CHAPTER 2
Business Combinations

BRIEF EXERCISES

BRIEF EXERCISE 2-1

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

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

Control exists when the investor is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.

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

BRIEF EXERCISE 2-2

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

It is important because on this date:

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

BRIEF EXERCISE 2-3

Contingent consideration is:

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

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

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

Changes in the measurement of the obligation subsequent to the acquisition date resulting from events after the acquisition date are accounted for differently depending on whether the obligation was classified as equity or debt.
If it is classified as equity, the equity shall not be remeasured and the subsequent settlement is accounted for within equity.
If it classified as a financial liability, it is accounted for under IAS 39 and is subsequently measured at fair value with movements being accounted for in accordance with that standard. Any adjustments are recognized in profit or loss.

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

BRIEF EXERCISE 2-4

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

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

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

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

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

BRIEF EXERCISE 2-5

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

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

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

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

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

BRIEF EXERCISE 2-6

The key steps in applying the acquisition method are:

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

BRIEF EXERCISE 2-7

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

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

BRIEF EXERCISE 2-8

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

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

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

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

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

BRIEF EXERCISE 2-9

IFRS 3.36 specifies the measurement of the gain.

It is required for an acquirer to:

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

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

BRIEF EXERCISE 2-10

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

EXERCISES

EXERCISES 2-1

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

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

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

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

EXERCISE 2-1 (Continued)

(a) Why is it necessary to identify an acquirer?

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

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

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

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

EXERCISE 2-2

(a) Consideration transferred:
Shares of New Ltd. 100,000 shares × \$6.50/share = \$650,000

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

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

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

Goodwill = \$650,000 – \$640,000 = \$10,000.
The journal entries can then be created from the acquisition analysis.

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

EXERCISE 2-2 (Continued)

(b) Consideration transferred:
Shares of New Ltd. 100,000 shares × $6.00/share = $600,000

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

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

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

Gain = $600,000 – $640,000 = $40,000.
The journal entries can then be created from the acquisition analysis.

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

EXERCISE 2-3

(a) Acquisition analysis

Consideration transferred:

Shares: 100,000 × 10 × $10 =	$10,000,000
Patent	1,000,000
Cash: 100,000 × $5.20 =	520,000
	$11,520,000

Fair value of identifiable assets and liabilities acquired:

Current assets	$980,000
Non-current assets	4,220,000
	5,200,000
Liabilities	500,000
	$4,700,000

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

EXERCISE 2-3 (Continued)

(b) Journal entries: Lai Hing Ltd

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

EXERCISE 2-4

Consideration transferred:

Shares: 2 × 100,000 × $4	$800,000
Cash: $1.50 × 100,000	150,000
	$950,000

Consideration received:
Equity = $850,000

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

Journal entries: Island Ltd

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

EXERCISE 2-5

(a) 100,000 shares issued at $1.80 per share

Consideration transferred:

Shares: 100,000 × $1.80	$180,000

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

Equipment	$50,000
Land	80,000
Trucks	40,000
Current assets	10,000
	180,000
Current liabilities	16,000
	$164,000

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

Journal entries: Lower Ltd.

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

EXERCISE 2-5 (Continued)

(b) 100,000 shares issued at $1.60 per share

Consideration transferred:
Shares: 100,000 × $1.60 $160,000

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

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

Journal entries: Lower Ltd

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

EXERCISE 2-6

(a) Consideration transferred	=	100,000 × $1.90
	=	$190,000
Net fair value of identifiable assets and liabilities of Dory Ltd.	=	$175,000
Goodwill	=	$190,000 – $175,000
	=	$15,000

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

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

EXERCISE 2-6 (Continued)

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

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

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

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

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

EXERCISE 2-6 (Continued)

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

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

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

The adjusting entry at March 1, 2014 is:

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

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

EXERCISE 2-6 (Continued)

(c) Consideration transferred	=	100,000 × $1.70
	=	$170,000
Net fair value of identifiable assets and liabilities of Dory Ltd	=	$175,000
Gain on bargain purchase	=	$175,000 – $170,000
	=	$5,000

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

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

EXERCISE 2-7

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

EXERCISE 2-8

The total acquisition price is:

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

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

EXERCISE 2-9

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

EXERCISE 2-10

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

Accounts Receivable	145,628	
Inventory	245,918	
Property Plant and equipment	501,234	
Goodwill	369,391	
Accounts payable		167,291
Long term debt		199,201
Cash		895,679

PROBLEMS

PROBLEM2-1

CHRAPATY LTD – SQUID LTD

Cost of the combination

Number of shares issued	=	½ (90% × 60,000)
	=	27,000
Cost per share	=	$6.20
Consideration transferred	=	27,000 × $6.20
	=	$167,400

(a) **Journal entries: Chrapaty Ltd**

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

PROBLEM2-1 (Continued)

(b) **Determining the fair value of shares issued**

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

(c)

CHRAPATY LTD
Statement of Financial Position

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

PROBLEM2-2

BILLIARDCO – QTECH LTD

Acquisition analysis

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

(a) **Journal entries: Billiardco**

Net fair value of identifiable assets and liabilities acquired:

Property, plant, and equipment	$30,000
Inventory	28,000
Accounts receivable	20,000
	78,000
Accounts payable	20,000
	$58,000

Consideration transferred =	$60,000
Net fair value of identifiable assets and liabilities acquired =	$58,000
Goodwill =	$2,000

PROBLEM 2-2 (Continued)

(a) (continued)

The journal entries are:

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

PROBLEM2-2 (Continued)

(b)

Billiardco
Statement of Financial Position

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

(c) **ERROR ADJUSTMENT**

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

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

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

Assuming no depreciation of plant:

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

PROBLEM2-3

Acquisition analysis

To Preferred Shareholders:

Cash	=	$3.10 x 50,000
	=	$155,000
Shares	=	(2 x 50,000) x $4.20
	=	$420,000

To Common Shareholders:
As 90% of the common shareholders accepted, 90% X 80,000 = 72,000

Cash	=	($1.20 x ½ x 72,000)
		+ ($1.20 x ½ x 72,000 x 0.925926)
	=	$43,200 + $40,000
	=	$83,200
Shares	=	(3 x 72,000) x $4.20
	=	$907,200
Total	=	$238,200 (Cash) + $1,327,200 (shares)
	=	$1,565,400

PROBLEM2-3 (Continued)

(a)

<u>Journal entries: Halbert Corp</u>

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

PROBLEM2-3 (Continued)

(b)

Journal entries: Delcon Ltd

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

PROBLEM2-4

HASTINGS LTD – F-SQUARED LTD

(a) Acquisition analysis

Net fair value of assets and liabilities acquired:

Accounts receivable	$34,700
Inventory	39,000
Land	130,000
Buildings	40,000
Property, plant and equipment	46,000
	$289,700

Consideration transferred

Shares: 2/3 × 60,000 × $3.20		$128,000
Cash		
Accounts payable ($43,500 + $1,600)	$45,100	
Mortgage and interest ($40,000 + $4,000)	44,000	
Bonds and premium	52,500	
Liquidation expenses	2,400	
	144,000	
Cash held by F-Squared	(12,000)	132,000
		$260,000

Gain on bargain purchase = $289,700 – $260,000
= $29,700

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

Share capital	1,200	
Cash		1,200
(Costs of issuing shares)		

PROBLEM2-4 (Continued)

(b)

Hastings Ltd.
Statement of Financial Position

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

PROBLEM2-5

NEWSTAR INC – PLX LTD

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

Consideration transferred

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

Net fair value of identifiable assets and liabilities acquired

Accounts receivable	$56,000
Inventory	39,200
Property, plant and equipment	140,000
Shares in Sefton Ltd	22,500
	$257,700

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

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

PROBLEM2-5 (Continued)

NEWSTAR INC
Journal Entries

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

PROBLEM2-5 (Continued)

(b)

Newstar Inc.
Statement of Financial Position

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

PROBLEM2-6

LING LTD – MORWONG LTD

(a)**Acquisition analysis**

Consideration transferred

Land				$120,000
Delivery trucks				28,000
Cash				
	Accounts payable	$23,500		
	Liquidation expenses	1,500	$25,000	
Cash held			(2,000)	23,000
				$171,000

Fair value of identifiable assets and liabilities acquired:

Accounts receivable	$15,000	
Land	120,000	
Buildings	40,000	
Cultivation equipment	40,000	
Irrigation equipment	22,000	$237,000
Loan—Bank of NB	(80,000)	
Loan—Farinacci Bros	(35,000)	
Loan—Long Cloud	(52,500)	167,500
		$69,500

Goodwill

Goodwill = $171,000 – $69,500
= $101,500

PROBLEM 2-6 (Continued)

LING LTD
Journal Entries

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

PROBLEM 2-6 (Continued)

MORWONG LTD
Journal Entries

(b)

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

PROBLEM 2-6 (Continued)

(c)

LING LTD
Statement of Financial Position
as at July 1, 2013

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

PROBLEM 2-7

ZANADU LTD – CORION LTD

Acquisition Analysis

Net fair value of identifiable assets and liabilities acquired:

Accounts receivable	$125,000
Land	840,000
Buildings	550,000
Farm equipment	364,000
Irrigation equipment	225,000
Vehicles ($172,000 – $48,000)	124,000
	2,228,000
Accounts payable	(80,000)
	$2,148,000

Consideration transferred:

Shares:	100,000 × $14 per share	$1,400,000
Cash:	($480,000 +$5,500 +$150,000 – $20,000)	$615,500
Land:		220,000
		$2,235,500

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

PROBLEM 2-7 (Continued)

The journal entries in ZanaduLtd are:

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

PROBLEM 2-8

SARATOGA LTD – KINGFISH LTD

(a)

(1)**<u>Assuming the fair value of "A" commonshares was $2 per share</u>**

<u>Acquisition analysis</u>

Net fair value of identifiable assets and liabilities acquired	=	$22,000 (inventory)
		+ $34,000 (land and buildings)
		+ $27,000 (plant and machinery)
	=	$83,000
Consideration transferred	=	40,000 shares × $2.00
	=	$80,000
Gain on bargain purchase	=	$3,000

<u>Journal entries:</u>

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

PROBLEM 2-8 (Continued)

(a) (continued)

(2)**<u>Assuming the fair value of “A” commonshares was $2.20 per share</u>**

<u>Acquisition analysis</u>

Net fair value of identifiable assets and liabilities acquired (above)	=	$83,000
Consideration transferred	=	40,000 shares × $2.20
	=	$88,000
Goodwill	=	$5,000

<u>Journal entries</u>:

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

PROBLEM 2-8 (Continued)

(b)

KINGFISH LTD

General Journal

(1) **<u>Assuming the fair value of “A” commonshares was $2 per share</u>**

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

Note: entries are treated as if a discontinued operation

PROBLEM 2-8 (Continued)

(b) (continued)

(2) **Assuming the fair value of "A" commonshares was $2.20 per share**

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

Note: entries are as if a discontinue operation

PROBLEM 2-8 (Continued)

(c)

SARATOGA LTD
Statement of Financial Position
as at January 1, 2013

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

PROBLEM 2-9

TAILOR LTD – FLATHEAD LTD – FLEXON LTD

(a)

Acquisition Analysis – Tailor Ltd – Flathead Ltd

Consideration transferred

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

Fair value of identifiable assets and liabilities acquired

Accounts receivable	$21,300
Inventory	26,000
Land and buildings	80,000
Plant and equipment	105,000
	$232,300

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

PROBLEM 2-9 (Continued)

Acquisition Analysis – Tailor Ltd – FlexonLtd

Consideration transferred

To Shareholders:				
Shares	Shares of Flexon Ltd	60,000		
	Shares in Tailor Ltd (1/2)	30,000	× $2.50	$75,000
Cash	60,000/2 × $1.50			45,000
				$120,000

TAILOR LTD
Journal Entries

Accounts receivable	21,300	
Inventory	26,000	
Land and buildings	80,000	
Plant and equipment	105,000	
Goodwill	20,000	
Payable to Flathead Ltd		112,300
Loss on disposal of asset	1,000	
Shares in listed companies		16,000
Share capital		125,000
(Acquisition of Flathead Ltd's assets)		

Acquisition-related expenses	7,600	
Cash		7,600
(Payment of acquisition-related costs)		
Share capital	950	
Cash		950
(Payment of share issue costs)		
Shares in Flexon Ltd	120,000	
Share capital		75,000
Cash		45,000
(Acquisition of shares in Flexon Ltd)		

PROBLEM 2-9

(b) Goodwill is measured differently for two reasons:

a) It is prohibited to recognize internally generated goodwill so the figure recorded in the books of Flathead Ltd does not represent the total goodwill of the company as at acquisition date.

b) Goodwill cannot be separated from the company and sold separately so no fair value is available. The only way goodwill can be measured is to compare the total value of the company against the fair values of its identifiable net assets, any surplus is deemed to represent the value of the net unidentifiable assets or goodwill.

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

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

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

(d)Tailor Ltd should post the following journal:

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

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

PROBLEM 2-10

SAVOIE LTEE – BLACKFISH LTD – LYNXLTD

(a)

Acquisition Analysis: SavoieLtee – Blackfish Ltd

Net fair value of identifiable assets and liabilities acquired:

Land & buildings	$60,000
Plant & machinery	50,000
Office equipment	4,000
Shares in listed companies	15,000
Accounts receivable	26,000
Inventory	54,000
	209,000
Accounts payable	14,000
Bank loan	16,000
	30,000
Net fair value of identifiable assets and liabilities acquired	$179,000

Consideration transferred:

Shares in Savoie Ltee			
Shares issued by Blackfish Ltd	60,000		
Shares in SavoieLtd to issue:			
(3/4 × 60,000) 45,000 × $3.00 =			$135,000
Cash			
Current tax liability		$6,000	
Provision for leave		10,000	
Bonds		50,000	
5% premium		2,500	
Liquidation costs		2,500	
		71,000	
Less cash held		11,000	60,000
Total consideration			$195,000

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

PROBLEM 2-10 (Continued)

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

Net fair value of identifiable assets and liabilities acquired

Land & buildings		$30,000
Plant & machinery		34,500
Office equipment		2,500
Inventory		12,000
Accounts receivable		20,000
		99,000
Accounts payable	$14,000	
Provision for leave	7,000	21,000
		$78,000

Consideration transferred:

Cash		$10,000
Shares	[11,000 × $3.00]	33,000
Land and Buildings		60,000
		$103,000

Goodwill	[$103,000 – $78,000]	$25,000

PROBLEM 2-10 (Continued)

(b)

SAVOIE LTEE
General Journal

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

PROBLEM 2-10 (Continued)

Acquisition-related expenses	1,000	
Cash		1,000
(Payment of acquisition-related costs)		
Payable to Lynx Ltd	10,000	
Cash		10,000
(Payment of purchase consideration)		

LYNX LTD
General Journal

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

WRITING ASSIGNMENTS

WRITING ASSIGNMENT 2-1

Nature of goodwill

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

How to account for it

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

WRITING ASSIGNMENT 2-2

Arguments in favour of expensing the acquisition related costs:

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

Arguments against expensing:

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

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

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

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

Note in IFRS it is argued that:

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

WRITING ASSIGNMENT 2-3

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

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

WRITING ASSIGNMENT 2-4

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

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

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

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

WRITING ASSIGNMENT 2-5

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

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

CASES

CASE 2-1

Principles in IAS 38 *Intangible Assets*:

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

How to account for the acquired research:

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

CASE 2-2

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

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

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

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

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

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

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

CASE 2-2 (Continued)

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

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

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

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

CASE 2-2 (Continued)

Evaluation guide

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

CASE 2-3

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

- The earnings potential of TPI may be a prime motivator in itself.

- Possible synergies between ACL and TPI may provide opportunities to enhance value through shared resources, author lists, cross-selling, etc.

- You may be simply looking for access to the publishing equipment and operations to supplement ACL's growth prospects. ACL is currently at capacity, and TPI currently has excess capacity.

- You have indicated that your motives are to see ACL grow so that it can be passed on to your children in two years. You have also indicated that you are conservative when it comes to financing, that you do not like to take on much debt, and that you will require income from the company after turning control over to your children.

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

- The earnings potential of TPI is highly questionable. There have been losses since Mr. Shewchuk's death and Ryan began managing. Mr. Shewchuk was the key man in the company. To date in 2013, the losses have continued and exceed budgeted losses.

- In prior years a government program subsidized 5% of the cost of all new university book purchases. This program has been discontinued, and its demise will have a negative effect on future sales and gross margins. The university market represents approximately 83% of sales.

- You do not have direct experience in book publishing. Although magazine publishing is similar, there are different critical success factors. In addition, you may not have the time to run both enterprises. If you must hire a manager for either of the businesses, you are adding another risk factor. TPI does not appear to have strong staff. The status of Ryan Gillis is also unclear. Mrs. Shewchuk expects him to continue, but that may not be in your best interests.

CASE 2-3 (Continued)

The Significant Risks and Opportunities Associated with the Proposed Purchase.

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

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

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

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

CASE 2-3 (Continued)

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

Analyze and Interpret the value of TPI

The purchase price has two components:

- $1,000,000 plus shareholders' equity at July 31, 2013.

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

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

Base amount Shareholders' equity at January 31, 2013:
Preliminary estimate

	$1,000,000
	449,000
	$1,449,000

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

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

CASE 2-3 (Continued)

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

- The current ratio decreased from 1.05 in 2012 to .93 at January 31, 2013, indicating less liquidity.

- Gross profit margins have also been steadily decreasing for the last two years. The gross profit margin was 35% in 2011, decreasing to 29% in 2012 and 25% in the six-month period ended January 31, 2013. Gross margin for the period ended January 31, 2013, was also lower than budget, which was 39% for the period. Sales were actually 18% above budget, but the increase appears to have been at the expense of margins. These deteriorating margins raise possible questions regarding the underlying value of the capital assets or inventory obsolescence.

- TPI has now recorded two consecutive financial periods with a net loss: $532,000 in 2012 and$444,000 for the first six months of 2013. The budget anticipated a loss before taxes for the first six months of only $105,000; the actual loss was $622,000. Even though the strongest sales are in the second half of the year, results for the remainder of the year may also be lower than budgeted in light of the results to date.

- Accounts receivable may include orders that have not been shipped. Accounts receivable have been increasing steadily, possibly due to the inclusion of unshipped orders or to an inadequate provision for doubtful accounts.

- Author advances may be overstated for books that will never get published. Consideration should also be given to the potential value of other assets and liabilities.

- There may be intangible assets such as author lists that may have value.

- If ACL purchases the shares of TPI, incremental costs may be attributed to capital assets that would not be deductible for income tax. The related income tax liability could be considered in arriving at the net value.

- We could also consider the value of the loss carryforwards.

- Long-term debt could be valued at fair market value by discounting the balances at current interest rates.

CASE 2-3 (Continued)

Discuss the Accounting Adjustments Required to be made to the TPI Financial Statements, Tying the Adjustments to the Purchase Price

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

- Revenue is recorded at the time that the bookstores place their orders. Normally revenue is recognized when the risks and rewards of ownership are transferred (i.e., delivered) from the seller to the buyer and collection of any amounts receivable is reasonably assured. The stated policy may not be in accordance with IFRS, given that the risks and rewards of ownership are not transferred at the time of placing the order. The effect of this policy is to potentially overstate net assets and shareholders' equity at the effective date of the purchase of TPI.

- There is an indication of "over-ordering," whereby books are recorded in quantities exceeding customer needs in order to inflate sales. Any over-orders in 2012 will be reflected in lower sales in 2013. If this practice is followed again at the end of 2013, shareholder's equity will be affected.

- TPI's return policy also presents a potential accounting problem. Bookstores are allowed to return any unsold books. This policy creates doubts about the collection assumption that is implicit in the revenue recognition policy. TPI should make a provision for estimated book returns. This provision could be based on historical practices or on surveys of bookstore inventories. There is no indication that TPI has made such provisions. The effect of not having a provision is to overstate net assets and shareholders' equity.

- Complimentary copies of new books are shipped without charge to generate interest from customers and are treated as inventory. This practice appears to be more in the nature of a sales incentive. Unless TPI expects these books to be ultimately sold, they should be treated as a sales expense and a period cost. The effect of the current practice is to overstate shareholders' equity and net assets.

CASE 2-3 (Continued)

- Author advances receivable have also increased from 2011 to 2013. Advances are recoverable only from future royalties, and the company has had declining sales and gross margins. Accordingly, the valuation of these advances may be questionable. A provision for possible non-recovery is necessary for advances to authors that do not result in a successful or commercially viable book. There is no indication that TPI has made such a provision and, as a result, net assets and shareholders' equity could be overstated.

- TPI has income-tax loss carryforwards that have not been recognized in the financial statements even though future income tax liabilities are recorded. If it is more likely than not that the timing differences related to the future income taxes could be reversed before the losses expire, then it would be appropriate to recognize the tax benefit at least to the extent of the future income tax liabilities.

- The current ratio may indicate other potentially serious problems. Accounts receivable have increased from $2,611,000 in 2011 to $3,075,000 in 2012, an increase of 18% in spite of an 8.8% decrease in sales. Accounts receivable increased further at January 31, 2013, to $3,211,000. There are indications that there was over-ordering in 2012, possibly leading to inflated accounts receivable balances. The aged profile of the receivables outstanding has also grown substantially. All of these factors cause us to believe that a further provision for doubtful accounts may be required.

- Inventory balances have also been rising. Inventory was $98,000 at the beginning of 2011, increasing to $545,000 by the end of the year, $1,073,000 by the end of 2012, and $1,931,000 by January 31, 2013. Although the balance at January 31 may reflect seasonal sales patterns, there has been a steady increase in inventory. This trend may reflect obsolescence, particularly in view of the technical nature of these books. They may have only a relatively short shelf life.

- Except for the treatment of future income taxes, the issues outlined above could result in an overstatement of shareholder's equity and directly affect the purchase price that ACL will pay for the shares of TPI.

- It may not be possible to structure a deal that provides the optimal tax position for both you and Mrs. Shewchuk.

CASE 2-3 (Continued)

- The purchase of shares from Mrs. Shewchuk will be most favourable to her since her entire gain will be taxed at capital gains rates, and she may be able to use the full capital gains exemption for the sale of private company shares involved in an active business. She may also benefit indirectly from a further exemption that may not have been triggered on Hugh's death it appears that Mrs. Shewchuk may not have to pay any taxes.

- Perhaps Mrs. Shewchuk would also consider the option of payment over time. However, she would not need to use the reserve for capital gains if her taxable capital gain is zero.

- A share purchase is not necessarily the best method for you, as you will only be able to utilize the tax balances in the company at the time of acquisition for deduction against future taxable income. If you decide to buy the assets directly, the entire purchase price will be allocated to the tax costs of the assets. An asset purchase also has the benefit of not having to take responsibility for TPI's liabilities.

<u>Discuss the Tax Implications of the Purchase for ACL and Mrs. Shewchuk</u>

- You may wish to use the fact that Mrs. Shewchuk does not have to pay taxes as a negotiating tool to bring the purchase price down. You should also consider adjusting the price for advances to shareholder ($14,000).

- If ACL acquires shares in TPI, there is an acquisition of control. Significant loss carryforwards are available in TPI that ACL might be able to use. In order to use the losses, the companies must meet a same or similar business test and there must be an expectation of profit. Since ACL is in the magazine publishing business and TPI is in the book printing and publishing business, it is not certain that the tax authorities will consider them to be in the same business for income tax purposes. Further investigation is required.

- To ensure that ACL benefits from the losses, TPI can continue to function as a subsidiary of ACL and recoup the losses once it returns to being profitable. If TPI is unable to turn a profit, TPI can then be merged with ACL.

- Even if the companies are not amalgamated, income can be shifted from ACL to TPI by various means. For example, ACL could borrow funds, using the TPI assets as security, and invest in shares of TPI. TPI would use the funds to repay debt. Interest expense would thus be moved from TPI to ACL, where it could be deducted from other sources of income. ACL would have to have a reasonable expectation of income from its share investment in TPI.

CASE 2-3 (Continued)

- It appears that the loss carryforward occurred in 2012. It is not known whether a request for a carry- back to the prior year was made. This should be investigated.

- There will be a deemed disposition of all assets that have inherent non-capital losses, resulting in non- capital losses to be carried forward. Inherent capital losses are also deemed to have been realized but cannot be carried forward.

Discuss the IT Decisions Facing TPI

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

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

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

Discuss the Financing Aspects of the Acquisition

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

CASE 2-3 (Continued)

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

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

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

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

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

Review Mr. Norwood's Personal Tax Situation and Suggests Improvements

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

- A shareholders' loan has been outstanding since 2011. Loans to shareholders that are not repaid within one year from the year end in which they are outstanding will be added to the shareholder's income. To avoid a possible reassessment and the resultant interest and penalties, this loan should be repaid. The funds cannot be re-advanced to the shareholder, as a series of loans and repayments will be viewed as a single loan.

- In each of 2011 and 2012 a significant bonus has been accrued. The accrual of the bonus must be properly and promptly documented in the minutes. Also, when the bonus is paid it should be treated as employment income and appropriate deductions made at source. The bonus must also be paid within 180 days following the year in which it is declared.

- The 2011 bonus that was not paid in 2012 will have to be added back to ACL's 2001 taxable income.

CASE 2-3 (Continued)

- There is a deemed taxable benefit based on the statutory interest rates applied to the interest-free shareholder loan.

- You should optimize the combination of salary and dividends paid. Rather than pay dividends as in2012, it would be more beneficial to declare sufficient bonus to reduce income below the threshold to obtain the small business deduction.

- If your wife and children can provide services to the company, you may want to consider paying them salaries since the income they receive will be taxed at a lower rate.

- You mentioned your wish to transfer the business to your children in two years' time. You should be aware that nothing needs to be done when you acquire TPI, although this may be an opportune time to do what is called an "estate freeze" so that some of the future growth in value will accrue to them. Estate planning and restructuring are quite complicated. We would be pleased to assist with a plan.

- You should consider utilizing a spousal RRSP so that your contributions would be made to your wife as beneficiary and allow for splitting of income in future years when funds are withdrawn.

- If your wife is receiving a salary she could also contribute to an RRSP.

CASE 2-4

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

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

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

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

Consideration transferred:

Cash	$1,600,000
Contingent consideration	162,500
Total consideration transferred	$1,762,500

CASE 2-4 (Continued)

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

Net assets acquired:

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

*1: Will use the estimated fair value of these assets acquired
*2: Goodwill already recognized by the acquiree is not carried forward in a business combination. Any goodwill that will be recognized will be accounted for by Fuschia Enterprises.

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

Goodwill = $1,762,500 – $1,038,232 = $724,268.
This goodwill will be recognized by Fuschia Enterprises upon consolidation and will be subject to an annual impairment test.

LEGAL NOTICE