Agenda:
(1) Overview of Pooling-of-interests Method and Purchase Method.
(2) Impact of 2 methods on financial reporting.
(3) Structuring of business combinations and tax considerations.
(4) Calculating goodwill.

(1) Overview of Pooling-of-interests Method and Purchase Method.

Pooling of Interests Method.
- Underlying theory/concept of Pooling method.
  - Not an acquisition.
  - Pooling of resources and a fusion of ownership interests.
  - Owners of P and owners of S now become the owners of the combined P&S companies.

- Criteria – Generally aimed at supporting the coming together of ownership interests. Accounting rules are designed to support the continuity of ownership from 2 years prior to the business combination to 2 years after the transaction is consumated. SEC is not a fan of poolings, and tends to look closely at the accounting rules for indication that pooling accounting is not appropriate.
  - Stock (of P) for stock (of S), or stock-for-assets.
  - If stock-for-stock, P must acquire at least 90% of the outstanding common stock. No more than a 10% minority interest permitted.
  - If stock-for-assets, P must acquire 100% of the assets.
  - No cash consideration permitted, except for fractional shares.
  - Both companies autonomous for at least 2 years prior to the combination.
  - Both companies independent of each other prior to the combination (prior to the business combination, maximum ownership of 10% permitted by one party of the other party.
  - No unusual purchases of treasury stock, stock issuances, above normal stock dividends by either company for 2 years prior to combination. Absence of planned transaction to reacquire shares issued in the combination.
  - Absence of plan to dispose of significant portion of the assets, except in the normal course or in case of duplicate facilities.
  - 12 criteria in all. All must be met for transaction to be treated as a Pooling.

- Overview of accounting.
  - Combining of book values of assets and liabilities. Not an acquisition.
  - Therefore, no change in basis of assets and liabilities.
  - P(book value) + S(bv) = Combined company’s assets and liabilities.
Purchase Method.

- Underlying theory/concept of purchase method.
  - An acquisition (no fusion of ownership interests).
  - Purchase price is allocated to the assets acquired and the liabilities assumed. Allocation is based on the fair value of the assets and liabilities acquired at the date of the combination. S Company’s book values (carrying values) are ignored.
  - The combined company’s assets and liabilities are reported at P(book value) + S(fair value).

- Criteria.
  - Business combination that does not meet all 12 criteria for poolings.
  - Typically a cash-for-stock transaction or stock-and-cash-for stock.

(2) Impact of 2 methods on financial reporting. See example in P&M pp121-122 and Illustration 4-1.

- Pooling-of-interests Method:
  - Combined assets and liabilities reported at the sum of the individual book value amounts. No change in basis.
  - Combined stockholders’ equity = Individual stockholders’ equity of the 2 companies prior to the combination. The components making up S/E may change.
  - Income statement for current year reflects the combined operations as if the 2 companies were combined for the entire year. All prior income statements presented must be restated to show the combined results as if the 2 companies were always one company. All prior balance sheets presented must be restated.

- Purchase Method:
  - Combined assets and liabilities reported at the sum of P’s book value + the fair value of the assets and liabilities acquired from S.
  - S’s stockholders’ equity is ignored since P is the acquiring (surviving public) company. Therefore, only P’s stockholders equity is shown in the combined balance sheet. In this example, P’s common stock increases because of the additional shares issued (at market value) for S’s stock. Combined Retained Earnings is = to P's alone.
• Goodwill is recognized as an intangible asset and represents the excess cost of the investment over the fair value of the net assets acquired by P.  
  Purchase price (5,000sh x $20mv) 100,000
  FV of net assets acquired:
  Assets at FV 288,000
  Liabilities at FV 200,000
  Net assets 88,000
  Goodwill (Excess cost) 12,000

• Combined income statement includes operations of S from the date of acquisition forward.
• Prior year income statements and balance sheets not restated to show the 2 companies as if they were one. Limited footnote disclosure is given to enhance comparison of company’s operating results pre- and post-acquisition. Discussed in Lesson 5 – See Quaker Oats 1995 ARS for disclosure regarding acquisition of Snapple.
• Additional information for comparability available through proxy or registration statement issued prior to combination and historical financial statements of acquired company.
• Discussion of goodwill as to is it an asset, amortization periods permitted and SEC position on amortization of high-tech companies.

(3) Structuring of business combinations and tax considerations.
• Stock-for-stock. Transaction between P Company and S stockholders. Transaction has no impact on S Company financial statements or tax position. S maintains own legal existence, and is now owned by P. Usually a tax-free exchange. Therefore, tax basis of S stock becomes the basis for the P shares received. Even if transaction is treated as a purchase, can still be a tax-free exchange. Tax treatment is not dependent upon accounting treatment. However, normally poolings are tax-free exchanges while purchases are taxable transaction.
• Cash-or-debt-for-stock. Transaction between P Company and S stockholders. S maintains own legal existence, and is now owned by P. Usually a taxable transaction to S stockholders. For tax purposes, P can elect to step up basis of assets acquired (which reduces the tax basis of S’s stock). If P does not step up tax basis of assets, then because of step-up in financial statements, deferred taxes will result.
• Acquiring assets instead of stock. May be used in situations where P wants to avoid acquiring unrecorded or contingent liabilities (litigation, tax), or avoid unfavorable contracts or union agreements. Also tax considerations, because acquisitions of assets may permit deduction for amortization of goodwill. Transaction is between P Company and S Company, and if taxable, is taxable to the S Company. Company S continues to be owned by the S stockholders, but it is a shell company with cash only.
(4) Calculation of goodwill.

Purchase price.

- Fair value of consideration given (cash, market or fair value of stock, present value of debt).
- Direct costs (directly related to the acquisition).
- Contingent consideration when based on future earnings or revenues (cash or additional stock @ FMV).
- Additional (contingent) stock issued based on a decline in market value does not increase the purchase price.

Fair value of net assets acquired.

- Need to determine the fair value of all assets acquired and liabilities assumed. This may include assets or liabilities that are not on S’s balance sheet.
- How fair value is determined.
  - Accounts receivable valued at realizable value (s/b same as book value).
  - Inventory: Selling price – normal profit – costs of disposal – costs to complete (if WIP). Raw materials valued at current replacement cost.
  - PP&E valued at current replacement cost.
  - Intangible assets. Includes identifiable assets such as patents, franchises, licenses, favorable contracts and leases, customer lists, trademarks, distribution rights, proprietary formulas (patents). Also R&D in process, which is then expensed at the date of acquisition. Intangible assets generally valued based on discounted cash flows. Highly judgmental.
  - Accounts payable and other current liabilities valued at amounts expected to be paid (usually equal to book value).
  - Long-term debt and other long-term liabilities valued at the present value of future cash outflows, discounted at current interest rates.
  - Unfavorable contracts and leases based on buy-out amounts estimated to be paid or present value of unfavorable portion of future cash outflows.
  - Pension costs if PBO > Plan Assets.

Bargain purchase.
- When purchase price < fair value of net assets acquired.
- “Negative goodwill” situation does not often happen. Indicative of a company with losses.
- “Negative goodwill” reduces the carrying value (fair value) of the acquired long-term assets of S. All long-term assets acquired are reduced proportionately, based on their fair value. Does not include long-term marketable securities, which are always recorded at their fair market value.