CHAPTER 3

Business Combinations

CHAPTER OUTLINE

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LEARNING OBJECTIVES

After studying this chapter, you should be able to do the following:

- Define a business combination, and describe the two basic forms for achieving a business combination.
- Describe the current acceptable method of accounting for a business combination.
- Compare and contrast the purchase and pooling methods.
- Prepare a balance sheet immediately after a purchase-of-net assets business combination, using the purchase method.
- Prepare a balance sheet immediately after a purchase-of-shares business combination, using the purchase method.

Introduction

In Chapter 2 we examined the accounting for two types of long-term intercorporate investments: available-for-sale and significant influence. The next seven chapters are largely devoted to the accounting for a third type — long-term investments that enable the investor to control the investee. Before we explore this topic, we must examine the accounting for a business combination. The definition of a business combination also uses the term *control*; it follows that there is a direct relationship between a business combination and the subsequent accounting for a long-term investment that grants control.

"Business combination" is an accounting term that describes a

> transaction whereby one economic unit unites with or obtains control over another economic unit regardless of the legal avenue by which such control is obtained and regardless of the form of economic unit emerging from the transaction. A *conglomerate business combination* involves economic units operating in widely different industries. A *horizontal business combination* involves economic units whose products are similar. A *vertical business combination* involves economic units where the output from one can be used as input for another.[1]

Other terms that are often used synonymously with the term business combination are takeover, amalgamation, acquisition, and merger. The *CICA Handbook* defines and outlines the concept of a business combination in the following paragraphs:

> A business combination occurs when an enterprise acquires net assets that constitute a business, or acquires equity interests of one or more other enterprises and obtains control over that enterprise or enterprises. [1581.06]

(Control in this section has the same meaning as the term that is defined and explained in Section 1590.)

> A business combination might involve either incorporated or unincorporated enterprises. This Section applies equally to a business combination in which one or more enterprises are merged or become subsidiaries; one enterprise transfers net assets or its owners transfer their equity interests to another; or all enterprises transfer net assets or the owners of those enterprises transfer their equity interests to a newly formed enterprise (some of which are referred to as roll-up or put-together transactions). All such transactions are business combinations regardless of whether the form of consideration given is cash, other assets, a business or a subsidiary of the enterprise, debt, common or preferred shares, or other equity interests, or a combination of those forms, and regardless of whether the former owners of one of the combining enterprises as a group retain or receive a majority of the voting rights of the combined enterprise. An exchange of a business for a business also is a business combination. [1581.07]
>
> This Section does not apply to the formation of a joint venture. However, this Section applies when a joint venture enters into a transaction meeting the definition of a business combination. [1581.04]
>
> A business combination does not include the purchase of a single asset or a group of assets that does not constitute a business. [1581.08]

For a business combination to exist, one economic unit must control substantially all of the net assets of another economic unit. The purchase of some but not

[1] *Terminology for Accountants*, 4th edition, Toronto: CICA, 1992, p. 35.

all of an entity's assets is not considered a business combination. While the units involved are usually incorporated, this is not a requirement for a business combination. Also, the units involved cannot have been under common control immediately before the combination. The transfer of assets or the exchange of shares between two subsidiaries of the same parent, or between a parent and its subsidiary, would not be considered a business combination.[2]

Item of Interest For example, in the late 1990s the Bank of Nova Scotia announced that it was combining its two in-house investment management companies into a single company, to be called Scotia Cassels Investment Counsel Ltd. The companies involved were Scotia Investment Management Limited and Cassels Blaikie Investment Management. The announcement described this as a $13 billion merger, but because both of the combining companies were subsidiaries of the Bank of Nova Scotia, this amalgamation did not meet the accounting definition of a business combination.[3]

Business combinations are frequent events in Canada and the United States and throughout the world. Hardly a week passes without some reference in the press to actual or proposed takeovers and mergers. During the stock market downturn that occurred in the period 2000 to 2002, merger activity declined but when the market became more bullish, the number of mergers increased substantially. Examples included:

- The merger of Air France and KLM Royal Dutch Airlines, making it the third-largest airline in the world with estimated combined annual revenues of $21.8 billion U.S.
- Manulife Financial Corp.'s $15 billion acquisition of John Hancock Financial Services Inc., which resulted in the fifth-largest insurer in the world with assets under administration of $333 billion.
- Maple Leaf Foods Inc.'s acquisition of Schneider Corp. from Smithfield Foods Inc. in a $413 million deal. This acquisition combined the largest meat processor in Canada (Maple Leaf) with the second largest in the country. Smithfield, the world's largest pork producer, located in Smithfield, Virginia, had previously gained control of Schneider in 1998 when it won a hostile takeover battle with Maple Leaf. Smithfield put Schneider up for sale when it decided to concentrate its business activities solely in the United States.

Business combinations can be described as either friendly or hostile. Often a merger is initiated by one company submitting a formal tender offer to the shareholders of another company. In a friendly combination, the top management and the board of directors of the companies involved negotiate the terms of the combination and then submit the proposal to the shareholders of both companies along with a recommendation for approval.

Sometimes one company will put up for sale a portion of its business that it no longer wishes to operate. A friendly combination occurs when another company either agrees to buy these assets at the requested selling price or submits a bid for them.

[2] *CICA Handbook*, paragraph 1581.03.

[3] However, note that the accounting involved in the merger of these two companies into one would have been exactly the same as that which is described for a pooling of interests business combination (see Appendix B).

Item of Interest Late in 2003, AOL Time Warner Inc., under pressure to reduce its $26 billon U.S. debt, announced that it was open for bidding for its music operations. The original $180 billion merger of AOL and Time Warner had been the world's largest when it took place and it resulted in goodwill of $158 billion being reflected in the new company's balance sheet. However, not all mergers are completely successful, and in this case, when music sales did not reach expectations, the music division was put up for sale. It was speculated that a number of companies were bidding for Time Warner's CD and DVD business, and when the smoke finally cleared, a $2.6 billion U.S. bid from a syndicate headed by Edgar Bronfman Jr. was announced as the winner.

Item of Interest In November 2003, the founder of Maax Inc., Canada's largest spa, bathroom fixture, and kitchen cabinet manufacturer, announced that the company was up for sale. The company, located in a small Quebec community, had grown to its current size of 26 plants and over 3,000 employees by a series of acquisitions over a ten-year period. The company's founder decided to retire, and rather than sell his shareholdings, decided instead to put the whole company on the market as a means of enhancing shareholder value. The announcement pushed the company's share price to a 52-week high on the TSX.

Item of Interest Alcan Inc.'s $6-billion takeover of French company Pechiney SA in 2004 made the Canadian company one of the world's largest aluminum companies. The deal attracted the attention of regulators in both North America and Europe, who indicated that if approval was to be forthcoming, certain assets of the new combined company would have to be sold. The problem with this requirement was that the purchaser(s) of such assets would, in all probability, be Alcan's competitors, who would probably be able to make a lowball offer knowing that the sale was required. Alcan's solution to this problem was to split itself into two companies by spinning off a portion of its assets into a newly created public company. The spinoff was in the form of a pro-rata distribution of the shares of the new company to Alcan's existing shareholders. The old company was to have revenue of $20 billion and 78,000 employees while the new company would have revenues of $6 billion and 10,000 employees.

An unfriendly combination occurs when the board of directors of the target company recommends that its shareholders reject the tender offer.

Item of Interest An example that dominated the news in the early part of 2001 was the Trilogy Retail Enterprises LP takeover offer for Chapters Inc. Trilogy, owned by Gerald Schwartz and Heather Reisman, wanted to merge Chapters with Indigo Books, owned by Reisman. The management of Chapters resisted the takeover and persuaded Future Shop Ltd. to come to its rescue with a competing offer. Eventually Trilogy won the battle and Chapters was merged with Indigo. Later in the year, Future Shop itself received a takeover offer from Best Buy Co. Inc., which is headquartered in Minneapolis. The directors of Future Shop recommended acceptance of the offer.

The management of the target company will often employ defences to resist the takeover. They include:

- *Poison pill.* This occurs when a company issues rights to its existing shareholders, exercisable only in the event of a potential takeover, to purchase additional shares at prices below market. Chapters attempted to use such a plan to squash Trilogy's takeover, but on appeal by Trilogy, the Ontario Securities Commission disallowed the poison pill.
- *Pac-man defence.* This involves the target company making an unfriendly countervailing takeover offer to the shareholders of the company that is attempting to take it over.
- *White knight.* In this case, the target company searches out another company that will come to its rescue with a more appealing offer for its shares. Example: In February 2001, it was reported that Anadarko Petroleum Corp. had agreed to buy Berkley Petroleum Corp. for $1.7 billion in cash in a friendly deal that outbid a hostile bid made by Hunt Oil Corp. Hunt had made an offer in December 2000, and Berkley's management scrambled to find a white knight after rejecting the offer and refusing to take it to their shareholders for approval.
- *Selling the crown jewels.* This involves selling certain desirable assets to other companies so the would-be acquirer loses interest.

A major cause of the merger activity in the past decade or so has been the emergence of the global corporation. In order to access markets in other countries, companies have been searching for takeover targets in these countries. In the high-tech area, companies have always looked for new innovative products, and often have determined that it is more suitable to buy them than to develop them on their own.

Item of Interest Events in the Middle East in 2004 caused world crude oil and natural gas prices to soar to new heights with predictions that shortages in supply could occur. This was of particular concern to producers of natural gas. Although consumption was increasing, no major new sources of supply were being discovered. This led to some gas producers to resort to takeovers of other gas-producing companies in order to increase their reserves. In short order the press reported the Kerr-McGee Corp's $ 2.5-billion takeover of Westport Resources Corp., Encana Corp.'s $2.3-billion acquisition of Tom Brown Inc., and Petro-Canada's $534-million purchase of Prima Energy Corp. It was speculated that one of the reasons for this flurry of acquisition activity was the fact that it was getting cheaper to buy known reserves of natural gas than it was to explore for new ones.

While the ultimate aim is to increase future profitability, one writer has indicated that approximately two-thirds of all mergers result in a loss in value to the acquiring company.[4] Chrysler-Daimler Benz, ATT-NCR, and Nortel Networks are examples of well-known companies whose merger activities have been less than successful.

Item of Interest In May 2001, Nortel Networks Corp. announced that it had closed the doors on Promatory Communications Inc. of Freemont, California. Nortel acquired Promatory in January 2000 by issuing $778 U.S. million in shares.

At least two companies are involved in a business combination, and the initial thrust to combine will usually come from one of the companies involved; thus, we

[4] See *CA magazine*, May 2001, p. 5.

can visualize one company (the acquirer) initiating the takeover of another company (the acquiree). The accounting for the combination involves looking at the event in a similar fashion. In some situations, the company that initiated the combination is accounted for as if it were the acquiree. Such a situation is described as a reverse takeover. The accounting for reverse takeovers is discussed in Chapter 4.

In the next section of this chapter we discuss the two basic forms of business combinations. The discussion then proceeds to the accounting for business combinations and the acceptable methods that have been used. We will then focus on current GAAP in Canada.

Forms of Business Combinations

Essentially, there are only two forms of business combinations. One company can obtain control over the net assets of another company by (a) purchasing its net assets, or (b) acquiring enough of its voting shares to control the use of its net assets. In examining these two forms of combination, one must also consider closely the method of payment used. Payment can be cash, or promises to pay cash in the future, or the issuance of shares, or some combination of these. As we will see later, the method of payment has a direct bearing on the determination of which company is the acquirer.

Purchase of Assets An obvious way to obtain control over another company's assets is to purchase them outright. The selling company is left only with the cash or other consideration received as payment from the purchaser, and the liabilities present before the sale. Often, the acquirer purchases all of the assets of the acquiree and assumes all its liabilities. In either case, the shareholders of the selling company have to approve the sale, as well as decide whether their company should be wound up or should continue operations.

Purchase of Shares An alternative to the purchase of assets is for the acquirer to purchase enough voting shares from the shareholders of the acquiree that it can determine the acquiree's strategic operating, investing, and financing policies without the co-operation of others. This is the most common form of combination, and it is often achieved through a tender offer made by the management of the acquirer to the shareholders of the acquiree. These shareholders are invited to exchange their shares for cash or for shares of the acquirer company.

The share purchase form of combination is usually the least costly to the acquirer because control can be achieved by purchasing less than 100 percent of the outstanding voting shares. In addition, in Canada there can be important tax advantages to the vendor if shares rather than assets are purchased.

Because the transaction is between the acquirer and the acquiree's shareholders, the acquiree's accounting for its assets and liabilities is not affected,[5] and this company carries on as a subsidiary of the acquirer. The acquirer becomes a parent company and therefore must consolidate its subsidiary when it prepares its financial statements.

Both forms of business combination result in the assets and liabilities of the acquiree being combined with those of the acquirer. If control is achieved by purchasing net assets, the combining takes place in the accounting records of the acquirer. If control is achieved by purchasing shares, the combining takes place when the consolidated financial statements are prepared.

[5] An exception to this occurs when the acquiree applies "push-down accounting." This topic is discussed in Chapter 4.

Variations One variation from the two basic forms of business combination occurs when the companies involved agree to create a new company, which either purchases the net assets of the combining companies, or purchases enough shares from the shareholders of the combining companies to achieve control of these companies. While this may appear to be a third form of combination, the substance of the transaction indicates otherwise.

Another variation that can occur is a *statutory amalgamation*, whereby under the provisions of federal or provincial law, two or more companies incorporated under the same companies act can combine and continue as a single entity. The shareholders of the combining companies become shareholders of the surviving company, and the nonsurviving companies are wound up. The substance of a statutory amalgamation indicates that it is simply a variation of one of the basic forms. If only one of the companies survives, it is essentially a purchase of assets, with the method of payment being shares of the surviving company.

Methods of Accounting for Business Combinations

There are three methods that have either been used in practice or discussed in theory over the years:

- the purchase method;
- the pooling-of-interests method; and
- the new entity method.

These methods will be outlined below under the assumption that two companies are party to a business combination involving the purchase of assets.

If one of the combining companies can be identified as the acquirer, the *purchase method* is used to account for the combination. Under this method, the acquiring company records the net assets of the acquired company at the price that it paid. This price includes any cash payment, the fair market value of any shares issued, and the present value of any promises to pay cash in the future. Any excess of the price paid over the fair market value of the acquired company's net assets is recorded as goodwill. The fair values of the net assets acquired are systematically charged against earnings in the normal manner of expense matching. In addition, any goodwill is regularly reviewed for impairment and any impairment loss is reflected as a charge against earnings. As a result, the price paid for the acquired company is reflected as a deduction from the revenues generated from that company over time. This method of accounting is consistent with the accounting of any assets acquired by a company. Such assets are initially recorded at the price paid for them, and subsequently their cost is charged against earnings over their useful lives.

Prior to July 1, 2001, *the pooling-of-interests method* was used to account for those business combinations where an acquirer could not be identified. If, under the terms of the combination, a cash payment was made by one of the combining companies, that company was (and still is) identified as the acquirer and the purchase method would have to be used. Therefore, pooling of interests could only be used when there was an exchange of shares between the combining companies and the shares were distributed in such a manner that an acquirer could not be identified. The idea behind pooling came from the concept of "a merger of equals," whereby the shareholders of the companies involved agreed to combine their companies. Under pooling, there was no concept of an acquired company, and so the accounting for the combination involved simply adding together the book values of the combining companies. This was justified by the argument that because they were simply carrying on the business of two (or more) former entities as one company, with no major disruptions in operations or key personnel, there was no need to revalue the assets of any of the entities. A major problem with this concept was determining if companies involved really were "equals."

Under pooling, the price paid (the fair market value of the shares issued) was not reflected in the financial statements. Because the price paid was ignored, fair values were not used and no goodwill was recognized. In most cases, future earnings were higher with pooling than they would have been under the purchase method, because expenses measured after the combination were not based on fair values at the date of the combination and no goodwill impairment losses or amortizations were reflected in subsequent years.

Based on the stringent Canadian rules for identifying an acquirer, the vast majority of business combinations were accounted for as purchases, and a pooling rarely occurred in Canada, although in the late 1990s the numbers began to increase (see details in Appendix B). In the United States, which used quite different guidelines, there were far more poolings than in Canada; even so, the purchase method was still predominant.

Item of Interest To illustrate how different guidelines in the two countries produce different results, consider the facts behind the Exxon–Mobil merger that occurred in the United States. A new corporation was formed, which issued shares to the shareholders of both companies. After the merger, former Mobil shareholders held 30 percent of the new company while former Exxon shareholders held 70 percent. Under *FASB's* rules this was accounted for as a *pooling*. Under Canadian rules it would have been a purchase because if one shareholder group held more than 50 percent of the shares of the combined company, that company (in this case Exxon) would be identified as the acquirer.

Despite the fact that since July 1, 2001 pooling of interests is no longer accepted as a method of accounting for business combinations, its effects on the financial statements of many large corporations in the United States and Canada will be felt for many years to come. Assets acquired in a combination often have lives ranging up to 20 or 30 years. Differences in yearly reported earnings between the two methods will exist during these time periods because of the fair value amortizations that have to take place under the purchase method. A large portion of the acquisition price of a purchase business combination is typically allocated to goodwill. Eventually, earnings will reflect goodwill write-offs if impairment occurs. Under pooling this does not take place. Even though pooling is no longer acceptable, financial statement analysts will need to understand its accounting and its affects on financial statements well into the future. Appendix B, page 95, provides additional coverage of the pooling-of-interests concept and numerical examples of its application.

The third method, the *new entity method*, has been proposed in the past as an alternative to the pooling of interests. It has been suggested that a new entity has been created when two companies combine by the joining together of two ownership groups. As a result, the assets and liabilities contributed by the two combining companies should be recorded by this new entity at their fair values. This method has received virtually no support because of the additional revaluation difficulties and costs that would result. Furthermore, it has been argued that if the owners were simply combining their interests, there would be no new invested capital and therefore no new entity created.

Provisions of Section 1581

The following *Handbook* sections outline the accounting requirements for business combinations:

> The purchase method of accounting should be used to account for all business combinations. [1581.09]
>
> Accounting for a business combination by the purchase method follows the concepts normally applicable to the initial recognition and measurement of assets acquired, liabilities assumed or incurred, and equity instruments issued, as well as to the subsequent accounting for those items. The acquirer's interest in assets acquired and liabilities assumed is accounted for in accordance with this Section. Non-controlling interests are accounted for in accordance with CONSOLIDATED FINANCIAL STATEMENTS, Section 1600. [1581.10]
>
> The acquirer in a business combination should recognize the assets acquired and liabilities assumed from the date of acquisition, including any assets and liabilities that may not have been recognized on the balance sheet of the acquired enterprise. [1581.11]
>
> The financial statements of the acquirer for the period in which a business combination occurs should include the earnings and cash flows of the acquired enterprise from the date of acquisition only. [1581.12]

Identifying the Acquirer Section 1581 outlines the requirements for identifying the company that is the acquirer in the business combination. This is important because it is the net assets of the acquiree that are accounted for at fair values. Considerations in determining which company is the acquirer are as follows:

- If the means of payment is cash or a promise to pay cash in the future, the acquirer has been identified as the company making the payment.
- If shares are issued as a means of payment, a key element would be the relative holdings of the voting shares of the combined company by shareholders as a group of the combining companies. In a combination involving two companies, if one shareholder group holds more than 50 percent of the voting shares of the combined company, that company is the acquirer. If more than two companies are involved, the shareholder group that holds the largest number of voting shares identifies the company that is the acquirer.
- When an acquirer cannot seem to be determined by examining voting rights because each group of shareholders owns the same percentage, then the makeup of the board of directors and senior management is examined to see which company is dominant.
- When there has been a share exchange, the acquirer is often (but not always) the company that issues shares.
- The acquirer is often (but not always) the larger company.
- Section 1581 makes it imperative that an acquirer be identified if the accounting requirements of the purchase method are to be applied.

After an acquirer has been identified, the acquisition cost has to be determined and then allocated to the assets and liabilities acquired.

Acquisition Cost The acquisition cost is made up of:

- any cash paid, *and/or*
- the present value of any promises to pay cash in the future, *and/or*
- the fair market value of any shares issued. The value of shares is based on the market price of the shares over a reasonable period of time before and after the date of the combination.
- If the fair market value of the shares cannot be determined, the fair value of the net assets acquired is used to determine the acquisition cost. (As you will see in the sections that follow, in a situation such as this there can be no goodwill recorded in the acquisition.)
- Included in the acquisition cost are any direct expenses incurred in the combination. Examples would be the fees of consultants, accountants, and lawyers.
- Costs incurred in issuing shares are not considered part of the acquisition cost, but rather are deducted from the amount recorded for the share issue. Alternatively, share issue costs can be shown as a direct charge on the statement of retained earnings.
- Also included in the acquisition cost is contingent consideration. Contingent consideration is discussed in a later chapter.

Allocation of the Acquisition Cost The acquisition cost is allocated to the acquirer's interest[6] in the fair value of the identifiable assets and liabilities of the acquired company. An identifiable asset is not necessarily one that is presently recorded in the records of the acquiree company. For example, the acquiree company may have patent rights that have a definite market value but are not shown on the balance sheet because they have been developed internally. Or the acquiree's balance sheet may show a pension asset, though an up-to-date actuarial valuation may make it necessary to report a net pension obligation.

The *Handbook* directs the management of the acquirer to make a strong effort to recognize and measure unrecorded intangible assets of the acquired company with the following statement.

> An intangible asset should be recognized apart from goodwill when:
>
> (a) the asset results from contractual or other legal rights (regardless of whether those rights are transferable or separable from the acquired enterprise or from other rights and obligations); or
>
> (b) the asset is capable of being separated or divided from the acquired enterprise and sold, transferred, licensed, rented, or exchanged (regardless of whether there is an intent to do so).
>
> Otherwise it should be included in the amount recognized as goodwill. [1581.48]

Section 1581 provides additional guidance along with an extensive list of possible intangibles that would satisfy the recognition criteria. (This list is reproduced in Appendix A of this chapter).

It has been implied in the past that a large portion of the acquisition cost in a business combination ends up as goodwill. This is because the amount recorded as goodwill is often made up of a mixture of goodwill itself plus intangible assets that were not

[6] This reference to the acquirer's interest applies only to the consolidation of a subsidiary that is less than 100 percent owned.

identified and measured. It will interesting to see if this additional guidance results in a better measure of goodwill.

Not all assets and liabilities on the balance sheet of the acquired entity are considered identifiable. Future income tax assets and liabilities are not fair valued and carried forward. Instead, new amounts for future tax assets and liabilities become part of the allocation of the acquisition cost. Because of the added complexity that this brings, discussion and illustration of this topic is saved until a later chapter.

Because goodwill is a residual and not considered to be an identifiable asset, any goodwill existing on the balance sheet of the acquired company on the date of the business combination is not carried forward.

If the acquisition cost is greater than the acquirer's interest in the identifiable assets and liabilities acquired, the excess is recorded in the acquirer's financial statements as goodwill. In theory, goodwill represents the amount paid for excess earning power; in practice, it represents the premium paid to achieve control.

If the acquisition cost is less than the fair value of the identifiable net assets acquired, we have what is sometimes described as a "negative goodwill" situation. The *Handbook* describes the accounting for such negative goodwill as follows:

> When the net of the amounts assigned to assets acquired and liabilities assumed exceeds the cost of the purchase ("excess" — sometimes referred to as "negative goodwill"):
>
> (a) the excess should be eliminated, to the extent possible, by allocating it as a pro rata reduction of the net amounts that otherwise would be assigned to all of the acquired assets except:
>
> (i) financial assets other than investments accounted for by the equity method;
> (ii) assets to be disposed of by sale;
> (iii) future income tax assets;
> (iv) prepaid assets relating to employee future benefit plans; and
> (v) any other current assets, to the extent the excess is eliminated; and
>
> (b) any remaining excess should be presented as an extraordinary gain. [1581.50]

It would be a rare event if there was still a residue left after allocating the negative goodwill to the acquired assets as directed in paragraph 1581.50. But if it did occur, this "remaining excess" would be presented on the income statement of the acquirer as an extraordinary gain unless there was provision for additional cash to be paid or additional shares to be issued contingent on some event happening in the future. In such a situation, the residue would be shown as a deferred credit on the balance sheet of the acquirer until the contingency was resolved.

The accounting for negative goodwill and contingent consideration is illustrated in Chapter 4.

Financial Reporting After the Combination The net income generated by the net assets of the acquired company is reported in the financial statements of the acquirer commencing with the date of acquisition. The expenses used to arrive at this income must be based on the amortizations of the fair values used and any goodwill losses due to impairment. Prior years' comparative financial statements are not retroactively changed to reflect the combination.

Illustrations of Business Combination Accounting

To illustrate the accounting involved using the purchase method, we will use the summarized balance sheets of two companies. Summarized statements are used here so that we can focus completely on the broad accounting concepts. In later examples, detailed statements will be used. Exhibit 3.1 presents the December 31, Year 1, balance sheets of the two companies that are party to a business combination.

Because the identification of an acquirer requires the analysis of shareholdings after the combination, Notes 1 and 2 are presented in the exhibit to identify the shareholders of each company as belonging to two distinct groups.

A Company Ltd. will initiate the takeover of B Corporation. The first two illustrations will involve the purchase of net assets with cash and the issuance of shares as the means of payment. Later illustrations will have A Company purchasing enough shares of B Corporation to obtain control over that company's net assets, and will introduce the preparation of consolidated statements.

Exhibit 3.1

A COMPANY LTD.
BALANCE SHEET
December 31, Year 1

Assets	$300,000
Liabilities	$120,000
Shareholders' equity	
Common stock (5,000 shares) (Note 1)	100,000
Retained earnings	80,000
	$300,000

Note 1
The shareholders of the 5,000 common shares issued and outstanding are identified as Group X.

B CORPORATION
BALANCE SHEET
December 31, Year 1

Assets	$ 88,000
Liabilities	$ 30,000
Shareholders' equity	
Common stock (——— shares) (Note 2)	25,000
Retained earnings	33,000
	$ 88,000

The fair market values of B Corporation's assets and liabilities are as follows as at December 31, Year 1:

Fair market value of assets	$109,000
Fair market value of liabilities	29,000
Fair market value of net assets	$ 80,000

Note 2
The shareholders of the common shares of B Corporation are identified as Group Y. The actual number of shares issued and outstanding has been purposely omitted because this number would have no bearing on the analysis required later.

Purchase of Assets

In the following illustrations, A Company offers to buy all assets and to assume all liabilities of B Corporation. The shareholders of B Corporation accept the offer.

Illustration 1 Assume that on January 1, Year 2, A Company pays $95,000 in cash to B Corporation for all of the net assets of that company, and that no direct expenses are involved. Because cash is the means of payment, A Company is the acquirer. The acquisition cost is allocated in the following manner:

Purchase price	$ 95,000
Fair market value of net assets acquired	80,000
Difference — goodwill	$ 15,000

A Company would make the following journal entry to record the acquisition of B Corporation's net assets:

Assets (in detail)	109,000	
Goodwill	15,000	
Liabilities (in detail)		29,000
Cash		95,000

A Company's balance sheet after the business combination would be as shown at the bottom of this page.

Using the purchase method to account for the business combination, the identifiable net assets acquired were recorded at fair market values, with the purchase price difference recorded as goodwill. The balance sheet of A Company is not a consolidated balance sheet. But note that if A Company had paid $95,000 cash for 100 percent of the common shares of B Corporation, the consolidated balance prepared immediately after the business combination would be identical to the one shown below. (See Exhibit 3.3.)

A COMPANY LTD.
BALANCE SHEET
January 1, Year 2

Assets (300,000 – 95,000* + 109,000)	$314,000
Goodwill	15,000
	$329,000
Liabilities (120,000 + 29,000)	$149,000
Shareholders' equity	
Common stock	100,000
Retained earnings	80,000
	$329,000

** $95,000 cash paid by A Company to B Corporation*

While this illustration focuses on the balance sheet of A Company immediately after the business combination, it is also useful to look at B Corporation in order to see the effect of this economic event on that company. The balance sheet of B Corporation immediately after the sale of all of its net assets is shown below:

B CORPORATION LTD.
BALANCE SHEET
January 1, Year 2

Cash	$ 95,000
Shareholders' equity	
Common stock	$ 25,000
Retained earnings (33,000 + 37,000*)	70,000
	$ 95,000

* *The gain on sale of the net assets amounts to $37,000 ($95,000 – $58,000).*

The shareholders of B Corporation must now decide the future of their company. They could decide to invest the company's cash in productive assets and carry on in some other line of business. Alternatively, they could decide to wind up the company and distribute the sole asset (cash) to themselves on a pro rata basis.

Illustration 2 Assume that on January 1, Year 2, A Company issues 4,000 common shares, with a market value of $23.75 per share, to B Corporation as payment for the company's net assets. B Corporation will be wound up after the sale of its net assets. Because the method of payment is shares, the following analysis is made to determine which company is the acquirer.

	Shares of A Company
Group X now holds	5,000
Group Y will hold (when B Corporation is wound up)	4,000
	9,000

Group X will hold 5/9 (56 percent) of the total shares of A Company after the combination, and Group Y will hold 4/9 (44 percent) of this total after the dissolution of B Corporation. Because one shareholder group holds more than 50 percent of the voting shares, an acquirer has been identified. The purchase price is allocated in the following manner:

Purchase price (4,000 shares @ $23.75)	$ 95,000
Fair market value of net assets acquired	80,000
Difference — goodwill	$ 15,000

A Company would make the following journal entry to record the acquisition of B Corporation's net assets and the issuance of 4,000 common shares at fair market value on January 1, Year 2:

Assets (in detail)	109,000	
Goodwill	15,000	
Liabilities (in detail)		29,000
Common stock		95,000

A Company's balance sheet after the business combination would be as follows:

A COMPANY LTD.
BALANCE SHEET
January 1, Year 1

Assets (300,000 + 109,000)	$409,000
Goodwill	15,000
	$424,000
Liabilities (120,000 + 29,000)	$149,000
Shareholders' equity	
Common stock (100,000 + 95,000)	195,000
Retained earnings	80,000
	$424,000

This balance sheet was prepared by combining the book values of A Company's assets and liabilities with the fair values of those of B Corporation.

B Corporation's balance sheet immediately following the sale of its net assets is reproduced below:

B CORPORATION
BALANCE SHEET
January 1, Year 2

Investment in shares of A Company	$ 95,000
Shareholders' equity	
Common stock	$ 25,000
Retained earnings (33,000 + 37,000)	70,000
	$ 95,000

B Corporation is wound up and distributes the investment, consisting of 4,000 shares of A Company, to its shareholders (Group Y). The reason for winding up B Corporation should be intuitively obvious. B Corporation's sole asset is 4,000 of the issued shares of A Company. This single block represents a voting threat to A Company's shareholders (Group X). A Company will insist that B Corporation be wound up and distribute these 4,000 shares to its shareholders (Group Y), who presumably will not get together to determine how to vote them.

Introduction to Consolidated Financial Statements

When a parent–subsidiary relationship is the result of a business combination, the two (or more) companies involved continue as separate legal entities, with each maintaining separate accounting records and producing separate financial statements. GAAP ignores this separate-company legal status and views the substance of the relationship as one that has created a single economic entity that should report as such.

The requirement for, and rationale behind, the preparation of consolidated financial statements is stated in Section 1590 of the *CICA Handbook* as follows:

> An enterprise should consolidate all of its subsidiaries. [1590.16]

> Consolidated financial statements recognize that, even though the parent and its subsidiaries may be separate legal entities, together they constitute a single economic unit. Such financial statements provide the most appropriate basis for informing users of the parent's financial statements about the resources and results of operations of the parent and its subsidiaries as a group. This presentation, supplemented by segment information prepared in accordance with segment disclosures, Section 1701, and any other information necessary for fair presentation, is more informative to the shareholders than separate financial statements of the parent and each of its subsidiaries. [1590.17]

Before Section 1590 was issued in 1991, the requirements for consolidation were contained in Section 3050, "Long-term Investments." While this section required consolidation in most situations, it described as well situations where some subsidiaries could be excluded from consolidation. When the requirement for the presentation of consolidated statements was transferred from Section 3050 to Section 1590, and a new definition of control was introduced, these exclusions were removed. Basically, Section 1590 says that if control exists, consolidated statements must be prepared; when control ceases to exist, consolidation should also cease.

The previous illustrations examined the accounting for a business combination when net assets were purchased. We will now turn our attention to the most common form of combination, the purchase of shares. We will continue to use the financial statements of the two companies in Exhibit 3.1.

In the next two illustrations, A Company issues a tender offer to the shareholders of B Corporation (Group Y) for all of their shareholdings. Group Y accepts the offer.

Illustration 3 Assume that on January 1, Year 2, A Company pays $95,000 in cash to the shareholders of B Corporation for all of their shares, and that no expenses are involved. Because cash was the means of payment, A Company is the acquirer.

A Company's journal entry to record the acquisition of 100 percent of B Corporation's shares on January 1, Year 2, is as follows:

Investment in B Corporation	95,000	
Cash		95,000

The financial statements of B Corporation have not been affected by this transaction. A Company is now a parent company and must prepare consolidated financial statements for external reporting purposes. We will now illustrate the preparation of the consolidated balance sheet as at January 1, Year 2, using a working paper approach.

Before preparing the working paper, it is useful to calculate and allocate the purchase discrepancy. The purchase discrepancy is defined as "the difference between the amount paid by an acquiring company for shares and its proportionate interest in the net book value of the assets of the acquired limited company, at the date of acquisition."[7] This concept was introduced in Chapter 2.

The required calculation and allocation is shown in Exhibit 3.2.

[7] *Terminology for Accountants*, 4th edition, Toronto: CICA, 1992, p. 168.

Exhibit 3.2

CALCULATION AND ALLOCATION OF THE PURCHASE DISCREPANCY

Cost of A Company's investment								$95,000
Net book value of B Company								
Common stock							25,000	
Retained earnings							33,000	
							58,000	
A Company's proportionate interest							100%	58,000
Purchase discrepancy								37,000
Allocated as follows:								
	Fair value	–	*Book value*	×	*Ownership percentage*			
Assets	109,000	–	88,000	×	100%	=	21,000	
Liabilities	29,000	–	30,000	×	100%	=	(1,000)	22,000
Balance — goodwill								$15,000

Section 1600 of the *Handbook*, "Consolidated Financial Statements," does not mention an item called the purchase discrepancy; instead, it describes the calculation of goodwill with the following statement:

> Where the cost of an investment exceeds the parent's portion of the costs assigned to the subsidiary's identifiable assets acquired and liabilities assumed, such an excess is a payment for an unidentifiable asset and should be accounted for in consolidated financial statements as goodwill. [1600.16]

The costs assigned to the subsidiary's net assets mentioned in this paragraph are fair market values on the date of acquisition. If we calculate goodwill in accordance with the *Handbook*'s description, we get the same amount for goodwill, as the following demonstrates:

Cost of A Company's investment		$95,000
Fair value of B Corporation's net assets		
Assets	109,000	
Liabilities	29,000	
	80,000	
A Company's proportionate interest	100%	80,000
Balance — goodwill		$15,000

Because consolidated working papers use the financial statements of the parent and its subsidiary, which do not contain fair values, the calculation and allocation of the purchase discrepancy is necessary because it provides the amounts needed to make the working paper eliminations and adjustments.

The working papers for the preparation of the consolidated balance sheet on the date of acquisition are shown in Exhibit 3.3.

The following points should be noted regarding the preparation of this working paper:

1. A Company's asset "Investment in B Corporation" and B Corporation's common

Exhibit 3.3

A COMPANY LTD.
CONSOLIDATED BALANCE SHEET WORKING PAPER
January 1, Year 2

	A Company	B Corp.	Adjustments and Eliminations Dr.	Adjustments and Eliminations Cr.	Consolidated balance sheet
Assets	$205,000	$88,000	(2) $ 21,000		$314,000
Investment in B Corporation	95,000			(1) 95,000	
Purchase discrepancy			(1) 37,000	(2) 37,000	
Goodwill			(2) 15,000		15,000
	$300,000	$88,000			$329,000
Liabilities	$120,000	$30,000	(2) 1,000		$149,000
Common stock	100,000				100,000
Retained earnings	80,000				80,000
Common stock		25,000	(1) 25,000		
Retained earnings		33,000	(1) 33,000		
	$300,000	$88,000	$132,000	$132,000	$329,000

shares and retained earnings do not appear on the consolidated balance sheet. These items are eliminated by a working paper elimination entry because they are reciprocal in nature. The entry labelled (1) eliminates the parent's ownership percentage of the shareholders' equity of the subsidiary against the parent's investment account. These shareholders' equity accounts are separately shown in the working paper to facilitate this. The purchase discrepancy that results is the portion of the investment account not eliminated.

2. The purchase discrepancy does not appear on the consolidated balance sheet. With reference to the calculations of Exhibit 3.2, the purchase discrepancy is allocated to revalue the net assets of B Corporation for consolidation purposes. This is accomplished by the entry labelled (2).
3. When we add the book value of the net assets of B Corporation to 100 percent of the difference between their fair value and book value, the resulting amount used for the consolidation is the fair value of each individual asset and liability of B Corporation. This is only true for a 100 percent owned subsidiary. As we will see in the next chapter, it is not true when we have a subsidiary that is less than 100 percent owned.
4. The elimination entries are made on the working paper only. They are not entered in the accounting records of the parent or the subsidiary.
5. The consolidated balance sheet is prepared from the amounts shown in the last column of the working paper.
6. Under the purchase method of accounting, consolidated shareholders' equity on acquisition date is that of the parent.

Illustration 4 Assume that on January 1, Year 2, A Company issues 4,000 common shares, with a market value of $23.75 per share, to the shareholders of B Corporation (Group Y) for all of their shares, and that there are no expenses involved. The analysis made in Illustration 2 indicates that A Company is the acquirer.

A Company's January 1, Year 2, journal entry to record the issuance of 4,000 shares at market value in payment for the acquisition of 100 percent of B Corporation's shares is:

Investment in B Corporation (4,000 × $23.75)	95,000	
Common stock		95,000

The calculation and allocation of the purchase discrepancy is identical to the one used in the last illustration (see Exhibit 3.2). The working papers for the preparation of the consolidated balance sheet as at January 1, Year 2, are shown in Exhibit 3.4.

Exhibit 3.4

A COMPANY LTD.
CONSOLIDATED BALANCE SHEET WORKING PAPER
January 1, Year 2

	A Company	B Corp.	Adjustments and Eliminations Dr.		Cr.		Consolidated balance sheet
Assets	$300,000	$88,000	(2)	$ 21,000			$409,000
Investment in B Corporation	95,000				(1)	95,000	
Purchase discrepancy			(1)	37,000	(2)	37,000	
Goodwill			(2)	15,000			15,000
	$395,000	$88,000					$424,000
Liabilities	$120,000	$30,000	(2)	1,000			$149,000
Common stock	195,000						195,000
Retained earnings	80,000						80,000
Common stock		25,000	(1)	25,000			
Retained earnings		33,000	(1)	33,000			
	$395,000	$88,000		$132,000		$132,000	$424,000

The accounting for a business combination has been examined in four illustrations. The first two involved the acquisition of net assets, and the last two the acquisition of 100 percent of shareholdings. Because the amount paid was the same in each of these paired illustrations, the balance sheets prepared immediately after the combination are identical for each pair.

Financial Statement Disclosure

Section 1581 of the *CICA Handbook* sets forth detailed disclosure requirements with respect to business combinations completed during the year. One paragraph requires details of the assets and liabilities of an acquired entity to be presented in condensed form.

The following footnote from Roman Corporation Limited's financial statements illustrates how this company complied with the *Handbook's* disclosure requirements:

> On March 1, 2002, the company completed the acquisition of A. & C. Boehmer Limited, operating as Boehmer Box. Immediately upon acquisition, the Company amalgamated with A. & C. Boehmer Limited and retired borrowings of A. & C. Boehmer Limited in the amount of $5,591,846. Boehmer Box manufactures printed folding cartons for consumer packaged goods. The following table reflects the allocation of the purchase price to the acquired business as at March 1, 2002:

Assets	
Current assets	$ 21,883,690
Goodwill	25,276,762
Property, plant, and equipment	21,556,318
	68,716,770
Liabilities	
Current liabilities	14,869,666
Future income taxes	3,296,495
Other	4,124,494
	22,290,655
Net assets at fair value	$ 46,426,115
Satisfied by:	
Cash	$ 43,912,701
Vendor notes and other	2,513,414
	$ 46,426,115

An International Perspective

The restrictions on pooling of interests and the treatment of goodwill in a purchase business combination are two major sites of variance in international accounting practices. With the elimination of pooling of interests in 2001 by United States, the number of poolings declined substantially because it was used in the U.S. far more than in any other country in the world. Great Britain, Germany, Japan, and Korea still allow its use in certain situations. Many other countries, including Australia, New Zealand, France, Mexico, and now Canada, do not allow its use.

Prior to March 31, 2004, the IASB allowed pooling of interests for combinations described as "uniting of interests," but a new standard (IFRS 3) effective on this date eliminated its use. So when the European Union countries completely adopt IASB standards, the purchase method will be the dominant one in the vast majority of industrialized countries throughout the world.

While the purchase method has become the only acceptable one, the subsequent accounting for goodwill still exhibits some variation. Canada, the United States, and the IASB require periodic write-downs due to impairment instead of regular amortization over some maximum life. This will eventually be the method used by European Union countries. Japan and Korea allow amortization over a maximum 5-year period, while Chile allows 10 years and Mexico, Australia, and New Zealand allow 20 years. Generally speaking, when accounting standards allow maximum amortization periods, many companies adopt this maximum because of the favourable effect on earnings.

The treatment of negative goodwill also varies widely. In Canada, the United States, Australia, and New Zealand, negative goodwill is allocated to reduce assets in some manner. Any unallocated balance is shown as an extraordinary item in both Canada and the U.S. The new IASB standard requires that negative goodwill be recognized immediately in income but does not require it to be shown as an extraordinary item. Hong Kong writes it off immediately to a reserve in shareholders' equity. Mexico and Chile show it on the balance sheet and then amortize it to earnings over varying periods.

Purchased in-process research and development is another area that produces diversity in accounting practices, particularly between Canada and the United States. In-process research and development is often a valuable asset purchased in a takeover. The FASB requires that the amount of the acquisition price allocated to this asset be written off immediately, which is consistent with its requirements for internally generated research and development. Canada would allow the development component to be capitalized and amortized over its estimated useful life.

SUMMARY

A *business combination* takes place when one company gains control over the net assets of another company. Control can be achieved by the purchase of the net assets or by the purchase of enough voting shares to gain control over the use of the net assets. In the latter situation a parent–subsidiary relationship is created that requires the preparation of consolidated financial statements.

Prior to 2001, both the purchase method and the pooling of interests method were acceptable methods to account for a business combination. Pooling could be used only if there was a share exchange and even then only in exceptional circumstances. On July 1, 2001, pooling was disallowed in both Canada and the United States, leaving the purchase method as the only acceptable method to account for a business combination.

With the *pooling-of-interests* method, the assets, liabilities, and equities of the companies involved are combined at book values. With the *purchase method*, the assets and liabilities acquired are recorded at fair values, with the acquisition cost excess recorded as goodwill.

APPENDIX A

Examples of Identifiable Intangible Assets

This appendix contains examples, reproduced from Section 1581 of the *CICA Handbook*, of identifiable intangible assets that may be acquired in a business combination. Identifiable intangible assets that can be separately identified and reliably measured should be separately recorded in the financial statements of the acquiring entity at their fair value. Each intangible asset listed below is not necessarily reliably measurable. That determination would be based on individual facts and circumstances. Those intangible assets that are identifiable but not reliably measurable, are included in goodwill.

> The following are illustrative examples of intangible assets acquired in a business combination that meet the criteria for recognition as an asset apart from goodwill.

Examples of marketing-related intangible assets include:

(a) trademarks, trade names;
(b) service marks, collective marks, certification marks;
(c) trade dress (unique color, shape or package design);
(d) newspaper mastheads;
(e) Internet domain names; and
(f) non-competition agreements.

Marketing-related intangible assets are those assets that are primarily used in the marketing or promotion of products or services. Trademarks are words, names, symbols, or other devices used in trade to indicate the source of the product and to distinguish it from the products of others. A service mark identifies and distinguishes the source of a service rather than a product. Collective marks are used to identify the goods or services of members of a group and certification marks are used to certify the geographic origin or other characteristics of a good or service. Trademarks, service marks, collective marks, and certification marks may be protected legally through registration with government agencies, by continuous use in commerce, or by other means. When registered, or otherwise provided legal protection, a trademark or other mark is an intangible asset that meets the criterion for recognition apart from goodwill in paragraph 1581.48(a). Otherwise a trademark or other mark is recognized apart from goodwill only when the criterion in paragraph 1581.48(b) is met, which is normally the case.

The terms "brand" and "brand name" often are used as synonyms for trademarks and trade names. However, the former are general marketing terms that are typically used to refer to a group of complementary assets such as the trademark (or service mark) and its related trade name, formulae, recipes and technological expertise (which may or may not be patented). An enterprise may recognize, as a single asset apart from goodwill, a group of complementary intangible assets commonly referred to as a brand when the assets making up that group have similar useful lives.

An Internet domain name is a unique alpha-numeric name that is used to identify a particular numeric Internet address. Registration of a domain name associates the name with a designated computer on the Internet for the period the registration is in effect. Registered domain names are recognized as intangible assets apart from goodwill because they meet the criterion in paragraph 1581.48(a).

Examples of customer-related intangible assets include:

(a) customer lists;
(b) order or production backlog;
(c) customer contracts and the related customer relationships; and
(d) non-contractual customer relationships.

A customer list consists of information about customers such as their name and contact information. A customer list also may be in the form of a database that includes other information about the customers such as their order history and demographic information. A customer list does not arise from contractual or other legal rights. However, customer lists are valuable and are frequently leased or exchanged. Therefore, an acquired customer list meets the criterion in paragraph 1581.48(b) for recognition apart from goodwill. However, an acquired customer list does not meet that criterion when the terms of confidentiality or other agreements prohibit an enterprise from selling, leasing, or otherwise exchanging information about its customers.

When an acquired order or production backlog arises from contracts such as purchase or sales orders, it meets the criterion in paragraph 1581.48(a) for recognition apart from goodwill (even when the purchase or sales orders are cancellable).

When an enterprise establishes relationships with its customers such that the enterprise has information about the customer and has regular contact with the customer, and the customer has the ability to make direct contact with the enterprise, through contracts, those customer relationships arise from contractual rights. Therefore, customer contracts and the related customer relationships are intangible assets that meet the criterion in paragraph 1581.48(a) for recognition apart from goodwill, even when confidentiality or other contractual terms prohibit the sale or transfer of the contract separately from the acquired enterprise.

When a customer relationship does not arise from a contract, and it meets the criterion in paragraph 1581.48(b), the relationship is recognized as an intangible asset apart from goodwill. Exchange transactions for the same asset or a similar type of asset provide evidence of separability of a non-contractual customer relationship and might also provide information about exchange prices to be considered when estimating its fair value. For example, relationships with depositors may be exchanged with the related deposits and, thus, meet the criteria for recognition as an intangible asset apart from goodwill.

An acquired customer base is an intangible asset. However, that asset generally does not meet the criteria for recognition apart from goodwill. A customer base does not arise from contractual or other legal rights nor can it generally be bought and sold separately from the acquired enterprise.

Examples of artistic-related intangible assets include:

(a) plays, operas, ballets;
(b) books, magazines, newspapers, other literary works;
(c) musical works such as compositions, song lyrics, advertising jingles;
(d) pictures, photographs; and
(e) video and audio-visual material, including motion pictures, music videos, and television programs.

Artistic-related intangible assets meet the criteria for recognition apart from goodwill when the assets arise from contractual rights or legal rights, such as those provided by copyright. Copyrights can often be transferred either in whole through assignments or in part through licensing agreements. In determining the fair value of a copyright intangible asset, consideration is given to the existence of any assignments or licenses of the acquired copyright. An acquirer may recognize a copyright intangible asset and any related assignments or license agreements as a single intangible asset for financial reporting purposes when their useful lives are similar.

Examples of contract-based intangible assets include:

(a) licensing, royalty, standstill agreements;
(b) advertising, construction, management, service, or supply contracts;
(c) lease agreements;
(d) construction permits;
(e) franchise agreements;
(f) operating and broadcast rights;
(g) use rights such as drilling, water, air, mineral, timber cutting, and route authorities;
(h) servicing contracts such as mortgage servicing contracts; and
(i) employment contracts.

Contract-based intangible assets represent the value of rights that arise from contractual arrangements. Customer contracts (see paragraph 1581.A26) are one particular type of contract-based intangible asset. While servicing is inherent in all financial assets, it becomes a distinct asset or liability only when contractually separated from the underlying financial assets by sale or securitization of the assets with servicing retained or through the separate purchase and assumption of the servicing. When mortgage loans, credit card receivables, or other financial assets are acquired in a business combination with servicing retained, this section does not require recognition of the inherent servicing rights as an intangible asset. The fair value of the servicing intangible asset is considered in the measurement of the fair value of the acquired financial asset. However, a contract representing an acquired servicing asset is an intangible asset that is recognized apart from goodwill.

When the terms of a contract give rise to a liability or commitment (which might be the case when the terms of an operating lease or customer contract are unfavourable relative to market prices), that liability or commitment is recognized as required by paragraph 1581.43(j).

Examples of technology-based intangible assets include:

(a) patented technology;
(b) compute software;
(c) non-patented technology;
(d) databases; and
(e) trade secrets, such as secret formulae, processes, recipes.

Technology-based intangible assets relate to innovations or technological advances. As discussed in paragraphs 1581.A36–A38, the future economic benefits of those assets are often protected through contractual or other legal rights. Thus, many technology-based intangible assets meet the criterion in paragraph 1581.48(a) for recognition apart from goodwill.

When computer software and program formats are protected legally, such as by patent or copyright, they meet the criterion in paragraph 1581.48(a) for recognition apart from goodwill.

Databases are collections of information, often stored in electronic form (such as on computer disks or files). An acquired database that includes original works of authorship is entitled to copyright protection and, when so protected, meets the criterion in paragraph 1581.48(a) for recognition apart from goodwill. However, a database often includes information created as a consequence of an enterprise's normal operations, such as a customer list, or specialized information such as scientific data and credit information. Databases that are not protected by copyright can be (and often are) exchanged in their entirety or in part. Alternatively, they can be (and often are) licensed or leased to others. Thus, even when the future economic benefit of a database does not arise from legal rights, it meets the criterion in paragraph 1581.48(b) for recognition as an asset apart from goodwill.

A trade secret is information, including a formula, pattern, compilation, program, device, method, technique, or process, that derives independent economic value, actual or potential, from not being generally known, and is the subject of efforts that are reasonable under the circumstances to maintain its secrecy. When laws or regulations legally protect the future economic benefit of an acquired trade secret, that asset meets the criteria for recognition apart from goodwill in paragraph 1581.48(a). Otherwise, a trade secret is recognized apart from goodwill only when the criterion in paragraph 1581.48(b) is met, which is likely to be the case.

APPENDIX B

Pooling of Interests — Further Discussion and Illustration

Prior to July 1, 2001, both the purchase and the pooling methods were used in Canada, not as optional alternatives but rather each as the required method under specific conditions. The purchase method was required when an acquirer could be identified. The pooling-of-interests method was required when it was impossible to identify an acquirer. During the years when both methods were in use, stories circulated suggesting that management often attempted to structure mergers so that they would satisfy the guidelines for pooling and therefore be able to report higher future earnings. This was more difficult to accomplish in Canada than in the U.S. because of Canada's more stringent rules. During the period 1973 to 1990 only two or three poolings in total were reported by the CICA publication *Financial Reporting in Canada*. Between 1991 and 1999 ten more poolings were reported by this publication. Based on the differences in the lengths of the two time periods this was a fairly substantial increase. Some of the more well-known pooling combinations were Abitibi-Price–StoneConsolidated, TransCanada Pipelines–Nova Corp., and BCTelecom–Tellus, The two proposed bank mergers that never saw the light of day because of a federal government veto, CIBC–TD Bank and Royal Bank–Bank of Montreal, were also planned to be accounted for as poolings.

Based on an examination of the information provided at the time of the announcements of the above mergers, it was often difficult to come to the conclusion that they were truly "mergers of equals." One could surmise that, in some instances, the companies involved were structuring the terms of the merger agreement in order to qualify as poolings.

On July 1, 2001, both the CICA in Canada and the FASB in the United States issued revised standards that allow only one method of accounting for a business combination. This method is the *purchase method*. The CICA worked closely with FASB on this project with the objective of harmonizing the accounting standards in this area. The two standards boards concluded that pooling was no longer acceptable and stated the following reasons for their decisions:

- Pooling does not reflect the values exchanged in the transaction because the fair value of the shares issued is ignored.
- Pooling information is less complete because the method does not reflect a record at all for any acquired assets or liabilities that were not previously recorded. The purchase method would record such assets at fair value.
- Pooling results in users of financial statements being unable to properly track the performance of the investment over the years. Subsequent rate-of-return measurements are inflated artificially under this method because the numerator (earnings) is higher and the denominator (assets) is lower.
- When two different methods are allowed to account for what is essentially the same economic event, investors have a difficult time comparing the results of companies that have used different methods.
- While future earnings will be different for many years, future cash flows will be the same under both methods.
- The purchase method is consistent with the way the acquisition of individual assets is recorded, and the method of recording the acquisition of an individual asset is the same regardless of the nature of the consideration paid (cash or shares).

- "True mergers" do not exist and it is possible to identify an acquirer in all, or virtually all, business combinations.
- Pooling is not allowed, or is severely restricted, in most countries in the world.

Item of Interest On June 25, 2001, the business press carried the announcement of a merger between Canadian-headquartered Barrick Gold Corp. and U.S.A.-based Homestake Mining Company. The date is very important because five days later, the accounting rules in both Canada and the United States were changed so that the pooling-of-interests method was banned. Barrick's shares traded on both the Toronto and New York stock exchanges and its financial reporting followed Canadian GAAP. The press announcement indicated that the pooling-of-interests method would be used to account for the merger and that the accounting method was a major factor in the deal's timing. They managed to get it in just under the wire, so to speak. The share exchange offered Homestake's shareholders a 31 percent premium for their shares based on their current prices. Under pooling, this premium would not be reflected in the transaction and its subsequent financial reporting. It was also announced that after the merger Barrick would adopt U.S. GAAP for its financial reporting.

Subsequent examination of the Barrick consolidated statements indicated some interesting information. Under Canadian GAAP that existed at the time of the merger, pooling would not have been allowed because Barrick would be clearly identified as the acquirer. Barrick prepared a set of financial statements under Canadian GAAP and accounted for the acquisition using the purchase method. For reporting to the U.S. Securities and Exchange Commission, Barrick prepared another set of financial statements prepared under U.S. GAAP accounting for the merger as a pooling of interests because the terms of the merger satisfied the U.S. standards for pooling at that time. One might question why a reporting method that was considered unfair and misleading to investors five days later could be considered a fair presentation of the event on the day it was used.

Pooling of interests illustrations

Earlier in this chapter, we presented four illustrations of business combinations accounted for using the purchase method. In two of them the method of payment was cash, while in the other two a share issue was the consideration. A cash payment could never result in a pooling; only a share issue could. We will now present the share issue illustrations using the pooling of interests method.

Illustration 5 In Illustration 2, on page 84, A Company issued 4,000 common shares with a total value of $95,000 to purchase all of B Corporations's assets and liabilities. The accounting in that particular illustration used the purchase method. We will use the same facts and present the accounting that would result if the pooling of interests method had been used.

Under pooling, the net assets acquired are recorded by A Company at the book values carried on the balance sheet of B Corporation, and no goodwill is recorded. A Company prepares a journal entry to record the acquisition of all the net assets of B Corporation and the issue of 4,000 common shares as payment on January 1, Year 2, as follows:

Assets (in detail)	88,000	
Liabilities (in detail)		30,000
Retained earnings		33,000
Common stock		25,000

A Company's balance sheet immediately after the business combination (a purchase of assets) would appear as follows:

A COMPANY LTD.
BALANCE SHEET
January 1, Year 2

Assets (300,000 + 88,000)	$388,000
Liabilities (120,000 + 30,000)	$150,000
Shareholders' equity	
Common stock (100,000 + 25,000)	125,000
Retained earnings (80,000 + 33,000)	113,000
	$388,000

Notice that this balance sheet has been prepared by adding all of the balance sheet components of the two companies. Fair market values are not used, and the 4,000 common shares issued are recorded at the $25,000 book value of the common shares of B Corporation, whereas under the purchase method they would be issued at their $95,000 fair market value. Note also that by purchasing assets, A company increased its retained earnings and its future legal dividend paying ability.

The balance sheet of B Corporation immediately after the sale of its assets and liabilities follows:

B CORPORATION
BALANCE SHEET
January 1, Year 2

Investment in shares of A Company	$95,000
Shareholders' equity	
Common stock	$25,000
Retained earnings (33,000 + 37,000)	70,000
	$95,000

When B Corporation is wound up, its shareholders (Group Y) surrender their shares and receive 4,000 shares of A Company, distributed on a pro rata basis.

Illustration 6 Assume that on January 1, Year 2, A Company issues 4,000 common shares to the shareholders of B Corporation (Group Y) for all of their shares. The fair market value of A Company's shares on this date is $95,000.

Notice that the facts are the same as Illustration 4 (page 89), which used the purchase method. Here we will present the accounting using the pooling of interests method. A purchase discrepancy calculation is made only when the parent–subsidiary relationship stems from a purchase business combination; therefore, we do not make this calculation in a pooling situation such as this one.

A Company would make the following journal entry for the acquisition on January 1, Year 2:

Investment in B Corporation	25,000	
Common stock		25,000

We are assuming that corporate legislation would allow A Company to record the 4,000 shares at the book value of B Corporation's share capital.

Exhibit 3.5 shows the preparation of the consolidated balance sheet working paper. The only working paper entry required is the one that eliminates the parent's ownership percentage of the common stock of the subsidiary against the investment account.

Exhibit 3.5

A COMPANY LTD.
CONSOLIDATED BALANCE SHEET WORKING PAPER
January 1, Year 1

	A Company	B Corp.	***Adjustments and Eliminations*** Dr.	***Adjustments and Eliminations*** Cr.	Consolidated balance sheet
Assets	$300,000	$88,000			$388,000
Investment in B Corporation	25,000			(1) $25,000	
	$325,000	$88,000			$388,000
Liabilities	$120,000	$30,000			$150,000
Common stock	125,000				125,000
Retained earnings	80,000	33,000			113,000
Common stock		25,000	(1) $25,000		
	$325,000	$88,000	$25,000	$25,000	$388,000

Exhibit 3.6 compares A Company's consolidated balance sheet under the two methods.

By noting the differences in net asset values, it becomes obvious why pooling will result in higher future earnings. Some other differences, noted below, produce some interesting results in the financial statements.

If the combination takes place late in the fiscal year of the combined company, pooling leads to "instant earnings" because the net incomes of the companies are combined from the beginning of the year. Under the purchase method they are combined only from the date of the combination.

Exhibit 3.6

A COMPANY
CONSOLIDATED BALANCE SHEET

	Purchase Method	*Pooling Method*
Assets	$409,000	$388,000
Goodwill	15,000	—
	$424,000	$388,000
Liabilities	$149,000	$150,000
Common stock	195,000	125,000
Retained earnings	80,000	113,000
	$424,000	$388,000

Pooling of interests requires that prior years' financial statements be restated as if the two companies had been combined for all of their historical lives. This means that prior years' financial statements that are presented for comparative purposes, and such items as 10-year summaries (which are often presented in annual reports), must be redone to reflect amounts as if the companies had been combined during those earlier periods. Under purchase accounting, prior years' results are not restated.

With pooling, additional profits can result in later years if assets of the former acquiree are sold. For example, an asset with a fair value of $150,000 and a book value of $90,000 might be sold shortly after the business combination. If pooling were used, a gain of $60,000 would be reported; if the purchase method were used, there would not be a gain.

REVIEW QUESTIONS

1. What key element must be present in a business combination?
2. "The form of a business combination determines the method used to account for the combination." Discuss this statement.
3. Can a statutory amalgamation be considered a form of business combination?
4. What is the basic condition that in the past determined whether purchase or pooling accounting could be used? Explain.
5. Explain how an acquirer is determined in a business combination.
6. Outline the accounting involved with the purchase method.
7. Outline the accounting involved with the pooling of interests method.
8. Briefly describe the accounting involved with the new entity method.
9. If one company issued shares as payment for the net assets of another company, it would probably insist that the other company be wound up after the sale. Explain why this condition would be part of the asset purchase agreement.
10. What is a purchase discrepancy, and where does it appear on the consolidated balance sheet?
11. The pooling of interests method can by its very nature lead to substantially different results than the purchase method. One such difference arises when assets originally belonging to the acquiree are sold after the date of the combination. Explain why a substantial difference might occur in this situation.
12. To what extent is pooling still being used in major industrialized countries in the world?

MULTIPLE-CHOICE QUESTIONS

1. Which of the following describes how to consolidate net assets using the pooling of interests method?
   a. Add together the companies' book values.
   b. Add together the companies' fair values.
   c. Add together the fair value of the acquired company and the book value of the acquiring company.
   d. Add together the book value of the acquired company and the fair value of the acquiring company.

2. When a parent uses the purchase method to consolidate a wholly owned subsidiary, what amount will appear as "common shares" in the equity section of the consolidated balance sheet?
   a. The book value of the parent's common shares plus the book value of the subsidiary's common shares.
   b. The book value of the parent's common shares plus the fair value of the subsidiary's common shares.
   c. The fair value of the parent's common shares on the date of the purchase of the subsidiary.
   d. The book value of the parent's common shares at the date of consolidation.
3. P Company acquires 100% of the common shares of S Company by issuing non-voting preferred shares. For both P Company and S Company, the fair value of all assets is greater than recorded book values. Which of the following approaches to consolidation will show the highest total asset value on the consolidated balance sheet on the date of acquisition?
   a. Pooling of interest.
   b. Purchase.
   c. New entity.
   d. Cannot be determined based on the information provided.
4. Which of the following characteristics is not associated with a business combination in Canada today?
   a. A clearly identified acquisition cost is evident for the transaction.
   b. Two subsidiaries of a single parent merge together as one.
   c. Cash or debt or shares can be used as payment for the acquired company.
   d. One company can always be identified as the acquirer.

The following data should be used for Questions 5 and 6.

Harper Corp. has only three assets:

	Book value	*Fair value*
Inventory	$ 165,000	$ 225,000
Land	1,050,000	900,000
Buildings	1,050,000	1,350,000

Kandon Inc. purchases Harper's assets by issuing 100,000 common shares with a market value of $30 per share.

5. At what amount will the inventory, land, and buildings respectively appear on Kandon's balance sheet?
   a. $165,000, $900,000, $1,350,000
   b. $165,000, $1,050,000, $1,050,000
   c. $225,000, $900,000, $1,350,000
   d. $225,000, $1,050,000, $1,350,000
6. What is the amount of goodwill from this business combination?
   a. $525,000
   b. Negative $525,000
   c. $735,000
   d. Nil

The following data should be used for Questions 7 and 8.

On January 1, 2006, Green Company acquired 100% of the outstanding common shares of Blue Inc. by issuing 10,000 common shares. The book values and the fair values of both companies immediately before the acquisition were as follows:

	Green Company		Blue Inc.	
	Book values	*Fair values*	*Book values*	*Fair values*
Assets	2,175,000	2,400,000	900,000	1,042,500
Liabilities	1,155,000	1,132,000	375,000	405,000
Common shares*	450,000		97,500	
Retained earnings	570,000		427,500	
	2,175,000		900,000	

** Immediately before the acquisition transaction, Green Company had 20,000 common shares outstanding and Blue Inc. had 6,500 common shares outstanding. Green's shares were actively trading at $75.00 on the date of the acquisition.*

7. What amount would Green Company report on its consolidated financial statements immediately after the acquisition transaction for "assets"?
   a. $3,075,000
   b. $3,217,500
   c. $3,330,000
   d. $3,442,500
8. What amount would Green Company report on its consolidated financial statements immediately after the acquisition transaction for "common shares"?
   a. $450,000
   b. $547,500
   c. $1,200,000
   d. $1,297,500
9. The pooling-of-interests method has been criticized for its approach to accounting for business combinations. Which of the following is a criticism of the pooling-of-interests method?
   a. Rarely, if ever, is there a true merger of equals when businesses combine.
   b. The pooling-of-interests method uses fair values in accounting for business combinations.
   c. The pooling-of-interests method reduces subsequent rates of return on the investment.
   d. The pooling-of-interests method tends to recognize identifiable assets and liabilities that had not previously been recognized.

   (CGA adapted)
10. On January 1, 2005, KL Corporation and XT Corporation entered into a business combination. On that date, the fair value of KL's net assets was greater than the book value. Similarly, the fair value of XT's net assets was greater than book value. Both companies have been profitable every year from 2002 through 2004. Which of the following is true regarding the earnings for the business combination on the 2005 consolidated financial statements?
    a. The pooling-of-interests method would produce lower earnings than the new entity method would.
    b. The purchase method would produce lower earnings than the pooling-of-interests method would.
    c. The new entity method would produce higher earnings than the purchase method would.
    d. Earnings would be the same under the pooling-of-interests and purchase methods.

    (CGA adapted)

11. Which of the following accounting methods *best* reflects Canadian requirements for public companies when accounting for business combinations where no acquirer can be easily identified?
    a. The pooling-of-interests method.
    b. The new-entity method.
    c. Proportionate consolidation.
    d. The purchase method.

(CGA adapted)

CASES

Case 1 Z Ltd. is a public company with factories and distribution centres located throughout Canada. It has 100,000 common shares outstanding. In past years it has reported high earnings, but in 2005 its earnings declined substantially due in part to a loss of markets as a result of the North American Free Trade Agreement. In 2006 it closed a large number of its manufacturing and distribution facilities and reported a substantial loss for the year.

Prior to 2006, 70,000 of Z Ltd.'s shares were held by C Ltd., with the remaining shares being widely distributed in the hands of individual investors in Canada and the United States. During 2006, C Ltd. sold 40,000 of its shares in Z Ltd. to W Corporation.

W Corporation is a joint venture that was formed in 2006 by A Ltd. and B Inc. Each company owns 50 percent of the common shares of W Corporation, and they have agreed in writing that all major decisions will be made jointly. W Corporation's sole asset is its holding of 40,000 shares of Z Ltd.

Required:

(a) How should C Ltd. report its investment in Z Ltd., both before the sale of 40,000 shares and after the sale?
(b) How should W Corporation report its investment in Z Ltd.?
(c) How should A Ltd. and B Inc. report their investments in W Corporation? Explain fully, and include in your answers a reference to Z Ltd.'s 2006 loss.

Case 2 The directors of Atlas Inc. and Beta Corp. have reached an agreement in principle to merge the two companies and create a new company called AB Ltd. The basics of the agreement confirmed so far are outlined below.

The new company will purchase all of the assets and assume all of the liabilities of Atlas and Beta by issuing shares. After the sale the two companies will be wound up. Some but not all members of the top management of each company will be retained.

The number of AB shares that will be issued has not yet been determined.

The chair of the merger committee has asked you to provide him with advice as to the accounting implications that will result from this merger, even though many of the details have not yet been ironed out. He has requested that you submit to him a preliminary report.

Required:

Prepare an outline of your report.

Case 3* Manitoba Peat Moss (MPM) was the first Canadian company to provide a reliable supply of high-quality peat moss to be used for greenhouse operations. Owned by Paul

* Adapted from a case prepared by J.C. (Jan) Thatcher, Lakehead University and Margaret Forbes, University of Saskatchewan.

Parker, the company's founder and president, MPM began operations in the late 1970s, when demand for peat moss was high. It has shown consistently high profits and stable growth for over 20 years. Parker holds all of the 50,000 outstanding common shares in MPM.

Prairie Greenhouses (PG), a publicly traded company that purchases over 70 percent of MPM's output, provides tree seedlings to various government agencies and logging companies for reforestation projects. In 2005 PG approached MPM with an offer to buy all of the company's outstanding shares in exchange for a part ownership in PG, with a view to vertically integrating. Parker was very interested in the offer, since he hoped to soon retire. PG currently has 100,000 shares outstanding and widely distributed. It would issue 100,000 new common shares in a two-for-one exchange for all of MPM's shares. PG's shares are currently trading on the TSE at $60 per share.

The board of directors of PG is uncertain as to the accounting implications of the proposed share exchange. They believe that since they are purchasing all of the outstanding common shares of MPM, it is similar to buying the company outright; as a result they want to report all of MPM's assets on PG's consolidated financial statements at fair market value. This will be very advantageous to PG, because the land carried on MPM's books was purchased in 1977 and has appreciated substantially in value over the years.

The board has asked you, as its accounting adviser, to prepare a report explaining how PG's purchase of shares should be reported. They are particularly interested in how the increase in the value of the land will be shown on the consolidated statements.

The condensed balance sheets of the two companies at the time of the offer are shown below:

	PG	*MPM*
Current assets	$ 870,000	$ 450,000
Fixed assets	8,210,000	2,050,000
	$9,080,000	$2,500,000
Current liabilities	$ 525,000	$ 200,000
Long-term debt	2,325,000	1,300,000
Common stock	4,000,000	500,000
Retained earnings	2,230,000	500,000
	$9,080,000	$2,500,000

Note: Land held by MPM at a book value of $1,000,000 has a fair market value of $6,000,000. All other assets of both companies have book values approximately equal to their fair market values.

Required:

Prepare the report to the board of directors.

Case 4 John Williams is the sole owner of Northern Flight Services, a small airline company with 12 float planes servicing remote communities in northern Manitoba and Ontario. He wants to expand, and approaches Billy Johnston, owner of Bearcat Airlines, which operates 15 planes providing freight and passenger services in the same area.

Scenario One Williams suggests that they join together and form one company. "We can probably save money on maintenance and overhead, and we can benefit from the discounts that suppliers will give us when we issue larger orders. Instead of each of us owning a small company, we will be co-owners of a larger airline operating 27 planes in the same area. Our company will be more profitable if we combine. I currently own all of the 3,000 outstanding shares of Northern Flight Services, and I will issue shares to you in exchange for all of the shares of Bearcat Airlines."

Scenario Two Williams approaches Johnston with a proposal, saying: "I will buy you out. I will pay cash for all of your assets or, if you prefer, for all of your shares. The amount will be based on our agreement as to the fair value of your company. You can continue to work for me or you can retire. I think it will be beneficial to have one company owning 27 planes."

Required:

What is the basic difference between Scenario One and Scenario Two? Explain how each scenario would be accounted for.

Case 5*

Effective May 31, 1999, Bruncor Inc. (Bruncor), Island Telecom Inc. (Island), Maritime Telegraph and Telephone Company Limited (MTT), and NewTel Enterprises Limited (NEL) combined their businesses to form Aliant Inc. This business combination was accounted for in the consolidated financial statements by the pooling of interests method.

Each of the predecessor companies operated the principal telecommunications companies in the provinces of New Brunswick (Bruncor), Prince Edward Island (Island), Nova Scotia (MTT), and Newfoundland (NEL). The shareholders of the predecessor companies exchanged all their shares for shares of Aliant Inc. as follows:

- Each Bruncor common share exchanged for 1.011 Aliant common shares;
- Each Island common share exchanged for 1.000 Aliant common share (other than those shares held by Maritime Holdings, a wholly owned subsidiary of MTT);
- Each MTT common share exchanged for 1.667 Aliant common shares;
- Each MTT 7.00% preference share exchanged for 0.605 Aliant common shares; and
- Each NEL common share exchanged for 1.567 Aliant common shares.

The share exchange resulted in a total of 126,437,484 Aliant common shares being issued, with the shareholders of the predecessor companies holding the following shares:

Shareholder group	*Number of Aliant common shares*	*% of shares outstanding*
Bruncor former shareholders	44,151,541	34.9%
Island former shareholders (other than Maritime Holdings)	3,533,469	2.8%
MTT former shareholders	49,889,477	39.5%
NEL former shareholders	28,862,997	22.8%
	26,437,484	100.0%

The annual report of the new company for 1999 included a full set of consolidated financial statements. These statements included the consolidated statement of retained earnings shown below:

CONSOLIDATED STATEMENTS OF RETAINED EARNINGS
(Thousands of dollars)
For the years ended December 31

	1999	*1998*
Balance, beginning of year	$312,030	$235,537
Net income	148,230	171,709
	460,260	407,246
Merger costs	(8,888)	—
Dividends on common shares	(106,305)	(95,216)
Balance, end of year	$345,067	$312,030

* Adapted from case prepared by Peter Secord, St. Mary's University.

Required:

Under the old Canadian accounting standards, pooling of interest would be the method of accounting when an acquirer could not be identified. If the shareholders of one of the combining companies as a group held more than 50 percent of the voting shares of the combined company, that company was identified as the acquirer and as a result the purchase method was required.

The pooling-of-interest method was rarely applied in Canadian practice before it was disallowed in 2001, and the Aliant merger was thought of in some circles as "the exception that proves the rule." In this context:

(a) Explain how the characteristics of this situation make the pooling-of-interest method an appropriate choice in the case of this business combination.
(b) Explain the mechanics of the pooling-of-interest method as applied to this business combination. Part of your answer should make reference to how the 1999 comparative retained earnings statement was prepared.
(c) Outline the reasons why the standard setters in Canada and the U.S.A. decided to disallow the pooling-of-interests method on July 1, 2001.
(d) Based on the *Handbook* changes that occurred on July 1, 2001, explain the mechanics of the accounting that would have to be applied to this business combination if it were to occur today.

PROBLEMS

Problem 1 G Company is considering the takeover of K Company, whereby it will issue 6,000 common shares for all of the outstanding shares of K Company. K Company will become a wholly owned subsidiary of G Company. The following information has been assembled:

	G Company		*K Company*	
	Book value	*Fair value*	*Book value*	*Fair value*
Current assets	$ 40,000	$47,500	$10,000	$ 9,200
Plant assets	60,000	70,000	20,000	25,000
	$100,000		$30,000	
Current liabilities	$ 20,000	20,000	$ 5,000	$ 5,000
Long-term debt	15,000	19,000	2,500	3,200
Common stock	30,000		10,000	
Retained earnings	35,000		12,500	
	$100,000		$30,000	

Required:

Prepare G Company's balance sheet immediately after the combination using:
(a) the pooling of interests method,
(b) the new entity method, and
(c) the purchase method.
(Assume that G Company's shares are trading at $4.90 on the date of the takeover.)

Problem 2 Three companies, A, L, and M, whose December 31, 2005, balance sheets appear below, have agreed to combine as at January 1, 2006.

Each of the companies has a very small proportion of an intensely competitive market dominated by four much larger companies. In order to survive, they have decided to merge into one company. The merger agreement states that Company A will buy the assets and liabilities of each of the other two companies by issuing 27,000 common shares to Company L and 25,000 common shares to Company M, after which the two companies will be wound up.

Company A's shares are currently trading at $5 per share.

Company A will incur the following expenses:

Costs of issuing shares	$ 8,000
Other costs	20,000
	$28,000

The following information has been assembled regarding the three companies:

COMPANY A

	Book value	Fair value
Current assets	$ 99,900	$102,000
Plant and equipment	147,600	160,000
	$247,500	
Liabilities	$ 80,000	$ 75,000
Common stock (50,000 NPV shares)	75,000	
Retained earnings	92,500	
	$247,500	

COMPANY L

	Book value	Fair value
Current assets	$ 60,000	$ 65,000
Plant and equipment	93,000	98,000
	$153,000	
Liabilities	$ 35,000	$ 36,000
Common stock (24,000 NPV shares)	48,000	
Retained earnings	70,000	
	$153,000	

COMPANY M

	Book value	Fair value
Current assets	$ 52,000	$ 68,000
Plant and equipment	115,000	120,000
	$167,000	
Liabilities	$ 72,000	$ 70,000
Common stock (33,000 NPV shares)	60,000	
Retained earnings	35,000	
	$167,000	

Required:

Prepare the balance sheet of Company A on January 2, 2006.

Problem 3 The balance sheet of Bagley Incorporated as at July 31, Year 4, is shown below:

BAGLEY INCORPORATED
BALANCE SHEET
July 31, Year 4

	Book value	Fair value
Current assets	$ 455,000	$507,000
Plant and equipment	910,000	1,053,000
Patents	—	78,000
	$1,365,000	

Current liabilities	$ 273,000	$273,000
Long-term debt	390,000	416,000
Common stock	182,000	
Retained earnings	520,000	
	$1,365,000	

On August 1, Year 4, the directors of Bagley were considering a takeover offer from Davis Inc. whereby the corporation would sell all of its assets and liabilities. Davis's costs of investigation and drawing up the merger agreement would amount to $19,500.

Required:

PART A

Assume that Davis made an $1,040,000 cash payment to Bagley for its net assets. Prepare the journal entries in the accounting records of Davis to record the business combination.

PART B

Assume that Davis issued 130,000 common shares, with market value of $8 per share, to Bagley for its net assets. Legal fees associated with issuing these shares amounted to $6,500 and were paid in cash. Davis had 150,000 shares outstanding prior to the takeover.

(a) Prepare the journal entries in the records of Davis to record the business combination.
(b) Prepare the balance sheet of Bagley immediately after the sale.

Problem 4 The shareholders of Prong Company and Horn Company agreed to a statutory amalgamation under which a share exchange took place. On September 1, Year 5, Prong Company issued 50,000 common shares for all of the common shares of Horn Company, after which Horn Company was dissolved. The common shares of Prong Company traded at $7.00 per share on this date.

After the amalgamation, Prong Company changed its name to Pronghorn Corporation.

The balance sheets of the two companies on August 31, Year 5, were as follows:

	Prong Company	*Horn Company*
Current assets	$135,000	$170,000
Plant and equipment (net)	430,000	300,000
Other assets	41,000	20,000
	$606,000	$490,000
Current liabilities	$ 96,000	$ 30,000
Long-term debt	180,000	160,000
Common stock (note 1)	70,000	100,000
Retained earnings	260,000	200,000
	$606,000	$490,000
Note 1		
Common shares outstanding	70,000 sh.	25,000 sh.

The book values of the net assets of both companies were equal to fair values except for plant and equipment. The fair values of plant and equipment were:

Prong Company	$ 500,000
Horn Company	280,000

Required:

Prepare the balance sheet of Pronghorn Corporation immediately after the statutory amalgamation.

Problem 5 The balance sheet of Drake Enterprises as at December 31, 2005, is as follows:

Assets

Cash	$ 99,000
Accounts receivable	143,000
Inventory	191,400
Land	132,000
Plant and equipment (net)	660,000
	$1,225,400

Liabilities and Equity

Current liabilities	$ 242,000
Bonds payable	352,000
Common stock (100,000 shares)	220,000
Retained earnings	411,400
	$1,225,400

Effective January 1, 2006, Drake proposes to issue 82,500 common shares (currently trading at $20 per share) for all of the assets and liabilities of Hanson Industries. In determining the acquisition price, the management of Drake noted that Hanson Industries has unrecorded customer service contracts and directed their accounting staff to reflect this when recording the acquisition. An independent appraiser placed a value of $150,000 on this unrecorded intangible asset. Costs of the acquisition are expected to be:

Costs of issuing shares	$44,000
Other costs	38,500
	$82,500

The balance sheet of Hanson Industries as at December 31, 2005, is as follows:

	Book value	Fair value
Cash	$ 55,000	$ 55,000
Accounts receivable	275,000	280,500
Inventory	187,000	178,200
Land	99,000	126,500
Plant and equipment (net)	770,000	891,000
	$1,386,000	
Current liabilities	$ 137,500	$137,500
Liability for warranties	99,000	129,800
Common stock	660,000	
Retained earnings	489,500	
	$1,386,000	

Hanson Industries is to be wound up after the sale.

Required:

Assume that Drake's offer is accepted by the shareholders of Hanson on the proposed date. Prepare Drake's January 2, 2006, balance sheet.

Problem 6 D Ltd. and H Corporation are both engaged in the manufacture of computers. On July 1, Year 5, they agree to a merger whereby D will issue 300,000 shares with current market value of $7.80 each for the net assets of H.

Summarized balance sheets of the two companies prior to the merger are presented below:

BALANCE SHEET
June 30, Year 5

	D Ltd.	*H Corporation*	
	Book value	*Book value*	*Fair value*
Current assets	$ 450,000	$ 500,000	$ 510,000
Fixed assets (net)	4,950,000	3,200,000	3,500,000
	$5,400,000	$3,700,000	
Current liabilities	$ 600,000	$ 800,000	$ 800,000
Long-term debt	1,100,000	900,000	920,000
Common stock	2,500,000	500,000	
Retained earnings	$1,200,000	$1,500,000	
	$5,400,000	$3,700,000	

Required:

Prepare the July 1, Year 5, balance sheet of D, assuming that the merger would be considered:
(a) a purchase combination, and
(b) a pooling of interests combination.

Problem 7 The July 31, Year 3, balance sheets of two companies that are parties to a business combination as follows:

	Red Corp.	*Sax Inc.*	
	Book value	*Book value*	*Fair value*
Current assets	$ 600,000	$ 420,000	$468,000
Plant and equipment	1,080,000	840,000	972,000
Patents	—	—	72,000
	$1,680,000	$1,260,000	
Current liabilities	$ 360,000	$ 252,000	$252,000
Long-term debt	480,000	360,000	384,000
Common stock	720,000	168,000	
Retained earnings	120,000	480,000	
	$1,680,000	$1,260,000	

Effective on August 1, Year 3, the shareholders of Sax accepted an offer from Red Corporation to purchase all of their common shares. Red's costs for investigating and drawing up the share purchase agreement amounted to $18,000.

Required:

PART A

Assume that Red made an $960,000 cash payment to the shareholders of Sax for 100% of their shares.
(a) Prepare the journal entry in the records of Red to record the share acquisition.
(b) Prepare the consolidated balance sheet of Red Corp. as at August 1, Year 3.

PART B

Assume that Red issued 120,000 common shares, with market value of $8 per share, to the shareholders of Sax for 100% of their shares. Legal fees associated with issuing these shares amounted to $6,000 and were paid in cash. Red is identified as the acquirer.

(a) Prepare the journal entries in the records of Red to record the share acquisition.
(b) Prepare the consolidated balance sheet of Red as at August 1, Year 3.

PART C

Would the assumption in Part A result in higher future earnings to Red than those resulting from the assumption in Part B? Explain.

Problem 8 The following are summarized balance sheets of three companies as at December 31, Year 3:

	Company X	*Company Y*	*Company Z*
Assets	$400,000	$300,000	$250,000
Liabilities	$232,500	$182,000	$155,000
Common stock (note 1)	75,000	48,000	60,000
Retained earnings	92,500	70,000	35,000
	$400,000	$300,000	$250,000
Note 1			
Shares outstanding	50,000 sh.	12,000 sh.	16,500 sh.

The fair values of the assets and liabilities of the three companies as at December 31, Year 3, were as follows:

	Company X	*Company Y*	*Company Z*
Assets	$420,000	$350,000	$265,000
Liabilities	233,000	180,000	162,000

On January 2, Year 4, Company X will purchase the assets and assume the liabilities of Company Y and Company Z. It has been agreed that Company X will issue common shares to each of the two companies as payment for their net assets as follows:

to Company Y — 13,500 shares
to Company Z — 12,000 shares

The shares of Company X traded at $14.00 on December 31, Year 3.

Company X will incur the following expenses associated with this acquisition:

Costs of registering and issuing shares	$12,000
Other expenses associated with the takeover	30,000
	$42,000

Company Y and Company Z will wind up after the sale.

Required:

(a) Prepare a summarized pro forma balance sheet of Company X as at January 2, Year 4.
(b) Prepare the pro forma balance sheets of Company Y and Company Z as at January 2, Year 4.

Problem 9 Myers Company Ltd. was formed ten years ago by the issuance of 22,000 common shares to three shareholders. Four years later the company went public and issued an additional 30,000 common shares.

The management of Myers is considering a takeover in which Myers would purchase all of the assets and assume all of the liabilities of Norris Inc. Other costs associated with the takeover would be as follows:

Legal, appraisal, and finders' fees	$ 5,000
Costs of issuing shares	7,000
	$12,000

Two alternative proposals are being considered:

PROPOSAL 1
Myers would offer to pay $300,000 cash for the Norris net assets, to be financed by a $300,000 loan due in five years.

PROPOSAL 2
Myers would issue 50,000 shares currently trading at $8.00 each for the Norris net assets. Norris shareholders would be offered five seats on the ten-member board of directors of Myers, and the management of Norris would be absorbed into the surviving company.

Balance sheet data for the two companies prior to the combination are as follows:

	Myers	Norris	
	Book value	Book value	Fair value
Cash	$ 140,000	$ 52,500	$ 52,500
Accounts receivable	167,200	61,450	56,200
Inventory	374,120	110,110	134,220
Land	425,000	75,000	210,000
Buildings (net)	250,505	21,020	24,020
Equipment (net)	78,945	17,705	15,945
	$1,435,770	$337,785	
Current liabilities	$ 133,335	$ 41,115	$ 41,115
Noncurrent liabilities	—	150,000	155,000
Common stock	500,000	100,000	
Retained earnings	802,435	46,670	
	$1,435,770	$337,785	

Required:

(a) Prepare the journal entries of Myers for each of the two proposals being considered.
(b) Prepare the balance sheet of Myers after the takeover for each of the proposals being considered.

Problem 10 Refer to Problem 9. All of the facts and data are the same except that in the proposed takeover, Myers Company will purchase all of the outstanding common shares of Norris Inc.

Required:

(a) Prepare the journal entries of Myers for each of the two proposals being considered.
(b) Prepare the balance sheet of Myers after the takeover for each of the proposals being considered.