LEARNING OBJECTIVES

After reading this chapter, you should be able to:

- Discuss the differences among horizontal, vertical, and conglomerate combinations.
- Differentiate among different types of defensive measures potential acquirees may pursue.
- Analyze the different ways in which business combinations can be organized.
- Discuss the differences that exist among the three legal forms of business combinations.
- Understand contingencies that may impact the consideration given in a business combination.
- Describe the general features required for a business combination to qualify as a nontaxable exchange.

Business expansion is often viewed as an indicator of a successful business. Expansion may occur internally or externally. Internal expansion is often the result of an entity undertaking research and development activities that culminate in the development and marketing of new products. An example is RCA's expansion into direct television. Alternatively, an entity may expand internally by selling new or existing products in new markets. This may be either the sale of existing products to new consumers in current geographic markets or the sale of new or existing products to new consumers in new geographic markets. An example is when Outback Steakhouse expanded from its home base of Florida to become a nationwide restaurant chain.

External expansion occurs when two or more businesses join together and operate as one entity, or related entities, under the direction and control of one management group. Generally such an expansion is known as a business combination and may be an offensive or a defensive maneuver. Two entities may combine to grow larger and take advantage of economies of scale or increased influence in the marketplace, or they may combine to survive the threat of increased competition or takeover by other entities. For example, Kemper Corporation combined with Conseco in 1994 to prevent Kemper from being acquired by GE Capital Corporation.
This chapter presents an introduction to business combinations. The first part of the chapter presents the economic reasons for, history of, and legal restrictions on business combinations. In addition, an introduction to the takeover process in both a friendly and hostile environment is provided. The second part of the chapter illustrates the more common ways by which one entity can take control of the net assets of another entity. Discussion of the different legal forms of business combinations is presented in the third part of the chapter. Subsequent parts of the chapter present a discussion of substance versus form, contingent consideration, and some tax implications of business combinations.

**BUSINESS COMBINATIONS IN THE UNITED STATES**

**Economic Motivation for Business Combinations**

Given that business expansion may be achieved through the development of new products and the construction of new production facilities, there must be perceived advantages to external expansion (combination) to explain why management often chooses to expand externally. One reason is that internal expansion is often a slow process because the entity may be required to develop a distribution system, generate demand for its new product, and/or build new production facilities to support new products or expanding sales. In addition, internal expansion may be viewed as risky in that the development and marketing of new products are often difficult tasks.

To overcome some of these perceived shortcomings of internal expansion, management may choose to expand through business combinations. The following is a summary list of advantages of business combinations. It is not intended to be all-inclusive, nor should it be inferred that each of these advantages exists in every business combination.

1. Expansion can be achieved more rapidly through combinations. Alternatively, the time necessary to construct a new facility, staff it, and develop a market for the output is comparatively long.
2. Combinations may provide an established, experienced management group immediately.
3. Combinations may lead to economies of scale. For example, the same sales force or accounting staff may be able to service two corporate structures as well as one.
4. The overall cost of capital may be reduced as a result of a combination because of the increased size of the entity.
5. Federal income tax laws provide some advantages to certain combined corporate entities that are not available to one corporation.
6. External expansion does not increase the total supply of goods available from that industry, whereas internal expansion may increase supply beyond existing demand levels.
7. Control over a greater market share may enable the combined entity to become a price leader in the market.
8. For some combinations, the guaranteed raw material sources and product markets provided by combinations provide a significant management advantage. In addition, the profits at each level accrue to the combined entity.

9. Diversification accomplished through combinations may provide a less volatile income stream. This reduces the riskiness of the entity, which, in turn, lowers borrowing rates.

A business combination results in one entity taking control of another entity’s net assets. Regardless of the manner in which the business combination occurs or the accounting required to recognize the combination, all business combinations are the result of one entity (the investor or acquirer) investing in the other entity (the investee or acquiree). The decision by the acquirer to undertake such an investment will involve the same type of analysis as is performed when deciding whether to make capital expenditures for other assets. Managers of the acquiring entity may prepare budgets and perform capital budgeting analysis using techniques such as net present value and internal rate of return to determine whether the investment is in the best interest of the acquirer. The difference between the purchase of an individual asset and the acquisition of another entity is that projecting the future cash flows may be more involved for an entity acquisition. When purchasing a piece of machinery, the relevant cash flows will be such items as the change in the operating costs, the tax implications of differences in depreciation, and the future salvage value of the machine. When considering the acquisition of another entity, some of the cash flows that may need to be evaluated result from the disposal of redundant facilities, reduction of fixed costs by eliminating duplicate operations, and internal coordination of operations when one part of the combined entity produces input for another part of the combined entity. In addition to the directly measurable cash flows, the acquisition of another entity also may result in benefits not directly measurable, such as (1) a readily available supply of scarce inputs (raw materials), (2) production and/or marketing expertise, (3) established market share for products, and (4) the potential synergy resulting from sales of complementary products.

**History of Business Combinations in the United States**

With the age of industrialization, which began in the second half of the nineteenth century, came the growth of large corporations and separation of ownership and management. Three types of business combinations have occurred since the first significant American business combination in the late 1800s. Business combinations may be categorized into three types by examining the nature of the combining companies and their relationship with one another.

The first type of business combination began about 1880. This type of combination may occur when management attempts to dominate or monopolize particular industries. In fact, early combinations in the steel industry, lead by J. P. Morgan’s U. S. Steel, and in the oil industry, led by Standard Oil, resulted in almost total domination within each industry by the combined companies. The business combinations that took place during this time period primarily resulted from entities acquiring competitors. This permitted the acquirers to increase sales by entering new product markets, increasing production capacity, and expanding into new geographic regions. This type of combination is generally referred to as a **horizontal combination** (a combination involving two or more entities that are in competition in the same industry).

The second type of business combination started in the 1920s. This type of business combination seems to be dominated by companies attempting to improve the efficiency of
operations by purchasing suppliers of inputs or purchasers of outputs. For example, General Motors, a manufacturing company, acquired an electrical equipment company, Alambrados Y Circuitos, and a car rental company, National Car Rental Systems. These acquisitions provided General Motors with a source of supply for electrical components for automobile engines and an outlet for selling output to the car rental company. A business combination of this nature is generally referred to as a **vertical combination** (a combination involving two or more entities which have a potential buyer–seller relationship).

The third type of business combination began in the late 1950s. Overall, the value of business combinations exceeded $3.4 trillion for 1999. Horizontal combinations (e.g., Exxon’s 1999 acquisition of Mobil for $79 billion) and vertical combinations (e.g., Eli Lilly’s 1994 acquisition of PCS Health Systems for $4 billion) still occur; however, now entities are also attempting to diversify business risk by acquiring companies in unrelated or tangentially related businesses (e.g., America Online’s 2000 acquisition of Time Warner for $156 billion). This type of business combination is often referred to as a **conglomerate combination** (a combination involving two or more entities in unrelated industries). One reason for the rise of conglomerates is that management has become more aware of the increased income stability provided by diversifying the asset base of an entity. Another reason for the increase in conglomerate combinations is that it has been considerably more difficult for the government to challenge a conglomerate business combination on the basis of antitrust regulations.

**Legal Restrictions on Business Combinations**

Business combinations may result in the concentration of economic power in the hands of fewer entities, resulting in an industry having only a small number of dominant entities (oligopoly) or, at the extreme, only one entity (monopoly). This concentration of economic power may result in business practices by the combined entities that are contrary to the public interest. Recognizing that such actual and potential abuses were not in the public interest, Congress passed legislation restricting the ability of entities to effect business combinations. The first of these legislative actions, the Sherman Act, was passed by Congress in 1890. Its basic purpose is to make illegal any action that would hinder free competition. Specifically, Section I of the Sherman Act in part reads:

> Every contract, combination in the form of a trust or otherwise, or conspiracy, in restraint of trade or commerce among the Several States, or with foreign nations, is hereby declared to be illegal …

The Sherman Act is directed at controlling monopolistic practices, but the act is worded in such a way that the burden of proof is placed on the government to show that trade had been restrained. Thus, combinations could not be prevented, only broken up after the fact. The Sherman Act was the basis for breaking up both Standard Oil and American Tobacco in 1911. However, because the Sherman Act proved to be inadequate, additional legislation was passed.

The Clayton Act, which became law in 1914, provided additional power to control business combination activities. In part, Section 7 of the Clayton Act (amended) reads:

> ... no corporation engaged in commerce shall acquire, directly or indirectly, the whole or any part of the stock or other share of capital and no corporation subject to the jurisdiction of the Federal Trade Commission shall acquire the whole or any part of the assets of another corporation engaged also in commerce, where in any line of commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly.
This wording prevents “the acquisition” when “the effect of such acquisition may” be contrary to the public policy of ensuring free competition. Thus, through the Clayton Act, the government can anticipate restraint of trade and legally stop proposed mergers based on arguments concerning the potential results.

Today, the Federal Trade Commission works closely with the Antitrust Division of the Department of Justice in enforcing the antitrust laws. As part of the ongoing scrutiny of business combinations, the Hart-Scott Rodino Amendment was passed in 1976. This act requires that the Antitrust Division and the Federal Trade Commission be notified of anticipated business combinations. This notification enables the Federal Trade Commission to assess the potential impact of the combination on such issues as industry concentration, barriers to entry, and restriction of trade. In 1999 a merger of Exxon and Mobil Oil was proposed. As part of the negotiations with the Federal Trade Commission to satisfy government antitrust concerns, late in the year it was announced that approximately 2,400 retail outlets, a refinery, and interests in several U.S. pipelines would be sold by the merging companies.¹ The enforcement of the law does not imply that the government will challenge every business combination. The vast majority of combinations are not disallowed because they involve relatively minor segments of competitive markets and, therefore, would not reduce or control competition in any significant way.

**Takeovers**

Business combinations may be accomplished by negotiations between the management of the acquirer and the acquiree. If these negotiations result in mutually agreeable terms, an offer will be made to the stockholders of the acquiree (target company). This offer will be publicly supported by the management of the acquiree and a friendly takeover will be initiated. An example of such a cash offer is the offer of $55 per share ($1.9 billion) that was made by Martin Marietta Corporation for all 34 million shares of Grumman Corporation.² The rationale for this particular combination may have been the perceived need for the existence of a larger entity to successfully compete in the defense industry given expected U.S. military spending reductions in the 1990s. Grumman’s chairman, Renso Capporali, stated that “the bidding environment was sure to become ‘increasingly difficult’ for a smaller enterprise squaring off against ever-larger rivals.” Martin Marietta’s proposed acquisition was a maneuver that left other mid-sized defense contractors scrambling to locate potential merger candidates. Among the companies known at that time to be searching for a merger candidate was Northrop Corporation. Northrop had been discussing a possible merger with Grumman after it was unsuccessful in attempts to acquire a division of International Business Machines Corporation, the tactical-fighter business of General Dynamics, and the missile division of McDonnell Douglas Corporation. The potential merger of Martin Marietta and Grumman was viewed by the U.S. government as a huge merger that would be “carefully scrutinized” if the companies were competitors in the defense industry.

**Tender Offer** If negotiations between the management of any two entities considering a combination do not result in mutually agreeable terms, the acquirer will either withdraw the proposal or make the proposal directly to the stockholders of the acquiree.


An offer by an acquirer to buy the stock of another company is commonly referred to as a **tender offer**. A tender offer is generally published in major newspapers (such as *The Wall Street Journal*) and the tender amount will be above the current market price. The tender offer generally contains stipulations regarding the length of time the offer is valid and the percentage of outstanding shares that must be offered to the acquirer to finalize the acquisition.

A tender offer is sometimes opposed by the acquiree’s management and the offer is viewed as a **hostile bid** for the acquiree. Returning to the defense industry example, soon after Grumman’s management had agreed to the friendly acquisition proposed by Martin Marietta Corporation, a hostile bid to acquire Grumman was made by Northrop. Northrop’s bid of $2.04 billion ($60 per share) exceeded Martin Marietta’s original agreement with Grumman’s management by $5 per share. Northrop was viewed by defense experts as being under pressure to buy or be bought. Martin Marietta’s chairman criticized the proposed acquisition by Northrop as an attempt to disrupt the friendly merger of Martin Marietta and Grumman. After almost 30 days of dispute and discussion, Northrop finally acquired Grumman for $62 per share, or $2.17 billion. During the negotiations, the market value of Grumman Corporation’s stock increased from $39.875 to over $65 per share.

**Defensive Measures**

Although Grumman Corporation did not engage in **defensive measures** to prevent the takeover by Northrop, these actions are possible when management of the target company perceives that the tender offer should not be accepted. Defensive maneuvers can take a variety of forms. For example, some companies attempt to avoid an undesired acquisition by offering the acquirer a premium over the market price of the stock to sell any stock already owned by the acquirer back to the acquiree. Such a strategy is termed **greenmail**. The potential acquiree may also seek to be acquired by an entity perceived to be a better match with the acquiree. In this instance the friendly replacement acquirer is termed a **white knight** because it has rescued the acquiree from an undesirable acquirer.

The acquiree may also engage in a variety of maneuvers to make itself less desirable to the acquirer. One maneuver used by a number of entities is a **poison pill**. This term is used to describe the issuance of preferred stock that is convertible into common stock of the unwanted acquirer. This would enable the holders of the preferred stock to convert at a later date and regain control by once again having the majority of voting common stock. The danger of the poison pill is that it can deter friendly as well as hostile acquirers. This problem can be avoided with careful planning when designing preferred stock features. In addition to these individual strategies, a potential acquiree can institute a broader plan, often called a **kamikaze strategy**. Under this strategy the potential acquiree takes action to reduce its value to the acquirer.

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6 Ibid., pp. 208–221.
7 Ibid., pp. 236–242.
Three common ways to implement a kamikaze strategy are through the sale of the crown jewels,9 the scorched earth defense,10 and the fatman defense.11 The sale of the crown jewels and the scorched earth defenses both result in the target selling profitable assets and distributing the proceeds of the sale to the stockholders to reduce the value of the acquiree. The sale of the crown jewels involves the sale of key assets, while the scorched earth defense involves a more broad-based sale of assets. Either of these defenses can fail to be successful because the rushed sale of assets will likely result in less than optimum prices for the assets sold. In addition, if the acquirer believes that the acquisition can be accomplished before the cash is distributed to the stockholders, the cash may be used to help the acquirer buy the acquiree. The fatman defense takes a different approach in that it results in the acquisition of assets, not the sale. This defense is one where management of the target purchases poorly performing assets of another entity. The fatman defense may be attractive if it is expected to reduce the short-term profits of the target but increase long-term profits. The result of this defense may be to deter the acquirer but make the potential acquiree stronger in the long run.

Rather than attempting to reduce the value of the potential acquiree, management may choose to make the acquiree more difficult to purchase by instituting administrative measures often called shark repellent.12 These defenses may include staggering the terms of the board of directors, thereby preventing an acquirer from attaining control quickly. This defense will buy time and, thus, better enable the potential acquiree to implement other defensive strategies if necessary. Another approach is to have additional requirements for membership on the board of directors, such as residency. Many entities have implemented a supermajority (greater than 50 percent) for approving business combinations. This percentage may be as high as 75 to 95 percent. As a result, hostile takeover of a company that requires a supermajority is more difficult to attain. Another technique often used to deter an unfriendly takeover is golden parachutes.13 This maneuver results in significant compensation to the acquiree’s top executives if a “change in control” of the acquiree occurs and the executive is terminated from the position currently held. As a result, golden parachutes transfer assets from the target to the executives, making the target less attractive.

All of the techniques discussed thus far are defensive and reactive. In a limited number of instances, the acquiree takes an offensive, proactive stand, often termed a packman defense.14 The packman defense occurs when the potential acquiree attempts to purchase the acquirer. This defense can take on two forms. First, the target may make a tender offer for some of the acquirer’s shares. Second, the target may purchase the acquirer’s shares in the open market. Either approach indicates that the target intends to purchase the acquirer rather than be the acquiree.

All the techniques discussed above are based on the assumption that they are in the best interest of the stockholders. Management has a fiduciary duty to undertake the activities that will maximize the benefits of the stockholders. Potential acquirers have contested all these defenses in court on the basis that management is acting in its own self-interest rather than in the interest of the stockholders.

9 Ibid., p. 198.
10 Ibid., p. 197.
11 Ibid., p. 199.
12 Ibid., pp. 344–358.
14 Ibid., pp. 38–39.
For a business combination to occur, one entity must gain “control” of the “net assets” of another entity. The manner by which control over an entity is determined has evolved from a majority ownership of an entity’s voting common stock to the “ability by itself to make the decisions that guide the ongoing activities of another entity (subsidiary).” Control over an entity represents a greater involvement than investing in an entity in that control enables the investor to direct the use of individual assets in a manner that will result in the maximum benefit to the controlling entity. In particular, control enables the acquiring entity to (1) direct the use of the controlled entity’s assets by having the power over policy-making that guides how the assets are used; and (2) enforce the budgets and policies by selecting, compensating, and terminating those responsible for implementing decisions.

Control over the net assets of an entity may be accomplished in a variety of ways. The two most common ways to attain control are by the purchase of the acquiree’s net assets or by the purchase of the acquiree’s voting stock, which represents ownership of the assets. While majority ownership is not absolutely required for control, the examples in this text will assume transactions involving at least 50 percent of the acquired firm. To achieve control (i.e., acquire control of net assets), the acquirer may give some of its own assets, issue debt instruments, and/or give shares of its own stock. Thus, the type of exchange may vary; however, a business combination has occurred when one entity gains control over the net assets of another entity.

The remainder of this section provides examples of different ways one entity can gain control of another entity. If the transaction results in the transfer of “control,” the transaction is a business combination by definition. The first two examples—Type 1 exchanges—present the acquisition of the net assets of an entity by: (1) an exchange of assets for assets and (2) an exchange of stock for assets. The next two examples—Type 2 exchanges—present the acquisition of the voting stock of another entity by (3) an exchange of assets for stock and (4) an exchange of stock for stock. Major differences exist in the required accounting recognition for the different types of exchanges, but in substance the economic values in a given exchange are the same (before taxes) no matter what type of exchange occurs. To simplify the examples in this chapter, all illustrations assume the acquirer purchases 100 percent of the acquiree.

Type 1 Exchange: Acquisition of Assets

In the first type of exchange, acquisition of assets, the acquiring entity desires the use and earning power of a particular set of assets that are owned by another entity. Assume that the RST Corporation (RST), a large entity, wishes to gain control of the assets of the growing but relatively small ABC Corporation (ABC). RST may accomplish its objective by either of two methods. First, it may give cash and/or other assets (possibly including promises of future payments in the form of notes) in exchange for ABC’s assets. Second, rather than exchanging assets, RST may issue shares of RST Corporation stock for ABC’s assets.

Exchange of RST Assets for ABC Assets  The upper section of Figure 1-1 outlines the flow of resources between ABC’s balance sheet and RST’s balance sheet for an asset for asset exchange. The solid line represents the rights to, and ownership of,
ABC’s net assets transferred to RST. In return, RST exchanges cash and future promises to pay cash, represented by the broken line from RST to ABC. Immediately below each balance sheet is a listing of the stockholders of the respective corporations as the transaction begins.

The lower section of the figure depicts the balance sheets and stockholder lists immediately after the transaction is complete. Immediately after the exchange, the financial records of RST include all the specific asset and liability account balances for the net assets acquired. The stockholders’ equity of RST is unchanged, and the individual stockholders of RST are the same. After the exchange, ABC’s balance sheet is nothing more than a skeleton. The monetary assets, cash and notes, are all that is left on ABC’s books. The stockholders of ABC have not changed. Therefore, Adams, Brown, and Carter may
choose to invest the cash in new productive assets and enter into a new line of business. Alternatively, Adams, Brown, and Carter also have the option of declaring a liquidating dividend, distributing all the assets among themselves, and disbanding the corporation. Note that the course of action chosen is controlled by Adams, Brown, and Carter, the original owners. In summary, Figure 1-1 presents an acquisition of assets for assets with no transfer of either ABC or RST common stock.

**Exchange of RST Stock for ABC Assets** In Figure 1-2, ABC Corporation again relinquishes its net assets to RST Corporation, creating another Type 1 exchange. This is depicted in the upper section of Figure 1-2, again by the solid line from ABC to
RST. In this case, however, shares of RST Corporation common stock are issued, with ABC Corporation becoming the registered owner of the shares. No RST assets are surrendered. Instead, the total capitalization of RST increases because the total number of outstanding shares of RST increases, whereas in Figure 1-1, the net assets on RST's balance sheet did not increase. The issuance of the RST shares to ABC is shown by the broken line from the RST stockholders’ equity section pointing to the ABC asset section.

In the lower-right-hand section of Figure 1-2, as in Figure 1-1, RST Corporation has recorded the asset and liability accounts for the net assets acquired from ABC. The difference between Figures 1-1 and 1-2 is that the stockholder list for RST now includes not only Ross, Smith, and Thorne, the original owners of RST, but also ABC Corporation, the holder of the shares that were issued as a result of the acquisition. In the lower-left-hand section, the only asset is ABC’s investment in RST stock. ABC’s stockholder list is unchanged. Again, as in the assets-for-assets exchange, Adams, Brown, and Carter may choose to continue the ABC Corporation, or they may declare a liquidating dividend (this time in RST stock certificates rather than cash) and disband the ABC Corporation.

Because RST Corporation is assumed to be the larger of the two companies involved in the exchange, the percentage of RST owned by ABC Corporation after the exchange is rather small. Therefore, Ross, Smith, and Thorne are not giving up control of RST Corporation, although they no longer collectively own 100 percent of it.

In summary, Figure 1-2 presents an acquisition of assets for shares of stock. ABC’s owners still control ABC Corporation’s outstanding stock, but ABC Corporation now owns an interest in RST. Again, the assets of ABC may be integrated into the current operations of RST or ABC may become a division of RST. The original RST owners still control RST Corporation stock. Notice that in neither Figure 1-1 nor Figure 1-2 did individual stockholders give up control of their respective corporations. That is, Adams, Brown, and Carter still control ABC while Ross, Smith, and Thorne control RST, although in Figure 1-2 ABC Corporation owns stock of RST Corporation.

**Type 2 Exchange: Acquisition of Stock**

In an asset acquisition type of combination, control of the net assets of ABC is achieved by acquiring the assets directly. In a stock acquisition type of combination, control of ABC’s net assets is accomplished by RST, but control is achieved by acquiring ABC’s stock rather than the assets directly. If RST Corporation owns enough of ABC Corporation’s stock to set operating policies and enforce the implementation of these policies, then RST controls ABC. This would often be accomplished by RST owning enough of ABC’s stock to elect a majority of ABC’s board of directors. The type 2 examples assume that RST acquires 100 percent of ABC’s stock. This assumption is made to simplify the examples, although control with less than 100 percent ownership is common in practice.

**Exchange of RST Assets for Outstanding ABC Stock** In Figure 1-3, RST Corporation transacts with Adams, Brown, and Carter individually, not ABC Corporation, the entity. The upper section shows the flow of the transaction. The solid line from the stockholder list of ABC to the asset section of RST depicts the flow of ABC’s stock certificates from the stockholders of ABC to the RST balance sheet. Adams, Brown, and Carter give up their ownership of ABC Corporation. The broken line from RST to the ABC stockholder list represents the assets that the individual stockholders receive in exchange for their shares of ABC stock.

The resulting balance sheet of RST, in the lower-right-hand section of Figure 1-3, includes an *Investment in ABC Corp. Stock*. Also, the stockholder list for RST has not
changed because no shares were issued in this case. Note that the ABC balance sheet, in the lower-left-hand section, is intact. No changes have occurred on the books of ABC. The only change is the configuration of ownership of ABC’s shares. The list of ABC stockholders now consists of the RST Corporation only. Adams, Brown, and Carter no longer own any interest in ABC or RST. Instead, they are holding the cash and notes that were distributed to them by RST Corporation.

In summary, Figure 1-3 presents the case where a company, RST, literally buys another, ABC, for cash. RST may do whatever it wishes with ABC Corporation subsequent to the purchase of the stock. ABC may continue to operate as a subsidiary corporation under the guidance of RST management, ABC may be liquidated, or ABC may cease to be a separate corporation and become a division of RST. The decision rests with the management of RST.
Exchange of RST Stock for Outstanding ABC Stock  Figure 1-4 presents the stock-for-stock transaction in which the ABC stockholders give up their shares of ABC Corporation stock in exchange for shares of RST Corporation stock. The solid line from the ABC stockholder list to the RST asset section represents the flow of ABC shares into the RST Corporation balance sheet. The shares issued by RST flow to the individuals who previously owned ABC Corporation, as depicted by the broken line from the RST stockholders’ equity section to the ABC stockholders.

After the transaction, all six individuals—Adams, Brown, Carter, Ross, Smith, and Thorne—are stockholders of the RST Corporation, as seen in the lower-right-hand section.
of Figure 1-4. Also, as with Figure 1-3, RST is now holding an asset: Investment in ABC Corp. Stock. Again, the lower-left-hand side of Figure 1-4 displays a balance sheet for ABC Corporation that is unchanged and a stockholder list that consists only of the RST Corporation, as in Figure 1-3. RST’s options regarding the future of ABC are identical to those presented in Figure 1-3.

In a stock-for-stock transaction, usually the entity that issues stock gains control of the entity whose existing stockholders give up their shares, although this is not necessarily the case. For example, assume RST is twice as large as ABC, but ABC is the company issuing the shares. Ross, Smith, and Thorne collectively would likely receive twice as many shares of ABC stock as were previously outstanding and owned by Adams, Brown, and Carter. Thus, although ABC is the issuer of additional shares of stock, the stockholders of RST could gain control of ABC. An example of this in practice was the 1993 combination of SoftKey Software Products Incorporated, Spinnaker Software Corporation, and WordStar International Incorporated. SoftKey was the entity making the acquisition, but the three-way stock swap was accomplished using WordStar stock.\(^\text{17}\) It is assumed in this text that the larger of the entities is the issuer of shares and that the issuer gains control of the combined entity.

In comparing the assets-for-stock to the stock-for-stock transactions, the only differences are that in Figure 1-3, RST gives up some of its monetary assets but Ross, Smith, and Thorne maintain 100 percent control of RST, whereas in Figure 1-4 all the original RST assets remain intact but some new stockholders are brought into RST.

### FORMS OF BUSINESS COMBINATIONS

Business combinations may be structured in ways that result in either one or two entities existing after the combination is completed. These different structures have resulted in three different legal forms of combinations. The relationship between the acquirer and the acquiree in each form of business combination is illustrated in Figure 1-5.

#### Statutory Mergers

As a part of the business combination plan, one or more participant companies may give up its corporate charter and cease to exist as a separate legal entity. When this occurs and at least one of the participant companies survives and continues to operate using its same legal charter, the combination is formally called a **statutory merger**. The word *statutory* refers to the various state laws (statutes) under which the corporate charters were obtained. These statutes generally provide for certain formal steps that must be followed in executing this type of combination. This form of business combination may result from the acquirer’s acquisition of the acquiree’s net assets where the acquiree’s stockholders decide to liquidate the corporation, or it may result from the acquirer’s acquisition of the acquiree’s stock. For example, when United HealthCare acquired HMO America in 1993, HMO America ceased to exist as a corporate entity and United HealthCare continued to operate as a single legal entity.

**Statutory Merger of RST and ABC** Figure 1-6 demonstrates the results of a statutory merger between ABC and RST, with RST being the surviving corporation. In

step 1 at the top of Figure 1-6, RST and ABC undertake a stock-for-stock exchange, identical to the one in Figure 1-4. However, in this case, under the terms of the agreement, ABC is to go out of existence. Thus, in step 2, presented in the middle of the figure, the solid line from ABC to RST represents a liquidating dividend that distributes 100 percent of the net assets of ABC to its only stockholder, RST Corporation. This step can occur because RST now owns 100 percent of the ABC stock, so RST is free to declare any dividend that it desires.

The bottom section of Figure 1-6 displays the balance sheet results. RST replaces the Investment in ABC Corp. Stock account that appears after the acquisition with the specific asset and liability accounts that underly the investment. ABC Corporation relinquishes its corporate charter and no longer exists.

In summary, the statutory merger is a special case of the acquisition-of-stock (Type 2) business combination. The results in Figure 1-6 differ from Figure 1-4 only in that one set of corporate accounting records and one corporation exist when the combination is completed, rather than two. In this case, Adams, Brown, and Carter received RST stock, though this is not critical to statutory mergers. Adams, Brown, and Carter could have received cash, for example. What is critical to the statutory merger notion is that RST Corporation must gain control of the ABC stock so that the ABC corporate entity may be dissolved.

Statutory Consolidations

Another legal form of business combination is called a statutory consolidation. As with statutory mergers, the word statutory refers to the fact that the combination is subject to certain state laws because a change in the number of existing chartered corporations is again involved. To qualify under the definition of statutory consolidation, however, a new corporation must be formed and a new charter granted by the state of incorporation. The newly created entity acquires the net assets of both combining entities, and the original
entities cease to exist. The acquisition is typically accomplished by the new entity issuing stock for the stock or assets of the combining entities. For example, American Bancorp and Central Penn National combined in a statutory consolidation in 1983, creating Meridian Bancorp.
Statutory Consolidation of RST and ABC into XYZ

If RST and ABC wish to combine as they did in Figure 1-4, but they wish to set up an entirely new corporate structure, a statutory consolidation may be undertaken. Figure 1-7 illustrates the results of a statutory consolidation. In this example, both ABC and RST relinquish their corporate charters and the only remaining entity is XYZ. At the top of Figure 1-7, step 1 displays the issuance of shares by the new XYZ Corporation, as shown by the solid line from XYZ to the stockholders of both ABC and RST. In exchange, outstanding shares of both ABC and RST are transferred by Adams, Brown, Carter, Ross, Smith, and Thorne to XYZ. XYZ records two accounts—Investment in ABC Corp. and Investment in RST Corp.—for the shares received.

In step 2, XYZ liquidates both ABC and RST by having each corporation declare a dividend of its entire net asset position. The result is that XYZ absorbs ABC’s and RST’s asset and liability account balances on XYZ’s books, with ABC and RST both ceasing to exist. Thus, the resulting balance sheet at the bottom of Figure 1-7 reflects the new structure of XYZ Corporation.

Notice that a Retained Earnings balance appears on the new corporate books. This is an example of recording the substance versus the form of the transaction. Legally, a new corporate shell was created. However, because RST is substantially larger than ABC, Ross, Smith, and Thorne will receive a proportionately larger percentage of the new XYZ shares than will Adams, Brown, and Carter. Essentially, the RST group has achieved control of the newly formed XYZ Corporation and should be treated as the acquirer. Had this been accomplished as it was in Figure 1-6, one set of books (RST’s books) including RST’s Retained Earnings balance would have resulted. The establishment of the XYZ corporate shell was purely a matter of legal form. It is reasonable, then, that the RST Retained Earnings be carried forward to the XYZ balance sheet. The substance of the transaction is that the stockholders of RST have gained control of ABC Corporation’s net assets and will continue as a going concern. RST’s corporate name has changed and it has acquired ABC. There is no substantive reason for RST’s retained earnings to disappear.

One common feature of statutory mergers and statutory consolidations is that only one entity exists at the end of the combination. As a result, no special accounting issues exist after the acquisition has been recognized. The single entity continues in existence, and the accounting records are maintained for the single legal entity.

Stock Acquisitions Resulting in Parent–Subsidiary Relationship

The third legal form of business combination is one where both original entities retain their separate legal existence. This form of combination is accomplished through a stock acquisition. The acquisition can be accomplished with the acquiree’s stockholders receiving part of the acquirer’s assets, debt, stock, or some combination of the three. An example of a stock acquisition is Mattel’s $1.1 billion acquisition of Fisher-Price through the issuance of Mattel stock to existing Fisher Price stockholders.18

Figure 1-4 presents a stock acquisition where RST decided that ABC is not to be liquidated. This form of business combination results in a parent–subsidiary relationship between the two entities, with the acquirer being the parent and the acquiree being the subsidiary. The existence of a parent–subsidiary relationship normally requires the preparation of consolidated financial statements for the consolidated entity.

**CHAPTER 1 INTRODUCTION TO BUSINESS COMBINATIONS**

**FIGURE 1-7 Statutory Consolidation of ABC and RST Corporations into Newly Formed XYZ Corporation**

*In substance, the newly formed XYZ Corporation is no different from a statutory merger. Thus, the Retained Earnings balance of of RST (the acquirer) is brought forward to XYZ's books.*
SUBSTANCE VERSUS FORM IN BUSINESS COMBINATIONS

In the statutory consolidation example, the issue of recording the economic substance versus the form of a business combination arose. Except for differences that result from tax implications, all the different legal forms of business combinations have the same substance. To illustrate this, a hypothetical example of an exchange is examined under the various forms.

Assume that the ABC Corporation and the RST Corporation have the following condensed balance sheets at January 1, 1991:

<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td>Assets</td>
</tr>
<tr>
<td>$8,000,000</td>
<td>$20,000,000</td>
</tr>
<tr>
<td>Liabilities</td>
<td>Liabilities</td>
</tr>
<tr>
<td>$3,000,000</td>
<td>$5,000,000</td>
</tr>
<tr>
<td>Capital Stock ($10 par)</td>
<td>Capital Stock ($10 par)</td>
</tr>
<tr>
<td>$4,000,000</td>
<td>$9,000,000</td>
</tr>
<tr>
<td>Retained Earnings</td>
<td>Retained Earnings</td>
</tr>
<tr>
<td>$1,000,000</td>
<td>$6,000,000</td>
</tr>
<tr>
<td>Total</td>
<td>Total</td>
</tr>
<tr>
<td>$8,000,000</td>
<td>$20,000,000</td>
</tr>
</tbody>
</table>

Further assume that the market value of ABC is equal to its $5,000,000 net assets, while the market value of RST is $45,000,000. RST Corporation approaches ABC about a possible combination. The management of RST and ABC agree that $5,000,000 is the market value of ABC’s net assets. The per-share market values of each firm’s outstanding stock are computed as follows:

<table>
<thead>
<tr>
<th>Market Value of Firm</th>
<th>Shares Outstanding</th>
<th>Market Value per Share</th>
</tr>
</thead>
<tbody>
<tr>
<td>RST $45,000,000</td>
<td>900,000 shares</td>
<td>$50.00 per share</td>
</tr>
<tr>
<td>ABC $5,000,000</td>
<td>400,000 shares</td>
<td>$12.50 per share</td>
</tr>
</tbody>
</table>

The substance of the exchange (ignoring tax aspects) is that ABC’s stockholders must receive resources worth $5,000,000 for their sacrifice of ABC’s net assets or for their holdings of ABC stock. Table 1-1 summarizes the various forms that result in a $5,000,000 exchange of value and the effects of the transaction on the stockholders of ABC.

In rows 1 and 2 of Table 1-1, the holdings of the ABC stockholders are unchanged. Either ABC Corporation must receive $5,000,000 in cash and notes (row 1) or it must receive 100,000 shares of RST stock (row 2) worth $50 per share. In row 3, the individual ABC stockholders receive assets worth $5,000,000 for their ABC stock. Further, in the cases where RST issues shares of stock directly to the ABC shareholders, rows 4 and 5, the number of shares issued is 100,000 ($5,000,000 / $50 per share).

Finally, with respect to the row 6 case, the $5,000,000 in value is in the form of new shares of XYZ stock. For example, assume the newly formed XYZ Corporation decides to issue 2,000,000 shares of voting common stock. The market value of the new XYZ shares will be $25 per share calculated:

\[
\text{Combined market value in XYZ} = \frac{\text{Number of new shares issued}}{2,000,000 \text{ shares}} = \frac{50,000,000}{2,000,000} = \$25 \text{ per share}
\]

Adams, Brown, and Carter would receive a total of 200,000 shares (10 percent) of XYZ stock if the market value of XYZ’s stock is $25 per share because their contribution to the new entity was $5,000,000 of the $50,000,000 total market value contributed.

As is seen in Table 1-1, regardless of the form of the exchange, the substance is identical for all cases. ABC’s stockholders have $5,000,000 in resources after the combination. The form of the business combination can vary significantly while, in substance, the value
exchanged is the same. The resulting relationship between the entities varies from case to case, but a $5,000,000 exchange has to be recorded in each case. In developing accounting principles for business combinations, the profession’s goal is to be sure that the accounting treatments capture the economic substance of each exchange.

## CONTINGENT CONSIDERATION

In the examples presented thus far, it has been assumed that the two parties involved in the business combination agreed on the value to be transferred by the acquirer for the acquiree’s assets or stock. It is also possible that the acquisition agreement may include contingencies making it difficult to determine the total resources to be transferred (i.e., the total price of the exchange) at the date of the acquisition. The typical contingencies relate to the future earnings of the acquiree or the value of noncash securities (debt or stock) given by the acquirer, the potential change in total resources to be transferred is referred to as **contingent consideration**.

A contingency based on the future earnings of the acquiree has a potential impact on the recognized cost of the investment by the acquirer. A common agreement would result in the acquirer giving additional consideration for the investment if the income of the acquiree exceeds a predetermined level during a specified time period. For example, assume that the acquirer is initially exchanging two shares of its common stock for every

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**TABLE 1-1 Summary of Holdings of the Stockholders of ABC before and after the Various Exchanges**

<table>
<thead>
<tr>
<th>Description of form of exchange</th>
<th>Personal holdings of Adams, Brown, and Carter before the exchange</th>
<th>Personal holdings of Adams, Brown, and Carter after the exchange</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exchange of RST assets for ABC assets (see Figure 1-1)</td>
<td>400,000 shares of ABC stock @ $12.50 = $5,000,000</td>
<td></td>
</tr>
<tr>
<td>Exchange of RST stock for ABC assets (see Figure 1-2)</td>
<td>400,000 shares of ABC stock @ $12.50 = $5,000,000</td>
<td></td>
</tr>
<tr>
<td>Exchange of RST assets for ABC stock (see Figure 1-3)</td>
<td>Cash and notes = $5,000,000</td>
<td></td>
</tr>
<tr>
<td>Exchange of RST stock for ABC stock (see Figure 1-4)</td>
<td>100,000 shares of RST stock @ $50 = $5,000,000</td>
<td></td>
</tr>
<tr>
<td>Exchange of RST stock for ABC stock (statutory merger) (see Figure 1-6)</td>
<td>100,000 shares of RST stock @ $50 = $5,000,000</td>
<td></td>
</tr>
<tr>
<td>Exchange of XYZ stock for ABC stock and RST stock (statutory consolidation) (see Figure 1-7)</td>
<td>200,000 shares of XYZ stock @ $25 = $5,000,000</td>
<td></td>
</tr>
</tbody>
</table>
share of acquiree common stock. If the market value of the acquirer’s common stock is $15 and the acquiree has 100,000 shares of common stock outstanding, the dollar amount recognized in the Investment in Subsidiary account at the date of acquisition would be $3,000,000 (100,000 shares \( \times 2 \times $15 \)). Assume also that the acquiree attains the required level of earnings, resulting in the acquirer exchanging three of its common shares for each acquiree share. The additional number of shares increases the payment by the acquirer, and the cost of the acquisition to the acquirer increases by the amount of the additional payment. This is reflected in an increase in the Investment in Subsidiary account from $3,000,000 to $4,500,000.

Conversely, a contingency based on the value of securities given by the acquirer does not impact the acquisition cost to the acquirer. One example may involve an acquirer whose stock price has been volatile (for example, $35–$55 per share). The acquiree may agree to the combination given that the value of the securities provided for the acquiree’s stock is at least equal to a predetermined market value at some future specified date (for example, $10,000,000). If the market value of the acquirer’s stock is $50 at the date the acquisition is agreed on (200,000 shares) and then declines to $40, the total market value of the stock to be transferred to the acquiree falls below the agreed total market value. The acquirer must issue additional shares of stock (50,000 shares). The issuance of additional shares of stock does not increase the total market value of the acquisition above the original agreed amount; it just returns the acquisition price to the original amount. The only adjustment made for the issuance of the new shares is a reallocation between Capital Stock and Additional Paid-in Capital on the books of the acquirer.

**TAXES AND BUSINESS COMBINATIONS**

Like most decisions that occur in business, the structure of a business combination has tax implications for the parties involved in the transaction. A business combination may be structured in a manner that will result in tax obligations for the acquiree and the inability to take advantage of a net operating loss carryforward by the acquirer, or it may result in what is referred to in the tax literature as a nontaxable exchange (in reality, it may result in a tax-deferred exchange to the acquiree stockholders, rather than a nontaxable exchange). A business combination is viewed to be a nontaxable exchange if it qualifies as a reorganization.

Reorganizations can occur regardless of whether the combination is accomplished via the acquisition of assets or the acquisition of stock. Furthermore, reorganizations can also occur regardless of whether the combination is structured as a statutory merger, statutory consolidation, or acquisition of stock.

For a combination to qualify as a reorganization, it must meet three criteria. First, the owners of the acquiree must continue to have an indirect ownership interest in the acquiree (i.e., the acquiree’s stockholders cannot sell their ownership interest in the acquired entity). Indirect ownership in the acquiree would be continued through an equity interest in the acquirer, although the equity interest does not have to be in the form of voting common stock. The issuance of preferred stock or a nonvoting class of stock would also qualify as an indirect equity interest in the acquiree.

The continuation of the indirect ownership provision also does not mean that some stockholders of the acquiree cannot accept consideration other than stock and cease to have an indirect ownership in the acquiree. Internal Revenue Service (IRS) regulations indicate that at least 50 percent of the consideration paid to the acquiree’s stockholders must be in the form of stock in the acquirer for the transaction to be considered a nontaxable exchange. This first provision essentially states that a reorganization has to
result in the restructuring of an entity, which must include the continuation of a significant portion of the original owners.

Second, the acquirer must continue the acquiree’s business or employ a significant portion of the acquiree’s net assets in an ongoing business. The second provision essentially states that the reorganization must result in the continued use of the assets of the entity. Third, the combination (reorganization) must occur for a valid business purpose. It cannot occur just to avoid the payment of taxes.

Types A and C

A number of different types of reorganizations are defined in the Internal Revenue code, and only the ones relevant to business combinations are discussed here. A statutory merger or a statutory consolidation that meets the three criteria outlined above qualifies as a nontaxable exchange. This type of reorganization is labeled Type A because it is addressed in subparagraph A of Section 368(a)(1)(A) of the Internal Revenue code. The benefit of a Type A reorganization is that the acquirer only has to give 50 percent of the consideration in stock; the remainder can be in any form. One disadvantage of the Type A reorganization is that the acquirer becomes liable for all known and contingent liabilities of the acquiree. In addition, another issue managers must consider when accomplishing a Type A reorganization is that statutory mergers and statutory consolidations must be approved by the stockholders of both entities, a potentially timely and costly undertaking for large entities.

Some managers avoid having to attain approval by both groups of stockholders by creating a new company for the purpose of accomplishing the merger or consolidation. Because the acquirer is the sole stockholder of the new company, there is no problem with getting stockholder approval for the statutory merger or statutory consolidation. The new company is then liquidated into the acquirer. To overcome the perceived problems with a Type A reorganization, some entities may choose to accomplish a Type C reorganization. This type of reorganization permits the acquirer to gain possession of the acquiree’s assets through contract rather than through the provisions of the state of incorporation. As a result, the acquirer does not become liable for contingent liabilities that are not expressly accepted as part of the agreement. The negative aspect of the Type C reorganization is that the acquirer’s voting common stock must be issued for 100 percent of the consideration given to the acquiree. In addition, the acquiree must distribute the stock to its shareholders and, in essence, terminate the operations of the target corporation.

Type B

The third type of nontaxable exchange relevant to business combinations, Type B, is a stock-for-stock exchange. This type of reorganization is accomplished when the acquirer desires to take possession of the acquiree’s voting common stock rather than net assets. The acquirer’s voting common stock must be exchanged for the acquiree’s outstanding stock. The acquirer must also own at least 80 percent of the acquiree’s stock after the reorganization is completed. One provision that the acquirer’s management must consider carefully is that any acquisition of the acquiree’s stock prior to the reorganization for consideration other than stock may result in denial of the nontaxable exchange status.

The acquiree’s net operating loss carryforward is not retained by the acquirer if the business combination results in a taxable exchange because it is not possible to purchase the tax aspects of another entity. On the other hand, structuring the reorganization as a nontaxable exchange always results in the acquirer being allowed to retain any net operating
loss carryforward of the acquiree. However, the IRS has placed a limit on the amount of the net operating loss carryforward that can be recognized in a tax year for Type A and Type C reorganizations, thus reducing the attractiveness of net operating loss carryforward benefits of potential takeover targets. This reduces the attractiveness of the takeover target.

**SUMMARY**

This chapter presented an overview of business combinations. First, a background of the environment surrounding business combinations was provided. A wide array of economic motivations for business combinations were listed. Then, some historical and legal perspectives relating to business combinations in the United States were discussed. The Sherman Act and Clayton Act, landmark legislative actions, were briefly covered to provide insights into the government’s concerns over the potential for abuses of power that may result when combinations result in potentially oligopolistic or monopolistic concentrations of power. Finally, modern takeover strategies and stockholder defenses were presented to provide an understanding of the dynamics of the business combination negotiating process.

The concept of “control” and the types of exchanges that result in a transfer of control were presented next. First, acquisitions of assets, Type 1 exchanges, were covered. Then, acquisitions of stock, Type 2 exchanges, were introduced. The forms of the various transactions were illustrated, and the changes in the holdings of the entities and various stockholder groups were diagrammed. Two special cases, statutory mergers and statutory consolidations, which result in a reduction of the total number of legal entities, were also presented, diagrammed, and compared to Type 1 and Type 2 exchanges. A summary example was then provided to illustrate how the same transfer of value (the substance) can be accomplished through various types of exchanges (the form). It was emphasized that accounting should strive to be sure that the substance of the exchange is recorded no matter what form the combination takes.

The last part of the chapter gave a brief introduction of (1) contingent consideration and the complications that result, as well as (2) the tax implications of various forms of business combinations to provide an overview of taxable versus nontaxable exchanges.

**QUESTIONS**

1-1. Discuss two reasons why external expansion may be preferred over internal expansion.

1-2. Discuss whether expansion from a regional market to a nationwide market is more likely to occur depending on whether the expansion occurs internally or externally.

1-3. Sam and Jim are board members who just left a meeting where external expansion was discussed. An issue presented by one of the consultants was economies of scale. Sam and Jim are confused about this concept. Prepare a brief memo explaining the concept of economies of scale as it is applied to business expansion.

1-4. Discuss the differences between the analysis conducted when acquiring a new piece of machinery and the analysis conducted when acquiring control over the net assets of another company.

1-5. Your company has acquired an interest in another entity that may result in control of that entity. Your CFO has asked you to explain what characteristics in the relationship would lead to the consolidation of this entity.

1-6. Discuss what is meant by horizontal combinations.

1-7. Discuss what is meant by vertical combinations.

1-8. Discuss what is meant by conglomerate combinations.

1-9. Discuss the reasons why the Sherman Act was passed.

1-10. Discuss how the Clayton Act addressed the primary weakness in the Sherman Act.

1-11. Phyllis, a friend, was watching the news when a story on business combinations was presented. One aspect of the story was friendly and hostile takeovers. Phyllis did not hear all of the story and asks for a clarification of the difference between hostile and friendly takeovers. Respond to Phyllis’s request.

1-12. The company where you work is being considered as a possible takeover target by a conglomerate entity. Bob Maxell, a board member, has asked your opinion about strategies to avoid being taken over. Your suggestions include a search for a white knight or a packman defense. Bob indicated that he does not understand these terms. Prepare an explanation of these terms for Bob.

1-13. Discuss what is meant by the term kamikaze strategy. Be sure to explain what maneuvers are often considered part of this strategy.

1-14. Shark repellent comes in a variety of forms. Discuss some of the more common types of shark repellent and explain what they accomplish.
24  CHAPTER 1  INTRODUCTION TO BUSINESS COMBINATIONS

1-15. Management has proposed that the board of directors institute golden parachutes that would become effective if the company were ever taken over through a business combination. Discuss what is meant by a golden parachute and indicate who, in your opinion, benefits from such a policy.

1-16. Discuss the similarities and differences between attaining control of another entity’s net assets through the purchase of the entity’s net assets versus through the purchase of the entity’s voting common stock.

1-17. Discuss the impact of the purchase of another entity’s net assets and the purchase of an entity’s voting common stock on the total capitalization of the acquirer.

1-18. When one entity acquires control over the net assets of another entity through the acquisition of net assets, who decides whether the acquired entity remains in existence or ceases to exist as a legal entity? Support your answer.

1-19. The management of your company is deciding whether the acquisition of another entity should be structured as an acquisition of assets or an acquisition of stock. Prepare a memo to provide information regarding any similarities and differences that may exist between the two alternatives.

1-20. Allen Schrader is a friend of yours who is not a business major. Allen has been hearing about mergers and takeovers in the news. One day he said, “If all of these takeovers keep occurring, there will soon be few companies left because every time a takeover occurs, there is one fewer company.” How do you respond to Allen?

1-21. Statutory mergers and statutory consolidations are very similar in that each results in only one company existing after the combination is completed. Why would two companies go through all the trouble of setting up another company to accomplish a statutory consolidation when a statutory merger is so similar?

1-22. Explain the meaning of the term parent company.

1-23. Explain the meaning of the term subsidiary company.

1-24. Jesse Cox is a board member for the Music Company, a company completing an acquisition. The acquiree, Piano Incorporated, is being purchased with stock of Music Company. The agreement states that Music Company will issue additional shares of stock if the market value of Music’s stock decreases by more than 5 percent before the stock is exchanged. Jesse has said that the additional shares of stock would not significantly dilute the ownership of the current stockholders and that it would have no impact on the acquisition price because the purchase is being accomplished with a stock-for-stock swap. Do you agree with Jesse? Support your answer.

1-25. Does a business combination have to be a stock-for-stock exchange to qualify as a tax-deferred exchange? Why or why not?

1-26. There are three different types of IRS tax-deferred exchange treatments that may apply to business combinations. Prepare a memo indicating the basic differences that exist among the three.

1-27. What is the primary advantage(s) and disadvantage(s) of a Type A business combination?

1-28. What is the primary advantage(s) and disadvantage(s) of a Type B business combination?

1-29. What is the primary advantage(s) and disadvantage(s) of a Type C business combination?

MULTIPLE CHOICE

1-1. Which of the following would not be a form of external business expansion for Sarah’s Dress Shop?
   a. Purchase of a trucking company to deliver dresses to distributors
   b. Purchase of a mill that weaves cloth
   c. Construction of a new store in a neighboring town
   d. Purchase of Millie’s Dress Emporium

1-2. When one company acquires a company in the same industry, what type of business combination has occurred?
   a. Horizontal combination
   b. Vertical combination
   c. Conglomerate combination
   d. All of the above

1-3. Which of the following may management be trying to accomplish when a conglomerate form of business combination is undertaken?
   a. Increase efficiency
   b. Guarantee a supply of raw materials
   c. Capitalize on market synergies
   d. Diversify risk across industries

1-4. Which of the following combinations would be considered “horizontal”?
   a. The two entities are unrelated.
   b. The two entities are competitors in the same industry.
   c. The two entities have a potential buyer–seller relationship.
   d. None of the above describe a horizontal combination.
EXERCISE 1-1 Stockholders after asset-for-asset exchange
EXERCISE 1-2 Stockholders after stock-for-asset exchange
EXERCISE 1-3 Stockholders after asset-for-stock exchange
EXERCISE 1-4 Stockholders after stock-for-stock exchange
EXERCISE 1-5 Acquisition price with contingent consideration based on income
EXERCISE 1-6 Acquisition price with contingent consideration based on stock price

EXERCISE 1-1 Bibby, Dyer, and Lozeau are the stockholders of East Coast Yachting Incorporated. These owners have just acquired control over the net assets of East Bay Sailing Company in an asset-for-asset exchange. The stockholders of East Bay Sailing are Clarke and Hartling.

Required: Who are the stockholders of East Coast Yachting and East Bay Sailing immediately after the transaction described above occurs?

EXERCISE 1-2 The owners of Pete’s Yard Maintenance, DeSimone and Murphy, just sold all of the company’s net assets to Independent Lawn Service, owned by Fortier, Miranda, and Rush. Independent Lawn Service paid for Pete’s assets by issuing stock.

Required: Who are the stockholders of Pete’s Yard Maintenance and Independent Lawn Service immediately after the transaction described above occurs?
EXERCISE 1-3
The stock of HealthCare Magazine was sold by its owners, Armstrong and Hart, to HealthCare Review for $650,000. HealthCare Review is owned by Perreault, Richards, and Sheldon.

Required:
Who are the stockholders of HealthCare Magazine and HealthCare Review immediately after the transaction described above occurs?

EXERCISE 1-4
The stock of Shawn’s Clothing was purchased by Casual Clothing in a stock-for-stock acquisition. The stockholders of Shawn’s Clothing before the transaction were Stafford and Vargas, while the stockholders for Casual Clothing were Best, Creedon, and Eikman.

Required:
Who are the stockholders of Shawn’s Clothing and Casual Clothing immediately after the transaction described above occurs?

EXERCISE 1-5
Mega Markets is considering combining with Minor Location. The combination would be accomplished with a stock swap. The current agreement is for each share of Minor Location (250,000 shares outstanding) to be exchanged for .6 share of Mega Markets. The current market value of the two stocks are $12 and $20 for Minor Location and Mega Markets, respectively. Minor Location’s managers believe the company is going to have an exceptionally high net income this period, so they negotiate an increased exchange ratio from .6 to .75 shares if return on equity is more than one-half percentage point greater than the same period last year.

Required:
Determine two investment amounts that could be recognized by Mega Markets. One amount should be based on Minor Location not meeting the return on equity target and the other based on Minor Location meeting the return on equity target.

EXERCISE 1-6
Philips Industries is in the process of combining with Reynolds Machine Company. The business combination has been negotiated whereby each of Reynolds’s 500,000 shares of stock (market value $30) will be exchanged for 1.5 shares of Phillips Industries (market value $20). This exchange ratio will change if the market value of Phillips changes by more than 10 percent before the combination is completed. For example, if the market price of the stock decreases from $20 to $15, then the exchange ratio will increase from 1.5 shares of Phillips per share of Reynolds to 2.0 shares (based on the new market ratio of $30/$15).

Required:
Determine the investment amount that would be recognized by Phillips Industries based on the three following independent situations.
A. Phillips’s stock price increases from $20 to $24, resulting in a change in the exchange rate from 1.5 to 1.25 shares of Phillips stock for each share of Reynolds.
B. Phillips’s stock price decreases from $20 to $12.50, resulting in a change in the exchange rate from 1.5 to 2.4 shares of Phillips stock for each share of Reynolds.
C. Phillips’s stock price decreases from $20 to $19, resulting in no change in the exchange ratio. Reynolds stockholders still receive 1.5 shares of Phillips stock for each share of Reynolds.

PROBLEMS

PROBLEM 1-1 Percentage stock ownership and market value after acquisition
PROBLEM 1-2 Percentage stock ownership based on different types of acquisition
PROBLEM 1-3 Acquisition price with contingent consideration based on income
PROBLEM 1-4 Acquisition price with contingent consideration based on stock price

PROBLEM 1-1
For each of the following independent cases, identify the stockholders of each company immediately after the transaction described, the percentage of the stock owned, and the market value of each group’s investment in each company.
A. Conlan, Jackson, and Perron own all 10,000 shares of Han’s Import/Export Company’s stock, market value $2,500,000. Han’s just purchased all of the net assets of Mass Production for $150,000 cash. Mass Production’s stock (1,000 shares) is owned by Hartley and Munson and the stock’s market value is $140,000.

B. The owners of Universal Plumbing sell all of the entity’s net assets to Random Pipefitters for 80,000 unissued shares of Random Pipefitters’ stock. Alberto and Amato owned all 25,000 shares of Universal’s stock prior to this transaction, and the stock had a market value of $2,750,000. Prior to the purchase of Universal Plumbing’s net assets, Random Pipefitters’ stock (240,000 shares) was owned by Davis, Hurd, and Ringrose (market value $15,000,000).

C. Heritage Cleaners purchases all of the stock of City Cleaners for $3,600,000. The market values of Heritage and City immediately prior to the transaction were $10,750,000 and $3,400,000, respectively. Prior to the transaction, the owners of Heritage Cleaners are Levin and Levy and the owners of City Cleaners are Bosco and Krone.

D. The owners of Chambers Music Store (Chambers and Garrett) exchange all 16,000 shares of their stock (market value $1,250,000) with Olympia Music Incorporated for 25,000 shares of Olympia’s common stock. Prior to this transaction, the market value of Olympia’s 100,000 shares of stock was $5,000,000 and the stockholders of Olympia were Forest and Gump.

PROBLEM 1-2

Monti’s Tools is owned by Brewer and Herold, and Chester’s Machinery is owned by Dorsey, Lawlor, and O’Flaherty. The stockholders of both companies have been discussing a business combination whereby Chester’s Machinery would acquire control of the net assets of Monti’s Tools. Dorsey, Lawlor, and O’Flaherty have asked for some information regarding how the structuring of the business combination would impact the ownership interest of the two groups of stockholders. Prior to the transaction, Monti’s Tools and Chester’s Machinery had 337,500 and 600,000 shares of stock outstanding, respectively, and the stock had market value of $6,750,000 and $27,000,000, respectively.

Required:
Complete the following table to indicate the stockholders of each company based on different types of transactions and the ownership interest each group would have in each company. Assume the market values presented above would be used to determine the numbers of shares of stock to be issued.

<table>
<thead>
<tr>
<th>TYPES OF EXCHANGES</th>
<th>Chester’s assets for Monti’s assets</th>
<th>Chester’s assets for Monti’s stock</th>
<th>Chester’s stock for Monti’s assets</th>
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</thead>
<tbody>
<tr>
<td>Shareholders</td>
<td>Monti’s</td>
<td>Chester’s</td>
<td>Monti’s</td>
<td>Chester’s</td>
</tr>
<tr>
<td>Percentage ownership</td>
<td></td>
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</tbody>
</table>

PROBLEM 1-3

Ace Building Products and Home Construction Company have been contemplating a business combination in which Ace Building would take control of Home Construction. The board of directors of Home Construction is concerned that the stockholders of Home Construction will not receive adequate compensation for their stock because the company’s net income fluctuates significantly. The current stock-for-stock exchange being considered is that each share of Home Construction stock, par value $1.00 and market value $17.875, would be exchanged for .65 shares of Ace Building Products’ stock, par value $.50 and market value $27.50. There are currently 320,000 shares of Home Construction Company stock outstanding. One proposal is that the exchange ratio be increased from .65 to .7 share of Ace Building for each share of Home Construction if the net income of Home Construction increases by more than 15 percent above last year.

Required:
Prepare a report for the board of directors explaining the impact of changing the exchange ratio on the financial records of Ace Building Products. Explain the reason for the impact determined.
PROBLEM 1-4

Management of Microsoft and Intuit discussed a possible merger for some time. While negotiations were eventually stopped, there are some interesting issues that could have come about. Assuming an agreement had been reached whereby Microsoft would have acquired all of the outstanding common stock of Intuit and that this agreement had not been challenged in the courts, a stock-for-stock exchange could have occurred. This type of exchange may have been viewed as risky by the stockholders of Intuit. Microsoft’s stock was trading at a 52-week high, approximately $90 per share, when management of the two companies were discussing the merger, while Intuit’s stock was trading at approximately $76 per share (approximately $10 below the 52-week high). If the stockholders of Intuit agreed to an exchange of stock—for example, .90 shares of Microsoft for each share of Intuit—the exchange value per share of Intuit stock would be $81. However, if the market value of Microsoft stock decreased, the exchange value per share of Intuit stock would also decrease. Suppose management of Intuit agreed to an exchange of stock if the agreement included the stipulation that for any decrease in the value of Microsoft’s stock, the ratio of shares exchanged would increase proportionately. For example, if the Microsoft’s stock decreased in value from $90 to $72 (a 20 percent decrease), the shareholders of Intuit would receive 1.125 (.9/.8) shares of Microsoft for each share of Intuit. Assume also that there are 5,000,000 shares of Intuit stock outstanding and 35,000,000 shares of Microsoft stock outstanding.

Required:
Prepare a report for Microsoft’s board of directors explaining the impact of a decrease in the market price of its stock from $90 per share to $67.50 per share on the financial records of Microsoft. Explain the reason for the impact determined.