CHAPTER 1

INTRODUCTION TO BUSINESS COMBINATIONS

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True-False Statements

1. Internal expansion often takes longer than external expansion.

2. Internal expansion is less risky than external expansion.

3. Internal expansion is often slow because the entity must build new production facilities to support new products or expanding sales.

4. The increase in the size of an entity resulting from a business combination would result in a lower cost of capital.

5. External combinations may result in economies of scale.

6. External expansion does not increase the total supply of products in the market place.

7. Internal expansion does not increase the total supply of products in the market place.

8. In a business combination, the investee takes control of the net assets of the investor.

9. All business combinations result in one entity taking control of the net assets of another entity.

10. An acquisition of net assets result in one entity taking control of the net assets of another entity while the acquisition of stock does not result in taking control of the net assets of another entity.

11. The capital budgeting techniques used to determine whether to acquire another entity are similar to the techniques used to evaluate purchases of equipment.

12. When two entities competing in the same industry combine, it is called a horizontal business combination.

13. Horizontal business combinations are likely to occur when management is attempting to dominate a geographic segment of the market.

14. One way that a horizontal business combination can increase sales for an entity is to expand into new product markets.

15. A vertical business combination generally involves companies attempting to improve the efficiency of operations by purchasing suppliers of inputs or purchasers of outputs.

16. When a retail clothing store purchases a competitor in another city, a vertical combination has occurred.

17. A vertical combination is one where the entities have a potential buyer-seller relationship.

18. A business combination in which a supplier of raw materials is acquired is a conglomerate combination.

19. A conglomerate combination is often undertaken to help increase income stability due to diversifying the asset base of an entity.

20. Conglomerate combinations are easy for the government to challenge in court.

21. The purpose of the Sherman Act of 1890 was to make illegal any action that would hinder free competition.

22. The Sherman Act requires the government to prove that trade has been restrained before it can be used to break up a company.

23. The Sherman Act can prevent a business combination from occurring.

24. The Clayton Act can prevent a business combination from occurring.

25. The government does not have to be notified when a business combination is anticipated.

26. The U.S. government opposes all business combinations because they are viewed as a threat to competition.

27. The Federal Trade Commission assesses the impact of a proposed business combination on industry concentration.

28. If negotiation between management groups leads to a mutually agreeable business combination, the process is called a friendly takeover.

29. An offer by an acquirer to buy the stock of another company is commonly called a tender offer.

30. A tender offer that is opposed by the acquiree management is called a hostile bid.

31. Greenmail exists when a company is encouraged to buy a potential acquiree.

32. A poison pill is the term used to describe the issuance of a special kind of convertible preferred stock to deter the acquisition of the company.

33. The sale of the crown jewels defensive maneuver involves the sale of more assets than does the scorched earth defense.

34. The fatman defensive maneuver involved the acquisition of assets by the potential acquiree.

35. Golden parachutes give a bonus to all employees if the company is acquired.

36. The packman defensive maneuver is where a potential acquiree attempts to purchase the acquirer.

37. A business combination occurs when one entity gains control over the net assets of another entity.

38. The only way to attain control over the net assets of another entity is to purchase the net assets.

39. In an acquisition where the acquirer pays cash for the acquiree assets, the book value of the acquirer increases.

40. In an acquisition of assets for assets, the ownership structure of the acquiree does not change.

41. In an acquisition of assets for assets, the ownership structure of the acquirer changes.

42. There is an increase in the total capitalization of an acquirer when the acquirer issues stock for acquiree assets.

43. In an exchange of stock (acquirer) for assets (acquiree), the ownership structure of the acquiree does not change.

44. In an exchange of stock (acquirer) for assets (acquiree), the acquiree stockholders become acquirer stockholders.

45. Control over the acquiree assets is directly achieved in an asset for asset exchange but indirectly achieved in an asset (acquirer) for stock (acquiree) exchange.

46. A business combination that occurs where only one of the original entities in existence after the combination is called a statutory consolidation.

47. The acquiree entity is liquidated in a statutory merger.

48. For a business combination to qualify as a statutory consolidation, a new corporation must be formed.

49. In a statutory consolidation form of business combination, the Retained Earnings account of the newly formed corporation has a balance of zero immediately after the combination.

50. After completing a business combination in the form of a statutory merger or statutory consolidation, there is only one legal entity in existence.

51. In a business combination accomplished as a stock acquisition normally two companies exist after the combination.

52. A business combination accomplished as a stock acquisition must be accomplished with a stock for stock exchange.

53. A stock acquisition is the only form of business combination that might require the preparation of consolidated financial statements.

54. The substance of statutory mergers, statutory consolidations, and stock acquisitions is the same if income tax considerations are ignored.

55. There are no uncertainties when two companies agree on a business combination.

56. When the acquisition price of an acquiree is contingent on acquiree future earnings, the acquisition price may change?

57. When the acquisition price of an acquiree is contingent on the market value of the acquirer stock, the acquisition price may change?

58. Business combinations can qualify as reorganizations (for tax purposes) regardless of whether accomplished via the acquisition of assets or the acquisition of stock.

59. For business combinations to qualify as reorganizations (for tax purposes), the acquiree stockholders must receive voting common stock of the acquirer.

60. Only stock for stock exchanges can qualify as reorganizations for tax purposes.

61. When a statutory merger or statutory consolidation is used to accomplish a reorganization (for tax purposes), the acquirer becomes liable for all known and contingent acquiree liabilities.

62. There are different required levels of stock ownership in the acquiree for the three different types of reorganizations for tax purposes.

63. One important benefit in a business combination is any net operating loss carryforward that might exist and be available to the acquirer.

True-False Statement Solutions

1. T
2. F, Developing and marketing new products is often a difficulty and risky process.
3. T
4. F, All else being equal, the combined entity's cost of capital may be higher or lower depending on whether the acquired entity is heavily laden with debt or is relatively debt free. Also, the amount of debt versus equity issued in the combination will affect the resulting cost of capital.
5. T
6. T
7. F, Internal expansion results in a particular entity offering more products or the same products to new consumers. Thus, the total supply of products increases.
8. F, The investor takes control of the net assets of the investee in a business combination.
9. T
10. F, Both the acquisition of the net assets and the acquisition of stock result in control of the net assets of another entity. The stock acquired represents ownership in the net assets.
11. T
12. T
13. F, A horizontal combination occurs when management attempts to dominate an industry.
14. T
15. T

16. F, A vertical combination exists when an entity purchases another entity that could have a buyer-seller relationship with the acquirer. The combination described here is a horizontal combination.
17. T
18. F, A conglomerate combination is one where an unrelated or tangentially related business is acquired. A vertical combination occurs when a supplier is acquired.
19. T
20. F, Conglomerate combinations are more difficult for the government to challenge in court because they do not result in market domination in any particular market.
21. T
22. T
23. F, The Sherman Act can only break up a company that has restrained free trade, it cannot stop a business combination from creating a company.
24. T
25. F, The Hart-Scott Rodino amendment requires that the Antitrust Division and the Federal Trade Commission be notified of anticipated business combinations.
26. F, 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.
27. T
28. T
29. T
30. T
31. F, Greenmail is the payment of a price above market value to acquire stock back from a potential acquirer.
32. T
33. F, The sale of the crown jewels results when a target sells assets that would be particularly valuable to the potential acquirer. The scorched earth defense results when a target generally sells large amounts of assets without regard to the specific desirability to the potential acquirer.
34. T
35. F, Golden parachutes are generally given only to top executives of the acquiree.
36. T
37. T
38. F, Control over the net assets of an entity can be accomplished by purchasing the net assets or by purchasing the acquiree voting common stock that represents ownership of the assets.
39. F, The amount of cash will always equal the net assets recorded by the acquirer. As a result, the acquirer book value will not change due to an acquisition.
40. T
41. F, There is no exchange of stock in an asset for asset acquisition so there cannot be a change in ownership structure of either entity.
42. T
43. T

44. F, The acquiree corporation becomes an acquirer stockholder, not the acquiree stockholders.
45. T
46. F, A combination that results in one of the original entities in existence after the combination is a statutory merger.
47. T
48. T
49. F, The combination results in the stockholders of one entity controlling the other entity. The Retained Earnings of the entity acquiring control is carried forward to the newly formed corporation.
50. T
51. T
52. F, The stock of the acquiree company must be purchased by the acquirer, but the value transferred to the acquiree stockholders does not have to be in stock. Payment may be in another asset or the issuance of debt.
53. T
54. T
55. F, The consideration to be given by the acquirer is sometimes not completely known because the consideration is based partially on acquiree future earnings or the market value of acquirer debt or stock.
56. T
57. F, Any change in the number of shares of acquirer stock given returns the purchase price to the agreed level. The adjustment is to stock and additional paid-in capital. The investment account is unchanged.
58. T
59. F, The acquiree stockholders must continue to have an indirect ownership interest in the acquiree net assets. Preferred stock or a nonvoting class of stock qualifies as an indirect ownership as well as voting common stock.
60. F, At least 50 percent of the consideration paid to the acquiree stockholders must be in acquirer stock.
61. T
62. T
63. F, A net operating loss carryforward cannot be acquired. They are only available to the acquirer if the combination qualifies as a nontaxable exchange.

Conceptual Multiple Choice Questions

64. Which of the following is not a form of internal business expansion?
    a. Development of a new product
    b. Construction of new production facility
    c. Purchase of a competitor
    d. Expanding the marketing effort into a new geographic area

65. Which can typically be accomplished more quickly?
    a. Internal expansion

b. External expansion
c. Internal and external expansion would likely take the same amount of time
d. There is no general pattern regarding how long either would take

66. Which of the following is a reason that internal expansion is often a slow process?
a. A new distribution system must be developed
b. Demand for the product does not have to be developed
c. Existing production facilities are adequate to meet expanded sales
d. All of the above are reasons that internal expansion is a slow process

67. Which of the following is not an advantage of business combinations when compared to internal expansion?
a. Combinations generally take longer to accomplish than internal expansion
b. The cost of capital may be reduced as a result of a combination due to increased entity size
c. The entity may obtain a relatively greater market share
d. All of the above are advantages of business combinations

68. Which of the following is a disadvantage of business combinations when compared to internal expansion?
a. Combinations may provide an established, experienced management group immediately
b. There are some tax advantages to combined corporation entities not available to one corporation
c. There may be a guaranteed source of raw material or product markets when a combination is effected
d. None of the above is a disadvantage of business combinations

69. Which of the following is not an advantage of business combinations when compared to internal expansion?
a. Combinations may lead to economies of scale
b. Combinations do not increase the total supply of goods available from the industry
c. Diversification accomplished through combinations may provide a less volatile income stream
d. All of the above are advantages of combinations

70. In a business combination, which of the following occurs?
a. The investee takes control of the investor
b. The investee and investor share control of each other
c. The investor takes control of the investee
d. Neither entity controls the other

71. Which of the following analysis techniques are commonly used when making business combination decisions?

a. Cash flow budgeting
b. Internal rate of return
c. Net present value
d. All of the above techniques are commonly used

72. Which of the following is not a directly observable cash flow resulting from a business combination?
a. Disposal of redundant facilities
b. Synergies resulting from sales of complementary products
c. Reduced fixed costs from eliminating duplicate operations
d. Savings due to increased coordination when one part of the new entity produces inputs for another part of the new entity

73. Which of the following is a directly observable cash flow resulting from a business combination?
a. Savings from production and marketing expertise
b. Acquisition of an established market share for products
c. Disposal of redundant facilities
d. A readily available supply of scarce inputs

74. Which of the following types of business combinations typically occurs when management is attempting to monopolize a particular industry?
a. Horizontal combination
b. Vertical combination
c. Conglomerate combination
d. Market domination can be the goal of any type of combination

75. Horizontal business combinations occur when one entity purchases which of the following?
a. A supplier
b. A customer
c. A competitor
d. None of the above

76. Horizontal business combinations help sales increase by all but which of the following?
a. Entering new product markets
b. Taking control of a distribution system
c. Increasing production capacity
d. Expanding into new geographic regions

77. Which of the following types of business combinations typically occurs when management is attempting to improve the efficiency of operations?
a. Horizontal combination
b. Vertical combination
c. Conglomerate combination

d. Improved efficiency can be the goal of any type of combination

78. A vertical combination occurs when one entity acquires another entity which has the following characteristic(s)?
   a. The acquiree purchases the acquirer's outputs
   b. The acquiree is a competitor of the acquirer
   c. The acquiree supplies raw materials to the acquirer
   d. Either a. or c.

79. Which of the following is a vertical combination?
   a. A combination where the two entities are unrelated
   b. A combination where the two entities are competitors in the same industry
   c. A combination where the two entities have a potential buyer/seller relationship
   d. None of the above describes a vertical combination

80. Which of the following types of business combinations typically occurs when management is attempting to diversify its investment?
   a. Horizontal combination
   b. Vertical combination
   c. Conglomerate combination
   d. Diversification can be the goal of any type of combination

81. Management acquires a business in a tangentially related industry to the current business. What form of business combination is accomplished?
   a. Vertical combination
   b. Conglomerate combination
   c. Mega combination
   d. Horizontal combination

82. One reason for conglomerate combinations is that management has become more aware that it helps accomplish which of the following?
   a. It helps increase income stability provided by diversifying the asset base of an entity
   b. It helps increase market share in the industry
   c. It helps assure a constant supply of raw materials
   d. A conglomerate combination helps accomplish all three

83. Business combinations that result in one dominant company in an industry are said to have formed which of the following?
   a. Pure competition
   b. Monopoly
   c. Oligopoly
   d. Free market

84. Which of the following is not true with regard to the Sherman Act of 1890?

a. It is the first legislation that restricts the ability to enter into business combinations
b. Its basic purpose was to make acts that would hinder free competition illegal
c. The act required the government to show that trade had been restrained as a result of a combination
d. The act could only be applied after a combination has occurred

85. Which of the following can be used to break up combined entities, but not to prevent the business combination from occurring?
a. Clayton Act
b. Sherman Act
c. Hart-Scott Rodino amendment
d. All of the above can only break up entities that have already combined

86. Which of the following allows the government to prevent proposed business combinations from occurring if the result of the combination would be the creation of a monopoly or the lessening of competition?
a. Clayton Act
b. Sherman Act
c. Hart-Scott Rodino amendment
d. All of the above can only break up entities that have already combined

87. When regulating business combinations the Federal Trade Commission does not assess which of the following?
a. The impact of the combination on industry concentration
b. The impact of the combination on barriers to entry into the industry
c. The impact of the combination on restriction of trade
d. The Federal Trade Commission assesses each of the above in regulating business combinations

88. When an offer is made to acquire a company and the acquiree management supports the offer, the offer is called which of the following?
a. Friendly takeover
b. Tender offer
c. Hostile takeover
d. Defensive measure

89. The defensive maneuver where a company buys stock from a potential acquirer at a premium over the market price is called which of the following?
a. White knight
b. Shark repellent
c. Greenmail
d. Sale of the crown jewels

90. The defensive maneuver where a company seeks to be acquired by a company perceived to be a better match than the company making an offer to buy the potential acquiree is called which of the following?
    a. Poison pill
    b. White knight
    c. Golden parachutes
    d. Fatman defense

91. Which of the following is not a Kamikaze strategy?
    a. Sale of the crown jewels
    b. Scorched earth defense
    c. Fatman defense
    d. All of the above are Kamikaze strategies

92. What is the term used for the defensive maneuver where management of a potential acquiree sells desirable assets to reduce the company's value?
    a. Sale of the crown jewels
    b. Scorched earth defense
    c. Fatman defense
    d. Greenmail

93. Shark repellent is a term for administrative measures that may make a hostile takeover more difficult. Which of the following is not a form of shark repellent?
    a. Staggering board of director terms
    b. Residency requirement for board members
    c. Issuance of convertible preferred stock that converts into common stock of the acquirer if a takeover is accomplished
    d. A supermajority vote is required to approve an acquisition

94. Defensive maneuvers can be internal to the potential acquiree (management or stockholders) or may involve activities external to the acquiree. Which of the following is not an internal defensive maneuver?
    a. Residency requirement for board members
    b. Golden parachutes
    c. Packman defense
    d. A supermajority vote is required to approve an acquisition

95. Control over an acquiree can be attained through which of the following?
    a. Acquisition of the acquiree assets
    b. Acquisition of the acquiree stock
    c. Either acquisition of the acquiree assets or stock
    d. Neither acquisition of the acquiree assets or stock

96. Control enables the acquiring entity to do which of the following?

a. Direct the use of the controlled entity's assets by establishing capital and operating budgets and policies
b. Enforce the budgets and policies by selecting, compensating, and terminating those responsible for implementing decisions
c. Either a or b will illustrate control
d. Both a and b are required to illustrate control

97. In an acquisition of assets, the acquirer must give up which of the following?
a. Cash
b. Other assets
c. Liabilities
d. Any of the above can be given

98. In an acquisition where there is an exchange of assets for assets, how does the value of the acquiree net assets change?
a. The net assets increase
b. The net assets decrease
c. There is no change in net assets
d. The net assets may increase, decrease or remain the same

99. In an acquisition where there is an exchange of assets for assets, how does the ownership structure of the acquiree change?
a. There is no change in the acquiree ownership structure
b. The acquirer stockholders become the acquiree stockholders
c. The acquirer and acquiree stockholders share ownership of the acquiree
d. It is not possible to determine if there is a change in the acquiree ownership structure

100. In an acquisition where there is an exchange of assets for assets, how does the ownership structure of the acquirer change?
a. There is no change in the acquirer ownership structure
b. The acquiree stockholders become the acquirer stockholders
c. The acquirer and acquiree stockholders share ownership of the acquirer
d. It is not possible to determine if there is a change in the acquirer ownership structure

101. In an acquisition where there is an exchange of stock (acquirer) for assets (acquiree), how does the value of the acquiree net assets change?
a. The net assets increase
b. The net assets decrease
c. There is no change in net assets
d. The net assets may increase, decrease or remain the same

102. In an acquisition where there is an exchange of stock (acquirer) for assets (acquiree), how does the ownership structure of the acquiree change?

a. There is no change in the acquiree ownership structure
b. The acquirer stockholders become the acquiree stockholders
c. The acquirer and acquiree stockholders share ownership of the acquiree
d. It is not possible to determine if there is a change in the acquiree ownership structure

103. In an acquisition where there is an exchange of stock (acquirer) for assets (acquiree), how does the ownership structure of the acquirer change?
a. There is no change in the acquirer ownership structure
b. The acquiree (company) becomes a stockholder of the acquirer
c. The acquiree stockholders as individuals become owners of the acquirer
d. It is not possible to determine if there is a change in the acquirer ownership structure

104. Control over acquiree assets is attained in a business combination. Indirect control is attained in which type of exchange?
a. Assets for assets
b. Stock (acquirer) for assets (acquiree)
c. Stock for stock
d. Either b or c

105. Which of the following forms of business combination is not subject to state laws specific to business combinations?
a. Asset for asset acquisition
b. Statutory merger
c. Statutory consolidation
d. All three are subject to state laws

106. Which of the following is not a true statement with regard to a statutory merger?
a. One entity continues to exist
b. One entity ceases to exist
c. The name of the new entity is not the same as either of the entities
d. All of the above are true statements with regard to a statutory merger

107. Which of the following is not true with regard to the statutory consolidation form of business combination?
a. A new corporation must be formed
b. Control of the net assets of the combining entities must be acquired by the new entity
c. The net assets of the combining entities must be acquired with assets of the new corporation
d. The combining entities both cease to exist after the combination

108. Following the completion of a business combination in the form of a statutory consolidation, what is the balance in the new corporation's Retained Earnings account?

a. The acquirer Retained Earnings account balance
b. The acquiree Retained Earnings account balance
c. Zero
d. The sum of the acquirer and acquiree Retained Earnings account balances

109. Which of the following is not true with regard to a business combination accomplished in the form of a stock acquisition?
a. Two companies remain in existence after the combination
b. A parent-subsidiary relationship is said to exist
c. Consolidated financial statements are normally required
d. All of the above statements are true

110. Which of the following contingencies may change the cost of an acquisition?
a. Future acquiree earnings
b. Future value of acquiree stock
c. Future value of acquirer stock
d. Future value of acquirer debt

111. To qualify as a reorganization (for tax purposes), a business combination must be structured as which of the following?
a. Statutory merger
b. Statutory consolidation
c. Stock acquisition
d. All of the above can qualify as reorganizations

112. To qualify as a reorganization (for tax purposes), a business combination must meet which of the following criteria?
a. Acquiree stockholders continue an indirect ownership interest in the acquiree
b. The acquirer must continue the acquiree business or employ a significant portion of the acquiree net assets in an ongoing business
c. The combination must be for a valid business purpose
d. All of the above criteria are required for a combination to qualify as a reorganization

113. Which of the following is not a feature of a Type A form of reorganization for tax purposes?
a. The acquirer only has to give 50 percent of the consideration in stock
b. Stockholder approval of the acquiree stockholders is required but not the acquirer stockholders
c. All known and contingent acquiree liabilities become acquirer liabilities
d. The combination can be structured as a statutory merger or statutory consolidation

114. Which of the following is not a feature of a Type C form of reorganization for tax purposes?

a. The acquirer is not responsible for liabilities not expressly accepted as part of the agreement
b. Acquirer voting common stock must be issued for 100 percent of the consideration given
c. Approval by acquirer and acquiree stockholders is required
d. The acquiree must distribute the acquirer stock to its shareholders and terminate operations

115. Which of the following is not a feature of a Type B form of reorganization for tax purposes?
a. The acquirer takes possession of the acquiree assets
b. Acquirer voting common stock is exchanged for acquiree voting common stock
c. The acquirer must own at least 80 percent of acquiree stock
d. Acquisition of acquiree stock prior to the reorganization can result in denial of nontaxable exchange status

Conceptual Multiple Choice Question Difficulty and Solutions

64.	easy	c
65.	easy	b
66.	moderate	a
67.	easy	a
68.	easy	d
69.	easy	d
70.	easy	c
71.	easy	d
72.	moderate	b
73.	moderate	c
74.	easy	a
75.	easy	c
76.	moderate	b
77.	easy	b
78.	moderate	d
79.	easy	c
80.	easy	c
81.	easy	b
82.	moderate	a
83.	easy	b
84.	easy	d
85.	easy	b
86.	easy	a
87.	moderate	d
88.	easy	a
89.	easy	c
90.	moderate	b
91.	moderate	d

92.	easy	a
93.	moderate	c
94.	difficult	c
95.	easy	c
96.	moderate	d
97.	easy	d
98.	moderate	d

The change in acquiree net assets will depend on the acquisition price and book value of the acquiree assets.

99.	easy	a
100.	easy	a
101.	moderate	d

The change in acquiree net assets will depend on the acquisition price and book value of the acquiree assets.

102.	moderate	a
103.	easy	b
104.	moderate	c
105.	easy	a
106.	easy	c
107.	easy	c
108.	moderate	a
109.	moderate	d
110.	easy	a
111.	moderate	d
112.	moderate	d
113.	difficult	b
114.	difficult	c
115.	difficult	a

Computational Multiple Choice Questions

116. Dull and Sharp are the stockholders of Knives Unlimited and Safe and Cracker are the owners of Quicky Locksmiths. Knives Unlimited purchases all of the assets of Quicky Locksmiths by paying cash and issuing notes payable. Who are the stockholders of Knives Unlimited immediately after the above transaction?
    a. Dull and Sharp (100%)
    b. Safe and Cracker (100%)
    c. Dull and Sharp (50%) and Safe and Cracker (50%)
    d. Dull and Sharp (50%) and Quicky Locksmiths (50%)

117. Dull and Sharp are the stockholders of Knives Unlimited and Safe and Cracker are the owners of Quicky Locksmiths. Knives Unlimited purchases all of the assets of Quicky Locksmiths by paying cash and issuing notes payable. Who are the stockholders of Quicky Locksmiths immediately after the above transaction?
    a. Dull and Sharp (100%)

b. Safe and Cracker (100%)
c. Dull and Sharp (50%) and Safe and Cracker (50%)
d. Dull and Sharp (50%) and Quicky Locksmiths (50%)

118. Quietkey is owned by Johnson and Video Junction is owned by Housewald. Quietkey issues new stock to acquire all of the net assets of Video Junction. Quietkey had 12,000 shares of stock outstanding before the acquisition and 16,000 shares outstanding after the acquisition. Who is (are) the stockholder(s) of Quietkey immediately after the transaction?
a. Johnson (100%)
b. Housewald (100%)
c. Johnson (75%) and Housewald (25%)
d. Johnson (75%) and Video Junction (25%)

119. Quietkey is owned by Johnson and Video Junction is owned by Housewald. Quietkey issues new stock to acquire all of the net assets of Video Junction. Quietkey had 12,000 shares of stock outstanding before the acquisition and 16,000 shares outstanding after the acquisition. Who is (are) the stockholder(s) of Video Junction immediately after the transaction?
a. Johnson (100%)
b. Housewald (100%)
c. Johnson (75%) and Housewald (25%)
d. Johnson (75%) and Video Junction (25%)

120. Oxford Industries is owned by Stuart and Tom while Samson Gyms is owned by Hank and Ruben. Oxford uses cash and notes to purchase all of the stock of Samson Gyms. Who are the stockholders of Oxford Industries immediately after the acquisition?
a. Stuart and Tom (100%)
b. Hank and Ruben (100%)
c. Stuart and Tom (50%) and Hank and Ruben (50%)
d. Stuart and Tom (50%) and Samson Gyms (50%)

121. Oxford Industries is owned by Stuart and Tom while Samson Gyms is owned by Hank and Ruben. Oxford uses cash and notes to purchase all of the stock of Samson Gyms. Who is (are) the stockholder(s) of Samson Gyms immediately after the acquisition?
a. Stuart and Tom (100%)
b. Hank and Ruben (100%)
c. Oxford Industries (100%)
d. Stuart and Tom (50%) and Hank and Ruben (50%)

122. Astronaut Aviation is owned by Roberto and Lou and Chill Air Conditioning is owned by John and Phillip. Astronaut Aviation issues 3,000 new shares of stock to acquire all of the outstanding stock of Chill Air Conditioning. Astronaut had 9,000 shares of stock outstanding before the acquisition and 12,000 shares outstanding after the acquisition. Who are the stockholders of Astronaut Aviation immediately after the acquisition?

a. Roberto and Lou (100%)
b. John and Phillip (100%)
c. Roberto and Lou (75%) and John and Phillip (25%)
d. Roberto and Lou (75%) and Chill Air Conditioning (25%)

123. Astronaut Aviation is owned by Roberto and Lou and Chill Air Conditioning is owned by John and Phillip. Astronaut Aviation issues 3,000 new shares of stock to acquire all of the outstanding stock of Chill Air Conditioning. Astronaut had 9,000 shares of stock outstanding before the acquisition and 12,000 shares outstanding after the acquisition. Who is (are) the stockholder(s) of Chill Air Conditioning immediately after the acquisition?
a. Roberto and Lou (100%)
b. John and Phillip (100%)
c. Roberto and Lou (75%) and John and Phillip (25%)
d. Astronaut Aviation (100%)

124. Value Inc. is acquiring High Priced Industries in a stock swap. Each of High Priced's 100,000 shares is to be exchanged for .75 shares of Value. The current estimated market value of the two stocks is $10 for Value, an actively traded stock, and $8 for High Priced, which is family-owned and not actively traded. The managers of High Priced have negotiated an increased exchange ratio from .75 to .8 shares if return on equity is more than a targeted value. Determine the investment amount that could be recognized by Value based on High Prices (1) not meeting the return on equity target, and (2) meeting the return on equity target.
a. $750,000; $640,000
b. $750,000; $800,000
c. $600,000; $640,000
d. $600,000; $800,000

125. Potters Petroleum is acquiring Deep Well Drilling in a stock swap. Each of Deep Well's 250,000 shares is to be exchanged for 1.50 shares of Potters. The current market values of the two stocks are $30 and $45 for Potters Petroleum and Deep Well, respectively. The managers of Deep Well have negotiated an increased exchange ratio from 1.50 to 1.80 shares if return on assets is more than a targeted value. Assume that the market value of Potters Petroleum is more objectively determinable in valuing the transaction. Determine the investment amount that could be recognized by Potters based on Deep Well (1) not meeting the return on assets target, and (2) meeting the return on assets target.
a. $5,000,000; $13,500,000
b. $5,000,000; $22,500,000
c. $11,250,000; $13,500,000
d. $11,250,000; $20,250,000

126. Three Kings Games is in the process of combining with Jacks-or-Better Playing Card Company. The business combination has been negotiated where each of Jacks' 500,000

shares of stock (market value $42.50) will be exchanged for 1.7 shares of Three Kings Games (market value $25). This exchange ratio will change if the per share market value of Three Kings changes by more than 20 percent before the combination is completed. For example, if the market price of Three Kings decreases 25 percent (from $25 to $18.75), then the exchange ratio will increase 25 percent from 1.7 shares of Three Kings per share of Jacks' to 2.125 shares (1.7 x 1.25). Determine the investment amount recognized by Jacks-or-Better if Three Kings' stock price decreases from $25 to $15.

a. $12,750,000
b. $16,612,500
c. $21,250,000
d. $35,416,667

127. Three Kings Games is in the process of combining with Jacks-or-Better Playing Card Company. The business combination has been negotiated where each of Jacks' 500,000 shares of stock (market value $42.50) will be exchanged for 1.7 shares of Three Kings Games (market value $25). This exchange ratio will change if the per share market value of Three Kings changes by more than 20 percent before the combination is completed. For example, if the market price of Three Kings decreases 25 percent (from $25 to $18.75), then the exchange ratio will increase 25 percent from 1.7 shares of Three Kings per share of Jacks' to 2.125 shares (1.7 x 1.25). Determine the investment amount recognized if Three Kings' stock price increases from $25 to $40.

a. $7,812,500
b. $12,750,000
c. $21,250,000
d. $34,000,000

Computational Multiple Choice Question Difficulty and Solutions

116. easy a
117. easy b
118. moderate d
119. easy b
120. easy a
121. moderate c
122. moderate c
123. moderate d
124. difficult b
Target not met: 100,000 shares x .75 share x $10 = $750,000
Target met: 100,000 shares x .8 x $10 = $800,000
125. difficult c
Target not met: 250,000 shares x 1.50 share x $30 = $11,250,000
Target met: 250,000 shares x 1.8 x $30 = $13,500,000
126. moderate c
500,000 shares x 1.7 exchange ratio x $25 = $21,250,000
The investment value does not change as a result of a change in the share prices.
127. moderate c

500,000 shares x 1.7 exchange ratio x $25 = $21,250,000
The investment value does not change as a result of a change in the share prices.

Problems

128. (5 Points) easy
Columbia Manufacturing is owned by Louis and Brian. They recently concluded an agreement to buy all of Bell Manufacturing, owned by Ken and Adam. Columbia will pay $500,000 in cash and assume $300,000 of Bell's liabilities in exchange for total ownership of Bell's net assets. Identify the stockholders of each company immediately after the above transaction is concluded.

Answer:
Louis and Brian will own 100 % of Columbia and Ken and Adam will own 100% of Bell. An asset for asset acquisition does not change the owners of either company.

129. (Part a. 10 Points; Part b. 10 Points) moderate, moderate
The following two cases are independent. Identify the stockholders of each company and the percentage ownership of each stockholder immediately after the transaction described.

a. The owners of Baylor Incorporated acquire the net assets of Waco Company by issuing 10,000 new shares of Baylor's stock. Baldwin and Rosco own all 40,000 shares of Baylor's stock prior to the transaction. Wilson and Montgomery own all of Waco's stock prior to the transaction.

b. Lincoln Enterprises purchase all of Jefferson Corporation's common stock for $5,000,000 in cash. Prior to this transaction, Ralph and Maureen are the stockholders of Lincoln while David and Jennifer are the stockholders of Jefferson. The total market value of Lincoln's and Jefferson's stock is estimated to be $18,000,000 and $6,000,000, respectively immediately before the acquisition.

Answer:

	Company	Shareholders	Percentage
a.	Company	Shareholders	Percentage
	Waco	Wilson and Montgomery	100%
	Baylor	Baldwin and Rosco 40,000/50,000 =	80%
		Waco 10,000/50,000 =	20%
b.	Company	Shareholders	Percentage
	Jefferson	Lincoln	100%
	Lincoln	Ralph and Maureen	100%

130. (10 Points) moderate
John and Andy own all 120,000 outstanding shares of Southern Enterprises while Dan

and Derek own all 25,000 shares of Northern Industries. An agreement was recently reached whereby Southern Enterprises will issue 40,000 new shares of stock in exchange for all 25,000 shares of Northern Industries. Identify the owners and their percentage ownership of each company immediately after the transaction.

Answer:

Company	Shareholders		Percentage
Southern	John and Andy	120,000/160,000 =	75%
	Dan and Derek	40,000/160,000 =	25%
Northern	Southern		100%

131. (10 Points) moderate
Johnstone Baby Supplies is in the process of acquiring Altez Baby Bottle Company. Altez is a relatively new company and its income has fluctuated substantially from period to period. Altez's owners are concerned that they will not receive adequate compensation for their stock because of this fluctuation. The current stock for stock exchange ratio being considered is that each share of Altez stock, par value $1 and market value $15, would be exchanged for .6 shares of Johnstone stock, par value $.50 and market value $25. Currently 50,000 shares of Altez stock are outstanding. The owners of Altez have proposed that the exchange ratio be increased from .6 to .75 share of Johnstone for each share of Altez if the net income of Altez increases next year by more than 25 percent above last year. Assuming the market prices of the stock do not change, determine the amount of the investment account to be recorded on Johnstone's books assuming that:
a. The net income increase does not occur
b. The net income increase does occur

Answer:
a. 50,000 shares x .6 x $25 = $750,000
b. 50,000 shares x .75 x $25 = $937,500

132. (10 Points) easy
Management of McAfee and Montego are discussing a possible merger. The current agreement is for McAfee to gain control of Montego by exchanging .75 of its shares for each Montego share. McAfee stock is trading at $40 per share (near the top of its 52-week range) while Montego is trading at $27. The concern is that the McAfee's stock price fluctuates significantly more than Montego's stock price. Montego's management is willing to endorse the proposed merger if the agreement is modified to include the clause that the exchange ratio will increase by .1 share for every $2 that McAfee's stock value falls below $40 at the exchange date. Montego's management is unwilling to accept a decrease in the exchange ratio if the stock price of McAfee increases. Montego currently has 100,000 shares of stock outstanding. What is the amount of the investment recognized by McAfee if its stock price:
a. Remains at $40
b. Decreases to $34
c. Increases to $44

Answer:
a. 100,000 shares x .75 x $3,000,000
b. $3,000,000
c. $3,000,000
The investment does not change as a result of a change in the acquirer stock price. The increase in the number of shares replaces the value that is lost due to the decrease in the share price. The change in par value that must be recorded is offset by an adjustment in the Additional Paid-in Capital account.

Short Answer Questions

133. Compare and contrast internal versus external business expansion.

Answer: Internal expansion results from changes within the entity. It is often the result of an entity undertaking research and development activities that culminate in the development and marketing of new products. It can also be the expansion of the company geographically by entering new markets with existing products. External business 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. In general, internal expansion is brought about by changes within an entity while the combining of two entities brings about external expansion.

134. Internal expansion is viewed as often being a slower process than external expansion. What are some of the reasons for this perception?

Answer: Internal expansion is often a slow process because the entity may have to develop a distribution system, generate demand for its new product, and/or build new production facilities to support new products or expanding sales.

135. Alice Baker and Kathy Reed are co-owners of a profitable local business. The owners have decided that they have as much market share in the local market as they are likely to attain. As a result, the owners are considering expanding their business geographically. Alice wants to buy a company in a nearby town but Kathy is opposed to that strategy. She indicates that there is no reason to buy someone else when we can buy a building and set up operations in the other town. You have been asked to prepare a report for Alice and Kathy explaining the advantages and disadvantages of external expansion. Prepare a list of the topics that could be included in the report. A complete writing of the report is not necessary.

Answer: Advantages will include more rapid expansion, established management, does not increase total supply of goods, greater market share, positive reputation of existing company. Disadvantages include defensive measures, negative reputation of existing company, corporate culture clash.

136. You are a financial advisor to a local corporation. The three primary stockholders in the corporation (Frank Phillips, Jim Wright, and Fred Bailey) are also the corporate officers.

The corporation is considering expanding. Frank is interested in expanding internally while Jim favors expanding externally. Fred has no strong opinion on this issue. Frank and Jim have been trying to influence Fred because he is the deciding vote on this issue. Prepare a memo to Fred outlining some of the advantages of external expansion.
Answer: Discussion may include the following:

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 size 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, and
9. Diversification accomplished through combinations may provide a less volatile income stream. This reduces the risk level of the entity that, in turn, lowers borrowing rates.

137. Assume a company primarily produces and sells a single product. This company is considering expanding geographically. Discuss the difference between internal and external expansion with regard to the total industry supply of, and demand for, the product sold by the expanding company.

Answer: Internal expansion results when a company increases its ability to produce output by acquiring additional facilities resulting in an overall increase in the supply of the product. External expansion results when a company attains control over the net assets of another company. The total productive capacity of the industry does not change because new productive assets are not added. The only change is in the ownership of existing productive assets. Neither internal nor external expansion has an impact on demand for the product.

138. Discuss the similarities 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.

Answer: 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 new entity produces input for another part of the new entity.

139. Sarah Clammers, a client, is reading newspaper articles on two of the companies in which stock are held. Some of the terms used in the articles are horizontal combination and vertical combination. Sarah understands the definition of horizontal and vertical but does not know what the terms mean in this context. Prepare a brief memo to differentiate these terms for Sarah.

Answer: A horizontal combination occurs when a company acquires a competitor in the same industry. A vertical combination occurs when a company acquires an entity that either provides production inputs or acquires the production output of the company.

140. You are making a presentation to a board of directors. Part of the presentation is a discussion of a business combination as a means of expansion. One issue that has been addressed is horizontal combinations. One board member has asked for a clarification of the advantages of horizontal business combinations as compared to other forms of business combinations. Prepare a response to this board member.

Answer: Horizontal combinations exist when an entity acquires a competitor. The result of such a combination is an increase in market share. A horizontal combination may result in greater control over the product's selling price because of the increased market share. This type of combination can also lead to economies of scale and a reduction in the number of persons needed to supply some support activities. Other types of combinations (vertical or conglomerate) may result in management being required to oversee the activities of business in which they do not have expertise.

141. You are making a presentation to a board of directors. Part of the presentation is a discussion of a business combination as a means of expansion. One issue that has been addressed is vertical combinations. One board member has asked for a clarification of the advantages of vertical business combinations as compared to other forms of business combinations. Prepare a response to this board member.

Answer: A vertical business combination occurs when an entity purchases a supplier of inputs or a purchaser of outputs. This type of business combination helps the company to improve the efficiency of operations. Management of the company has better control over the products from acquisition of raw materials, through manufacturing and distribution, to final sale to customers. Other types of business combinations (horizontal and conglomerate) leave other entities in control of more aspects of production and distribution.

142. You are making a presentation to a board of directors. Part of the presentation is a discussion of a business combination as a means of expansion. An issue that has been addressed is conglomerate combinations. One board member has asked for a clarification of the advantages of conglomerate business combinations as compared to other forms of business combinations. Prepare a response to this board member.

Answer: A conglomerate form of business combination occurs when one entity acquires a company in unrelated or tangentially related businesses. Conglomerate combinations have two general advantages over other types of combinations (horizontal and vertical). Conglomerate combinations help improve income stability provided by diversifying the asset base of an entity. Another advantage is that it has been considerably more difficult for the government to challenge a conglomerate business combination on the basis of antitrust regulations.

143. Discuss the reason the Sherman Act was not sufficient to address the problems that exist as a result of business combinations.

Answer: The Sherman Act of 1890 only permits the government to break up a company after the government has proven that the company has restrained free trade. It does not give the government the power to prevent the creation of a company that would endanger free trade.

144. Discuss how the Clayton Act broadens the government's ability to oversee business combinations as compared to the Sherman Act.

Answer: The Clayton Act can prevent a business combination from taking place if the anticipated result is a lessening of competition or the creation of a monopoly while the Sherman Act only permits the government to break up a company after the government has proven that the company restrained free trade.

145. The Wall Street Journal has articles almost daily in which business combinations are announced. How can there be so many business combinations when the Federal Trade Commission assesses the impact of proposed combinations on such issues as industry concentration, barriers to entry, and restriction of trade?

Answer: 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.

146. Richard, a friend, was reading in the newspaper about an attempted takeover that did not succeed. The reason given for the acquirer stopping the acquisition was that greenmail was paid. Richard does not understand the meaning of the term greenmail. Prepare a brief note to Richard explaining this concept.

Answer: Greenmail exists when the potential acquiree management buys acquiree stock back from a potential acquirer for a price above the price paid by the potential acquirer.

147. A poison pill is one maneuver an entity can employ to avoid a takeover attempt. Explain how a poison pill can accomplish this objective and discuss the major potential problem with undertaking this maneuver.

Answer: A poison pill involves the issuance of preferred stock that is convertible into common stock of the unwanted acquirer allowing preferred stockholders to regain control by converting into common stock. The problem is that it can deter friendly acquirers as well as hostile acquirers.

148. Your company is attempting to take over another entity. One of the board members has suggested that the target may attempt to sell the crown jewels or undertake a scorched earth defense. Another board member is unaware of the meaning of these terms and has requested your input. Prepare a brief memo outlining the similarities and differences between the two concepts.

Answer: The sale of the crown jewels and the scorched earth defense both result in the target company selling some of its assets. The difference is in the amount of assets sold and how selective the target is in determining which assets to sell. The sale of the crown jewels results when a target sells assets that would be particularly valuable to the potential acquirer. The scorched earth defense results when a target generally sells large amounts of assets without regard to the specific desirability to the potential acquirer. In both instances, the target's objective is to reduce its overall value thereby reducing the potential acquirer interest.

149. Your company is in a takeover struggle with a larger company. Management has determined that either a scorched earth defense or a fatman defense would most likely be successful in thwarting the takeover attempt. The CEO has asked for your input. Prepare a memo outlining the differences between the two measures.

Answer: The scorched earth defense involves a broad-based sale of assets. The proceeds are distributed to stockholders reducing the potential acquiree value. The fatman defense results in the acquisition of poorly performing assets. The potential acquiree value is reduced due to the poor performance of the newly acquired assets.

150. You serve on the board of directors of a large company. A topic of discussion at a recent meeting is the acquisition of another entity. One board member stated that the company

should purchase 49 percent of the other entity so we would not have to consolidate the acquiree into our financial statements. Prepare a note to respond to the board member.

Answer: The control of another entity's assets and operations is the determining factor in deciding whether consolidated financial statements are required. Purchasing 49 percent would likely result in control unless the other 51 percent is owned by one or a small number of stockholders.

151. The Board of Directors of Mesa, Incorporated is discussing the acquisition of a competitor. One board member is new and has asked for an explanation of the difference between acquiring all the net assets and acquiring all the stock of the other company. The CFO has asked you to respond to this question.

Answer: From an economic perspective there is no difference between acquiring all of the net assets and acquiring all of the stock. Mesa still has control over all the assets. The difference that exists pertains to the preparation of the financial statements. If Mesa acquires all the net assets, there is only one economic entity, so consolidation is not needed. If Mesa acquires all the stock, there are two legal entities and the consolidation process is used to prepare the financial statements. The financial statements will appear the same regardless of the manner in which the other company is acquired.

152. Discuss how a business combination accomplished with an exchange of assets for assets differs from an exchange of stock (acquirer) for assets (acquiree) from the perspective of the acquirer. Then, discuss the differences from the acquiree perspective.

Answer: From the acquirer perspective, the asset for asset acquisition results in no change to the net assets and liabilities although the composition of the assets will change. The exchange of stock for assets results in an increase in acquirer's net equity and assets. From the acquiree perspective, there is a change in the assets owned. Subsequent to the asset for asset exchange, the acquiree assets owned are likely cash or receivables but subsequent to the stock for asset exchange the resulting asset owned is an investment in the acquirer.

153. Jim and Fred are two managers in Clippers Corporation. They are discussing a combination being planned. Jim states that the other entity (Heads R Us) is being taken over by Clippers because Clippers' stock is being issued for Heads R Us stock. Fred says that he has been reading the paper, and it sounds to him as if Heads R Us is taking over Clippers. In fact, Fred had an article on his desk that contained the following statement by the board of directors of Heads R Us, "The synergy that exists between Clippers and Heads R Us will make Clippers a welcome addition to our corporate family." Jim and Fred have asked you to clarify their confusion.

Answer: While the company issuing new shares is normally the acquirer, the stock issued does not always determine the stockholder group that controls the consolidated entity after a combination is completed. Control depends on the stock exchange ratio. The party owning the greater portion of the outstanding stock after the combination is the

controlling entity. For example, if Clippers has 10,000 shares outstanding prior to the combination, but has to issue 20,000 shares of voting common to the stockholders of Heads R Us to complete the transaction, then the acquirer is Heads R Us.

154. Ken Sanders has been a classmate of yours for some time. He has come to you with this question. "Any time a new corporate entity is formed, it begins with zero Retained Earnings. Why is there a balance in Retained Earnings as soon as an corporate entity is formed in a statutory consolidation?" Prepare a response to Ken's question.

<u>Answer</u>: The establishment of a new corporate shell is a matter of legal form. In reality, the larger corporation is taking control of the smaller corporation, so the Retained Earnings of the larger corporation is carried forward to the new entity's balance sheet.

155. Mary Brian is a board member for Big Hats, a company completing an acquisition. The acquiree, Sombrero Incorporated, is being purchased with stock of Big Hats. The agreement states that Big Hats will issue 5,000 additional shares of stock if Sombrero's income exceeds $2,000,000 for the most recent year. Mary has indicated 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 Mary? Support your answer.

<u>Answer</u>: You should not agree with Mary. The additional number of shares of stock issued is a result in a change in the perceived value of Sombrero because of its additional contribution to consolidated net income. The total value of the stock being distributed is not a result of a change in the value of the stock, it is a result of a change in the value of the acquiree. Thus, the acquisition cost would increase.

156. Management has asked you to provide input on how to structure a business combination so it will result in a tax deferred exchange. Prepare a memo indicating the three basic criteria that must be met to accomplish this objective.

<u>Answer</u>: The answer will include the following:

1. The acquiree's owners must continue to have an indirect ownership in the acquiree.
2. The acquirer must continue acquiree business or employ a significant portion of the acquiree net assets in an ongoing business.
3. The combination must occur for a valid business purpose.

157. When a business combination does not qualify as a tax deferred exchange, the acquirer is not permitted to take advantage of the acquiree net operating loss carryforward. Given that the two companies are now one company, why is the net operating loss carryforward not transferred to the acquirer?

<u>Answer</u>: If the business combination does not qualify as a tax deferred exchange, the acquirer has purchased the acquiree. It is not possible to purchase tax aspects of an entity.

As a result, an acquiree’s net operating loss carryforward does not transfer to the acquirer in a combination that does not qualify as a tax deferred exchange.