash flows or financial position.

## Humana 2008 Annual Report

### 3. Acquisitions

On October 31, 2008 we acquired PHP Companies, Inc. (d/b/a Cariten Healthcare), or Cariten, for cash consideration of approximately \$256.1 million. The Cariten acquisition increased our commercial fully-insured and ASO presence as well as our Medicare HMO presence in eastern Tennessee. The total consideration paid exceeded our estimated fair value of the net tangible assets acquired by approximately \$113.5 million of which we allocated \$79.4 million to other intangible assets and \$34.1 million to goodwill. The other intangible assets, which primarily consist of customer contracts, have a weighted-average useful life of 9.7 years. The acquired goodwill is not deductible for tax purposes. The purchase price allocation is preliminary, subject to completion of valuation analyses including refining assumptions used to calculate the fair value of other intangible assets, fixed assets, and certain reserves.

On August 29, 2008, we acquired Metcare Health Plans, Inc., or Metcare, for cash consideration of approximately \$14.9 million. The acquisition expanded our Medicare HMO membership in central Florida.

On May 22, 2008, we acquired OSF Health Plans, Inc., or OSF, a managed care company serving both Medicare and commercial members in central Illinois, for cash consideration of approximately \$84.0 million. This acquisition expanded our presence in Illinois, broadening our ability to serve multi-location employers with a wider range of products including our specialty offerings. The total consideration paid exceeded our estimated fair value of the net tangible assets acquired by approximately \$27.8 million of which we allocated \$10.1 million to other intangible assets and \$17.7 million to goodwill. The other intangible assets, which primarily consist of customer contracts, have a weighted-average useful life of 9.9 years. The acquired goodwill is not deductible for tax purposes.

On April 30, 2008, we acquired UnitedHealth Group's Las Vegas, Nevada individual SecureHorizons Medicare Advantage HMO business, or SecureHorizons, for cash consideration of approximately \$185.3 million, plus subsidiary capital and surplus requirements of \$40 million. The acquisition expanded our presence into the rapidly growing Las Vegas market. The total consideration paid exceeded our estimated fair value of the net tangible assets acquired by approximately \$185.3 million of which we allocated \$69.3 million to other intangible assets and \$116.0 million to goodwill. The other intangible assets, which primarily consist of customer and provider contracts, have a weighted-average useful life of 10.9 years. The acquired goodwill is deductible for tax purposes.

The Cariten, OSF, and Metcare purchase agreements contain provisions under which there may be future contingent consideration paid or received, primarily related to balance sheet settlements associated with medical claims runout and Medicare reconciliations with CMS. Any contingent consideration will be recorded as an adjustment to goodwill when the contingencies are resolved.

The pro forma effects of the 2008 acquisitions, individually and in the aggregate, on the consolidated statements of income were not material.



On November 30, 2007, we acquired KMG America Corporation, or KMG, for cash consideration of \$155.2 million plus the assumption of \$36.1 million of long-term debt. KMG provides long-duration insurance benefits including supplemental health and life products. The acquisition expanded our commercial product offerings allowing for significant cross-selling opportunities with our medical insurance products. The total consideration paid exceeded our estimated fair value of the net tangible assets acquired by approximately \$204.5 million of which we allocated \$43.0 million to other intangible assets and \$161.5 million to goodwill. The other intangible assets, which primarily consist of customer contracts, have a weighted-average useful life of 19.3 years. The acquired goodwill is not deductible for tax purposes.

On October 1, 2007, we acquired CompBenefits Corporation, or CompBenefits, for cash consideration of \$369.6 million. CompBenefits provides dental and vision insurance benefits. The acquisition expanded our commercial product offerings allowing for significant cross-selling opportunities with our medical insurance products. The total consideration paid exceeded our estimated fair value of the net tangible assets acquired by approximately \$354.9 million of which we allocated \$54.1 million to other intangible assets and \$300.8 million to goodwill. The other intangible assets, which primarily consist of customer and provider contracts, have a weighted-average useful life of 11.5 years. The acquired goodwill is not deductible for tax purposes.

During 2008, we revised the fair value estimate of certain other intangible assets and future policy benefit reserves associated with our fourth quarter 2007 acquisitions of CompBenefits and KMG. This resulted in an increase in goodwill of \$125.7 million, primarily related to refining assumptions used to calculate the fair value assigned to the KMG future policy benefits payable and customer contracts acquired, net of related deferred income taxes.

On March 1, 2007, we acquired DefenseWeb Technologies, Inc., or DefenseWeb, a company responsible for delivering customized software solutions for the Department of Defense, for cash consideration of \$27.5 million.

On May 1, 2006, we acquired CHA Service Company, or CHA Health, a health plan serving employer groups in Kentucky, for cash consideration of \$67.5 million.

The results of operations and financial condition of Cariten, Metcare, OSF, SecureHorizons, KMG, CompBenefits, DefenseWeb, and CHA have been included in our consolidated statements of income since the acquisition dates.

## **WM. Wrigley Jr. 2007 Annual Report**

### **10. Acquisitions**

On January 31, 2007, the Company acquired an 80% interest in A. Korkunov, a privately held premium chocolate company in Russia. The acquisition provided an opportunity for the Company to enter the chocolate confectionery marketplace, a significant component of the broader confectionery market, with a well recognized brand in a growing region. The Company acquired the 80% interest in A. Korkunov for \$318,590. The Company financed the acquisition through short-term debt and cash on hand. Included in this purchase price is \$25,000 the Company expects to pay in 2008 to A. Korkunov's minority shareholders due to the entity exceeding certain performance targets in 2007; however, final resolution and payment remains subject to review and due diligence. The Company

expects to acquire an additional 10% in 2008 and the final 10% in 2009. The purchase price allocation remains preliminary and the results of operations have been included since January 31, 2007.

The following table contains a tentative purchase price allocation summarizing the assets and liabilities acquired, including the restated basis for 80% of the fair value with the remaining basis carried at historical cost, as prescribed for step acquisitions, at the date of acquisition:

<i>(\$ in millions)</i>	
Current assets	\$ 22,834
Net property, plant and equipment	54,024
Goodwill	207,987
Intangibles	64,488
Other noncurrent assets	2,025
Total assets	351,358
Current liabilities	18,705
Noncurrent liabilities	14,063
Net assets acquired	\$318,590

The fair value of intangible assets includes \$54,776 with indefinite lives and \$9,712 with determinable lives. Goodwill recognized is included in the EMEAI segment. All goodwill recognized for income tax purposes is deductible.

On June 26, 2005, the Company completed a transaction with Kraft Foods Global, Inc. to acquire certain confectionery assets. The transaction included the purchase of the Life Savers, Altoids, Crème Savers and Sugus brands. In addition, the transaction included the purchase of certain production facilities in the United States and Europe. The purchase provided additional diversification in key categories of mints and hard and chewy candy, expanded the product offering to customers' worldwide, added scale and brand depth to the innovation pipeline and increased efficiency across the Company's supply chain. The results of operations for the businesses acquired have been included in the consolidated financial results of the Company since June 26, 2005.

Cash consideration, including direct acquisition costs, totaled \$1,436,259, net of proceeds received from the sale of the Trolli brand and related assets. The acquisition was initially funded with \$1,350,000 of commercial paper, negotiated in part for purposes of this transaction, with the remaining amount funded from the Company's available cash.

The purchase price was allocated to the underlying assets acquired and liabilities assumed based upon their fair values at the date of acquisition. The Company determined the fair values based on independent appraisals, discounted cash flow analyses, quoted market prices and estimates made by management. To the extent the purchase price exceeded the fair value of the net identifiable tangible and intangible assets acquired, such excess was recorded as goodwill.

The following table contains the final purchase price allocation, which summarizes the fair values of the assets acquired and liabilities incurred as a result of integration plans, at the date of acquisition.

Inventory	\$ 47,365
Net property, plant and equipment	86,904
Other noncurrent assets	45,808
Goodwill	912,093
Intangibles	367,695
Total assets	1,459,865
Accrued liabilities	23,606
Net assets acquired	\$1,436,259

The fair value of the intangible assets as of the acquisition date is primarily associated with brand names which are not subject to amortization.

Other noncurrent assets included \$28,356 associated with Sugus operations in China, the final purchase of which did not close until April 17, 2006.

Goodwill of \$912,093 was recognized in connection with the acquisition, with \$890,902 and \$21,191 included in the North America and EMEAI segments, respectively. All goodwill recognized for income tax purposes is deductible.

The Company closed the acquired facility in Bridgend, Wales as of April 18, 2006. The Company recognized severance and other cash closing costs of \$23,606 as a result of the Bridgend and other facility closures as well as other asset transfers. The majority of the activities were significantly completed by the first quarter of 2007.

#### **Acquisition—Pro Forma Financial Statements**

Results of operations of the acquired Kraft Foods Global, Inc. confectionery assets are included in the Company's consolidated financial statements from June 26, 2005. The following table includes the unaudited pro forma combined net sales, earnings and earnings per share for 2005, as if the Company had completed the acquisitions of the Kraft Goods Global, Inc. confectionery assets as of January 1, 2005.

In determining the unaudited pro forma amounts, income taxes, interest expense and depreciation and amortization of assets have been adjusted to the accounting base recognized for each in recording the combinations.

	<i>2005</i>
Net sales	\$4,372,864
Net earnings	\$ 519,217
Net earnings per share:	
Basic	\$ 1.85
Diluted	\$ 1.84

The pro forma results are not necessarily indicative of what actually would have occurred if the acquisitions had been completed as of the beginning of 2005, nor are they necessarily indicative of future consolidated results.

**Beazer Homes**  
**2009 Annual Report**

**(3) Investments in Unconsolidated Joint Ventures**

As of September 30, 2009, we participated in land development joint ventures in which Beazer Homes had less than a controlling interest. The following table presents our investment in our unconsolidated joint ventures, the total equity and outstanding borrowings of these joint ventures and our guarantees of these borrowings as of September 30, 2009 and September 30, 2008:

<i>(in thousands)</i>	<b>2009</b>	<b>2008</b>
Beazer's investment in joint ventures	<b>\$ 30,124</b>	\$ 33,065
Total equity of joint ventures	<b>328,875</b>	340,374
Total outstanding borrowing of joint ventures	<b>422,682</b>	524,431
Beazer's estimate of its portions of loan-to-value maintenance guarantees	<b>3,850</b>	5,839
Beazer's estimate of its portion of repayment guarantees	<b>15,789</b>	39,166

The reduction in our investment in unconsolidated joint ventures from September 30, 2008 to September 30, 2009 relates primarily to impairments totaling \$14.8 million, distributions of earnings totaling \$3.0 million, and return of capital in the form of cash and inventory assets totaling \$15.9 million which were offset by \$25.5 million of additional investments and \$4.6 of accrued liabilities for guarantee payments and deferred income. During fiscal 2009, we also acquired our joint venture partner's interest in two joint ventures which are consolidated as of September 30, 2009. In connection with the acquisition of one of these joint ventures, we paid off the joint venture's debt of approximately \$13.6 million.

For the fiscal year ended September 30, 2009, 2008 and 2007, the impairments of our investments in certain of our other unconsolidated joint ventures, totaling \$14.8 million, \$68.8 million and \$28.6 million, respectively, were recorded in accordance with APB 18. In fiscal 2007, we also recorded \$3.4 million in contractual obligation abandonments related to those ventures. Impairments totaling \$13.8 million, \$64.0 million and \$28.6 million for fiscal 2009, 2008 and 2007, respectively, are included in equity in loss of unconsolidated joint ventures on the accompanying Consolidated Statements of Operations. The remaining impairments of \$1.0 million and \$4.8 million for fiscal 2009 and 2008 are included in loss from discontinued operations, net of taxes in the accompanying Consolidated Statements of Operations. Equity in loss of unconsolidated joint ventures related to our continuing operations totaled \$13.3 million, \$76.6 and \$35.1 million for the fiscal years ended September 30, 2009, 2008 and 2007, respectively.

The aggregate debt of the unconsolidated joint ventures was \$422.7 million and \$524.4 million at September 30, 2009 and 2008, respectively. At September 30, 2009, total borrowings outstanding include \$327.9 million related to one joint venture in which we are a 2.58% partner. The \$101.7 million reduction in total outstanding joint venture debt during fiscal 2009 resulted primarily from the cancellation of \$51.5 million of debt of four joint ventures and debt payments of \$76.7 million in accordance with loan agreements and/or negotiated settlements offset by loan draws of \$27.9 million to fund the development activities of the joint ventures.

During the fourth quarter of fiscal 2009, one of our unconsolidated joint ventures completed a modification of its loan agreement with its lender, which resulted in, among other things, an extension of its maturity, enhanced guarantees from our joint venture partner and the release of Beazer under all guarantees related to this joint venture. Beazer contributed \$9.7 million as an additional investment in the joint venture as part of the loan modification. Also during the fourth quarter of fiscal 2009, the Company and its joint venture partners entered into agreements with a lender to repay the notes payable of one of its unconsolidated joint ventures at a discount. The Company contributed an additional \$4.3 million as an investment which was used to reduce the loan balance of this joint venture. We also entered into an agreement with a lender and our joint venture partner to purchase the notes payable and our partner's interest in one of our unconsolidated joint ventures for a total of \$13.6 million. This joint venture is consolidated in our financial statements as of September 30, 2009. In fiscal 2009, we also paid \$3.0 million to settle our obligations under guarantees for three ventures which we had previously estimated at a maximum potential obligation of \$16.6 million. As part of the settlement agreements, the lenders also cancelled \$48.6 million of the outstanding debt of these three joint ventures. Subsequent to September 30, 2009, together with our joint venture partner, we reached agreement with a lender to another joint venture to pay down the outstanding debt by \$7.6 million (\$3.8 million per partner). In connection with this loan repayment, the lender has agreed to release the obligations under the related loan-to-value maintenance guarantee.

Three of our joint ventures are in default (or have received default notices) under their respective debt obligations. During fiscal 2008, the lender to the joint venture, in which we have a 2.58% investment, notified the joint venture partners that it believes the joint venture is in default of certain joint venture loan agreements as a result of certain of the Company's joint venture partners not complying with all aspects of the joint ventures' loan agreements. The joint venture partners are currently in discussions with the lender. In December 2008, the lender has filed individual lawsuits against some of the joint venture partners and certain of those partners' parent companies (including the Company), seeking to recover damages under completion guarantees, among other claims. We intend to vigorously defend against this legal action. The Company's share of the outstanding debt is approximately \$14.5 million at September 30, 2009. Under the terms of the agreement, our repayment guarantee is estimated at \$15.1 million, which is only triggered in the event of bankruptcy of the joint venture. Our equity interest at September 30, 2009 was \$8.6 million in this joint venture. Given the inherent uncertainties in this litigation, as of September 30, 2009, no accrual has been recorded, as losses, if any, related to this matter are not both probable and reasonably estimable.

In addition, certain of our joint venture partners have curtailed their funding of their allocable joint venture obligations. Given the inherent uncertainties in these negotiations, as of September 30, 2009, no accrual has been recorded, as obligations to Beazer, if any, related to these matters were not both probable and reasonably estimable.

Our joint ventures typically obtain secured acquisition, development and construction financing. Generally Beazer and our joint venture partners provide varying levels of guarantees of debt and other obligations for our unconsolidated joint ventures. At September 30, 2009, these guarantees included, for certain joint ventures, construction completion guarantees, loan-to-value maintenance agreements, repayment guarantees and environmental indemnities.

In assessing the need to record a liability for the contingent aspect of these guarantees in accordance with FIN 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (ASC 400), we consider our historical experience in being required to perform under the guarantees, the fair value of the collateral underlying these guarantees and the financial condition of the applicable unconsolidated joint ventures. In addition, we monitor the fair value of the collateral of these unconsolidated joint ventures to ensure that the related borrowings do not exceed the specified percentage of the value of the property securing the borrowings. We have not recorded a liability for the contingent aspects of any guarantees that we determined were reasonably possible but not probable.

#### *Construction Completion Guarantees*

We and our joint venture partners may be obligated to the project lenders to complete land development improvements and the construction of planned homes if the joint venture does not perform the required development. Provided the joint venture and the partners are not in default under any loan provisions, the project lenders typically are obligated to fund these improvements through any financing commitments available under the applicable loans. A majority of these construction completion guarantees are joint and several with our partners. In those cases, we generally have a reimbursement arrangement with our partner which provides that neither party is responsible for more than its proportionate share of the guarantee. However, if our joint venture partner does not have adequate financial resources to meet its obligations under such reimbursement arrangement, we may be liable for more than our proportionate share, up to our maximum exposure, which is the full amount covered by the relevant joint and several guarantee. The guarantees cover a specific scope of work, which may range from an individual development phase to the completion of the entire project. No accrual has been recorded, as losses, if any, related to construction completion guarantees are not both probable and reasonably estimable.

#### *Loan-to-Value Maintenance Agreements*

We and our joint venture partners may provide credit enhancements to acquisition, development and construction borrowings in the form of loan-to-value maintenance agreements, which can limit the amount of additional funding provided by the lenders or require repayment of the borrowings to the extent such borrowings plus construction completion costs exceed a specified percentage of the value of the property securing the borrowings. The agreements generally require periodic reappraisals of the underlying property value. To the extent that the underlying property gets reappraised, the amount of the exposure under the loan-to value-maintenance (LTV) guarantee would be adjusted accordingly and any such change could be significant. In certain cases, we may be required to make a re-balancing payment following a reappraisal in order to reduce the applicable loan-to-value ratio to the required level.

Our estimate of the Company's portion of LTV guarantees of the unconsolidated joint ventures was \$3.9 million at September 30, 2009 and \$5.8 million at September 30, 2008. Subsequent to September 30, 2009, the Company and its joint venture partner have reached an agreement with the lender of a joint venture to release the LTV guarantee and extend the related loan maturity up to two years in exchange for a loan repayment of \$7.6 million. The Company and its joint venture partner have agreed to each invest an additional \$3.8 million in the joint venture to facilitate this repayment.

### *Repayment Guarantees*

We and our joint venture partners have repayment guarantees related to certain joint ventures' borrowings. These repayment guarantees require the repayment of all or a portion of the debt of the unconsolidated joint venture only in the event the joint venture defaults on its obligations under the borrowing or in some cases only in the event the joint venture files for bankruptcy.

Our estimate of Beazer's portion of repayment guarantees related to the outstanding debt of its unconsolidated joint ventures was \$15.8 million and \$39.2 million at September 30, 2009 and 2008, respectively. The reduction in the estimate of joint venture repayment guarantees was driven primarily by 1) the negotiated settlement with the lenders of two joint ventures for the cancellation of debt and the release of other loan obligations including \$16.6 million in repayment guarantees for nominal consideration and 2) the negotiated loan modification and release of guarantees with the lender of one joint venture in return for the repayment of a portion of the outstanding debt. The Company contributed \$9.7 million as an additional investment in this latter joint venture which was used to reduce the outstanding loan balance.

### *Environmental Indemnities*

Additionally, we and our joint venture partners generally provide unsecured environmental indemnities to joint venture project lenders. In each case, we have performed due diligence on potential environmental risks. These indemnities obligate us to reimburse the project lenders for claims related to environmental matters for which they are held responsible. During the fiscal years ended September 30, 2009 and 2008, we were not required to make any payments related to environmental indemnities. No accrual has been recorded, as losses, if any, related to environmental indemnities are not both probable and reasonably estimable.

## **FMC**

### **2007 Annual Report**

#### **Note 5. Investments in Joint Ventures**

We are party to several joint venture investments throughout the world, which individually and in the aggregate are not significant to our financial results. Investment gains for the year ended December 31, 2005.

In November 2005, Astaris LLC (now known as Siratsa LLC), our 50%-owned joint venture with Solutia, completed the sale of substantially all of its assets, other than certain excluded assets used in the business of Astaris to certain subsidiaries of Israel Chemicals Limited ("ICL"). The buyers also assumed certain of the liabilities of Astaris. The final sales price was \$263 million. In connection with this sale, we recorded a gain of \$57.7 million, before tax. This gain is included in "Equity in (earnings) loss of affiliates" on our consolidated statements of income for the year ended December 31, 2005. We received cash totaling \$99.4 million of which \$69.1 million is a distribution and \$30.3 million is the final payment of Astaris obligations due to us as well as payments for certain liabilities transferred from Astaris to us.

In the second quarter of 2005, we sold our 50 percent ownership investment in Sibelco Española SA ("Sibelco") for cash of \$13.7 million. We accounted for Sibelco on the equity method. We recorded a gain of \$9.3 million in conjunction with this sale which is included in "Investment gains" on our consolidated statements of income for the year ended December 31, 2005.

## **Note 6. In-Process Research and Development**

### *Proprietary Fungicide Agreement*

In the second quarter of 2006, our Agricultural Products segment entered into development agreements with a third-party company, whereby we were given the right to develop further one of the third party company's products in certain geographic markets. Under the agreements, we paid \$2.0 million and have recorded this amount as a charge to "In-process research and development" in the consolidated statements of income for the year ended December 31, 2006.

In the first quarter of 2007, our Agricultural Products segment acquired further rights from this third-party company to develop their proprietary fungicide. In acquiring those further rights, we paid an additional \$1.0 million and have recorded this amount as a charge to "In-process research and development" in the consolidated statements of income for the year ended December 31, 2007.

### *Collaboration and License Agreement*

In the third quarter of 2007, our Agricultural Products segment entered into a collaboration and license agreement with another third-party company for the purpose of obtaining certain technology and intellectual property rights. We paid an initial \$1.0 million upon entering into this agreement and have recorded the amount as a charge to "In-process research and development" in the consolidated statements of income for the year ended December 31, 2007.



## Glossary

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**Accounting consolidation.** The process of combining the financial statements of a parent company and one or more legally separate and distinct subsidiaries.

**Acquisition.** Acquirer purchases a controlling financial interest in an acquiree and agrees to operate it as a majority owned or wholly owned subsidiary. One enterprise pays cash or issues stock or debt, for all or part of the voting stock of another enterprise. The acquired enterprise remains intact as a separate legal entity.

**Acquisition method.** Required by ASC 805 and ASC 810 for consolidation of companies controlled by an acquirer; focuses on business fair value, not historical price paid to acquire a company.

**Bargain purchase.** Under the acquisition method, when business fair value is less than the fair value of net assets received; under the purchase method, when purchase price is less than the fair value of net assets acquired.

**Book value.** Amount recorded on the accounting records, also referred to as “carrying value.”

**Business combinations (mergers and acquisitions).** Legal joining of two or more companies into one economic entity.

**Business fair value.** The sum of the fair value of the controlling interest and the fair value of the noncontrolling (minority) interest.

**Combination.** Any transaction whereby one enterprise obtains control over the assets and properties of another enterprise, regardless of the resulting form of the enterprise emerging from the combination transaction.

**Combined financial statements.** Financial statements presenting the financial position and/or results of operations of legally separate entities, related by common ownership, as if they were a single entity.

**Consolidated financial statements.** Consolidated statements present, primarily for the benefit of the shareholders and creditors of the parent company, the results of operations and the financial position of a parent company and its subsidiaries essentially as if the group were a single enterprise with one or more branches or divisions.

**Consolidation.** A new enterprise is formed to acquire two or more other enterprises through an exchange of voting stock. The acquired enterprises then cease to exist as separate legal entities.

**Contingent consideration.** Amounts that may be paid at a future date by the acquirer based on whether certain conditions are met (e.g., earnings, stock price, or employee retention).

**Control.** The ability (whether used or not) of the acquirer to make decisions about the manner in which the acquiree conducts business (e.g., pricing of products, dividends, use of technology, or interchange of management personnel). It is typically ownership by one enterprise, directly or indirectly, of more than 50% of the outstanding voting shares of another enterprise.

**Control premium.** Additional amount paid by the acquirer to gain a controlling financial interest in the acquiree.

**Cost, equity, and partial equity methods.** Alternative accounting methods used by a parent to account for its investment in its consolidated subsidiary on the parent's books.

**Direct acquisition costs.** Costs incurred to complete the business combination (e.g., lawyer's and accountant's fees).

**Economic unit method for consolidation of noncontrolling interests.** Required by ASC 810 for consolidation of noncontrolling interests arising from acquisitions completed by acquirers having a fiscal year beginning after December 15, 2008.

**Entity concept.** A method of preparing consolidated financial statements of a parent and majority-owned subsidiary which involves restatement of net assets of the subsidiary to fair value at the date of acquisition for both majority and minority interests.

**Fair value.** A price at which a willing buyer and a willing seller will exchange goods or services, with both parties under no duress to complete the transaction.

**Goodwill.** Future economic benefits, obtained in a business combination, that are not attributable to separately recognized assets and liabilities of the acquiree.

**Implied value.** Price paid to acquire a company divided by ownership percentage; used for the goodwill impairment test and the economic unit method of consolidating noncontrolling interests.

**In process research and development costs.** Amounts expended by the acquiree for research and development costs prior to the date of acquisition, regardless of whether they are treated as an asset or expense on the acquiree books.

**Intangible assets.** Gives the owner rights transferred by contract or other means.

**Intercompany transactions.** Transactions that take place within the same economic entity, typically between a parent and a subsidiary.

**Merger.** One enterprise acquires all of the net assets of one or more other enterprises through an exchange of stock, payment of cash or other property, or the issue of debt instruments.

**Minority interest.** Any remaining outstanding voting stock of a subsidiary not purchased by the acquiring enterprise.

**Negative goodwill.** Referred to as the “excess of fair value over cost of purchased business acquisition.” This amount represents the net excess of fair value of the net assets of a business acquisition accounted for as a purchase, after offsetting the maximum amount against the fair value of all noncurrent assets acquired (except marketable securities).

**Net assets.** Total assets minus total liabilities.

**Noncontrolling interests (sometimes referred to as minority interests).** Ownership associated with holders of less than 50% of the voting common shares of the acquiree.

**Parent company.** Acquirer, when the acquiree is operated as a subsidiary.

**Parent company concept.** A method of preparing consolidated financial statements of a parent and majority-owned subsidiary which involves restatement of net assets of the subsidiary to fair value at the date of acquisition for only the majority interest.

**Parent company method for consolidation of noncontrolling interests.** Most prevalent method prior to the new consolidation standards for consolidation of noncontrolling interests—acquiree balance sheet accounts consolidated at 100% of book value + (ownership percentage × [fair value - book value]); this method was viewed as a “hybrid method” between the economic unit method and the proportionate method.

**Pooling of interests method.** Accounting method that is intended to reflect a “merger of equals”; acquiree book values (not fair values) are recorded in consolidation; there is no goodwill in a pooling (no longer available to acquisitions closed after June 30, 2001).

**Preacquisition contingencies.** Uncertainties existing at the date of an acquisition accounted for by the purchase method, which if resolved within one year of the acquisition result in a reallocation of the purchase price.

**Proportionate method for consolidation of noncontrolling interests.** Acquiree assets and liabilities consolidated at fair value multiplied by the percentage of ownership; this method is no longer permissible for new acquisitions subject to ASC 810.

**Purchased preacquisition earnings.** An account used to report the earnings of a subsidiary attributable to percentage ownership acquired at the interim date in the current reporting period.

**Purchase method.** Accounting method that focuses on the historical cost of the acquisition (e.g., price paid by the parent); acquiree assets and liabilities are recorded in consolidation at fair value (no longer available to acquisitions closed after December 15, 2008, where the acquirer's fiscal year-end begins after that date).

**Statutory consolidation.** Both companies agree to merge with a newly formed company replacing the two previous companies.

**Statutory merger.** Acquirer purchases net assets or stock of acquiree and dissolves the acquiree, bringing the net assets on to the acquirer books at fair value (acquisition method).

**Stock issuance costs.** Costs to register securities issued in conjunction with a business combination (e.g., exchange fees, printing costs [prospectus]).

**Subsidiary.** An enterprise that is controlled, directly or indirectly, by another enterprise.

**Subsidiary company.** Acquiree, when it is operated as a subsidiary of the parent.

**Unrealized intercompany profit.** The excess of the transaction price over the carrying value of an item (usually inventory or plant assets) transferred from (or to) a parent to (or from) the subsidiary (or among subsidiaries) and not sold to an outside entity. For purposes of consolidated financial statements, recognition must be deferred until subsequent realization through a transaction with an unrelated party.

**Variable interest entity.** Entity where the primary beneficiary (generally, the sponsor) does not own shares but nonetheless maintains control through contractual agreement (sometimes referred to as a special purpose vehicle or special purpose entity).

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