Chapter

3

Business Combinations

Introduction

In the previous chapter, we pointed out that a corporation can obtain a subsidiary either by establishing a new corporation (a *parent-founded subsidiary*) or by buying an existing corporation (through a *business combination*). We also demonstrated the preparation of consolidated financial statements for a parent-founded subsidiary.

When a subsidiary is purchased in a business combination, the consolidation process becomes significantly more complicated. The purpose of this chapter is to explore the meaning and the broad accounting implications of business combinations. First, we will examine the general meaning of *business combination*, which can mean a purchase of assets as well as a purchase of a subsidiary. Next, we will look more closely at the issues surrounding purchase of a subsidiary and at consolidation at the date of acquisition. The procedures for consolidating a purchased subsidiary subsequent to acquisition are the primary focus of Chapters 4 to 7.

Definition of a Business Combination

A **business combination** occurs when one corporation obtains *control* of a group of *net assets* that constitutes a *going concern*. A key word is *control*—**control** can be obtained either by:

1. buying the assets themselves (which automatically gives control to the buyer), or
2. buying *control* over the corporation that owns the assets (which makes the purchased corporation a subsidiary).

A second key aspect of the definition of a business combination is that the purchaser acquires control over "net assets that constitute a business" [ED 1980.03][1]—i.e., a going concern. Purchasing a group of idle assets is not a business combination.

A third aspect is the phrase *net assets*—**net assets** means assets minus liabilities. Business combinations often (but not always) require the buyer to assume some or all of the seller's liabilities. When the purchase is accomplished by buying control over another corporation, liabilities are automatically part of the package. But when the purchaser buys a group of assets separately, there may or may not be liabilities attached, such as when one corporation sells an operating division to another company. In any discussion of business combinations, remember that *net assets* includes any related liabilities.

[1] "ED" refers to the September 1999 CICA Exposure Draft on business combinations.

Finally, observe that *business combination* is not synonymous with *consolidation*. As we discussed in the previous chapter, consolidated financial statements are prepared for a parent and its subsidiaries. The subsidiaries may be either parent-founded or purchased. A purchased subsidiary *usually* is the result of a business combination. But sometimes one corporation will buy control over a shell corporation or a defunct corporation. Since the acquired company is not an operating business, no business combination has occurred.

As well, not all business combinations result in a parent-subsidiary relationship. When a business combination is a direct purchase of net assets, the acquired assets and liabilities are recorded directly on the books of the acquirer, as we shall discuss shortly.

Accounting for Business Combinations—General Approach

The general approach to accounting for business combinations, whether (1) a direct purchase of net assets or (2) a purchase of control, is a three-step process:

1. Measure the cost of the purchase
2. Determine the fair values of the assets and liabilities acquired
3. Allocate the cost on the basis of the fair values

The *mechanics* of accounting for the acquisition will depend on the nature of the purchase, particularly on whether the purchase was of the *net assets* directly or of *control* over the net assets through acquisition of shares of the company that owns the assets. Let's look at the general features that apply to all business combinations before we worry about the acquisition method used.

Measuring the cost

The acquirer may pay for the assets (1) in cash or other assets, (2) by issuing its own shares as consideration for the net assets acquired, or (3) by using a combination of cash and shares.

When the purchase is by cash, it is not difficult to determine the total cost of the net assets acquired. When the purchase is paid for with other assets, the cost is measured by the fair value of the assets surrendered in exchange.

One of the most common methods of acquiring the net assets of another company is for the acquirer to issue its own shares in full or partial payment for the net assets acquired. When shares are issued as consideration for the purchase, the cost of the purchase is the value of the shares issued. If the acquirer is a public company, then the valuation of the shares issued is based on the market value of the existing shares.

Note that although the valuation of the shares issued is *based* on the market value, the value assigned to the newly issued shares may not actually *be* the market price on the date of acquisition. The value assigned to the issued shares is more likely to reflect an average price for a period (e.g., 60 days) surrounding the public announcement of the business combination. The *CICA Handbook* suggests, for example, that the value of shares issued should be "based on the market price of the shares over a reasonable period of time before and after the date the terms of the acquisition are agreed to and announced" [ED 1580.18]. Notice the use of the words *based* and *reasonable*, both of which are subject to professional judgement.

The assigned value may be further decreased to allow for the under-pricing that is necessary for a new issue of shares. Nevertheless, the value eventually assigned to shares issued by a public company normally will bear a proximate relationship to the value of the shares in the public marketplace.

Exceptions to the use of market values do still arise, even when a public market value exists. The *CICA Handbook* suggests that the fair value of the net assets acquired could be used instead of the value of the shares issued if "the quoted market price is not indicative of the fair value of the shares issued, or the fair value of the shares issued is not otherwise clearly evident" [ED 1580.18]. Again, notice the use of the judgemental words *not indicative* and *clearly evident*.

A business combination, whether paid for by assets or by shares, may include a provision for **contingent consideration**. Contingent consideration is an add-on to the base price that is determined some time after the deal is finalized. The amount of contingent consideration can be based on a number of factors, such as:

- a fuller assessment of the finances and operations of the acquired company,
- the outcome of renegotiating agreements with debt holders,
- achievement of stated earnings objectives in accounting periods *following* the change of control, or
- achievement of a target market price for the acquirer's shares by a specified future date.

Contingent consideration that is paid in future periods usually is considered to be additional compensation. The treatment of additional compensation varies:

- If the additional future amount can be estimated at the time that the business combination takes place, the estimate is included in the original calculation of the cost of the purchase [ED 1580.20].
- If the amount cannot be estimated at the date of the combination but additional compensation is paid in the future, the fair value of the net assets is adjusted (usually by increasing the amount of goodwill attributed to the purchase) [ED 1580.23].
- If additional shares are issued because the market price of the issued shares falls below a target price (or fails to reach a target price in the future), the additional shares do *not* represent an additional cost, but simply the issuance of more shares to maintain the same purchase price [ED 1580.24].

Valuation of shares issued by a private company is even more judgemental. If it is not feasible to place a reliable value on the shares issued, it will instead be necessary to rely upon the fair value of the net assets acquired in order to measure the cost of the purchase. In practice, the fair values assigned to the acquired assets and liabilities in a purchase by a private corporation often are remarkably similar to their recorded book values on the books of the acquiree.

There is a lot of room for the exercise of professional judgement in determining the cost of an acquisition.

Determining fair values

Guidelines for determining fair values of net assets are outlined in the *CICA Handbook* [ED 1580.38]. In general, the recommended approaches are:

1. Net realizable value for assets held for sale or conversion into cash

2. Replacement cost for productive assets such as raw materials and tangible capital assets
3. Appraisal values for intangible capital assets, land, natural resources, and non-marketable securities
4. Market value for liabilities, discounted at the current market rate of interest

These guidelines are completely consistent with International Accounting Standards and the newly issued standard in the U.S.A. However, they are only guidelines. Furthermore, it should be apparent that fair value measurements are *accounting estimates*. The fair values are judgemental combinations of different methods of valuation—a bit of a hodgepodge, really. There is a great deal of latitude for management to exercise judgement in determining these values. As we shall explain in the next chapter, such judgement can have significant consequences for reporting in future periods.

Fair values should be determined for all identifiable assets (and liabilities) acquired, whether or not they appear on the balance sheet of the selling company. The basket of acquired assets may include valuable trademarks, patents, or copyrights, none of which may be reflected on the seller's books. Similarly, unrealized tax benefits (that is, the benefits from tax loss carryforwards) may also accrue to the purchaser; these too should be valued.

One type of asset and/or liability that is not given a fair value is any future income tax amounts that appear on the selling company's balance sheet.[2] These are not assets and liabilities from the standpoint of the buyer, since they relate solely to the differences between tax bases and accounting carrying values on the books of the *acquired company*.

We don't escape the complications of income tax allocation, however. Future income tax accounting is a factor in the purchaser's financial reporting for purchased subsidiaries. Acquiring companies must determine their own future income tax balances based on the difference between the asset and liability values they show on their consolidated financial statements and the tax bases. Future income tax considerations tend to confuse students who are trying to understand the sufficiently complex issues in business combinations and consolidations. Therefore, we have decided to treat future income tax aspects separately in an appendix to this chapter (as well as in an appendix to Chapter 4).

Allocating the cost

The third step in accounting for a business combination is to allocate the cost. It is a generally accepted principle of accounting that when a company acquires a group of assets for a single price, the total cost of the assets acquired is allocated to the individual assets on the basis of their fair market values. If a company buys land and a building for a lump sum, for example, the land and building are recorded at their proportionate cost, as determined by estimates of their fair values.

The same general principle applies to assets and liabilities acquired in a business combination. The total cost of the purchase is allocated on the basis of the fair market values of the assets and liabilities acquired.

However, the price paid for the operating unit will be determined in part by its earnings ability. The acquirer may or may not choose to continue to operate the unit in the same manner; but regardless of the acquirer's plans, the price to be paid will take into account the acquired unit's estimated future net revenue stream.

[2] This refers to the results of the interperiod income tax allocation process, sometimes known as deferred income tax accounting. Any *current* taxes receivable or payable are assigned a fair value.

If the unit has been successful and has demonstrated an ability to generate above-average earnings, then the acquirer will have to pay a price that is higher than the aggregate fair value of the net assets. On the other hand, if the unit has not been successful, the price may be less than the fair value of the net assets (but not normally less than the liquidating value of the net assets including tax effects).

The difference between the fair value of the net assets (assets less liabilities assumed) and the acquisition cost is known as **goodwill** when the acquisition cost is higher than the fair value of the net assets, and as **negative goodwill** when the cost is less.

Goodwill acquired in a purchase of net assets is recorded on the acquirer's books, along with the fair values of the other assets and liabilities acquired. It is important to understand that goodwill *is* a purchased asset. The purchaser paid good money (or shares) for the goodwill just as surely as for buildings and inventory. In some circles (and in some countries), goodwill is called a "nothing," which derives from the fact that it does not represent any specific asset, either tangible or intangible. But the fact that we can't point at an object (for a tangible asset) or a specific right (for an intangible or financial asset) does not make its cost any less real.

Negative goodwill, however, is not recorded as such. Instead, the costs assigned to the *non-financial* assets are reduced until the total of the costs allocated to the individual assets and liabilities is equal to the total purchase price of the acquired net assets. If there still is negative goodwill left over after the fair value of the non-financial assets has been written down to zero, the excess is reported as an extraordinary item.[3]

The allocation process, therefore, is essentially a two-step process:

1. acquisition cost is allocated to the fair values of the net assets acquired, and
2. any excess of acquisition cost over the aggregate fair value is viewed as goodwill.

Illustration of Direct Purchase of Net Assets

To illustrate the accounting for a direct purchase of net assets, assume that on December 31, 2001, Purchase Ltd. (Purchase) acquires all of the assets and liabilities of Target Ltd. (Target) by issuing 40,000 Purchase common shares to Target. Before the transaction, Purchase had 160,000 common shares outstanding. After the transaction, 200,000 Purchase shares are outstanding, of which Target owns 20%. The pre-transaction balance sheets of both companies are shown in Exhibit 3-1.

The estimated fair values of Target's assets and liabilities are shown at the bottom of Exhibit 3-1. Their aggregate fair value is $1,100,000. If we assume that the market value of Purchase's shares is $30 each, then the total cost of the acquisition is $1,200,000. The transaction will be recorded *on the books of Purchase* as follows:

Cash and receivables	200,000	
Inventory	50,000	
Land	400,000	
Buildings and equipment	550,000	
Goodwill	100,000	
Accounts payable		100,000
Common shares		1,200,000

[3] Negative goodwill is discussed more fully at the end of this chapter.

EXHIBIT 3–1 PRE-TRANSACTION BALANCE SHEETS

December 31, 2001

	Purchase Ltd.	**Target Ltd.**
Cash	$1,000,000	$50,000
Accounts receivable	2,000,000	150,000
Inventory	200,000	50,000
Land	1,000,000	300,000
Buildings and equipment	3,000,000	500,000
Accumulated depreciation	(1,200,000)	(150,000)
Total assets	$6,000,000	$900,000
Accounts payable	$1,000,000	$100,000
Long-term notes payable	400,000	—
Common shares*	2,600,000	200,000
Retained earnings	2,000,000	600,000
Total liabilities and shareholders' equity	$6,000,000	$900,000

* for Purchase Ltd.—160,000 shares outstanding

Fair values of Target Ltd.'s net assets:

Cash	$50,000
Accounts receivable	150,000
Inventory	50,000
Land	400,000
Buildings and equipment	550,000
Accounts payable	(100,000)
Total	$1,100,000

The selling company, Target, will record the transaction by writing off all of its assets and liabilities and entering the new asset of Purchase's shares, recognizing a gain of $400,000 on the transaction.

The post-transaction balance sheets for the two companies will appear as shown in Exhibit 3-2. Purchase's assets and liabilities increase by the amount of the fair values of the acquired assets and by the purchased goodwill, while Target's previous net assets have been replaced by its sole remaining asset, the shares in Purchase. If the transaction had been for cash instead of Purchase shares, Target's sole remaining asset would have been the cash received.

The purchase of Target's net assets by Purchase is a business combination, but it is not an intercorporate investment by Purchase because Purchase is not investing in the *shares* of Target. Since Purchase is acquiring the assets and liabilities directly instead of indirectly through the purchase of Target shares, Purchase records the assets and liabilities directly on its books and there is no need for consolidated statements; Target is not a subsidiary of Purchase.

After the net asset purchase has been recorded, Purchase Ltd. will account for the assets as they would any new assets. There is no special treatment required.

EXHIBIT 3–2 POST-TRANSACTION BALANCE SHEETS

December 31, 2001

	Purchase Ltd.	**Target Ltd.**
Cash	$1,050,000	$ —
Accounts receivable	2,150,000	—
Inventory	250,000	—
Land	1,400,000	—
Buildings and equipment	3,550,000	—
Accumulated depreciation	(1,200,000)	—
Goodwill	100,000	
Investment in Purchase Ltd. shares	—	1,200,000
Total assets	$7,300,000	$1,200,000
Accounts payable	$1,100,000	$ —
Long-term notes payable	400,000	—
Common shares*	3,800,000	200,000
Retained earnings	2,000,000	1,000,000
Total liabilities and shareholders' equity	$7,300,000	$1,200,000

* for Purchase Ltd.—200,000 shares outstanding

Purchase of Shares

Reasons for purchasing shares

Buying the *assets* (or *net assets*) of another company is one way to accomplish a business combination. However, a much more common method of acquiring control over the assets of another company is to buy the *voting shares* of the other business. If one company buys a controlling block of the shares of another company, then control over the assets has been achieved, and the acquirer has a new subsidiary.

An acquirer can obtain a controlling share interest by any one or a combination of three methods:

- buying sufficient shares on the open market,
- entering into private sale agreements with major shareholders, or
- issuing a public tender offer to buy the shares.

Regardless of the purchase method used, the acquirer purchases shares already outstanding. The transaction is with the existing shareholders, not with the target company. The buyer does not need the co-operation of the acquired company itself. Sometimes the target company's board of directors opposes a takeover attempt and tries to persuade the shareholders not to sell their shares to the acquirer—this is known as a **hostile takeover**. Nevertheless, if the purchaser can convince enough of the target company's shareholders to sell their shares, a business combination will occur.

Unlike a direct purchase of assets, a business combination that is achieved by an acquisition of shares does not have any impact on the asset and equity structure of the acquired company.[4] The acquired company continues to carry its assets and liabilities on its own books. The purchaser has acquired *control* over the assets, but has not acquired the assets themselves.

Purchase of shares rather than assets has the obvious advantage that control can be obtained by buying considerably less than 100% of the shares. Control can be obtained at substantially less cost than would be the case if the acquirer purchased the assets directly.

There are several other advantages to buying shares rather than the net assets themselves:

- The shares may be selling at a price on the market that is less than the fair value per share (or even book value per share) of the net assets. The acquirer can therefore obtain control over the assets at a lower price than could be negotiated for the assets themselves.
- By buying shares rather than assets, the acquirer ends up with an asset that is more easily saleable than the assets themselves, in case the acquirer later decides to divest itself of the acquired business, or a portion thereof.
- The acquirer may prefer to retain the newly acquired business as a separate entity for legal, tax, and business reasons. The acquired business's liabilities need not be assumed directly, and there is no interruption of the business relationships built up by the acquired corporation.
- Income tax impacts can be a major factor in the choice between purchasing assets and purchasing shares. A purchase of shares may benefit the seller because any gain to the seller on a sale of shares will be taxed as a capital gain. However, if the assets are sold, gains may be subject to tax at full rates, such as (1) CCA (capital cost allowance) recapture, (2) a sale of inventory, or (3) a sale of intangibles that were fully deducted for tax purposes when paid for initially. Also, the acquired company may have substantial tax loss carryforwards, the benefits of which are unlikely to be realized. The purchaser may be able to take advantage of these carryforwards.

For the buyer, however, a purchase of assets may be more desirable than a purchase of shares from a tax viewpoint. When the assets are purchased directly, their cost to the acquiring company becomes the basis for their tax treatment. For example, depreciable assets are recorded on the acquiring company's books at fair values, and CCA will be based on those fair values. Similarly, goodwill purchased is treated as *eligible capital property* for tax purposes and 75% of the goodwill is subject to CCA (the other 25% is not deductible).

If control over the assets is obtained via a share purchase, on the other hand, there is no change in the tax basis for the assets because there is no change in the assets' ownership. Thus the buyer cannot take advantage of any increased tax shields if net assets are purchased at fair values that are greater than book values.

Another advantage of buying control over another company is that the acquirer does not automatically assume the contingent liabilities of the target company, such as lawsuits or environmental liabilities. If large unexpected liabilities arise, the controlling company can let the subsidiary go bankrupt—the parent loses its investment, but that's better than being pulled down by overwhelming liabilities.

[4] An exception occurs when "push-down" accounting is used. We will discuss this concept towards the end of the chapter.

Obviously, the decision on acquisition method is subject to many variables. In a friendly takeover, the method of purchase and the purchase price are subject to negotiation, taking into account the various factors affecting both parties, including income tax. If the takeover is hostile, then a purchase of shares is the only alternative.

The share acquisition can be accomplished by paying cash or other assets, or by issuing new shares of the acquirer, or by some combination thereof. When the acquirer issues new shares as consideration for the shares of an acquired business, the transaction is frequently called an **exchange of shares**. When there is an exchange of shares, it is important to keep track of who owns which shares, in order to determine who exercises control over whom.

Share exchanges

There are many different ways in which shares can be exchanged in order to accomplish a business combination. Some of the more common and straightforward methods include the following:

- The acquirer issues new shares to the shareholders of the acquired company in exchange for the shares of the target company (the acquiree).
- *Subsidiaries* of the acquirer issue shares in exchange for the acquiree's shares.
- A new corporation is formed; the new corporation issues shares to the shareholders of both the acquirer and the acquiree in exchange for the outstanding shares of both companies.
- The shareholders of the two corporations agree to a statutory amalgamation.
- The acquiree issues new shares to the shareholders of the acquirer in exchange for the acquirer's outstanding shares.

The first method listed above is the most common approach. The acquirer ends up having more shares outstanding in the hands of shareholders, while the acquiree's shares that were previously held by external shareholders are now held by the acquirer. Both corporations continue to exist as separate legal entities, but the acquirer's shareholder base has been expanded to include shareholders who had previously been shareholders of the acquiree. The acquiree does not hold any shares in the acquirer; it is the former *shareholders* of the acquiree who hold the newly issued acquirer shares.

The second approach is similar to the first, except that the acquirer does not issue its own shares to acquire the company directly. Instead, the acquirer obtains indirect control by having its subsidiaries issue new shares to acquire the company. This approach is useful when the acquirer does not want to alter the ownership percentages of the existing shareholders by issuance of additional shares. For example, if the controlling shareholder of the acquirer owns 51% of the acquirer's shares, the issuance of additional shares would decrease the controlling shareholder's interest to below 50%, and control could be lost. But if the acquirer has a subsidiary that is, say, 70% owned, quite a number of additional shares could be issued by the subsidiary without jeopardizing the parent's control.

Under the third method, a new company is created that will hold the shares of both the other combining companies. The holding company issues its new shares in exchange for the shares of both of the acquiree and the acquirer. After the exchange, the shares of both operating companies are held by the holding company, while the shares of the holding company are held by the former shareholders of both the acquiree and the acquirer.

In a **statutory amalgamation**, the shareholders of the two corporations approve the combination or amalgamation of the two companies into a single surviving corporation. Statutory amalgamations are governed by the provincial or federal corporations acts under which the companies are incorporated. For two corporations to amalgamate, they must be incorporated under the same act. The shareholders of the combined company are the former shareholders of the two combining companies.

Statutory amalgamation is the only method of combination wherein the combining companies cease to exist as separate legal entities. It is also the only method of share exchange in which the assets of both companies end up being recorded on the books of one company, similar to the recording of assets in a direct purchase of net assets. In all other forms of share exchange, there is no transfer of assets and thus no recording of the acquiree's assets on the acquirer's books—the results of the combination are reported by means of consolidated financial statements, as we discussed in the previous chapter. In contrast, consolidated statements are not needed for the combined companies after a statutory amalgamation because only one company survives. Of course, if either amalgamating company had subsidiaries, it would still be necessary to prepare consolidated statements that include those subsidiaries.

The foregoing four methods of combination all specify one corporation as the acquirer. The acquirer is defined as the corporation "that obtains control over the other entity" [ED 1580.10]. It is possible to arrange the combination in such a way that the company that legally appears to be the acquirer is, in substance, the acquiree (the fifth method).

For example, suppose that LesserLimited has 100,000 shares outstanding before the combination, and issues 200,000 new shares to acquire all of GreaterCorp's shares. LesserLimited will own all of the shares of GreaterCorp and thus will legally control GreaterCorp. However, two-thirds of the shares of LesserLimited will be owned by the former shareholders of GreaterCorp, and the former shareholders of GreaterCorp will have voting control of LesserLimited after the combination. The substance of the combination is that control resides with GreaterCorp's shareholders even though the legal form of the combination is that LesserLimited acquired GreaterCorp. This form of business combination is called a **reverse takeover**.

After a reverse takeover occurs, the consolidated financial statements will be issued under the name of the legal parent (in this example, LesserLimited) but should reflect the substance of the combination as a continuation of the financial statements of the legal subsidiary (i.e., GreaterCorp). Pre-combination comparative statements and historical data should be those of the legal subsidiary (and in-substance acquirer) rather than of the legal parent (and in-substance acquiree). Because of the potential confusion from reporting the substance of the activities of the legal subsidiary under the name of the legal parent, it is common for reverse takeovers to be accompanied by a company name change so that the name of the legal parent becomes almost indistinguishable from that of the legal subsidiary.

An example of a reverse takeover is the 1999 acquisition of Allied Hotel Properties by King George Development Corporation. King George acquired 100% of the shares of Allied by issuing King George shares. After the share exchange, the former shareholders of Allied owned a majority of the shares of King George. In the 1999 annual report, the consolidated financial statements after the acquisition reflect the fair values of King George and the book values of Allied. After the combination, the name of King George Development Corporation was changed to Allied Hotel Properties Inc.[5]

[5] For additional details, the post-consolidation financial statements of Allied Hotel Properties Inc. (i.e., the new name) can be accessed through SEDAR.com.

One of the main reasons for a reverse takeover is to acquire a stock exchange listing. If LesserLimited had a Toronto Stock Exchange (TSE) listing and GreaterCorp wanted one, a reverse takeover can be arranged instead of going to the trouble and expense of applying to the Ontario Securities Commission (OSC) and the TSE for a listing. In some instances, the legal acquirer (and in-substance acquiree) is just a shell company that has an exchange listing but no assets.

The accounting problem in any business combination is to report in accordance with the *substance* of the combination, and not to be misled by its legal form. Accountants must be sensitive to the objectives of managers and owners in arranging business combinations, and must examine the end result in order to determine who purchased what and for how much.[6]

Illustration of a share exchange

To illustrate the acquirer's accounting for a purchase of shares, assume that on December 31, 2001, Purchase Ltd. acquires all of the outstanding shares of Target Ltd. by issuing 40,000 Purchase shares with a market value of $30, or $1,200,000 total, in exchange.[7] After the exchange of shares, all of the Target shares will be held by the corporate entity of Purchase, while the newly issued shares of Purchase will be held by the former shareholders of Target and *not* by Target as a corporate entity. Target will have no shareholders external to the combined entity, while the shareholder base and the number of shares outstanding for Purchase have increased.

When Purchase acquires the shares, the entry to record the purchase on the books of Purchase will be as follows:

Investment in Target	1,200,000	
Common shares		1,200,000

There will be no entry on Target's books, because Target is not a party to the transaction; the transaction is with the shareholders of Target and not with the company itself. After the original purchase is recorded, the investment is accounted for on Purchase's books by either the cost or equity method, as discussed in Chapter 2.

Exhibit 3-3 shows the balance sheets of Purchase and Target on December 31, 2001, both before and after the purchase of Target's shares by Purchase. The pre-transaction amounts are the same as were shown in Exhibit 3-1, when Purchase purchased the net assets of Target.

The post-transaction amounts on Purchase's separate-entity balance sheet differ from the pre-transaction amounts only in one respect—Purchase now has an account, "Investment in Target Ltd.," that reflects the cost of buying Target's shares, offset by an equal increase in Purchase's common share account. The purchase price was $1,200,000, determined by the value of the 40,000 Purchase common shares given to Target's shareholders in exchange for their shares in Target.

Target's balance sheet is completely unaffected by the exchange of shares. Target's *owner* has changed, but nothing has changed in the company's accounts. Target's net asset book value was $800,000 prior to the change of ownership, and remains $800,000 after the change of ownership.

[6] A detailed description of reverse takeover accounting is beyond the scope of this book. The Emerging Issues Committee issued abstract EIC-10 in January 1990, "Reverse Takeover Accounting," which deals with many of the issues that arise when attempting to account for reverse takeovers.

[7] This transaction has the same value as the illustration used earlier in the chapter for a direct purchase of net assets.

EXHIBIT 3–3 BALANCE SHEETS, DECEMBER 31, 2001

	Before the exchange of shares		After the exchange of shares	
	Purchase Ltd.	Target Ltd.	Purchase Ltd.	Target Ltd.
Cash	$1,000,000	$ 50,000	$1,000,000	$ 50,000
Accounts receivable	2,000,000	150,000	2,000,000	150,000
Inventory	200,000	50,000	200,000	50,000
Land	1,000,000	300,000	1,000,000	300,000
Buildings and equipment	3,000,000	500,000	3,000,000	500,000
Accumulated depreciation	(1,200,000)	(150,000)	(1,200,000)	(150,000)
Investment in Target Ltd.	—	—	1,200,000	—
Total assets	$6,000,000	$900,000	$7,200,000	$900,000
Accounts payable	$1,000,000	$100,000	$1,000,000	$100,000
Long-term notes payable	400,000	—	400,000	—
Common shares*	2,600,000	200,000	3,800,000	200,000
Retained earnings	2,000,000	600,000	2,000,000	600,000
Total liabilities and share equity	$6,000,000	$900,000	$7,200,000	$900,000

*For Purchase Ltd., 160,000 shares before the exchange; 200,000 shares after the exchange.

Target is now a subsidiary of Purchase, and therefore Purchase will prepare consolidated financial statements for public reporting purposes. The preparation of consolidated statements for a purchased subsidiary is somewhat more complex than for parent-founded subsidiaries, and involves choices from among several optional approaches. Consolidation of a purchased subsidiary at the date of acquisition will be illustrated shortly.

Alternative Approaches to Reporting Business Combinations

Overview

In Chapter 2, we demonstrated the preparation of consolidated statements for Parco. To obtain the Parco consolidated balance sheet, we simply added the balances of Subco's assets and liabilities to those of Parco, after eliminating the intercompany balances. It might seem logical to use the same procedure to prepare Purchase's consolidated balance sheet, adding the book values of the two companies' assets and liabilities together to get the consolidated amounts.

However, in Chapter 2 we were demonstrating consolidation of a *parent-founded* subsidiary. In wholly-owned parent-founded subsidiaries, the carrying values of the subsidiary's net assets represent the cost of the assets to the consolidated economic entity, because it was the parent's initial investment (and subsequent non-withdrawal of earnings) that provided the equity to purchase the assets. When a subsidiary is purchased, however, the purchase price of the net assets acquired will almost certainly be different from the carrying value of those assets on the subsidiary's books.

Target has net assets with a book value of $800,000. Purchase issued shares worth $1,200,000 to acquire control over Target's net assets. The $400,000 difference between the purchase price and the book value of the net assets acquired is known as the **purchase price discrepancy**. Any method of combining the balance sheets of the two companies must find a way of disposing of the $400,000 difference.

Three general alternative approaches are available for combining the balance sheets of Purchase and Target in order to obtain a consolidated balance sheet for Purchase. These alternatives are:

1. Add together the book values of the assets and liabilities of the two companies (the **pooling-of-interests** method).
2. Add the fair values of Target's assets and liabilities at the date of acquisition to the book values of Purchase's assets and liabilities (the **purchase** method).
3. Add the fair values of Target's assets and liabilities to the fair values of Purchase's assets and liabilities (the **new-entity** method).

The two variables that determine the results are (1) the valuation of the parent's net assets and (2) the valuation of the subsidiary's net assets. The alternatives can be summarized as follows:

Method	Net assets of parent company	Net assets of subsidiary
Pooling of interests	Book value	Book value
Purchase	Book value	Fair value
New entity	Fair value	Fair value

To demonstrate the alternatives, we need to know the fair values of the two companies' net assets. Exhibit 3-4 compares each company's book values with its assumed fair values. To keep this example simple, we assume that only the capital assets have fair values that are different from book values. The capital assets are highlighted in Exhibit 3-4.

Pooling of interests

Pooling of interests certainly is the simplest method of consolidating a purchased subsidiary. Under this method, the book values of the parent and the subsidiary are added together and reported on the parent's consolidated balance sheet.

EXHIBIT 3–4 BOOK VALUES AND FAIR VALUES, DECEMBER 31, 2001

[Dr/(Cr)]

	Purchase Ltd.		Target Ltd.	
	Book value	Fair value	Book value	Fair value
Cash	$ 1,000,000	$ 1,000,000	$ 50,000	$ 50,000
Accounts receivable	2,000,000	2,000,000	150,000	150,000
Inventory	200,000	200,000	50,000	50,000
Land	**1,000,000**	**2,000,000**	**300,000**	**400,000**
Buildings and equipment	**3,000,000**	**2,300,000**	**500,000**	**550,000**
Accumulated depreciation	**(1,200,000)**	**—**	**(150,000)**	**—**
Accounts payable	(1,000,000)	(1,000,000)	(100,000)	(100,000)
Long-term notes payable	(400,000)	(400,000)	—	—
Net assets	$ 4,600,000	$ 6,100,000	$ 800,000	$1,100,000

The assumption underlying the pooling method is that the combined economic entity is a continuation under common ownership of two previously separate going concerns, and that the operations of both companies will continue without substantial change. If the companies continue to function as separate entities—although now under common ownership—then it is presumed that there should be no change in the basis of accountability for the assets and liabilities as a result of the combination.

If we consolidate the net assets of the two companies at book values, then a problem remains: what should we do with the $400,000 purchase price discrepancy (i.e., $1,200,000 purchase price minus Target's $800,000 net asset book value)?

The theoretically correct approach in pooling is to carry forward on the consolidated statements the pre-acquisition combined shareholders' equity of the two companies. That means we add Target's common shares and retained earnings to those of Purchase *prior* to the purchase—the amounts shown in the first two columns of Exhibit 3-3. The first column of Exhibit 3-5 shows the result.

The consolidated (pooled) shareholders' equity is $5,400,000, as compared to Purchase's unconsolidated shareholders' equity of $5,800,000 after the combination. The $400,000 difference is offset against the investment account upon consolidation, thereby completely eliminating the $1,200,000 investment account.

The difficulty with applying this approach is that corporations acts in Canada generally state that corporations must record and report issued shares at their *current cash equivalent* at the date of issue. For example, Article 25 of the *Canada Business Corporations Act* provides that "a share shall not be issued until the consideration for the share is fully paid in money or in property or past service that is *not less in value than the fair equivalent of the money that the corporation would have received if the share had been issued for money*" (emphasis added). Article 26 states that "a corporation shall add to the appropriate stated capital account the

EXHIBIT 3–5 ALTERNATIVE APPROACHES TO CONSOLIDATED STATEMENTS FOR A BUSINESS COMBINATION

Purchase Ltd.
Consolidated Balance Sheet
December 31, 2001

	Pooling	Purchase	New Entity
Cash	$ 1,050,000	$ 1,050,000	$1,050,000
Accounts receivable	2,150,000	2,150,000	2,150,000
Inventory	250,000	250,000	250,000
Land	**1,300,000**	**1,400,000**	**2,400,000**
Buildings and equipment	**3,500,000**	**3,550,000**	**2,850,000**
Accumulated depreciation	**(1,350,000)**	**(1,200,000)**	**—**
Goodwill	—	**100,000**	**100,000**
Total assets	$ 6,900,000	$ 7,300,000	$8,800,000
Accounts payable	$ 1,100,000	$ 1,100,000	$1,100,000
Long-term notes payable	400,000	400,000	400,000
Common shares*	**2,800,000**	**3,800,000**	**3,800,000**
Add'l paid-in capital: Reappraisal surplus	**—**	**—**	**1,500,000**
Retained earnings	**2,600,000**	**2,000,000**	**2,000,000**
Total liabilities and share equity	$ 6,900,000	$ 7,300,000	$8,800,000

*200,000 shares issued and outstanding

full amount of any consideration it receives for any shares it issues." If the Purchase shares were worth $1,200,000 at the date of their issue, then it would be in contravention of the *Act* to report the shares at only $800,000 on the consolidated financial statements. Therefore, the Purchase shareholders' equity cannot legally be reduced to $5,400,000 for consolidated reporting; the full $5,800,000 must be reported.

While there is a technical legal impediment to application of the pooling-of-interests approach in many instances of corporate combination, there can be combinations that would satisfy the legal requirements, as when shares are issued whose market value approximates the book value of the shares acquired. Also, pooling is easily applied to private companies, where there is no market value for the shares and therefore no readily measurable current cash equivalent. Finally, the fact is that there is no effective enforcement mechanism in the corporations acts short of the extreme remedy of withdrawing the corporation's legal charter.

Purchase method

The purpose of Purchase's purchase of Target's common shares was to obtain control over the net assets and the operations of Target. The control obtained by a purchase of shares is essentially the same as by purchasing Target's net assets directly. If Purchase had purchased the net assets, Purchase clearly would have recorded the acquired net assets at their fair values. If the price paid exceeded the total fair value, the excess would be assigned to goodwill.

The purchase of shares achieves the same result, as does the direct purchase of assets. Therefore, the objective of the purchase method of consolidation is to report the results of the purchase of shares as though the assets had been acquired directly. The fair values of the subsidiary's assets and liabilities are added to those of the parent (at book value), because the fair value is considered to be the cost of the assets and liabilities to the acquirer. Any excess of the purchase price over the aggregate fair value is assigned to goodwill.

The allocation of the purchase price discrepancy was illustrated earlier, when we assumed that Purchase bought Target's net assets directly. The same calculation applies when the method of combining is an exchange of shares. The fair value of Target's net assets is $1,100,000. The purchase price was $1,200,000. The difference of $100,000 between the purchase price and the net asset fair value is attributed to Goodwill.

The second column of Exhibit 3-5 shows Purchase's consolidated balance sheet under the purchase method. Note that the purchase-method consolidated balance sheet is exactly the same as the post-transaction balance sheet for direct purchase of the assets as shown in Exhibit 3-2.

New-entity method

The purchase method has been criticized because the consolidated balance sheet contains a mixture of old book values (for Purchase's assets) and date-of-acquisition fair values (for Target's assets). One can argue that when a business combination occurs, a new economic entity is formed, and that a new basis of accountability should be established for *all* of the assets.

Under the new-entity approach, the assets and liabilities of Purchase are revalued to fair value, so that the consolidated balance sheet will disclose the current fair values (on the date of the combination) of all of the assets for the combined entity. The third column of Exhibit 3-5 shows Purchase's consolidated balance sheet under the new-entity method.

Notice that a new account has appeared in the new-entity column: "reappraisal surplus." We have written up the carrying values of Purchase Ltd.'s assets, and we need an offsetting account to credit. Any upward asset revaluation is reflected in shareholders' equity, as a part of paid-in capital. This is true any time that an asset is written up, whether as a part of a business combination or because assets are carried at fair value instead of cost.

Under certain circumstances, there is merit in the arguments for the new-entity method. If the combining enterprises are of roughly comparable size, and if the operations of the newly combined enterprises are going to be substantially different from the predecessor operations, then a case can be made for establishing a new basis of accountability.

However, there are significant practical problems in implementing the method. Obtaining fair values for all of the assets is likely to be an expensive and time-consuming project, unless the acquiring company already uses current values for internal reporting purposes. In addition, a substantial degree of subjectivity would inevitably exist in the fair-value determination.

While subjective estimates are required to assign the purchase price of a subsidiary to the subsidiary's specific assets and liabilities, the total of the fair values assigned is limited by the total purchase price paid by the parent. But in revaluing the parent's assets for application of the new-entity method, there is no verifiable upper limit for the fair values because no transaction has occurred. In addition, the measurement of goodwill for the parent corporation would be highly subjective. Since it is not clear how the new-entity method would improve the decisions of users of the consolidated financial statements, it has not been accepted in practice.

Other approaches

In the past, approaches to consolidation other than the three discussed above have been used in practice. One of the more common was to value the transaction at the fair value of the consideration given, as in a purchase, but to consolidate the subsidiary's assets and liabilities at their book values, as under pooling. The difference between the book value and the purchase price would be assigned to goodwill on the consolidated statements.

This approach, sometimes called the *carrying-value purchase method*, has the same net impact on the acquirer's net assets as the fair-value purchase method. However, the assignment of the entire excess of the purchase price over net book value to goodwill can have a significant impact on consolidated earnings subsequent to the acquisition, because amortization of goodwill will most likely be different in impact than would subsequent reporting of the fair values of specific assets and liabilities.

Purchase vs. pooling

Before leaving our discussion of the alternative methods of consolidation, we should consider further the use of the purchase method as opposed to the pooling-of-interests method.

In most business combinations, one company clearly is acquiring the other. The acquirer is the company whose pre-combination shareholders have a majority of the voting shares in the combined enterprise, regardless of which company is legally acquiring the shares of the other. If one company can be identified as the acquirer, then there is widespread agreement that the purchase method should be used.

An acquirer can *always* be identified when the purchase of shares is for cash, notes, or other assets of the acquirer. In such an acquisition, the former shareholders of the acquiree have no stake in the combined venture, and clearly they are not pooling their interests with those of the acquirer's shareholders. An exchange of shares must occur for the possibility of pooling even to arise.

Consolidated financial statements can be drastically affected by the choice of pooling or purchase accounting. The consolidated asset values usually will differ considerably, especially for tangible and intangible capital assets. Goodwill that is reported under the purchase method is not shown under pooling. The difference in the asset values will have a consequent impact on earnings measurement because the amounts of amortization will be different.

Another important difference between purchase and pooling is that pooling is applied retroactively, while the purchase method is applied only from the date of the purchase. Under pooling, the two enterprises are reported as though they had always been combined. The comparative financial statements and other financial information (such as earnings per share, total assets, total sales, and so forth) are restated for the periods prior to the combination in order to reflect the operations of both companies. Under the purchase method, however, there is no restatement of prior years' results. The business combination is viewed as any other investment by the acquiring company, and the acquired company's operating results are reflected in the acquirer's operating results only from the date of acquisition.

The difference in reporting can have an impact not only on the *size* of earnings, but also the comparative *direction* over time. Pooling could cause post-combination earnings per share (EPS) to increase, relative to pre-combination earnings, while purchase accounting could cause EPS to decrease. The reverse situation could also occur.

The difference in results is not something that external financial statement users can adjust for. If pooling is used, there is no way to know what the reported results would have been under purchase accounting—there is no information available to the public about the fair values of the net assets acquired. When information on measurements under different accounting methods does not exist, the market cannot adjust for the differences.

Due to the significant differences between reported results under the two methods, there has long been a controversy about the use of pooling versus purchase. This controversy has now been resolved firmly in favour of purchase, as we shall discuss in the next section.

Current Canadian practice

Purchase method

The recommendation of the Business Combinations exposure draft is clear: "The purchase method should be used to account for all business combinations" [ED 1580.08]. This recommendation is intended to slam the door on the use of pooling by public companies.

Pooling was never widespread in Canada. Indeed, around the world, pooling was in widespread use only in the United States. Other countries either prohibited pooling or restricted its use to very narrow circumstances. The *CICA Handbook*, for example, previously stated that pooling could be used only *when an acquirer could not be identified*. As we will discuss more fully in a later section, the change in Canada to prohibit pooling was basically part of a multi-country strategy to help the Financial Accounting Standards Board (FASB) to prohibit pooling in the United States.

Identifying the acquirer

The acquirer in a business combination is the corporation whose shareholders control the combined economic entity. When the purchase is for cash (or other assets), it is obvious that the acquirer is the company that pays to acquire the other (or the assets of the other). When the combination is effected by an exchange of shares, the acquirer may not be so obvious.

The corporation that issues the shares is usually, but not always, the acquirer. Earlier in this chapter, we discussed the issue of *control* and the fact that some business combinations are reverse takeovers. Therefore, it is necessary to examine which shareholder group has control of the combined economic entity in order to determine who is the acquirer.

Voting control may appear to be evenly split between the shareholders of the two combining companies. If that is the case, other factors must be examined to determine who is the acquirer [ED 1580.12]. Examples of other factors include:

- the existence of major voting blocks,
- special voting rights for some shareholders, or voting restrictions on others,
- holdings of convertible debt securities and other options or derivatives,
- the composition of the board of directors, and
- the composition of the senior management team.

Corporate restructurings—non-arm's-length pooling

The AcSB's purchase method recommendation does not apply to combinations of companies under common control [ED 1580.02]. The *CICA Handbook* cites three examples that relate to transfers between subsidiaries or between a parent and its existing or newly-formed subsidiaries. The exemption of transfers between entities under common control also would apply to corporations that are not in a parent-subsidiary relationship, but that have a common controlling shareholder.

A shifting of assets among companies under common control is often called a **corporate restructuring**. A parent company (or its owners) may decide to rearrange the intercorporate ownerships of the economic entity comprised of the parent and its several subsidiaries. New subsidiaries may be formed, or parts of the economic entity may be combined or otherwise regrouped or redefined. When a corporate restructuring takes place, there is no arm's-length transaction because all of the legal corporations are ultimately controlled by the same shareholders. Since there is no arm's-length transaction, the assets cannot be revalued for reporting on either the separate-entity or the consolidated financial statements.

Voluntary restructurings of corporate ownerships are quite common in both public and private companies in Canada. Since corporate ownership restructurings are accounted for as though they were poolings of interest, it is necessary to understand the pooling method even though it is not widely used for business combinations reported by public companies.[8]

International Practices for Business Combinations

In general, countries around the world have required that the purchase method be used for business combinations. Pooling has been permitted in many coun-

[8] The relevance of pooling for combinations by private companies is another matter, however. These will be discussed in a later section of this chapter, "Acquisitions by private companies."

tries, such as Canada and the U.K., if an acquirer cannot be determined. The one big exception to the general application of the purchase method has been, throughout the last half of the twentieth century, the United States. The U.S.A. has been the most enthusiastic pooler in the world, by far.

In contrast, Australia and New Zealand banned the use of pooling altogether; only purchase accounting has been permitted. Although it may, in some instances, be difficult to establish which company among equals is the acquirer, "experience with the Australian standard suggests that any difficulties in identifying the acquirer are not insurmountable."[9]

Originally, there were absolutely no restrictions on the use of pooling in the United States. Pooling could be used for *any* business combination, regardless of the relative size and power of the combining companies. Pooling could even be used when the purchase was for cash, with no continuing share ownership by the previous shareholders of the target company.

In 1970, the AICPA's Accounting Principles Board tried to rein in the use of pooling by imposing a set of 12 criteria that would govern whether the transaction should be accounted for as a purchase or by pooling.[10] Given the radically different reported results that can be obtained under pooling, it was hardly surprising that many U.S. acquirers structured their purchase transactions in a way that would then require them to use their preferred method of accounting.[11]

The result of the use of pooling was that "two economically similar business combinations can be accounted for using different accounting methods that produce dramatically different financial results."[12] A further consequence was that companies that could not use pooling (such as Canadian companies that were competing for acquisitions) felt that they were severely disadvantaged by lower reported earnings that may be caused by their inability to use pooling. Some observers felt that companies that could use pooling were able to pay more for a target acquisition than a company that could not use pooling. Therefore, "having two accounting methods that produce dramatically different results affect competition in markets for mergers and acquisitions."[13]

In 1999, the standard setters of Canada, Australia, New Zealand, the U.K., and the U.S. (i.e., the "G4" countries) co-operated on the issuance of new standards to eliminate the use of pooling. Effectively, the only country whose standards were seriously changed by the new proposals was the U.S.A. The new standards will achieve international harmonization on a major issue in accounting.

International Accounting Standard 22, *Business Combinations*, is in agreement with the new harmonized standard of the G4. However, it does still permit the pooling of interests method, known as "uniting of interests." It is quite possible that the IASC will eliminate this alternative in a future amendment of the standard.

[9] *Methods of Accounting for Business Combinations: Recommendations of the G4+1 for Achieving Convergence*, paragraph 75. Published simultaneously by the standard setting bodies of Canada, U.S.A., U.K., Australia and New Zealand, December 1998.

[10] *APB Opinion 16*, issued in 1970. The Accounting Principles Board, or APB, was the standard-setting body in the U.S. prior to establishment of the FASB in 1971.

[11] This should be a familiar scenario. It is similar to companies' approach to lease transactions—decide how they want the lease to be reported (i.e., capital or operating), and then structure the lease contract accordingly.

[12] Edmund L. Jenkins, FASB Chairman, in testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, March 2, 2000; quoted in the FASB *Status Report* of March 24, 2000.

[13] *Ibid*.

Consolidation Procedures

Exhibit 3-5 illustrated the purchase-method consolidated statements in the second column. We explained that the amounts in that column were obtained by adding the book value of each of Purchase's assets and liabilities to the fair values of Target's.

Before plunging into the greater complexities of consolidation in the following chapters, we will more carefully illustrate the general procedure for consolidating subsidiaries that were acquired through a business combination. The key factor that differentiates the procedure is that, for business combinations, consolidation mechanics must adjust for fair values. Fair values are not an issue for parent-founded subsidiaries.

Direct method

After one company acquires control over another, each company will still continue to prepare its own separate-entity financial statements. Remember that each company is still a legal and operating entity. Consolidated statements are an artificial construct of the accounting profession—*artificial* in that there is no legal entity that corresponds to the economic entity of the parent and its subsidiaries. But the reporting objective is *substance over form*. Although the parent and its subsidiaries are separate *legal* entities and prepare separate, individual financial statements, the overall *economic* entity is the group of companies. For that reason, consolidated statements are called **group accounts** in most parts of the world, even though there are no formal group accounts—just consolidation working papers and statements.

In theory, purchase accounting combines the book values of the parent with the fair values (*at date of acquisition*) of the purchased subsidiaries. In practice, consolidation actually begins with *book values* of both companies. At date of acquisition, it is clear that the book values and the fair values relate to the same assets and liabilities. As time moves on, however, assets will enter and leave the balance sheet of each purchased subsidiary, and the asset base will change.

Therefore, consolidation takes the book values of both companies and adds the *fair value increments* relating to the assets of Target that existed when Target was acquired. The fair value increments (or decrements) are the differences between Target's book values and fair values at the date of acquisition.

An analysis of the purchase price is illustrated in Exhibit 3-6. Of the $1,200,000 purchase price, $800,000 is attributed to the book value of the net assets acquired, $300,000 is the total of the fair value increments, and the residual $100,000 is attributed to goodwill. On a continuing basis, consolidated net assets will be computed as:

- book value of each asset and liability,
- plus any fair value increments (or minus any fair value decrements) relating to assets still on Target's books from the date of consolidation,
- plus goodwill, if any.

Exhibit 3-7 (page 98) shows the derivation of Purchase's consolidated balance sheet at December 31, 2001, using the direct method. For each item on the balance sheet, we take the book value for Purchase, add the book value of Target, and add the fair value increment. The fair value increment (and goodwill) adjustments are indicated with a "**b**." Also, we must eliminate Purchase's investment account and Target's shareholders' equity accounts (indicated with an "**a**"). The

EXHIBIT 3–6 ALLOCATION OF PURCHASE PRICE

100% Purchase of Target Ltd., December 31, 2001

	Book value	Fair value	Fair value increment	% share	FVI acquired	
Purchase price						**$1,200,000**
Cash	$50,000	$50,000	—			
Accounts receivable	150,000	150,000	—			
Inventory	50,000	50,000	—			
Land	300,000	400,000	$100,000	× 100% =	$100,000	
Buildings and equipment	500,000	550,000	50,000	× 100% =	50,000	
Accumulated depreciation	(150,000)	—	150,000	× 100% =	150,000	
Accounts payable	(100,000)	(100,000)	—			
Total fair value increment						300,000
Net asset book value	$ 800,000			× 100% =		800,000
Fair value of assets acquired						$1,100,000
Goodwill						$ 100,000

resulting balance amounts are identical to those shown in the second column of Exhibit 3-5.

There is one aspect of Exhibit 3-7 that merits explanation. You'll notice that *accumulated depreciation* is calculated by adding the two companies' amounts together, and then *subtracting Target's accumulated depreciation at the date of acquisition*. We subtract Target's accumulated depreciation because we want to show the fair value of Target's depreciable assets at the date of acquisition. This amount is included in the capital asset account itself. If we carried Target's accumulated depreciation forward, we would be reducing the fair value. In effect, we would be combining fair value in the asset account with written-off cost in the accumulated depreciation. To emphasize the point, the *CICA Handbook* explicitly points out that "the accumulated depreciation of the acquired entity is not carried forward" in the consolidated statements [ED 1580.38(d)].

Although we have indicated which adjustments on Exhibit 3-7 are for fair value increments and which are eliminations, bear in mind that these purchase adjustments and eliminations are not independent. Essentially, all of the adjustments shown in Exhibit 3-7 are allocations of the $1,200,000 purchase price. In future years, all of the components of this purchase adjustment must be made simultaneously, as we will illustrate in the following chapters.

Worksheet method

Exhibit 3-8 shows the trial balance-based spreadsheet for Purchase's consolidated balance sheet. The separate-entity columns for the individual companies correspond to the post-transaction balance sheets shown in the last two columns of Exhibit 3-3.

The eliminations and adjustments that are necessary in order to prepare the consolidated trial balance are composed of two elements. First, it is necessary to eliminate the shareholders' equity accounts of Target Ltd. by offsetting the balances of these accounts against the investment account:

EXHIBIT 3–7 PURCHASE LTD. CONSOLIDATED BALANCE SHEET

Balance Sheet
December 31, 2001

Assets	
Current assets:	
Cash [1,000,000 + 50,000]	$ 1,050,000
Accounts receivable [2,000,000 + 150,000]	2,150,000
Inventory [200,000 + 50,000]	250,000
	3,450,000
Property, plant, and equipment:	
Land [1,000,000 + 300,000 **+ 100,000b**]	1,400,000
Buildings and equipment [3,000,000 + 500,000 **+ 50,000b**]	3,550,000
Accumulated depreciation [1,200,000 + 150,000 **– 150,000b**]	(1,200,000)
	3,750,000
Other assets:	
Investment in Target Ltd. [1,200,000 **– 800,000a – 400,000b**]	—
Goodwill [**+ 100,000b**]	100,000
Total assets	$ 7,300,000
Liabilities and shareholders' equity	
Liabilities:	
Current accounts payable [1,000,000 + 100,000]	$ 1,100,000
Long-term notes payable [400,000 + 0]	400,000
	1,500,000
Shareholders' equity:	
Common shares [3,800,000 + 200,000 **– 200,000a**]	3,800,000
Retained earnings [2,000,000 + 600,000 **– 600,000a**]	2,000,000
	5,800,000
Total liabilities and shareholders' equity	$ 7,300,000

a	Common shares (Target)	200,000	
	Retained earnings (Target)	600,000	
	Investment in Target Ltd. (Purchase)		800,000

The names in parentheses indicate the company trial balance to which that particular elimination element refers. Again, we must emphasize that there is no actual journal entry on either company's books—this is purely a worksheet entry.

The second entry adjusts the asset accounts of the subsidiary from their carrying values on the subsidiary's books to the fair values at the date of acquisition:

b	Land (Target)	100,000	
	Buildings and equipment (Target)	50,000	
	Accumulated depreciation (Target)	150,000	
	Goodwill	100,000	
	Investment in Target Ltd. (Purchase)		400,000

EXHIBIT 3–8 PURCHASE LTD. CONSOLIDATION WORKSHEET AT DATE OF ACQUISITION

December 31, 2001

	Trial balances			
	Purchase Dr/(Cr)	Target Dr/(Cr)	Adjustments Dr/(Cr)	Purchase consolidated trial balance
Cash	$ 1,000,000	$ 50,000		$ 1,050,000
Accounts receivable	2,000,000	150,000		2,150,000
Inventories	200,000	50,000		250,000
Land	1,000,000	300,000	100,000 **b**	1,400,000
Buildings and equipment	3,000,000	500,000	50,000 **b**	3,550,000
Accumulated depreciation	(1,200,000)	(150,000)	150,000 **b**	(1,200,000)
Investment in Target Ltd.	1,200,000	—	(800,000) **a** (400,000) **b**	—
Goodwill			100,000 **b**	100,000
Accounts payable	(1,000,000)	(100,000)		(1,100,000)
Long-term notes payable	(400,000)	—		(400,000)
Common shares	(3,800,000)	(200,000)	200,000 **a**	(3,800,000)
Retained earnings	(2,000,000)	(600,000)	600,000 **a**	(2,000,000)
	$ —	$ —	$ —	$ —

The net result of these two adjustments is to eliminate the investment account, eliminate the subsidiary's share equity accounts at the date of acquisition, and establish the fair values of the assets and liabilities acquired by Purchase through purchase of Target's shares. These two adjustments will be made in every subsequent period when the consolidated statements are prepared.

Negative Goodwill

In the example of a business combination used earlier in this chapter, control over net assets with a fair value of $1,100,000 was acquired for $1,200,000. The difference between the purchase price and the fair value of the acquired net assets is treated as goodwill.

It is not unusual, however, for the total fair value of the assets and liabilities to be *greater* than the purchase price. This excess of fair values over the purchase price is commonly known as **negative goodwill**, although the title is not particularly indicative of the accounting treatment of the amount. The total of the net debits (to record the fair values) is greater than the credits (to record the consideration paid), and therefore there are more debits than credits in the consolidated statements—not a tolerable situation in a double-entry system. The task is to correct the balance by either increasing the credits or decreasing the debits.

Once upon a time, it was common practice to increase the credits by establishing an account to credit for the amount of negative goodwill. It was not normally called "negative goodwill," of course. Usually a more opaque title was chosen, such as "excess of fair value over cost of assets acquired." This is now a prohibited practice in Canada, and in most countries. Instead of creating a credit for negative goodwill, the balance of debits and credits must be achieved by reducing the total amount allocated to the net assets.

Negative goodwill is, in essence, an indication that the acquirer achieved a bargain purchase. A bargain purchase is possible for a variety of reasons. If the acquisition is by a purchase of shares, then the market price of the acquiree's shares may be well below the net asset value per share. Or if the acquiree is a private company, a bargain purchase may be possible if the present owners are anxious to sell because of the death of the founder-manager, divorce, changed family financial position, or simply an inability to manage effectively.

Regardless of the reason, negative goodwill should be viewed as a discount on the purchase and not as a special credit to be created and amortized. When any company buys an asset at a bargain price, the asset is recorded at its cost to the purchaser, and not at any list price or other fair value. For example, suppose that a company buys a large computer from a financially troubled distributor for only $80,000. The price of the computer from any other source would be $120,000. On the buyer's books, the computer obviously would be recorded at $80,000, not at $120,000 with an offsetting credit for $40,000.

The same general principle applies to bargain purchases in business combinations. The purchase price is allocated to the acquired assets and liabilities on the basis of fair values, but not necessarily *at* fair values if the total fair value exceeds the purchase price. A problem does arise, however, in deciding to which assets and liabilities the bargain prices or negative goodwill should be assigned.

A business combination involves the assets and liabilities of a going concern. The net assets acquired usually comprise a mixture of financial and non-financial, current and long-term assets and liabilities. Because the various assets and liabilities have varying impacts on reported earnings, the allocation of negative goodwill will affect the amount of future revenues and expenses.

For example, suppose that Purchase acquired all of the shares of Target, as above, but at a cost of only $1,050,000. Since the fair value of Target's net assets is $1,100,000, negative goodwill of $50,000 exists. Target's assets and liabilities will be reported on Purchase's consolidated balance sheet at a total amount of $1,050,000, $50,000 less than their fair values. At least one of the Target assets must be reported at an amount that is less than its fair value.

If the negative goodwill were assigned to inventory, Target's inventory would be consolidated at zero value, since the fair value of Target's inventory was assumed to be $50,000 (Exhibit 3-4). Reduction in the cost assigned to inventory will flow through to the income statement in the following year as a reduction in cost of goods sold and an increase in net income. If, on the other hand, the negative goodwill were assigned to buildings and equipment, then the effect of the bargain purchase would be recognized over several years in the form of reduced depreciation on the lower cost allocated to buildings and equipment. Allocation of the negative goodwill to land would result in no impact on earnings until the land was sold; allocation to monetary receivables would result in a gain when the receivables were collected.

The choice of assets to report at less than fair values is essentially arbitrary. The AcSB [ED 1580.32] recommends that negative goodwill should be allocated in the following order:

1. pro rata to any intangible assets that do not have an observable market value, and then
2. pro rata to depreciable *non-financial* assets (both tangible and intangible).

If the purchase price allocations to the non-financial assets have all been reduced to zero and there still is negative goodwill remaining, the remaining amount is recognized as an extraordinary gain, even though the normal conditions for recognizing an extraordinary gain have not been met.

Disclosure

Business combinations are significant events. They often change the nature of operations of a company and thus change the components of the earnings stream. All users' financial reporting objectives are affected by substantial business combinations. At a minimum, the asset and liability structure of the reporting enterprise is changed. Disclosure of business combinations therefore is quite important.

The AcSB recommends a long list of disclosures for business combinations completed during the period [ED 1580.65-1580.68]. We will not reproduce the list here, but the acquirer should disclose essential aspects such as:

- a description of the acquired subsidiary, its business, the date of purchase, and the nature of the purchase transaction,
- the cost of the acquisition and the nature and value of the consideration given,
- a summary of the major classes of asset and liability acquired,
- the amount of the purchase price that is attributed to goodwill, and
- the nature of any contingent consideration.

For acquisitions that are individually immaterial, similar information should be disclosed in the aggregate [ED 1580.66].

Also, the acquirer should disclose significant intangible assets that have been acquired as part of the business combination. The nature of the assets and the amortization basis should be described.

Exhibit 3-9 shows the 1999 disclosure note of Geac Computer Corporation Limited. This disclosure has several interesting aspects:

- Geac acquired seven businesses during fiscal 1999.
- Three of the business combinations were purchases of assets; the other four were purchases of shares. One of the asset purchases (Cruickshank Technology) included the shares of a subsidiary.
- In all seven acquisitions, Geac paid cash.
- The purchase price for News Holdings Corp. was $25,808,000. Of the purchase price, $45,842,000 was allocated to goodwill, 178% of the purchase price. The reason that goodwill is higher than the purchase price is that the acquired company had a negative net asset value (i.e., more liabilities than assets).
- In aggregate, the other acquired businesses also had negative net assets—goodwill amounted to 186% of the total purchase prices.

Exhibit 3-10 (page 103) illustrates disclosure of another purchase. In this case, the acquisition was of significant influence, and therefore is not a business combination. Corel will report this investment by the equity method, as the note states. An unusual aspect of Corel's purchase of 25% of Rebel.com is that the consideration was neither cash nor shares—the purchase was paid for by exchanging the assets shown in the note, described as follows in Corel's MD&A (Management's Discussion and Analysis):

On February 17, 1999, the Company transferred all of the assets of Corel Computer supporting the NetWinder family of Linux-based thin client/thin server computers and $1.6 million cash in exchange for a 25% equity stake in Rebel.com.

Recording Fair Values: Push-Down Accounting

We have emphasized that the fair values of the net assets of the acquiree are never recorded in the books of the acquirer; the full purchase price is simply recorded in an investment account on the acquirer's books. We have also stated that when a business combination is accomplished by a purchase of shares (rather than by a direct purchase of assets), the acquiree continues to exist as a separate legal and reporting entity. The carrying values of the acquiree's net assets are not affected by the acquisition or by the fair values attributed to the assets by the acquirer.

EXHIBIT 3–9 DISCLOSURE OF ACQUISITIONS

Geac Computer Corporation

13. ACQUISITIONS

Year ended April 30, 1999

During the year ended April 30, 1999, the Company acquired for cash the businesses shown in the table below. Cruickshank Technology Pty Limited, Stowe Computing Australia, Stowe Computing Finance Pty Limited, Stowe Computing (NZ) Limited, and Phoenix Systems Limited were asset purchases. The Company acquired the remaining 75% interest in its former joint venture Soluzioni Gestionali. In each of the remaining acquisitions, the Company acquired all of the issued and outstanding shares. Acquisitions are accounted for by the purchase method with the results of operations of each business included in the financial statements from the respective dates of acquisition. Geac accrues or reserves for known or anticipated customer, supplier, or other problems at the time of acquisition just as it would in ongoing businesses.

The total purchase price of News Holdings Corp. and its subsidiary Interealty Corp. was $25,808. The acquired business included, at fair value, $13,685 of current assets, $11,654 of fixed assets, and $45,373 of current liabilities. The difference between the total purchase price and the net fair value of all identifiable assets and liabilities acquired was $45,842 and is accounted for as goodwill.

The total purchase price of the remaining acquired business was $15,088. These businesses included, at fair value, $979 of cash, $10,833 of other current assets, $1,191 of fixed assets, and $26,032 of current liabilities. The difference between the total purchase price and the net fair value of all identifiable assets and liabilities acquired was $28,117 and is accounted for as goodwill.

Acquisition	**Effective date**
Remanco International, Inc. and its subsidiary Remanco Systems, Ltd.	May 31, 1998
Assets of Cruickshank Technology Pty Limited and all of the issued and outstanding shares of its subsidiary Mainpac Limited	June 1, 1998
News Holdings Corp. and its subsidiary Interealty Corp.	September 7, 1998
Soluzioni Gestionali SrL	October 15, 1998
TWG Technologies Inc.	December 1, 1998
Assets of Stowe Computing Australia Pty Ltd., Stowe Computing Finance Pty Limited and Stowe Computing (NZ) Limited	December 3, 1998
Assets of Phoenix Systems Limited	April 30, 1999

EXHIBIT 3–10 PURCHASE OF SIGNIFICANT INFLUENCE

Corel Corporation

3. Investments

(a) Rebel.com

On February 17, 1999, the Company purchased a 25% interest in Rebel.com for $3,351,000. The Company's share of the net book value of the underlying assets was $1,299,000. The remaining balance of the purchase price of $2,052,000 has been allocated to goodwill and is being amortized on a straight-line basis over three years. The fair value of the assets used to purchase the Company's share of Rebel.com was as follows (in thousands of US$):

Cash	$ 1,561
Capital assets	1,341
Inventory	381
Accounts receivable	68
Total purchase price	$ 3,351

The Company is accounting for this investment using the equity method. In 1999, $342,000 of goodwill was amortized and the Company's share of Rebel.com's net loss of $136,000 was deducted from the value of the investment.

An exception to the general rule that the acquiree's carrying values are unaffected by the purchase may arise when substantially all of the acquiree's shares are purchased by the acquirer. In that case, the acquirer may direct the acquiree to revalue its assets in accordance with the fair values attributed thereto by the acquirer. This practice is known as **push-down accounting**, because the fair values are "pushed down" to the acquiree's books. The net effect is the same as if the acquirer had formed a new subsidiary, which then purchased all of the assets and liabilities of the acquiree.

There are two advantages to push-down accounting. The first is that the financial position and results of operations of the acquiree will be reported on the same economic basis in both the consolidated statements and its own separate-entity statements. Without push-down accounting, for example, it would be possible for the subsidiary to report a profit on its own and yet contribute an operating loss to the parent's consolidated results, if the consolidation adjustments are sufficient to tip the balance between profit and loss.

The second advantage is that the process of consolidation will be greatly simplified for the parent. Since the carrying values will be the same as the acquisition fair values, there will be no need for many of the consolidation adjustments that otherwise will be required every time consolidated statements are prepared.

Although push-down accounting is used in Canada, the practice is more prevalent in the United States, where the Securities and Exchange Commission *requires* its registrants to use the practice when an acquired subsidiary is "substantially" wholly owned and there is no publicly held debt or senior shares.

In 1992, the CICA Accounting Standards Board issued *CICA Handbook* section 1625, "Comprehensive Revaluation of Assets and Liabilities." Push-down accounting *may* be used when:

> All or virtually all of the equity interests in the enterprise have been acquired, in one or more transactions between non-related parties, by an acquirer who controls the enterprise after the transaction or transactions. [CICA 1625.04(a)]

A guideline of 90% ownership is provided for the phrase "virtually all of the equity interests" [CICA 1625.10]. Note that the recommendation provides for acquisitions that are accomplished by a series of smaller share purchases rather than by one large transaction—substantially complete ownership need not be achieved all at once.

Despite the permissibility of applying push-down accounting, acquirers may choose not to apply push-down accounting to subsidiaries that have outstanding public debt. The reason is that the basis for assessing contract compliance is disturbed by an asset revaluation. Reported results (e.g., earnings per share) will be discontinuous, and debt covenants may be violated or rendered less suitable if the reporting basis is changed. Indeed, debt agreements with banks may be based on accounting principles in effect on the date of the agreement, and thereby effectively constrain the application of push-down accounting.

A special case of push-down accounting arises in a reverse takeover. In a reverse takeover, it is the legal acquirer that is really the in-substance acquiree—the fair values reported on the consolidated statements will be those of the company issuing the statements (the legal parent but in-substance subsidiary). In that case, it makes little sense for the in-substance acquiree to be carrying its assets and liabilities at book values that will never be reported in its own financial statements. It is more logical simply to put the fair values on the books of the in-substance acquiree.

Summary of Key Points

1. A business combination is the acquisition of net assets or *control* over net assets that constitute a functioning business. Control over net assets is usually obtained by buying a majority of the shares in the operating company that owns the assets. When control is acquired, the acquired net assets remain the property of the controlled subsidiary. Therefore, consolidated financial statements are necessary.

2. Accounting for a business combination requires three steps: (1) determine the cost of the acquisition, or purchase price, (2) determine the fair values of the acquired assets and liabilities, and (3) allocate the purchase price to the identifiable assets and liabilities, with any excess attributed to goodwill.

   The basis for the allocation of purchase price is the fair values of the acquired assets and liabilities. If the purchase price is less than the aggregate fair value of the net assets, negative goodwill arises. The value assigned to non-financial assets, starting with intangible assets with no observable market value, must be reduced until the total allocated amount equals the purchase price.

   If the purchase price is less than the fair value of the non-financial assets, the excess of fair value over the purchase price is recognized as an extraordinary item.

   A purchase of net assets may be accomplished (1) by paying cash or other assets or (2) by issuing shares. A combination of cash and shares may be used.

   When shares are issued, the purchase price is based on the market value of the shares, if determinable. If the market value of issued shares is not determinable, the fair value of the net assets acquired may be used as the measure of the purchase price. Fair values are determined on various bases, depending on the type of asset or liability. Generally, fair values of assets are based on net realizable values, replacement costs, and appraised values. Liabilities are measured at their discounted present value, using the market rate of interest at the time of the combination.

If the net assets are purchased directly, the fair values of the acquired assets and liabilities are recorded on the books of the acquirer. There is no parent-subsidiary relationship because the acquirer did not buy another corporation—it bought the net assets instead.

3. Acquisition of majority control over another company enables the investor to obtain control over the assets without having to pay the full fair value of the assets. Shares can be purchased for cash or other assets. Alternatively, the purchaser can issue its own shares in exchange for the shares of the acquiree. If there is an exchange of shares, the acquirer does not have to give up any cash. The previous holders of the acquiree's shares now hold shares in the acquirer instead.

4. Theoretically, there are three approaches to reporting consolidated financial statements following purchase of control over another corporation: pooling, purchase, and new entity.

   Under the pooling method, the book values of the parent and the subsidiary are simply added together and reported as the consolidated amounts.

   Under purchase accounting, the date-of-acquisition fair values of the subsidiary are added to the parent's book values. The purchase method of consolidation gives the same results as if the net assets had been purchased directly.

   With the new-entity method, the fair values of the parent and the subsidiary are added together to form a new basis of accountability for the ongoing economic entity.

5. Pooling has been in widespread use only in the U.S.A. Other countries, including Canada, have sharply limited pooling to those rare instances in which an acquirer cannot be identified. Effective in 2001, the pooling method is not permitted for arm's-length business combinations by the *CICA Handbook*, by FASB standards in the U.S.A., or by International Accounting Standards. However, the pooling method is applied to non-arm's-length corporate restructurings, including the combination of companies under common control.

6. Normally, fair values are not recorded on the books of the acquiree; adjustments are made solely on working papers to prepare consolidated financial statements. However, fair values may be recorded on the books of the acquired company if the investor corporation has acquired substantially all of the shares of the subsidiary. This practice is known as *push-down accounting*.

Weblinks

Ontario Securities Commission
www.osc.gov.on.ca/

The Ontario Securities Commission administers and enforces securities legislation in the Province of Ontario. Their mandate is to protect investors from unfair improper and fraudulent practices, foster fair and efficient capital markets, and maintain public and investor confidence in the integrity of those markets. Learn about the rules and regulations, market participants, and investor resources from this comprehensive Web site.

Allied Hotel Properties
www.alliedhotels.com/

Allied Hotel Properties is a Canadian hotel company focused on the ownership of first class business hotels in major Canadian urban centres. Properties include the Crowne Plaza Hotel Georgia and Delta Pacific Resort & Conference Centre in Vancouver, Crowne Plaza Chateau Lacombe in Edmonton, and Crowne Plaza Toronto Don Valley Hotel in Toronto. Read news releases and stock quotes at their Web site.

Corel
www.corel.com

From its early years as a pioneer in the graphics software field to its current innovations in business and Internet software for a variety of platforms, Corel has consistently developed products that respond to evolving consumer needs. Current products include CorelDraw, WordPerfect, and Corel Painter. Find out more about these programs or order them online at their Web site.

Self-Study Problem 3-1

Ace Corporation acquired Blue Corporation on August 31, 2004. Both corporations have fiscal years ending on August 31. Exhibit 3-11 shows the balance sheet for each corporation as of August 31, 2004, immediately *prior* to the combination, and net income amounts for each corporation for the fiscal year ended August 31, 2004.

The fair values of the assets and liabilities of the two companies at the date of acquisition are shown in Exhibit 3-12. The deferred development costs represent the unamortized amount of the companies' leading-edge products. There is no observable market value for this identifiable intangible asset, but Ace expects to fully recover the costs in future years.

Before the combination, Ace had 1,200,000 common shares issued and outstanding. Blue had 750,000 common shares issued and outstanding.

EXHIBIT 3–11 PRE-COMBINATION BALANCE SHEETS, AUGUST 31, 2004

	Ace	Blue
Cash and cash equivalents	$ 2,350,000	$ 1,200,000
Accounts receivable	2,000,000	1,800,000
Land	5,000,000	—
Machinery and equipment, net	13,500,000	8,400,000
Deferred development costs	600,000	3,100,000
	$23,450,000	$14,500,000
Accounts payable	$ 650,000	$ 1,100,000
Notes payable, long-term	2,000,000	1,000,000
Common shares	15,000,000	6,950,000
Retained earnings	5,800,000	5,450,000
	$23,450,000	$14,500,000
Net income, year ended August 31, 2004	2,450,000	1,300,000

EXHIBIT 3–12 FAIR VALUES, AUGUST 31, 2004

	Ace	Blue
Cash and cash equivalents	$ 2,350,000	$ 1,200,000
Accounts receivable	2,000,000	1,800,000
Land	8,500,000	—
Machinery and equipment, net	11,000,000	11,000,000
Deferred development costs	750,000	4,000,000
Accounts payable	(650,000)	(1,100,000)
Notes payable, long-term	(2,000,000)	(900,000)
Net asset fair value	$21,950,000	$16,000,000

Required:

Prepare the Ace Corporation post-combination balance sheet under each of the following *independent* situations:

1. Ace Corporation purchased the assets and assumed the liabilities of Blue Corporation by paying $2,000,000 cash and issuing long-term instalment notes payable of $18,000,000.
2. Ace issued 400,000 common shares for all of the outstanding common shares of Blue. The market value of Ace's shares was $50 per share.
3. Ace purchased 100% of Blue's outstanding common shares from Blue's previous shareholders. As consideration, Ace issued 270,000 common shares and paid $1,000,000 in cash. The market value of Ace's shares was $50 per share.

Appendix

Income Tax Allocation

Introduction

In your intermediate accounting course, you undoubtedly studied the topic of income tax allocation. The effects of income tax allocation show up as "future income taxes" on almost all balance sheets, as well as being a component of income tax expense. Future income taxes arise from two causes:

1. temporary differences between accounting income and taxable income, and
2. unrealized tax loss carryforwards.

In the main body of Chapter 3, we avoided any discussion of future income taxes as they relate to business combinations. However, they do play a part in the allocation of the purchase price and the calculation of goodwill. We have left this topic to an Appendix because we did not want to obscure the principal issues of accounting for business combinations. Income taxes are not irrelevant, but they are not central to an understanding of business combinations and the reporting of strategic investments.

Temporary differences in business combinations

In general, temporary differences arise because the carrying values of assets (and liabilities) differ from their tax bases. The most common type of temporary difference relates to depreciable capital assets—book depreciation methods *(accounting method)* are usually different from CCA *(tax method)*, and therefore an asset's carrying value is different from its tax basis.

A similar situation arises in business combinations. The cost allocated to an asset in a business combination is based on the asset's fair value. The fair value then becomes its carrying value. However, Canada Customs and Revenue Agency doesn't care about an asset's fair value—only its tax basis matters. Therefore, a temporary difference arises and must be dealt with.

For the purpose of consolidated statements, an asset's temporary difference is measured as the difference between its tax basis and the carrying value on the *parent's* consolidated financial statements—which is based on the asset's fair value at the date of acquisition. The relevant carrying value is ***not*** *its carrying value on the books of the* ***subsidiary***.

Exhibit 3-13 attempts to clarify the situation. Suppose that a newly acquired subsidiary, S, has an asset with a tax basis of $70 and a carrying value *on S's books* of $100. The temporary difference is $30. If S's tax rate is 40%, the future income tax liability pertaining to that asset is $30 × 40% = $12 on *S's separate-entity balance sheet*.

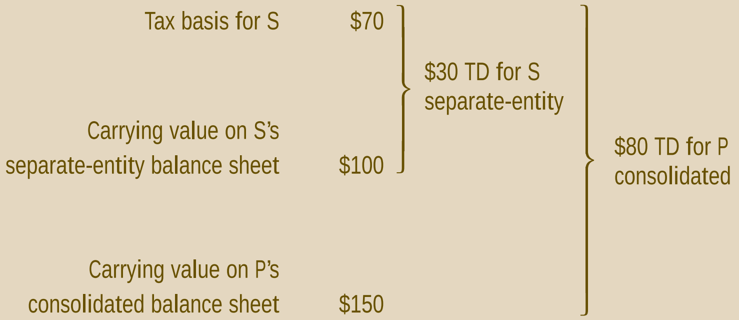
However, the fair value of that asset is $150. P, the parent company, will show the asset on P's *consolidated* balance sheet at $150. For P's consolidated statements, the temporary difference is $150 – $70 = $80. At a 40% tax rate, the future income tax liability pertaining to that asset is $80 × 40% = $32 *on P's consolidated balance sheet*.

The amount shown as the future income tax liability on P's consolidated balance sheet does not affect the tax status of S. S and P are each taxed as a separate corporate entity.

Now, let's apply income tax allocation to the example in the main body of this chapter.

- Purchase acquired 100% of the shares of Target for $1,200,000.
- The carrying value of Target's net assets *on Target's books* was $800,000.

EXHIBIT 3–13 TEMPORARY DIFFERENCES IN BUSINESS COMBINATIONS



Tax basis for S $70

Carrying value on S's separate-entity balance sheet $100

Carrying value on P's consolidated balance sheet $150

$30 TD for S separate-entity

$80 TD for P consolidated

TD = temporary difference.

The future income tax liability is the TD × the tax rate.

- Fair value increments totalled $300,000: $100,000 for land plus $200,000 for buildings and equipment.
- Goodwill was $100,000.

Let's make some additional assumptions:

- The tax basis for the land is equal to its carrying value on Target's books of $300,000.
- The tax basis of Target's buildings and equipment is $250,000.
- The tax basis for all other Target Ltd. assets and liabilities is equal to their carrying values.
- The tax rate for both Target and Purchase is 40%.

The relevant amounts can be summarized as follows.

	Land	Buildings & Equipment	Total
Tax basis	$300,000	$250,000	$550,000
Target Ltd.'s carrying value	300,000	350,000	650,000
Fair value to Purchase Ltd.	400,000	550,000	950,000

For Target Ltd., the total temporary difference is $650,000 – $550,000 = $100,000. The future income tax liability is $100,000 × 40% = $40,000. For simplicity's sake, we did not include this amount among the net assets shown in the main body of the chapter.

For Purchase Ltd.'s consolidated statements, the temporary difference is $400,000, and the future income tax liability (at 40%) is $160,000. Exhibit 3-14 shows the allocation of the purchase price with the future income tax liability included. We have fudged the original amounts a bit by subdividing accounts payable and shifting $40,000 to a future income tax liability account,

EXHIBIT 3–14 ALLOCATION OF PURCHASE PRICE, INCLUDING FUTURE INCOME TAXES

100% purchase of Target Ltd., December 31, 2001

	Book value	Fair value	Fair value increment	% share	FVI acquired	
Purchase price						**$1,200,000**
Cash	$ 50,000	$ 50,000	—			
Accounts receivable	150,000	150,000	—			
Inventory	50,000	50,000	—			
Land	300,000	400,000	$ 100,000	× 100% =	$ 100,000	
Buildings and equipment	500,000	550,000	50,000	× 100% =	50,000	
Accumulated depreciation	(150,000)	—	150,000	× 100% =	150,000	
Accounts payable	(60,000)	(60,000)	—			
Future income tax liability	**(40,000)**	**(160,000)**	**(120,000)**	× **100% =**	**(120,000)**	
Total fair value increment						**180,000**
Net asset book value	$ 800,000			× 100% =		**800,000**
Fair value of assets acquired		$980,000				**$ 980,000**
Goodwill						**$ 220,000**

to be consistent with our calculation of Target's temporary differences. This slight adjustment to the original numbers maintains the total amount of Target's net assets at $800,000. Thus we can clearly see what impact future income taxes have on the allocation of the purchase price.

Notice what happens to goodwill. Because we now are recognizing a liability that we did not recognize in Exhibit 3-6, the amount of the purchase price that is allocated to the net assets goes down. This forces the difference between the purchase price and the net book value to go up, thereby increasing the residual. The residual is goodwill. Therefore, the net result of recognizing the future income taxes is to increase liabilities with an offsetting increase in goodwill.

The current recognition of future income taxes based on consolidation fair values has been subject to some criticism. Prior to the effective date of Section 3465 (in 2000), fair value increments were viewed as permanent differences because the fair value increments never flow through to the income tax return. Fair value increments are purely an accounting construct and are irrelevant for tax purposes.

Now, however, temporary differences are recognized in this situation because the current approach to income tax accounting requires a future tax liability to be recognized on the assumption that assets are sold *at their carrying values*, thereby attracting taxation.[1] Since the carrying values for a purchased subsidiary are the fair values at date of acquisition, strict application of the concept results in the recognition of future income tax liabilities for what are sometimes called "phantom" values.

What happens to these amounts? We shall see in the following chapters that the fair value increments must be amortized (except for land). As the fair values are amortized, the temporary difference goes down and the future income tax liability is comparably reduced. As well, goodwill (at its heightened amount) is either amortized or subjected to the impairment test. Therefore, the recognition of future income tax liabilities based on fair values triggers three types of interperiod allocation in following years. Such complexity is the reason that we have chosen to put income tax allocation factors in Appendices rather than in the main body of each chapter.

Unrecognized tax loss carryforwards

One valuable asset that some companies have is tax loss carryforwards. Sometimes, this is a target company's most attractive asset. When substantial amounts of unused tax loss carryforwards exist, a purchaser may be willing to pay quite a lot for those benefits even if the target company appears to be a real loser. To obtain the benefit of tax loss carryforwards, the business combination must be accomplished through an exchange of shares, not by paying cash (or other assets).

The target company may or may not have already recognized those benefits on their balance sheet. Recognition depends on the "more likely than not" criterion prior to acquisition. If the company has serious financial difficulties, the probability criterion won't have been met and therefore their tax losses would not be recorded as a future income tax asset. However, the acquisition may change the probabilities, so that the "more likely than not" criterion may have now been met. Therefore these losses now have value to the parent company. The losses will be recognized at their fair value in the purchase price allocation and be identified as a future income tax asset in the purchaser's consolidated balance sheet.

Using the following data we will consider what will happen in a business combination under two scenarios. XYZ Corporation purchased 100% of the

[1] CICA 3465.02.

shares of ABC Corporation for $2,000,000 and the fair value of the net assets (excluding tax losses) totalled $1,400,000. In addition, unused tax loss carryforwards that the target company had not recorded on the books have a fair value of $200,000.

If it is more than 50% likely that the benefit will occur, then the purchase price will be allocated as follows:

Purchase price		$2,000,000
Fair value of net assets acquired (excluding tax loss benefits)	$1,400,000	
Future income tax asset	200,000	1,600,000
Goodwill		$ 400,000

If the "more likely than not" criterion has *not* been met, the purchase price will be recorded as:

Purchase price		$2,000,000
Fair value of net assets acquired (excluding tax loss benefits)	$1,400,000	
Future income tax asset	0	1,400,000
Goodwill		$ 600,000

Note the difference in the goodwill amount depending on whether the "more likely than not" criterion has been met. This difference will have an impact on future financial statements through increased amortization expense when goodwill is recognized at a higher amount. If the future income tax asset is recognized this will be considered a temporary difference.

Equity-basis reporting

The preceding brief discussion focused on business combinations. However, exactly the same process is followed for all investments that are reported on the equity basis, whether they are unconsolidated subsidiaries or significantly influenced affiliates. Temporary differences and future tax loss carryforward benefits must enter the allocation of the purchase price exactly as illustrated above.

Review Questions

3-1 Define the following terms:

a. Business combination

b. Net assets

c. Goodwill

d. Negative goodwill

e. Hostile takeover

f. Statutory amalgamation

g. Reverse takeover

h. Purchase price discrepancy

i. Exchange of shares

j. Corporate restructuring

k. Push-down accounting

3-2 Describe the two basic types of acquisitions that can result in a business combination.

3-3 What are the three steps in accounting for a business combination?

3-4 What are the forms of consideration that can be used in a business combination?

3-5 When one corporation buys the assets or assets and liabilities of another company, at what values are the acquired assets recorded on the buyer's books?

3-6 Does a direct purchase of assets constitute an intercorporate investment by the buying company?

3-7 P Ltd. has just purchased all of the assets of S Corp.'s automobile parts division. S Corp. had shut down the division the year before. Has a business combination occurred? Explain.

3-8 In general, how would fair values be determined for productive assets?

3-9 In general, how would fair values be determined for liabilities?

3-10 When an acquirer buys the net assets of another company by issuing shares, what is the relationship between the two companies after the transaction has taken place?

3-11 On what basis is the cost of a purchase of assets allocated?

3-12 What are the advantages for the acquirer of obtaining control over assets by a purchase of shares rather than by a direct purchase of assets?

3-13 What are the disadvantages for the acquirer of obtaining control by a purchase of shares?

3-14 For the acquirer, what is the difference in income tax treatment of goodwill acquired in a direct purchase of assets as compared to goodwill acquired in a purchase of shares?

3-15 How can an acquirer obtain control if the management of the acquiree is hostile to the business combination?

3-16 If an acquirer issues a tender offer, is it necessary for the offering company to buy all of the shares tendered?

3-17 From an income tax standpoint, what may be the disadvantages for an acquirer in obtaining control through a purchase of shares rather than by a direct purchase of net assets?

3-18 Company P issues its shares in exchange for the shares of Company S. After the exchange, who owns the newly issued shares of P?

3-19 In an exchange of shares, how can the acquirer be identified?

3-20 What is the most common reason for a combination of a public company and a private company accomplished by means of a reverse take-over?

3-21 In consolidated statements following a reverse take-over, which company's net assets are reported at fair values: the legal acquirer or the legal subsidiary?

3-22 Why is a reverse take-over often immediately followed by a name change of the legal parent corporation?

3-23 In what form(s) of business combination do the combining companies cease to exist as separate legal entities?

3-24 When a business combination is executed via a purchase of shares, at what values are the assets and liabilities of the acquiree recorded on the books of the acquirer?

3-25 Briefly explain the difference between these three approaches to preparing consolidated financial statements:

a. Pooling-of-interests method

b. New-entity method

c. Purchase method

3-26 What is the purchase price discrepancy?

3-27 What is the logic underlying the use of pooling-of-interests reporting for a business combination?

3-28 How prevalent is pooling-of-interests reporting in Canada?

3-29 What is the essential characteristic that must be present in a business combination in order for it to be reported as a pooling of interests?

3-30 How does the treatment of pre-combination financial data differ under pooling-of-interests reporting as compared to purchase reporting for a business combination?

3-31 What is a corporate restructuring? How are restructurings accounted for?

3-32 Why has the new-entity method not found acceptance in practice?

3-33 What is the recommended treatment of negative goodwill, according to the *CICA Handbook*?

3-34 Company P has 800,000 common shares outstanding. The shares are traded on the Montreal Exchange. The founders and managers of Company P hold 200,000 shares, and another 250,000 are held by institutional investors as long-term investments. P's board of directors has approved issuance of an additional 300,000 shares to acquire the net assets of Company S. What difficulties may arise in attempting to set a value on the newly issued shares in order to determine the cost of the acquisition?

3-35 Under what circumstances would a corporation be able to obtain control over the net assets of another corporation for less than the fair value of those net assets?

3-36 Define *push-down accounting*.

3-37 Under what circumstances is push-down accounting most likely to be used?

Cases

Case 3-1

XYZ Ltd.

During 2001, XYZ Ltd. purchased for cash all of the 100,000 Class B shares of Sub Limited. Each share carries one vote. The previous owner, Mr. Bill, retained all 20,000 outstanding Class A shares of Sub Limited, each carrying four votes. In order to avoid sudden changes, Mr. Bill stipulated in the sale agreement that he was to retain the right to refuse the appointment of management for Sub Limited and to approve any significant transactions of Sub Limited.

Required:

Should XYZ Ltd. consolidate the operations of Sub Limited in its 2001 financial statements, which are to be issued in accordance with generally accepted accounting principles? Provide support for your recommendation.

[CICA]

Case 3-2

Boatsman Boats Limited

Boatsman Boats Limited (BBL) is a dealer in pleasure boats located in Kingston, Ontario. The company is incorporated under the *Ontario Business Corporations Act* and is wholly owned by its founder and president, Jim Boatsman. In 2000, BBL had revenues of $2,500,000 with total assets of about $1,000,000 at year-end.

Late in 2001, Jim Boatsman reached an agreement with Clyde Stickney for the combination of BBL and Stickney Skate Corporation (SSC). SSC is a manufacturer of ice skates and is located in Ottawa, Ontario. SSC's 2000 revenue totalled $2,000,000 and year-end assets totalled $1,500,000. Clyde Stickney is president and general manager of SSC, and he owns 65% of the SSC shares. The other 35% is owned by Clyde's former partner, who left the business several years previously because of a policy disagreement with Clyde.

Clyde and Jim decided to combine the two businesses because their seasonal business cycles were complementary. Common ownership would permit working capital to be shifted from one company to the other, and the larger asset base and more stable financial performance of the combined company would probably increase the total debt capacity.

Under the terms of the agreement, BBL would issue common shares to Clyde Stickney in exchange for Clyde's shares in SSC. As a result of the exchange, Jim's share of BBL would drop to 60% of the outstanding BBL shares, and Clyde would hold the remaining 40%. Clyde and Jim signed a shareholders' agreement that gave each of them equal representation on the BBL board of directors.

As the end of 2001 approached, Jim, Clyde, and CA (the BBL auditor) were discussing the appropriate treatment of the business combination on BBL's 2001 financial statements. Clyde was of the opinion that CA should simply add together the assets and liabilities of the two companies at their book values (after eliminating intercompany balances and transactions, of course). Jim, on the other hand, thought that the combination had resulted in a new, stronger entity, and that the financial statements should reflect that fact by revaluing the net assets of both BBL and SSC to reflect fair values at the date of the combination. CA, however, insisted that only SSC's net assets should be revalued, and then only to the extent of the 65% of the assets that were represented by BBL's shareholdings in SSC.

While Jim and Clyde disagreed with each other on the appropriate valuation of the assets, both disagreed with CA's proposal. Jim and Clyde clearly controlled SSC through BBL, they argued; that was the whole point of the combination. In their opinion it would be inappropriate to value the same assets on two different bases, 65% current value and 35% book value. If only SSC's assets were to be revalued, then they reasoned that the assets at least should be valued consistently, at 100% of fair value.

In an effort to resolve the impasse that was developing, Jim and Clyde hired an independent consultant to advise them. The consultant was asked (1) to advise the shareholders on the pros and cons of each alternative in BBL's specific case, and (2) to make a recommendation on a preferred approach. The consultant was supplied with the condensed balance sheets of BBL and SSC as shown in Exhibit 1, and with CA's estimate of fair values (Exhibit 2).

Required:

Prepare the consultant's report. Assume that the business combination took place on December 31, 2001.

EXHIBIT 1

Condensed Balance Sheets
December 31, 2001

	Boatsman Boats Ltd.	Stickney Skate Corp.
Current assets	$ 600,000	$ 350,000
Land	—	250,000
Buildings and equipment	—	2,500,000
Accumulated depreciation	—	(1,500,000)
Furniture and fixtures	800,000	300,000
Accumulated depreciation	(330,000)	(100,000)
Investment in Stickney Skate Corp.	1,300,000	—
Total assets	$2,370,000	$ 1,800,000
Current liabilities	$ 370,000	$ 400,000
Long-term liabilities	300,000	900,000
Common shares	1,500,000	200,000
Retained earnings	200,000	300,000
Total equities	$2,370,000	$ 1,800,000

EXHIBIT 2

Net Asset Fair Values
December 31, 2001

	Boatsman Boats Ltd.	Stickney Skate Corp.
Current assets	$ 600,000	$ 350,000
Land	—	700,000
Buildings and equipment:		
estimated replacement cost new	—	5,000,000
less depreciation	—	(3,000,000)
Furniture and fixtures:		
estimated replacement cost new	1,300,000	500,000
less depreciation	(520,000)	(240,000)
Current liabilities	(370,000)	(400,000)
Long-term liabilities*	(270,000)	(930,000)
Net asset fair value	$ 740,000	$ 1,980,000

* Discounted at current long-term interest rates.

[ICAO]

Case 3-3

Ames Brothers Ltd.

Ames Brothers, Ltd. (ABL) is a relatively small producer of petrochemicals located in Sarnia. The common shares of the firm are publicly traded on the Brampton stock exchange, while the non-voting preferred shares are traded on the over-the-counter market. Because of the strategic competitive position of the firm, there was considerable recent interest in the shares of the company. During 2001, much active trading occurred, pushing the price of the common shares from less than eight dollars to more than twenty dollars by the end of the year. Similarly, the trading interest in the preferred shares pushed the dividend yield from 12% to only 9%.

Shortly after the end of 2001, three other firms made public announcements about the extent of their holdings in ABL shares. Silverman Mines announced that they had acquired, on the open market, 32% of the common shares of ABL; Hislop Industries announced that it had acquired 24% of ABL's common shares in a private transaction with an individual who had previously been ABL's major shareholder; and Render Resources announced that it had accumulated a total of 58% of ABL's preferred shares.

However, Silverman Mines and Hislop Industries are related. The Patterson Power Corporation owns 72% of the voting shares of Hislop Mines and 38% of the voting shares of Silverman Mines. There are no other large holdings of stock of either Silverman or Hislop. Render Resources is not related to Silverman, Hislop, or Patterson.

Required:

a. Has a business combination occurred in 2001, with respect to ABL, as the term "business combination" is used in the context of the *CICA Handbook* recommendations? Explain fully.

b. What implications do the various accumulations of ABL shares have for the financial reporting (for 2001 and following years) for:

1. Silverman Mines
2. Hislop Industries
3. Render Resources
4. Patterson Power Corporation

Case 3-4

Pool Inc. and Spartin Ltd.

Pool Inc. and Spartin Ltd. are both public companies incorporated under the *Canada Business Corporations Act*. The common shares of Pool have been selling in a range of $30 to $43 per share over the past year, with recent prices in the area of $33. Spartin's common shares have been selling at between $18 and $23; recently the price has been hovering around $20.

The two companies are in related lines of business. In view of the increasing exposure of the companies to world competition arising from the reduction in tariff barriers, the boards of directors have approved an agreement in principle to combine the two businesses. The boards have also agreed that the combination should take the form of a share exchange, with one share of Pool equivalent to two shares of Spartin in the exchange.

The manner of executing the combination has not yet been decided. Three possibilities are under consideration:

1. Pool could issue one new share in exchange for two of Spartin's shares.
2. Spartin could issue two new shares in exchange for each of Pool's shares.
3. A new corporation could be formed, PS Enterprise Inc., which would issue one share in exchange for each share of Spartin and two shares in exchange for each share of Pool.

The directors are uncertain as to the accounting implications of the three alternatives. They believe that the fair values of the assets and liabilities of both companies are approximately equal to their book values. They have asked you to prepare a report in which you explain how the accounting results would differ under the three share exchange alternatives. They have provided you with the condensed balance sheets of both companies. Pool Inc. presently has 1,600,000 common shares outstanding, and Spartin Ltd. has 1,200,000 shares outstanding.

Required:

Prepare the report requested by the boards of directors.

Condensed Balance Sheets

	Pool Inc.	Spartin Ltd.
Current assets	$ 7,000,000	$ 4,500,000
Capital assets	63,000,000	22,500,000
	$70,000,000	$27,000,000
Current liabilities	$ 6,000,000	$ 1,500,000
Long-term debt	14,000,000	5,500,000
Common shares	17,000,000	16,000,000
Retained earnings	33,000,000	4,000,000
	$70,000,000	$27,000,000

Case 3-5

Growth Inc.

Growth Inc. has just acquired control of Minor Ltd. by buying 100% of Minor's outstanding shares for $6,500,000 cash. The condensed balance sheet for Minor on the date of acquisition is shown below.

Growth is a public company. Currently, it has two bank covenants. The first requires Growth to maintain a specific debt-to-equity ratio and the second requires a specific current ratio. If these covenants are violated, the bank loan will be payable on demand. Growth is in a very competitive business. To encourage its employees to stay, it has adopted a new business plan. This plan provides managers a bonus based on a percentage of net income.

The president of Growth Inc., Teresa, has hired you, CA, to assist her with the accounting for Minor.

In order to account for the acquisition, Growth's management has had all of Minor's capital assets appraised by two separate, independent engineering consultants. One consultant appraised the capital assets at $7,800,000 in their present state. The other consultant arrived at a lower figure of $7,100,000, based on the assumption that imminent technological changes would soon decrease the value-in-use of Minor's capital assets by about 10%.

The asset amount for the leased building is the discounted present value of the remaining lease payments on a warehouse that Minor leased to Growth Inc. five years ago. The lease is noncancellable and title to the building will transfer to Growth at the end of the lease term. The lease has fifteen years yet to run, and the annual lease payments are $500,000 per year. The interest rate implicit in the lease was 9%.

Minor's debentures are thinly traded on the open market. Recent sales have indicated that these bonds are currently yielding about 14%. The bonds mature in 10 years.

The future income tax balance is the accumulated balance of CCA/depreciation temporary differences. The management of Minor sees no likelihood of the balance being reduced in the foreseeable future, because projected capital expenditures will enter the CCA classes in amounts that will more than offset the amount of depreciation for the older assets.

The book value of Minor's inventory appears to approximate replacement cost. However, an overstock of some items of finished goods may require temporary price reductions of about 10% in order to reduce inventory to more manageable levels.

Required:

Provide a report for Teresa outlining how the assets of Minor Ltd. should be valued for purposes of preparing consolidated financial statements. She wants you to identify alternatives and support your decision.

Minor Ltd.
Condensed Balance Sheet

Cash	$ 200,000
Accounts receivable	770,000
Inventories	1,000,000
Capital assets (net)	5,000,000
Leased building	4,030,000
	$11,000,000
Accounts payable	$ 300,000
8% debentures payable	7,000,000
Future income taxes	700,000
Common shares	1,000,000
Retained earnings	2,000,000
	$11,000,000

Case 3-6

Greymac Credit Corp.

Greymac Credit Corporation purchased 54% of the shares of Crown Trust Co. from Canwest Capital Corporation at $62 per share. Greymac Credit was a private investment company controlled by Leonard Rosenberg, a Toronto mortgage broker. Greymac also negotiated a purchase of another 32% of Crown Trust shares from BNA Realty Ltd. at a somewhat lower price. BNA Realty had purchased its block of Crown Trust shares only a few weeks earlier, but BNA's ownership was being challenged by the Ontario Securities Commission because "the regulators had alleged that Mr. Burnett [who controlled BNA Realty] was unfit to hold what amounted to veto control over the affairs of Crown." The two purchases of blocks of Crown Trust shares, in addition to other shares already held by Greymac, gave Greymac 97% of the shares of Crown Trust. Greymac was expected to make an offer for the remaining minority shares.

A little earlier in the same year, Greymac Credit Corporation had arranged a deal to purchase most of Cadillac Fairview Corporation's Toronto-area apartment buildings. The purchase involved some 10,931 apartments in 68 buildings, and was in line with Cadillac-Fairview's intention of leaving the residential housing market.

Required:

a. Had business combinations occurred with respect to Greymac's purchase of (1) the Crown Trust shares and (2) the Cadillac-Fairview apartments?

b. How could the OSC view a 32% minority interest as having "veto control"?

Case 3-7

Sudair Ltd.

On February 7, 2001, Sudair Ltd. and Albertair Ltd. jointly announced a merger of the two regional airlines. Sudair had assets totalling $500 million and had 1,000,000 common shares outstanding. Albertair had assets amounting to $400 million and 600,000 shares outstanding. Under the terms of the merger, Sudair will issue two new Sudair shares for each share of Albertair outstanding. The two companies will then merge their administrative and operating structures and will coordinate their routes and schedules to improve interchange between the two lines and to enable the combined fleet of nine jet aircraft to be more efficiently used. Both companies are publicly owned.

Required:

How should the merger of Sudair and Albertair be reported?

Problems

P3-1

Company L and Company E have reached agreement in principle to combine their operations. However, the boards of directors are undecided as to the best way to accomplish the combination. Several alternatives are under consideration:

1. L acquires the net assets of E (including the liabilities) for $1,000,000 cash.
2. L acquires all of the assets of E (but not the liabilities) for $1,400,000 cash.
3. L acquires the net assets of E by issuing 60,000 shares in L, valued at $1,000,000.
4. L acquires all of the shares of E by exchanging them for 60,000 newly issued shares in L.

The current, condensed balance sheets of L and of E are shown below. Prior to the combination, L has 240,000 shares outstanding and E has 30,000 shares outstanding.

Required:

a. In a comparative, columnar format, show how the consolidated balance sheet of L would appear immediately after the combination under each of the four alternatives using the purchase method.

b. For each of the four alternatives, briefly state who owns the shares of each corporation and whether L and E are related companies.

Condensed Balance Sheets
(thousands of dollars)

	L Co.		E Co.	
	Balance sheet	**Fair values**	**Balance sheet**	**Fair values**
Current assets	$ 4,000	$ 4,000	$ 300	$300
Capital assets	6,000	8,000	400	700
Investments	—	—	300	200
	$10,000		$1,000	
Current liabilities	$ 2,000	3,000	100	100
Long-term liabilities	3,000	3,000	400	300
Future income taxes	1,000	1,000	100	—
Common shares	1,000	10,000	200	900
Retained earnings	3,000		200	
	$10,000		$1,000	

P3-2

North Ltd. acquired 100% of the voting shares of South Ltd. In exchange, North Ltd. issued 50,000 common shares, with a market value of $10 per share to the common shareholders of South Ltd. Both companies have a December 31 year-end, and this transaction occurred on December 31, 2001. The outstanding preferred shares of South Ltd. did not change hands. The call price of the South Ltd. preferred shares is equal to their book value.

Following are the balance sheets of the two companies at December 31, 2001, before the transactions took place:

Balance Sheets
As at December 31, 2001

	North Ltd.		South Ltd.	
	Book value	**Fair value**	**Book value**	**Fair value**
Current assets	$ 150,000	$200,000	$210,000	$260,000
Capital assets, net	950,000	820,000	780,000	860,000
Goodwill	110,000		—	
Total	$1,210,000		$990,000	
Current liabilities	$ 100,000	$ 90,000	$165,000	185,000
Long-term liabilities	500,000	520,000	200,000	230,000
Preferred shares	—		270,000	270,000
Common shares	300,000		100,000	
Retained earnings	310,000		255,000	
Total	$1,210,000		$990,000	

Required:

Prepare the consolidated balance sheet for the date of acquisition, December 31, 2001, under each of the following methods:

a. Pooling of interests

b. Purchase

c. New entity

[CGA–Canada, adapted]

P3-3

On December 31, 2001, the balance sheets of the Bee Company and the See Company are as follows:

	Bee Company	See Company
Cash	$ 400,000	$ 700,000
Accounts receivable	1,600,000	1,800,000
Inventories	1,000,000	500,000
Plant and equipment (net)	3,500,000	5,000,000
Total assets	$6,500,000	$8,000,000
Current liabilities	$ 600,000	$ 300,000
Long-term liabilities	900,000	600,000
Common shares	2,500,000	1,000,000
Retained earnings	2,500,000	6,100,000
Total equities	$6,500,000	$8,000,000

Bee Company has 100,000 common shares outstanding, and See Company has 45,000 shares outstanding. On January 1, 2001, Bee Company issues an additional 90,000 common shares to See Company at $90 per share in return for all of the assets and liabilities of that company. See Company distributes Bee Company's common shares to its shareholders in return for their outstanding common shares, and ceases to exist as a separate legal entity. At the time of this transaction the cash, accounts receivable, inventories, and current liabilities of both companies have fair values equal to their carrying values. The plant and equipment and long-term liabilities have fair values as follows:

	Bee Company	See Company
Plant and equipment (net)	$3,900,000	$5,300,000
Long-term liabilities	600,000	500,000

The plant and equipment of both companies has a remaining useful life of nine years on December 31, 2001, and the long-term liabilities of both companies mature on December 31, 2001. Goodwill, if any, is to be amortized over 20 years.

For the year ending December 31, 2001, Bee Company, as a separate company, has a net income of $980,000. The corresponding figure for See Company is $720,000.

Required:

Assume that this business combination is to be accounted for by the purchase method of accounting for business combinations. Prepare the balance sheet at January 1, 2002, for Bee Company after the purchase.

[SMA, adapted]

P3-4

On December 31, 2001, Retail Ltd. purchased 100% of the outstanding shares of Supply Corporation by issuing Retail Ltd. shares worth $960,000 at current market prices. Supply Corporation was a supplier of merchandise to Retail Ltd.; Retail had purchased over 80% of Supply's total output in 2001. Supply had experienced declining profitability for many years, and in 1999 began experiencing losses. By December 31, 2001, Supply had accumulated tax-loss carry-forwards amounting to $280,000. In contrast, Retail Ltd. was quite profitable, and analysts predicted that Retail's positioning in the retail market was well suited to weather economic downturns without undue deterioration in profit levels.

The balance sheet for Supply Corporation at the date of acquisition is shown below, together with estimates of the fair values of Supply's recorded assets and liabilities. In addition, Supply held exclusive Canadian rights to certain Swedish production processes; the fair value of these rights was estimated to be $200,000.

Required:

Explain what values should be assigned to Supply Corporation's assets and liabilities when Retail Ltd. prepares its consolidated financial statements (including goodwill, if any).

Supply Corporation

	Balance Sheet December 31, 2001		Fair values
Current assets:			
Cash	$ 20,000		$ 20,000
Accounts receivable (net)	40,000		40,000
Inventories	210,000		200,000
		$ 270,000	
Plant, property, and equipment:			
Buildings	$ 600,000		500,000
Machinery and equipment	500,000		370,000
Accumulated depreciation	(450,000)		
	$ 650,000		
Land	200,000		360,000
		850,000	
Investments in shares		100,000	110,000
Total assets		$1,220,000	
Current liabilities:			
Accounts payable	$ 60,000		60,000
Unearned revenue	170,000		150,000
Current portion of long-term debt	100,000		100,000
		$ 330,000	
Bonds payable		400,000	380,000
Shareholders' equity:			
Common shares	$ 150,000		
Retained earnings	340,000		
		490,000	
Total liabilities and shareholders' equity		$1,220,000	

P3-5

Askill Corporation (Askill), a corporation continued under the *Canada Business Corporations Act*, has concluded negotiations with Basket Corporation (Basket) for the purchase of all of Basket's assets at fair market value, effective January 1, 2001. An examination at that date by independent experts disclosed that the fair market value of Basket's inventories was $150,000; the fair market value of its machinery and equipment was $160,000. The original cost of the machinery and equipment was $140,000 and its undepreciated capital cost for tax purposes at December 31, 2000, was $110,000. It was determined that accounts receivable were fairly valued at book value.

Basket held 1,000 common shares of Askill and the fair market value of these shares was $62,000. This value corresponds to the value of Askill's common shares in the open market and is deemed to hold for transactions involving a substantially large number of shares.

The purchase agreement provides that the total purchase price of all assets will be $490,000, payable as follows:

1. The current liabilities of Basket would be assumed at their book value.
2. The Basket debenture debt would be settled at its current value in a form acceptable to Basket debenture holders.
3. Askill shares held by Basket and acquired by Askill as a result of the transaction would be subsequently returned to Basket at fair market value as part of the consideration.
4. Askill holds 1,000 shares of Basket and these would be returned to Basket. The value to be ascribed to these shares is 1/10 of the difference between the total purchase price of all assets stated above ($490,000) less the current value of its liabilities.
5. The balance of the purchase consideration is to be entirely in Askill common shares, except for a possible fractional share element that would be paid in cash.

The Basket debenture holders, who are neither shareholders of Askill nor Basket, have agreed to accept face value of newly issued Askill bonds equal to the current value of the Basket bonds. The Basket debentures are currently yielding 10%. The Askill bonds carry a 10% coupon and trade at par.

Basket, upon conclusion of the agreement, would be wound up. The balance sheets of both corporations, as at the date of implementation of the purchase agreement (January 1, 2001), are as follows:

	Askill Corp.	Basket Corp.
Cash	$ 100,000	$ —
Accounts receivable	288,000	112,000
Inventories at cost	250,000	124,000
Investment in Basket (1,000 shares)	20,000	—
Investment in Askill (1,000 shares)	—	40,000
Machinery and equipment—net	412,000	100,000
Total assets	$1,070,000	$376,000
Current liabilities	$ 60,000	$ 35,000
7% debentures due Dec. 31, 2005 (Note 1)	—	100,000
10% bonds due Dec. 31, 2005 (Note 1)	500,000	—
Premium on bonds	20,000	—
Capital–common shares (Note 2)	200,000	100,000
Retained earnings	290,000	141,000
Total liabilities and shareholders' equity	$1,070,000	$376,000

Note 1—Interest is paid annually.
Note 2—Each company has issued 10,000 shares.

Both corporations have fiscal years that are identical to the calendar year.

Required:

a. Prepare Askill's pro-forma balance sheet at January 1, 2001.

b. Draft a note to the 2001 Askill financial statements disclosing the purchase of Basket's net assets.
[CICA, adapted]

P3-6

Par Ltd. purchased 100% of the voting shares of Sub Ltd. for $1,400,000 on October 1, 2001. The balance sheet of Sub Ltd. at that date was:

Sub Ltd.
Balance Sheet
October 1, 2001

	Net book value	Fair market value
Cash	$ 300,000	$300,000
Receivables	410,000	370,000
Inventory	560,000	750,000
Capital assets, net	1,220,000	920,000
	$2,490,000	
Current liabilities	$ 340,000	370,000
Preferred shares (Note 1)	800,000	
Common shares	400,000	
Retained earnings	950,000	
	$2,490,000	

Note 1:
The preferred shares are cumulative, pay dividends of $4 per year ($1 per quarter at the end of each calendar quarter) and have a call (redemption) premium of $1 per share. There are 100,000 preferred shares outstanding and they are non-participating.

Required:

Prepare the eliminating entry(ies) required *at the date of acquisition* that would be necessary to consolidate the financial statements of Sub Ltd. with those of Par Ltd.

[CGA–Canada, adapted]

P3-7

On December 31, 2001, Prager Limited acquired 100% of the outstanding voting shares of Sabre Limited for $2 million in cash; 75% of the cash was obtained by issuing a five-year note payable. The balance sheets of Prager and Sabre and the fair values of Sabre's identifiable assets and liabilities immediately before the acquisition transaction were as follows:

	Prager Limited	Sabre Limited	
		Book value	Fair value
Assets:			
Cash	$ 800,000	$ 100,000	$ 100,000
Accounts receivable	500,000	300,000	300,000
Inventory	600,000	600,000	662,500
Land	900,000	800,000	900,000
Buildings and equipment	6,000,000	1,400,000	1,200,000
Accumulated depreciation	(2,950,000)	(400,000)	
Patents	—	200,000	150,000
	$5,850,000	$3,000,000	
Liabilities and shareholders' equity:			
Accounts payable	$1,000,000	$ 500,000	500,000
Long-term debt	2,000,000	1,000,000	900,000
Common shares	1,500,000	950,000	
Retained earnings	1,350,000	550,000	
	$5,850,000	$3,000,000	

Required:

Prepare the consolidated balance sheet for Prager Limited immediately following the acquisition of Sabre Limited.

[SMA, adapted]

P3-8

On January 4, 2001, Practical Corp. acquired 100% of the outstanding common shares of Silly Inc. by a share-for-share exchange of its own shares valued at $1,000,000. The balance sheets of both companies just prior to the share exchange are shown below. Silly has patents that are not shown on the balance sheet, but that have an estimated fair value of $200,000 and an estimated remaining productive life of four years. Silly's buildings and equipment have an estimated fair value that is $300,000 in excess of book value, and the deferred charges are assumed to have a fair value of zero. Silly's building and equipment are being depreciated on the straight-line basis and have a remaining useful life of 10 years. The deferred charges are being amortized over the following three years.

Balance Sheets
December 31, 2001

	Practical	Silly
Cash	$ 110,000	$ 85,000
Accounts and other receivables	140,000	80,000
Inventories	110,000	55,000
Buildings and equipment	1,500,000	800,000
Accumulated depreciation	(700,000)	(400,000)
Deferred charges	—	120,000
	$1,160,000	$740,000
Accounts and other payables	$ 200,000	$100,000
Bonds payable	—	200,000
Future income taxes	60,000	40,000
Common shares*	600,000	150,000
Retained earnings	300,000	250,000
	$1,160,000	$740,000

*Practical = 300,000 shares; Silly = 150,000 shares.

Required:

Prepare a consolidated balance sheet for Practical Corp., immediately following the share exchange.