

Comprehensive Revaluation of Assets and Liabilities

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Comprehensive Revaluation

- Comprehensive Revaluation
 - In earlier chapters, we illustrated the revaluation of assets and liabilities of companies which had been acquired in a business combination - *the acquisition justified a new basis of valuation*
 - There are other situations where similar revaluation of assets and liabilities is warranted
 - These situations, which generally involve a *change in control* for the corporation, are the subject of CICA Handbook section 1625, which *provides for the comprehensive revaluation of assets and liabilities*

Comprehensive Revaluation

- Section 1625 of the CICA Handbook sets out recognition, measurement and disclosure standards to enable comprehensive revaluation of assets and liabilities by businesses, establishing a new cost basis
 - **Recognition standards** are concerned with the conditions necessary for assets to be revalued
 - **Measurement standards** involve how the revaluation is to be conducted and recorded
 - **Disclosure standards** relate to information which must be provided with the financial statements in the periods after revaluation

Comprehensive Revaluation

- **Recognition:** the following conditions are required for comprehensive revaluation:
 - All or virtually all of the equity interests in the enterprise have been acquired, in one or more transactions between non-related parties, by an acquirer who controls the enterprise after the transaction or transactions; **or**
 - The enterprise has been subject to a financial reorganization, and the same party does not control the enterprise both before and after the reorganization;
 - **and**, in either situation, new costs are reasonably determinable (*from CICA Handbook, s. 1625.04*)

Comprehensive Revaluation

- The **recognition** criteria can be met in only two situations:
 - Intercorporate investment where control has changed (that is, a **business combination** accounted for as a **purchase**)
 - **Financial reorganization**, where there has been a substantial realignment of equity and non-equity interests resulting in a change of control

Comprehensive Revaluation

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 - Intercorporate investment where control has changed (that is, a **business combination** accounted for as a **purchase**)
 - **Financial reorganization**, where there has been a substantial realignment of equity and non-equity interests resulting in a change of control
- Other situations were considered by the ASB, but *no others meet the necessary condition of a change in control* to establish a new cost basis for assets and liabilities

Comprehensive Revaluation

- The *CICA Handbook* recommends that identifiable assets and liabilities should be comprehensively revalued when the conditions of paragraph 1625.04 are satisfied as a result of a financial reorganization
 - When the financial reorganization arises out of severe financial difficulties, including bankruptcy, it is very common for there to be a change in control, as the “old” shareholders have relinquished their rights to the assets of the corporation in favour of the creditors
 - *Canadian Airlines was a high profile, recent case*

Comprehensive Revaluation

*Canadian Airlines Corporation
Financial Restructuring*

AIR CANADA



2000 Annual Report

During 2000, Canadian Airlines completed a financial restructuring of its debt, lease and other obligations prior to the completion of the acquisition of Canadian Airlines by Air Canada. The restructuring was approved by the courts in late June 2000. As a result of the restructuring, future payment obligations for debt and aircraft leases were reduced by approximately \$500 million, measured on a present value basis. As well, as a result of the restructuring and the comprehensive revaluation of Canadian Airlines, its shareholders' deficiency prior to the acquisition was lowered by more than \$600 million. As a result of the Canadian Airlines acquisition, the Corporation recorded goodwill of \$502 million which is being amortized over a 40 year period.

- *Significant additional disclosure was provided*

Comprehensive Revaluation

- *Measurement:*
 - Fair market value is the basis for comprehensive revaluation in a business combination
 - *When comprehensive revaluation is applied, push down accounting is also applied*
 - The values of the subsidiary's assets are determined for the consolidated financial statements (*fair value of the parent's share plus book value of the non controlling interest's share*)
 - ***These values are recorded directly on the books of the subsidiary company***

Comprehensive Revaluation

- The comprehensive revaluation of the assets and liabilities of a company, including an application of push down accounting, will always result in the need for an adjustment to shareholders' equity of the revalued company

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- The **net effect of a comprehensive revaluation** (the balancing amount) should be accounted for as a **capital transaction**
 - This amount is recorded as either share capital, contributed surplus, or a separately identified account within shareholders' equity and ***does not flow through the income statement*** of the company

Comprehensive Revaluation

- For push down accounting, **disclosure** requirements in the first period include:
 - the date push-down accounting was applied, and the date or dates of the purchase transaction or transactions that led to the application of push-down accounting;
 - a description of the situation resulting in the application of push-down accounting; and
 - the amount of the change in each major class of assets, liabilities and shareholders' equity arising from the application of push-down accounting
- For three years, pertinent details to be disclosed

Comprehensive Revaluation

- For financial reorganization, **measurement criteria** differ:
 - The new costs of identifiable assets and liabilities of an enterprise comprehensively revalued as a result of a financial reorganization, should reflect the **values established in the negotiation of claims** among non-equity and equity interests and should not exceed the fair value of the enterprise as a whole, if known.

Comprehensive Revaluation

- **Disclosure** criteria are similar:
 - The financial statements for the period in which the financial reorganization took place should disclose the following:
 - The date of the financial reorganization;
 - A description of the financial reorganization; and
 - The amount of the change in each major class of assets, liabilities and shareholders' equity resulting from the financial reorganization
 - The measurement bases of the affected assets and liabilities, for as long as the revalued amounts are significant.

Bankruptcy and Receivership

Bankruptcy and Receivership

- Bankruptcy and Receivership both indicate serious financial difficulty, yet are very different legal situations
- To understand these situations, it is necessary to consider the various types of creditors that a company can have
 - *Secured creditors* hold a mortgage or other lien against a property owned by the debtor, as security for the debt owed to the creditor, and these rights are legally enforceable
 - *Unsecured creditors* hold debt, against which no property has been pledged

Bankruptcy and Receivership

- *Receivership indicates action taken by the secured creditors*
 - This action is similar in nature to the foreclosure on a mortgage: in the event of default on a secured loan, the secured creditor may appoint a receiver/manager to seize the pledged assets
 - It is the duty of the receiver to sell the seized assets in order to pay off the debt, and frequently operates the business during this process, in order to maximize the yield from liquidation
 - Any excess on the sale reverts to the debtor
 - Any deficiency becomes an unsecured liability

Bankruptcy and Receivership

- By contrast, *bankruptcy is initiated by action taken by the unsecured creditors*
- As secured creditors are generally protected by the assets pledged as security, bankruptcy provisions work to the benefit of unsecured creditors
- Under the *Constitution Act*, the federal government has exclusive legislative and administrative authority in the area of bankruptcy and insolvency

Bankruptcy and Receivership

- Control of the bankruptcy and insolvency process is exercised by the Superintendent of Bankruptcy in accordance with the provisions of the *Bankruptcy and Insolvency Act* (BIA)
- Locally, the BIA is administered by a government officer called the official receiver
- The actual bankrupt company or estate is administered by a licensed trustee in bankruptcy, who is a court appointed officer (generally a private sector firm or a person)

Bankruptcy and Receivership

- The BIA confers on the Superintendent of Bankruptcy statutory responsibility for:
 - supervising the administration of estates in bankruptcy, commercial reorganizations and consumer proposals (as alternatives to bankruptcy) and receiverships; maintaining a publicly accessible record of bankruptcy and insolvency proceedings; recording and investigating complaints from creditors, debtors, and the general public; the licensing of private-sector trustees to administer estates; and the setting and enforcement of professional standards in estate administration in order to maintain the integrity of the process.

Bankruptcy and Receivership

- The licensed trustee in bankruptcy:
 - Takes possession of all assets and records
 - Prepares an inventory of assets
 - Takes requisite precautions to safeguard assets, including insurance and physical security
 - Notifies all creditors as to the date and location of the first meeting of creditors
 - Verifies the bankrupt's *statement of affairs*
- The meeting of creditors is chaired by the Official Receiver, who will examine creditors under oath and seek to verify claims

Bankruptcy and Receivership

- Bankruptcy is distinct from insolvency
 - An “insolvent person” means a person who is not bankrupt and who resides, carries on business or has property in Canada, whose liabilities to creditors provable as claims under this Act amount to one thousand dollars, and
 - who is for any reason unable to meet his obligations as they generally become due,
 - who has ceased paying his current obligations in the ordinary course of business as they generally become due, or
 - the aggregate of whose property is not, at a fair valuation, sufficient, or, if disposed of at a fairly conducted sale under legal process, would not be sufficient to enable payment of all his obligations, due and accruing due

Bankruptcy and Receivership

- The provisions of the *Bankruptcy and Insolvency Act* set out the rights accorded to each class of creditors
- The provisions of the Act must be followed carefully, in order that these rights and claims of creditors are honoured precisely in accordance with the law
- An accounting tool very useful in the administration of bankrupts is the *statement of affairs*

Bankruptcy and Receivership

- A company may also take action **voluntarily** under the BIA to enter bankruptcy, in order to gain **temporary protection from creditors**
- The Companies' Creditors Arrangement Act, which is designed to facilitate compromises and arrangements between companies and their creditors, provides similar protection
- Voluntary bankruptcy and arrangements under the CCAA are also administered by the Official Receiver and private sector trustees

Bankruptcy and Receivership

- The Statement of Affairs is a special, extended balance sheet which sets out not only the book values of assets and liabilities, but also provides:
 - Estimated current values of assets
 - Amounts pledged as security and estimated amount available to meet unsecured claims

Bankruptcy and Receivership

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 - Estimated current values of assets
 - Amounts pledged as security and estimated amount available to meet unsecured claims
- The objective of this statement is to provide a **summary analysis of the financial position** of the firm and of the **prospects of the various categories of creditors** in liquidation

International View

- Bankruptcy and receivership provisions in each country are subject to the laws and practices of that particular country
- Most developed countries have statutes and domestic administrative practices which govern the administration of bankrupt companies and estates
- In less developed countries, provisions are less systematic and, in some cases, do not exist at all

Reference

Secord, Peter. 2003. *Modern Advanced Accounting*.
Canada: McGraw-Hill.