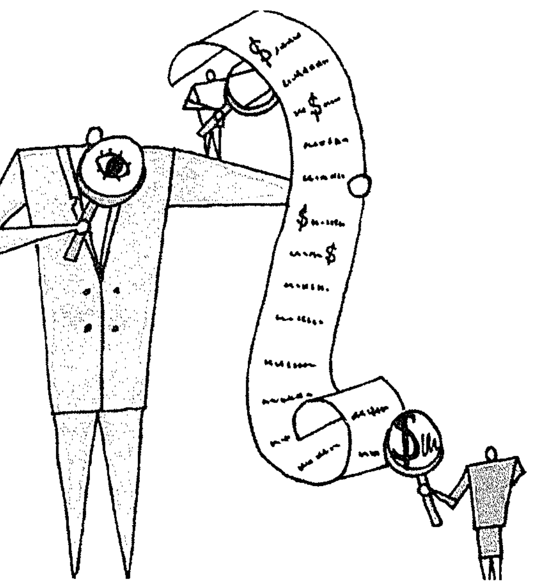
Focus BUSINESS LAW

Buying a company? Think assets or shares

Steven Polisuk

When contemplating the purchase of a business, a due diligence investigation is important in order to highlight the benefits and pitfalls. As a first step in the process, it is necessary to determine whether the acquirer is purchasing the assets or shares of the target company, as there are material differences in approach with respect to a purchase and sale of assets versus that of shares.



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Asset purchase

In most cases an acquirer prefers to purchase the assets in order to write up asset values to their fair market value and then have the future benefit of a higher tax base for the purposes of claiming capital cost allowance (CCA), thereby reducing future income taxes payable. Furthermore, by purchasing assets, a purchaser only acquires those assets it wants, and is not responsible for any existing, contingent or unknown liabilities of the company save for those specifically attached to the asset(s) acquired.

It also is important to determine whether any third parties have an interest in the assets, such as creditors or government bodies. Where land and buildings are part of the purchase, a title search should be conducted to identify the owner of the property and any liens thereon. The purchaser will likely require an appraisal to assess its fair market value. Appraisals may also be required to value the target's inventory, machinery and equipment if these assets form a material part of the transaction.

It is also prudent to have an environmental assessment of the land to identify the presence, if any, of environmental hazards. If the purchaser is financing the acquisition, the financial institution will likely require that an environmental assessment be undertaken.

Other assets that may be acquired, including inventory, will have to be examined for saleability and obsolescence. Inventory should be counted to confirm that the physical inventory agrees with the target company's records. Capital assets such as machinery and equipment will also have to be appraised and inspected for their value and expected remaining useful life.

Share purchase

Vendors normally prefer to sell shares, as the proceeds (in excess of the adjusted cost base) are generally considered a capital gain, and are taxed more favourably than other forms of income. Only 50 per cent of the gain is included in income. Also, if the shares are those of a "qualified small business corporation," the seller may be eligible to receive up to $750,000 in capital gains ($375,000 of taxable gains) tax-free. Effective Jan. 1, this exemption increases to $800,000.

In a share purchase, the purchaser is in effect stepping into the shoes of the shareholder vendor. The purchaser may be responsible for many different liabilities such as payroll taxes, income taxes, harmonized sales tax and other. These pitfalls can be avoided by reviewing the target company's tax remittances and statements provided by the various government bodies.

The purchaser may also wish to have a legal due diligence conducted to uncover liens, contingencies or lawsuits for which the purchaser may become responsible. The purchaser will assume responsibility for the target company's employees who are retained and will not be able to dismiss those employees it may consider to be redundant. Longstanding employees will be entitled to compensation and other entitlements such as pensions. If the target company has a unionized workplace, the terms of the union contract should be reviewed to uncover clauses or terms that will negatively affect operations going forward. As part of the purchase and sale agreement, the status of the target company's employee relationships will be subject to negotiation between the parties, with the vendor paying for some of these costs on closing.

An important area to examine as part of the share purchase is the revenue component. The quality of the earnings must be measured and reviewed, including who are the clients/customers, and any contracts that may be in place, including those with suppliers and clients. Other issues to consider are economic dependence on key clients (or suppliers), the loss of whom could impact the business. The purchaser should request and review a summary of sales and gross profit (that agrees to the financial statements) by customer for the past three years for indications of growth or reduction in year-to-year customer sales.

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Earnings should be adjusted for non-recurring and unusual items such as gains or losses on the disposition of capital assets, and write-ups or write-downs in the value of other assets. A company that deals with foreign exchange in its sales and/or purchases can have a gain or loss unrelated to its core business. Related party transactions are an area that requires scrutiny as these transactions may inflate the sales, reduce costs or not be available to the purchaser after closing.

The expenses of the target company should be examined. A summary of several years' results can be compiled and then reviewed for patterns or unusual items. For example: an increase in professional fees may be an indication of a lawsuit against the company, or a decrease in margin may indicate a problem with inventory or an increase in costs that will affect profitability.

A due diligence investigation is an important safeguard when considering the acquisition of a target company's assets or shares. It will provide invaluable assistance in making a decision to buy or not, and if the asking price is justified.

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Bill would allow guns made of food in schools

A new bill introduced in the Oklahoma state legislature includes allowing the "brandishing of a pastry or other food which is partially consumed in such a way that the remnant resembles a weapon" in schools, Tulsa TV station KJRH reports. Among its eight gun-related provisions, The Common Sense Zero Tolerance Act also seeks to give students the right to bring toy weapons to school, use a finger or hand to simulate a weapon, draw a picture of a gun and vocalize imaginary firearms. Bill 2351, introduced by Oklahoma City Republican representative Sally Kern, was deemed necessary "for the preservation of the public peace, health and safety" – a reference to an incident in which a 7-year-old in Baltimore, Md., was suspended for shaping his Pop-Tart into a gun at school. If passed, the act would become law July 1. – **STAFF**