Accounting for Acquisitions - Goodwill Explained

When a firm purchases a company in total, meaning it purchases 100% of the common stock, then it is buying all of the assets and assuming all of the liabilities of the target firm (the firm being acquired).

In essence the firm is paying the FAIR MARKET VALUE or FMV (the Price Paid, usually in cash) for the firm's Net Assets, to the selling shareholders, in return for their stock. Since Net Assets = Shareholders' Equity, the acquiring firm is paying the FMV of Equity in the company, which will almost always be different from, and higher than, the book value of the Equity in the target firm.

Since we are taking the ***Financial Perspective*** in this transaction, the acquiring firm will take the target firm's Assets and Liabilities onto its balance sheet at Market Value (MV), not the book value shown on the target firm's balance sheet.

If there is a difference between the Market Value of the Net Assets, or the MV of the Assets minus the MV of the Liabilities, and the Price Paid, then the difference is recorded on the acquiring firm's books as ***Goodwill.***

Goodwill = Price paid – MV of Target firm Equity
= Price paid – MV of Target firm's Net Assets
= Price Paid – (MV of target assets – MV of target Liabilities)

	Acquiring Company Balance Sheet	Target Company Balance Sheet			Consolidated (Combined) Balance Sheet		
	Pre-Acquistion	**Pre-Acquistion *Book Value***	**Pre-Acquisition *Market Value***		**Post-Acquisition**		**Post-Acquistion with Goodwill**
ASSETS							
Cash	500	500	500		500		500
A/R	200	100	80	Quality issues	280		280
Inventory	300	100	50	Obsolete Inv.	350		350
Prepaids	100	0	0		100		100
Total Curr. Assets	1100	700	630		1230		1230
Capital Assets	1000	700	800	Incr. in Value	1800		1800
Intangibles					0		0
Trademarks and Patents	100	100	150	Incr. in Value	250		250
Goodwill	0	0	0		0		**220**
Total Capital Assets	1100	800	950		2050		2270
TOTAL ASSETS	**2200**	**1500**	**1580**	**MV of Assets**	**3280**		**3500**
LIABILITIES							
A/P	250	200	200		450		450
Bank Loan	350	300	300		650	Note the difference of $220	650
L.T. Debt	1000	800	800	**MV of Liabilities**	1800		1800
TOTAL LIABILITIES	**1600**	**1300**	**1300**		**2900**		**2900**
SH EQUITY	**600**	**200**	**280**	***Net Assets* @ MV**	**600**		**600**
TOTAL LIABILITIES & EQUITY	**2200**	**1500**	**1580**		**3500**		**3500**

Purchases the company at right for $500

Note that the company being bought has only $200 in Equity or "Net Assets"

Taking the financial perspective we see that some of the assets are actually worth different values than shown in the target company's books (the book value). This market value is what is used to determine if any goodwill is created by the transaction.

In this case, the acquiring firm is paying $500 for $280 of Net Assets. This creates $220 of Goodwill on that firm's balance sheet.