**CHAPTER 2**

**Business Combinations**

**BRIEF EXERCISES**

BRIEF EXERCISE 2-1

According to IFRS 3 *Business Combinations*, a business combination is a transaction or other event in which an acquirer obtains control of one or more businesses.

For a business combination to occur, there has to be an economic transaction between two entities.

Control exists when the investor 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.

A business is an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants.

BRIEF EXERCISE 2-2

 The acquisition date is the date on which the acquirer obtains control of the acquiree.

 It is important because on this date:

* The fair values of the identifiable assets acquired and liabilities assumed are measured.
* The fair value of the consideration transferred is measured.
* The goodwill or gain on bargain purchase is calculated.

BRIEF EXERCISE 2-3

 Contingent consideration is:

Usually, an obligation of the acquirer to transfer additional assets or equity interests to the former owners of an acquiree as part of the exchange for control of the acquiree if specified future events occur or conditions are met. However, contingent consideration also may give the acquirer the right to the return of previously transferred consideration if specified conditions are met.

The consideration transferred includes any asset or liability resulting from a contingent consideration arrangement. This is measured at fair value at acquisition date.

 The acquirer shall classify the obligation to pay contingent consideration as a liability or equity.

Changes in the measurement of the obligation subsequent to the acquisition date resulting from events after the acquisition date are accounted for differently depending on whether the obligation was classified as equity or debt.

If it is classified as equity, the equity shall not be remeasured and the subsequent settlement is accounted for within equity.

If it classified as a financial liability, it is accounted for under IAS 39 and is subsequently measured at fair value with movements being accounted for in accordance with that standard. Any adjustments are recognized in profit or loss.

The subsequent accounting for contingent consideration is to treat it as a post-acquisition event and it does not affect the measurements made at the acquisition date.

BRIEF EXERCISE 2-4

In a business combination, the identifiable assets acquired and liabilities assumed shall be recognized separately from goodwill.

Because the assets and liabilities are measured at fair value, the assets and liabilities are recognized regardless of the degree of probability of inflow/outflow of economic benefits. The fair value reflects expectations in its measurement.

The assets and liabilities recognised must meet the definitions of assets and liabilities in the *Framework*.

The assets and liabilities recognised must also be part of the exchange transaction rather than resulting from separate transactions.

In recognizing the assets and liabilities, it is necessary to classify or designate them. The acquirer does this based on the contractual terms, economic conditions, its operating or accounting policies, and other pertinent conditions that exist at the acquisition.

BRIEF EXERCISE 2-5

According to IFRS 3 *Business Combinations*, for each business combination, one of the combining entities shall be identified as the acquirer.

 The acquirer is the entity that obtains control of the acquiree.

Control is the power to govern the financial and operating policies of the acquiree so as to obtain benefits from its activities.

Determination of the acquirer sometimes requires judgement. IFRS 3 provides some indicators to assist in assessing which entity is the acquirer:

* *Is there a large minority voting interest in the combined entity*? The acquirer is usually the entity that has the largest minority voting interest in an entity that has a widely dispersed ownership.
* *What is the composition of the governing body of the combined entity*? The acquirer is usually the combining entity whose owners have the ability to elect, appoint or remove a majority of the members of the combined entity’s governing body.
* *What is the composition of the senior management that governs the combined entity subsequent to the combination?* This is an important indicator given that the criterion for identifying an acquirer is that of control.
* *What are the terms of the exchange of equity interests?* Has one of the combining entities paid a premium over the pre-combination fair value of one of the combining entities, an amount paid in order to gain control?
* *Which entity is the larger?* This could be measured by the fair value of each of the combining entities, or relative revenues or profits. In a takeover, it is normally the larger company that takes over the smaller company (that is, the larger company is the acquirer).
* *Which entity initiated the exchange?* Normally the entity that is the acquirer is the one undertakes action to take over the acquiree.
* *What are the relative voting rights in the combined entity after the business combination?* The acquirer is usually the entity whose owners have the largest portion of the voting rights in the combined entity

BRIEF EXERCISE 2-6

The key steps in applying the acquisition method are:

1. Identify the acquirer.
2. Determine the acquisition date.
3. Recognize and measure the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree.
4. Recognize and measure goodwill or a gain from a bargain purchase.

BRIEF EXERCISE 2-7

 IFRS 3 *Business Combinations* states that the consideration transferred shall be:

* measured at fair value, determined at acquisition date, and
* calculated as the sum of the fair values of the assets transferred by the acquirer, the liabilities incurred by the acquirer to former owners of the acquiree, and the equity interests issued by the acquirer.

BRIEF EXERCISE 2-8

 Fair value is defined according to IFRS 13 *Fair Value Measurement* as:

“the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.”

Fair value is a market-based measurement, not an entity-specific measurement. For some assets and liabilities, observable market transactions or market information might be available. For other assets and liabilities, observable market transactions and market information might not be available. However, the objective of a fair value measurement in both cases is the same — to estimate the price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants at the measurement date under current market conditions (i.e., an exit price at the measurement date from the perspective of a market participant that holds the asset or owes the liability).

When a price for an identical asset or liability is not observable, an entity measures fair value using another valuation technique that maximizes the use of relevant observable inputs and minimizes the use of unobservable inputs. Because fair value is a market-based measurement, it is measured using the assumptions that market participants would use when pricing the asset or liability, including assumptions about risk. As a result, an entity's intention to hold an asset or to settle or otherwise fulfill a liability is not relevant when measuring fair value.

A fair value measurement is for a particular asset or liability. Therefore, when measuring fair value an entity shall take into account the characteristics of the asset or liability if market participants would take those characteristics into account when pricing the asset or liability at the measurement date.

BRIEF EXERCISE 2-9

IFRS 3.36 specifies the measurement of the gain.

It is required for an acquirer to:

Reassess whether it has correctly identified all assets acquired and liabilities assumed, measured at fair value all the assets acquired and liabilities assumed, and measured the consideration transferred.

An acquirer is required to recognize any remaining gain on bargain purchase immediately in profit or loss.

BRIEF EXERCISE 2-10

The acquisition method requires the assets and liabilities of the acquiree to be measured at fair value whereas the assets and liabilities of the acquirer continue to be measured at their carrying values. It is therefore necessary in a business combination to determine which entity is the acquirer and which is the acquiree.

**EXERCISES**

EXERCISES 2-1

1. According to IFRS 3 *Business Combinations*, the acquirer is the combining entity that obtains **control** of the other combining entities.

 Determination of the acquirer requires judgment and IFRS 3 provides indicators/guidelines to assist in this judgment:

 Determination of the acquirer requires judgement. IFRS 3 provides some indicators to assist in assessing which entity is the acquirer:

* *Is there a large minority voting interest in the combined entity*? The acquirer is usually the entity that has the largest minority voting interest in an entity that has a widely dispersed ownership.
* *What is the composition of the governing body of the combined entity*? The acquirer is usually the combining entity whose owners have the ability to elect, appoint or remove a majority of the members of the combined entity’s governing body.
* *What is the composition of the senior management that governs the combined entity subsequent to the combination?* This is an important indicator given that the criterion for identifying an acquirer is that of control.
* *What are the terms of the exchange of equity interests?* Has one of the combining entities paid a premium over the pre-combination fair value of one of the combining entities, an amount paid in order to gain control?
* *Which entity is the larger?* This could be measured by the fair value of each of the combining entities, or relative revenues or profits. In a takeover, it is normally the larger company that takes over the smaller company (that is, the larger company is the acquirer).
* *Which entity initiated the exchange?* Normally the entity that is the acquirer is the one undertakes action to take over the acquiree.
* *What are the relative voting rights in the combined entity after the business combination?* The acquirer is usually the entity whose owners have the largest portion of the voting rights in the combined entity.

EXERCISE 2-1 (Continued)

1. Why is it necessary to identify an acquirer?

The consideration transferred is measured on the basis of the consideration given by the acquirer, while the identifiable assets and liabilities of the acquiree are measured at fair value.

In relation to White Ltd – Cloud Ltd, the main effect then would be:

**If** White Ltd is the acquirer, the identifiable assets, liabilities and contingent liabilities of Cloud Ltd would be measured at fair value while White Ltd’s assets and liabilities would remain at their original carrying amounts.

**If** Cloud Ltd were the acquirer, it would be White Ltd.’s assets and liabilities that would be at fair value while Cloud Ltd.’s assets and liabilities would remain at their original carrying amounts.

EXERCISE 2-2

1. Consideration transferred:

Shares of New Ltd. 100,000 shares × $6.50/share = $650,000

Net assets acquired (these are measured at fair value):

|  |  |
| --- | --- |
| Land | $350,000 |
| Plant  | $290,000 |
| Inventory | $85,000 |
| Cash | $15,000 |
| Accounts payable | ($20,000) |
| Loans | ($80,000) |
| Net fair value | $640,000 |

The consideration transferred is then compared with the net fair value of the identifiable assets and liabilities to determine whether goodwill or a gain arises. In this case, the consideration transferred is greater, therefore goodwill will have been acquired.

Goodwill = $650,000 – $640,000 = $10,000.

The journal entries can then be created from the acquisition analysis.

|  |  |  |  |
| --- | --- | --- | --- |
|  | Land | 350,000 |  |
|  | Plant | 290,000 |  |
|  | Inventory | 85,000 |  |
|  | Cash | 15,000 |  |
|  | Goodwill | 10,000 |  |
|  |  Accounts payable |  | 20,000 |
|  |  Loans |  | 80,000 |
|  |  Share capital |  | 650,000 |
|  | (To record the acquisition of net assets of Daylight Ltd.) |  |  |

EXERCISE 2-2 (Continued)

1. Consideration transferred:

Shares of New Ltd. 100,000 shares × $6.00/share = $600,000

Net assets acquired (these are measured at fair value):

|  |  |
| --- | --- |
| Land | $350,000 |
| Plant  | $290,000 |
| Inventory | $85,000 |
| Cash | $15,000 |
| Accounts payable | ($20,000) |
| Loans | ($80,000) |
| Net fair value | $640,000 |

The consideration transferred is then compared with the net fair value of the identifiable assets and liabilities to determine whether goodwill or a gain arises. In this case, the consideration transferred is less, therefore a bargain purchase (gain) will have been acquired.

Gain = $600,000 – $640,000 = $40,000.

The journal entries can then be created from the acquisition analysis.

|  |  |  |  |
| --- | --- | --- | --- |
|  | Land | 350,000 |  |
|  | Plant | 290,000 |  |
|  | Inventory | 85,000 |  |
|  | Cash | 15,000 |  |
|  |  Gain on bargain purchase |  | 40,000 |
|  |  Accounts payable |  | 20,000 |
|  |  Loans |  | 80,000 |
|  |  Share capital |  | 600,000 |
|  | (To record the acquisition of net assets of Daylight Ltd.) |  |  |

EXERCISE 2-3

1. Acquisition analysis

*Consideration transferred:*

 Shares: 100,000 × 10 × $10 = $10,000,000

 Patent 1,000,000

 Cash: 100,000 × $5.20 = 520,000

 $11,520,000

 *Fair value of identifiable assets and liabilities acquired:*

 Current assets $980,000

 Non-current assets 4,220,000

 5,200,000

 Liabilities 500,000

 $4,700,000

*Goodwill* = $11,520,000 – $4,700,000 = $6,820,000

EXERCISE 2-3 (Continued)

1. Journal entries: Lai Hing Ltd

|  |  |  |  |
| --- | --- | --- | --- |
|  | Current assets | 980,000 |  |
|  | Non-current assets | 4,220,000 |  |
|  | Goodwill | 6,820,000 |  |
|  |  Liabilities |  | 500,000 |
|  |  Patent 1 |  | 350,000 |
|  |  Share capital |  | 10,000,000 |
|  |  Gain on sale of patent |  | 650,000 |
|  |  Cash |  | 520,000 |
|  | (Acquisition of Sound Ltd) |  |  |
|  | 1 to remove the NBV of the patent as a result of the transfer |
|  | Acquisition-related expenses | 10,000 |  |
|  |  Cash |  | 10,000 |
|  | (Payment of costs associated with the acquisition to former shareholders) |  |  |
|  |  |  |  |
|  |  |  |  |
|  | Share capital | 500 |  |
|  |  Cash |  | 500 |
|  | (Costs of issuing shares) |  |  |

EXERCISE 2-4

*Consideration transferred:*

 Shares: 2 × 100,000 × $4 $800,000

 Cash: $1.50 × 100,000 150,000

 $950,000

*Consideration received:*

Equity = $850,000

Goodwill = $950,000 – $850,000 = $100,000.

**Journal entries: Island Ltd**

|  |  |  |  |
| --- | --- | --- | --- |
|  | Net assets in Island Ltd | 850,000 |  |
|  | Goodwill | 100,000 |  |
|  |  Share capital |  | 800,000 |
|  |  Cash |  | 150,000 |
|  | (Acquisition of shares in Island Ltd) |  |  |
|  |  |  |  |
|  | Share capital | 800 |  |
|  |  Cash |  | 800 |
|  | (Share issue costs) |  |  |

EXERCISE 2-5

1. 100,000 shares issued at $1.80 per share

 *Consideration transferred:*

 Shares: 100,000 × $1.80 $180,000

 *Net fair value of identifiable assets, liabilities, and contingent liabilities acquired:*

 Equipment $50,000

 Land 80,000

 Trucks 40,000

 Current assets 10,000

 180,000

 Current liabilities 16,000

 $164,000

 *Goodwill* = $180,000 – $164,000 = $16,000

 **Journal entries: Lower Ltd.**

|  |  |  |  |
| --- | --- | --- | --- |
|  | Equipment | 50,000 |  |
|  | Land | 80,000 |  |
|  | Trucks | 40,000 |  |
|  | Current assets | 10,000 |  |
|  | Goodwill | 16,000 |  |
|  |  Current liabilities |  | 16,000 |
|  |  Share capital |  | 180,000 |
|  | (Acquisition of assets and liabilities of Audet Ltd.) |  |  |

EXERCISE 2-5 (Continued)

1. 100,000 shares issued at $1.60 per share

 *Consideration transferred:*

 Shares: 100,000 × $1.60 $160,000

 *Net fair value of net assets acquired (see above)* $164,000

 *Gain on bargain purchase* = $164,000 – $160,000 = $4,000

 **Journal entries: Lower Ltd**

|  |  |  |  |
| --- | --- | --- | --- |
|  | Equipment | 50,000 |  |
|  | Land | 80,000 |  |
|  | Trucks | 40,000 |  |
|  | Current assets | 10,000 |  |
|  |  Current liabilities |  | 16,000 |
|  |  Gain on bargain purchase |  | 4,000 |
|  |  Share capital |  | 160,000 |
|  | (Acquisition of assets & liabilities of Audet Ltd) |  |  |

EXERCISE 2-6

1. Consideration transferred = 100,000 × $1.90

 = $190,000

 Net fair value of identifiable assets and

 liabilities of Dory Ltd. = $175,000

 Goodwill = $190,000 – $175,000

 = $15,000

 The journal entries at acquisition date, December 1, 2013 are:

|  |  |  |  |
| --- | --- | --- | --- |
|  | Cash  | 50,000 |  |
|  | Furniture &fixtures | 20,000 |  |
|  | Accounts receivable | 5,000 |  |
|  | Property, plant, and equipment | 125,000 |  |
|  | Goodwill | 15,000 |  |
|  |  Accounts payable |  | 15,000 |
|  |  Current tax liability |  | 8,000 |
|  |  Provision for vacation pay |  | 2,000 |
|  |  Share capital |  | 190,000 |
|  | (To record the acquisition of Dory Ltd. by Meeru) |  |  |

EXERCISE 2-6 (Continued)

**Acquisition of Dory Ltd.**

On December 1, 2013 all of the assets and liabilities of Dory Ltd. were acquired by the Company in exchange for issuing 100,000 shares. The fair value on the date of acquisition of the shares issued was $1.90 each.

The acquisition-date fair value of the total consideration transferred and the acquisition-date fair value of each major class of consideration were as follows:

|  |  |  |
| --- | --- | --- |
|  |  |  |
| Cash  | 50,000 |  |
| Furniture & fixtures | 20,000 |  |
| Accounts receivable | 5,000 |  |
| Property, plant, and equipment | 125,000 |  |
| Goodwill | 15,000 |  |
| Accounts payable |  | 15,000 |
| Current tax liability |  | 8,000 |
| Provision for vacation pay |  | 2,000 |

Additional information that would be required in the note disclosure for which there is currently not enough information is as follows:

* Reason for the acquisition
* What goodwill is comprised of
* The amounts of revenue and profit or loss of the acquiree since the acquisition date included in the consolidated statement of comprehensive income for the reporting period; and
* The revenue and profit or loss of the combined entity for the current reporting period as though the acquisition date for all business combinations that occurred during the year had been as of the beginning of the annual reporting period.

EXERCISE 2-6 (Continued)

1. At December 31, 2013, the provisional amounts must be used as per journal entries in part (a).

In 2014, the carrying amount of the plant must be calculated as if its fair value at the acquisition date had been recognized from that date, with an adjustment to goodwill. The plant increased by $6,000 from the estimated value. This means that Goodwill will increase by $6,000.

If the plant had a 5-year life from acquisition date, Dory Ltd would have charged depreciation for 1 month in 2013. Extra depreciation of $100 is required (calculated as 1/5 × 1/12 × $6,000).

The adjusting entry at March 1, 2014 is:

|  |  |  |  |
| --- | --- | --- | --- |
|  | Plant | 6,000 |  |
|  |  Goodwill |  | 6,000 |
|  | (Adjustment for provisional accounting) |  |  |
|  |  |  |  |
|  | Retained earnings (beginning) | 100 |  |
|  |  Accumulated depreciation |  | 100 |
|  | (Adjustment to depreciation due to provisional accounting) |  |  |

If depreciation has been calculated monthly for 2014, further adjustments would be required.

EXERCISE 2-6 (Continued)

1. Consideration transferred = 100,000 × $1.70

 = $170,000

 Net fair value of identifiable assets and

 liabilities of Dory Ltd = $175,000

 Gain on bargain purchase = $175,000 – $170,000

 = $5,000

 The journal entries at acquisition date, December 1, 2013 are:

|  |  |  |  |
| --- | --- | --- | --- |
|  | Cash  | 50,000 |  |
|  | Furniture &fixtures | 20,000 |  |
|  | Accounts receivable | 5,000 |  |
|  | Property, plant, and equipment | 125,000 |  |
|  |  Accounts payable |  | 15,000 |
|  |  Current tax liability |  | 8,000 |
|  |  Provision for vacation pay |  | 2,000 |
|  |  Gain on bargain purchase |  | 5,000 |
|  |  Share capital |  | 170,000 |
|  | (To record the acquisition of Dory Ltd. by Meeru) |  |  |

EXERCISE 2-7

The acquisition date is the date on which the acquirer obtains control of the acquiree. In this situation, there are three potential dates which could be considered to be the acquisition date. May 1, 2013 is the date that Chevron Inc. decided to acquire all of the outstanding shares of Chow Ltd. However, as of that date, Chevron Inc. has not obtained control of Chow Ltd., and as such it would not be considered to be the acquisition date. The preliminary acquisition price is based on the March 31, 2013 financial statements. However, again control of Chow Ltd. has not passed to Chevron Inc. and as such it also would not be considered to be the acquisition date. June 30, 2013 is the date when payment will be made, when the final purchase price is to be determined and it is when the shares of Chow Ltd. are to be transferred to Chevron Inc. As the shares will have been transferred to Chevron Inc., this is when control will have transferred and that is to be considered to be the acquisition date.

EXERCISE 2-8

The total acquisition price is:

|  |  |
| --- | --- |
| $947,695 | purchase price |
|  $0 | contingent consideration (given that the net income of Paisley Limited has historically been under $250,000 there is a remote chance that the net income will exceed $500,000) |
| $947,695 | total |

The legal and consulting fees would be expensed as incurred and not included in the total acquisition price as they are not part of the fair value exchange between the buyer and seller, they are separate transactions and they do not represent assets of the acquirer at the acquisition date because the benefits obtained are consumed as the services are received.

EXERCISE 2-9

|  |  |
| --- | --- |
| Consideration transferred: |  |
|  Cash | $847,103 |
|  |  |
| Net assets acquired: |  |
|  Fair market value of net assets  | $678,103 |
|  |  |
| Goodwill = $847,103 – $678,103 = | $169,000 |

EXERCISE 2-10

|  |  |  |
| --- | --- | --- |
| Consideration transferred: |  |  |
|  Cash  |  | $895,679 |
|  |  |  |
| Net assets acquired: |  |  |
|  Accounts receivable | $145,628 |  |
|  Inventory | $245,918 |  |
|  Property, plant, and equipment | $501,234 |  |
|  Accounts payable | ($167,291) |  |
|  Long-term debt | ($199,201) |  |
| Fair value of net assets acquired |  | $526,288 |
|  |  |  |
| Goodwill = $895,679 – $526,288 = |  | $369,391 |

Accounts Receivable 145,628

Inventory 245,918

Property Plant and equipment 501,234

Goodwill 369,391

 Accounts payable 167,291

 Long term debt 199,201

 Cash 895,679

**PROBLEMS**

PROBLEM 2-1

**CHRAPATY LTD – SQUID LTD**

**Cost of the combination**

Number of shares issued = ½ (90% × 60,000)

 = 27,000

Cost per share = $6.20

Consideration transferred = 27,000 × $6.20

 = $167,400

1. **Journal entries: Chrapaty Ltd**

|  |  |  |  |
| --- | --- | --- | --- |
|  | Shares in Squid Ltd | 167,400 |  |
|  |  Share capital |  | 167,400 |
|  | (Cost of shares acquired) |  |  |
|  |  |  |  |
|  | Share capital | 2,000 |  |
|  |  Cash |  | 2,000 |
|  | (Costs of shares issued) |  |  |

PROBLEM 2-1 (Continued)

1. **Determining the fair value of shares issued**

In acquiring the Squid Ltd shares, Chrapaty Ltd gave up 27,000 of its own shares. The problem is to determine which share price should be used to determine the cost. $6.20 is used here as it represents the fair value at the date of acquisition.

**CHRAPATY LTD**

##### Statement of Financial Position

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | **Current Assets** |  |  | $146,000 |
|  | **Non-current Assets** |  |  |  |
|  |  Investment in Squid Ltd |  | $167,400 |  |
|  |  Other |  |  190,000 |  |
|  | **Total Non-current Assets** |  |  |  357,400 |
|  | **Total Assets** |  |  | $503,400 |
|  | **Liabilities and Shareholder’s Equity** |  |  |  |
|  | **Liabilities** |  |  |  |
|  |  Creditors and provisions |  | $28,000 |  |
|  | **Total Liabilities** |  |  | $28,000 |
|  | **Equity** |  |  |  |
|  |  Share capital ($80,000 + $167,400 – $2,000) |  | $245,400 |  |
|  |  Reserves |  |  |  |
|  |  Asset revaluation reserve |  | $140,000 |  |
|  |  Retained earnings |  |  90,000 |  |
|  | **Total Shareholder’s Equity** |  |  |  475,400 |
|  | **Total Liabilities and Shareholder’s Equity** |  |  | $503,400 |

PROBLEM 2-2

**BILLIARDCO – QTECH LTD**

## Acquisition analysis

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | Consideration transferred | = | $20,000 |  (cash) |
|  |  | + | $40,000 |  (shares: 16,000 × $2.50) |
|  |  | = | $60,000 |  |

1. **Journal entries: Billiardco**

Net fair value of identifiable assets and liabilities acquired:

|  |  |
| --- | --- |
| Property, plant, and equipment | $30,000 |
| Inventory | 28,000 |
| Accounts receivable |  20,000 |
|  | 78,000 |
| Accounts payable |  20,000 |
|  | $58,000 |
|  |  |
|  |  |
| Consideration transferred = | $60,000 |
| Net fair value of identifiable assets and liabilities acquired = | $58,000 |
| Goodwill = | $2,000 |
|  |  |
| PROBLEM 2-2 (Continued) |  |

1. (continued)

**The journal entries are:**

|  |  |  |  |
| --- | --- | --- | --- |
|  | Property, plant and equipment | 30,000 |  |
|  | Inventory | 28,000 |  |
|  | Accounts receivable | 20,000 |  |
|  | Goodwill | 2,000 |  |
|  |  Accounts payable |  | 20,000 |
|  |  Payable to Qtech |  | 20,000 |
|  |  Share capital |  | 40,000 |
|  | (Net assets acquired from Qtech Ltd. and issue of shares) |  |  |
|  |  |  |  |
|  | Payable to Qtech Ltd | 20,000 |  |
|  |  Cash |  | 20,000 |
|  | (Payment of cash consideration) |  |  |
|  |  |  |  |
|  | Acquisition-related expenses | 500 |  |
|  |  Cash |  | 500 |
|  | (Payment of acquisition-related costs) |  |  |
|  |  |  |  |
|  | Share capital | 400 |  |
|  |  Cash |  | 400 |
|  | (Share issue costs) |  |  |

PROBLEM 2-2 (Continued)

# Billiardco

# Statement of Financial Position

|  |  |  |  |
| --- | --- | --- | --- |
|  | Current Assets |  |  |
|  |  Cash ($30,000 – $20,000 – $500 – $400) | $9,100 |  |
|  |  Accounts receivable ($8,000 + $20,000) | 28,000 |  |
|  |  Inventories ($14,000 + $28,000) |  42,000 |  |
|  | **Total Current Assets** |  | $79,100 |
|  | Non-current Assets |  |  |
|  |  Property, plant and equipment ($50,000 + $30,000) | $80,000 |  |
|  |  Government bonds | 12,000 |  |
|  |  Goodwill |  2,000 |  |
|  | **Total Non-current Assets** |  |  94,000 |
|  | **Total Assets** |  | $173,100 |
|  | Shareholder’s Equity and Liabilities |  |  |
|  | Current Liabilities |  |  |
|  |  Accounts payable ($20,000 + $2,000) | $22,000 |  |
|  | **Total Liabilities** |  | $22,000 |
|  | Equity |  |  |
|  |  Share capital ($100,000 + $40,000 – $400) | $139,600 |  |
|  |  Retained earnings ($12,000 – $500) |  11,500 |  |
|  | **Total Equity**  |  | $151,100 |
|  | **Total Liabilities and Shareholder’s Equity** |  | $173,100 |

 (c) **ERROR ADJUSTMENT**

 *According to IFRS 3 “Business Combinations”, an entity shall correct material prior period errors retrospectively in the first set of financial statements authorized for issue after their discovery by:*

*(a) restating the comparative amounts for the prior period(s) presented in which the error occurred; or*

*(b) if the error occurred before the earliest prior period presented, restating the opening balances of assets, liabilities and equity for the earliest prior period presented.*

 Assuming no depreciation of plant:

|  |  |  |  |
| --- | --- | --- | --- |
|  | Property Plant and equipment - net |  5,900 |  |
|  |  Goodwill/ bargain purchase |  | 6,000 |
|  | Retained earnings (beginning balance) 6000/5 = 1200/year x 1/12 | 100 |  |
|  | (Adjustment for error) |  |  |

PROBLEM 2-3

**Acquisition analysis**

 *To Preferred Shareholders:*

 Cash = $3.10 x 50,000

 = $155,000

 Shares = (2 x 50,000) x $4.20

 = $420,000

 *To Common Shareholders:*

As 90% of the common shareholders accepted, 90% X 80,000 = 72,000

 Cash = ($1.20 x ½ x 72,000)

 + ($1.20 x ½ x 72,000 x 0.925926)

 = $43,200 + $40,000

 = $83,200

 Shares = (3 x 72,000) x $4.20

 = $907,200

 Total = $238,200 (Cash) + $1,327,200 (shares)

 = $1,565,400

PROBLEM 2-3 (Continued)

 **Journal entries: Halbert Corp**

|  |  |  |  |
| --- | --- | --- | --- |
|  | 30/11/2013 |  |  |
|  | Preferred shares in Delcon Ltd | 575,000 |  |
|  |  Cash |  | 155,000 |
|  |  Share capital |  | 420,000 |
|  | (Acquisition of all preference shares of Delcon Ltd) |  |  |
|  |  |  |  |
|  | Common shares in Delcon Ltd | 990,400 |  |
|  |  Cash |  | 43,200 |
|  |  Payable (to ex-Delcon shareholders) |  | 40,000 |
|  |  Share capital |  | 907,200 |
|  | (Acquisition of 90% of the common shares of Delcon Ltd) |  |  |
|  |  |  |  |
|  | 30/11/2014 |  |  |
|  | Payable (to ex-Delcon shareholders) | 40,000 |  |
|  | Interest expense | 3,200 |  |
|  |  Cash |  | 43,200 |
|  | (Payment of deferred amount) |  |  |

PROBLEM 2-3 (Continued)

 **Journal entries: Delcon Ltd**

|  |  |  |  |
| --- | --- | --- | --- |
|  | 1/12/2013 |  |  |
|  | Shares in other companies | 160,000 |  |
|  |  Asset revaluation reserve |  | 160,000 |
|  | (Revaluation of asset) |  |  |
|  |  |  |  |
|  | 1/12/2013 |  |  |
|  | Asset revaluation reserve | 32,000 |  |
|  |  Dividend payable |  | 32,000 |
|  | (Declaration of dividends) |  |  |
|  |  |  |  |
|  | Dividend payable | 32,000 |  |
|  |  Share capital—Common shares |  | 32,000 |
|  | (Payment – 16,000 common shares) |  |  |

PROBLEM 2-4

**HASTINGS LTD – F-SQUARED LTD**

###### Acquisition analysis

 *Net fair value of assets and liabilities acquired:*

 Accounts receivable $34,700

 Inventory 39,000

 Land 130,000

 Buildings 40,000

 Property, plant and equipment 46,000

 $289,700

######  *Consideration transferred*

 Shares: 2/3 × 60,000 × $3.20 $128,000

 Cash

 Accounts payable ($43,500 + $1,600) $45,100

 Mortgage and interest ($40,000 + $4,000) 44,000

 Bonds and premium 52,500

 Liquidation expenses 2,400

 144,000

 Cash held by F-Squared (12,000) 132,000

 $260,000

 *Gain on bargain purchase* = $289,700 – $260,000

 = $29,700

|  |  |  |  |
| --- | --- | --- | --- |
|  | Property, plant, and equipment | 46,000 |  |
|  | Inventory | 39,000 |  |
|  | Buildings | 40,000 |  |
|  | Accounts receivable | 34,700 |  |
|  | Land | 130,000 |  |
|  |  Gain on bargain purchase |  | 29,700 |
|  |  Cash |  | 132,000 |
|  |  Share capital |  | 128,000 |
|  | (Net assets acquired from F-Squared Ltd. and issue of shares) |  |  |
|  |  |  |  |
|  | Share capital | 1,200 |  |
|  |  Cash |  | 1,200 |
|  | (Costs of issuing shares) |  |  |

PROBLEM 2-4 (Continued)

# Hastings Ltd.

# Statement of Financial Position

|  |  |  |  |
| --- | --- | --- | --- |
|  | Current Assets |  |  |
|  |  |  |  |
|  |  Accounts receivable ($25,000 + $34,700) | 59,700 |  |
|  |  Inventories ($35,500 + $39,000) |  74,500 |  |
|  | **Total Current Assets** |  | $134,2000 |
|  | Non-current Assets |  |  |
|  |  Property, plant, and equipment ($65,000 + $46,000) | 111,000 |  |
|  |  Buildings ($60,000 + $40,000) | 100,000 |  |
|  |  Land ($150,000 + $130,000) | 280,000 |  |
|  |  Goodwill |  25,000 |  |
|  | **Total Non-current Assets** |  |  516,000 |
|  | **Total Assets** |  | $650,200 |
|  | Shareholder’s Equity and LiabilitiesCurrent Liabilities |  |  |
|  |  Bank indebtedness ($23,000 – $132,000 – $1,200) | $ 110,200 |  |
|  |  Accounts payable | 56,000 | $166,200 |
|  | **Non-current liabilities** |  |  |
|  |  Mortgage loan | $50,000 |  |
|  |  Bonds |  100,000 |  |
|  | **Total Non-current liabilities** |  | $150,000 |
|  |  |  |  |
|  | **Total Liabilities** |  | $316,200 |
|  | Equity |  |  |
|  |  Share capital ($100,000 + $128,000 – $1,200) | $226,800 |  |
|  |  Retained earnings ($77,500 + $29,700) |  107,200 |  |
|  | **Total Equity**  |  | $334,000 |
|  | **Total Liabilities and Shareholder’s Equity** |  | $650,200 |

PROBLEM 2-5

**NEWSTAR INC – PLX LTD**

(a) **Acquisition Analysis – Newstar Ltd – PLX Ltd**

*Consideration transferred*

|  |  |  |  |
| --- | --- | --- | --- |
| Shareholders |  |  |  |
| Debentures  | ‘A’ shares of PLX Ltd. ($40,000/2) | 20,000 |  |
|  | Debentures in Newstar (1:1) 20,000 |  × $3.50 | $70,000 |
| Shares | B shares of PLX Ltd. 60,000 |  |  |
|  | Shares in Newstar (2/3) 40,000 × $2.70 =  |  | $108,000 |
| Creditors |  |  |  |
| Cash | Debentures issued | $30,000 |  |
|  | Plus premium (10%) |  3,000 |  |
|  |  | 33,000 |  |
|  | Accounts payable |  31,000 |  |
|  | Mortgage loan | 21,500 |  |
|  | Liquidation costs | 5,000 |  |
|  | Annual vacation pay |  16,200 |  |
|  | Total cash required | 106,700 |  |
|  | Less cash already held |  (20,000) |  $86,700 |
|  |  |  | $264,700 |

*Net fair value of identifiable assets and liabilities acquired*

 Accounts receivable $56,000

 Inventory 39,200

 Property, plant and equipment 140,000

 Shares in Sefton Ltd 22,500

 $257,700

*Goodwill* [$264,700\* – $257,700] = $7,000

\* The $1,600 transport costs are not included in the total consideration given to calculate goodwill. Rather they are expensed as incurred.

PROBLEM 2-5 (Continued)

**NEWSTAR INC**

**Journal Entries**

|  |  |  |  |
| --- | --- | --- | --- |
|  | Accounts receivable | 56,000 |  |
|  | Inventory | 39,200 |  |
|  | Property, plant, and equipment | 140,000 |  |
|  | Shares in Sefton Ltd | 22,500 |  |
|  | Goodwill | 7,000 |  |
|  |  Payable to PLX Ltd |  | 86,700 |
|  |  Share capital |  | 108,000 |
|  |  7% Debentures |  | 70,000 |
|  | (Acquisition of PLX Ltd) |  |  |
|  |  |  |  |
|  | Payable to PLX Ltd | 86,700 |  |
|  |  Cash |  | 86,700 |
|  | (Payment of cash consideration) |  |  |
|  |  |  |  |
|  | Acquisition-related expenses | 1,600 |  |
|  |  Cash |  | 1,600 |
|  | (Payment of acquisition-related costs) |  |  |
|  |  |  |  |
|  | Share capital | 900 |  |
|  |  Cash |  | 900 |
|  | (Payment of share issue costs) |  |  |

PROBLEM 2-5 (Continued)

(b)

# Newstar Inc.

# Statement of Financial Position

|  |  |  |  |
| --- | --- | --- | --- |
|  | Current Assets |  |  |
|  |  |  |  |
|  |  Accounts receivable ($75,000 + $56,000) | 131,000 |  |
|  |  Inventories ($56,000 + $39,200) |  95,200 |  |
|  | **Total Current Assets** |  | $226,200 |
|  | Non-current Assets |  |  |
|  |  Property, plant, and equipment ($180,000 + $140,000) | 320,000 |  |
|  |  Accumulated depreciation | (60,000) |  |
|  |  Land | 65,000 |  |
|  |  Investment in Sefton Ltd. | 22,500 |  |
|  |  Bonds in Akaroa Ltd. | 10,000 |  |
|  |  Goodwill |  7,000 |  |
|  | **Total Non-current Assets** |  |  364,500 |
|  | **Total Assets** |  | $590,700 |
|  |  |  |  |
|  | Shareholder’s Equity and Liabilities Current Liabilities |  |  |
|  |  Bank indebtedness($50,000 – $86,700 – $1,600 – $900) | $39,200 |  |
|  |  Accounts payable  | 62,000 | $101,200 |
|  | **Non-current liabilities** |  |  |
|  |  Mortgage loan | $75,000 |  |
|  |  Bonds ($100,000 + $70,000) | 170,000 |  |
|  | **Total Non-current liabilities** |  |  245,000 |
|  |  |  |  |
|  | **Total Liabilities** |  | $346,200 |
|  | Equity |  |  |
|  |  Share capital ($100,000 + $108,000 – $900) | $207,100 |  |
|  |  Retained earnings ($39,000 – $1,600) |  37,400 |  |
|  | **Total Equity**  |  | $244,500 |
|  | **Total Liabilities and Shareholder’s Equity** |  | $590,700 |

PROBLEM 2-6

**LING LTD – MORWONG LTD**

(a) **Acquisition analysis**

###### *Consideration transferred*

 Land $120,000

 Delivery trucks 28,000

 Cash

 Accounts payable $23,500

 Liquidation expenses 1,500 $25,000

 Cash held (2,000) 23,000

 $171,000

*Fair value of identifiable assets and liabilities acquired:*

 Accounts receivable $15,000

 Land 120,000

 Buildings 40,000

 Cultivation equipment 40,000

 Irrigation equipment 22,000 $237,000

 Loan—Bank of NB (80,000)

 Loan—Farinacci Bros (35,000)

 Loan—Long Cloud (52,500) 167,500

 $69,500

 *Goodwill*

 Goodwill = $171,000 – $69,500

 = $101,500

##### PROBLEM 2-6 (Continued)

##### LING LTD

##### Journal Entries

|  |  |  |  |
| --- | --- | --- | --- |
|  | Accounts receivable | 15,000 |  |
|  | Land | 120,000 |  |
|  | Buildings | 40,000 |  |
|  | Cultivation equipment | 40,000 |  |
|  | Irrigation equipment | 22,000 |  |
|  | Goodwill | 101,500 |  |
|  | Loss on disposal of the trucks | 2,000 |  |
|  |  Loan—Bank of NB |  | 80,000 |
|  |  Loan—Farinacci Bros |  | 35,000 |
|  |  Loan—Long Cloud |  | 52,500 |
|  |  Land |  | 50,000 |
|  |  Gain on disposal of land |  | 70,000 |
|  |  Trucks |  | 30,000 |
|  |  Payable to Morwong Ltd |  | 23,000 |
|  | (Acquisition of net assets of Morwong Ltd) |  |  |
|  |  |  |  |
|  | Payable to Morwong Ltd | 23,000 |  |
|  |  Cash |  | 23,000 |
|  | (Payment of the consideration transferred) |  |  |
|  |  |  |  |

##### PROBLEM 2-6 (Continued)

##### MORWONG LTD

##### Journal Entries

(b)

|  |  |  |  |
| --- | --- | --- | --- |
|  |  Receivable from Ling Ltd | 171,000 |  |
|  |  Accounts receivable |  | 15,000 |
|  |  Land |  | 100,000 |
|  |  Buildings |  | 30,000 |
|  |  Cultivation equipment |  | 46,000 |
|  |  Irrigation equipment |  | 22,000 |
|  | Loan—Bank of NB | 80,000 |  |
|  | Loan—Farinacci Bros | 35,000 |  |
|  | Loan—Long Cloud | 52,500 |  |
|  |  Retained earnings |  | 125,500 |
|  | (Transfer of assets and liabilities) |  |  |
|  | Land | 120,000 |  |
|  | Delivery trucks | 28,000 |  |
|  | Cash | 23,000 |  |
|  |  Receivable from Ling Ltd |  | 171,000 |
|  | (Receipt of purchase consideration) |  |  |
|  |  |  |  |
|  | Retained earnings | 1,500 |  |
|  |  Liquidation expenses payable |  | 1,500 |
|  | (Expense payable) |  |  |
|  |  |  |  |
|  | Liquidation expenses payable | 1,500 |  |
|  | Accounts payable | 23,500 |  |
|  |  Cash |  | 25,000 |
|  | (Payment of outstanding debts) |  |  |
|  |  |  |  |
|  | Share capital | 60,000 |  |
|  |  Retained earnings | 156,000 |  |
|  |  Shareholders’ distribution dividend payable |  | 216,000 |
|  | (Transfer of share capital and RE) |  |  |
|  |  |  |  |
|  | Shareholders’ distribution payable | 216,000 |  |
|  |  Land |  | 120,000 |
|  |  Motor vehicle |  | 32,000 |
|  |  Delivery trucks |  | 64,000 |
|  | (Transfer of assets to shareholders) |  |  |

##### PROBLEM 2-6 (Continued)

(c)

##### LING LTD

**Statement of Financial Position**

**as at July 1, 2013**

|  |  |  |  |
| --- | --- | --- | --- |
|  | **Current Assets** |  |  |
|  |  Accounts receivable ($25,000 + $15,000) | $40,000 |  |
|  | **Total Current Assets** |  | 40,000 |
|  | **Non-Current Assets** |  |  |
|  |  Land ($250,000 – $50,000 + $120,000) | 320,000 |  |
|  |  Buildings ($25,000 + $40,000) | 65,000 |  |
|  |  Cultivation equipment ($65,000 + $40,000) | 105,000 |  |
|  |  Irrigation equipment ($16,000 + $22,000) | 38,000 |  |
|  |  Delivery trucks ($45,000 – $30,000) | 15,000 |  |
|  |  Motor vehicles  | 25,000 |  |
|  |  Goodwill | 101,500 |  |
|  | **Total Non-current Assets** |  |  669,500 |
|  | **Total Assets** |  | $709,500 |
|  |  |  |  |
|  | **Liabilities and Shareholder’s Equity** |  |  |
|  | **Current Liabilities** |  |  |
|  |  Bank overdraft  | 19,500 |  |
|  |  Accounts payable |  26,000 |  |
|  | **Total Current Liabilities** |  | 45,500 |
|  | **Non-current Liabilities** |  |  |
|  |  Loan—Bank of NB ($150,000 + $80,000) | 230,000 |  |
|  |  Loan—Farinacci Bros ($35,000 + $35,000) | 70,000 |  |
|  |  Loan—Long Cloud ($70,000 + $52,500) | 122,500 |  |
|  | **Total Non-current Liabilities** |  |  422,500 |
|  | **Total Liabilities** |  | 468,000 |
|  |  |  |  |
|  | **Equity** |  |  |
|  |  Share capital | $100,000 |  |
|  |  |  |  |
|  |  Retained earnings ($73,500 + 70,000 -2000) |  141,500 |  |
|  | **Total Equity** |  |  241,500 |
|  | **Total Liabilities and Shareholder’s Equity** |  | $709,500 |

##### PROBLEM 2-7

**ZANADU LTD – CORION LTD**

#### Acquisition Analysis

*Net fair value of identifiable assets and liabilities acquired:*

 Accounts receivable $125,000

 Land 840,000

 Buildings 550,000

 Farm equipment 364,000

 Irrigation equipment 225,000

 Vehicles ($172,000 – $48,000) 124,000

 2,228,000

 Accounts payable (80,000)

 $2,148,000

*Consideration transferred:*

 Shares: 100,000 × $14 per share $1,400,000

 Cash: ($480,000 +$5,500 +$150,000 – $20,000)

 $615,500

 Land: 220,000

 $2,235,500

*Goodwill* $2,235,500 – $2,148,000 = $87,500

##### PROBLEM 2-7 (Continued)

**The journal entries in Zanadu Ltd are:**

|  |  |  |  |
| --- | --- | --- | --- |
|  | Accounts receivable | 125,000 |  |
|  | Land | 840,000 |  |
|  | Buildings | 550,000 |  |
|  | Farm equipment | 364,000 |  |
|  | Irrigation equipment | 225,000 |  |
|  | Vehicles | 124,000 |  |
|  | Goodwill | 87,500 |  |
|  |  Accounts payable |  | 80,000 |
|  |  Share capital |  | 1,400,000 |
|  |  Cash |  | 615,500 |
|  |  Land |  | 80,000 |
|  |  Gain on sale of land |  | 140,000 |
|  | (Acquisition of net assets of Corion Ltd) |  |  |
|  |  |  |  |
|  | Acquisition-related expenses | 25,000 |  |
|  |  Cash |  | 25,000 |
|  | (Payment of acquisition-related costs) |  |  |
|  |  |  |  |
|  | Share capital | 18,000 |  |
|  |  Cash |  | 18,000 |
|  | (Share issue costs) |  |  |
|  |  |  |  |

##### PROBLEM 2-8

**SARATOGA LTD – KINGFISH LTD**

(a)

(1) **Assuming the fair value of “A” common shares was $2 per share**

**Acquisition analysis**

 *Net fair value of identifiable assets and*

 *liabilities acquired* = $22,000 (inventory)

 + $34,000 (land and buildings)

 + $27,000 (plant and machinery)

 = $83,000

 *Consideration transferred* = 40,000 shares × $2.00

 = $80,000

 *Gain on bargain purchase* = $3,000

**Journal entries:**

|  |  |  |  |
| --- | --- | --- | --- |
|  | Inventory | 22,000 |  |
|  | Land and buildings | 34,000 |  |
|  | Plant and machinery | 27,000 |  |
|  |  Gain on bargain purchase |  | 3,000 |
|  |  Share capital—“A” common |  | 80,000 |
|  | (Assets acquired and shares issued) |  |  |

##### PROBLEM 2-8 (Continued)

(a) (continued)

(2) **Assuming the fair value of “A” common shares was $2.20 per share**

 **Acquisition analysis**

 Net fair value of identifiable assets

 and liabilities acquired (above) = $83,000

 Consideration transferred = 40,000 shares × $2.20

 = $88,000

 Goodwill = $5,000

 **Journal entries:**

|  |  |  |  |
| --- | --- | --- | --- |
|  | Inventory | 22,000 |  |
|  | Land and buildings | 34,000 |  |
|  | Plant and machinery | 27,000 |  |
|  | Goodwill | 5,000 |  |
|  |  Share capital—“A” common |  | 88,000 |
|  | (Assets acquired and shares issued) |  |  |

##### PROBLEM 2-8 (Continued)

(b)

# KINGFISH LTD

# General Journal

(1) **Assuming the fair value of “A” common shares was $2 per share**

|  |  |  |  |
| --- | --- | --- | --- |
|  | Income from sale of segment (carrying amount of segment sold) | 45,000 |  |
|  | Accumulated depreciation—plant & machinery | 18,000 |  |
|  |  Inventory |  | 15,000 |
|  |  Land and buildings |  | 10,000 |
|  |  Plant and machinery |  | 38,000 |
|  | (Transfer of assets sold) |  |  |
|  |  |  |  |
|  | Receivable from Saratoga Ltd | 80,000 |  |
|  |  Income from sale of segment |  | 80,000 |
|  | (Purchase consideration) |  |  |
|  |  |  |  |
|  | Shares in Saratoga Ltd | 80,000 |  |
|  |  Receivable from Saratoga Ltd |  | 80,000 |
|  | (Receipt of purchase consideration) |  |  |

**Note: entries are treated as if a discontinued operation**

##### PROBLEM 2-8 (Continued)

(b) (continued)

(2)  **Assuming the fair value of “A” common shares was $2.20 per share**

|  |  |  |  |
| --- | --- | --- | --- |
|  | Income from sale of segment (carrying amount of segment sold) | 45,000 |  |
|  | Accumulated depn.—plant and machinery | 18,000 |  |
|  |  Inventory |  | 15,000 |
|  |  Land and buildings |  | 10,000 |
|  |  Plant and machinery |  | 38,000 |
|  | (Transfer of assets sold) |  |  |
|  |  |  |  |
|  | Receivable from Saratoga Ltd | 88,000 |  |
|  |  Income from sale of segment |  | 88,000 |
|  | (Purchase consideration) |  |  |
|  |  |  |  |
|  | Shares in Saratoga Ltd | 88,000 |  |
|  |  Receivable from Saratoga Ltd |  | 88,000 |
|  | (Receipt of consideration) |  |  |

Note: entries are as if a discontinue operation

##### PROBLEM 2-8 (Continued)

(c)

# SARATOGA LTD

# Statement of Financial Position

as at January 1, 2013

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | **Current Assets** |  |  |  |
|  |  Cash |  | $12,000 |  |
|  |  Accounts receivable |  | 18,000 |  |
|  |  Inventory ($43,000 + $22,000) |  |  65,000 |  |
|  | **Total Current Assets** |  |  | $95,000 |
|  |  |  |  |  |
|  | **Non-Current Assets** |  |  |  |
|  |  Land and buildings ($23,000 + $34,000) |  | 57,000 |  |
|  |  Plant and machinery ($52,000 + $27,000) | $79,000 |  |  |
|  |  Less: Accumulated depreciation |  34,000 | 45,000 |  |
|  |  Goodwill |  |  5,000 |  |
|  | **Total Non-Current Assets** |  |  |  107,000 |
|  | **Total Assets** |  |  | $202,000 |
|  |  |  |  |  |
|  | **Liabilities and Shareholder’s Equity** |  |  |  |
|  | **Current Liabilities** |  |  |  |
|  |  Accounts payable |  |  | $42,000 |
|  | **Non-current Liabilities** |  |  |  |
|  |  Bonds |  |  |  20,000 |
|  | **Total Liabilities** |  |  | $62,000 |
|  |  |  |  |  |
|  | **Equity** |  |  |  |
|  |  Share capital |  |  |  |
|  |  40,000 common shares, fully paid  | $40,000 |  |  |
|  |  40,000 “A” common shares, fully paid |  88,000 | $128,000 |  |
|  |  Retained earnings  |  |  12,000 |  |
|  | **Total Equity** |  |  |  140 000 |
|  | **Total Liabilities & Shareholder’s Equity** |  |  | $202,000 |

##### PROBLEM 2-9

**TAILOR LTD – FLATHEAD LTD – FLEXON LTD**

(a)

**Acquisition Analysis – Tailor Ltd – Flathead Ltd**

*Consideration transferred*

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | *Shareholders* |  |  |  |
|  | Shares | Shares of Flathead Ltd | 150,000 |  |
|  |  | Shares in Tailor Ltd (1/3) = | 50,000 × $2.50 | $125,000 |
|  | Shares in Listed Companies |  |  | 15,000 |
|  |  |  |  |  |
|  | *Creditors* |  |  |  |
|  |  | Cash |  |  |
|  |  | Accounts payable |  $49,100 |  |
|  |  | Mortgage loan | 30,000 |  |
|  |  | Liquidation costs | 8,700 |  |
|  |  | Accrued vacation pay  |  29,700 |  |
|  |  | Total cash required | 117,500 |  |
|  |  | Less cash already held |  (5,200) |  112,300 |
|  |  |  |  | $252,300 |

*Fair value of identifiable assets and liabilities acquired*

 Accounts receivable $21,300

 Inventory 26,000

 Land and buildings 80,000

 Plant and equipment 105,000

 $232,300

**Goodwill** = $252,300 – $232,300 = $20,000

##### PROBLEM 2-9 (Continued)

**Acquisition Analysis – Tailor Ltd – FlexonLtd**

*Consideration transferred*

 To Shareholders:

 Shares Shares of Flexon Ltd 60,000

 Shares in Tailor Ltd (1/2) 30,000 × $2.50 $75,000

 Cash 60,000/2 × $1.50 45,000

  $120,000

**TAILOR LTD**

**Journal Entries**

|  |  |  |
| --- | --- | --- |
| Accounts receivable | 21,300 |  |
| Inventory | 26,000 |  |
| Land and buildings | 80,000 |  |
| Plant and equipment | 105,000 |  |
| Goodwill | 20,000 |  |
|  Payable to Flathead Ltd |  | 112,300 |
| Loss on disposal of asset | 1,000 |  |
|  Shares in listed companies |  | 16,000 |
|  Share capital |  | 125,000 |
|  (Acquisition of Flathead Ltd’s assets) |  |  |
|  |  |  |  |
|  |  |  |  |
|  | Acquisition-related expenses | 7,600 |  |
|  |  Cash |  | 7,600 |
|  | (Payment of acquisition-related costs) |  |  |
|  |  |  |  |
|  | Share capital | 950 |  |
|  |  Cash |  | 950 |
|  | (Payment of share issue costs) |  |  |
|  |  |  |  |
|  | Shares in Flexon Ltd | 120,000 |  |
|  |  Share capital |  | 75,000 |
|  |  Cash |  | 45,000 |
|  | (Acquisition of shares in Flexon Ltd) |  |  |

##### PROBLEM 2-9

(b) Goodwill is measured differently for two reasons:

1. It is prohibited to recognize internally generated goodwill so the figure recorded in the books of Flathead Ltd does not represent the total goodwill of the company as at acquisition date.
2. Goodwill cannot be separated from the company and sold separately so no fair value is available. The only way goodwill can be measured is to compare the total value of the company against the fair values of its identifiable net assets, any surplus is deemed to represent the value of the net unidentifiable assets or goodwill.

(c) The journal entry to record the dividend cheque is:

|  |  |  |  |
| --- | --- | --- | --- |
|  | Cash | 1,500 |  |
|  |  Dividend revenue |  | 1,500 |
|  | (Dividend received from Flexon Ltd) |  |  |

All dividends are treated as revenue by the acquirer regardless out of which equity the dividend is paid.

(d) Tailor Ltd should post the following journal:

|  |  |  |  |
| --- | --- | --- | --- |
|  | Goodwill | 25,000 |  |
|  |  Cash |  | 25,000 |
|  | (Payment to Flathead Ltd) |  |  |

If the liability had been identified at acquisition date then Tailor Ltd would have paid an extra $25,000 cash to acquire the assets of Flathead Ltd. As the cost of the combination has increased but there has been no change in the fair values of identifiable assets and liabilities, then the value of goodwill acquired must increase.

##### PROBLEM 2-10

**SAVOIE LTEE – BLACKFISH LTD – LYNX LTD**

(a)

# Acquisition Analysis: SavoieLtee – Blackfish Ltd

*Net fair value of identifiable assets and liabilities acquired*:

 Land & buildings $60,000

 Plant & machinery 50,000

 Office equipment 4,000

 Shares in listed companies 15,000

 Accounts receivable 26,000

 Inventory 54,000

 209,000

 Accounts payable 14,000

 Bank loan 16,000

 30,000

 Net fair value of identifiable assets and liabilities acquired $179,000

*Consideration transferred:*

 *Shares in Savoie Ltee*

 Shares issued by Blackfish Ltd 60,000

 Shares in Savoie Ltd to issue:

 (3/4 × 60,000) 45,000 × $3.00 = $135,000

 *Cash*

 Current tax liability $6,000

 Provision for leave 10,000

 Bonds 50,000

 5% premium 2,500

 Liquidation costs 2,500

 71,000

 Less cash held 11,000 60,000

 Total consideration $195,000

*Goodwill*  [$195,000 – $179,000] $16,000

##### PROBLEM 2-10 (Continued)

## Acquisition Analysis: Savoie Ltee – Lynx Ltd’s Spare Parts Retail Division

*Net fair value of identifiable assets and liabilities acquired*

 Land & buildings $30,000

 Plant & machinery 34,500

 Office equipment 2,500

 Inventory 12,000

 Accounts receivable 20,000

 99,000

 Accounts payable $14,000

 Provision for leave 7,000 21,000

 $78,000

*Consideration transferred:*

 Cash $10,000

 Shares [11,000 × $3.00] 33,000

 Land and Buildings 60,000

 $103,000

*Goodwill* [$103,000 – $78,000] $25,000

PROBLEM 2-10 (Continued)

(b)

**SAVOIE LTEE**

**General Journal**

|  |  |  |  |
| --- | --- | --- | --- |
|  | Land & buildings | 60,000 |  |
|  | Plant & machinery | 50,000 |  |
|  | Office equipment | 4,000 |  |
|  | Shares in listed companies | 15,000 |  |
|  | Inventory | 54,000 |  |
|  | Accounts receivable | 26,000 |  |
|  | Goodwill | 16,000 |  |
|  |  Accounts payable |  | 14,000 |
|  |  Bank loan |  | 16,000 |
|  |  Payable to Blackfish Ltd |  | 60,000 |
|  |  Share capital |  | 135,000 |
|  | (Acquisition of assets and liabilities of Blackfish Ltd and issue of shares) |  |  |
|  |  |  |  |
|  | Share capital | 2,000 |  |
|  |  Cash |  | 2,000 |
|  | (Payment of costs of issuing shares) |  |  |
|  |  |  |  |
|  | Acquisition-related expenses | 2,500 |  |
|  |  Cash |  | 2,500 |
|  | (Costs related to acquisition) |  |  |
|  |  |  |  |
|  | Payable to Blackfish Ltd | 60,000 |  |
|  |  Cash |  | 60,000 |
|  | (Payment of cash) |  |  |
|  |  |  |  |
|  | Land & buildings | 30,000 |  |
|  | Plant & machinery | 34,500 |  |
|  | Office equipment | 2,500 |  |
|  | Inventory | 12,000 |  |
|  | Accounts receivable | 20,000 |  |
|  | Goodwill | 25,000 |  |
|  |  Accounts payable |  | 14,000 |
|  |  Provision for leave |  | 7,000 |
|  |  Payable to Lynx Ltd |  | 10,000 |
|  |  Share capital |  | 33,000 |
|  |  Gain on sale of Land and Building |  | 60,000 |
|  | (Acquisition of the spare parts retail division of Lynx Ltd and issue of shares) |  |  |
|  | PROBLEM 2-10 (Continued) |  |  |
|  | Acquisition-related expenses | 1,000 |  |
|  |  Cash |  | 1,000 |
|  | (Payment of acquisition-related costs) |  |  |
|  |  |  |  |
|  | Payable to Lynx Ltd | 10,000 |  |
|  |  Cash |  | 10,000 |
|  | (Payment of purchase consideration) |  |  |
|  |  |  |  |

**LYNX LTD**

**General Journal**

|  |  |  |  |
| --- | --- | --- | --- |
|  | Cost of net assets of division sold | 66,000 |  |
|  | Accounts payable | 14,000 |  |
|  | Provision for leave | 7,000 |  |
|  |  Land & buildings |  | 20,000 |
|  |  Plant & machinery |  | 32,000 |
|  |  Office equipment |  | 2,000 |
|  |  Inventory |  | 12,000 |
|  |  Accounts receivable |  | 21,000 |
|  | (Carrying amount of net assets sold) |  |  |
|  |  |  |  |
|  | Receivable from Savoie Ltee | 103,000 |  |
|  |  Income on sale of division |  | 103,000 |
|  | (Consideration for net assets of division sold)Note: the difference between the income of 103000 and the cost of 66,000 will be reflected as a net gain |  |  |
|  |  |  |  |
|  | Cash | 10,000 |  |
|  | Shares in Savoie Ltee | 33,000 |  |
|  | Land & buildings | 60,000 |  |
|  |  Receivable from Savoie Ltee |  | 103,000 |
|  | (Receipt of consideration from SavoieLtee) |  |  |

**WRITING ASSIGNMENTS**

WRITING ASSIGNMENT 2-1

**Nature of goodwill**

* Is it an asset?
* 2 types: Internal vs external/acquired goodwill
* Nature of internal goodwill: undervalued/unrecorded assets, core goodwill
* Nature of acquired goodwill? Core goodwill: going concern & combination
* Why did acquirer pay for goodwill? Synergy – extra benefits

**How to account for it**

* Internal goodwill IAS 38 *Intangible Assets*: not recognized as cannot determine a cost
* Acquired goodwill
* Recognized only in a business combination
* Measured as a residual and is calculated as the excess of the consideration transferred in a business combination over the acquirer’s interest in the net fair value of the identifiable assets acquired and liabilities assumed from the acquiree
* Subject to annual impairment test
* If the goodwill is allocated to a cash generating unit, write off the goodwill first if there is an impairment loss
* If reversal of impairment loss, no reinstatement of goodwill
* Future effects on Statement of Comprehensive Income
* No cause for concern
* No annual amortization
* Only expense if impairment loss
* Impairment loss cushioned by various accounting treatments such as use of cost method for PPE, non-recognition of internally generated goodwill & internally generated intangibles

WRITING ASSIGNMENT 2-2

Arguments in favour of expensing the acquisition related costs:

* These costs are not part of the fair value exchange between the buyer and the seller.
* They are separate transactions for which the buyer pays the fair value for the services received.
* The services received from the outlays have been consumed, and so do not give rise to assets.

Arguments against expensing:

* Inconsistent with other accounting standards such as *IAS 16* *Property, Plant and Equipment* and *IAS 38 Intangible Assets* where directly attributable costs are considered as part of the cost of acquisition and capitalized into the cost of the asset acquired*.*
* The costs are an integral part of the acquisition price, with the outlays being incurred in order to generate future benefits.

Under IFRS 3 *Business Combinations*, a fair value model is adopted so consistency with IAS 16 and IAS 38 is not a strong argument.

The acquirer is prepared to incur the costs at acquisition. Hence there must be an expectation on the acquirer’s part that these will be recouped via future benefits from the business combination. As noted by Ms. Yamaguchi, business combinations do not result in immediate losses. However, because the fair value model is used, the assets acquired cannot be stated in excess of fair value – compare the initial measurement of financial instruments acquired under IAS 39 *Financial Instruments: Recognition and Measurement*.

If goodwill reflects expected future benefits and is measured as a residual, then it may be argued the total benefits acquired by the acquirer are reflected in the cost of the combination being the sum of the consideration transferred and the directly attributable costs. Under this view there would be a larger goodwill measured than currently recognised under IFRS 3, but no expense for the acquisition-related costs.

Note in IFRS it is argued that:

1. Acquisition-related costs are not part of the fair value exchange between the buyer and the seller.
2. They are separate transactions for which the buyer pays the fair value for the services received.
3. These amounts do not generally represent assets of the acquirer at acquisition date because the benefits obtained are consumed as the services are received.

WRITING ASSIGNMENT 2-3

TC Corp entered into the employment agreement before the negotiations of the combination began, and the purpose of the agreement was to obtain the services of CEO. Thus, there is no evidence that the agreement was arranged primarily to provide benefits to AC Ltd or the combined entity. Therefore, the liability to pay $5 million is included in the application of the acquisition method.

In other circumstances, TC might enter into a similar agreement with the CEO at the suggestion of AC during the negotiations for the business combination. If so, the primary purpose of the agreement might be to provide severance pay to the CEO, and the agreement may primarily benefit AC or the combined entity rather than TC or its former owners. In that situation, AC would account for the liability to pay the CEO in its post-combination financial statements separately from application of the acquisition method.

WRITING ASSIGNMENT 2-4

1. The agreement, whether cancellable or not, meets the contractual-legal criterion. Additionally, because RAH Ltd establishes its relationship with Bourassa Corp. through a contract, not only the agreement itself but also RAH’s customer relationship with Bourassa meets the contractual-legal criterion. As a result, the agreement should be recorded at its fair value.

2. The contract to be Wearhuis’ exclusive supplier of sporting goods, whether cancellable or not, meets the contractual-legal criterion. Additionally, because Total Sporting Goods establishes its relationship with Wearhuis through a contract, the customer relationship with Wearhuis meets the contractual-legal criterion. Because Total Sporting Goods has only one customer relationship with Wearhuis, the fair value of that relationship incorporates assumptions about Total Sporting Good’s relationship with Wearhuis related to both sporting goods and electronics. However, if Divestex Ltd. determines that the customer relationships with Wearhuis for sporting goods and for electronics are separate from each other, Divestex Ltd. would assess whether the customer relationship for electronics meets the separability criterion for identification as an intangible asset. The agreement should be recorded at its fair value.

3. Regardless of whether they are cancellable or not, the purchase orders from 60% of TransOntario’s customers meet the contractual-legal criterion. Additionally, because TransOntario has established its relationship with 60% of its customers through contracts, not only the purchase orders but also TransOntario’s customer relationships meet the contractual-legal criterion. Because TransOntario has a practice of establishing contracts with the remaining 40% of its customers, its relationship with those customers also arises through contractual rights and therefore meets the contractual-legal criterion even though TransOntario does not have contracts with those customers at December 31, 2013. As a result, the agreement should be recorded at its fair value in the business combination.

4. Because Financeco establishes its relationships with policyholders through insurance contracts, the customer relationship with policyholders meets the contractual-legal criterion. IAS 36 *Impairment of Assets* and IAS 38 *Intangible Assets* apply to the customer relationship intangible asset.

WRITING ASSIGNMENT 2-5

Wheatnix would calculate a loss of $5 million (the lesser of the $6 million stated settlement amount and the amount by which the contract is unfavourable to the acquirer) separately from the business combination. The $3 million ‘at-market’ component of the contract is part of goodwill.

Whether Wheatnix had recognized previously an amount in its financial statements related to a pre-existing relationship will affect the amount recognized as a gain or loss for the effective settlement of the relationship. Suppose that IFRSs had required Wheatnix to recognize a $6 million liability for the supply contract before the business combination. In that situation, Wheatnix recognizes a $1 million settlement gain on the contract in profit or loss at the acquisition date (the $5 million measured loss on the contract less the $6 million loss previously recognized). In other words, Wheatnix has in effect settled a recognized liability of $6 million for $5 million, resulting in a gain of $1 million.

**CASES**

CASE 2-1

Principles in IAS 38 *Intangible Assets*:

* Definitions of research (In the research phase of an internal project, an entity cannot demonstrate that an intangible asset exists that will generate probable future economic benefits. Therefore, this expenditure is recognized as an expense when it is incurred) versus development (In the development phase of an internal project, an entity can, in some instances, identify an intangible asset and demonstrate that the asset will generate probable future economic benefits. This is because the development phase of a project is further advanced than the research phase).
* There are criteria to determine what is research & development:
	+ the technical feasibility of completing the intangible asset so that it will be available for use or sale.
	+ its intention to complete the intangible asset and use or sell it.
	+ its ability to use or sell the intangible asset.
	+ how the intangible asset will generate probable future economic benefits. Among other things, the entity can demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset.
	+ the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset.
	+ its ability to measure reliably the expenditure attributable to the intangible asset during its development.
* Expense research outlays, capitalize development .
* Never recognize certain internally generated intangibles .

How to account for the acquired research:

* IFRS 3 *Business Combinations* is the relevant accounting standard to be followed as it was acquired in a business combination, not IAS 38.
* Measured at fair values using hierarchy: active market, similar transactions & valuation techniques.
* Intangibles that meet the recognition criteria must be accounted for separately from goodwill. Directors may prefer a classification of goodwill as the latter is not amortized, whereas intangibles generally have a finite life.

CASE 2-2

CC acquired 220 leasehold interests from MC and their online store. They intend to use the locations purchased to eventually open CC stores in Eastern Canada, in addition to the website that was purchased.

CC must maintain the net income and equity figures for the debt to equity covenant imposed by the lender who assisted with financing this acquisition.

The CFO of CC thought that this transaction could be accounted for as a business combination. In doing so, the identifiable assets acquired, the leasehold interests and the website, would be measured at their acquisition date fair values and any goodwill or gain from bargain purchase would be recognized. By recognizing goodwill, which is not amortized but rather is tested for impairment on annual basis, by not amortizing it or expensing it immediately the equity figure would be more favourable. Similarly, by recognizing a gain from bargain purchase, it would be recognized in net income immediately and it would positively impact the equity and net income figures.

However, it must be assessed if this transaction meets the conditions to be a business combination, whereby what was acquired constitutes a business or if the assets acquired are not a business, if it should be accounted for as an asset acquisition.

A business combination is a transaction in which an acquirer, in this case CC, acquires control of a business. Must assess if CC has obtained control and if a business has been acquired.

A reporting entity controls another entity when they have the power to direct its activities so as to generate returns for the reporting entity. CC has obtained control of the leasehold interests and website of MC as they are changing the activities so as to obtain benefits from it. However, must assess if these activities constitute a business or are simply an acquisition of assets.

A business is an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return directly to owners or investors. A business consists of inputs and processes applied to those inputs that have the ability to create outputs. A business need not include all of the inputs or processes that the seller (MC) used in operating that business if market participants are capable of acquiring the business and continuing to produce outputs, for example by integrating the business with their own inputs and processes.

CASE 2-2 (Continued)

What CC acquired from MC are the leases for 220 of their 279 locations and their online website. Do these leases constitute a business (are there input, processes, and outputs) or are they an intangible asset- the favourable leases and the online site? It could be viewed that they did not buy the MC business since they did not buy the MC brand. However, the major value in MC are the lease locations. By not using the name brand MC to carry on the business subsequent to the acquisition, could conclude that the business itself is not being acquired and that it is only the assets they have purchased. However, part of what they paid for is the elimination of the competition called MC. In addition, the remaining stores are being wound up subsequent to the acquisition by CC and CC plans to start operating their own book stores within the 220 leasehold interests they acquired, which could be viewed as CC having bought a business.

Therefore, what was acquired were intangible assets in a business combination—the leases and the website. Intangible assets are identifiable non-monetary assets without physical substance. It appears that the assets acquired would meet the criteria to be capitalized as intangible assets, as they are identifiable, CC has control over them, and there is the existence of future economic benefits.

CC paid $150 million over 2 payments of $75 million each. The present value of this would be calculated and this would be the initial consideration given, and would be allocated separately to the leases and to the website based on their acquisition date fair values. The remainder of the purchase price over the fair value of the intangible assets would be considered to be goodwill. Based on the present fair values of $75 million for the leasehold interests and $15 million for the website, it would give rise to a preliminary goodwill figure of $60 million. CC would determine if it had a limited life, which appears to be the case (the average remaining term of the lease of ten years). This right would be amortized over that term. However, MC will continue to use the property initially so the actual lease term is less to CC. CC will put additional costs into renovating the locations. This would be a separate asset called leasehold improvements and would be depreciated over the lease term and taking into consideration any potential lease renewals. Would have to assess what is the useful life of the online site as well, and amortize over that period. It could be the period of time it takes to integrate the MC site within CC’s site, which is a short period of time and the annual amortization expense would be quite high and negatively impact the net income and equity figures.

In addition, the acquisition related costs of $250,000 will be expensed as incurred, which would adversely impact the net income and equity figures, unless it can be demonstrated that these costs were incurred to get the assets ready for their intended use then they could potentially be capitalized to these costs. However, since the assets will be recognized at their acquisition date fair values and they seem to be costs related to the acquisition itself and not to getting the assets ready, they would be expensed as incurred.

CASE 2-2 (Continued)

**Evaluation guide**

|  |  |  |  |
| --- | --- | --- | --- |
| **Issue** | **Surpassed expectation** | **Reasonable analysis** | **Weak discussion** |
| Student understood the role and bias to maintain the net income and equity figures for the debt equity covenant | Most issues discussed in terms of the effect on income and debt equity ratio and proper conclusions provided | Some issued discussed in terms of the effect on income or debt equity ratio and proper conclusions provided | Recognition to the bias but little incorporation into the solution |
|  | **6** | **4** | **2** |
| **Assessment of business combination:** whether constitutes a business and whether control has been achieved; discussion of the intangibles acquired | Assessed whether it meets the definition of a business AND whether control achieved | Assessed whether it meets the definition of a business OR whether control achieved | Discussed that it is a business combination but little relation to case facts |
|  | **8** | **6** | **3** |
| **Allocation of purchase price:** discussion of price paid for leases, website, and goodwill. Treatment of acquisition related costs. Effect on current and future period. | Complete analysis with a conclusion  | Reasonable discussion of allocation of purchase price | Superficial discussion ; not directly related to case facts |
|  | **8** | **6** | **3** |
| **TOTAL – Max 20** | **22** | **16** | **8** |

CASE 2-3

Before deciding whether to buy TPI, you must first determine why you want to acquire it. There are several strategic reasons for doing so:

* The earnings potential of TPI may be a prime motivator in itself.
* Possible synergies between ACL and TPI may provide opportunities to enhance value through shared resources, author lists, cross-selling, etc.
* You may be simply looking for access to the publishing equipment and operations to supplement ACL’s growth prospects. ACL is currently at capacity, and TPI currently has excess capacity.
* You have indicated that your motives are to see ACL grow so that it can be passed on to your children in two years. You have also indicated that you are conservative when it comes to financing, that you do not like to take on much debt, and that you will require income from the company after turning control over to your children.

In light of the constraints and motives outlined above, the most relevant factors for you to consider are as follows:

* The earnings potential of TPI is highly questionable. There have been losses since Mr. Shewchuk’s death and Ryan began managing. Mr. Shewchuk was the key man in the company. To date in 2013, the losses have continued and exceed budgeted losses.
* In prior years a government program subsidized 5% of the cost of all new university book purchases. This program has been discontinued, and its demise will have a negative effect on future sales and gross margins. The university market represents approximately 83% of sales.
* You do not have direct experience in book publishing. Although magazine publishing is similar, there are different critical success factors. In addition, you may not have the time to run both enterprises. If you must hire a manager for either of the businesses, you are adding another risk factor. TPI does not appear to have strong staff. The status of Ryan Gillis is also unclear. Mrs. Shewchuk expects him to continue, but that may not be in your best interests.

CASE 2-3 (Continued)

**The Significant Risks and Opportunities Associated with the Proposed Purchase.**

* Marketing synergies between the two companies are not evident. TPI operates in a very specialized area, namely, books focused on the university market.
* While TPI may provide additional production facilities to meet ACL’s growth needs, there may be less risky ways of meeting those needs. Outsourcing may be less expensive and less risky.
* Although the purchase price appears to be lower than the net market value of the assets, this difference may be narrowed if TPI’s losses continue for a couple of years before the company’s performance can be turned around.
* TPI is very highly leveraged.
* The most pertinent consideration may be the amount of risk you are willing to assume to consummate this transaction. After this transaction, both companies will be leveraged. Any downturn or unforeseen event may place both companies at risk.
* Ryan is a computer programmer. He was forced to take over the business for his father. He has spent 80% of his time on the computer system. The operating losses may be in large part due to his poor management of the company.

**Recognize the Significant Role Mr. Shewchuk Played in TPI and how TPI’s Current and Future Position is Affected by his Death.**

There are a number of other factors that should be fully considered before completing the acquisition:

* Mr. Shewchuk was not only the founder and the driving force in the company but he was also the most prolific author. The value of the company since Mr. Shewchuk’s death is seriously diminished. Evidence of this is the history of losses that have occurred since Mr. Shewchuk’s death.
* Mr. Shewchuk’s books accounted for one-third of all book sales in 2012. TPI relies heavily upon Mr. Shewchuk’s books to meet sales objectives and can no longer count on new books from Mr. Shewchuk.

CASE 2-3 (Continued)

* Mr. Shewchuk’s books also generated the highest gross margins: approximately 33% in 2012. As these books account for a decreasing percentage of total sales, the gross margins will continue to decrease unless new books of similar quality are sourced.
* Many of the authors are associated with the university environment, and without Mr. Shewchuk it may be more difficult to find new authors in the future.

**Analyze and Interpret the value of TPI**

 The purchase price has two components:

* $1,000,000 plus shareholders’ equity at July 31, 2013.

Certain aspects of the purchase price require clarification. It is not clear how a shareholders’ deficit (if any) would be handled. We should find out whether a deficit would be deducted from the purchase price.

We have estimated the shareholders’ equity at January 31, 2013 because we have historical financial statements as of that date. Although the ultimate purchase price may be different at July 31, 2013, any increase or decrease may be offset by increases or decreases in the value of other assets and liabilities. We can also compare this purchase price to the estimate of fair values of the assets. The estimated purchase price is as follows:

 Base amount Shareholders’ equity at January 31, 2013:

Preliminary estimate

 $1,000,000

 449,000

 $1,449,000

We can compare this estimated purchase price to the fair value of the assets being acquired:

|  |  |
| --- | --- |
| Inventory, lands, buildings and equipment (per appraiser) | $9,400,000 |
| Adjustments: |  |
|  Reduce inventory to cost (2,400-1,931) | (469,000) |
| Net financial assets at January 31, 2013: |  |
|  Current assets (excluding inventory) | 3,778,000 |
|  Current liabilities | (6,123,000) |
|  Long-term debt | (4,230,000) |
|  Future income taxes |  (170,000) |
| Estimated net asset value | $2,186,000 |

CASE 2-3 (Continued)

The above analysis shows that the fair value of the assets is greater than the estimated purchase price of the shares before considering any adjustments to shareholder’s equity that may be necessary to make the financial statements conform to IFRS. Although we have used book values, our analysis of the financial statements reveals potential concerns:

* The current ratio decreased from 1.05 in 2012 to .93 at January 31, 2013, indicating less liquidity.
* Gross profit margins have also been steadily decreasing for the last two years. The gross profit margin was 35% in 2011, decreasing to 29% in 2012 and 25% in the six-month period ended January 31, 2013. Gross margin for the period ended January 31, 2013, was also lower than budget, which was 39% for the period. Sales were actually 18% above budget, but the increase appears to have been at the expense of margins. These deteriorating margins raise possible questions regarding the underlying value of the capital assets or inventory obsolescence.
* TPI has now recorded two consecutive financial periods with a net loss: $532,000 in 2012 and$444,000 for the first six months of 2013. The budget anticipated a loss before taxes for the first six months of only $105,000; the actual loss was $622,000. Even though the strongest sales are in the second half of the year, results for the remainder of the year may also be lower than budgeted in light of the results to date.
* Accounts receivable may include orders that have not been shipped. Accounts receivable have been increasing steadily, possibly due to the inclusion of unshipped orders or to an inadequate provision for doubtful accounts.
* Author advances may be overstated for books that will never get published. Consideration should also be given to the potential value of other assets and liabilities.
* There may be intangible assets such as author lists that may have value.
* If ACL purchases the shares of TPI, incremental costs may be attributed to capital assets that would not be deductible for income tax. The related income tax liability could be considered in arriving at the net value.
* We could also consider the value of the loss carryforwards.
* Long-term debt could be valued at fair market value by discounting the balances at current interest rates.

CASE 2-3 (Continued)

**Discuss the Accounting Adjustments Required to be made to the TPI**

**Financial Statements, Tying the Adjustments to the Purchase Price**

Accounting issues are important because the purchase price calculation is based on the amount of shareholders’ equity stated in accordance with generally accepted accounting principles. In addition, the estimate of fair value includes values for many of these assets based upon generally accepted accounting principles. There is not enough information to quantify the potential impact of accounting irregularities; however, there are a number of potential issues:

* Revenue is recorded at the time that the bookstores place their orders. Normally revenue is recognized when the risks and rewards of ownership are transferred (i.e., delivered) from the seller to the buyer and collection of any amounts receivable is reasonably assured. The stated policy may not be in accordance with IFRS, given that the risks and rewards of ownership are not transferred at the time of placing the order. The effect of this policy is to potentially overstate net assets and shareholders’ equity at the effective date of the purchase of TPI.
* There is an indication of “over-ordering,” whereby books are recorded in quantities exceeding customer needs in order to inflate sales. Any over-orders in 2012 will be reflected in lower sales in 2013. If this practice is followed again at the end of 2013, shareholder’s equity will be affected.
* TPI’s return policy also presents a potential accounting problem. Bookstores are allowed to return any unsold books. This policy creates doubts about the collection assumption that is implicit in the revenue recognition policy. TPI should make a provision for estimated book returns. This provision could be based on historical practices or on surveys of bookstore inventories. There is no indication that TPI has made such provisions. The effect of not having a provision is to overstate net assets and shareholders’ equity.
* Complimentary copies of new books are shipped without charge to generate interest from customers and are treated as inventory. This practice appears to be more in the nature of a sales incentive. Unless TPI expects these books to be ultimately sold, they should be treated as a sales expense and a period cost. The effect of the current practice is to overstate shareholders’ equity and net assets.

CASE 2-3 (Continued)

* Author advances receivable have also increased from 2011 to 2013. Advances are recoverable only from future royalties, and the company has had declining sales and gross margins. Accordingly, the valuation of these advances may be questionable. A provision for possible non-recovery is necessary for advances to authors that do not result in a successful or commercially viable book. There is no indication that TPI has made such a provision and, as a result, net assets and shareholders’ equity could be overstated.
* TPI has income-tax loss carryforwards that have not been recognized in the financial statements even though future income tax liabilities are recorded. If it is more likely than not that the timing differences related to the future income taxes could be reversed before the losses expire, then it would be appropriate to recognize the tax benefit at least to the extent of the future income tax liabilities.

* The current ratio may indicate other potentially serious problems. Accounts receivable have increased from $2,611,000 in 2011 to $3,075,000 in 2012, an increase of 18% in spite of an 8.8% decrease in sales. Accounts receivable increased further at January 31, 2013, to $3,211,000. There are indications that there was over-ordering in 2012, possibly leading to inflated accounts receivable balances. The aged profile of the receivables outstanding has also grown substantially. All of these factors cause us to believe that a further provision for doubtful accounts may be required.
* Inventory balances have also been rising. Inventory was $98,000 at the beginning of 2011, increasing to $545,000 by the end of the year, $1,073,000 by the end of 2012, and $1,931,000 by January 31, 2013. Although the balance at January 31 may reflect seasonal sales patterns, there has been a steady increase in inventory. This trend may reflect obsolescence, particularly in view of the technical nature of these books. They may have only a relatively short shelf life.
* Except for the treatment of future income taxes, the issues outlined above could result in an overstatement of shareholder’s equity and directly affect the purchase price that ACL will pay for the shares of TPI.
* It may not be possible to structure a deal that provides the optimal tax position for both you and Mrs. Shewchuk.

CASE 2-3 (Continued)

* The purchase of shares from Mrs. Shewchuk will be most favourable to her since her entire gain will be taxed at capital gains rates, and she may be able to use the full capital gains exemption for the sale of private company shares involved in an active business. She may also benefit indirectly from a further exemption that may not have been triggered on Hugh’s death it appears that Mrs. Shewchuk may not have to pay any taxes.
* Perhaps Mrs. Shewchuk would also consider the option of payment over time. However, she would not need to use the reserve for capital gains if her taxable capital gain is zero.
* A share purchase is not necessarily the best method for you, as you will only be able to utilize the tax balances in the company at the time of acquisition for deduction against future taxable income. If you decide to buy the assets directly, the entire purchase price will be allocated to the tax costs of the assets. An asset purchase also has the benefit of not having to take responsibility for TPI’s liabilities.

**Discuss the Tax Implications of the Purchase for ACL and Mrs. Shewchuk**

* You may wish to use the fact that Mrs. Shewchuk does not have to pay taxes as a negotiating tool to bring the purchase price down. You should also consider adjusting the price for advances to shareholder ($14,000).
* If ACL acquires shares in TPI, there is an acquisition of control. Significant loss carryforwards are available in TPI that ACL might be able to use. In order to use the losses, the companies must meet a same or similar business test and there must be an expectation of profit. Since ACL is in the magazine publishing business and TPI is in the book printing and publishing business, it is not certain that the tax authorities will consider them to be in the same business for income tax purposes. Further investigation is required.
* To ensure that ACL benefits from the losses, TPI can continue to function as a subsidiary of ACL and recoup the losses once it returns to being profitable. If TPI is unable to turn a profit, TPI can then be merged with ACL.
* Even if the companies are not amalgamated, income can be shifted from ACL to TPI by various means. For example, ACL could borrow funds, using the TPI assets as security, and invest in shares of TPI. TPI would use the funds to repay debt. Interest expense would thus be moved from TPI to ACL, where it could be deducted from other sources of income. ACL would have to have a reasonable expectation of income from its share investment in TPI.

CASE 2-3 (Continued)

* It appears that the loss carryforward occurred in 2012. It is not known whether a request for a carry- back to the prior year was made. This should be investigated.
* There will be a deemed disposition of all assets that have inherent non-capital losses, resulting in non- capital losses to be carried forward. Inherent capital losses are also deemed to have been realized but cannot be carried forward.

**Discuss the IT Decisions Facing TPI**

Several computer and information system issues require consideration. The current system does not appear to be very sophisticated and, while it may have been suitable when Mr. Shewchuk was in charge because of his intimate knowledge of the business, it may need to be upgraded. Before any major investment is made, a needs assessment should be conducted. It can then be determined whether the needs can be met by an off- the-shelf software product with some modifications or customization, or whether programs need to be developed from scratch. In the latter case, the cost will likely be greater and the implementation time longer. Given the current financial and operating circumstances, this may not be a practical alternative.

The available off-the-shelf product appears to be more expensive than completing the customized system and may have less functionality than the system that Ryan is working on. However, it may be quicker to install and should be more reliable since it is likely being used by a number of companies. We are also sceptical about Ryan’s ability and experience levels and whether they are sufficient to handle a project of this scope. Regardless of the decision, the hardware should be chosen after the needs analysis has been performed and the software design decisions have been made.

We also need to consider whether the system will be compatible with ACL’s system and whether integration of the two systems is desirable. It would be prudent to ensure that sufficient additional funds are available to finance the system needs. The investment to date is now a sunk cost, and it would be a mistake to attempt to reduce costs by making the wrong system choice.

**Discuss the Financing Aspects of the Acquisition**

Arranging the financing for the acquisition will be a key aspect of executing the transaction. Based on TPI’s current financial position, it is unlikely its assets can be used to finance a portion of the purchase price. The debt-to-equity ratio at July 31, 2012, was greater than 9 to 1, and conditions appear to have deteriorated since then.

CASE 2-3 (Continued)

The fair value of the land, buildings and equipment is $7,000,000 (Land + Building + Equipment). The total long-term debt is $4,696,000, representing 67% of the fair value.

There are also signs that the company has experienced cash flow problems in the past. A large number of cheques cleared the bank 30-50 days after issuance. This may be indicative of a cash crunch within the company.

The expected cash portion of the purchase price was calculated to be approximately $1.4 million. Utilizing the ACL balance sheet, ACL may be able to raise the funds as follows:

|  |  |
| --- | --- |
| Current cash | $285,000 |
| Sell marketable securities | 394,000 |
| Finance 60% of A/R | 703,000 |
| Finance 50% of inventory |  86,000 |
|  | $1,468,000 |

While it appears that the funds can be raised for the cash portion of the acquisition price, making this acquisition will require the assumption of considerable debt and will increase ACL’s risk profile. If TPI’s losses continue for any period of time before they can be reversed, there may not be sufficient funds to cover ongoing operations.

**Review Mr. Norwood’s Personal Tax Situation and Suggests Improvements**

 There are a number of tax issues that you should be aware of:

* A shareholders’ loan has been outstanding since 2011. Loans to shareholders that are not repaid within one year from the year end in which they are outstanding will be added to the shareholder’s income. To avoid a possible reassessment and the resultant interest and penalties, this loan should be repaid. The funds cannot be re-advanced to the shareholder, as a series of loans and repayments will be viewed as a single loan.
* In each of 2011 and 2012 a significant bonus has been accrued. The accrual of the bonus must be properly and promptly documented in the minutes. Also, when the bonus is paid it should be treated as employment income and appropriate deductions made at source. The bonus must also be paid within 180 days following the year in which it is declared.
* The 2011 bonus that was not paid in 2012 will have to be added back to ACL’s 2001 taxable income.

CASE 2-3 (Continued)

* There is a deemed taxable benefit based on the statutory interest rates applied to the interest-free shareholder loan.
* You should optimize the combination of salary and dividends paid. Rather than pay dividends as in2012, it would be more beneficial to declare sufficient bonus to reduce income below the threshold to obtain the small business deduction.
* If your wife and children can provide services to the company, you may want to consider paying them salaries since the income they receive will be taxed at a lower rate.
* You mentioned your wish to transfer the business to your children in two years’ time. You should be aware that nothing needs to be done when you acquire TPI, although this may be an opportune time to do what is called an “estate freeze” so that some of the future growth in value will accrue to them. Estate planning and restructuring are quite complicated. We would be pleased to assist with a plan.
* You should consider utilizing a spousal RRSP so that your contributions would be made to your wife as beneficiary and allow for splitting of income in future years when funds are withdrawn.
* If your wife is receiving a salary she could also contribute to an RRSP.

CASE 2-4

We have been asked by the partner of the audit team to address and discuss the accounting issues identified with respect to Fuschia Enterprises. This is to be used at a follow up meeting, which has been scheduled for two weeks from now. The partner would like you to prepare a memo that addresses any issues identified relating to their December 31, 2013 year-end in the meantime in preparation for this meeting.

One item to note is that during the year, Fuschia Enterprises instituted a net management compensation plan whereby certain members of senior management will be paid an annual bonus based on audited net income. Management has a bias to overstate net income as a result of this change. It will be particularly important to ensure that items affecting net income are accounted in accordance with Generally Accepted Accounting Principals (GAAP) so management will wish to receive a fair bonus.

On June 30, 2013 Fuschia Enterprises purchased Neon Limited, a company engaged in the production and distribution of coloring books. As they purchased a business, a business combination occurred on this date and should be accounted for accordingly. A business combination is a transaction in which an acquirer obtains control of one or more businesses. In this case, Fuschia Enterprises acquired control of Neon Limited. As of the acquisition date, it will be necessary for Fuschia Enterprises to account for the assets and liabilities acquired, as well as the measurement of the consideration transferred.

It will be necessary to prepare an acquisition analysis which involves looking at the two sides of the transaction, determining the fair value of the identifiable assets and liabilities acquired, and calculating the consideration transferred. The difference between these two amounts will be goodwill or a gain on bargain purchase. I will do an acquisition analysis based on the information provided, however when meeting again with management of Fuschia Enterprises we should verify that the information provided by them is correct.

Consideration transferred:

Cash $1,600,000

Contingent consideration 162,500

Total consideration transferred $1,762,500

CASE 2-4 (Continued)

As there is a 65% chance of having to make an additional payment of $250,000, we will take a probability weighted amount to estimate the contingent consideration. This will be 65% × $250,000=$162,500. Subsequent to the acquisition date at each reporting date it will be necessary to re-value the estimate of the contingent consideration and any changes in the value will be reflected in income, which could adversely or positively affect the annual management bonus which is based on audited net income.

Net assets acquired:

|  |  |  |
| --- | --- | --- |
| Cash | $501,633 |  |
| Accounts receivable | 475,103 |  |
| Inventory | 1,025,000\*1 |  |
| Property, plant and equipment (net) | 550,000\*1 |  |
| Intangible assets | 600,000\*1 |  |
| Goodwill | 0\*2 |  |
| Bank indebtedness | (625,102) |  |
| Accounts payable | (587,201) |  |
| Long-term debt |  (901,201) |  |
| Net assets acquired | $1,038,232 |  |

\*1: Will use the estimated fair value of these assets acquired

\*2: Goodwill already recognized by the acquiree is not carried forward in a business combination. Any goodwill that will be recognized will be accounted for by Fuschia Enterprises.

The consideration transferred is then compared with the net fair value of the identifiable assets and liabilities acquired to determine whether goodwill or a gain on bargain purchase has arose. This case, the consideration transferred is greater, therefore goodwill has been acquired.

Goodwill = $1,762,500 – $1,038,232 = $724,268.

This goodwill will be recognized by Fuschia Enterprises upon consolidation and will be subject to an annual impairment test.

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