B8101 Corporate Financial Reporting II
Lecture 18 – Business Combinations II

Agenda: Using Written Assignment #12:
(1) Preparing pro-forma income statement and balance sheet assuming the business combination is treated as a purchase.
(2) Preparing pro-forma financial statements assuming the business combination is treated as a pooling-of-interests.
(3) Preparing pro-forma financial statements assuming purchase accounting and less that 100% of outstanding stock is owned by Parent **(see Lecture 19).**

(1) Purchase Accounting (See solutions distributed to Written Ass #12).

Combined balance sheet.

- Combined balance sheet at December 31 is based on the sum of the individual assets and liabilities of Push at book value and the fair value of Shove's assets and liabilities. This can be accomplished by simply adding together the book values of P & S and applying the "purchase adjustments."
- Goodwill can be calculated as follows (excluding the effect of taxes):

Purchase price		300,000
Book value of net assets acquired	190,000	
Additional value of net assets	85,000	
Fair value of net assets acquired		275,000
Goodwill (residual)		25,000

- If we take into account the effect of taxes, deferred tax liabilities (or deferred tax assets) have to be recognized for the deferred tax consequences of differences between the assigned book values and the tax bases of assets and liabilities acquired. Deferred taxes are not recognized for a difference between the book basis and tax basis of goodwill.

Purchase price		300,000
Book value of net assets acquired	190,000	
Additional value of net assets	85,000	
Deferred tax liability due to difference in book and tax basis of net assets acquired (85,000x40% tax rate)	(34,000)	
Fair value of net assets acquired		241,000
Goodwill (residual)		59,000

- The "purchase adjustments" to the balance sheet are as follows (presented excluding the effect of deferred income taxes). In addition, the annual "future income statement adjustments" are shown related to the purchase adjustments.

	Purchase Adjustment	Annual Future Income Stmt Adjustment	Explanation
Inventory write-up	5,000	(5,000)	1 year increase in CGS
Land write-up	30,000	-0-	Land not amortized
Equipment write-up	60,000	(6,000)	Add'l annual depreciation (10 yrs)
Patent write-down	(10,000)	2,000	Reduc in annual amortization (5 yrs)
Goodwill	25,000	(2,500)	Amortization over 10 yrs
Adjustment before income taxes		(11,500)	
Tax impact (40%)		4,600	
Adjustment to net income		(6,900)	

- The Accumulated Depreciation Adjustment. When a company acquires PP&E, it records its cost (fair value) without accumulated depreciation. Therefore, if the 2 balance sheets are being added together, Shove's accumulated depreciation should be set to –0- and the accumulated depreciation should deducted from the cost of the combined PP&E.

	PP&E (at cost)	Accum Deprec	NBV
Push book values	800,000	150,000	
Shove book values	200,000	40,000	160,000
	1,000,000	190,000	
Write-up of PP&E	60,000		60,000
Replacement (fair value)			220,000
Accum Deprec adjustment	(40,000)	(40,000)	
Combined balances	1,020,000	150,000	

- The combined stockholders' equity reflects the P Company's S/E only, since it is the reporting (publicly held) company. Stockholders' equity has not increased because there has been no increase in combined net assets as a result of this transaction.

Pro-forma combined income statement.

- The pro-forma combined income statement adjusts the historical results of P + S by the "future income statement adjustments" that arise as a result of Purchase method accounting.
- If the funds were borrowed, the combined income statement should include an adjustment for interest expense on the borrowed funds.

(2) Pooling-of-interests accounting.

Combined pro-forma balance sheet.

- Assets and liabilities recorded at historical book values. No accumulated depreciation adjustment. No goodwill.
- Combined stockholders' equity = to P & S. Since the 2 companies are considered to have always been together, their retained earnings are combined. The mix of the common stock and additional paid-in capital will change based on the par value and shares outstanding of the Parent Company.

	Push Co	Shove Co	Combined
Stockholders' equity:			
Common stock	60,000	20,000	75,000(a)
APIC	240,000	80,000	325,000(b)
Retained earnings	450,000	90,000	540,000
Total S/E	750,000	190,000	940,000

(a) 60,000 P shares o/s + 15,000 issued = 75,000 x $1 par value = 75,000.
(b) Combined APIC adjusted to balance the total S/E.

- Before combining P and S balance sheets, any differences in accounting methods need to be reconciled.
- Any receivables or payables between the 2 companies must be eliminated. The effect of any intercompany transactions must be eliminated.

Combined pro-forma income statement.

- Historical results of P + historical results of S.
- Reconciliation of accounting methods.
- Effect of any intercompany transactions eliminated.