

## Chapter 1 – Buying Assets

### Introduction (What we already know from Intro Acct Class)

- Intro Acct Class
  - When Buying Assets
    - Use Historical Cost
  - When Buying Bundle of Assets
    - E.g. Purch of Shopping Center
      - Buying Land & Building
    - Allocate Purchase Price By FMV
- That is what we are doing in Chap 1
  - **BUT** with more details

- E.g., You are buying Shopping Center
  - Building has FMV of \$400,000
  - Land has FMV of \$300,000
  - Land Improvements have FMV of \$100,000
- You paid \$800,000 for Shopping Center
  - Gave \$800,000 cash payment

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- You would make the following journal entries on your books:

|                   |           |           |
|-------------------|-----------|-----------|
| D. Building       | \$400,000 |           |
| Land              | 300,000   |           |
| Land Improvements | 100,000   |           |
| Cr. Cash          |           | \$800,000 |

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### Different Ways to Pay For Assets (Debt)

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- E.g., You are buying Shopping Center
  - Building has FMV of \$400,000
  - Land has FMV of \$300,000
  - Land Improvements have FMV of \$100,000
- You paid \$800,000 for Shopping Center
  - Gave \$200,000 cash down payment
  - Assumed existing Mortgage for \$600,000

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- You would make the following journal entries on your books:

|                   |           |           |
|-------------------|-----------|-----------|
| D. Building       | \$400,000 |           |
| Land              | 300,000   |           |
| Land Improvements | 100,000   |           |
| Cr. Cash          |           | \$200,000 |
| Mortgage Payable  |           | 600,000   |

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- E.g., Assume same facts:
  - Building has FMV of \$400,000
  - Land has FMV of \$300,000
  - Land Improvements have FMV of \$100,000
- You paid \$800,000 for Shopping Center
  - Gave \$200,000 cash down payment
  - Assumed existing Mortgage
- This Time assume Mortgage has face value of \$700,000 & FMV of \$600,000.

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- Treat this like issuing a bond
- Set up a Mortgage Payable of \$700,000 with a discount of \$100,000
  - Net debt is \$600,000 (FMV)
  - Amortize the Discount over life of the Mortgage

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- You would make the following journal entries on your books:

|                   |           |           |
|-------------------|-----------|-----------|
| D. Building       | \$400,000 |           |
| Land              | 300,000   |           |
| Land Improvements | 100,000   |           |
| Mortgage Discount | 100,000   |           |
| Cr. Cash          |           | \$200,000 |
| Mortgage Payable  |           | 700,000   |

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### Different Ways to Pay For Assets (Stock)

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- E.g., You are buying Shopping Center
  - Building has FMV of \$400,000
  - Land has FMV of \$300,000
  - Land Improvements have FMV of \$100,000
- You paid \$800,000 for Shopping Center
  - Gave \$800,000 worth of your stock
    - You are Corp
    - Stock has Par Value of \$40,000

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- You would make the following journal entries on your books:

|   |           |          |
|---|-----------|----------|
| D. Building                             | \$400,000 |          |
| Land                                    | 300,000   |          |
| Land Improvements                       | 100,000   |          |
| Cr. Common Stock (Par Value)            |           | \$40,000 |
| Paid In Capital in Excess of Par (APIC) |           | 760,000  |

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Payments To Others (Not To Seller)

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Acquisition Costs

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- You can hire outsiders to advise you on the purchase
  - E.g., Accountants and Lawyers
- You can use internal resources
  - E.g., Employee salaries
- Expensed
  - ID as acquisition cost in notes or in IS
- Old Ed capitalized direct acquisition costs

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## Stock Issuance Costs

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- Stock Issuance Costs
  - Fees paid to government regulators
  - Printing costs
  - Professional fees paid to effect the issuance
- Two alternative treatments → Either:
  - expense cost
  - Or reduce APIC
  - Old Ed → No choice → Just Reduce APIC

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- Why reduce APIC?
  - Remember what you did when you gave your stock
  - You got the assets their FMV without your giving any asset/assuming debt
  - You increased your equity (BV):

|   |           |          |
|---|-----------|----------|
| D. Building                             | \$400,000 |          |
| Land                                    | 300,000   |          |
| Land Improvements                       | 100,000   |          |
| Cr. Common Stock (Par Value)            |           | \$40,000 |
| Paid In Capital in Excess of Par (APIC) |           | 760,000  |

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- What if you had to pay \$ to issue the stock?
  - Fees to SEC
- Then you really did have to pay something for the assets
  - Fees to SEC
- Your net worth went up by the amount of the assets you got, but your net worth went down by the amount you had to pay the SEC

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- Increase Your Equity By the Assets

|                              |           |          |
|------------------------------|-----------|----------|
| D. Building                  | \$400,000 |          |
| Land                         | 300,000   |          |
| Land Improvements            | 100,000   |          |
| Cr. Common Stock (Par Value) |           | \$40,000 |
| APIC                         |           | 760,000  |

- Decrease Your Equity By the Stock Issuance Costs:

|          |          |          |
|----------|----------|----------|
| D. APIC  | \$10,000 |          |
| Cr. Cash |          | \$10,000 |

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Goodwill

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- Sometimes a bundle of assets is worth more as a package than those assets are worth separately
- E.g, a hamburger stand's individual assets are worth \$200,000
  - BUT if the hamburger stand has the name Tommy's, then it has a value of \$500,000
- When you pay \$500,000 for assets worth \$200,000, you treat the extra \$300,000 as a new asset called "Goodwill"

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- E.g., You are buying Hamburger Stand
  - Building has FMV of \$400,000
  - Land has FMV of \$300,000
  - Equipment has FMV of \$100,000
- You paid \$1,000,000 for Hamburger Stand
  - Gave \$1,000,000 cash payment

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- You would make the following journal entries on your books:

|             |           |             |
|-------------|-----------|-------------|
| D. Building | \$400,000 |             |
| Land        | 300,000   |             |
| Equipment   | 100,000   |             |
| Goodwill    | 200,000   |             |
| Cr. Cash    |           | \$1,000,000 |

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### Bargain Purchase

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- What if you negotiated a good deal
  - Assets were worth more, but your seller was desperate and took less than FMV for a quick sale
- Old Ed used historical cost
- Now:
  - Give net assets full FMV; and
  - Create Gain
    - ID gain on IS or disclose in notes

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- E.g., You are buying Hamburger Stand
  - Building has FMV of \$400,000
  - Land has FMV of \$400,000
  - Inventory has FMV of \$200,000
- You paid \$800,000 for Hamburger Stand
  - Gave \$200,000 cash down payment
  - Assumed \$700,000 mortgage with FMV of \$600,000

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- You would make the following journal entries on your books:

|                  |           |           |
|------------------|-----------|-----------|
| D. Building      | \$400,000 |           |
| Land             | 400,000   |           |
| Inventory        | 200,000   |           |
| Discount         | 100,000   |           |
| Cr. Cash         |           | \$200,000 |
| Gain             |           | 200,000   |
| Mortgage Payable |           | 700,000   |

- Mortgage nets to FMV of \$600,000

31 – Contingent Purchase Price - Heading

## Contingent Purchase Price

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- Sometimes, parties can't really agree on the purchase terms
- They may not be able to agree on what the **assets** are worth
- OR they may not be able to agree on what the **stock** being given for the assets is worth

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- Parties may agree to let dispute be decided by future events
- E.g., Seller thinks that assets worth \$400,000 & Buyer thinks assets are worth \$300,000
  - They agree \$300,000 will be paid up front
  - & if sales revenue is > \$1Million, then Buyer will pay additional \$100,000 in cash

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- E.g., Seller thinks that Buyer's stock is overvalued and will drop soon. Seller thinks Buyer's stock is really only worth \$300,000 & Buyer thinks its stock is properly valued at \$400,000
  - They agree stock will be given initial value of \$400,000 & if stock drops in value, then Buyer will pay additional \$100,000 in cash

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- This is a contingent liability and it is treated like you learned in Intro Acct class
- Buyer asks two questions:
  - Is it likely that I will have to pay extra money?
  - If likely, can I estimate the amount I will have to pay?
- If the answer is YES, then put liability on the books,
- If the answer is NO, then don't put liability on books

36 – Contingent Purchase Price E.g. - # 101

- E.g., Purchase price is \$300K in stock
  - BUT, if Sales > \$1M, then buyer pays \$100K more in cash
- **Not likely to happen**
  - Record transaction with only \$300K in stock:

|                                  |           |          |
|----------------------------------|-----------|----------|
| D. Asset                         | \$300,000 |          |
| C. Common Stock                  |           | \$20,000 |
| Paid-In Capital In Excess of Par |           | 280,000  |

37 – Contingent Purchase Price E.g. - # 201

- E.g., Purchase price is \$300K in stock
  - BUT, if Sales > \$1M, then buyer pays \$100K more in cash
- **Likely to happen**
  - Record transaction with \$400K price
    - Create \$100K liability

|                                 |           |          |
|---------------------------------|-----------|----------|
| D. Asset                        | \$400,000 |          |
| C. Common Stock                 |           | \$20,000 |
| Paid-In Capital In Excess of Pa |           | 280,000  |
| Liability                       |           | 100,000  |

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- Once Future Event happens and you know how much you will have to pay →
- You need to change original numbers to what they would have been had you known the real numbers at the sales date

39 – Unexpected Payment E.g. - # 101

- E.g., Purchase Contract says Buyer must pay \$100K more if sales > \$1Million
  - This is a dispute over value of assets
  - Additional payment considered unlikely
  - Future Events → Buyer has to pay more for assets
    - Assets worth more than originally recorded
    - Change assets to reflect increased price paid

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- Orig Transaction:

|           |           |           |
|-----------|-----------|-----------|
| D. Assets | \$300,000 |           |
| Cr. Cash  |           | \$300,000 |

- Adjustment:

|                    |           |           |
|--------------------|-----------|-----------|
| D. Assets/Goodwill | \$100,000 |           |
| Cr. Cash           |           | \$100,000 |

41 – Unexpected Payment E.g. - # 201

- E.g., Purchase Contract says Buyer must pay up to \$100K more if sales > \$1Million
  - Dispute over value of assets
  - Additional payment considered likely
    - \$100K Liability originally created
  - Future Events → Buyer only pays \$80,000
    - Need to write down asset & liability to reflect reduced price

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- Orig Transaction:

|           |           |           |
|-----------|-----------|-----------|
| D. Assets | \$400,000 |           |
| Cr. Cash  |           | \$300,000 |
| Liability |           | 100,000   |

- Adjustment:

|              |          |          |
|--------------|----------|----------|
| D. Liability | \$20,000 |          |
| Cr. Asset    |          | \$20,000 |
| D. Liability | \$80,000 |          |
| Cr. Cash     |          | \$80,000 |

43 – Unexpected Payment E.g. - # 301

- E.g., Purchase Contract says Buyer must pay \$100K more if stock value drops
  - Dispute over value of stock given to seller
    - Buyer says if stock drops in value over next year, I will give you cash instead
  - Additional payment considered unlikely

44 – Unexpected Payment E.g. - # 401

- Future Events → Stock drops in value, buyer gives \$100K
  - The stock wasn't worth what parties originally assumed
  - Need to change transaction to reflect real value of stock
    - Reduce value of stock
    - Note cash was also paid for Net Assets
      - Payment made up for decline in value of stock
- Assets are not changed
  - Stock value has changed → replaced with cash

45 – Unexpected Payment E.g. - # 402

|                                     |           |           |
|-------------------------------------|-----------|-----------|
| Orig Trans:                         |           |           |
| D. Asset                            | \$300,000 |           |
| C. Common Stock                     |           | \$20,000  |
| Paid-In Capital In Excess of Par    |           | 280,000   |
| Adjustment:                         |           |           |
| D. Paid-In Capital In Excess of Par | \$100,000 |           |
| C. Cash                             |           | \$100,000 |
| Net effect of both entries:         |           |           |
| D. Asset                            | \$300,000 |           |
| C. Common Stock                     |           | \$20,000  |
| Paid-In Capital In Excess of Par    |           | 180,000   |
| Cash                                |           | 100,000   |

46 – Unexpected Payment E.g. - # 501

- E.g., Purchase Contract says Buyer must give more shares if contingency happens
  - Dispute over value of stock given to seller
    - Buyer says if stock drops in value over next year, I will give you more stock to give buyer value promised
  - Additional payment considered unlikely
  - Future Events → Stock drops in value, buyer gives more shares
  - The stock wasn't worth what parties originally assumed

47 – Unexpected Payment E.g. - # 502

- Assets are not changed
  - Total stock value unchanged
  - More shares given for same total value
- Ask yourself what would original transaction would have been if more shares given
  - Common Stock would be higher
    - Par Value for all shares given
  - APIC
    - APIC is Value of Stock less Par Value
    - If Par goes up → APIC goes down

48 – Unexpected Payment E.g. - # 503

|                                     |           |          |
|-------------------------------------|-----------|----------|
| Orig. Trans:                        |           |          |
| D. Asset                            | \$300,000 |          |
| C. Common Stock                     |           | \$20,000 |
| Paid-In Capital In Excess of Par    |           | 280,000  |
| Adjustment:                         |           |          |
| D. Paid-In Capital In Excess of Par | \$20,000  |          |
| C. Common Stock                     |           | \$20,000 |
| Net effect of both entries:         |           |          |
| D. Asset                            | \$300,000 |          |
| C. Common Stock                     |           | \$40,000 |
| Paid-In Capital In Excess of Par    |           | 260,000  |

49 – Goodwill Impairment - Heading

## Goodwill Impairment

50 – Goodwill Impairment

- GW is calculated as described above.
  - not subject to amortization
  - subject to a separate impairment testing.
    - usually done annually.
- Impairment testing is done
  - for the company as a whole &
  - for reporting units with GW

51 – Goodwill Impairment Test

- How do you do GW impairment testing?
- Compare:
  - BVs of all net assets (including GW) to
  - FMV of Co
- If BV (with GW) is more than the FMV then old GW value is wrong (GW impaired)

52 – Goodwill Impairment Journal Entry

- If GW impairment has occurred:

|                    |                       |                       |
|--------------------|-----------------------|-----------------------|
| D. Impairment Loss | \$ (amt of reduction) |                       |
| Cr. Goodwill       |                       | \$ (amt of reduction) |

- Once GW impairment loss taken
  - Can't restore it even if FMV of Co goes up later

53 – Miscellaneous Issues - Heading

## Miscellaneous Issues

54 – Pooling Method

- There used to be 2 ways to record asset acquisition:
  - Purchase Method
    - Described above
  - Pooling Method
    - Buyer used seller's BVs as cost
- Now, Buyer must use Purchase Method

55 – Seller's Recognition of Gain/Loss

- How does Seller treat sale of assets?
- Seller records gain/loss
  - Purchase Price less BVs
  - Do not include Acquisition Costs not received by Seller

56 – Application of Rules To Specific Assets/Liabilities - Heading

## Application of Rules To Specific Assets/Liabilities

57 – Special Rules For Recording FMV of Specific Assets - #1

- If assets are recorded at FMV → Special Rules for certain assets
  - A/R
    - Record at face value
    - Use allowance to adjust face value to FMV
  - N/R
    - Record at face value
    - Use premium/discount account to adjust face value to FMV

58 – Special Rules For Recording FMV of Specific Assets - #2

- Fixed assets
  - Record at FMV
    - No "accumulated depreciation" or "accumulated depletion"
    - Depreciation or depletion expenses based on FMV, remaining useful lives and salvage values
- Intangible assets
  - Record at FMV.
    - Amortized over determinable economic life (no limit)
    - If no determinable economic life → no amortization
    - Subject to impairment testing

59 – Special Rules For Recording FMV of Specific Assets - #3

- Operating lease
  - Create asset if rent below market
    - Amortize asset over life of lease
  - Create liability if rent above market
    - Amortize liability over life of lease
- Capital lease
  - Create asset & liability equal to PV of future payments

60 – Special Rules For Recording FMV of Specific Assets - #4

- Current liabilities
  - Usually face value
- Bonds payable
  - Record at face value
  - Use premium/discount accounts to adjust to FMV