

In class Tutorial Questions & Solutions
Exercise 25.5 Accounting by an acquirer

Howard Ltd is seeking to expand its share of the widgets market and has negotiated to take over the operations of Falcon Ltd on 1 January 2021. The statements of financial position of the two companies as at 31 December 2020 were as follows.

| | Howard Ltd | Falcon Ltd |
|--------------------------------|------------------|------------------|
| Cash | \$ 23 000 | \$ 12 000 |
| Accounts receivable | 25 000 | 34 700 |
| Inventories | 35 500 | 27 600 |
| Freehold land | 150 000 | 100 000 |
| Buildings (net) | 60 000 | 30 000 |
| Plant and equipment (net) | 65 000 | 46 000 |
| Goodwill | 25 000 | 2 000 |
| | <u>\$383 500</u> | <u>\$252 300</u> |
| Accounts payable | 56 000 | 45 100 |
| Mortgage loan | 50 000 | 44 000 |
| Debentures | 100 000 | 52 500 |
| Share capital — 100 000 shares | 100 000 | — |
| — 60 000 shares | — | 60 000 |
| Other reserves | 28 500 | 26 800 |
| Retained earnings | 49 000 | 23 900 |
| | <u>\$383 500</u> | <u>\$252 300</u> |

Howard Ltd is to acquire all the identifiable assets, except cash, of Falcon Ltd. The assets of Falcon Ltd are all recorded at fair value except the following.

| | Fair value |
|---------------|------------|
| Inventories | \$ 39 000 |
| Freehold land | 130 000 |
| Buildings | 40 000 |

In exchange, Howard Ltd is to provide sufficient extra cash to allow Falcon Ltd to repay all of its outstanding debts and its liquidation costs of \$2400, plus two fully paid shares in Howard Ltd for every three shares held in Falcon Ltd. The fair value of a share in Howard Ltd is \$3.20.

Costs of issuing the shares were \$1200.

Required

Prepare the acquisition analysis and journal entries to record the business combination in the records of Howard Ltd.

HOWARD LTD – FALCON LTD

Acquisition analysis:

Net fair value of assets and liabilities acquired:

Accounts receivable

\$34 700

HOWARD LTD – FALCON LTD

Acquisition analysis:

Net fair value of assets and liabilities acquired:

| | |
|---------------------|------------------|
| Accounts receivable | \$34 700 |
| Inventory | 39 000 |
| Freehold land | 130 000 |
| Buildings | 40 000 |
| Plant and equipment | <u>46 000</u> |
| | <u>\$289 700</u> |

Consideration transferred:

| | |
|-------------------------------|------------------|
| Shares: 2/3 x 60 000 x \$3.20 | \$128 000 |
| Cash | |
| Accounts payable | \$45 100 |
| Mortgage and interest | 44 000 |
| Debentures and premium | 52 500 |
| Liquidation expenses | <u>2 400</u> |
| | 144 000 |
| Cash already held by Falcon | <u>(12 000)</u> |
| | <u>\$260 000</u> |

Gain on bargain purchase = \$289 700 - \$260 000
= \$29 700

HOWARD LTD General Journal

| | | | |
|---|----|---------|---------|
| Accounts receivable | Dr | 34 700 | |
| Inventory | Dr | 39 000 | |
| Freehold land | Dr | 130 000 | |
| Buildings | Dr | 40 000 | |
| Plant and equipment | Dr | 46 000 | |
| Cash | Cr | | 132 000 |
| Share capital | Cr | | 128 000 |
| Gain on bargain purchase | Cr | | 29 700 |
| (Acquisition of net assets of Falcon Ltd and shares issued) | | | |
| Share capital | Dr | 1 200 | |
| Cash | | Cr | 1 200 |
| (Costs of issuing shares) | | | |

Exercise 26.6 Options

Toby Ltd and Fred Ltd own 80% and 20% respectively of the ordinary shares that carry voting rights at a general meeting of shareholders of Stella Ltd. Toby Ltd sells half of its interest to Coco Ltd and buys call options from Coco Ltd that are exercisable at any time at a premium to the market price when issued and, if exercised, would give Toby Ltd its original 80% ownership interest and voting rights. At the end of the current financial period, the options are out of the money.

Exercise 26.6 Options

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Required

Discuss whether Toby Ltd is the parent of Stella Ltd. (LO2)

Facts:

| | | |
|----------|---|--------------------------------------|
| Toby Ltd | - | 40% of ordinary shares of Stella Ltd |
| Fred Ltd | - | 20% of ordinary shares of Stella Ltd |
| Coco Ltd | - | 40% of ordinary shares of Stella Ltd |

Toby Ltd owns call options that would give it 80% of the voting rights of Stella Ltd.

When considering potential voting rights, an investor shall consider the purpose and design of the instrument, as well as the purpose and design of any other involvement the investor has with the investee. This includes an assessment of the various terms and conditions of the instrument as well as the investor's apparent expectations, motives and reasons for agreeing to those terms and conditions.

If the investor also has voting or other decision-making rights relating to the investee's activities, the investor assesses whether those rights, in combination with potential voting rights, give the investor power.

An investor, in assessing whether it has power, considers only substantive rights relating to an investee (held by the investor and others). For a right to be substantive, the holder must have the practical ability to exercise that right. It is necessary to consider any barriers that might prevent the holder from exercising the rights. Examples of such barriers include:

- (i) Financial penalties and incentives that would prevent (or deter) the holder from exercising its rights.
- (ii) An exercise or conversion price that creates a financial barrier that would prevent (or deter) the holder from exercising its rights.
- (iii) Terms and conditions that make it unlikely that the rights would be exercised, for example, conditions that narrowly limit the timing of their exercise.
- (iv) The absence of an explicit, reasonable mechanism in the founding documents of an investee or in applicable laws or regulations that would allow the holder to exercise its rights.
- (v) The inability of the holder of the rights to obtain the information necessary to exercise its rights.
- (vi) Operational barriers or incentives that would prevent (or deter) the holder from exercising its rights (e.g. the absence of other managers willing or able to provide specialised services or provide the services and take on other interests held by the incumbent manager).
- (vii) Legal or regulatory requirements that prevent the holder from exercising its rights (e.g.

Exercise 27.13 Undervalued assets, pre-acquisition reserves transfers

Ethan Ltd acquired all the issued shares (ex div.) of Darren Ltd on 1 July 2018 for \$110 000. At this date Darren Ltd recorded a dividend payable of \$10 000 and equity of the following.

Share capital

\$54 000

Exercise 27.13 Undervalued assets, pre-acquisition reserves transfers

Ethan Ltd acquired all the issued shares (ex div.) of Darren Ltd on 1 July 2018 for \$110 000. At this date Darren Ltd recorded a dividend payable of \$10 000 and equity of the following.

| | |
|---------------------------|----------|
| Share capital | \$54 000 |
| Retained earnings | 36 000 |
| Asset revaluation surplus | 18 000 |

All the identifiable assets and liabilities of Darren Ltd were recorded at amounts equal to their fair values at acquisition date except for the following.

| | Carrying amount | Fair value |
|----------------------------|-----------------|------------|
| Inventories | \$14 000 | \$16 000 |
| Machinery (cost \$100 000) | 92 500 | 94 000 |

Of the inventories, 90% was sold by 30 June 2019. The remainder was sold by 30 June 2020. The machinery was considered to have a further 5-year life and it is depreciated on a straight-line basis.

Both Darren Ltd and Ethan Ltd use the revaluation model for land. At 1 July 2018, the balance of Ethan Ltd's asset revaluation surplus was \$13 500. In May 2019, Darren Ltd transferred \$3000 from the retained earnings at 1 July 2018 to a general reserve. The tax rate is 30%.

The following information was provided by the two companies at 30 June 2019.

| | Ethan Ltd | Darren Ltd |
|--|------------|------------|
| Profit before tax | 120 000 | 12 500 |
| Income tax expense | (56 000) | (4 200) |
| Profit for the year | 64 000 | 8 300 |
| Retained earnings (1/7/18) | 80 000 | 36 000 |
| | 144 000 | 44 300 |
| Transfer to general reserve | (0) | (3 000) |
| Retained earnings (30/6/19) | \$ 144 000 | \$ 41 300 |
| Share capital | 360 000 | 54 000 |
| Retained earnings | 144 000 | 41 300 |
| General reserve | 10 000 | 3 000 |
| Asset revaluation surplus | 18 500 | 20 000 |
| Liabilities | 42 500 | 13 000 |
| | \$ 575 000 | \$131 300 |
| Land | \$ 160 000 | \$ 20 000 |
| Plant and machinery | 360 000 | 125 600 |
| Accumulated depreciation — plant and machinery | (110 000) | (33 000) |
| Inventories | 55 000 | 18 700 |
| Shares in Darren Ltd | 110 000 | 0 |

1. Acquisition analysis at 1 July 2018:

$$\begin{aligned}
 &\text{Net fair value of identifiable assets} \\
 &\text{and liabilities of Darren Ltd} = (\$54\,000 + \$36\,000 + \$18\,000) \text{ (equity)} \\
 &+ (\$16\,000 - \$14\,000) (1 - 30\%) \text{ (BCVR - inventories)} \\
 &+ (\$94\,000 - \$92\,500) (1 - 30\%) \text{ (BCVR - machinery)} \\
 &= \$110\,450
 \end{aligned}$$

1. Acquisition analysis at 1 July 2018:

| | | | |
|---|---|--|--|
| Net fair value of identifiable assets and liabilities of Darren Ltd | = | (\$54 000 + \$36 000 + \$18 000) (equity) | |
| | | + (\$16 000 – \$14 000) (1 – 30%) (BCVR – inventories) | |
| | | + (\$94 000 – \$92 500) (1 – 30%) (BCVR – machinery) | |
| | | = \$110 450 | |
| Consideration transferred | = | \$110 000 | |
| Gain on bargain purchase | = | \$110 450 – \$110 000 | |
| | | = \$450 | |

As the acquisition of shares is ex div., the dividend declared by the subsidiary prior to the acquisition is not considered in the acquisition analysis.

2. Worksheet entries at 30 June 2019:

(1) **Business combination valuation entries:**

The BCVR entries are affected by the following events that took place during the period from acquisition to 30 June 2019:

- the sale of 90% of the inventories during the current period
- the depreciation of the machinery during the current period.

The BCVR entry for the inventory unsold during the current period will be the same as the BCVR entry for inventory at acquisition date, but only for the 10%.

| | | | |
|--|----|-------|-------|
| Cost of sales | Dr | 1 800 | |
| Income tax expense | Cr | | 540 |
| Transfer from business combination valuation reserve | Cr | | 1 260 |
| Inventories | Dr | 200 | |
| Deferred tax liability | Cr | | 60 |
| Business combination valuation reserve | Cr | | 140 |
| Accumulated depreciation - machinery | Dr | 7 500 | |
| Machinery | Cr | | 6 000 |
| Deferred tax liability | Cr | | 450 |
| Business combination valuation reserve | Cr | | 1 050 |
| Depreciation expense | Dr | 300 | |
| Accumulated depreciation - machinery (1/5 x \$1 500) | Cr | | 300 |
| Deferred tax liability | Dr | 90 | |
| Income tax expense (30% x \$300) | Cr | | 90 |

(2) **Pre-acquisition entries:**

At 30 June 2019:

The pre-acquisition entries at 30 June 2019 are affected by:

- the transfer from business combination valuation reserve as a result of the sale of 90% of the inventories during the current period

(2) Pre-acquisition entries:

At 30 June 2019:

The pre-acquisition entries at 30 June 2019 are affected by:

- the transfer from business combination valuation reserve as a result of the sale of 90% of the inventories during the current period
- the transfer from pre-acquisition equity to general reserve of \$3 000 during the current period.

The first pre-acquisition entry is the same as the one at 1 July 2018. The other pre-acquisition entry needs to reverse:

- the current period transfer from business combination valuation reserve due to the sale of 90% of the inventories
- the current period transfer from pre-acquisition retained earnings to general reserve.

| | | | |
|--|----|--------|---------|
| Retained earnings (1/7/18) | Dr | 36 000 | |
| Share capital | Dr | 54 000 | |
| Asset revaluation surplus | Dr | 18 000 | |
| Business combination valuation reserve | Dr | 2 450 | |
| Gain on bargain purchase | Cr | | 450 |
| Shares in Darren Ltd | Cr | | 110 000 |
| Transfer from business combination valuation reserve | Dr | 1 260 | |
| Business combination valuation reserve | Cr | | 1 260 |
| General reserve | Dr | 3 000 | |
| Transfer to general reserve | Cr | | 3 000 |

3. Consolidated financial statements for Ethan Ltd's group at 30 June 2019:

In order to prepare the consolidated financial statements, the consolidation worksheet at 30 June 2019 is first prepared based on the entries above. The consolidation worksheet at 30 June 2019 is then:

| | Ethan | Darren | | Adjustments | | Group |
|--|--------------|---------------|--|--------------------|--|--------------|
|--|--------------|---------------|--|--------------------|--|--------------|

3. Consolidated financial statements for Ethan Ltd's group at 30 June 2019:

In order to prepare the consolidated financial statements, the consolidation worksheet at 30 June 2019 is first prepared based on the entries above. The consolidation worksheet at 30 June 2019 is then:

| | Ethan Ltd | Darren Ltd | | Adjustments | | | Group |
|--|-----------|------------|----------|-------------|-------|----------|-----------|
| | | | | Dr | Cr | | |
| Profit before tax | 120 000 | 12 500 | <i>1</i> | 300 | 450 | 2 | 130 850 |
| | | | <i>1</i> | 1 800 | | | |
| Income tax expense | 56 000 | 4 200 | | | 90 | <i>1</i> | 59 570 |
| | | | | | 540 | <i>1</i> | |
| Profit for the year | 64 000 | 8 300 | | | | | 71 280 |
| Retained earnings (1/7/18) | 80 000 | 36 000 | 2 | 36 000 | | | 80 000 |
| Transfer from BCVR | - | - | 2 | 1 260 | 1 260 | <i>1</i> | 0 |
| | 144 000 | 44 300 | | | | | 151 280 |
| Transfer to general reserve | 0 | 3 000 | | | 3 000 | 2 | 0 |
| Retained earnings (30/6/19) | 144 000 | 41 300 | | | | | 151 280 |
| Share capital | 360 000 | 54 000 | 2 | 54 000 | | | 360 000 |
| BCVR | - | - | 2 | 2 450 | 1 050 | <i>1</i> | 0 |
| | | | | | 140 | <i>1</i> | |
| | | | | | 1 260 | 2 | |
| General reserve | 10 000 | 3 000 | 2 | 3 000 | | | 10 000 |
| | 514 000 | 98 300 | | | | | 521 280 |
| Asset revaluation surplus (1/7/18) | 13 500 | 18 000 | 2 | 18 000 | | | 13 500 |
| Gains | 5 000 | 2 000 | | | | | 7 000 |
| Asset revaluation surplus (30/6/19) | 18 500 | 20 000 | | | | | 20 500 |
| | 532 500 | 118 300 | | | | | 541 780 |
| Liabilities | 42 500 | 13 000 | <i>1</i> | 90 | 450 | <i>1</i> | 55 920 |
| | | | | | 60 | <i>1</i> | |
| | 575 000 | 131 300 | | | | | 597 700 |
| | | | | | | | |
| Land | 160 000 | 20 000 | | | | | 180 000 |
| Plant and machinery | 360 000 | 125 600 | | | 6 000 | <i>1</i> | 479 600 |
| Accumulated depreciation – plant and machinery | (110 000) | (33 000) | <i>1</i> | 7 500 | 300 | <i>1</i> | (135 800) |
| Inventories | 55 000 | 18 700 | <i>1</i> | 200 | | | 73 900 |

ETHAN LTD
Consolidated Statement of Profit or Loss and Other Comprehensive Income
for the financial year ended 30 June 2019

| | |
|------------------------------|-----------------|
| Profit before income tax | \$130 850 |
| Income tax expense | <u>59 570</u> |
| Profit for the period | \$71 280 |

ETHAN LTD
Consolidated Statement of Profit or Loss and Other Comprehensive Income
for the financial year ended 30 June 2019

| | |
|-----------------------------------|------------------------|
| Profit before income tax | \$130 850 |
| Income tax expense | <u>59 570</u> |
| Profit for the period | \$71 280 |
| Other comprehensive income | |
| Gains on revaluation of assets | <u>7 000</u> |
| Total comprehensive income | <u>\$78 280</u> |

ETHAN LTD
Consolidated Statement of Changes in Equity
for the financial year ended 30 June 2019

| | |
|---|------------------|
| Comprehensive income for the period | \$78 280 |
| Retained earnings at 1 July 2018 | \$80 000 |
| Profit for the period | 71 280 |
| Retained earnings at 30 June 2019 | <u>\$151 280</u> |
| Share capital at 1 July 2018 | <u>\$360 000</u> |
| Share capital at 30 June 2019 | <u>\$360 000</u> |
| Asset revaluation surplus at 1 July 2018 | \$13 500 |
| Gains | 7 000 |
| Asset revaluation surplus at 30 June 2019 | <u>\$20 500</u> |
| General reserve at 1 July 2018 | \$10 000 |
| General reserve at 30 June 2019 | <u>\$10 000</u> |

ETHAN LTD
Consolidated Statement of Financial Position as at 30 June 2019

| | |
|--|-------------------------|
| Current Assets | |
| Inventories | \$73 900 |
| Non-current Assets | |
| Property, plant and equipment: | |
| Land | 180 000 |
| Plant and machinery | \$479 600 |
| Accumulated depreciation – plant and machinery | <u>(135 800)</u> |
| Total Non-current Assets | <u>\$523 800</u> |
| Total Assets | <u>\$597 700</u> |
| Equity | |
| Share capital | \$360 000 |
| Retained earnings | 151 280 |
| General reserve | 10 000 |
| Asset revaluation surplus | <u>20 500</u> |
| Total Equity | <u>\$541 780</u> |
| Liabilities | <u>\$55 920</u> |
| Total Equity and Liabilities | <u>\$597 700</u> |