DEBRA C. JETER • PAUL K. CHANEY

ADVANCED ACCOUNTING

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ADVANCED ACCOUNTING

DEBRA C. JETER

PAUL K. CHANEY

WILEY

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PREFACE

This book is designed for advanced courses dealing with financial accounting and reporting in the following topical areas: business combinations, consolidated financial statements, international accounting, foreign currency transactions, accounting for derivative instruments, translation of financial statements of foreign affiliates, segment reporting and interim reporting, partnerships, fund accounting and accounting for governmental units, and accounting for nongovernment—nonbusiness organizations. The primary objective of this book is to provide a comprehensive treatment of selected topics in a clear and understandable manner. The changes related to FASB ASC Topics 805 and 810 (SFAS No. 141R and 160) are integrated throughout the edition. As in previous editions, we strive to maintain maximum flexibility to the instructor in the selection and breadth of coverage for topics dealing with consolidated financial statements and other advanced topics.

We track the number and characteristics of mergers and acquisitions through various eras and allow this information to influence our coverage in the textbook. For instance, the frequency of acquisitions with earnouts and with noncontrolling interests is approximately equal (each around 10% of acquisitions). Therefore, we have increased the number of examples and homework where contingent consideration is included. In addition, because of the increase in cross-border acquisitions, we address the issue of consolidating multinational firms and of reporting performance over time when exchange rates change. We have added a section in Chapter 13 on non-GAAP constant currency reporting.

One of the challenges of this revision relates to situations in which FASB spreads the effective implementation of a change in standard over several years, with early adoption allowed. Thus, financial statements that will be observed over the next few years may reflect the new standards or the prior standards. We have chosen to report the newest standard changes in the textbook (supplemented either by discussions of the prior rules or through the use of an appendix illustrating the former standards).

We expanded the number and variety of exercises and problem materials at the end of each chapter. In addition, we include financial statement analysis exercises that relate to real companies and practical applications in every chapter. Two appendices (Appendix ASC at the back of the book and Appendix A to Chapter 1) are presented to assist the student in solving these exercises. All chapters have been updated to reflect the most recent pronouncements of the Financial Accounting Standards Board and the Governmental Accounting Standards Board as of this writing. We include codification exercises that require the student to research the FASB's Codification to determine the appropriate GAAP for a variety of issues.

In teaching consolidation concepts, a decision must be made about the recording method that should be emphasized in presenting consolidated workpaper procedures. The three major alternatives for recording investments in subsidiaries are the (1) cost method, (2) partial equity (or simple equity) method, and (3) complete equity (or sophisticated equity) method. A brief description of each method follows.

1. *Cost method*. The investment in subsidiary is carried at its cost, with no adjustments made to the investment account for subsidiary income or dividends. Dividends received by the parent company are recorded as an increase in cash and as dividend income.

2. *Partial equity method*. The investment account is adjusted for the parent company's share of the subsidiary's reported earnings or losses, and dividends received from the subsidiary are deducted from the investment account. Generally, no other adjustments are made to the investment in subsidiary account.
3. *Complete equity method*. This method is the same as the partial equity method except that additional adjustments are made to the investment in subsidiary account to reflect the effects of (a) the elimination of unrealized intercompany profits, (b) the amortization (depreciation) of the difference between cost and book value, and (c) the additional stockholders' equity transactions undertaken by the subsidiary that change the parent company's share of the subsidiary's stockholders' equity.

All three are acceptable under both U.S. GAAP and IFRS, so long as the appropriate consolidating entries are made. While the FASB appears to prefer the complete equity method, the IASB, on the other hand, seems to prefer the cost method. We continue to present all three methods, using generic icons to distinguish among the three methods. The instructor has the flexibility to teach all three methods, or to instruct the students to ignore one or two. If the student is interested in learning all three methods, he or she can do so, even if the instructor only focuses on one or two. In addition, we believe this feature makes the book an excellent reference for the student to keep after graduation, so that he or she can easily adapt to any method needed in future practice.

WHAT'S NEW IN THE TEXT?

- We have updated the online videos explaining some of the critical concepts from each chapter and walk students through how to solve selected problems throughout the book.
- The partnership chapters have been updated to comply with FASB's position regarding when goodwill should (and should not) be recorded in business transactions/combinations. However, since many partnerships are not required to comply with GAAP and are thus allowed greater flexibility with respect to goodwill, we continue to present the traditional goodwill method for accounting for changes in partnership composition; we clarify which approaches are (are not) GAAP compliant.
- The coverage of certain topics has been expanded (such as contingent consideration and bargain purchases) to incorporate information gleaned from the FASB's Post-Implementation Review of FASB Statement No. 141R and to include more realistic real-world issues.
- Chapter 11 on International Accounting has been completely rewritten to focus on International Financial Reporting Standards (IFRS). In addition, in Section 11.5, we have written a stand-alone section on accounting for mergers and acquisitions using IFRS that can be used with the material in Chapters 4 or 5 to embrace an international focus on cross-border mergers and acquisitions if desired.
- Chapter 19 was revised to incorporate FASB's new not-for-profit standards on the reporting of net assets and other significant changes to the not-for-profit model.
- Chapter 2 was reorganized for improved flow of topics. It has been updated for the new goodwill impairment standards and other changes in the standards (measurement period adjustments and contingent consideration).
- We continue to provide real-world examples and use these to motivate coverage in the textbook. For instance, in Chapter 13, we have added a discussion of non-GAAP disclosures on constant currency amounts.
- To conserve space, two chapters (Chapters 9 and 10) and some topics within chapters are now located online (see www.wiley.com/go/jeter/AdvancedAccounting7e; see table of contents for more details).
- A continuous consolidation problem is introduced in Chapters 4 and 5. This allows students to build on concepts learned in prior chapters.

OTHER HIGHLIGHTED FEATURES OF THE TEXT

1. For all mergers and acquisition problems involving workpapers, we provide printable excel templates that can be used to reduce student time required in solving the problems.
2. We include a discussion of international accounting standards on each topic where such standards exist and compare and contrast U.S. GAAP and IFRS. An IFRS icon appears in the margins where this discussion occurs.
3. We have written Chapter 11 to highlight IFRS. We have added new analyzing financial statement problems; each highlights a specific difference in accounting between U.S. GAAP and IFRS. Also in this chapter, Section 11.5 on accounting for mergers and acquisitions using IFRS was written so that it can be used

as a stand-alone section and/or incorporated into the mergers and acquisition Chapters 4 or 5. Thus, if a professor would like to cover global mergers and acquisition, this can easily be accomplished.

4. FASB's conceptual framework is discussed as it relates to Advanced Accounting in Chapter 1. We also include marginal references to ***Related Concepts*** throughout the book. The GASB's conceptual framework is discussed in Chapters 17 and 18.
5. Questions or problems related to ***Business Ethics*** are included in the end-of chapter materials for every chapter.
6. We include real-company annual reports or excerpts from reports with related questions ***(Analyzing Financial Statements)*** in the end-of-chapter materials and/or online for most chapters excluding Chapters 15 and 16.
7. In Chapter 9 of the 6th edition, the homework material includes the effective interest, in addition to the straightline method for amortization of bond premiums and discounts. The 6th edition also includes online appendices on deferred taxes which are related to the topics in Chapter 6 and 7. (Go to www.wiley.com/go/jeter/AdvancedAccounting7e.)
8. The ***in-the-news*** boxes that appear throughout the book reflect recent business and economic events relevant to the subject matter.
9. We have integrated ***goodwill impairment*** into some illustrations in the body of Chapter 5, as well as in several homework problems. We illustrate the newly modified goodwill impairment test. The simplification of the goodwill impairment tests for smaller companies is also discussed, along with the role of qualitative factors for determining which steps are necessary. There are exercises on this topic in Chapters 2 and 5.
10. At the beginning of Chapter 4, we discuss three methods of accounting for investments, depending on the level of ownership and the presumption of influence or control. We emphasize the importance of the complete equity method for certain investments that are not consolidated, or in the parent-only statements. In addition, online materials include an expanded discussion of the ***accounting for investments***. (See www.wiley.com/go/jeter/AdvancedAccounting7e.)
11. ***Learning objectives*** are included in the margins of the chapters, and relevant learning objective numbers are provided with end-of-chapter materials.
12. We continue the use of ***graphical illustrations***, which was introduced in prior editions.
13. A few short-answer questions (and solutions) are periodically provided throughout each chapter to enable students to test their knowledge of the content before moving on.
14. The organization of the worksheets applies a format that separates accounts to the income statement, the statement of retained earnings, and the balance sheet in distinct sections. The worksheets are placed near the relevant text.
15. All illustrations are printed upright on the page and labeled clearly for convenient study and reference.
16. Entries made on consolidated statements workpapers are presented in general journal form. These entries are shaded in blue to distinguish them from book entries, to facilitate exposition and study. To distinguish among parent company entries and workpaper entries in the body of the text, we present parent entries in gray and workpaper entries in blue.
17. We include a feature that requires students to research the FASB Codification in order to locate the current standard that applies to various issues. These exercises appear before the problems at the end of each chapter and often, but not always, relate to topics addressed in that chapter. (Similar questions appear on the CPA exam.)
18. Summaries appear at the end of each chapter, and a glossary of key terms is provided at the end of the book.
19. An appendix to Chapter 1 has been posted online at www.wiley.com/go/jeter/AdvancedAccounting7e. This appendix illustrates a strategy or technique for analyzing a given company, such as a potential acquisition target. This strategy may be applied in some of the end-of-the-chapter Analyzing Financial Statements (AFS) problems.
20. Chapters 17 through 19 reflect the latest GASB and FASB pronouncements related to fund accounting.

Clearly, there are more topics in this text than can be covered adequately in a one semester or one-quarter course. We believe that it is generally better for both students and instructors to cover a selected number of topics in depth rather than to undertake a superficial coverage of a larger number of topics. Modules of material that an instructor may consider for exclusion in any one semester or quarter include the following:

- Chapters 7–9. An expanded analysis of problems in the preparation of consolidated financial statements.
- Chapter 10. Insolvency—liquidation and reorganization.

- Chapters 11–14. International accounting, foreign currency transactions and translation, and segment and interim reporting.
- Chapters 15 and 16. Partnership accounting.
- Chapters 17 through 19. Fund accounting, accounting for governmental units, and accounting for nongovernment–nonbusiness organizations (NNOs).

SUPPLEMENTS

The following supplements are available on the book companion web site: Study Guide, Excel Templates, Power-Point Slides, Instructors' Manual, Solutions Manual, Test Bank, and videos for each chapter. These materials are accessible from www.wiley.com/go/jeter/AdvancedAccounting7e.

WILEYPLUS

WileyPLUS is an online learning and assessment environment, where students test their understanding of concepts, get feedback on their answers, and access learning materials such as the eText and multimedia resources. Instructors can automate assignments, create practice quizzes, assess students' progress, and intervene with those falling behind.

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1

INTRODUCTION TO BUSINESS COMBINATIONS AND THE CONCEPTUAL FRAMEWORK

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LEARNING OBJECTIVES

1. Describe historical trends in types of business combinations.
2. Identify the major reasons firms combine.
3. Identify the factors that managers should consider in exercising due diligence in business combinations.
4. Identify defensive tactics used to attempt to block business combinations.
5. Distinguish between an asset and a stock acquisition.
6. Indicate the factors used to determine the price and the method of payment for a business combination.
7. Calculate an estimate of the value of goodwill to be included in an offering price by discounting expected future excess earnings over some period of years.
8. Describe the two alternative views of consolidated financial statements: the economic entity and the parent company concepts.
9. Discuss the *Statements of Financial Accounting Concepts (SFAC)*.

1.1 GROWTH THROUGH MERGERS

Growth through mergers and acquisitions (M&A) has become a standard in business not only in America but throughout the world. The total volume of 2017 deal-making reached $3.5 trillion, increasing the record streak to four consecutive years in which deals surpassed $3 trillion in volume. In 2017, the United States remained the most active region conducting 12,400 deals, an all-time U.S. record. U.S. deals totaled $1.4 trillion, falling 16% from 2016. Dealmakers expect an M&A surge in 2018 as a result of President Trump's corporate tax reform.

The total volume of Asia Pacific deals reached $912 billion in 2017, up 11% from 2016. Chinese companies committed $140 billion to outbound deals in 2017, down 35% from 2016 but still China's second biggest year on record. A new capital controls regime in China, coupled with increased scrutiny of tech deals from U.S. and European governments, limited outbound deals.[1] In the new millennium, the most recent in a series of booms in merger activity was sparked by cheaper credit and by global competition, in addition to the usual growth-related incentives predominant during the boom of the 1990s.

Merger activity has historically been highly correlated with the movement of the stock market. Increased stock valuation increases a firm's ability to use its shares to acquire other companies and is often more appealing than issuing debt. During the merger cycle of the 1990s, equity values fueled the merger wave. The slowing of merger activity in the early years of the 21st century provided a dramatic contrast to this preceding period. Beginning with the merger of Morgan Stanley and Dean Witter Discover and ending with the biggest acquisition to that date—WorldCom's bid for MCI—the year 1997 marked the third consecutive year of record M&A activity. The pace accelerated still further in 1998 with unprecedented merger activity in the banking industry, the auto industry, financial services, and telecommunications, among others. This activity left experts wondering why and whether bigger was truly better. It also left consumers asking what the impact would be on service. A wave of stock swaps was undoubtedly sparked by record highs in the stock market, and stockholders reaped benefits from the mergers in many cases, at least in the short run. Regulators voiced concern about the dampening of competition, and consumers were quick to wonder where the real benefits lay. Following the accounting scandals of 2001 (WorldCom, Enron, Tyco, etc.), merger activity lulled for a few years.

Also in 2001, the *Financial Accounting Standards Board* (*FASB*) voted in two major accounting changes related to business combinations. The first met with vehement protests that economic activity would be further slowed as a result and the second with excitement that it might instead be spurred. Both changes are detailed in Chapter 2.

By the middle of 2002, however, these hopes had been temporarily quelled. Instead of increased earnings, many firms active in mergers during the 1990s were forced to report large charges related to the diminished value of long-lived assets (mainly goodwill). Merger activity slumped, suggesting that the frenzy had run its course. Market reaction to the mergers that did occur during this period typified the market's doubts. When ***Northrop Grumman Corp.*** announced the acquisition of ***TRW Inc.*** for $7.8 billion, the deal was praised but no market reaction was noted. In contrast, when Vivendi Universal admitted merger-gone-wrong woes, investors scurried.

By the middle of the first decade of the 21st century, however, the frenzy was returning with steady growth in merger activity from 2003 to 2006. In 2005, almost 18% of all M&A (mergers & acquisitions) deals were in the services sector. In a one-week period in June of 2006, $100 billion of acquisitions occurred, including Phelps Dodge's $35.4 billion acquisition of Inco Ltd. and Falconbridge Ltd. In addition, because of the economic rise in China and India, companies there were looking to increase their global foothold and began acquiring European companies. Thus, cross-border deals within Europe accounted for a third of the global M&A deals.

However, by the end of 2008, a decline in overall merger activity was apparent as the U.S. economy slid into a recession, and some forecasters were predicting the

[1] http://www.ft.com/content/9f0270aa-eabf-11e7-bd17-521324c81e23.

next chapter in M&A to center around bankruptcy-related activity. Data from Thomson Reuters revealed that in 2008, bankruptcy-related merger activity increased for the first time in the last six years. For example, the number of Chapter 11 M&A purchases rose from 136 for the entire year of 2007 to 167 for the first 10 months of 2008, with more to come. Overall mergers, on the other hand, decreased from $87 billion in the United States ($277 billion globally) during October 2007 to $78 billion in the United States ($259 billion globally) during October 2008, based on the Reuters data.

"If we are going to ride the IASB and the IFRS [International Financial Reporting Standards] horse, we want to make sure that it's as good as it can be. We want to make sure that the IASB is strong, is independent, is well resourced, and is properly funded in a broad-based and secure way."[2]

On December 4, 2007, FASB released two new standards, *FASB Statement No. 141 R*, Business Combinations, and *FASB Statement No. 160*, Noncontrolling Interests in Consolidated Financial Statements [ASC 805, "Business Combinations" and ASC 810, "Consolidations," based on FASB's new codification system]. These standards have altered the accounting for business combinations dramatically.

Both statements became effective for years *beginning after December 15, 2008*, and are intended to improve the relevance, comparability, and transparency of financial information related to business combinations, and to facilitate the convergence with international standards. They represent the completion of the first major joint project of the FASB and the IASB (International Accounting Standards Board), according to one FASB member, G. Michael Crooch. The FASB also believes the new standards will reduce the complexity of accounting for business combinations. These standards are integrated throughout this text.

Planning M&A in a Changing Environment and Under Changing Accounting Requirements

In 2017, 86% of private equity investors anticipate an uptick in M&A activity. Divestitures may be a major focus in 2017.

1. The timing of deals is critical. The number of days between agreement or announcement and deal consummation can make a huge difference.
2. The effects on reporting may cause surprises. More purchases qualify as business combinations than previously. Income tax provisions can trigger disclosures.
3. Assembling the needed skill and establishing the needed controls takes time. The use of fair values is expanded, and more items will need remeasurement or monitoring after the deal.
4. The impact on earnings in the year of acquisition and subsequent years will differ from that in past mergers, as will the effects on earnings of step purchases or sales.
5. Unforeseen effects on debt covenants or other legal arrangements may be lurking in the background, as a result of the changes in key financial ratios.[3]

Growth is a major objective of many business organizations. Top management often lists growth or expansion as one of its primary goals. A company may grow slowly, gradually expanding its product lines, facilities, or services, or it may skyrocket almost overnight. Some managers consider growth so important that they say their companies must "grow or die." In the past hundred years, many U.S. businesses have achieved their goal of expansion through business combinations. A **business combination** occurs when *the operations of two or more companies are brought under common control*.

[2] "Change Agent: Robert Hertz discusses FASB's priorities, the road to convergence and changes ahead for CPAs," *Journal of Accountancy*, February 2008, p. 31.

[3] BDO Seidman, LLP, "Client Advisory," No. 2008-1, 1/31/08.

1.2 NATURE OF THE COMBINATION

A business combination may be friendly or unfriendly. In a **friendly combination**, *the boards of directors of the potential combining companies negotiate mutually agreeable terms of a proposed combination*. The proposal is then submitted to the stockholders of the involved companies for approval. Normally, a two-thirds or three-fourths positive vote is required by corporate bylaws to bind all stockholders to the combination.

An **unfriendly (hostile) combination** results when *the board of directors of a company targeted for acquisition resists the combination*. A formal ***tender offer*** enables the acquiring firm to deal directly with individual shareholders. The tender offer, usually published in a newspaper, typically provides a price higher than the current market price for shares made available by a certain date. If a sufficient number of shares are not made available, the acquiring firm may reserve the right to withdraw the offer. Because they are relatively quick and easily executed (often in about a month), tender offers are the preferred means of acquiring public companies.

Although tender offers are the preferred method for presenting hostile bids, most tender offers are friendly ones, done with the support of the target company's management. Nonetheless, hostile takeovers have become sufficiently common that a number of mechanisms have emerged to resist takeover.

IN THE NEWS

Men's Wearhouse acquired all the outstanding shares of Jos. A Bank with a per share offer that represented a 56% premium over Jos. A. Bank's closing share price. During a six-month period, Jos. A. Bank made several offers to acquire Men's Wearhouse. At the end of this six-month period, Men's Wearhouse, using a Pac Man strategy, made an offer to acquire Jos. A Bank. No rebranding of the companies is expected and Men's Wearhouse shareholders hope to benefit from $100 to $150 million in synergies.[4]

Defense Tactics

LO 4 Defensive tactics are used.

Resistance often involves various moves by the target company, generally with colorful terms. Whether such defenses are ultimately beneficial to shareholders remains a controversial issue. Academic research examining the price reaction to defensive actions has produced mixed results, suggesting that the defenses are good for stockholders in some cases and bad in others. For example, when the defensive moves result in the bidder (or another bidder) offering an amount higher than initially offered, the stockholders benefit. But when an offer of $40 a share is avoided and the target firm remains independent with a price of $30, there is less evidence that the shareholders have benefited.

A certain amount of controversy surrounds the effectiveness, as well as the ultimate benefits, of the following defensive moves:

1. *Poison pill:* Issuing stock rights to existing shareholders enabling them to purchase additional shares at a price below market value, but exercisable only in the event of a potential takeover. This tactic has been effective in some instances, but bidders may take managers to court and eliminate the defense. In other instances, the original shareholders benefit from the tactic. Chrysler Corp. announced that it was extending a poison pill plan until February 23, 2008, under which the rights become exercisable if anyone announces a tender offer for 15% or more, or acquires 15%, of Chrysler's outstanding common shares. Poison pills are rarely triggered, but their existence serves as a preventative measure.
2. *Greenmail:* The purchase of any shares held by the would-be acquiring company at a price substantially in excess of their fair value. The purchased shares are then held as treasury stock or retired. This tactic is largely ineffective because it may result in an expensive excise tax; further, from an accounting perspective, the excess of the price paid over the market price is expensed.

[4] "Men's Wearhouse Reaches $1.8 Billion Deal to Acquire Jos. A. Bank," by Maggie McGrath, Forbes.com, 3/11/14.

3. *White knight or white squire:* Encouraging a third firm more acceptable to the target company management to acquire or merge with the target company.
4. *Pac-man defense:* Attempting an unfriendly takeover of the would-be acquiring company.
5. *Selling the crown jewels:* The sale of valuable assets to others to make the firm less attractive to the would-be acquirer. The negative aspect is that the firm, if it survives, is left without some important assets.
6. *Leveraged buyouts:* The purchase of a controlling interest in the target firm by its managers and third-party investors, who usually incur substantial debt in the process and subsequently take the firm private. The bonds issued often take the form of high-interest, high-risk "junk" bonds. Leveraged buyouts will be discussed in more detail in Chapter 2.

1.3 BUSINESS COMBINATIONS: WHY? WHY NOT?

LO 2 Reasons firms combine.

A company may expand in several ways. Some firms concentrate on **internal** expansion. A firm may expand internally by engaging in product research and development. Hewlett-Packard is an example of a company that relied for many years on new product development to maintain and expand its market share. A firm may choose instead to emphasize marketing and promotional activities to obtain a greater share of a given market. Although such efforts usually do not expand the total market, they may redistribute that market by increasing the company's share of it.

For other firms, **external** expansion is the goal; that is, they try to expand by acquiring one or more other firms. This form of expansion, aimed at producing relatively rapid growth, has exploded in frequency and magnitude in recent years. A company may achieve significant cost savings as a result of external expansion, perhaps by acquiring one of its major suppliers.

In addition to rapid expansion, the business combination method, or external expansion, has several other potential advantages over internal expansion:

IN THE NEWS

Views on whether synergies are real or simply a plug figure to justify a merger that shouldn't happen are diverse. Time Warner, for example, has fluctuated back and forth on this issue in recent years. President Jeffrey Bewkes recently was quoted as saying, "No division should subsidize another." When queried about the message his predecessors sent to shareholders, he said, "It's bull—"[5]

1. ***Operating synergies*** may take a variety of forms. Whether the merger is **vertical** (*a merger between a supplier and a customer*) or **horizontal** (*a merger between competitors*), combination with an existing company provides management of the acquiring company with an established operating unit with its own experienced personnel, regular suppliers, productive facilities, and distribution channels. In the case of vertical mergers, synergies may result from the elimination of certain costs related to negotiation, bargaining, and coordination between the parties. In the case of a horizontal merger, potential synergies include the combination of sales forces, facilities, outlets, and so on, and the elimination of unnecessary duplication in costs. When a private company is acquired, a plus may be the potential to eliminate not only duplication in costs but also unnecessary costs.

   Management of the acquiring company can draw upon the operating history and the related historical database of the acquired company for planning purposes. A history of profitable operations by the acquired company may, of course, greatly reduce the risk involved in the new undertaking. A careful examination of

[5] *WSJ*, "After Years of Pushing Synergy, Time Warner Inc. Says Enough," by Matthew Karnitschnig, 6/2/06, p. A1.

GAINS FROM BULKING UP[6]

Industry	*Key Benefit of Consolidation*
Antenna towers	Frees up capital and management time for wireless communications operators
Funeral homes	Yields greater discounts on coffins, supplies, and equipment
Health clubs	Spreads regional marketing and advertising costs over more facilities
Landfill sites	Lets operators cope with the new environmental and regulatory demands
Physician group practices	Reduces overhead and costs of medical procedures

the acquired company's expenses may reveal both expected and unexpected costs that can be eliminated. On the more negative (or cautious) side, be aware that the term "synergies" is sometimes used loosely. If there are truly expenses that can be eliminated, services that can be combined, and excess capacity that can be reduced, the merger is more likely to prove successful than if it is based on growth and "so-called synergies," suggests Michael Jensen, a professor of finance at the Harvard Business School.

2. Combination may enable a company to compete more effectively in the **international marketplace**. For example, an acquiring firm may diversify its operations rather rapidly by entering new markets; alternatively, it may need to ensure its sources of supply or market outlets. Entry into new markets may also be undertaken to obtain cost savings realized by smoothing cyclical operations. Diminishing savings from cost-cutting *within* individual companies makes combination more appealing. The financial crisis in Asia accelerated the pace for a time as American and European multinationals competed for a shrinking Asian market. However, a combination of growing competition, globalization, deregulation, and financial engineering has led to increasingly complex companies and elusive profits.

Having incurred heavy losses over the last several decades, the U.S. airline industry is often considered a laggard by investors. Consequently, a number of airlines were pushed into bankruptcy post the slowdown, resulting in a number of M&A over the last decade. These mergers resulted in the consolidation of capacity with the top four U.S. airlines in the industry, namely American, United, Delta, and Southwest Airlines. At present, these airlines hold almost 85% of the market share, as opposed to only 65% share (on average) held by the top four U.S. airlines in the past.[7]

3. Business combinations are sometimes entered into to take advantage of **income tax** laws. The opportunity to file a consolidated tax return may allow profitable corporations' tax liabilities to be reduced by the losses of unprofitable affiliates. When an acquisition is financed using debt, the interest payments are tax deductible, creating a **financial synergy** or "tax gain." Many combinations in the past were planned to obtain the advantage of significant operating loss carryforwards that could be utilized by the acquiring company. However, the Tax Reform Act of 1986 limited the use of operating loss carryforwards in merged companies. Because tax laws vary from year to year and from country to country, it is difficult to do justice to the importance of tax effects within the scope of this chapter. Nonetheless, it is important to note that tax implications are often a driving force in merger decisions.

4. **Diversification** resulting from a merger offers a number of advantages, including increased flexibility, an internal capital market, an increase in the firm's debt capacity, more protection from competitors over proprietary information, and, sometimes, a more effective utilization of the organization's resources. In debating

[6] *Business Week*, "Buy 'Em Out, Then Build 'Em Up," by Eric Schine, 5/18/95, p. 84.

[7] *Forbes*, "How M&A Has Driven the Consolidation of the US Airline Industry over the Last Decade? 5/4/16.

the tradeoffs between diversification and focusing on one (or a few) specialties, there are no obvious answers.

5. **Divestitures** accounted for 40% of global merger activity in 2014, which has increased from 30% in the period from 2001 to 2010. Shedding divisions that are not part of a company's core business became common during this period. In some cases, the divestitures may be viewed as "undoing" or "redoing" past acquisitions. A popular alternative to selling off a division is to "spin off" a unit. Examples include AT&T's spin-off of its equipment business to form ***Lucent Technologies Inc.,*** Sears Roebuck's spin-off of ***Allstate Corp.*** and ***Dean Witter Discover & Co.,*** and Cincinnati Bell's proposed spin-off of its billing and customer-management businesses to form ***Convergys Corp.***

Notwithstanding its apparent advantages, business combination may not always be the best means of expansion. An overriding emphasis on rapid growth may result in the pyramiding of one company on another without sufficient management control over the resulting conglomerate. Too often in such cases, management fails to maintain a sound enough financial equity base to sustain the company during periods of recession. Unsuccessful or incompatible combinations may lead to future divestitures.

In order to avoid large dilutions of equity, some companies have relied on the use of various debt and preferred stock instruments to finance expansion, only to find themselves unable to provide the required debt service during a period of decreasing economic activity. The junk bond market used to finance many of the mergers in the 1980s had essentially collapsed by the end of that decade.

Business combinations may destroy, rather than create, value in some instances. For example, if the merged firm's managers transfer resources to subsidize money-losing segments instead of shutting them down, the result will be a suboptimal allocation of capital. This situation may arise because of reluctance to eliminate jobs or to acknowledge a past mistake.

Some critics of the accounting methods used in the United States prior to 2002 to account for business combinations argued that one of the methods did not hold executives accountable for their actions if the price they paid was too high, thus encouraging firms to "pay too much." Although opinions are divided over the relative merits of the accounting alternatives, most will agree that the resulting financial statements should reflect the economics of the business combination. Furthermore, if and when the accounting standards and the resulting statements fail even partially at this objective, it is crucial that the users of financial data be able to identify the deficiencies. Thus we urge the reader to keep in mind that an important reason for learning and understanding the details of accounting for business combinations is to understand the economics of the business combination, which in turn requires understanding any possible deficiencies in the accounting presentation.

1.4 BUSINESS COMBINATIONS: HISTORICAL PERSPECTIVE

LO 1 Historical trends in types of M&A.

In the United States there have been three fairly distinct periods characterized by many business mergers, consolidations, and other forms of combinations: 1880–1904, 1905–1930, and 1945–present. During the first period, huge holding companies, or trusts, were created by investment bankers seeking to establish monopoly control over certain

industries. This type of combination is generally called **horizontal integration** because it involves the combination of companies within the same industry. Examples of the trusts formed during this period are J. P. Morgan's U.S. Steel Corporation and other giant firms such as Standard Oil, the American Sugar Refining Company, and the American Tobacco Company. By 1904, more than 300 such trusts had been formed, and they controlled more than 40% of the nation's industrial capital.

The second period of business combination activity, fostered by the federal government during World War I, continued through the 1920s. In an effort to bolster the war effort, the government encouraged business combinations to obtain greater standardization of materials and parts and to discourage price competition. After the war, it was difficult to reverse this trend, and business combinations continued. These combinations were efforts to obtain better integration of operations, reduce costs, and improve competitive positions rather than attempts to establish monopoly control over an industry. This type of combination is called **vertical integration** because it involves the combination of a company with its suppliers or customers. For example, Ford Motor Company expanded by acquiring a glass company, rubber plantations, a cement plant, a steel mill, and other businesses that supplied its automobile manufacturing business. From 1925 to 1930, more than 1,200 combinations took place, and about 7,000 companies disappeared in the process.

The third period started after World War II and has exhibited rapid growth in merger activity since the mid-1960s, and even more rapid growth since the 1980s. The total dollar value of M&A grew from under $20 billion in 1967 to over $300 billion by 1995 and over $1 trillion in 1998, and $3.5 trillion by 2006. Even allowing for changes in the value of the dollar over time, the acceleration is obvious. By 1996, the number of yearly mergers completed was nearly 7,000. Some observers have called this activity **merger mania**, and most agreed that the mania had ended by mid-2002. However, by 2006, merger activity was soaring once more. Illustration 1-1 presents two rough graphs of the level of merger activity for acquisitions over $10 million from 1985 to 2017 in number of deals, and from 1985 to 2017 in dollar volume. Illustration 1-2 presents summary statistics on the level of activity for the years 2000 through 2018 by industry sector for acquisitions with purchase prices valued in excess of $10 million.

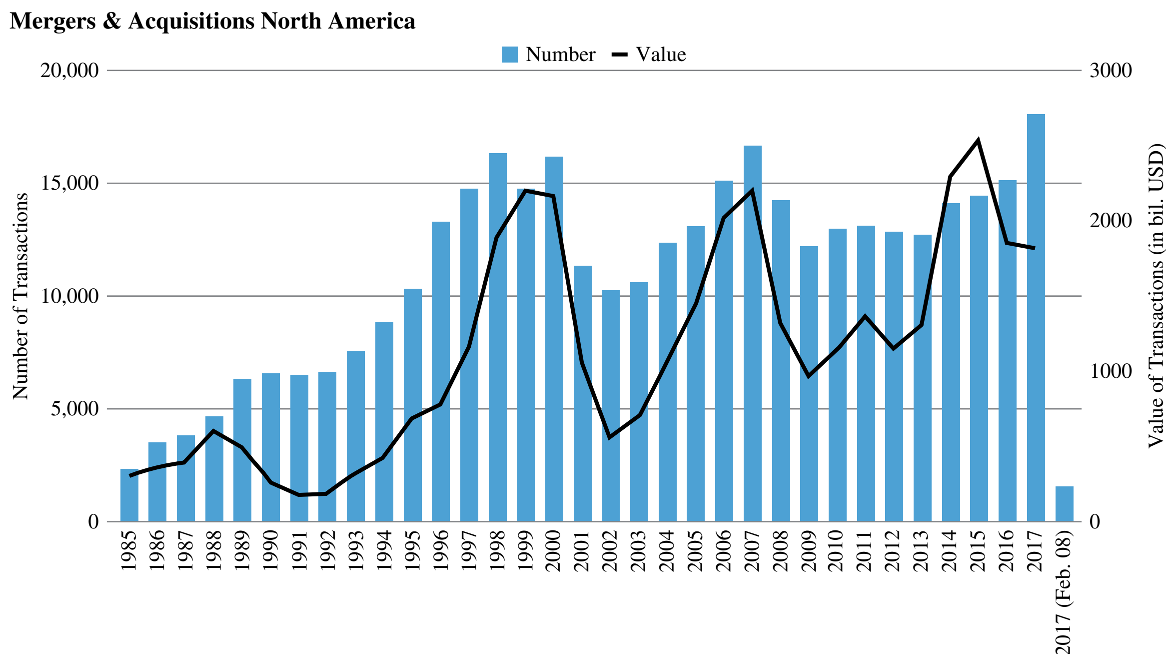
This most recent period can be further subdivided to focus on trends of particular decades or subperiods. For example, many of the mergers that occurred in the United States from the 1950s through the 1970s were **conglomerate** mergers. Here the primary motivation for combination was often to diversify business risk by combining companies in different industries having little, if any, production or market similarities, or possibly to create value by lowering the firm's cost of capital. One conjecture for the popularity of this type of merger during this time period was the strictness of regulators in limiting combinations of firms in the same industry. One conglomerate may acquire another, as Esmark did when it acquired Norton-Simon, and conglomerates may spin off, or divest themselves of, individual businesses. Management of the conglomerate hopes to smooth earnings over time by counterbalancing the effects of economic forces that affect different industries at different times.

In contrast, the 1980s were characterized by a relaxation in antitrust enforcement during the Reagan administration and by the emergence of high-yield junk bonds to finance acquisitions. The dominant type of acquisition during this period and into the 1990s was the **strategic acquisition**, claiming to benefit from **operating synergies**. These synergies may arise when the talents or strengths of one of the firms complement the products or needs of the other, or they may arise simply because the firms were former competitors. An argument can be made that the dominant form of acquisition shifted in the 1980s because many of the conglomerate mergers of the

1960s and 1970s proved unsuccessful; in fact, some of the takeovers of the 1980s were of a disciplinary nature, intended to break up conglomerates.

Deregulation undoubtedly played a role in the popularity of combinations in the 1990s. In industries that were once fragmented because concentration was forbidden, the pace of mergers picked up significantly in the presence of deregulation. These industries include banking, telecommunications, and broadcasting. Although recent

ILLUSTRATION 1-1 Number and Value of M&A North America 1985 to 2017



https://imaa-institute.org/mergers-and-acquisitions-statistics/

ILLUSTRATION 1-2

Ten Most Active Industries (Domestic Deals) by Number and Value of Transactions from 2000 to 2018

	Number of Deals			*Value of Deals*		
Industry	*Rank*	*Number of Deals*	*% of all M&A Deals*	*Rank*	*Value ($ billions)*	*% of Total M&A Value*
High Technology	1	38,350	19.91%	3	2,807	12.10%
Financials	2	22,049	11.45%	4	2,779	11.98%
Consumer Products	3	21,816	11.32%	11	875	3.77%
Industrials	4	20,863	10.83%	6	1,745	7.52%
Healthcare	5	16,592	8.61%	1	3,292	14.19%
Media and Entertainment	6	15,203	7.89%	5	2,362	10.18%
Energy and Power	7	13,978	7.26%	2	3,078	13.27%
Materials	8	13,843	7.19%	8	1,494	6.44%
Real Estate	9	9,010	4.68%	7	1,521	6.56%
Retail	10	7,909	4.11%	12	647	2.79%
Consumer Staples	11	7,649	3.97%	10	1,269	5.47%
Telecommunications	12	5,387	2.80%	9	1,333	5.75%
		192,649	100.00%		23,202	100.00%

Source: Institute of Mergers, Acquisitions and Alliances (IMAA), retrieved from https://imaa-institute.org/mergers-and-acquisitions-statistics

years have witnessed few deals blocked due to antitrust enforcement, an example of a major transaction dropped in 1996 because of a planned FTC (Federal Trade Commission) challenge was in the drugstore industry. The FTC challenged the impact of a proposed merger between ***Rite Aid Corp.*** and ***Revco D.S. Inc.*** on market power in several sectors of the East and Midwest. Nonetheless, subsequent deals in the industry saw both companies involved: Rite Aid acquired ***Thrifty PayLess Holdings Inc.,*** and ***CVS Inc.*** purchased Revco in February 1997.

Later, the Justice Department sued to block Primestar's acquisition of a satellite slot owned by ***MCI*** and ***News Corp.*** Other deals were dropped in the face of possible intervention, including a planned merger between CPA firms KPMG Peat Marwick and Ernst & Young in 1998. Nonetheless, over time the group of large CPA firms once referred to as the Big 8 has blended into the Big 4, raising concerns about a possible lack of competition in the audit market for large companies. The Justice Department reached a settlement in 2013 with American Airlines and US Airways requiring them to sell facilities at seven airports before being allowed to consummate the planned merger.[8]

In Broadcom's bid for Qualcomm, the chipmaker agreed to pay an $8 billion breakup fee should the deal ultimately be blocked by regulators, representing the second largest breakup fee ever recorded. Of the ten deals with the largest breakup fees, three were ultimately terminated resulting in a $3–$3.5 billion loss for the acquirer (T-Mobile and AT&T in 2011, Baker Hughes and Halliburton in 2016, and Pfizer and Allergan in 2016).[9]

IN THE NEWS

Virtually every deal in the 2010 Wall Street lineup of potential mega-mergers faced regulatory challenges both in the United States and in Europe. Examples include Oracle and Sun; Exxon and XTO Energy; Yahoo and Microsoft, Kraft and Cadbury.

1.5 TERMINOLOGY AND TYPES OF COMBINATIONS

LO 5 Stock versus asset acquisitions.

From an accounting perspective, the distinction that is most important at this stage is between an **asset acquisition** and a **stock acquisition**. In Chapter 2, we focus on the acquisition of the assets of the acquired company, where only the acquiring or new company survives. Thus the books of the acquired company are closed out, and its assets and liabilities are transferred to the books of the acquirer. In subsequent chapters, we will discuss the stock acquisition case where the acquired company and its books remain intact and consolidated financial statements are prepared periodically. In such cases, the acquiring company debits an account "Investment in Subsidiary" rather than transferring the underlying assets and liabilities onto its own books.

Note that the distinction between an asset acquisition and a stock acquisition does not imply anything about the medium of exchange or consideration used to consummate the acquisition. Thus a firm may gain control of another firm in a stock acquisition using cash, debt, stock, or some combination of the three as consideration. Alternatively, a firm may acquire the total assets of another firm using cash, debt,

[8] CNN Money, "US Air and American Airlines Reach Deal with Justice to Allow Merger," by C. Isadore and E. ¸Perez, 11/12/2013.

[9] http://www.bloomberg.com/gadfly/articles/2018-02-14/broadcom-s-8-billion-breakup-pledge-to-qualcomm-shows-chutzpah

stock, or some combination of the three. There are two independent issues related to the consummation of a combination: what is acquired (assets or stock) and what is given up (the consideration for the combination). These are shown in Illustration 1-3.

In an analysis of mergers involving a public acquirer from 2001 to 2017, the authors found that approximately 30% of deals used cash only as the consideration until around 2014, when the percentage of deals consummated using only cash began a sharp decline. By 2017, the percentage of cash-only deals was cut in half, to a new average of 15%. The percentage of deals consummated using stock only was around 25% in 2001 but declined shortly thereafter to approximately 10% and remained at this level until 2014. It too began a decline, though less dramatic and appears to have stabilized at about 7 to 8%. The change in recent years has likely been driven by low interest rates and inexpensive debt financing.

In an asset acquisition, a firm must acquire 100% of the assets of the other firm. In a stock acquisition, a firm may obtain control by purchasing 50% or more of the voting common stock (or possibly even less). This introduces one of the most obvious advantages of the stock acquisition over the asset acquisition: a lower total cost in many cases. Also, in a stock acquisition, direct formal negotiations with the acquired firm's management may be avoided. Further, there may be advantages to maintaining the acquired firm as a separate legal entity. The possible advantages include liability limited to the assets of the individual corporation and greater flexibility in filing individual or consolidated tax returns. Finally, regulations pertaining to one of the firms do not automatically extend to the entire merged entity in a stock acquisition. A stock acquisition has its own complications, however, and the economics and specifics of a given situation will dictate the type of acquisition preferred.

Other terms related to M&A merit mention. For example, business combinations are sometimes classified by method of combination into three types—statutory mergers, statutory consolidations, and stock acquisitions. However, the distinction between these categories is largely a technicality, and the terms **mergers**, **consolidations**, and **acquisitions** are popularly used interchangeably.

A **statutory merger** results when *one company acquires all the net assets of one or more other companies through an exchange of stock, payment of cash or other property, or issue of debt instruments (or a combination of these methods)*. The acquiring company survives, whereas the acquired company (or companies) ceases to exist as a separate legal entity, although it may be continued as a separate division of the acquiring company. Thus, if A Company acquires B Company in a statutory merger, the combination is often expressed as

Statutory Merger

A Company + B Company = A Company

ILLUSTRATION 1-3

What Is Acquired:	*What Is Given Up:*
Net Assets of S Company (Assets and Liabilities) →	1. Cash 2. Debt
Common Stock of S Company →	3. Stock 4. Combination of Above

Synergistic deals may be viable even in the current environment, given adequate flexibility and preparation. Although the successful financing of large deals depends largely on capital markets, local middle market deals—say, less than $20 million—more often rely on a combination of commercial loans, seller financing, and equity from private sources or a private equity group.[10]

The boards of directors of the companies involved normally negotiate the terms of a plan of merger, which must then be approved by the stockholders of each company involved. State laws or corporation bylaws dictate the percentage of positive votes required for approval of the plan.

A **statutory consolidation** results when *a new corporation is formed to acquire two or more other corporations through an exchange of voting stock; the acquired corporations then cease to exist as separate legal entities*. For example, if C Company is formed to consolidate A Company and B Company, the combination is generally expressed as

Statutory Consolidation

A Company + B Company = C Company

Stockholders of the acquired companies (A and B) become stockholders in the new entity (C). The combination of ***Chrysler Corp.*** and ***Daimler-Benz*** to form ***Daimler-Chrysler*** is an example of this type of consolidation. The acquired companies in a statutory consolidation may be operated as separate divisions of the new corporation, just as they may under a statutory merger. Statutory consolidations require the same type of stockholder approval as do statutory mergers.

A **stock acquisition** occurs when *one corporation pays cash or issues stock or debt for all or part of the voting stock of another company, and the acquired company remains intact as a separate legal entity*. When the acquiring company acquires a controlling interest in the voting stock of the acquired company (for example, if A Company acquires 50% of the voting stock of B Company), a parent–subsidiary

NOTE: Solutions to ***Test Your Knowledge*** questions are found at the end of each chapter before the end-of-chapter questions.

Short Answer

1. Name the following takeover defense tactics:
   a. Issuing stock rights to existing shareholders, enabling them to purchase additional shares at a price below market value, but exercisable only in the event of a potential takeover. __________
   b. The purchase of a controlling interest in the target firm by its managers and third-party investors, who usually incur substantial debt in the process and subsequently take the firm private. __________
   c. Encouraging a third firm, more acceptable to the target company management, to acquire or merge with the target company. __________

Multiple Choice

2. Which one of the following statements is ***incorrect***?
   a. In an asset acquisition, the books of the acquired company are closed out, and its assets and liabilities are transferred to the books of the acquirer.
   b. In many cases, stock acquisitions entail lower total cost than asset acquisitions.
   c. Regulations pertaining to one of the firms do not automatically extend to the entire merged entity in a stock acquisition.
   d. A stock acquisition occurs when one corporation pays cash, issues stock, or issues debt for all or part of the voting stock of another company; and the acquired company dissolves and ceases to exist as a separate legal entity.
3. Which of the following can be used as consideration in a stock acquisition?
   a. Cash
   b. Debt
   c. Stock
   d. Any of the above may be used

[10] "The Credit Puzzle," by Lou Banach and Jim Gettel, Mergers & Acquisitions, December 2008.

relationship results. Consolidated financial statements (explained in later chapters) are prepared and the business combination is often expressed as

Consolidated Financial Statements

Financial Statements of A Company	+	Financial Statements of B Company	=	Consolidated Financial Statements of A Company and B Company

1.6 TAKEOVER PREMIUMS

IN THE NEWS

CVS Health Corp.'s outstanding bonds fell Tuesday, as the company completed an offering of $40 billion in new debt to be used to finance the company's proposed $69 billion acquisition of Aetna Corp. "The combination of CVS and Aetna will create a one-of-a-kind vertically integrated health-care company with huge scale and mark an industry shift toward a more seamless approach to managing health-care costs as it brings together the overall management of a patient's medical bills and prescription drugs under one umbrella," Moody's Vice President Mickey Chadha said in a note. "However, the transaction will result in significant weakening of CVS's credit metrics as it will be financed with a large amount of debt and will come with high execution and integration risks."[11]

A **takeover premium** is *the term applied to the excess of the amount offered, or agreed upon, in an acquisition over the prior stock price of the acquired firm*. It is not unusual for the takeover premium to be as high as 100% of the target firm's market share price before the acquisition, and the average hovered around 40% to 50% into the late 1990s. In the face of the already high stock prices of this period, speculation was mixed as to the future of takeover premiums. Some experts predicted the premiums would shrink, leading to "takeunders" in some cases where companies are acquired below the listed stock prices. These predictions found some subsequent fulfillment as premiums in 2006 declined to around 20%.

Possible reasons acquirers are willing to pay high premiums vary. One factor is that the acquirers' own stock prices may be at a level that makes it attractive to issue stock (rather than cash) to consummate the acquisition. Another factor is the availability of relatively cheap credit for M&A.

Bidders may have private information about the target firm suggesting that it is worth more than its current market value or has assets not reported on the balance sheet (such as in-process research and development). Alternatively, companies desperate to boost earnings may believe that growth by acquisitions is essential to survive in the global marketplace and that the competition necessitates the premiums. At the other end of the spectrum, a final possibility, which cannot be entirely ruled out, is that managers eager for growth may simply pay too much.

One research study presented evidence that higher premiums were offered for firms with high cash flows, relatively low growth opportunities, and high tax liabilities relative to their equity values.[12] Another study suggested that the bigger the ego of the acquiring firm's CEO, the higher the takeover premium, while still another suggested that any premium over 25% is extremely risky.[13] Some compensation analysts argue that the massive options payouts to executives combined with golden parachutes provide an unhealthy incentive for executives to negotiate mergers, citing Chrysler's merger with Daimler-Benz as an example.[14]

Takeover premiums have attracted so much attention that some strategists (e.g., Paine Webber's Edward Kerschner) have advised clients looking for investments to choose stocks that might get taken over. Cautious financial advisors point out that lofty

[11] www.marketwatch.com, by Ciara Linnane, 3/7/18.

[12] The study, entitled "Free Cash Flow and Stockholder Gains in Going Private Transactions," was conducted by Lehn and Poulsen (*Journal of Finance*, July 1989, pp. 771–787). Also see "The Case against Mergers," by Phillip Zweig, *Business Week*, 10/30/95, pp. 122–130.

[13] "Acquisition Behavior, Strategic Resource Commitments and the Acquisition Game: A New Perspective on Performance and Risk in Acquiring Firms," by Mark Sirower, doctoral dissertation, Columbia University, 1994.

[14] *WSJ*, "Chrysler Executives May Reap Windfall," by Gregory White, 5/13/98, p. A3.

Some statistics suggest that of "6000 acquisitions, only 900 return the cost of capital. It is easy to do deals. It is very difficult to make them succeed."[16]

stock prices are a double-edged sword for financial buyers because they mean high prices for both companies' stocks and costlier acquisitions. Also, when stock prices fluctuate, the agreed-upon purchase price may suddenly appear more or less attractive than it did at the time of agreement. For example, a proposed acquisition of ***Comsat Corp.*** by Lockheed Martin Corp. was announced in September 1998, with the acquisition valued at $2.6 billion, of which 49% was to be paid in cash and the rest in Lockheed stock. When Lockheed Martin's stock price subsequently faltered enough to suggest a 16% drop in the total value of the transaction, Comsat shareholders questioned whether the consideration for the transaction was fairly priced.[15]

1.7 AVOIDING THE PITFALLS BEFORE THE DEAL

In a survey of 101 corporations that completed a merger or acquisition transaction of at least $100 million, KPMG found that 93% of companies queried believed that their deal enhanced shareholder value and over a third said they would not do anything different in subsequent deals. However, KPMG's objective examination of the deals showed that only 31% of these deals improved value. KPMG concluded that many companies may not be prepared to make an honest assessment of the success of their deals in order to avoid making mistakes in future deals.[17]

LO 3 Factors to be considered in due diligence.

To consider the potential impact on a firm's earnings realistically, the acquiring firm's managers and advisors must exercise **due diligence** in considering the information presented to them. The factors to beware of include the following:

1. Be cautious in interpreting any **percentages** presented by the selling company. For example, the seller may be operating below capacity (say, at 60% of capacity), but the available capacity may be for a product that is unprofitable or that is concentrated at a specific location, while the desirable product line (which the acquirer wishes to expand) is already at capacity.
2. Don't neglect to include **assumed liabilities** in the assessment of the cost of the merger. The purchase price for a firm's assets is the sum of the cash or securities issued to consummate the merger **plus** any liabilities assumed. This is equivalent to viewing the purchase price for a firm's **net** assets (assets **minus** liabilities assumed) as the sum of the cash or securities issued to consummate the merger.

An important part of a buyer's preparation involves the development of a due diligence report (sometimes by a public accounting firm) for the purpose of uncovering "skeletons in the closet" (like vendor reliance or customer concentrations). These reports offer a fairly objective perspective of the business, so sharing them with potential lenders is one way of building trust and confidence in the collateral and cash flow. Most lenders prefer a 1-to-1 loan-to-collateral ratio in any deal and regular monitoring through a monthly borrowing base. A lot of the scrutiny by senior lenders gets directed to the buyer's credentials and familiarity with the industry.[18]

[15] *WSJ*, "Lockheed Bid for Comsat Hits Obstacles," by Anne Marie Squeo, 6/11/99, p. A3.

[16] *M&A*, "How Acquirers Can Be Blindsided by the Numbers," May/June 1997, p. 29.

[17] *KPMG Transaction Services*, "The Morning After—Driving for Post Deal Success," 1/31/06.

[18] "The Credit Puzzle," by Lou Banach and Jim Gettel, Mergers & Acquisitions, December 2008.

In addition to liabilities that are on the books of the acquired firm, be aware of the possibility of less obvious liabilities. FASB ASC Section 805–20–25 [Recognition] requires an acquiring firm to recognize at fair value all assets acquired and liabilities assumed, whether or not shown in the financial statements of the acquired company.[19]

Furthermore, FASB ASC paragraph 805–30–25–5 states that any *contingent* assets or liabilities that are acquired or assumed as part of a business combination must be measured and recognized at their fair values (provided they satisfy the definition of assets or liabilities), **even if they do not meet the usual recognition criteria for recording contingent items** (FASB ASC paragraph 450–20–25–2).[20]

IN THE NEWS

"While everything in the offering memorandum may very well be true, although not necessarily, the facts are designed to make the company look better than it would if an analyst were to dig into those facts."[23]

FASB ASC topic 805 [Business Combinations] also states that any costs associated with restructuring or exit activities should not be treated as liabilities at the acquisition date unless they meet the criteria for recognition laid out in FASB ASC paragraph 420-10-15-2.[21] Instead, costs not meeting these criteria should be expensed in the period in which they are incurred. For example, future costs expected with regard to exiting an activity of the target, terminating the employment of the acquiree's employees, or relocating those employees are not accounted for as part of the business combination.[22]

3. Watch out for the impact on earnings of the **allocation of expenses** and the effects of production increases, standard cost variances, LIFO liquidations, and by-product sales. For example, a firm that is planning to be acquired may grow inventory levels in order to allocate its fixed costs over more units, thus decreasing the cost of goods sold and increasing the bottom line. However, the inventory level that is acquired may be excessive and ultimately costly.
4. Note any **nonrecurring items** that may have artificially or temporarily boosted earnings. In addition to nonrecurring gains or revenues, look for recent **changes in estimates**, **accrual levels**, ***and*** **methods**. While material changes in method are a required disclosure under GAAP, the rules on materiality are fuzzy, and changes in estimates and accruals are frequently not disclosed (see Illustration 1-4).
5. Be careful of **CEO egos**. Striving to be number one may make business sense, but not everyone can hold that spot. One CEO drew both praise and criticism with his deal-of-the-month style. He stated, "There are the big dogs, there are the ankle-biters, and then there are those caught in the middle." The midsize firms have to combine, he claimed.[24]

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[19] See the section later in the chapter on the FASB Codification.

[20] FASB ASC paragraph 450–20–25–2 (*FASB Statement No. 5*) states that, in general, contingent liabilities (and related losses) should be accrued if they are both probable and reasonably estimable while contingent assets (and gains) should usually not be reflected to avoid misleading implications about their realizability. These conditions still apply for noncontractual contingent liabilities unless it is *more likely than not* that an asset or liability exists. The number of deals with contingent payments nearly doubled between 1997 and 2006, while the dollar value of those deals more than doubled (with the earn-out value portion rising from 3.3 billion dollars in 1997 to a high of 6.1 billion dollars in 2001 and leveling back to 5.3 billion dollars in 2006). See Chapter 2 for further details.

[21] FASB ASC paragraph 420–10–25–2 (*FASB Statement No. 146*) reiterates the definition of a liability and states that only present obligations to others are liabilities. It clarifies by specifying that an obligation becomes a present obligation when a past transaction or event leaves little or no discretion to avoid settlement and that an exit or disposal plan, by itself, does not create a present obligation.

[22] FASB's new Codification system, referenced here, is discussed near the end of Chapter 1.

[23] *M&A*, "How Acquirers Can Be Blindsided by the Numbers," May/June 1997, p. 29.

[24] *WSJ*, "In the New Mergers Conglomerates Are Out, Being No. 1 Is In," by Bernard Wysocki Jr., 12/31/97, p. A1.

ILLUSTRATION 1-4

Mode of Payment in M&A Deals

	% of All Deals					
	Cash Only		*Stock Only*		*Earnouts*	
Year	#	%	#	%	#	%
2010	416	35.6%	136	11.6%	97	8.3%
2011	386	32.6%	114	9.6%	113	9.5%
2012	460	36.6%	98	7.8%	101	8.0%
2013	445	37.5%	113	9.5%	92	7.7%
2014	498	35.1%	137	9.7%	111	7.8%
2015	283	22.9%	83	6.7%	96	7.7%
2016	172	17.8%	59	6.1%	70	7.2%
2017	117	13.6%	52	6.1%	61	7.1%

Source: Thomson SDC Platinum

1.8 DETERMINING PRICE AND METHOD OF PAYMENT IN BUSINESS COMBINATIONS

LO 6 Factors affecting price and method of payment.

Whether an acquisition is structured as an asset acquisition or a stock acquisition, the acquiring firm must choose to finance the combination with cash, stock, or debt (or some combination). The cash-only financed portion of acquisition prices dropped approximately 10% from the early 2000s to an average of 63% between 2010 and 2014 and has continued to drop to less than 30%. The number of deals financed with stock-only increased by 6% to an average of 20% between 2010 and 2014, but has since dropped to less than 10%. Earnouts were used in approximately 7% to 9% of acquisitions.

The mode of payment also affects the number of days it takes to complete the merger (from the announcement date to the effective date). The following schedule provides the average days to complete a merger for various modes of payment in an acquisition.

Mode of Payment*	**Days to Complete Acquisition**	
	Public Targets	*Private Targets*
Common stock	158 days	90 days
Cash only	84 days	67 days
Earnout	75 days	48 days

* SDC Platinum (2010 to 2013).

As can be seen, if earnouts are used as part of the consideration, the time to complete the merger is significantly shorter (especially for private acquisitions, with an average of 48 days). Acquisitions using stock generally take much longer to complete. Information on the mode of payment in M&A is provided in Illustration 1-4.

The trends are often explained by fluctuating stock valuations. The higher the acquiring firm's stock valuation, the fewer shares are needed to pay for the acquisition. This means less dilution to existing shareholders, a frequent concern in the planning stages of a proposed acquisition. When stock prices slumped in the middle of 2001, merger activity slowed as well. But by the middle of the decade, both were booming once more. Then, merger activity rose steadily from 2002 to 2006, remained