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Chapter 3 Business Combinations

A brief description of the major points covered in each case and problem.

CASES

Case 3-1

Management of the parent company wants to compare the consolidated balance sheet under two methods of reporting a 100%-owned subsidiary and wants to know why fair value is not always used for all companies and which method best reflects the economic reality of the business combination.

Case 3-2

Two companies have agreed to form a third company that will issue shares for each company's net assets. A report is required that discusses the accounting implications.

Case 3-3 (adapted from case prepared by J. C. (Jan) Thatcher of Lakehead University, and Margaret Forbes formerly of the University of Saskatchewan)

This case involves a share exchange between two companies where the shareholders of the combining companies will each own 50 percent of the shares of the combined company. The student has to adopt the role of an accounting adviser to the board of directors, and prepare a report explaining the accounting required for the share acquisition and the amounts that will appear on the balance sheet for certain assets.

Case 3-4 (prepared by Peter Secord, Saint Mary's University)

The merger of Conoco Inc. and Gulf Canada Resources Limited presented many problems with allocating the acquisition cost to a wide variety of tangible and intangible assets associated with companies in the oil and gas industry. Students are required to discuss the valuation problems resulting from this merger.

Case 3-5

This case, adapted from a CGA exam, involves the purchase of net assets of a small start-up company with a cash down payment and annual payments for 3 years. The student must prepare a PowerPoint presentation to explain the accounting implications of the business combination.

Case 3-6

This case, adapted from a past UFE, involves the merger of two publishing companies and the restructuring that followed soon thereafter. There are some revenue and expense recognition issues. Students are also expected to provide advice on how to improve the financial situation for the company.

Case 3-7

This case, adapted from a past UFE, involves the acquisition of a company by issuing shares which declined in value between the announcement of the acquisition and the acquisition date. Other issues include revenue recognition, stock options and impairment of intangible assets. Students are also expected to provide advice on whether the acquisition fits with the company's business strategy.

PROBLEMS

Problem 3-1 (30 min.)

Preparation of the journal entries and balance sheets on the date of acquisition for both the purchaser and seller in a purchase-of-net assets business combination.

Problem 3-2 (25 min.)

Determination of balances in specified accounts for the separate entity financial statements of the parent and subsidiary and the parent's consolidated financial statements.

Problem 3-3 (60 min.)

Preparation of a consolidated balance sheet under the acquisition and new entity methods. The question also asks the student to calculate the resulting current and debt/equity ratios under each method and describe which method shows the stronger liquidity and solvency positions. Also required is the preparation of a consolidated worksheet under the acquisition method.

Problem 3-4 (25 min.)

Three companies agree to merge. The preparation of a balance sheet immediately after the merger is required.

Problem 3-5 (25 min.)

Journal entries and preparation of a statement of financial position are required for a purchase-of-net-assets type of business combination where the method of payment is either cash or a common share issue.

Problem 3-6 (20 min.)

This problem requires the preparation of a statement of financial position immediately after the statutory amalgamation of two companies. Part of the acquisition cost needs to be allocated to an unrecorded patent.

Problem 3-7 (60 min.)

This problem requires the preparation of a consolidated balance sheet and a separate-entity balance where the parent uses the equity method immediately after a business combination. Part of the acquisition cost needs to be allocated to unrecorded customer service contracts. It also requires the calculation of the debt-to-equity ratio for both balance sheets and an explanation as to which balance sheet best reflects the company's solvency position. Also, preparation of a consolidated balance sheet using the worksheet approach.

Problem 3-8 (20 min.)

Two companies agree to merge whereby one will issue shares to acquire the net assets of the other. A balance sheet using the acquisition method is required. Part of the acquisition cost needs to be allocated to a favourable lease arrangement.

Problem 3-9 (30 min.)

A journal entry and the preparation of a consolidated balance sheet are required after one company acquires 100% of the shares of another company under 2 scenarios: a cash purchase versus the issuance of shares to pay for the acquisition. The student needs to determine whether part of the acquisition cost should be allocated to the subsidiary's assembled workforce. Then, a journal entry and the preparation of a balance sheet are required if the parent uses the cost method under ASPE.

Problem 3-10 (25 min.)
Preparation of a statement of financial position after a business combination involving the acquisition of net assets of two companies. The problem also requires the statements of financial position of the two companies after they have sold all of their assets and liabilities.

Problem 3-11 (30 min.)
Two alternatives are presented under which one company acquires all of the net assets of another company either by paying cash or by issuing shares. The question requires journal entries for the combination and a balance sheet after the combination for each alternative.

Problem 3-12 (30 min.)
Exactly the same facts as Problem 9 except that the shares are acquired instead of net assets.

Problem 3-13 (30 min.)
This question requires the calculation of consolidated net income and consolidated balances for selected balance sheet accounts at the date of acquisition.

Problem 3-14 (20 min.)
Intercorporate investments involving three companies are outlined and the student is required to discuss the accounting treatment for the various types of investments.

Problem 3-15 (40 min.)
Preparation of a consolidated balance sheet in a reverse takeover situation is required.

SOLUTIONS TO REVIEW QUESTIONS

1. The key element that must be present in a business combination is one company gaining control of another business.

2. A statutory amalgamation is a legal form of a business combination, whereby only one of the companies involved survives. Therefore, it is really a purchase of net assets with voting shares as the means of payment.

3. If the means of payment is cash, the company that makes the payment is identified as the acquirer. If the means of payment is the issue of shares, an examination is made as to the extent of the shareholdings of two distinct groups of shareholders. If the shareholders of one of the combining companies as a group hold greater than 50% of the voting shares of the combined company, that company is identified as the acquirer. When an acquirer cannot be determined in this manner, an additional examination is made of the composition of the board of directors and the management of the combined company to determine who has the current ability to direct the activities that most significantly affect the returns of the investee has power over the investee. Often (but not always) the acquirer is the larger company, and the company that issues the shares.

4. Acquisition cost consists of the sum of the cash paid, the present value of any debt instruments issued, the fair value of any shares issued, and the fair value of any contingent consideration if determinable. This total acquisition cost is compared with the fair value of the identifiable assets less the fair value of the identifiable liabilities of the acquired company. If the acquisition cost is greater than the fair value of the identifiable net assets acquired, the excess is recorded as goodwill. If the acquisition cost is less than the fair value of the identifiable net assets acquired, the result is negative goodwill, which is recognized as a gain on purchase. The balance sheet immediately after the business combination consists of the carrying amount of the assets and liabilities of the acquiring company, plus the carrying amount of the assets and liabilities of the acquired company, plus the acquirer's share of the excess of the fair values of the assets and liabilities of the acquired company over their related carrying amount, plus any goodwill that arose on the combination. Shareholders' equity is that of the acquirer. Subsequent net income consists of the acquirer's net income plus the acquirer's share of the net income of the acquiree earned since acquisition date, subject to some adjustments (for the amortization of the acquisition differential.)

5. Under the new entity method, the net assets of both the acquirer and acquiree are brought into the combination at their fair values. The justification for this treatment is that a new entity has been created and fair value is the most appropriate representation for the new entity.

6. If the other company is allowed to continue as a single shareholder of the issuing company, it may be in a position to dominate. When this other company is wound up, the shares of the issuing company are distributed to the shareholders of this other company, and domination by one or two shareholders is thus less likely.

7. For a subsidiary to be consolidated, the parent must control the subsidiary. An investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.

8. A parent may have control of a subsidiary without having greater than 50% of the voting shares when it holds irrevocable agreements, convertible securities, and/or warrants, which give the parent the power to direct the activities that most significantly affect the returns of the subsidiary.

9. An acquisition differential is the difference between total consideration given by the parent and non-controlling interest, if any, and the carrying amounts of the net assets and liabilities of its subsidiary. It does not appear on the consolidated balance sheet as a single amount, but rather is distributed to individual identifiable assets and liabilities of the subsidiary so that these assets and liabilities are measured at fair value, and any positive remaining balance is reflected as goodwill. Negative balances remaining are recognized on the income statement as gains on the date of acquisition.

10. The acquisition cost is often greater than the carrying amount of the acquiree's assets and liabilities for two reasons. First, the fair value of the acquiree's identifiable assets is often greater than the carrying amounts, especially when the assets are reported by the acquiree at historical cost. Secondly, the acquiree may have an additional value over and above the fair value of its identifiable net assets because of its earnings potential. This additional value is referred to as goodwill. Like many other assets, goodwill is recognized at cost when it is purchased. It is not recognized as it is developed.

11. Goodwill is the excess of the total consideration given by the parent and non-controlling interest, if any, over the fair value of the identifiable net assets. Goodwill represents the amount paid for excess earnings power due to reputation and employee workforce, etc.

12. An intangible asset should be recognized apart from goodwill when it either meets the contractual-legal criterion or the separability criterion. That is:

(a) the asset results from contractual or other legal rights (regardless of whether those rights are transferable or separable from the acquired enterprise or from other rights and obligations); or

(b) the asset is capable of being separated or divided from the acquired enterprise and sold, transferred, licensed, rented, or exchanged (regardless of whether there is an intent to do so). Otherwise, it should be included in the amount recognized as goodwill.

13. Fair value reporting takes precedence over the historical cost principle when reporting the subsidiary's identifiable assets and liabilities under the acquisition method because those assets and liabilities are reported at their fair values regardless of the amount paid by the parent.

14. Separate financial statements are separate-entity financial statements of the parent that do not include the consolidation of all controlled subsidiaries. A parent may present separate financial statements if:

1. the parent itself is a wholly or partially owned subsidiary of another entity and that entity consents to having separate financial statements presented;
2. the parent's debt/equity instruments are not traded in any public market;
3. the parent did not, or is not in the process of, filing financial statements with any exchange commission for the purpose of raising funds publicly; and
4. the ultimate or intermediate parent of the parent produces financial statements that are publicly available and prepared in accordance with IFRS.

15. Protective rights are rights granted to an individual or entity to protect their interest in an entity without granting them control. For example, a stakeholder might be granted the right to veto certain decisions that do not affect the current ability to direct the activities that most significantly affect the returns of the other entity. Similarly, a creditor for example may be granted the right to remove management and/or the Board of Directors in the event that the entity has entered bankruptcy. Any right granted to a stakeholder must be evaluated to determine the extent to which it may give that stakeholder control over the entity. Although protective rights are not intended to grant control in the entity to which the rights relate, they must be evaluated to determine whether or not they give the holder the power to direct the activities that most significantly affect the returns of the other entity. To the extent that they do, they may indeed result in control. Alternatively, they may give the holder significant influence over the strategic operating and financing decisions of the entity. In any case, it is always important to take into consideration any rights, contractual or otherwise, that may impact the decision making of an entity when determining which party controls that entity.

16. No. If the subsidiary used push-down accounting, the fair value differences would be recorded in the records of the subsidiary as at the date of acquisition. Consolidation would then be the simple procedure of combining like items from the parent's and subsidiary's statements.

17. IFRS requires that a parent consolidate its subsidiaries. Under ASPE, an enterprise shall make an accounting policy choice to either consolidate its subsidiaries or report its subsidiaries using either the equity method or the cost method. All subsidiaries should be reported using the same method. When a subsidiary's equity securities are quoted in an active market and the parent would normally choose to use the cost method, the investment should not be reported at cost. Under such circumstances, the investment should be reported at fair value, with changes in fair value reported in net income.

IFRS does not allow push-down accounting. ASPE allows push-down accounting, but the entity must disclose the amount of the change in each major class of assets, liabilities, and shareholders' equity in the year that push-down accounting is first applied.

18. A reverse takeover occurs when one company acquires the shares of another company by issuing enough of its own shares as payment so that the shareholders of the other company end up being in control of the combined company. It is often used by a non-public company as a device to obtain a stock exchange listing without having to go through the formalities of an exchange's listing procedures. A takeover of a public company is arranged in such a way that the public company being taken over becomes the legal parent while the non-public company is the parent in substance.

19. A Company issues shares to acquire B Company such that the shareholders of B Company end up holding the majority of the shares of A Company (for example, 75%). Because B Company is the deemed acquirer, the acquisition cost is determined as if B Company had issued shares to the shareholders of A Company. A calculation is made to determine how many shares B Company would have had to issue so that its existing shareholders would end up holding 75% of its outstanding shares. This calculated number, multiplied by the fair value of B Company's shares, becomes the acquisition cost.

SOLUTIONS TO CASES

Case 3-1

Note to Instructors: There is no right answer to the last question of the case i.e. which method best reflects economic reality. In the author's opinion, fair value is a better measure of economic reality. However, other people may feel the acquisition method best reflects economic reality.

The balance sheet at the date of acquisition under the two different reporting methods would be as follows (in 000s):

	Acquisition	**New-Entity**
Identifiable assets	\$660[1]	\$760[2]
Goodwill	140[3]	340[4]
	\$800	\$1,100
Liabilities	\$468[5]	\$488[6]
Shareholders' equity	332[7]	612[8]
	\$800	\$1,100
Debt to equity ratio	1.41:1	0.80:1

Notes:

1) 400 + 260
2) 500 + 260
3) 0 + 140
4) 200 + 140
5) 300 + 168
6) 320 + 168
7) 100 + 232
8) 380 + 232

The acquisition method is a hybrid of historical cost accounting and fair value accounting. At the date of acquisition, the historical cost principle is applied when measuring the parent's net assets at their carrying amount. The subsidiary's identifiable net assets are measured at fair value at the date of acquisition regardless of the amount that the parent paid for these identifiable net assets. Fair value accounting is applied for the subsidiary because fair value is a more relevant measure. Furthermore, the cost of obtaining the fair value information is not very high because the information is fairly readily available due to the extensive amount of work done by the parent in determining what price to pay for the subsidiary. The values assigned to the net assets at the date of acquisition are the deemed cost for future reporting. Subsequent to the date to acquisition, the normal measurement basis is applied to these assets and liabilities. Some assets will be reported at fair value and some at historical cost. We do not use fair value for all assets subsequent because the cost of remeasuring every year is quite expensive and not worth it from a cost-benefit point of view.

The new entity method presents the fair value of the identifiable net assets plus the cost of goodwill for both entities at the date of acquisition. Many people believe that fair value is a better reflection of economic reality. However, if we were to revalue both companies at fair value at the date of acquisition, we would be violating the historical cost principle which is a long standing tradition of our accounting model.

The debt to equity ratio is significantly different under the two methods. The ratio is greater under the acquisition method because the parent's net assets are not re-measured to fair value. Once again, the new entity method probably better reflects the risk associated with the level of debt being carried by the two entities because it reflects the fair value of identifiable net assets plus a value for goodwill for both entities. Since goodwill cannot be sold separately, it cannot readily be used to pay off debt. However, if an entire business including its goodwill is sold, then goodwill does have some value in paying off debt.

Case 3-2

Basic outline of the contents of the report would be as follows:

1. The acquisition method will have to be used to account for this merger, and one of the companies involved will have to be identified as the acquirer.

2. The shares issued by AB Ltd. will end up in the hands of the shareholders of Atlas Inc. and Beta Corp. The company whose shareholders own the largest number of shares will be identified as the acquirer. In determining the number of shares held by the shareholders of Atlas, it will be necessary to take into account the common shares that will be issued as a result of the conversion of the preferred shares. If each group holds an identical number of shares, the makeup of the board of directors and top management of AB Ltd. will have to be examined to see if an acquirer can be identified. Domination by one company would indicate the acquirer. If this analysis is inconclusive, the existence of the veto rights with respect to the patents would be a factor in favour of control by the shareholders of Atlas. This would need to be taken into consideration along with other relevant factors. In the absence of a conclusion resulting from this analysis, the larger company would then be declared the acquirer. All of these problems could be avoided if the number of shares issued to each company were not equal.

3. The assets and liabilities appearing on the balance sheet of AB Ltd., on the date of the merger, will be the result of the combining of the assets and liabilities of Atlas Inc. and Beta Corp.

4. The combination will use the carrying amount of the net assets of acquirer, and the fair value of the net assets of the other company.

5. In a combination where one company (the acquirer) issues shares to acquire the net assets of another company, the acquisition cost is compared with the fair value of the other company's net assets and the difference is either positive or negative goodwill. The acquisition cost is determined by multiplying the number of shares issued by their value (which would be determined by examining their market price before and after the combination). Direct costs incurred in the combination (consultant, legal, and accounting fees) would be expensed.

6. In this case the acquisition cost may be difficult to determine because a new company is being formed to purchase the net assets of the two companies that are part of the merger. If Atlas and Beta are public companies and AB Ltd. is to continue as a public company, the market price of its shares in a period after the merger would have to be used to determine the acquisition cost. If Atlas and Beta were both private companies, presumably AB Ltd. would also be private, and the acquisition cost would be almost impossible to determine with any degree of reliability.

7. When the acquisition cost cannot be determined, no goodwill can be reported. The number of shares issued to the company identified as the acquirer will be measured at the carrying amount of that company's net assets. The number of shares issued to the acquiree will be valued at the fair value of that company's net assets.

Case 3-3

(adapted from case prepared by J. C. (Jan) Thatcher of Lakehead University, and Margaret Forbes formerly of the University of Saskatchewan)

Report to: Board of Directors
From: Accounting Adviser
Regarding: Proposed Business Combination of PG and MPM

The Board has proposed that PG issue 100,000 common shares in a two-for-one exchange for all outstanding shares of MPM. You have asked me to provide some insight into how this exchange of shares will be reported on PG's financial statements.

This combination will have to be accounted for using the acquisition method. In order to do so, an acquirer will have to be identified. Normally this is fairly easy to do. For example, when shares are purchased for cash in a business combination, the company paying cash is the acquirer. However, if shares are exchanged we have to examine the holding of the two shareholder groups to see if an acquirer can be identified in this manner. In this case, both groups will hold exactly 50% of the shares of PG and therefore no clear acquirer is identified. IFRS requires that an acquirer must be identified because the net assets of the acquiree are measured at fair value. It can be justifiably argued that PG is the acquirer for the following reasons:

1. Paul Parker, the sole shareholder of MPM, intends to retire. Therefore, although he will own 50% of PG, he probably will not take an active role in the day-to-day affairs of the company.
2. PG seems to be the largest company, which often is an indicator of an acquirer.
3. PG is the company that is issuing shares, which also is often an indicator of an acquirer.

Because PG is viewed as the acquirer, the fair value of the net assets of MPM will be combined with the carrying amount of the net assets of PG. This means the land would be reported at $6,000,000 rather than $1,000,000. The consolidated financial statements at the date of the combination would appear as follows:

Current assets (870,000 + 450,000)	$1,320,000
Property, plant & equipment (8,210,000 + 2,050,000 + **(b) 5,000,000**)	15,260,000
Goodwill **(c)**	500,000
	$17,080,000
Current liabilities (525,000 + 200,000)	$725,000
Long-term debt (2,325,000 + 1,300,000)	3,625,000
Common shares (4,000,000 + **(a) 6,500,000)**	10,500,000

Retained earnings	2,230,000
	$17,080,000

In the event that Paul Parker is appointed as the chairman of the Board of PG, it could be argued that the business combination could be viewed as a reverse takeover. PG's net assets would be measured at fair value and MPM's net assets would be measured at carrying amount. MPM's land would be measured at $1,000,000. Goodwill, if any, would be PG's goodwill. Shareholders' equity would be MPM's shareholders' equity plus the fair value attributed to 100 percent of PG's outstanding shares.

SUPPORTING CALCULATIONS:

Acquisition cost (100,000 shares x 65)		$6,500,000	**(a)**
Carrying value of shareholders' equity			
Common shares	$500,000		
Retained earnings	$500,000	1,000,000	
Acquisition differential		5,500,000	
Fair value excess for land (6,000,000 –1,000,000)		5,000,000	**(b)**
Goodwill		$500,000	**(c)**

Case 3-4

(adapted from case prepared by Peter Secord, Saint Mary's University)

Under the provisions of *IFRS 3*, Conoco should measure the net assets as follows:

(a) all identifiable assets acquired and liabilities assumed in a business combination, whether or not recognized in the financial statements of the acquired enterprise, except goodwill and future income taxes recognized by an acquired enterprise before its acquisition, should be measured at their fair values at the date of acquisition*; and

(b) the excess of the acquisition cost over the net of the amounts assigned to identifiable assets acquired and liabilities assumed should be recognized as an asset referred to as goodwill.

* Some assets are required by other IFRSs to be reported at an amount other than their fair value. The relevant standards (IAS 12, IAS 19, IFRS 2, and IFRS 5) outline how such assets are to be measured.

Conoco will have to identify all the assets and liabilities of Gulf Canada Ltd. as a part of this process. This includes not only the recorded assets but also a variety of unrecorded assets, both tangible and intangible.

The first issue is identification of those assets that must be recorded. The list of assets in the case provides an indication of their very diverse nature. Included are proven and probable reserves of oil and natural gas.

IFRS 3 provides that identifiable assets and liabilities should be valued using appropriate valuation techniques when active market prices are not available. Discounting may be used when the value of an asset or liability is to be based on estimated future cash flows.

Using cash flows to value these reserves should take into account future prices for oil and gas and future costs to develop these reserves. The proven reserves will probably be easier to value than the unproven probable reserves. Recent acquisition prices might be useful in attaching a value to the undeveloped land.

The 72% interest in Gulf Indonesia Resources Limited results in another subsidiary that will have to be consolidated along with Gulf Canada Resources Limited. The first task is to identify and measure the recorded and unrecorded net assets of this company. The valuation problems just discussed will no doubt also apply to this company's assets.

The contractual relationships (such as the long-term natural gas sales contracts) should be valued on the basis of the present value of the associated net cash flows. These contracts should be recognized as intangible assets as per IFRS 3 paragraph B31. This paragraph states that an intangible asset should be recognized apart from goodwill when it meets either contractual-legal criterion or the separability criterion, that is:

> the asset results from contractual or other legal rights (regardless of whether those rights are transferable or separable from the acquired enterprise or from other rights and obligations); or
>
> the asset is capable of being separated or divided from the acquired enterprise and sold, transferred, licensed, rented, or exchanged (regardless of whether there is an intent to do so).

After measuring all of the identifiable net assets at fair value, the excess of the acquisition cost over the fair value of the identifiable net assets should be reported as goodwill acquired in the business combination.

Case 3-5

Slide #1

Speaker's Notes

Acquisition Cost

Immediate cash	$ 400,000
Present value of	
3 payments of	
$200,000 cash	315,420
Total acquisition cost	$ 915,420

- Cash of $400,000 is due up front
- PV of annuity for 3 years at $200,000 per year
  = $200,000 × 2.5771 = $515,420
- Use 8% discount rate = incremental borrowing rate
- Minimum price is $915,420
- $915,420 is cost. It must be used according to historical cost principle

Slide #2

Measurement of Assets & Liabilities

• Measure the identifiable assets and liabilities at their fair values

Current assets	$ 100,000
Computer equipment	70,000
Liabilities	- 20,000
Patent	765,420
Total acquisition cost	$ 915,420

- Regina bought the assets and assumed the liabilities
- Not yet a business since no processes established and no outputs
- Treat as a basket purchase of assets
- Must allocate acquisition cost to these identifiable net assets based on fair value
- Fair value is fairly objective for computer equipment
- Patent is most significant asset; most of acquisition cost could be allocated to it
- Goodwill cannot exist when not purchasing a business
- Arthur will not like the fact that nothing is allocated to goodwill

Slide #3

Period of Amortization

• Amortize over period of benefit

	Useful Life	**Physical/ Legal Life**
Computer	4	6
Patent	5	20

• Useful life is more reliable and relevant

- Must match to period of benefit according to matching principle
  Two options: useful life or physical/legal life
- Computer could last 10 years but likely will only be used for 2 to 4 years before it is traded due to obsolescence
- With rapid change in technology, 3 to 5 years is likely the maximum period of use for patents. By that time, someone is likely to come up with better technology to replace the Davin

technology

- Upper end of range is used for useful life to satisfy Arthur's request for minimum charge to income

Slide #4

Charge to Income for Year 15	
• Amortization of computer	$ 17,500
(35,000 / 4 years)	
• Patent	153,084
(765,420 / 5 years)	
•	
Total annual charge	$ 170,584

- We must capture reality to the best of our abilities
- You paid $915,420 for assets
- This is the true cost of using these assets in the first year, assuming an equal amount of benefit each year, that is, straight-line basis
- These expenses are the most optimistic because they use the longest period

A more conservative approach would be to use the lower end of the range in useful life

- Computer (70,000 / 2)=	$ 35,000
- Patent (765,420 / 3) =	255,140
Total	$290,140

Slide #5

Other Comments
• Consulting services to be expensed as services are provided
• Regina could adopt ASPE rather than IFRS unless it plans to go public

- Consulting services are not a cost of the acquisition.
- The services provide benefits as they are rendered. According to matching principle, these costs should be expensed over the period of benefit

Case 3-6

President
Planet Publishing Limited

Dear President,

Enclosed is the report that you requested discussing the accounting treatment that should be given to the merger of Space Communications Ltd. and Planet Publishing Limited and to the transactions since February 28, Year 3. It also deals with financial and professional issues arising from the merger or other recent events.

If you need any further information, please let us know.

Yours truly,

CPA

REPORT ON ISSUES RELATING TO PLANET PUBLISHING

Planet has experienced significant changes in its operating and financial structure. Planet's bank has made a $1 million demand loan and a $2 million term loan. In extending these loans, the bank has set up covenants that Planet must adhere to.

This report analyzes the accounting issues related to Planet Publishing Limited's (Planet) Year 4 financial statements. Planet will have to pay attention to its accounts receivable and inventory levels as well as its debt-to-equity level, as the bank will be using Planet's financial statements to assess the loans. TDC, Planet's main supplier of magazines, is now a creditor and receives financial statements. TDC will be trying to assess Planet's performance and cash flows. Planet has stated that it will be seeking private debt and equity capital. Therefore, potential investors will be relying on Planet's financial statements to evaluate Planet as an investment.

Planet's objective in preparing financial statements will be to present a favourable position by maximizing receivables, inventory, and profit figures. The bank and creditors would, however, prefer to use the financial statements to make cash flow predictions.
Planet wants to use Part I of the CPA Canada Handbook because it plans an initial public offering in the near future.

Accounting treatment for merger

The acquisition method of accounting for an acquisition should be used. Since Planet is the acquirer. Space Communications Ltd.'s (Space) assets should be recorded at fair value (FV). Details of the acquisition, including date of the acquisition, net assets acquired, and consideration given should be disclosed.

Since the consideration given was shares of Planet, it is necessary to determine the FV of these shares to determine the value of any goodwill acquired as part of the acquisition. However, since Planet is a privately owned company (not publicly traded), determining the FV of the shares issued is difficult. The next choice would be to use the FV of the assets of Space, but the value cannot be determined without considering the value of the combined company. The main value of the combined company is the value of the ongoing distribution rights. It is difficult to allocate this value between the two predecessor companies since, if they had stayed separate, neither would have received the rights. A specialist will be needed to determine the value of the distribution rights or the combined company.

The shares have been allocated in such a way that the previous Space shareholders have 25% of the shares of the combined company. Therefore, 25% of the value of the combined company could be allocated to Space's assets less liabilities. Planet's preference would be to allocate a high value to the shares issued since doing so would decrease the debt-to-equity ratio (assuming that it is greater than 1).

Costs to be recognized in applying the acquisition method

Planet should expense the direct costs of the acquisition, such as legal and appraisal costs, since these costs do not increase the fair value of the assets acquired. In addition, Planet should expense the loss incurred by closing Space’s offices and any employee termination costs that were caused by the acquisition of Space.

Debt Restructuring

Debt restructuring that occurred after the merger, causing liabilities to be revalued, may be accounted for as part of the acquisition depending on the timing relative to the acquisition. Revaluing the liabilities as part of the merger, instead of after the merger, results in the adjustment being reflected in the values of the liabilities and the residual value for goodwill or negative goodwill. The effects of the debt restructuring will be known by the time the financial statements for the year ended February Year 4 are finalized. If the final settlements are largely related to events that occurred after the merger and are not related to the merger, changes in the value of liabilities should be recorded as events of the new company and reported in income as follows:

Account payable turned into a note. The current market rate of interest should be used to discount the accounts payable and a gain recorded for the difference between the accounts payable and the discounted value of the note payable. Interest expense should be accrued each year on the note payable.

Shareholder loan. The loan that the major shareholder forgave should be valued at zero and a gain recognized.

Creditor settlement at $0.80 on the dollar. The $0.20 difference on the dollar could be accounted for as a gain or as an expense reduction.

The gains recognized on the loan that was forgiven and on the amounts owed to creditors that were settled at reduced amounts may impact favourably the debt-to-equity ratio that the bank uses in a covenant in the bank loan agreement.

Debt converted to equity. Details of the debt that was converted to equity should be disclosed. The equity should be reported at the same amount as the shareholder loan since there is not a significant change in the benefits or risks associated with the shareholder loan.

Other accounting issues

Since Planet cannot return merchandise to Typset Daily Corporation (TDC), an allowance must to be set up to reflect inventory that has little value. An allowance will also be needed for expected returns from customers. A further allowance should be set up against the accounts receivable (AR) from stores that have gone bankrupt, since payment is uncertain.

Planet acquired intangibles when it purchased the specialist magazine. The acquisition cost should be allocated to the assets acquired based on their fair values. The assets should then be amortized based on their expected useful lives. The expected life of the magazine may be a basis for estimating the useful life of some of the intangibles acquired. The longer the period used, the higher assets and income will be in the first few years.

Planet plans to capitalize and amortize its investment in an advertising campaign to attract subscribers. It is often difficult, however, to establish whether it is the advertising or another source that attracts customers. Further, it would be difficult to determine when the benefits from a campaign have decreased and new subscribers are from another source. Profitability of Planet's magazines is affected by whether advertisers are found. If the possibility (created by the campaign) of new subscribers is not what is attracting advertisers, then it would be difficult to justify capitalizing the costs. If the advertisements are published over a period of more than one year, then there is support for capitalizing the cost and amortizing it over the period of publication.

Management wants to capitalize expenditures for subscription drives (likely the above campaign as well as other subscription drives) and employ a ten-year amortization period. Ten years seems unduly long considering that subscriptions and advertisers' commitments are usually for only a few years. Although a long amortization period meets Planet's objective of making the income statement appear more favourable, support will be needed to justify it.

If the one to two year life of a subscription is used as the basis of the amortization rate, the impact of capitalizing will not be that large. The accounting treatment of the costs of the subscription drive should correspond to the treatment of the revenues received. If the revenue is recognized over the subscription period, then the costs could be capitalized and amortized over the subscription period.

The $300,000 trade of services is a non-monetary transaction and should be recorded as a regular trade transaction. The $300,000 should include the regular profit that Planet would charge for advertising space. When the advertising company advertises on behalf of Planet, the expense and accounts payable should be set up. When Planet does the advertising, the accounts receivable and revenue should be recognized. At year-end, the revenue and expense may not be equal, since the timing of the use of the services may differ.

The nature and amounts of non-arm's length transactions will have to be fully disclosed.

Other issues

Given Space's previous problems and the recently issued shares to Space's shareholders, it is probably not a good time to try to sell more shares. The bank has debentures on all unencumbered assets; so another debtor would probably expect high interest rates to compensate for the lack of security.

The bank requires monthly listings of inventory, aged receivables and cash flows. Planet must, therefore, have systems in place that enable it to present these lists on a timely basis with adjustments for allowances and other items, so that at year end the banker will not see huge adjustments.

Planet places heavy reliance on income from TDC. However, WAL went into receivership and TDC could face problems similar to those experienced by WAL. Planet should look for ways to reduce its dependence.

Planet must fulfill the obligation for the remaining years of the lease on the building that Space vacated. Planet should try to sublet the premises and recoup some of the loss. Alternatively, Planet may be able to reach a settlement with the landlord and pay right away. However, Planet would need to have funds on hand when the settlement was reached.

Case 3-7

To: Dominic Jones

From: CPA

Object: Floral Impressions Ltd

FIL has become more and more involved with business on the Internet, and Liz Holtby, President, would like our thoughts as to whether FIL is moving in the right direction and what steps we believe FIL should take next.

Strategic issues

Steps FIL should take:

Liz's change in strategy seems aggressive and poorly planned. Her management decisions appear to change from one day to the next, as suggested by her latest idea of doing everything through the Internet. Liz's plan to move to the Internet was made after she decided to do FIL's billings through RWC's site.

It does not seem prudent to be making such drastic changes when the new management plans that had been put in place seem to be working. FIL's financial results appear to have improved. It is also interesting to note that the shareholders and the employees seem concerned about the new direction being set. Other companies seem to be getting out of the Internet, while Liz is pushing to become more and more involved with the Internet.

Liz is very excited about the purchase of RWC. FIL is a seasonal business. Buying RWC, which sells fresh flowers, could help even out the sales cycle. However, it is also possible it is competing with FIL's silk flowers. On the other hand, cross-selling opportunities may be developed between the two companies. FIL should assess these possibilities and take them into account in developing its strategy for the future. Competition has increased in the last six years, resulting in declining sales. FIL could access RWC's existing website. Liz should perhaps consider developing a different product. Moving into RWC may have been a good decision for FIL.

Liz has a potential bias to increase revenue since her stock option plan is based upon the percentage increase in FIL's revenue from one year to another. The acquisition of RWC will increase FIL's consolidated revenues and income. On the other hand, Liz is a major shareholder and has a longer-term interest. It is doubtful that she would deliberately take actions detrimental to herself in the long run.

Overall, the recent decisions made by Liz appear to increase the business risks that FIL faces. FIL must assess whether the new opportunities presented by the changes warrant the additional risk being taken. Liz should begin by summarizing where FIL is currently. A formal strategic plan should be written up for presentation to the Board before moving forward.

FIL should obtain advice on the synergistic opportunities that may exist through the RWC purchase. This would allow FIL to judge whether RWC's product is competing or complementary.

Liz should ensure that the Board is aware of her management decisions and is comfortable with the direction being taken.

The Board should do a complete risk assessment before proceeding with any expansion plans.

Employees should be informed so that they understand why the change in direction is being pursued and "buy into it."

FIL should set up monitoring processes to ensure that impact of strategy decisions is tracked and any new occurrences that impact those decisions are identified quickly.

Accounting issues

Subsidiary - RWC

<u>Acquisition</u>

On January 15, Year 3, FIL announced an agreement with Rest-EZE Wreath Co (RWC) shareholders whereby FIL would acquire 100% of the voting shares of RWC by issuing 200,000 FIL common shares, thus acquiring control. The acquisition of RWC was completed on October 31, Year 3. The market value of FIL's shares has dropped since the announcement (January 15) from $4.00 to $2.25 at October 31.

FIL's statements at October 31 do not show this acquisition, and it should be accounted for using the acquisition method (IFRS 3). In this case FIL is clearly the acquirer as it obtained control of RWC. According to paragraph 18, "The acquirer shall measure the identifiable assets acquired and the liabilities assumed at their acquisition-date fair values." The acquisition was announced on January 15, Year 3 when the share price was $4.00. However, the acquisition took place October 31, Year 3 when the share price was $2.25. The acquisition date is the date on which the acquirer effectively obtains control of the acquiree, which appears to be October 31, Year 3. Therefore the purchase price is $450,000.

RWC needs to be consolidated in FIL's statements as required by IFRS 10. RWC's assets, mainly trade receivables and office equipment, less the liabilities assumed, have a fair value of $150,000, as established by an independent evaluator. RWC may have other intangible assets, such as a list of clients, since RWC has well-established relations with two major funeral home chains. We need to estimate the value of any intangible assets in order to calculate the amount of goodwill (IAS 38).

<u>Revenue recognition:</u>

RWC accounts for 100% of its sales at the advertised price on its website and remits 85% of the sale to the supplier. RWC absorbs any bad debts and therefore bears the credit risk. The fact that the credit risk lies with RWC supports the possibility of RWC's accounting for its sales at the gross amount. However, RWC earns a 15% fixed commission, does not establish the sales prices, has no inventory risk, and makes no changes to the product sold.

It appears that RWC is an agent for the supplier. Accordingly, under IFRS 15 paragraph B36, RWC should report its sales at the net price of 15%. Doing so will reduce the consolidated revenues, which is contrary to Liz's objective of increasing revenues.

Stock options

For the first time in its history, FIL granted stock options to an employee. The number of options granted to Liz is not very significant (4,500 at $2.25), and options were granted at the market price of the shares at the time of issuance.

Under IFRS 2, employee stock options must be recorded at the time of grant. The stock options must be accounted for based on their fair value determined using an appropriate option-pricing model. These models generally require estimates for the expected term of the options, expected volatility of the price of the FIL's shares, expected dividends and a risk free rate. In addition, the fair value of the options granted must be expensed over the vesting period of the options.

IFRS 2 requires disclosure of the following: a description of the plan, including the general terms of awards under the plan such as vesting requirements; the maximum term of options granted; and the number of shares authorized for grants of options or other equity instruments. The number of options granted during the year, and their exercise price should also be disclosed.

Intangibles – Customer List

On October 1, Year 3, FIL purchased a customer lists for $20,000 from a former competitor who was going out of business. We would have to ensure that this meets the definition of an intangible asset in that the asset will provide future economic benefits to FIL. No amortization policy has yet been determined by FIL. We will have to consider the amortization period FIL will choose. The useful life at time of purchase must be used to amortize this asset, not a longer life that might result due to efforts performed by FIL. It is likely that this will be relatively short.

Also, at the reporting date, the customer list must be assessed for impairment and written down to recoverable amount if this is below cost.

Finally, under IAS 38, intangible assets can be measured using the revaluation model or a cost model. In order for the revaluation model to be used, there must be a market value determinable from an active market. In this case, this is unlikely, and FIL will be required to use the cost model (cost less accumulated amortization).

Other issues

FIL has pre-sold 10 advertising spots at $200 each. The controller has recognized the advertising revenue as sales. The accounting as sales is consistent with Liz's bias to increase revenue. These revenues should be deferred until service is rendered, especially since the current system's problems are causing the advertisers anxiety. Some advertisers have threatened to pull out, and others have cancelled their contracts. We have to ensure that the 10 spots do not include those that have been cancelled. The revenue is therefore not certain.

Loan covenant

During the year, FIL negotiated a $2 million operating line of credit with a new financial institution. The actual amount advanced on the credit line is limited to 75% of accounts receivable under 90 days old and 50% of saleable inventory. The October 31, Year 3 quarterly statements indicate bank indebtedness of $1,850,000, accounts receivable of $2,003,000 and inventory of $610,000. The assets available as security are: (75% x $2,003,000) + (50% x $ 610,000) = $1,807,250. The covenant is therefore in breach at that date. This calculation does not take into account any adjustments for accounts receivable older than 90 days or obsolete inventory. The breach could be more serious.

We will need to see whether the covenant is breached at year-end. Craig expects the inventory to be lower at year-end — FIL may have a bigger problem. We should also consider that the year-end financial statements will be consolidated with RWC. We should enquire of the financial institution whether or not RWC's receivables and inventory may be included for the purposes of the covenant. If so, FIL may not be in breach at year-end. If there is still a breach at year-end, the breach should be disclosed.

FIL should consider approaching the bank now to see whether the situation can be rectified before year-end. Perhaps the bank will be willing to renegotiate some of the terms of the loan, or waive the covenant requirements. Alternatively, FIL could perhaps look for additional sources of financing.

SOLUTIONS TO PROBLEMS

Problem 3-1

(a)

Journal entry on Abdul's books

Cash and receivables	20,150
Inventory	10,050
Plant assets	70,100
Goodwill (plug)	19,100

Current liabilities		27,600
Long-term debt		33,800
Cash		58,000

Journal entry on Lana's books

Cash	58,000	
Current liabilities	27,600	
Long-term debt	40,100	
Cash and receivables		20,150
Inventory		8,150
Plant assets		66,350
Gain on sale of net assets		31,050

(b)

	Abdul	*Lana*
Cash and receivables	$ 55,150	$ 58,000
Inventory	70,550	0
Plant assets (net)	306,100	0
Goodwill	19,100	0
	$450,900	$58,000
Current liabilities	$ 93,100	$ 0
Long-term debt	128,050	0
Common shares	140,500	40,050
Retained earnings (deficit)	89,250	17,950
	$450,900	$58,000

Problem 3-2

Cost of acquisition (20,000 x $36 per year)		720,000
Fair value of Au's identifiable assets (190 + 500 + 270)	960,000	
Fair value of Au's liabilities	330,000	
Fair value of Au's identifiable net assets		630,000

Value of Au's goodwill		90,000	

	(a)	(b)	(c)
	Walla	Au	Walla
	Separate	Separate	Consolidated
Land (600 + 500)	600,000	450,000	1,100,000
Goodwill			90,000
Investment in common shares (20 x 36)	720,000		
Liabilities (400 + 330)	400,000	310,000	730,000
Common shares (200 + 720)	920,000	50,000	920,000
Revenues	800,000	640,000	800,000

Problem 3-3

(a)

(i)

(ii) Acquisition method

Acquisition cost (7,400 shares @ $8.00)	$59,200
Fair value of net assets of K Company	44,200
Goodwill	$15,000

G Company

Consolidated Balance Sheet

Current assets (47,000 + 16,200)	$63,200
Plant assets (74,000 + 39,000)	113,000
Goodwill	15,000
	$191,200
Current liabilities (21,400 + 6,400)	$27,800
Long-term debt (22,000 + 4,600)	26,600
Common shares (44,000 + 59,200)	103,200
Retained earnings	33,600
	$191,200

(ii) New entity method

	G Company	**K Company**

Fair value of total company prior to acquisition		
(13,000 shares x $8.00)	$104,000	
(7,400 shares x $8.00)		$59,200
Fair value of identifiable assets less liabilities	91,100	44,200
Goodwill	12,900	$ 15,000

Fair value of total company prior to acquisition	$104,000
Carrying amount of assets less liabilities prior to acquisition	77,600
Revaluation adjustment to fair value	$26,400

G Company

Consolidated Balance Sheet

Current assets (54,500 + 16,200)	$ 70,700
Plant assets (84,000 + 39,000)	123,000
Goodwill (12,900 + 15,000)	27,900
	$221,600
Current liabilities (21,400 + 6,400)	$27,800
Long-term liabilities (26,000 + 4,600)	30,600
Common shares (44,000 + 59,200)	103,200
Revaluation adjustment (Note)	26,400
Retained earnings	33,600
	$221,600

Note:

Other interpretations of how to treat the excess that arises when fair values are used are possible.

(b)

	New Entity Method	**Acquisition Method**
Current Ratio	70,700 / 27,800 = 2.54	63,200 / 27,800 = 2.27
Debt/Equity Ratio	(27,800 + 30,600) / (103,200 + 33,600 + 26,400) = 0.36	(27,800 + 26,600) / (103,200 + 33,600) = 0.40

The table above shows the calculation of current and debt/equity ratios under both methods. The New Entity Method shows a better liquidity position (current ratio is higher) and a better solvency position (debt/equity ratio is lower). The New Entity method shows a more realistic view of the entity as a whole since it takes into account the fair value of the parent company's identifiable assets and the value of goodwill on the date of acquisition. Since goodwill cannot be sold separately, it cannot readily be used to pay off debt. However, if an entire business including its goodwill is sold, then goodwill does have some value in paying off debt.

(c)

CONSOLIDATED FINANCIAL STATEMENT WORKING PAPER
G COMPANY
CONSOLIDATED BALANCE SHEET
December 31, Year 1

	G COMPANY	K COMPANY		Eliminations Dr.		Eliminations Cr.	Consolidated
Current assets	$ 47,000	$ 24,000			3	$ 7,800	$ 63,200
Plant assets (net)	74,000	34,000	3	$ 5,000			113,000
Goodwill	-	-	3	15,000			15,000
Investment in K Company	-	-	1	59,200	2	59,200	0
Acquisition differential			2	11,500	3	11,500	
	$ 121,000	$ 58,000					$ 191,200
Current liabilities	$ 21,400	$ 6,400					$ 27,800
Long-term debt	22,000	3,900			3	700	26,600
Common shares	44,000	24,000	2	24,000	1	59,200	103,200
Retained earnings	33,600	23,700	2	23,700			33,600
	$ 121,000	$ 58,000					$ 191,200
			Total	$138,400		$138,400	

JOURNAL ENTRIES

		$	
1	Investment in K Company	59,200	
	Common shares		$ 59,200
	To record investment in K Company		
2	Common shares	24,000	
	Retained earnings	23,700	
	Acquisition differential	11,500	
	Investment in K Company		59,200
	To eliminate investment account and establish acquisition differential		
3	Current assets		7,800
	Plant assets	5,000	
	Goodwill	15,000	
	Long-term debt		700
	Acquisition differential		11,500
	To allocate the acquisition differential		

Total	$ 138,400	$ 138,400

Problem 3-4

Company A shareholders hold	50,000 shares
Company L shareholders will hold	27,000 shares
Company M shareholders will hold	25,000 shares
	102,000 shares

Company A shareholders own the largest group so Company A is the acquirer.

Company L

Acquisition cost (27,000 shares × $5)		$135,000	(a)
Fair value of assets	$163,000		
Fair value of liabilities	(36,000)	127,000	
Goodwill		$8,000	(b)

Company M

Acquisition cost (25,000 shares × $5)		$125,000	(c)
Fair value of assets	$188,000		
Fair value of liabilities	(70,000)	118,000	
Goodwill		$ 7,000	(d)

Total goodwill — Company L (b)	$8,000	
Company M (d)	7,000	
	$15,000	(e)
Additional costs incurred:		
Cost of issuing shares	$8,000	(f)
Professional fees	20,000	(g)
Total	$28,000	(h)

Company A

Consolidated Balance Sheet

January 1, Year 6

Current assets (99,900 – (h) 28,000 + 65,000 + 68,000)	$204,900
Plant and equipment (147,600 + 98,000 + 120,000)	365,600
Goodwill (e)	15,000
	$585,500
Liabilities (80,000 + 36,000 + 70,000)	$186,000
Common shares (102,000 shares)	
(75,000 + (a) 135,000 + (c) 125,000 – (f) 8,000)	327,000
Retained earnings (92,500 – (g) 20,000)	72,500
	$585,500

Problem 3-5

(a)

Acquisition cost	$1,090,600
Fair value of net assets	952,000
Goodwill	$138,600

Davis journal entry

Current assets	510,000	
Plant and equipment	1,056,000	
Patents	81,000	
Goodwill	138,600	
Current liabilities		276,000
Long-term debt		419,000
Cash		1,090,600
Professional fees expense	21,000	
Cash		21,000

(b)

Davis is clearly the acquirer because its shareholder group holds the largest block of shares.

(i) The goodwill calculation is the same as in (a) above because 133,000 shares @ $8.20 per share equals $1,090,600.

Current assets	510,000	
Plant and equipment	1,056,000	
Patents	81,000	
Goodwill	138,600	
Current liabilities		276,000
Long-term debt		419,000
Ordinary shares (133,000 shares x $8.2)		1,090,600
Ordinary shares	6,800	
Cash		6,800
Professional fees expense	21,000	
Cash		21,000

(ii)

Bagley Corporation

Statement of Financial Position

August 1, Year 4

Investment in Davis Inc.	$1,090,600
Ordinary shares	$185,000
Retained earnings (517,000 + 388,600*)	905,600
	$1,090,600

*Gain on sale (1,090,600 – [1,371,000 – 393,000 – 276,000] = 388,600)

Problem 3-6

Note:

Under IFRS 3, although the two companies are being amalgamated, the transaction still represents a business combination for which an acquirer must be identified. To identify the acquirer, it is important to examine the number of shares of the new entity held by each company's shareholders. After Prong issues 60,000 new ordinary shares, Prong's previous shareholders will hold 53.8% (70,000/130,000) of the total outstanding shares and Horn's previous shareholders will hold 46.1% (60,000/130,000) of the total outstanding shares. Prong is therefore the acquirer.

Acquisition cost (60,000 shares × $7)		$420,000	(a)
Fair value of Horn			
Current assets	$170,000		
Plant and equipment	280,000*		
Accumulated depreciation	0		
Other assets	20,000**		
Current liabilities	(30,000)		
Long-term debt	(160,000)	280,000	
Goodwill		$140,000	(b)

* The net method is used to report the plant and equipment at $280,000 with no accumulated depreciation.

** Patent registration costs belonged to Prong and would therefore not be re-valued as part of the transaction since Prong is the acquirer. The transaction is essentially accounted for as a purchase of net assets. The assets of Horn are recognized at fair value and the excess of the acquisition cost over the fair value of net assets acquired is goodwill.

Pronghorn Corporation
Statement of Financial Position
September 1, Year 5

Plant and equipment (430,000 + 280,000)	$710,000
Other assets (41,000 + 20,000)	61,000
Goodwill (b)	140,000
Current assets (135,000 + 170,000)	305,000
	$1,216,000
Ordinary shares* (70,000 + (a) 420,000)	$490,000
Retained earnings	260,000
Long-term debt (180,000 + 160,000)	340,000
Current liabilities (96,000 + 30,000)	126,000
	$1,216,000

* 130,000 shares outstanding.

Problem 3-7

(a)

Acquisition cost: 82,500 shares @ $20		$1,650,000	(a)
Fair value of Hanson assets (as listed)	$1,531,200		
Unrecorded customer service contracts	150,000		
	1,681,200		
Fair value of Hanson liabilities (137,500 + 129,800)	-267,300	1,413,900	
Goodwill		$ 236,100	(b)
Direct costs associated with acquisition:			
Costs of issuing shares		$44,000	(c)
Professional fees		38,500	(d)
Total		$82,500	(e)

Drake Enterprises

Consolidated Balance Sheet

January 2, Year 6

Cash (99,000 – (e) 82,500 + 55,000)	$71,500
Accounts receivable (143,000 + 280,500)	423,500
Inventory (191,400 + 178,200)	369,600
Property, plant and equipment (1,692,000 + 1,017,500)	2,709,500
Accumulated depreciation (900,000 + 0)	(900,000)
Customer service contracts	150,000
Goodwill (b)	236,100
	$3,060,200
Current liabilities (242,000 + 137,500)	$379,500
Liability for warranties	129,800
Bonds payable	352,000
Common shares (220,000 + 1,650,000 (a) – (c) 44,000)	1,826,000
Retained earnings (411,400 – (d) 38,500)	372,900
	$3,060,200

(b)

Drake Enterprises

Balance Sheet

January 2, Year 6

Assets	
Cash (99,000 –82,500)	$16,500
Accounts receivable	143,000
Inventory	191,400
Property, plant and equipment	1,692,000
Accumulated depreciation	(900,000)
Investment in Hanson (82,500 shares x 20)	1,650,000
	$2,792,900
Liabilities and Equity	
Current liabilities	$ 242,000
Bonds payable	352,000
Common shares (220,000 + 1,650,000 – 44,000)	1,826,000
Retained earnings (411,400 – 38,500)	372,900
	$2,792,900

(c)

	Consolidated	Equity Method
Total Debt	$861,300	$594,000
Equity	2,198,900	2,198,900
Debt-to-equity ratio	0.39	0.27

The consolidated balance sheet shows the highest debt-to-equity ratio. It also better reflects the solvency risk because it shows the total debt of the economic entity.

(d)

CONSOLIDATED FINANCIAL STATEMENT WORKING PAPER
DRAKE COMPANY
CONSOLIDATED BALANCE SHEET
December 31, Year 5

	DRAKE	HANSON	Eliminations Dr.		Eliminations Cr.		Consolidated
Cash	$ 99,000	$ 55,000			2	$ 82,500	$ 71,500
Accounts receivable	143,000	275,000	5	$ 5,500			423,500

Inventory	191,400	187,000			5	8,800	369,600
Property, plant, and equipment	1,692,000	1,169,000	5	148,500	4	300,000	2,709,500
Accumulated depreciation	(900,000)	(300,000)	4	300,000			(900,000)
Investment in Hanson			1	1,650,000	3	1,650,000	0
Acquisition differential			3	500,500	5	500,500	0
Customer service contracts			5	150,000			150,000
Goodwill			5	236,100			236,100
	$1,225,400	$1,386,000					$ 3,060,200
Current liabilities	$ 242,000	$ 137,500					$ 379,500
Bonds payable	352,000						352,000
Liability for warranties	-	99,000			5	30,800	129,800
Common shares	220,000	660,000	2	44,000	1	1,650,000	1,826,000
			3	660,000			
Retained earnings	411,400	489,500	2	38,500			372,900
			3	489,500			
							-
	$1,225,400	$1,386,000					$ 3,060,200
			Total	$4,222,600		$4,222,600	

JOURNAL ENTRIES

1	Investment in Hanson	$1,650,000	
	Common shares		$1,650,000
	To record investment in Hanson		
2	Common shares	44,000	
	Retained earnings	38,500	
	Cash		82,500
	To record direct acquisition costs		
3	Common shares	660,000	
	Retained earnings	489,500	
	Acquisition differential	500,500	
	Investment in K Company		1,650,000
	To eliminate investment account and establish acquisition differential		
4	Accumulated depreciation	300,000	
	Property, plant, and equipment		300,000
	To offset accumulated depreciation against original cost		
5	Accounts receivable	5500	
	Inventory		8,800
	Property, plant, and equipment	148,500	
	Liability for warranties		30,800
	Customer service contracts	150000	
	Goodwill	236100	
	Acquisition differential		500,500
	To allocate the acquisition differential		

Total	$4,222,600	$4,222,600

Problem 3-8

Acquisition cost (300,000 shares × $9.00)	$2,700,000	(a)
Fair value of net assets	2,290,000	
Favourable lease contract**	60,000	(b)
Goodwill	$350,000	(c)

** IFRS 3 requires favourable lease terms to be recognized at fair value as an identifiable asset in a business combination (par. B29 to B31). Note that the fact that the lease cannot be transferred or assigned does not affect the requirement to recognize it as an identifiable asset on acquisition as it still meets the contractual-legal criterion (i.e. the asset results from contractual or other legal rights (regardless of whether those rights are transferable or separable from the acquired enterprise or from other rights and obligations).

D Ltd.

Balance Sheet

July 1, Year 5

Current assets (450,000 + 510,000)	$ 960,000
Non-current assets (4,950,000 + 3,500,000)	8,450,000
Intangible asset – lease contract (b)	60,000
Goodwill (c)	350,000
	$9,820,000
Current liabilities (600,000 + 800,000)	$1,400,000
Long-term debt (1,100,000 + 920,000)	2,020,000
Common shares (2,500,000 + (a) 2,700,000)	5,200,000
Retained earnings	1,200,000
	$9,820,000

Problem 3-9

(a)

(i)

Investment in Sax	960,000		
Professional fees expense	18,000		(a)
Cash		978,000	(b)

(ii)

Acquisition cost		$960,000	(c)
Fair value of assets	$1,512,000		
Fair value of liabilities	636,000	876,000	
Goodwill		$ 84,000	(d)

Note that under IFRS 3, an assembled workforce is not considered an identifiable asset (par. B37). As such, it cannot be recognized apart from goodwill. On this basis, the $100,000 value that management believed the assembled workforce to be worth would be recognized as part of goodwill and NOT as a separate intangible asset. This is supported by the criteria for separate recognition of an intangible asset apart from goodwill as outlined in IFRS 3 requiring that the asset either meet the contractual-legal criterion or the separability criterion. That is:

(a) the asset results from contractual or other legal rights (regardless of whether those rights are transferable or separable from the acquired enterprise or from other rights and obligations); or

(b) the asset is capable of being separated or divided from the acquired enterprise and sold, transferred, licensed, rented, or exchanged (regardless of whether there is intent to do so). Otherwise, it should be included in the amount recognized as goodwill.

Neither of the above criteria is met in the case of the assembled workforce.

Red Corp
Consolidated Balance Sheet
August 1, Year 3

Current assets (1,600,000 – (b) 978,000 + 468,000)	$1,090,000
Plant and equipment (1,080,000 + 972,000)	2,052,000

Patents (0 + 72,000)		72,000	
Goodwill (d)		84,000	
		$3,298,000	
Current liabilities (1,360,000 + 252,000)		$1,612,000	
Long-term debt (480,000 + 384,000)		864,000	
Common shares		720,000	
Retained earnings (120,000 – (a) 18,000)		102,000	
		$3,298,000	

(b)

(i)

Investment in Sax	960,000		
Common shares (c)		960,000	(e)
Professional fees expense	18,000		(f)
Common shares	6,000		(g)
Cash		24,000	(h)

(ii)

Goodwill calculation is the same as part (a) because the acquisition cost is 120,000 shares @ $8 per share equals $960,000

Red Corp.
Consolidated Balance Sheet
August 1, Year 3

Current assets (1,600,000 + 468,000 – (h) 24,000)	$2,044,000
Plant and equipment (1,080,000 + 972,000)	2,052,000
Patents	72,000
Goodwill (d)	84,000
	$4,252,000
Current liabilities (1,360,000 + 252,000)	$1,612,000
Long-term debt (480,000 + 384,000)	864,000

Common shares (720,000 + (e) 960,000 – (g) 6,000)		1,674,000
Retained earnings (120,000 – (f) 18,000)		102,000
		$4,252,000

(c)

(i)

Investment in Sax	960,000		(i)
Common shares (c)		960,000	(j)
Professional fees expense	18,000		(k)
Common shares	6,000		(l)
Cash		24,000	(m)

(ii)

Red Corp.
Balance Sheet
August 1, Year 3

Current assets (1,600,000 – (m) 24,000)	$1,576,000
Plant and equipment (net)	1,080,000
Investment in Sax (i)	960,000
	$3,616,000
Current liabilities	$1,360,000
Long-term debt	480,000
Common shares (720,000 + (j) 960,000 – (l) 6,000)	1,674,000
Retained earnings (120,000 – (k) 18,000)	102,000
	$3,616,000

Problem 3-10

(a)

Company X is clearly the acquirer of Company Y and Company Z.

Company Y

Acquisition cost (13,500 shares × $15)	$202,500	(a)
Fair value of net assets	170,000	
Goodwill	$ 32,500	(b)

Company Z

Acquisition cost (12,000 shares × $15)	$180,000	(c)
Fair value of net assets	103,000	
Goodwill	$ 77,000	(d)

Total goodwill

Company Y above (b)	$32,500	
Company Z above (d)	77,000	
	$109,500	(e)

Direct costs associated with acquisition:		
Cost of issuing shares	$12,000	(f)
Professional fees	30,000	(g)
Total	$42,000	(h)

Company X
Pro Forma Statement of Financial Position
January 2, Year 4

Assets (400,000 – (h) 42,000 + 350,000 + 265,000)	$973,000
Goodwill (e)	109,500
	$1,082,500
Ordinary shares (75,000 – (f) 12,000 + (a) 202,500 + (c) 180,000)	$445,500

Retained earnings (92,500 – (g) 30,000)	62,500
Liabilities (232,500 + 180,000 + 162,000)	574,500
	$1,082,500

(b) Pro forma Statements of Financial Position

	January 2, Year 4	
	Company Y	**Company Z**
Investment in shares of Company X	$202,500	$180,000
Ordinary shares	48,000	60,000
Retained earnings**	154,500	120,000
	$ 202,500	$180,000
**Retained earnings before sale	$70,000	$35,000
Gain on sale of net assets	84,500	85,000
	$154,500	$120,000

(Company Y: $202,500 – $118,000 = $84,500)

(Company Z: $180,000 – $95,000 = $85,000)

Problem 3-11

Proposal 1

Acquisition cost	$446,400	(a)
Fair value of net assets	344,770	
Goodwill	$101,630	(b)

(a)

Cash	446,400		(c)
Long-term bank loan payable		446,400	(d)
Cash	64,500		
Accounts receivable	68,200		
Inventory	146,220		
Land	222,000		
Buildings	36,020		

Equipment	27,945		
Goodwill (b)	101,630		
Current liabilities		53,115	
Non-current liabilities		167,000	
Cash		446,400	(e)
Professional fees expense	6,200		(f)
Cash		6,200	(g)

(b) **Myers Company**

Balance Sheet

Cash (152,000 + (c) 446,400 – (e) 446,400 – (g) 6,200 + 64,500)	$210,300
Accounts receivable (179,200 + 68,200)	247,400
Inventory (386,120 + 146,220)	532,340
Land (437,000 + 222,000)	659,000
Buildings (net) (262,505 + 36,020)	298,525
Equipment (net) (90,945 + 27,945)	118,890
Goodwill (b)	101,630
	$2,168,085
Current liabilities (145,335 + 53,115)	$198,450
Noncurrent liabilities (0 + (d) 446,400 + 167,000)	613,400
Common shares	512,000
Retained earnings (850,435 – (f) 6,200)	844,235
	$2,168,085

Proposal 2

Under IFRS 3, an acquirer must be identified in the transaction. Myers' shareholders will own 51% of the outstanding shares post transaction (64,000/(64,000 + 62,000)) and Norris' shareholders will own 49% (62,000/(64,000 + 62,000)). Therefore, Myers is the acquirer.

Acquisition cost 62,000 shares @ $7.20	$446,400	(h)
Fair value of net assets	344,770	
Goodwill	$101,630	(i)

(a)	Cash	64,500		
	Accounts receivable	68,200		
	Inventory	146,220		
	Land	222,000		
	Buildings	36,020		
	Equipment	27,945		
	Goodwill	101,630		
	Current liabilities		53,115	
	Non-current liabilities		167,000	
	Common shares		446,400	(j)
	Professional fees expense	6,200		(k)
	Common shares	8,200		(l)
	Cash		14,400	(m)

(b) **Myers Company**

Balance Sheet

Cash (152,000 + 64,500 – (m) 14,400)	$202,100
Accounts receivable (179,200 + 68,200)	247,400
Inventory (386,120 + 146,220)	532,340
Land (437,000 + 222,000)	659,000
Building (net) (262,505 + 36,020)	298,525
Equipment (net) (90,945 + 27,945)	118,890
Goodwill (i)	101,630
	$2,159,885
Current liabilities (145,335 + 53,115)	$198,450
Noncurrent liabilities (0 + 167,000)	167,000
Common shares (512,000 + (h) 446,400 – (l) 8,200)	950,200
Retained earnings (850,435 – (k) 6,200)	844,235
	$2,159,885

Problem 3-12

Proposal 1

(a)

Cash	446,400		(a)
Long-term bank loan payable		446,400	(b)
Investment in Norris Inc.	446,400		
Professional fees expense	6,200		(c)
Cash		452,600	(d)
Acquisition cost		$446,400	(e)
Fair value of net assets		344,770	
Goodwill		$101,630	(f)

(b)

Myers Company

Consolidated Balance Sheet

Cash (152,000 + (a) 446,400 – (d) 452,600 + 64,500)	$210,300
Accounts receivable (179,200 + 68,200)	247,400
Inventory (386,120 + 146,220)	532,340
Land (437,000 + 222,000)	659,000
Buildings (net) (262,505 + 36,020)	298,525
Equipment (net) (90,945 + 27,945)	118,890
Goodwill (f)	101,630
	$2,168,085
Current liabilities (145,335 + 53,115)	$198,450
Noncurrent liabilities (0 + (b) 446,400 + 167,000)	613,400
Common shares	512,000
Retained earnings (850,435 – (c) 6,200)	844,235
	$2,168,085

Proposal 2

(a)

Investment in Norris Inc.	446,400	

Common shares		446,400	(g)
Common shares	8,200		(h)
Professional fees expense	6,200		(i)
Cash		14,400	(j)

Acquisition cost 62,000 shares @ $7.20	$446,400	(k)
Fair value of net assets	344,770	
Goodwill	$101,630	(l)

(b) **Myers Company**

Consolidated Balance Sheet

Cash (152,000 – (j) 14,400 + 64,500)	$202,100
Accounts receivable (179,200 + 68,200)	247,400
Inventory (386,120 + 146,220)	532,340
Land (437,000 + 222,000)	659,000
Building (net) (262,505 + 36,020)	298,525
Equipment (net) (90,945 + 27,945)	118,890
Goodwill (l)	101,630
	2,159,885
Current liabilities (145,335 + 53,115)	$198,450
Noncurrent liabilities	167,000
Common shares (512,000 + (g) 446,400 – (h) 8,200)	950,200
Retained earnings (850,435 – (i) 6,200)	844,235
	$2,159,885

Problem 3-13

(a) Parent's profit prior to the date of acquisition, $254,000, less $37,000 paid to broker = $217,000

(b) Parent's retained earnings prior to the date of acquisition, $964,000, less $37,000 paid to broker = $927,000

(c) $714,000 + $752,000 = $1,466,000

(d) $914,000 + $284,000 = $1,198,000

(e)	Acquisition cost (($314,000 + (12,400 shares x $54))		$983,600
	Carrying amount of SAP's net assets		826,000
	Acquisition differential		157,600
	Fair value excess allocated to:		
	Patented technology	$(44,000)	
	Equipment	138,000	94,000
	Goodwill		$63,600

(f) $544,000 + (12,400 shares x $54) - $54,000 = $1,159,600

(g) $614,000 + $424,000 + $314,000 = $1,352,000

Problem 3-14

(a) Before the sale C Ltd. owned 70% of the shares of Z Ltd. Because C Ltd. had control, C Ltd. would report its investment by consolidating Z Ltd. After the sale, C Ltd. owns 30% of Z Ltd., which ordinarily would be considered a significant influence investment and C would use the equity method to report its investment in Z. The Year 6 loss recorded by Z would be recognized as an investment loss by C to the extent it occurred after the sale.

(b) W Corporation owns 40% of Z Ltd., which would not be enough for control given that C Ltd. owns 30%. Therefore, this 40% would probably qualify as a significant influence investment reported using the equity method. Forty percent of Z Ltd.'s loss subsequent to the date of acquisition would be reflected in the income statement of W Corporation as an investment loss.

Problem 3-15

(a)
The December 31, Year 6 transaction results in the following share ownership in A Ltd.:

A Ltd. shareholders	100 shares	40%
B Ltd. shareholders	150 shares	60%
Shares of A Ltd.	250 shares	100%

Since the former shareholders of B Ltd. now have control of A Ltd., B is deemed to be the acquirer. Therefore, this is a reverse takeover. One likely reason for this transaction is that B Ltd. wants a stock exchange listing and A Ltd. has such a listing. Typically, a reverse takeover occurs when a publicly listed company has limited capital and limited operations. It issues shares to buy a company or asset worth much more. Given that the company or asset being purchased has a much higher value, it results in the owners of the transferred asset or company having control post-closing.

(b) Although A Ltd. acquired B Ltd., B Ltd. will be deemed to be the acquirer because the former shareholders of B now own 60% of A Ltd. Therefore, the net assets of B Ltd. will be measured at carrying amount and the net assets of A Ltd. will be measured at fair value. To determine the value of A Ltd., we concoct a hypothetical situation where B Ltd. acquired A Ltd. in a manner that the relative shareholdings were the same as in a) i.e. A Ltd. shareholders own 40% and B Ltd. shareholders own 60%. To achieve this position, B Ltd. would have to issue 40 shares so that the share ownership in B Ltd. would be as follows:

B Ltd. shareholders	60 shares	60%
A Ltd. shareholders	40 shares	40%
	100 shares	100%

Acquisition cost is 40 shares @ $40	$1,600
Carrying amount of A Ltd.'s net assets	1,100
Acquisition differential	500
Allocated: non-current assets	200
Balance: goodwill	$300

A Ltd.

Consolidated Balance Sheet

December 31, Year 6

Current assets (300 + 1,000)	$1,300
Non-current assets (1,700 + 2,700)	4,400
Goodwill	300
	$6,000
Current liabilities (400 + 900)	$1,300
Long-term debt (300 + 800)	1,100
Common shares (600 + 1,600*)	2,200
Retained earnings	1,400
	$6,000

*** acquisition cost as calculated above**