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IFRS® Standard 3 Business Combination

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CASE STUDY – IFRS 3 BUSINESS COMBINATION

Introduction

Business combinations occur for a variety of reasons, including resources, production processes or human capital required by the business. First of all, it needs to be determined whether a contract could be identified as a business combination. Second, it needs to be identified whether the IFRS 3 should be applied and whether a business combination transaction is covered by the scope of IFRS 3.

Aim of this case study is to familiarize the students with the issues of business combination transitions and how they affect the financial statements. Thus, this case study introduces the following issues:

- How to identify the differences between the purchase of assets and business combination?
- Why it is important to identify the acquirer and the acquisition date?
- How to evaluate the acquired assets and liabilities, what effect will there be in the acquirer's financial statements

The Case Information

Company "Delicious Food" (DF) produces frozen food that complies with the standards of high nutritional standards and uses only the highest quality ingredients. The main range of DF products includes daily lunch meals (e.g.: meatballs, soups, etc.). DF has decided to expand its range to include exotic dishes such as frozen clam chowder, octopus and more. This resulted in an agreement to make a business combination with company "Queen's Sea Food" (QSF) with all of its managed equipment and the business model.

On 31 December 20x0, company DF acquires all assets and liabilities of company QSF by issuing 40,000 units of shares of company DF. Before this agreement, company DF owned 160,000 units of shares and after the transaction, it will have 200,000 shares in total. According to the agreement, 20% of the shares will be owned by company QSF. In the example below, the balance sheets of both companies are presented:

Items	**Company DF** **31 December 20x0, CU**	**Company QSF** **31 December 20x0, CU**
Cash	1,000,000	50,000
Receivables	2,000,000	150,000
Inventory	200,000	50,000
Land	1,000,000	300,000
Buildings and equipment	3,000,000	500,000
Accumulated deprecation	(1,200,000)	(150,000)
TOTAL ASSETS:	**6,000,000**	**900,000**
Non-current liabilities	1,000,000	100,000
Current liabilities	400,000	-

Equity (shares)	2,600,000	200,000
Profit (Loss)	2,000,000	600,000
TOTAL EQUITY AND ASSETS	**6,000,000**	**900,000**

When acquiring the business, company DF measured the fair value of the assets acquired and liabilities assumed from company QSF. The estimated fair value is set out below:

Article	**Fair value** **31 December 20x0, CU**
Cash	50,000
Receivables	150,000
Inventory	50,000
Land	400,000
Buildings and equipment	550,000
Non-current liabilities	(100,000)
TOTAL NET ASSETS:	**1,100,000**

Taking into the account that the market value of the shares of company DF is CU30, the total acquisition price of the new shares shall be 1.2 million CU (400,000 shares x CU30).

Discussion Questions

1. Explain whether the situation presented can be considered a business combination. Identify the steps Company DF will take after acquiring Company QSF.
2. Measure the goodwill in Company DF after taking the assets and acquiring liabilities of Company QSF.
3. Identify whether the company acquired QSF will receive gain or loss after the business combination?
4. Please present the entry record which will be made in the accounts of the acquiring company DF on the acquisition date. Prepare the statement of financial position after the business combination.
5. Please present the entry record which will be made in the accounts of the acquiree company QSF on the acquisition date. Prepare the statement of financial position after the business combination.

SOLUTION OF CASE STUDY – IFRS 3 BUSINESS COMBINATION

Given that Company DF does not invest in Company QSF or does not purchase the assets of Company QSF, under the situation presented, Company DF acquired the assets and liabilities of Company QSF. Therefore, this case study will be treated as that of a business combination under the given situation. In case of a business combination, Company DF must (1) identify the acquisition date; (2) assess the fair value of the assets and liabilities to be acquired; (3) make a record of the assets and liabilities acquired; and (4) prepare financial statements.

Taking into consideration the value of the shares, the value of the assets taken, and the liabilities acquired, goodwill can be measured, and a transaction entry can be recorded in the accounts. Goodwill is measured as the difference between the cost of the business and the fair value of the net assets acquired:

Goodwill = Cost of acquisition – The net asset fair value of the acquiree
Cost of acquisition is new shares amounting to 1.2 million CU (400,000 shares x CU30). The net asset fair value of the acquiree is 1.1 million CU. Goodwill = 1,200,000 – 1,100,000 = CU100,000

An entry will be made in the accounts of the acquiring company DF for the date of the business combination:

Dr. Cash	50,000	
Dr. Receivables	150,000	
Dr. Inventory	50,000	
Dr. Land	400,000	
Dr. Buildings and equipment	550,000	
Dr. Goodwill	100,000	
Cr. Shares		1,200,000
Cr. Cr. Non-current liabilities		100,000

Meanwhile, the company QSF selling the business will record the transaction by writing off all of its assets and liabilities and introducing the acquisition of new shares and recognizing the gain on the transaction. It should be noted that after the transfer of assets and liabilities, the only remaining assets are the shares acquired.

This transaction is not considered an investment between the respective companies, as company DF acquires assets and liabilities directly rather than by purchasing target shares. Company QSF is not considered a subsidiary of Company DF. Based on these facts, company QSF will calculate the gain and record the entry. Gain would be calculated as the difference between the values of the consideration (shares) received and the value of the assets and liabilities transferred:

Gain = Cost of acquisition – The net asset balance value
Cost of acquisition is new shares is 1.2 million CU (400,000 shares x CU30). The net asset balance value is CU0.8 million. Gain = 1,200,000 – 800,000 = CU400,000

An entry will be made in the accounts of the acquiree company QSF for the date of the business combination:

Dr. Financial assets (shares)	1,200,000	
Dr. Non-current liabilities	100,000	
Dr. Accumulated Depreciation	150,000	
Cr. Cash		50,000
Cr. Receivables		150,000
Cr. Inventory		50,000
Cr. Land		300,000
Cr. Buildings and equipment		500,000
Cr. Gain		400,000

The financial statements of both companies have changed since the transaction.

Item	**Company DF 31 December 20x0, CU**			**Company QSF 31 December 20x0, CU**		
	Before transaction	**Changes**	**After transaction**	**Before transaction**	**Changes**	**After transaction**
Cash	1,000,000	+50,000	1,050,000	50,000	-50,000	
Receivables	2,000,000	+150,000	2,150,000	150,000	-150,000	
Inventory	200,000	+50,000	250,000	50,000	-50,000	
Land	1,000,000	+400,000	1,400,000	300,000	-300,000	
Buildings and equipment	3,000,000	+550,000	3,550000	500,000	-500,000	
Accumulated deprecation	(1,200,000)		(1,200,000)	(150,000)	+150,000	
Financial assets					+1,200,000	1,200,000
Goodwill		+100,000	100,000			
TOTAL ASSETS:	**6,000,000**		**7,300,000**	**900,000**		**1,200,000**
Non-current liabilities	1,000,000	+100,000	1,100,000	100,000	-100,000	
Current liabilities	400’000		400,000	-		
Equity (shares)	2,600,000	+1,200,000	3,800,000	200,000		200,000
Profit (Loss)	2,000,000		2,000,000	600,000	+400,000	1,000,000
TOTAL EQUITY AND ASSETS	**6,000,000**		**7,300,000**	**900,000**		**1,200,000**

Depending on the nature of the transaction, company QSF could continue its activities or be liquidated.