CHAPTER 14

(A) Comprehensive Revaluation of Assets and Liabilities (B) Bankruptcy and Receivership

CHAPTER OUTLINE

(A) Comprehensive Revaluation of Assets and Liabilities

Push-down Accounting

- Application of Push-down Accounting
- Reasons for Push-down Accounting
- Arguments Against Push-down Accounting
- Push-down Accounting with a Noncontrolling Interest
- Subsequent Consolidation with Push-down Accounting

Comprehensive Revaluation Under a Financial Reorganization

- Accounting for a Comprehensive Revaluation

(B) Bankruptcy and Receivership

Business Failure

- Secured and Unsecured Creditors
- Receivership vs. Bankruptcy
- Receivership
- Bankruptcy

The Accounting Statement of Affairs

Summary

Review and Multiple-choice Questions, Cases, and Problems

LEARNING OBJECTIVES

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

- Describe the conditions necessary for a comprehensive revaluation of the assets and liabilities of an enterprise.
- Describe and apply the concepts of push-down accounting.
- Apply the concepts of comprehensive revaluation when a financial reorganization has taken place.
- Distinguish between bankruptcy and receivership.

- Be familiar with the terminology and basic concepts associated with bankruptcy and receivership.
- Prepare calculations showing the estimated amounts that would be distributed to the various classes of creditors in a business insolvency situation.

This chapter is divided into two parts. Part A examines comprehensive revaluation of assets and liabilities, while Part B looks at bankruptcy and receivership. At first glance, the two parts may seem divergent and unrelated; however, as we develop these topics, it should become obvious that the type of comprehensive revaluation that results from a corporate reorganization has a direct relationship to the topic of bankruptcy and receivership. This is because such a reorganization occurs only when a business is in dire financial straits.

A second type of comprehensive revaluation that we examine involves push-down accounting, which has a direct relationship to some of the material on consolidation that we discussed in the textbook.

(A) Comprehensive Revaluation of Assets and Liabilities

In December 1992, Section 1625 of the *Handbook*, "Comprehensive Revaluation of Assets and Liabilities," was issued by the Accounting Standards Board of the CICA. Under this new section, an enterprise may depart from the historical cost model and comprehensively revalue its assets and liabilities, provided that certain conditions have been satisfied. Before this section was issued, fixed asset appraisals were allowed in certain limited instances; the resulting revaluation increments can still be seen in the financial statements of a small number of companies.

At the time when the "old" Canadian standards allowed the limited use of fixed asset appraisals, appraisal accounting was not sanctioned at all by the FASB in the United States. However, in the early 1980s the concept of push-down accounting (which uses appraised values) gained some acceptance in that country. The Securities and Exchange Commission required push-down accounting by companies that had become substantially wholly owned as a result of a business combination. This requirement applied only to the filings with the commission and did not apply to the general purpose statements issued to the public. Subsequently, debate began as to whether or not push-down accounting should become part of GAAP. A similar debate began in Canada, and in 1987 the CICA issued an Accounting Guideline on the subject, which stated:

> the use of push-down accounting by a reporting enterprise is acceptable only when:
> (a) virtually all of its voting shares have been acquired; and
> (b) no significant outstanding public interest remains in its debt securities, preferred shares, non-voting common shares or other securities.

The Accounting Guideline quoted above was withdrawn when the new Section 1625 was issued in 1992. This section deals with recognition, measurement,

and disclosure standards involved in establishing a new cost basis as a result of the comprehensive revaluation of all of the assets and liabilities of a profit-oriented enterprise. This is basically a one-time revaluation, and any subsequent revaluations of the individual assets and liabilities of the enterprise would have to be made in accordance with other relevant *Handbook* sections.[1] This is not a shift to a current-value model, since such a model would provide for the continuous yearly recognition of changing values.

Under this section, a comprehensive revaluation of an enterprise can take place only if:

(a) all or virtually all of the equity interests (at least 90 percent) have been acquired by an acquirer who controls the enterprise after the transaction; or
(b) the enterprise has been subject to a financial reorganization (i.e., as provided for under the Bankruptcy Act, or the Companies Creditors Arrangements Act), and there has been a change in control as a result of a substantial realignment of nonequity and equity interests; and
(c) new costs can reasonably be determined in either situation.

The section also states that the transaction resulting in the acquisition of virtually all of the equity interests of the enterprise must be between nonrelated parties. Furthermore, even when an acquirer has obtained virtually all of the equity interests of a company, the existence of control must still be established in accordance with the guidelines provided in Section 1590, "Subsidiaries."

The revaluation when condition (a) has been met is the application of push-down accounting and is *optional* under Section 1625. This concept will be illustrated first. Revaluations as a result of financial reorganizations are *required* and will be illustrated later.

Push-down Accounting

The basic point of push-down accounting is to record in the accounts of a subsidiary the fair value increments used by the parent in the preparation of the consolidated statements. The acquirer's costs of the business combination are "pushed down" and recorded in the accounting records of the acquiree company. An example follows.

On January 1, Year 1, P Company acquired all of the outstanding common shares of S Company at a cost of $162,000. On this date the asset and liability values on the balance sheet of S Company were reflective of fair market values except for the following assets, whose fair values were:

	Fair value
Inventory	$60,000
Land	36,000
Plant and equipment	56,000

The plant and equipment have a remaining life of 10 years. Goodwill will be evaluated yearly for impairment.

Exhibit 14.1 shows the separate balance sheets of P Company and S Company on January 1, Year 1, and the consolidated balance sheet prepared on that date. S Company

[1] For example, lower of cost or market applications, and the use of markets to value financial statements.

has *not* used push-down accounting in this illustration. The calculation and allocation of the purchase discrepancy is also shown.

The consolidated balance sheet was prepared by eliminating the shareholders' equity accounts of S Company ($150,000) against the investment account of P Company ($162,000). The resulting purchase discrepancy ($12,000) was allocated to revalue the inventory, land, and plant and equipment, with the balance reflected as goodwill.

Application of Push-down Accounting

With push-down accounting, the following journal entries are made by S Company as at January 1, Year 1:

Retained earnings	80,000	
Common stock		80,000
To reclassify retained earnings as share capital on acquisition date		

Exhibit 14.1

BALANCE SHEET — January 1, Year 1

	P Company	*S Company without push-down*	*P Company consolidated*
Cash	$ 32,000	$ 35,000	$ 67,000
Accounts receivable	90,000	63,000	153,000
Inventory	120,000	59,000	180,000
Land	100,000	30,000	136,000
Plant and equipment	300,000	54,000	356,000
Investment in S	162,000	—	—
Goodwill	—	—	3,000
	$804,000	$241,000	$895,000
Liabilities	$120,000	$ 91,000	$211,000
Common stock	400,000	70,000	400,000
Retained earnings	284,000	80,000	284,000
	$804,000	$241,000	$895,000

PURCHASE DISCREPANCY

Cost of 100% of S		$162,000
Book value of S		
Common stock	70,000	
Retained earnings	80,000	150,000
Purchase discrepancy		12,000
Allocated		
Inventory	1,000	
Land	6,000	
Plant and equipment	2,000	9,000
Goodwill		$ 3,000

Any retained earnings on acquisition date are to be reclassified as either share capital, contributed surplus, or a separately identified component of shareholders' equity.[2] This reclassification produces a retained earnings amount comparable to that which would exist if P Company had purchased the net assets of S Company instead of its shares.

The next journal entry records the comprehensive revaluation of all of the assets and liabilities of S Company.

Inventory	1,000	
Land	6,000	
Plant and equipment	2,000	
Goodwill	3,000	
Common stock		12,000
To comprehensively revalue the net assets based on the price paid by P Company for 100% of its common shares		

Section 1625 states that the net-asset increases or decreases resulting from a comprehensive revaluation must not be reflected in the income statement of the enterprise (i.e., it is a capital transaction); rather, they should be recorded as either share capital, contributed surplus, or some other component of shareholders' equity that is readily identified.[3]

Exhibit 14.2 contains the January 1, Year 1, balance sheet of P Company, the balance sheet of S Company after the recording of the push-down journal entries, and the consolidated balance sheet of P Company.

Exhibit 14.2

BALANCE SHEET — January 1, Year 1

	P Company	*S Company push-down*	*P Company consolidated*
Cash	$ 32,000	$ 35,000	$ 67,000
Accounts receivable	90,000	63,000	153,000
Inventory	120,000	60,000	180,000
Land	100,000	36,000	136,000
Plant and equipment	300,000	56,000	356,000
Goodwill	—	3,000	3,000
Investment in S	162,000	—	—
	$804,000	$253,000	$895,000
Liabilities	$120,000	$ 91,000	$211,000
Common stock	400,000	162,000	400,000
Retained earnings	284,000	—	284,000
	$804,000	$253,000	$895,000

ELIMINATION

Investment in S	$162,000
Shareholders' equity — S	
Common stock	162,000
Difference	–0–

[2] *CICA Handbook*, paragraph 1625.29.

[3] *CICA Handbook*, paragraph 1625.30.

When push-down accounting has been used, the preparation of the consolidated balance sheet is considerably simplified, requiring only the elimination of the shareholders' equity accounts of S Company against the investment account of P Company. A comparison of Exhibit 14.2 with Exhibit 14.1 shows that the consolidated amounts are identical.

The preparation of S Company's consolidated financial statements one year after acquisition will be examined next: first *without* push-down accounting applied, and then *with* push-down accounting applied.

Subsequent Consolidation Without Push-down Accounting Exhibit 14.3 contains the financial statements of P Company and S Company, and the consolidated financial statements of P Company, prepared as at December 31, Year 1. A goodwill impairment test conducted on this date yielded a loss of $600. S Company did not pay dividends during Year 1, and P Company has used the equity method to account for its investment.

Exhibit 14.3

Financial Statements

INCOME STATEMENT — December 31, Year 1

	P Company	*S Company without push-down*	*P Company consolidated*
Sales	$310,000	$115,000	$425,000
Income from S	28,200	—	—
	$338,200	$115,000	$425,000
Cost of sales	$120,000	$ 59,000	$180,000
Miscellaneous expenses	70,000	20,600	90,600
Amortization — plant and equipment	40,000	5,400	45,600
Goodwill impairment loss	—	—	600
	$230,000	$ 85,000	$316,800
Net Income	$108,200	$ 30,000	$108,200

BALANCE SHEET

	P Company	*S Company without push-down*	*P Company consolidated*
Cash	$ 54,000	$ 28,400	$ 82,400
Accounts receivable	150,000	100,000	250,000
Inventory	138,000	71,000	209,000
Land	100,000	30,000	136,000
Plant and equipment	260,000	48,600	310,400
Investment in S	190,200	—	—
Goodwill	—	—	$ 2,400
	$892,200	$278,000	$990,200
Liabilities	$100,000	$ 98,000	$198,000
Common stock	400,000	70,000	400,000
Retained earnings, Jan. 1	284,000	80,000	284,000
Net income	108,200	30,000	108,200
	$892,200	$278,000	$990,200

The purchase discrepancy amortization schedule (shown below) was prepared by the accountant of P Company, to be used for the equity method journal entries and for the preparation of the consolidated financial statements.

	Balance Jan. 1	*Amortization Year 1*	*Balance Dec. 31*
Inventory	$ 1,000	$1,000	—
Land	6,000	—	6,000
Plant and equipment	2,000	200	1,800
Goodwill	3,000	600	2,400
	$12,000	$1,800	$10,200

The use of the equity method resulted in the changes in the investment account of P Company shown below. (The equity method accounts used in P Company's financial statements are shown in boldface.)

Investment in S, January 1, Year 1		$162,000
S net income, Year 1	30,000	
Less purchase discrepancy amortization	1,800	
Income from S (equity method)		28,200
Investment in S, December 31, Year 1		$190,200

When the consolidated income statement is prepared, the item "Income from S" on P Company's income statement is replaced by the revenues and expenses from S Company's income statement and the purchase discrepancy amortization, as follows:

Replace —

Income from S	$28,200

With —

	S Co.	*Purchase discrep.*	
Sales	$115,000		$115,000
Cost of sales	$ 59,000	$1,000	$ 60,000
Miscellaneous expenses	20,600	—	20,600
Amortization			
Plant and equipment	5,400	200	5,600
Goodwill impairment loss	—	600	600
	$ 85,000	$1,800	$ 86,800
Adjusted net income, S Company			$ 28,200

In a similar manner, the consolidated balance sheet is prepared by replacing the asset "Investment in S" on the balance sheet of P Company with the assets and liabilities from S Company's balance sheet revalued by the unamortized purchase discrepancy. The following illustrates this concept:

Replace —

Investment in S Company	$190,200

With —

	S Co.	*Purchase discrep.*	
Cash	$ 28,400		$ 28,400
Accounts receivable	100,000		100,000
Inventory	71,000		71,000
Land	30,000	6,000	36,000
Plant and equipment	48,600	1,800	50,400
Goodwill	—	2,400	2,400
	$278,000	$10,200	$288,200
Liabilities	$ 98,000		$ 98,000
Revalued net assets, S Company			$190,200

Subsequent Consolidation with Push-down Accounting Exhibit 14.4 shows the December 31, Year 1, financial statements of P Company and S Company, as well as P Company's consolidated statements. Push-down accounting has been used in the preparation of S Company's statements, and P Company has used the equity method to account for the investment.

The Year 1 financial statements of S Company *without* push-down and *with* push-down are presented below for comparative purposes:

	Exhibit 14.3 (without push-down)	*Exhibit 14.4 (with push-down)*	*Difference*
Sales	$115,000	$115,000	—
Cost of sales	$ 59,000	$ 60,000	$ 1,000
Miscellaneous expense	20,600	20,600	—
Amortization — plant and equipment	5,400	5,600	200
Goodwill impairment loss	—	600	600
	$ 85,000	$ 86,800	$ 1,800
Net income	$ 30,000	$ 28,200	($ 1,800)
Cash	$ 28,400	$ 28,400	—
Accounts receivable	100,000	100,000	—
Inventory	71,000	71,000	—
Land	30,000	36,000	6,000
Plant and equipment	48,600	50,400	1,800
Goodwill	—	2,400	2,400
	$278,000	$288,200	$10,200
Liabilities	$ 98,000	$ 98,000	—
Common stock	70,000	162,000	92,000
Retained earnings, Jan. 1	80,000	—	(80,000)
Net income	30,000	28,200	(1,800)
	$278,000	$288,200	$10,200

The differences in push-down expenses result from the write-off and amortization of the acquisition-date fair-value increments that were "pushed down" to S Company. The differences in push-down assets are the result of the unamortized fair-value increments. These same differences were shown above, where they were used to prepare the consolidated financial statements when S Company had not used push-down accounting.

Exhibit 14.4

FINANCIAL STATEMENTS — December 31, Year 1

INCOME STATEMENT

	P Company	*S Company push-down*	*P Company consolidated*
Sales	$310,000	$115,000	$425,000
Income from S	28,200	—	—
	$338,200	$115,000	$425,000
Cost of sales	$120,000	$ 60,000	$180,000
Misc. expenses	70,000	20,600	90,600
Amortization — plant and equipment	40,000	5,600	45,600
Goodwill impairment loss	—	600	600
	$230,000	$ 86,800	$316,800
Net income	$108,200	$ 28,200	$108,200

BALANCE SHEET

	P Company	*S Company push-down*	*P Company consolidated*
Cash	$ 54,000	$ 28,400	$ 82,400
Accounts receivable	150,000	100,000	250,000
Inventory	138,000	71,000	209,000
Land	100,000	36,000	136,000
Plant and equipment	260,000	50,400	310,400
Investment in S	190,200	—	—
Goodwill	—	2,400	2,400
	$892,200	$288,200	$990,200
Liabilities	$100,000	$ 98,000	$198,000
Common stock	400,000	162,000	400,000
Retained earnings, Jan. 1	284,000	—	284,000
Net income	108,200	28,200	108,200
	$892,200	$288,200	$990,200

The differences in shareholders' equity require further elaboration. Push-down common stock ($162,000) is the sum of the original capital stock, the reclassified acquisition-date retained earnings, and the increase from the comprehensive revaluation of the net assets (70,000 + 80,000 + 12,000). As a result, push-down retained earnings as at January 1, Year 1, has a zero balance.

CICA Handbook, paragraph 1625.33, states: "The revaluation adjustment is accounted for as capital of the acquired enterprise." This implies that a transfer from this recorded increase to retained earnings, based on a realization through sale or depreciation, should *not* take place.

P Company's equity method adjustments to the investment account are simplified, as the following shows:

Investment in S, January 1, Year 1		$162,000
S net income, Year 1	28,200	
	100%	
Income from S (equity method)		28,200
Investment in S December 31, Year 1		$190,200

The preparation of the consolidated income statement (Exhibit 14.4) should be obvious and requires no further explanation. When the consolidated balance sheet is prepared, the parent's share of the shareholders' equity of S Company is eliminated against the parent's investment account as follows:

Investment in S		$190,200
S Company		
Common stock	$162,000	
Retained earnings	28,200	190,200
		–0–

Reasons for Push-down Accounting

The following reasons have been advanced for the use of push-down accounting:

Creditor Requirements If the parent company financed the acquisition of the subsidiary with borrowed funds, and the amount of the loan was based on (or even secured by) the fair value of the subsidiary's assets, the lender may insist that the fair values be reflected in the audited financial statements of the subsidiary. The lender may also insist that the loan itself be shown in these statements, but Section 1625 does not allow this:

> When an acquisition is financed by debt, in whole or in part, it is not considered appropriate for the acquired enterprise to record the debt, unless it is a liability of the acquired enterprise. [1625.28]

Based on this paragraph, the loan could not appear on the subsidiary's balance sheet because it is a liability of the parent. However, it is possible to structure the acquisition so that the loan *does* appear on the balance sheet, as the lender wishes. This could be achieved in the following manner:

1. P Company forms a wholly owned subsidiary, "A Company."
2. A Company obtains a bank loan, and with the loan proceeds and the money from P Company's investment acquires all of the outstanding shares of S Company. The loan is secured by the assets of S Company, and P Company guarantees the loan.
3. S Company applies push-down accounting based on the price paid by A Company.
4. A Company and S Company amalgamate into a single surviving company. The balance sheet of this surviving company, a subsidiary of P Company, contains both the net assets of S Company and the related bank loan used to finance their acquisition.

Assessing Returns on the Acquisition With push-down accounting, the net income of the subsidiary is measured using fair-value amortizations. Return-on-investment calculations thus show the situation more accurately than would old historical costs, especially in the years immediately preceding the revaluation. Of course, in later years, the return-on-investment measurements exhibit the usual historical-cost handicaps.

Simplicity of Consolidation When push-down accounting has been used, the preparation of the consolidated statements is simplified because no consolidation adjustments are needed for the fair-value increments and amortizations. Exhibits 14.2 and 14.4 have illustrated this.

Arguments Against Push-down Accounting

Even though a case can be made for the use of push-down accounting in certain circumstances, the following points can be made against it.[4]

- Since the subsidiary itself did not participate in the transaction (the purchase of all of its net assets), the recording of the transaction is a violation of the historical cost concept. Accounting has not adopted a current value model, and a departure from historical costs to appraised values is not acceptable.
- Some readers of the financial statements (e.g., creditors) may be frustrated by the lack of comparability in the statements. Also, the lack of consistency over time in applying accounting principles may make the numbers less useful.
- The concept could be extended to situations where a company makes a large treasury acquisition of its shares and revalues its assets on the basis of the price paid. It is doubtful that this variation would receive widespread acceptance.

In general, however, there is probably some justification for the optional use of push-down accounting, as provided in Section 1625.

Push-down Accounting with a Noncontrolling Interest

Push-down accounting simplifies the consolidation process *only* when the subsidiary is 100 percent owned by the parent company. If the subsidiary is less than 100 percent owned, the consolidation becomes much more complex because the amount for the noncontrolling interest is based on the carrying value of the subsidiary's net assets before push-down accounting was applied.

In the previous illustration, P Company acquired 100 percent of S Company for $162,000. Assume instead that P Company purchased 95 percent of S Company on January 1, Year 1, for $153,900. The following calculation would be made by P Company:

PURCHASE DISCREPANCY

Cost of 95% of S		$153,900
Book value of S		
Common stock	70,000	
Retained earnings	80,000	
	150,000	
	95%	142,500
Purchase discrepancy		11,400
Allocated		
Inventory (1,000 × .95)	950	
Land (6,000 × .95)	5,700	
Plant and equipment (2,000 × .95)	1,900	8,550
Goodwill		$ 2,850

[4] For a further discussion, see Michael E. Cunningham, "Push-down Accounting: Pros and Cons," *Journal of Accountancy*, June 1984, p. 72.

The noncontrolling interest is based on the carrying value of S Company's identifiable net assets and would appear on the consolidated balance sheet in the amount \$7,500 (150,000 × .05).

Conditions for the use of push-down accounting from Section 1625 have been met because P Company has acquired at least 90 percent of S Company.[5] Also assumed is that control has been established in accordance with Section 1590, "Subsidiaries."

It should be noted again that Section 1625 does not require the use of push-down accounting by S Company. If P Company directs that push-down accounting be used, S Company would make the following journal entries as at January 1, Year 1:

Retained earnings	76,000	
Contributed surplus		76,000
To reclassify 95% of the retained earnings on the date of acquisition		

Paragraph 1625.29 of the *Handbook* requires the reclassification of "that portion of retained earnings which has not been included in the consolidated retained earnings of the acquirer, or is not related to any continuing non-controlling interests in the enterprise …"

Inventory	950	
Land	5,700	
Plant and equipment	1,900	
Goodwill	2,850	
Contributed surplus		11,400
To comprehensively revalue the net assets on the basis of the price paid by P Company for 95% of the common shares		

Only the parent's share of the fair value differences is "pushed down" to the subsidiary (see paragraphs 1625.25–26).

The reclassified retained earnings and the revaluation adjustment have been recorded as contributed surplus in order to simplify the noncontrolling interest calculation that is needed to prepare the consolidated statements.

After the push-down accounting has been applied, the balance sheet of S Company as at January 1, Year 1, would appear as shown below:

Cash	\$ 35,000
Accounts receivable	63,000
Inventory	59,950
Land	35,700
Plant and equipment	55,900
Goodwill	2,850
	\$252,400
Liabilities	\$ 91,000
Common stock	70,000
Contributed surplus	87,400
Retained earnings	4,000
	\$252,400

[5] This 90 percent interest is also consistent with the level of ownership required by many of the corporation acts in Canada when they allow a parent company to apply for an order to force the minority shareholders to sell their ownership interest in a subsidiary to the parent.

In comparing this push-down balance sheet with the previous one for a 100 percent interest (see Exhibit 14.2), we should note that only 95 percent of the fair value increments have been "pushed down"; the goodwill is 95 percent of the previous goodwill; the parent company's share of the acquisition retained earnings and the revaluation adjustment have been recorded as contributed surplus; and the noncontrolling interest in acquisition retained earnings is carried forward. If at a later date P Company acquires the remaining 5 percent of the shares from the minority shareholders, a further revaluation of the identifiable net assets of S Company will have to be made based on the additional cost incurred with the second purchase. This would require additional push-down entries, including an entry to reclassify the retained earnings that previously belonged to the noncontrolling interest.

Section 1625 requires the following financial statement disclosures by S Company in the first year of application of push-down accounting and during the next three years (see paragraphs 1625.34–35):

- The date that push-down accounting was applied;
- The date of acquisition by P Company, and the reason that push-down accounting was used;
- The amount of the changes recorded in the major classes of assets, liabilities, and shareholders' equity;
- The amount and description of the revaluation adjustment;
- The amount and description of the retained earnings reclassified.

Exhibit 14.5 shows the preparation of P Company's January 1, Year 1, consolidated balance sheet. Because there is a noncontrolling interest, the eliminations shown at the bottom of the exhibit are more complex than those required when there is 100 percent ownership.

Subsequent Consolidation with Push-down Accounting

Consolidation in subsequent years is also more complex because the noncontrolling interest shown in the consolidated statements cannot be based on the amounts shown in the subsidiary's financial statements. When a subsidiary has not used push-down accounting, the noncontrolling interest on the consolidated balance sheet is based on the carrying values of the subsidiary's net assets, and the noncontrolling interest on the consolidated income statement is based on the subsidiary's net income. Consolidated statements prepared when the subsidiary has used push-down accounting must produce identical results.

S Company's December 31, Year 1, financial statements using push-down accounting are shown in boldface in Exhibit 14.6. A goodwill impairment test conducted on this date yielded a loss of $570.

The statements without the use of push-down accounting, which have been reproduced from Exhibit 14.3, are also presented for comparison. The differences between the two statements are easily understood by examining how the fair value increments were amortized in the push-down statements.

Exhibit 14.5

BALANCE SHEET — January 1, Year 1

	P Company	*S Company push-down*	*P Company consolidated*
Cash	$ 40,100	$ 35,000	$ 75,100
Accounts receivable	90,000	63,000	153,000
Inventory	120,000	59,950	179,950
Land	100,000	35,700	135,700
Plant and equipment	300,000	55,900	355,900
Goodwill	—	2,850	2,850
Investment in S	153,900	—	—
	$804,000	$252,400	$902,500
Liabilities	$120,000	$ 91,000	$211,000
Noncontrolling interest	—	—	7,500
Common stock	400,000	70,000	400,000
Contributed surplus	—	87,400	—
Retained earnings	284,000	4,000	284,000
	$804,000	$252,400	$902,500

ELIMINATION

Investment in S		$153,900
Shareholders' equity — S		
Capital stock	70,000	
Parents ownership	95%	
	66,500	
Contributed surplus	87,400	153,900
Difference		–0–
Noncontrolling interest calculation:		
Shareholders' equity — S		
Capital stock		$ 70,000
Noncontrolling ownership		5%
		3,500
Acquisition retained earnings — not reclassified		4,000
Noncontrolling interest		$ 7,500

Exhibit 14.7 shows the December 31, Year 1, financial statements of P Company and S Company, and P Company's consolidated statements.

The use of the equity method resulted in changes in the investment account of P Company (see following). (Note that the equity method accounts used in P Company's financial statements are shown in boldface.)

Exhibit 14.6

S COMPANY
FINANCIAL STATEMENTS
December 31, Year 1
("without push-down" compared to "with push-down")

	Without push-down	***With push-down***	*Difference*
Sales	$115,000	**$115,000**	—
Cost of sales	$ 59,000	**$ 59,950**	$ 950
Miscellaneous expenses	20,600	**20,600**	—
Amortization – plant and equipment	5,400	**5,590**	190
Goodwill impairment loss	—	**570**	570
	$ 85,000	**$ 86,710**	$ 1,710
Net income	$ 30,000	**$ 28,290**	$ (1,710)
Cash	$ 28,400	**$ 28,400**	—
Accounts receivable	100,000	**100,000**	—
Inventory	71,000	**71,000**	—
Land	30,000	**35,700**	5,700
Plant and equipment	48,600	**50,310**	1,710
Goodwill	—	**2,280**	2,280
	$278,000	**$287,690**	$ 9,690
Liabilities	$ 98,000	**$ 98,000**	—
Common stock	70,000	**70,000**	—
Contributed surplus	—	**87,400**	87,400
Retained earnings, Jan. 1	80,000	**4,000**	(76,000)
Net income	30,000	**28,290**	(1,710)
	$278,000	**$287,690**	$ 9,690

The fair value increments that were "pushed down" to S Company were amortized and reflected in the financial statements shown above as follows:

	Balance Jan. 1	*Amortization Year 1*	*Balance Dec. 31*
Inventory	$ 950	$ 950	—
Land	5,700	—	5,700
Plant and equipment	1,900	190	1,710
Goodwill	2,850	570	2,280
	$11,400	$1,710	$9,690

Investment in S, January 1, Year 1		$153,900
S Company's push-down net income, Year 1	28,290	
Add amortization of fair value increments	1,710	
Net income without push-down	30,000	
P Company's ownership	.95	
	28,500	
Less amortization of fair value increments	1,710	
Income from S, (equity method)		26,790
Investment in S, December 31, Year 1		$180,690

Exhibit 14.7

FINANCIAL STATEMENTS — December 31, Year 1

INCOME STATEMENT

	P Company	S Company push-down	P Company consolidated
Sales	$310,000	$115,000	$425,000
Income from S	26,790	—	—
	$336,790	$115,000	$425,000
Cost of sales	$120,000	$ 59,950	$179,950
Miscellaneous expenses	70,000	20,600	90,600
Amortization – plant and equipment	40,000	5,590	45,590
Goodwill impairment loss	—	570	570
	$230,000	$ 86,710	$316,710
Net incomes	$106,790	$ 28,290	
Net income — entity			$108,290
Less noncontrolling interest			1,500
Net income			$106,790

BALANCE SHEET

	P Company	S Company push-down	P Company consolidated
Cash	$ 62,100	$ 28,400	$ 90,500
Accounts receivable	150,000	100,000	250,000
Inventory	138,000	71,000	209,000
Land	100,000	35,700	135,700
Plant and equipment	260,000	50,310	310,310
Investment in S	180,690	—	—
Goodwill	—	2,280	2,280
	$890,790	$287,690	$997,790
Liabilities	$100,000	$ 98,000	$198,000
Noncontrolling interest	—	—	9,000
Common stock	400,000	70,000	400,000
Contributed surplus	—	87,400	—
Retained earnings, Jan. 1	284,000	4,000	284,000
Net income	106,790	28,290	106,790
	$890,790	$287,690	$997,790

The following points should be noted regarding the consolidated income statement:

- Noncontrolling interest is based on S Company's net income without push-down (30,000 × .05 = 1,500).
S Company's push-down net income	$28,290
Less noncontrolling interest	1,500
P Company's "Income from S"	$26,790
- "Net income — entity" is equal to consolidated revenues less expenses.

The eliminations used to prepare the consolidated balance sheet follow.

Investment in S Company			$180,690
S Company			
Common stock		70,000	
Post-acquisition retained earnings without push-down, December 31:			
Net income	28,290		
Add fair value amortizations	1,710		
Retained earnings without push-down		30,000	
		100,000	
Parent company's ownership		95%	
		95,000	
Less fair-value amortizations		1,710	
		93,290	
Contributed surplus		87,400	180,690
Difference			–0–

Noncontrolling interest as at December 31, Year 1, is calculated as follows:

S Company capital stock	$ 70,000
Post-acquisition retained earnings without push-down (see above)	30,000
	100,000
Noncontrolling ownership	5%
	5,000
Acquisition retained earnings — not reclassified	4,000
Noncontrolling interest	$ 9,000

To summarize, the concepts of push-down accounting can be applied only if virtually all of the equity interests (at least 90 percent) have been acquired and the new costs to be used in the revaluation can be determined. Its use is not mandatory and will depend on whether it is required by a creditor involved in the financing of the acquisition, or whether the acquirer feels that it will provide a better measurement of return on investment. Its use can simplify the preparation of the consolidated statements if all of the equity interests were acquired. If there is a noncontrolling interest, the consolidation is more complex.

Comprehensive Revaluation Under a Financial Reorganization

The previous discussion focused on push-down accounting. Under the provisions of Section 1625, a comprehensive revaluation can also take place as a result of a financial reorganization.

In a business sense, the term "reorganization" often reflects a situation where major changes in the management, policies, or financial structure of a company have occurred. In the past, the term reorganization had a more specific meaning for accountants. It was used to depict the accounting involved when, due to serious cash flow problems and/or a history of successive losses, the shareholders and creditors of a corporation agreed to reduce their rights and claims. Usually, asset amounts were adjusted to reflect more realistic values, share capital and creditor claims were reduced, and accumulated deficits were removed. The term "quasi-reorganization" has had a similar meaning, except that creditors are not involved in this particular type of reorganization.

Section 1625 is even more specific in its definition. It describes a "financial reorganization" as:

> a substantial realignment of the equity and non-equity interests of an enterprise such that the holders of one or more of the significant classes of non-equity interest and the holders of all of the significant classes of equity interests give up some (or all) of their rights and claims upon the enterprise. [1625.03]

In accordance with this section, the comprehensive revaluation of an enterprise's assets and liabilities *must* take place if:

(a) there has been a financial reorganization, and

(b) the original shareholders have lost control, and

(c) new costs can reasonably be determined.

A substantial realignment of equity and nonequity interests is assumed not to have taken place if the same party that had control before the reorganization has control after the reorganization. Using Section 1590, "Subsidiaries," the number of shares held before and after a reorganization would be persuasive evidence regarding a change in control. However, it must be remembered that "control" as described in this section involves the continuing power to determine strategic operating, financing, and investing policies without the co-operation of others.

A financial reorganization often takes place when a corporation seeks protection from the actions of its creditors by making a "proposal" under a statute such as the Bankruptcy and Insolvency Act or the Companies' Creditors Arrangement Act. (The legal provisions concerning proposals are discussed later in this chapter in the section on bankruptcy and receivership.) Proposals can also be made outside of statutes such as these. The form of the reorganization is not important; if the substance does not result in a loss of control, the provisions of Section 1625 do not apply, and a revaluation of net assets cannot take place.

Item of Interest After its 1999 takeover of Canadian Airlines, Air Canada struggled with $13 billion in debt. With air traffic suffering as a result of the September 11, 2001 terrorist attacks, the company found itself in a desperate situation. In April 2003, it was granted protection from its creditors under provisions of the Companies' Creditors Arrangement Act. Seventeen months later, on September 30, 2004, after having received a number of extensions, Air Canada emerged from this protection as a new entity called ACE Aviation Holdings Inc. (ACE). It is interesting to note that, right up to the end, Air Canada's shares continued to trade on the TSX, even though financial analysts noted many times that its shares would be worthless. When it came out of restructuring, its shares were de-listed and the shares of ACE (issued to former creditors) commenced trading.

Accounting for a Comprehensive Revaluation

A financial reorganization involves self-interest bargaining between creditors and shareholders; both sides negotiate the realignment of their rights and claims, recognizing that the company has financial and operating problems. They also recognize that the end result may provide greater benefits to both groups than would have been received if the company had been liquidated. The rights and claims being

negotiated are those associated with the assets and future cash flows of the company. The historical cost asset values presented on the most recent balance sheet of the company are not the values being considered by the two sides in the negotiations. Rather, they are examining the current fair values of individual assets and the value of the company as a whole (perhaps by discounting expected future cash flows). It is these negotiated values that are recorded in a comprehensive revaluation and establish the new costs for the company on a fresh-start basis.

Measurement of New Costs If the negotiations do not establish the fair values for individual net assets, the fair values to be used for accounting purposes are estimated in accordance with the provisions of Section 1581, "Business Combinations." If a fair value has been established for the company as a whole, and the sum of the fair values of the identifiable net assets exceeds this total value, the excess is used to reduce the values assigned to noncurrent assets. If the value established for the company as a whole exceeds the sum of the fair values of the identifiable net assets, the excess is *not* recorded as goodwill, as would be the case in a business combination. On reflection, it does not make sense to record goodwill for a company that has just experienced severe financial difficulty. To summarize, if a fair value has been established for the company as a whole, this fair value will be used only when it is less than the fair values of the individual net assets.

The increase or decrease in equity resulting from the revaluation is treated as a capital transaction and is not reflected in the income statement. However, losses due to the write-downs of assets that relate to circumstances existing prior to the reorganization would appear in the income statement for the period prior to the fresh start. An example of this might be the recognition that the allowance for bad debts or the liability for warranties was inadequate at the time of the financial reorganization. Any retained earnings balance that existed prior to the reorganization is reclassified to reflect a fresh start.

Illustration of a Comprehensive Revaluation Fabricore Corporation is in financial difficulty due to its inability to discharge its liabilities and meet the interest payments on its debentures. On December 31, Year 1, it filed for protection from creditor actions under statutory provisions. The balance sheet of the company on this date is shown in Exhibit 14.8. After extensive negotiations, nonequity and equity interests have agreed upon a plan of reorganization. The essence of the plan is as follows:

- Management has agreed that prior to the comprehensive revaluation of assets and liabilities, the allowance for bad debts should be increased by $3,000, and the goodwill should be written off.
- Fabricore's trade creditors have agreed to accept the payment of 80 percent of their claims, with payment to be made at such time as cash becomes available.
- The bank loan that is now payable on demand will be changed to a two-year loan, payable in quarterly instalments.
- The holders of 14 percent debentures agree to forgive the amount of interest owing and to exchange their debentures for $100,000, 9 percent, first-mortgage bonds and 250,000 newly issued no-par-value common shares.

Exhibit 14.8

FABRICORE CORPORATION
BALANCE SHEET
December 31, Year 1
(before financial reorganization)

Cash	$ 5,000
Accounts receivable (net)	40,000
Inventory	45,000
Land	20,000
Buildings and equipment (net)	100,000
Goodwill	15,000
	$225,000
Accounts payable	$ 40,000
Note payable — bank	30,000
Accrued interest — 14% debentures	20,000
14% debentures	150,000
Common stock (100,000 NPV shares)	140,000
Retained earnings (deficit)	(155,000)
	$225,000

- The parties have determined the following fair values for the company's assets:

	Fair value
Cash	$ 5,000
Accounts receivable (net)	37,000
Inventory	45,000
Land	32,000
Buildings and equipment (net)	109,000
	$228,000

  They also agree that the fair value of the company is the sum of the individual fair values of its assets.

Because there has been a substantial realignment of the equity and nonequity interests, and because new costs have been established, the Section 1625 conditions for comprehensive revaluation have been satisfied.

Fabricore's entries to record the revaluation as at January 1, Year 2, are as follows:

Retained earnings	18,000	
Accounts receivable		3,000
Goodwill		15,000
To increase the allowance for bad debts and to write off the goodwill		

This write-down will be reflected in the Year 1 income statement because it is considered to be related to circumstances that existed prior to the reorganization.

CICA Handbook, paragraph 1625.43, requires any retained earnings (in this case a deficit) existing prior to reorganization to be reclassified to either share capital, or contributed surplus, or some other shareholders' equity account. In this case, the journal entry is:

Common stock	173,000	
Retained earnings		173,000
To reclassify the deficit on December 31, Year 1		

Paragraph 1625.44 states that the revaluation adjustment resulting from the comprehensive revaluation of assets and liabilities should be accounted for as a capital transaction and may be recorded as either share capital, or contributed surplus, or some other shareholders' equity account. In this case, share capital will be used. Fabricore will record this adjustment in a reorganization account to reflect the loss or gain on the revaluation, then transfer the balance to common stock.

Accounts payable	8,000	
Accrued interest on debentures	20,000	
Reorganization account		28,000
To record the forgiveness of 20% of the accounts payable and the accrued debenture interest		

14% debentures	150,000	
9% first-mortgage bonds		100,000
Reorganization account		50,000
To record the exchange of the debentures for first-mortgage bonds and 250,000 common shares		

Land	12,000	
Buildings and equipment (net)	9,000	
Reorganization account		21,000
To revalue land, buildings, and equipment to fair values as per the agreement		

Reorganization account	99,000	
Common stock		99,000
To reclassify the reorganization account to share capital		

Exhibit 14.9 shows the balance sheet of Fabricore as at January 1, Year 2, reflecting a "fresh start" for the company. Consistent with this view, retained earnings accumulate from the date of the reorganization.

Exhibit 14.9

FABRICORE CORPORATION
BALANCE SHEET
January 1, Year 2
(after financial reorganization)

Cash	$ 5,000
Accounts receivable (net)	37,000
Inventory	45,000
Land	32,000
Buildings and equipment (net)	109,000
	$228,000
Accounts payable	$ 32,000
Notes payable — bank	30,000
9% first-mortgage bonds	100,000
Common stock (350,000 NPV shares)	66,000
	$228,000

Disclosure The footnotes to Fabricore's financial statements should disclose the following in the year of the financial reorganization and the next three years (see paragraphs 1625.50–.52).

- The date of the financial reorganization and a description thereof;
- The amount of the changes recorded in the major classes of assets, liabilities, and shareholders' equity;
- The amount and description of the revaluation adjustment;
- The amount and description of the retained earnings reclassified;
- The measurement basis of the affected assets and liabilities.

Comprehensive Revaluation and Future Income Taxes In Chapter 10 of the textbook we discussed the effects that Section 3465, "Income Taxes," will have on the allocation of the acquisition cost of a business combination. Future income tax assets and liabilities arising from new temporary differences will have to form part of the allocation of the purchase discrepancy. This is also the case for the future tax assets arising from the availability of the carry-forward of unused tax losses. Because push-down accounting results in the subsidiary recording its parent's purchase discrepancy allocations, these future income tax assets and liabilities will be recorded by the subsidiary. Each year, the subsidiary will compare carrying values with tax basis, and make the required adjustments to the future income tax balances. This will obviously simplify the parent's consolidation procedures.

The new income tax section will also require the accounting recognition of temporary differences created by the comprehensive revaluations required as a result of a financial reorganization. The following paragraph outlines the treatment required:

> Revaluation adjustments to specific classes of identifiable assets and liabilities are made without reference to their values for tax purposes, or tax bases. The tax effects of differences between the revalued amounts of the identifiable assets and liabilities and their tax bases would be recorded as future income tax liabilities and assets in accordance with INCOME TAXES, Section 3465. In addition, the benefit of any unused tax losses or income tax reductions that meet the recognition criteria set out in INCOME TAXES, Section 3465, would be recognized as future income tax assets. The future income tax liabilities and assets recognized at the time of the financial reorganization would be included with the new costs of the other identifiable assets and liabilities in determining the amount of the total revaluation adjustment. [1625.42]

Assessment of Section 1625 The comprehensive revaluation of assets and liabilities from historical costs to fair market values can take place only under very restrictive conditions. Because of this, it seems fairly clear it will not be a recurring event for most Canadian companies. Since the concept was first introduced as a Canadian accounting standard in 1992, it has been difficult to assess how widely it has been used. The 2000 edition of *Financial Reporting in Canada* stated the following with regard to its survey of the 1996 to 1999 financial statements of 200 Canadian companies:

> From the point of view of the acquiring or parent company, the use of push down accounting is simply a procedural convenience. The use of this approach

> would make absolutely no difference in the financial statements that emerge from the consolidation process. This means that, from the point of view of the parent company, there is no need for any disclosure related to push down accounting. This is not the case for the subsidiary.... As none of our survey companies are subsidiaries for which push down accounting would be applicable, it is not surprising that we found no reference to the use of push down accounting in any of the annual reports surveyed.

Because push-down accounting can only be used if the ownership is 90 percent or greater, then at least 90 percent of a company's shares must be owned by a parent. All companies making up the survey sample trade on Canada's major stock exchanges. Because of the 90 percent or greater restriction, the amount that is available for trading must be the very small percentage not owned by the parent — an amount that is probably not large enough to warrant a stock exchange listing.

Interestingly, although the concept of push-down accounting originated in the United States, it has not yet been the subject of a FASB pronouncement. Its use is required by the SEC for any subsidiary that must file with the commission. A company need only file in situations where it is planning to issue debt or equity securities to the public. In both Canada and the United States, the main advantage of push-down accounting from the standpoint of companies is that it simplifies the consolidation process. Thus, one might question the need for a standard in this area.

Financial Reporting in Canada also reported that none of the companies surveyed was subject to a financial reorganization during the periods covered. However, that publication also reported that a few prominent Canadian companies, including Canadian Airlines International, Dylex Limited, Silcorp Limited, and Trizec Corporation, reported financial reorganizations between 1993 and 1995.

(B) Bankruptcy and Receivership

Business Failure

Because of the many risks involved with business ventures, there is always the possibility of failure. Even in good economic times, some businesses fail, and when the country enters prolonged periods of economic decline the number of failures increases dramatically. This was the case during the economic recession of the 1980s, and particularly during the longer recession of the early 1990s. During this latter severe recession, size did not seem to have a bearing on which companies were affected, and we saw many very large companies such as Cadillac Fairview and Trizec Corporation making radical changes to avoid going under. In this section we discuss the various legal and accounting issues involved with business failures, as well as the common terms associated with such failure — namely, receivership and bankruptcy. Because business failure often results from creditor actions, it is useful to start by looking at the various classes of creditors.

Secured and Unsecured Creditors

A secured creditor is one that holds a mortgage, charge, or lien against the property of a debtor as security for a debt due from that debtor. Secured creditors can be either fully secured or partially secured depending on the amount of the debt relative to the value of the property that is pledged.

An unsecured creditor is one that holds a debt due from a debtor against which no property has been pledged. The Bankruptcy and Insolvency Act, which exists primarily to provide remedies for unsecured creditors, further classifies this unsecured category of creditors by describing certain types of claims as having a first priority for full payment before any payment is made to the remaining unsecured creditors.

In conjunction with the going concern concept, accountants classify the liabilities of a business as *current* and *long-term*. When it is questionable that a company is a going concern, such as when a business is in financial difficulty, it is often more informative to view (and sometimes account for) liabilities as fully secured, partially secured, unsecured with priority, and unsecured. These classifications will be discussed in more detail in a later section.

Receivership vs. Bankruptcy

Receivership and *bankruptcy* both describe a state of financial difficulty of a particular business. The two terms are not interchangeable; in fact, they refer to two quite different conditions. A condition of receivership exists when, due to the violation of a debt covenant, a secured creditor has appointed an agent to seize the debtor's property pledged against the debt. The agent is often called the receiver, or the receiver-manager. While the result of this action is often the complete liquidation of the business, the business itself is not legally bankrupt. The Bankruptcy Act contains terms such as "official receiver," "receiving order," and "interim receiving order," and this has probably added to the confusion that exists between the terms receivership and bankruptcy.

Bankruptcy is a legal state under which the assets of a debtor have been seized by a licensed trustee in bankruptcy for the protection and benefit of the unsecured creditors. This legal state may be the result of actions taken by unsecured creditors (involuntary bankruptcy) or by the debtor (voluntary bankruptcy). The eventual result, in nearly all bankruptcy cases, is the complete liquidation of the business.

Receivership

Many bank loans are secured by a general assignment of accounts receivable and/or inventory under Section 178 of the Bank Act, and land, buildings, and equipment are often pledged as security to the mortgage and debenture liabilities of a business. Sometimes assets are pledged more than once (first mortgage, second mortgage, etc.). As a remedy to a loan default, a secured creditor will often appoint a receiver-manager to seize the pledged assets. It is the duty of the receiver to sell these assets at the highest possible price on behalf of the client, the secured creditor. If the proceeds from the sale are greater than the debt, the amount of the excess reverts to the debtor. If the proceeds are not sufficient to discharge the debt, the deficiency becomes an unsecured liability. Any payment of this unsecured portion may only be possible if the business is forced into bankruptcy.

The person appointed as the receiver-manager is often a licensed trustee in bankruptcy. In some instances this receiver-manager operates the business for a period of time in order to maximize the total proceeds from the sale of the pledged assets. For example, inventory that is in the process of manufacture does not have much value. It makes good economic sense for the receiver-manager to operate a factory for a time in order to transform raw materials and work in process into finished products.

The receiver-manager may also attempt to sell a business as a going concern, rather than sell the individual assets piecemeal, especially if the business itself appears to be viable and an infusion of capital and new management is all that is necessary to turn the operation around. In all of the situations described, the owners will probably lose most if not all of their equity in the business.

Bankruptcy

The Bankruptcy Act is a federal statute. It was first passed in 1919 and has been amended from time to time, with the last significant amendment occurring in 1992. At that time the name was changed to the Bankruptcy and Insolvency Act. While all creditors come under the jurisdiction of the act, most of the remedies that are available to secured creditors because of their loan agreements are not affected. For this reason, it is safe to say that the act's provisions and remedies exist primarily for the benefit of the unsecured creditors of a business.

Administration The Bankruptcy and Insolvency Act falls within the portfolio of the Minister of Consumer and Corporate Affairs. The senior civil servant responsible for the act's administration is called the Superintendent of Bankruptcy. This person, located in Ottawa, is also responsible for the licensing of bankruptcy trustees.

Each province in Canada is designated as a bankruptcy district; some provinces are further divided into two or more divisions. Each division comes under the administration of a person called the Official Receiver. The Official Receiver becomes involved when bankruptcy proceedings are first initiated; among other things, he or she examines the bankrupt under oath and chairs the first meeting of creditors.

The act provides the senior court of each province with jurisdiction over bankruptcy proceedings. All bankruptcy matters are heard by either the bankruptcy judge or, if judicial interpretation is not required, by the registrar of the court. The actual administration of the estate of the bankrupt is handled by a licensed trustee in bankruptcy. Upon receiving his or her appointment by the court, the trustee:

(a) takes possession of all of the assets as well as the accounting records of the bankrupt,
(b) prepares an inventory of the assets,
(c) takes all necessary precautions to protect the assets, including insuring all insurable assets,
(d) notifies all creditors as to the date of the first meeting of creditors, and
(e) verifies the bankrupt's statement of affairs.[6]

The first meeting of creditors is held to examine the bankrupt's statement of affairs, to confirm the appointment of the trustee, and to elect inspectors to oversee the trustee in the administration of the estate. Creditors must file a proof of claim with the trustee if they wish to share in the proceeds from the sale of assets and to participate at meetings. The trustee sells the unpledged assets in the estate and

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[6] The reference here is to a legal document required by the act, in which the debtor provides details of all liabilities and assets. An *accounting statement of affairs* is a report that departs from the historical cost principle and presents assets at their estimated liquidation values while at the same time providing an estimate of the amount that the various classes of creditors would receive under a bankruptcy liquidation.

distributes the proceeds to the unsecured creditors in accordance with the provisions of the act. Pledged assets are not normally realized by the trustee, although the secured creditors may ask the trustee to sell the assets on their behalf.

It is not uncommon to have a business go into receivership upon the action of a secured creditor and later be declared bankrupt upon actions of unsecured creditors. Complications may arise if the receiver-manager and the bankruptcy trustee are different persons. Such a situation requires cooperation between the two trustees and may involve court intervention to resolve conflicts.

Insolvency and Bankruptcy The act provides descriptions of insolvent persons and bankrupt persons.[7] Insolvent persons are ones:

(a) who are not bankrupt but carry on business in Canada and have liabilities exceeding $1,000 *and*

(b) who are unable to meet, or have ceased paying, their obligations as they come due, *or*

(c) whose assets, measured at fair market value, are less than the amount of their debts.

Bankrupt persons are ones who, in accordance with provisions of the act:

(a) have made an assignment of their assets for the benefit of their creditors, *or*

(b) against whom a receiving order has been made.

Bankruptcy is a legal state, while insolvency is not. A person can be insolvent without being bankrupt, but cannot be bankrupt without being insolvent.

Voluntary and Involuntary Bankruptcy Persons may declare bankruptcy voluntarily (as a result of their own actions), or they may be declared bankrupt involuntarily (as a result of the actions of their creditors). Voluntary bankruptcy occurs when persons make an assignment of their assets for the benefit of their creditors. The assignment is made to the Official Receiver and is accompanied by a statement of affairs and a listing of creditors. A trustee is appointed and the administration of the bankrupt's estate commences. There is one other voluntary action that a person may enter into that might possibly result in bankruptcy. This action, called a proposal, will be discussed later in this chapter.

Persons may be declared bankrupt involuntarily as a result of an action taken by their creditors. The act provides that one or more creditors with claims totalling at least $1,000 may file a petition with the court to have a receiving order granted against a debtor. The petitioning creditor(s) must show that the debtor has committed an "act of bankruptcy" within the preceding six months. The following is a partial listing of "acts of bankruptcy":

- Debtors give notice to any of their creditors that they have suspended or are about to suspend payments of their debts;

[7] Persons include individuals, partnerships, unincorporated associations, corporations, and cooperative societies. Not included are banks, insurance companies, trust and loan companies, and railway companies. Bankruptcy provisions for these companies are covered under their own incorporation statutes. The main focus of our discussion will be on the bankruptcy provisions that apply to incorporated businesses, although most of the items would also apply to individuals.

- Debtors exhibit to any meetings of their creditors a statement of assets and liabilities that shows that they are insolvent;
- Debtors make a fraudulent conveyance, gift, or transfer of their property or any part thereof;
- Debtors cease to meet their liabilities as they become due.

If the court agrees with the petition and grants a receiving order, a debtor is bankrupt.

It might appear from this discussion that it is fairly easy for a creditor to have a debtor declared bankrupt. However, it is not quite as easy as it seems. The petition for the receiving order must include the name of a licensed trustee who is willing to act. The trustee's fees come only from the proceeds from the sale of the nonpledged (or free) assets of the debtor. If a large percentage of the debtor's assets is pledged, the trustee may not be able to collect his or her fee from this source; that trustee will therefore be unwilling to act unless the petitioning creditors guarantee the fees. In some involved and complex cases, a trustee's fees can be very large, and this guarantee may be considered too great a risk for the creditor to assume.

Proposals and Reorganizations In general, the word "proposal" describes a situation where a debtor corporation calls a meeting of its creditors, outlines its financial difficulties, and suggests remedies to alleviate the situation, such as all or some of the following:

- Postponement of interest and principal payments;
- Reduction of the interest rate;
- Debt forgiveness;
- Acceptance of the payment of a percentage of the claims as full payment;
- Conversion of debt to equity.

The idea is to convince the creditors that the business is viable and worth saving, and that a larger payment will eventually be forthcoming as a result of the suggested remedies than would be the case under a forced bankruptcy liquidation.

Proposals can be made either outside of or within the provisions of the Bankruptcy and Insolvency Act.[8] There are dangers involved when proposals are made outside of the acts. The creditors are now aware of the extent of the debtor's financial difficulties, and any one creditor armed with this knowledge could commence receivership or bankruptcy proceedings.

Under the Bankruptcy and Insolvency Act, a bankrupt or an insolvent debtor may file a notice of intent to file a plan of reorganization with the Official Receiver. Accompanying the notice is a listing of creditors and the name of a trustee who is willing to act. This act of filing the notice of intent results in all creditor actions being stayed for 30 days. This 30-day period can be extended by the court for an additional 5 months in certain circumstances. During this period the trustee monitors the debtor's financial position and reports on it periodically to the court. If a proposal (reorganization plan) is not filed before the allotted time expires, the debtor is deemed to have filed an assignment in bankruptcy.

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[8] A proposal can also be made under the provisions of the Companies' Creditors Arrangement Act.

Once the proposal is filed, a further stay is imposed on all creditors to whom the proposal is directed (secured and unsecured). The Official Receiver chairs the first meeting of creditors. A vote is taken by the various classes of creditors, and if the proposal is accepted it proceeds to the court for approval. If the proposal is rejected by either the creditors or the court, the debtor is deemed to have made an assignment in bankruptcy.

Item of Interest In June 2001, Laidlaw Inc. announced that it intended to seek bankruptcy protection in order to restructure its US$3.5 billion debt. It would appear that this was a classic case of over-ambitious expansion into unfamiliar areas of business. Once regarded as a premier waste management company with headquarters in Canada, it acquired 38 ambulance companies in 1997 alone for a total cost of $1.3 billion. These acquisitions made it the largest ambulance operator in the United States. Shortly thereafter, it acquired both Safety-Kleen Corp. and Greyhound Lines Inc. In 1999, Safety-Kleen filed for bankruptcy protection, and in 2000, Laidlaw wrote off its $2.2 billion investment in Safety-Kleen.

Interim Receivership During the period between the presentation of a proposal made under the act and its consideration by the creditors, the debtor's assets are not held under the jurisdiction of the court. This is also the case during the period between the application for and the granting of a receiving order. In order to protect the interests of the creditors during this time, the act allows the court to appoint an interim receiver upon the application of one or more creditors. If the application is granted, a trustee is appointed. The trustee does not take title to the debtor's assets, as is the case in bankruptcy, but rather is given the power to control the debtor's cash flows during the period. The interim receivership ends with the acceptance or rejection of the proposal or with the granting of the receiving order. Note that the term "receivership" as used here is a bankruptcy term; more often, it describes the seizing of pledged assets by a secured creditor.

Item of Interest When Dylex Ltd. sought protection from its creditors under the Bankruptcy and Insolvency Act, Richter & Partners of Toronto were appointed interim receiver by the courts and subsequently proceeded to arrange the sale of Dylex's 71-store Fairweather chain and to unload leases for its BiWay discount stores, which had all been closed.

Unsecured Liabilities with Priority During the liquidation of the bankrupt's estate, the nonpledged (free) assets are sold and the proceeds therefrom — together with the excess of the proceeds from the sale of pledged assets over the amount of their related secured claims — become available for payment to the unsecured creditors. However, Section 136 of the act describes certain unsecured claims as having priority for payment in full before any payment is made to the remaining unsecured creditors. This is much like saying that all unsecured creditors are equal but some are more equal than others. The priorities listed in Section 136 can be summarized as follows:

1. Funeral expenses of a deceased bankrupt. (Obviously, this does not apply to incorporated businesses.)
2. Costs of administering the bankrupt estate, including the trustee's fees and any legal costs associated with such administration.

3. The levy of the Superintendent of Bankruptcy. The act provides for a levy to be deducted from funds distributed to unsecured creditors to help defray the costs of administering the act. The levy is 5 percent on the first $1,000,000, with a decreasing percentage on amounts in excess of this.
4. Wages owed to employees for a period not exceeding six months prior to bankruptcy, provided that the maximum owing to each employee does not exceed $2,000. Any amount owing that exceeds $2,000, but is within the six-month period, or any amount owing for a period exceeding six months, is unsecured without priority.
5. Municipal taxes, not including property taxes, but only to a maximum of the bankrupt's interest in the property.
6. A maximum of three months' rental arrears owing, with the proviso that the total owing to the landlord cannot exceed the value of the bankrupt's property contained in the rented premises.

After these unsecured claims listed in Section 136 have been paid in full, the remaining cash is paid ratably to the remaining unsecured creditors, subject of course to the deduction for the superintendent's levy.

Funds Held in Trust The act allows the trustee to seize all of the property of the bankrupt, but specifies that property held in trust is not part of the bankrupt's property. This simply clarifies the notion that property held in trust belongs to someone else, and therefore the bankruptcy trustee would have to return this property to the rightful owner(s). The Income Tax Act, the Unemployment Insurance Act, and the Canada Pension Plan Act all require employers to make deductions from their employees' pay and to remit these to the government; furthermore, each act specifies that these deductions are held in trust by the employer. Under the provisions of the Bankruptcy and Insolvency Act, unremitted deductions do not constitute property of a bankrupt. Before the act was amended in 1992, items such as these were included in the unsecured claims with priority.

Unpaid Suppliers This feature, provided in the 1992 amendment, gives unpaid suppliers the right to repossess goods within 30 days after delivery, if the debtor is in a state of bankruptcy or receivership at the time that the demand is made. This applies only to unsold goods in possession of the debtor, or the trustee, or the receiver, and to goods that are identifiable and are in exactly the same state as when they were delivered. Obviously, this would not apply to the work-in-process inventories of the debtor, or to services purchased but unpaid. This new provision will probably result in inventory being less attractive as security for bank loans.

Creditor Preferences and Customer Deposits Bankruptcy law attempts to ensure that an insolvent person's creditors within a particular class receive equal treatment. There are provisions within the act that require the trustee to examine all transactions entered into by the bankrupt for varying time periods prior to the date of bankruptcy. For example, if unsecured creditor X of a bankrupt had received preferential treatment by being paid in full, whereas unsecured creditors Y and Z received no payment, the trustee could apply to the court to have the transaction set aside, and require X to return the amount of the payment to the trustee. Transactions under which assets were sold for less than fair value could also be set aside. The

transfer of assets to a spouse by an insolvent individual would be viewed as a transaction entered into to avoid payment to creditors; as such, it could also be annulled by the court.

How to treat deposits made by customers of a business that subsequently goes bankrupt has long been a contentious issue. Too often, innocent people have made large deposits with furniture stores or automobile dealers, only to learn the next afternoon that the store or dealership went bankrupt that morning. They are understandably dismayed when they learn that they rank as ordinary unsecured creditors without priority, and will probably receive very little (if any) of their deposit back. It is small consolation that the bankrupt might be charged under the act for accepting deposits while in a state of insolvency.

The Accounting Statement of Affairs

As previously mentioned, the act requires an insolvent company to file a statement of affairs with the court. Another statement that is not officially filed under bankruptcy, but could provide useful information for creditors, is the accounting statement of affairs. This financial statement is prepared under a quitting concern concept and shows the estimated amounts that the various classes of creditors might receive under a bankruptcy liquidation. In this statement, assets are measured at estimated current values and classified as to their availability to settle fully secured, partially secured, and unsecured claims, as well as unsecured liabilities with priority under the act. The book values of the assets are often included as a tie-in to the most recent historical cost, going concern balance sheet.

Illustration: Statement of Affairs Jurassic Corporation was declared bankrupt on May 14, Year 3. The company's balance sheet is shown in Exhibit 14.10.

The trustee has gathered the following information about the company's assets and liabilities:

- The notes receivable, which are considered to be fully collectible, are pledged as security to the note payable to the Bank of Commerce.
- The inventory will probably be sold for $50,000, and only 60 percent of the accounts receivable are expected to be collected. The supplies and prepaid expenses have no value.
- The land and buildings have an estimated market value of $110,000 and are pledged against the first-mortgage bonds.
- The equipment has been pledged against the note payable to trade suppliers. The trustee believes that $45,000 is the maximum amount that the equipment can be sold for.
- The wages and salaries fall within the requirements of Section 136 of the Bankruptcy and Insolvency Act. Trustee's fees are estimated to be $4,300.

The statement of affairs of Jurassic as at May 14, Year 3, is presented in Exhibit 14.11.

It should be noted that current and noncurrent classifications are no longer relevant for this company. Instead, assets and liabilities are presented in order of priority for liquidation by the trustee. The estimated proceeds represent the trustee's best estimate as of this date. Actual proceeds from the sale of the assets will probably be different.

Exhibit 14.10

JURASSIC CORPORATION
BALANCE SHEET
May 14, Year 3

Current assets		
Cash		$ 3,100
Notes receivable		15,200
Accounts receivable		18,500
Merchandise inventories		76,700
Supplies		7,500
Prepaid expenses		1,100
		122,100
Property and plant at cost (less accumulated depreciation)		
Land and buildings	70,500	
Equipment	73,000	143,500
		$265,600
Current liabilities		
Notes payable (including accrued interest)		
Bank of Commerce		$ 17,600
Trade suppliers		59,000
Accounts payable		60,000
Wages and salaries payable		10,200
Accrued interest on first-mortgage bonds		2,000
Legal and audit fees		3,300
UIC and income taxes withheld		1,700
		153,800
Long-term liabilities		
First-mortgage bonds		104,000
Total liabilities		257,800
Shareholders' equity		
Common stock	87,000	
Retained earnings (deficit)	(79,200)	7,800
		$265,600

Fully secured creditors are expected to be paid in full from the proceeds from the sale of pledged assets. In this example, an additional $4,000 from the sale of the land and buildings becomes a free asset available for unsecured creditors.

Partially secured creditors will not have their claims fully paid because the proceeds from the sale of pledged assets will be less than the amount of the claim. In this example the amounts still owing — $2,400 on the Bank of Commerce note and $14,000 on the notes to trade creditors — become unsecured claims without priority.

Free assets are available for unsecured creditors, and in this case monies held in statutory trust are deducted first because this money is not the property of the company. Liabilities having priority under Section 136 of the act are deducted next because they are entitled to full payment before any payment is made to the remaining unsecured creditors. Regarding the remaining $79,700 in unsecured liabilities: There is an estimated $52,000 in cash available to satisfy these claims. This represents a payment of 65 cents on the dollar before the levy for the Superintendent of Bankruptcy. In this particular case, after the levy of 5 percent, the unsecured creditors would receive a payment estimated to be 61.98 cents on the dollar.

Exhibit 14.11

JURASSIC CORPORATION
STATEMENT OF AFFAIRS
May 14, Year 3

Book values	*Assets*	*Estimated current values*	*Estimated amount available, unsecured claims*
	Assets pledged with fully secured creditors:		
$ 70,500	Land and buildings	110,000	
	Less first-mortgage bonds	106,000	$ 4,000
	Assets pledged with partially secured claims:		
15,200	Notes receivable (deducted contra)	15,200	
73,000	Equipment (deducted contra)	45,000	
	Free assets:		
3,100	Cash	3,100	
18,500	Accounts receivable	11,100	
76,700	Merchandise inventory	50,000	
7,500	Supplies	–0–	
1,100	Prepaid expenses	–0–	64,200
			68,200
	Less liability for funds held in trust		1,700
	Estimated amount available		66,500
	Less unsecured claims with priority		14,500
	Net estimated amount available to unsecured creditors (65 cents on the dollar)		52,000
	Estimated deficiency to unsecured creditors		27,700
$265,600			
	Total unsecured claims		$79,700

Book values	*Liabilities and shareholders' equity*		*Amount unsecured*
	Fully secured creditors:		
$104,000	First-mortgage bonds	104,000	
2,000	Accrued interest	2,000	
	Total (deducted contra)	106,000	
	Partially secured creditors:		
17,600	Notes payable, Bank of Commerce	17,600	
	Less notes receivable pledged as collateral	15,200	$ 2,400
59,000	Notes payable, trade creditors	59,000	
	Less equipment pledged as collateral	45,000	14,000
	Liability for funds held in trust:		
1,700	UIC and income tax withholdings (deducted contra)	1,700	

continued

Exhibit 14.11 *continued*

	Creditors with priority under Section 136:		
10,200	Wages and salaries payable	10,200	
	Trustee's fees	4,300	
	Total (deducted contra)	14,500	
	Unsecured creditors:		
60,000	Accounts payable		60,000
3,300	Legal and audit fees payable		3,300
	Shareholders' equity:		
87,000	Common stock		
(79,200)	Retained earnings (deficit)		
$265,600			$79,700

SUMMARY

Push-down accounting is one application of the comprehensive revaluation of all of the assets and liabilities of a company. It can be applied only if the company was party to a business combination in which at least 90 percent of its voting shares were acquired by another company, and its use is not mandatory in this situation.

Another application arises when, due to severe financial difficulties, a company undertakes a financial reorganization and as a result its previous shareholders lose their control in the company. The proposal to reorganize is often made when the company is in a situation of insolvency and receivership or bankruptcy appears imminent. If control changes, comprehensive revaluation must take place.

REVIEW QUESTIONS

1. What is the purpose of push-down accounting?
2. "The use of push-down accounting greatly simplifies the consolidation process." Discuss and evaluate this statement.
3. Not all accountants favour the use of push-down accounting. What are some of the arguments against it?
4. Accountants have historically recognized corporate reorganizations in the accounting records. Section 1625 provides a key condition that must be present before a revaluation of assets and liabilities can occur. What is this key condition?
5. In a business combination situation, goodwill is recorded when the fair value of the firm is greater than the fair values of its individual assets and liabilities. Would this be the case if a financial reorganization has occurred under Section 1625? Explain.
6. Identify the various classes of creditors whose claims are dealt with in bankruptcy liquidations.

7. What is the difference between voluntary and involuntary bankruptcy?
8. What is an accounting statement of affairs?
9. Explain the difference between secured and unsecured creditors.
10. Describe three ways in which a business organization could be declared bankrupt.
11. Is there any difference between an insolvent person and a bankrupt person? Explain.
12. A business that has fallen under the jurisdiction of a licensed trustee in bankruptcy shows a future tax liability on its balance sheet caused by undepreciated capital cost allowance/book value differences. How will this liability be reported on the statement of affairs? Explain.
13. Explain the following terms: official receiver, receivership, receiving order, interim receiver, and receiver-manager.
14. What potential future problem may exist when an individual makes a deposit with a retailer to hold merchandise for a future purchase?

MULTIPLE-CHOICE QUESTIONS

Use the following data for Questions 1 to 3.

The balance sheet for Prairie Co. as at December 31, Year 4, is as follows:

Assets	
Cash	$ (5,000)
Current receivables	635,000
Inventories	900,000
Equipment (net)	670,000
Intangibles	160,000
	$2,360,000
Liabilities and shareholders' equity	
Current liabilities	$ 900,000
Note payable	1,330,000
Long-term liabilities	300,000
Common stock	100,000
Retained earnings	(270,000)
	$2,360,000

The creditors and shareholders have accepted the following financial reorganization agreement, whereby the assets will be revalued to fair value as follows:

Accounts receivable	$160,000 write-down
Inventory	$340,000 write-down
Intangibles	$160,000 write-off
Equipment	$200,000 write-up

The holders of the current liabilities will accept 50% of the amount they are owed in a 3-year note, forgive 30%, and retain a current claim on 20%. The current common shares will be surrendered and cancelled, and the holder of the note payable will receive 10,000 newly issued shares in satisfaction of the amount due. The other balance sheet items will remain unchanged.

1. Which of the following is the amount that will be reported as common shares after the financial reorganization?
   a. $680,000
   b. $880,000
   c. $970,000
   d. $1,330,000
2. Which of the following is the amount that will be reported as current liabilities after the financial reorganization?
   a. $0
   b. $180,000
   c. $270,000
   d. $630,000
3. Which of the following is the amount that will be reported as retained earnings after the financial reorganization?
   a. ($360,000)
   b. ($270,000)
   c. $0
   d. $360,000
4. Which of the following is the best description of "push-down accounting"?
   a. The subsidiary is required to adopt the accounting policies of the parent.
   b. The parent requires the subsidiary to revalue its assets and liabilities on its books based on the purchase transaction.
   c. The subsidiary records its assets at lower values to reduce its attractiveness for takeover bids.
   d. The parent allocates any negative goodwill that arose on the purchase transaction to the subsidiary's nonmonetary assets and liabilities.
5. Which of the following is the best description of involuntary bankruptcy?
   a. Upon default of payment, a secured creditor appoints an agent to seize the debtor's property that has been pledged against the debt.
   b. A company liquidates its assets and uses the proceeds to settle debt, with any remaining amount being distributed to preferred, then common shareholders.
   c. Upon default of payment, unsecured creditors appoint a trustee to seize all of a debtor's property and protect them until further actions can be taken.
   d. A person is unable to meet his or her obligations and holds assets that have fair values less than the amount of these obligations.

CASES

Case 1 Southern Ltd. is negotiating the takeover of Northern Corp. and intends to finance the acquisition in part with a loan provided by a large Canadian pension fund. To date it has been agreed that the assets of Northern will be pledged as partial security to the loan.

The president of Southern has just completed further talks with the pension fund managers and has called you into his office. He explains what has transpired and then exclaims, "These guys not only want the fair values of Northern's assets to appear on its balance sheet, but they also want their loan to appear there as well. I wasn't aware that this was possible under GAAP. Draft up a memo for me so I can report on this to the executive committee tomorrow morning."

Required:

Prepare your memo to the president.

Case 2 Reed Corporation is under creditor protection in accordance with the provisions in the Companies' Creditors Arrangement Act. The last two years have not been profitable and the company has a sizable deficit. Cash flows have been substantially reduced, and as a result the company has been having trouble paying suppliers on time and paying interest when it is due. Concerned that its creditors might take legal action against it, Reed was granted court permission to make a proposal to its creditors. After extensive negotiations, the creditor groups have accepted the following proposal:

- Trade creditors have agreed to accept 90 percent of the amounts owing to them as payment in full.
- Holders of unsecured notes have agreed to an extension of maturity date and a reduction of interest.
- Existing shareholders will subscribe to a new share issue on the basis of two new shares for each share currently held.
- Debenture holders have agreed to an exchange of five newly issued cumulative redeemable preferred shares for each $1,000 bond held. If dividends fall into arrears, the preferred shareholders have the option of converting the preferred shares into common shares of the company. Such a conversion would allow the election of 2 members on the 12-member board of directors.

The president of Reed has asked you to provide advice regarding the proper accounting for this reorganization. He feels that for some of the company's assets, the fair values are greater than carrying values, while for others, the opposite is the case. He would like to reflect these fair values in the financial statements and at the same time write off the accumulated deficit to reflect the fresh start.

Required:

Prepare a report for the president.

Case 3 Late last evening, your favourite uncle Harry phoned you because he knows that you are nearly ready to write your professional accounting entrance examinations. He is excited, and also quite upset because as he was perusing the business section of the local newspaper he came across a notice that involves one of his major customers. He is quite worried about the potential consequences. After he reads the notice to you, you tell him that you will call him tomorrow and explain the situation. After the call, you locate the following notice that he was referring to in the paper:

> IN THE MATTER OF THE BANKRUPTCY OF SUMMERSET ENTERPRISES INC., A COMPANY DULY INCORPORATED UNDER THE LAWS OF THE PROVINCE OF ONTARIO, WITH A HEAD OFFICE IN THE CITY OF DUNDAS.
> NOTICE IS HEREBY GIVEN THAT A RECEIVING ORDER WAS MADE AGAINST SUMMERSET INDUSTRIES LIMITED ON MONDAY THE 6th DAY OF MARCH 2006, AND THAT THE FIRST MEETING OF CREDITORS WILL BE HELD ON THE 10th DAY OF APRIL 2006 AT THE HOUR OF 1:00 O'CLOCK IN THE AFTERNOON AT 55 ST. CLAIR AVENUE, ROOM 308, TORONTO ONTARIO. TO BE ELIGIBLE TO VOTE, CREDITORS MUST FILE WITH ME PROOFS OF CLAIM PRIOR TO THE MEETING.
>
> YARRUM NOTLIH
> Trustee.

Required:

Outline what you will say tomorrow.

Case 4 Your accounting instructor has presented you with the following article that she has just clipped out of a well-known business newspaper:

> The creditors of Cordova Real Estate Investment Ltd. (CREL) have given their blessing to a plan that calls for the once high-flying developer to shrink by more than a third, a decision that almost assures the company's smooth exit from bankruptcy court. After a string of costly and ill-fated land acquisitions, the company was forced to confront its growing liquidity crisis. The final two of CREL's five creditor groups cast their votes in favour of the plan yesterday, a move that concluded a long period of negotiations to restructure $6.19 billion of debt. When CREL filed for protection under the Companies' Creditors Arrangement Act last month, it had in hand a plan that had been already negotiated with lenders, so the official approval won yesterday came as little surprise.
>
> On the stock exchange, yesterday's announcement triggered a 13 percent drop in price as the market reacted to the substantial dilution that will occur to the holdings of CREL's common shareholders. The plan, to go into effect next month, calls for the ambitious sale of $3.9 billion of properties, the deferral of principal repayments on secured debt, and the exchange of unsecured debt for shares. The next step will be a request next Wednesday for a court order to make the plan binding on the company and its creditors, including the small minority that rejected the plan.

Required:

Her instructions to you are as follows:

Based on this article (which is skimpy on detail) and any reasonable assumptions that you wish to make, discuss the financial accounting implications resulting from the "plan."

PROBLEMS

Problem 1 The balance sheets of Peach Corp. and Sabourin Ltd. on December 31, Year 1, are shown below:

	Peach	*Sabourin*
Cash	$100,000	$ 2,000
Accounts receivable	25,000	7,000
Inventory	30,000	21,000
Plant	175,000	51,000
Trademarks	—	7,000
	$330,000	$88,000
Current liabilities	$ 50,000	$10,000
Long-term debt	80,000	20,000
Common stock	110,000	30,000
Retained earnings	90,000	28,000
	$330,000	$88,000

The fair values of the identifiable net assets of Sabourin on December 31, Year 1, are as follows:

Cash		$ 2,000
Accounts receivable		7,000
Inventory		26,000
Plant		60,000
Trademarks		14,000
		109,000
Current liabilities	10,000	
Long-term debt	19,000	29,000
Net assets		$ 80,000

On January 1, Year 2, Peach paid $95,000 in cash to acquire all of the common shares of Sabourin, and instructed the management of Sabourin to apply push-down accounting as an aid in the preparation of future consolidated financial statements.

Required:

(a) Prepare Sabourin's push-down journal entries.
(b) Prepare the consolidated balance sheet on January 1, Year 2.

Problem 2 An agreement has been reached whereby Pace Company will issue 6,000 common shares on January 1, Year 2, for all of the outstanding shares of Stetlar Company in a purchase-method business combination. Push-down accounting will be applied. Pace's shares are currently trading at $4.90. The following information has been assembled as at December 31, Year 1:

	Pace		*Stetlar*	
	Book value	*Fair value*	*Book value*	*Fair value*
Cash	$ 10,000	$10,000	$ 2,000	$ 2,000
Accounts receivable	12,000	12,000	—	
Inventory	18,000	22,500	8,000	5,200
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:

(a) Prepare the required push-down journal entries on January 1, Year 2.
(b) Prepare a consolidated balance sheet on January 1, Year 2.

Problem 3

The balance sheets of Peko Corp. and Scott Ltd. on December 31, Year 4, are as follows:

	Peko book value	*Scott book value*
Cash	$ 10,000	$ 5,000
Accounts receivable	100,000	35,000
Inventory	90,000	160,000
Land	70,000	40,000
Plant and equipment	360,000	290,000
Investment in Scott	261,000	—
Goodwill	90,000	30,000
	$981,000	$560,000
Current liabilities	$120,000	$ 80,000
Long-term debt	320,000	220,000
Common stock	400,000	300,000
Retained earnings	141,000	(40,000)
	$981,000	$560,000

On December 30, Year 4, Peko purchased all of the common shares of Scott for $261,000. On this date the inventory of Scott had a fair value of $165,000, its land had a fair value of $70,000, and its plant and equipment had a fair value of $280,000. Scott has been directed to apply push-down accounting.

Required:

Prepare the necessary push-down journal entries and the consolidated balance sheet as at December 31, Year 4.

Problem 4 On January 1, Year 2, Pic Ltd. gained control over Bic Inc. through an acquisition of the common shares of that company.

Balance sheet data of Bic on December 31, Year 1, are presented next.

	Book value	*Fair value*
Cash	$ 2,000	$ 2,000
Accounts receivable	7,000	7,000
Inventory	21,000	26,000
Plant	51,000	60,000
Trademarks	7,000	14,000
	$88,000	
Current liabilities	$10,000	$10,000
Long-term debt	20,000	19,000
Common stock	30,000	
Retained earnings	28,000	
	$88,000	

Required:

PART A

Assume that Pic paid $97,000 for 100% of the outstanding common shares of Bic.

Prepare Bic's journal entries to apply push-down accounting.

PART B

Assume that Pic paid $63,000 for 90% of Bic's shares.

Prepare Bic's journal entries to apply push-down accounting.

Problem 5 On July 1, 2006, Peaks Corp. purchased 100% of the voting shares of Valleys Inc. for $679,800. The balance sheet of Valleys on that date was as follows:

VALLEYS INC.
BALANCE SHEET
as at July 1, 2006

	Net book value	*Fair market value*
Cash	$ 96,000	$ 96,000
Accounts receivable	120,000	144,000
Inventory	180,000	228,000
Fixed assets (net)	540,000	450,000
	$936,000	
Current liabilities	$107,200	$107,200
Bonds payable	200,000	190,000
Common shares	120,000	
Retained earnings	508,800	
	$936,000	

The accounts receivable of Valleys were collected in October 2006, and the inventory was completely sold by May 2007. The fixed assets had a remaining life of 15 years on July 1, 2006, and the bonds payable mature on June 30, 2010. A goodwill impairment loss of $14,750 was recorded in 2007.

The financial statements for Peaks and Valleys as at December 31, 2008, are presented below. Peaks has used the equity method to account for its investment; Valleys applied push-down accounting effective with the acquisition date.

BALANCE SHEETS

	Peaks	*Valleys*
Cash	$ 120,000	$ 84,000
Accounts receivable	180,000	114,000
Inventory	300,000	276,000
Fixed assets (net)	720,000	465,000
Investment in Valleys	651,200	—
Goodwill	—	44,250
Other investments	250,666	—
	$2,221,866	$983,250
Current liabilities	$ 180,200	$115,000
Bonds payable	315,000	217,050
Common shares	300,600	679,800
Retained earnings	1,348,066	(29,600)
Net income	128,000	6,000
Dividends	(50,000)	(5,000)
	$2,221,866	$983,250

INCOME STATEMENTS

	Peaks	*Valleys*
Sales	$1,261,000	$1,200,000
Investment income (equity method)	6,000	—
Income from other investments	25,000	—
	$1,292,000	$1,200,000
Cost of goods sold	$ 840,000	$1,020,000
Depreciation	60,000	48,000
Interest	37,000	28,900
Other	227,000	97,100
	$1,164,000	$1,194,000
Net income	$ 128,000	$ 6,000

Required:

Prepare the consolidated financial statements for the year ended December 31, 2008.

Problem 6 The following financial statements were prepared on December 31, Year 6.

BALANCE SHEET

	Pearl	*Strand*
Cash	$ 300,000	$ 100,000
Accounts receivable	200,000	600,000
Inventory	2,000,000	420,000
Plant and equipment	3,000,000	2,340,000
Accumulated depreciation	(750,000)	(450,625)
Goodwill	—	55,000
Investment in Strand — equity method	2,764,375	—
	$7,514,375	$3,064,375
Accounts payable	$ 900,000	$ 300,000
Capital stock	3,850,000	2,500,000
Retained earnings	2,764,375	264,375
	$7,514,375	$3,064,375

INCOME STATEMENT

	Pearl	*Strand*
Sales	$4,000,000	$1,000,000
Investment income	358,750	—
	$4,358,750	$1,000,000
Cost of sales	$2,500,000	$ 400,000
Miscellaneous expenses	370,000	70,000
Depreciation expense	80,000	41,250
Goodwill impairment loss	—	10,000
Income tax expense	250,000	120,000
	$3,200,000	$ 641,250
Net income	$1,158,750	$ 358,750

RETAINED EARNINGS STATEMENT

	Pearl	*Strand*
Balance, January 1	$2,105,625	$ 105,625
Net income	1,158,750	358,750
	3,264,375	464,375
Dividends	500,000	200,000
Balance, December 31	$2,764,375	$ 264,375

Other Information

Pearl purchased 100% of the outstanding voting stock of Strand for $2,500,000 on July 1, Year 2, at which time Strand's retained earnings were $400,000 and common stock amounted to $1,600,000. The purchase discrepancy on this date was allocated as follows: 30% to undervalued inventory; 50% to equipment (remaining life: 8 years); and balance to goodwill.

Strand applied push-down accounting on acquisition date, and Pearl has used the equity method to account for its investment since that date.

Strand owes Pearl $75,000 on December 31, Year 6.

Required:

Prepare consolidated financial statements on December 31, Year 6.

Problem 7 Even though Tizoc Development Corp. has a history as a very successful property developer, its fortunes have waned in recent years, and it has been unable to service its debt due to cash flow difficulties. Rather than force the liquidation of the company, the creditors have accepted a proposal from management as a last-ditch effort to salvage the operation. The corporation's balance sheet as at May 31 of the current year is presented below:

TIZOC DEVELOPMENT CORP.
BALANCE SHEET — May 31

Cash	$ 34,730
Investments	252,890
Land	550,000
Buildings	908,731
Accumulated depreciation	(512,481)
Goodwill	50,000
	$1,283,870
Current liabilities	$ 136,860
12% first-mortgage bonds	600,000
14% debenture bonds	200,000
Common stock (10,000 shares)	170,940
Retained earnings	176,070
	$1,283,870

The following is a summary of the reorganization plan.

- The investments are portfolio and significant interest investments in other land development companies. These companies have also experienced high vacancy rates and declining property values. These investments are to be written down to $100,000.
- All concerned agree that the land is overvalued by $120,000 and the net book value of the buildings by $90,000. The goodwill has no value.
- The 12% first-mortgage bonds are to be exchanged for $400,000, 7.5% first-mortgage bonds and 25,000 new common shares.
- The current liabilities will be paid as cash becomes available.
- Each 14% debenture is to be exchanged for a 5% debenture. This interest rate is far below current interest rates. The present value of the future cash payments discounted at today's market interest rates amounts to $185,000.

Required:

(a) Prepare the journal entries to record the reorganization.
(b) Prepare a balance sheet after the reorganization.

Problem 8 The trial balance of Sussex Inc. as at December 31, Year 6, is as follows:

	Debit	*Credit*
Cash	$ 45,000	
Accounts receivable	95,000	
Allowance for doubtful accounts		18,000
Inventory	150,000	
Property, plant, and equipment	540,000	
Accumulated depreciation		210,000
Patents	120,000	
Accounts payable		110,000
Notes payable (10% interest)		150,000
Accrued interest on notes		40,000
12% bonds payable		400,000
Common stock (9,000 shares)		200,000
Retained earnings (deficit)	178,000	
	$1,128,000	$1,128,000

The following reorganization plan has been approved by the shareholders and the creditors:

- The holders of the notes payable agree to cancel the accrued interest owing, to extend the due date, and to reduce the interest rate. In return they will receive a pledge of inventory and receivables as security throughout the life of the notes.
- Trade creditors agree to accept a payment of $95,000 as full settlement of their claims.
- The bondholders agree to exchange their bonds for $250,000 in 8% first-mortgage bonds and 15,000 common shares.
- The deficit is to be eliminated.
- All parties have agreed that the following reflect the fair values of the individual assets:

Accounts receivable	$ 72,000
Allowance for doubtful accounts	2,000
Inventory	130,000
Property, plant, and equipment	250,000
Patents	190,000

Required:

(a) Prepare the journal entries to record the reorganization.
(b) Prepare a balance sheet after the reorganization.

Problem 9

The following information was taken from the accounting records of Pembina Manufacturing Limited, which has recently come under the jurisdiction of a licensed trustee in bankruptcy:

	Carrying amount
Cash	$ 4,000
Accounts receivable (100% estimated collectible)	46,000
Inventories: estimated fair value, $18,000; pledged on $21,000 of notes payable	39,000
Equipment: Est. fair value, $67,400; pledged on mortgage note payable	107,000
Manufacturing supplies: Est. fair value, $1,500	2,000
Wages payable: current month	5,800
Income tax and CPP source deductions	1,200
Trade accounts payable	60,000
Notes payable, $21,000 secured by inventory	40,000
Mortgage note payable	50,000
Accrued interest on mortgage note	400
Common stock	100,000
Deficit	59,400

Required:

Prepare a statement of affairs.