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IFRS® Standard 3 Business Combinations

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IFRS® Standard 3 Business Combination

Scope and Key Definitions

Business combinations are made due to various economic reasons in order to gain a market advantage, acquire equipment or inventory, to use human resources, reduce costs, etc. There are different models of business combinations, which will have different merging results. The results of business combinations provide benefit at the time of the combination or in the future through the returns generated. The business combination must be properly reflected in the financial statements and important information must be disclosed to users.

IFRS® Standards set out the requirements for recognizing and measuring the assets acquired and liabilities assumed by an entity and how it must be presented in the financial statements. In the case of a business combination where the price paid differs from the fair value of the inherited asset and liability, goodwill must be measured and recognized in accordance with IFRS Standards. The IFRS Standards prescribe what information is relevant to a business combination that affects and should be disclosed to users.

<u>Key definitions (IFRS 3.AppendixA):</u>

Acquiree – is the business or businesses that the acquirer obtains control of in a business combination

Acquirer – the entity that obtains control of the acquire.

Acquisition date – the date when the business combination was made, and control was transferred to the acquirer.

Business – an integrated set of activities and assets that is used to provide goods or services to customers that generate investment income or other operating income.

Business combination – a transaction or other event in which an acquirer obtains control of one or more businesses. Transactions sometimes referred to as ‘true mergers’ or ‘mergers of equals’ are also business combinations as that term is used in IFRS Standard 3 Business combination.

Fair value – is the price that would be received for selling an asset or paid to transfer a liability between market participants.

Goodwill – the assets acquired from the business combination representing the future economic benefits that are separately recognized as assets.

Fundamental Issues: Recognition

IFRS 3 does not apply to the following provisions: the cases of a joint arrangement; the acquisition of an asset that is not a business and thus the transaction does not create goodwill; a combination of jointly controlled entities and an investment in a subsidiary.

A business combination is accounted for using the acquisition method, this method of accounting is used when an entity acquires another entity, and the difference between the business purchase price and the fair value is measured as goodwill. If a business combination agreement happens, the following four-step acquisition method needs to take place (see Figure 1).

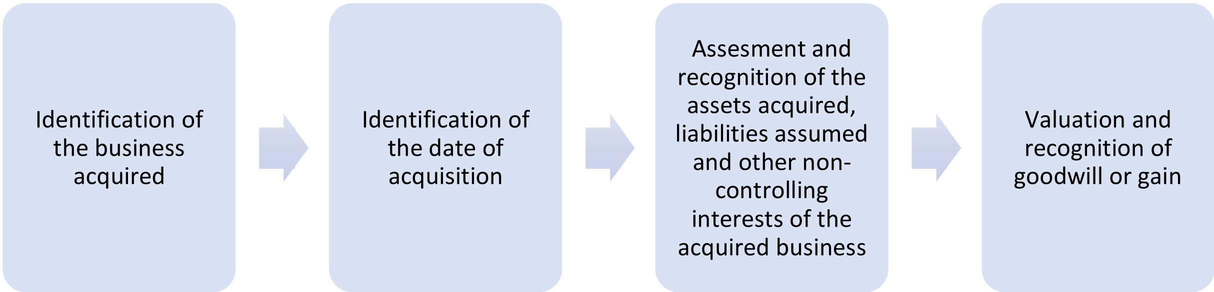


Figure 1. The acquisition method steps for businesses combination recognition

First, it is needed to identify the acquirer and assess whether an agreement includes the definition of a business combination. After identification of the entity acquiring the business and entity transferring the business, it is necessary to identify the date of acquisition. The date of the business combination is needed to account for the transaction and the acquirer shall disclose the date on which the control of the entity will be taken. The date of a business combination is usually the date on which the consideration for the assets acquired and liabilities assumed was transferred. This date is considered to be the closing date of the business in question. In some cases, the date of the consideration paid may differ from the control of the asset and liability assumed. This may be provided for in a written contract and all facts and circumstances must be taken into account. After the date of the business combination identification, the assets taken and the liabilities assumed are measured. Recognition of goodwill is determined on the acquirer's side. Business combination may be a bargain purchase when a gain is recorded.

According to the principle of recognition, it is important to identify any non-controlling interest in the acquirer. In the case of a business combination, the components of the acquiree's non-controlling interests (current ownership; owner's right to a proportionate share of the net assets of the acquiree) shall be measured at fair value and the proportionate share of the current equity in the acquiree's identifiable net assets. All other components of the non-controlling interest shall be measured at fair value at the acquisition date.

Fundamental Issues: Measurement

It is important to identify the applicable model in a business combination. Depending on the business combination models a new entity can be formed or one of the entities can be liquidated.

Table 1. Examples of business combination forms

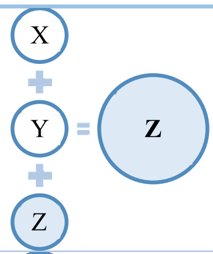
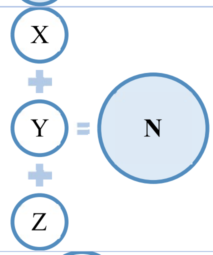
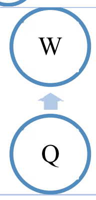
Legal form	Explanation	Illustration
The entities are merged into one entity	One or more entities (X, Y) are merged with another entity (Z) which continues activity, and the merged entities (X, Y) are liquidating.	
The entities transfer their net assets to a newly-formed entity	One or more entities (X, Y, Z) are formed into one new entity (N), and the other entities are liquidating.	
Acquisition of the business part	The acquirer (W) must continue the same business using the assets acquired. Following the business combination, the two entities (W, Q) continue to operate and remain independent of each other.	

Table 1 provides examples of forms of business combinations, but in practice, there can be many different business combination cases found. Cases of a business combination may differ in whether or not the acquirer acquires control of another entity (see Table 2).

Table 2. Acquisition of control of another entity after a business combination

Situation	A business acquisition is entered into between the acquiring entity Z and the entity selling the business Q. Entity Z agrees to pay CU10,000 and to take over 10,000 shares of entity Q valued at CU5. Following the business combination, entity Z takes the assets and liabilities from entity Q and entity Q will be liquidated.
Results	*As not only the price is paid for the business combination but also all the shares are taken over, entity Z acquires control of entity Q.*

In case of business combination, one needs to know the measurement methods which are used for measuring the assets acquired and liabilities assumed. The price paid for business combination could be higher as the value of assets acquired and liabilities assumed, and finally goodwill is assessed.

As mentioned above, in the case of a business combination, the acquisition method is applied. In order for the acquisition method to be applied, the assets acquired and the liabilities assumed at the acquisition date must be in line with the definitions of assets and liabilities according to the conceptual framework of financial reporting. It should be noted that in the case of an exchange in a business combination, the assets acquired and liabilities assumed are recorded under the acquisition method and not as a result of the transaction.

IFRS 3 sets the recognition and measurement principles for accounting for business combinations. The principle of recognition is used to identify assets, liabilities and non-controlling interests which are recognized separately from goodwill. The principle of measurement means that assets and liabilities are measured at fair value on the business combination acquisition date.

Assets acquired and liabilities assumed shall be measured at fair value. The methods used to determine fair value are defined in IFRS Standard 13 Fair Value Measurement. Determining fair value is significant to measuring goodwill. Goodwill is measured as the difference between the consideration transferred for a business combination and the fair value of the identifiable assets and liabilities. The calculation of goodwill can be expressed in formulas. Depending on the complexity of the business combination, a simplified calculation can be distinguished (see Fig. 2) and when the business combination is more complex, this involves more components (see, Fig. 3).

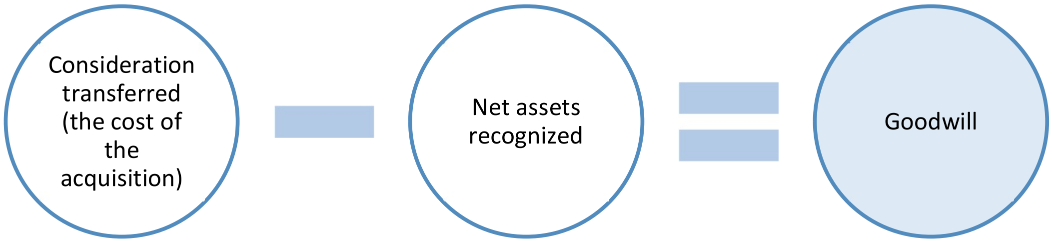


Figure 2. Goodwill calculation in a simplified business combination

Amounts paid at the acquisition date, other assets transferred, liabilities and equity instruments issued and all costs directly attributable to the business combination constitute the consideration transferred. Net assets mean the acquired entities assets minus liabilities, which are measured at fair value. Goodwill is calculated by deducting net assets from the consideration transferred. Table 3 provides an example of goodwill calculation.

Table 3. Example of goodwill calculation

<table>
<tr><th>Example of a situation</th><th>Goodwill calculation</th></tr>
<tr><td>Entity Q has simple statement of the financial position structure:
<table><tr><td>Land CU12,000</td><td>Equity CU7,000
Liabilities CU5,000</td></tr></table>In business combination case, the entity W takes the assets and liabilities. Entity W agrees to pay CU8,000.</td><td><u>Consideration transferred</u> = CU8,000
<u>Net assets recognized</u> = assets CU12,000 – liabilities CU5,000 = CU7,000
<u>Goodwill</u> = CU8,000 – CU7,000 = CU1,000

Entity W will record in the financial statements the assets acquired, the liabilities assumed and the goodwill of CU1,000.</td></tr>
</table>

If the acquisition is made in several stages, then the previous equity interests should be taken into account when assessing goodwill (see, Fig. 3).

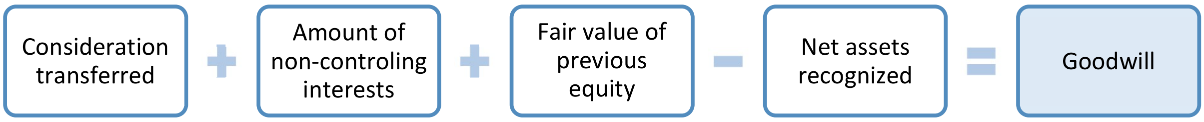


Figure 3. Goodwill calculation in complex business combination

As mentioned above, two methods can be used to determine the non-controlling interest: fair value or the proportionate share of the current equity of non-controlling interest. If the entity has not had a pre-emptive ownership of another entity and acquired a controlling interest which is in line with definition of a business combination, then there is a need not only to recognize the assets acquired and goodwill, but also measure the non-controlling interest as well (see Table 4).

Table 4. Example of non-controlling interests amount calculation

<table>
<tr><th colspan="2">Example of measuring non-controlling interest (minority interest)</th></tr>
<tr><td colspan="2"><u>Situation:</u>
Entity P acquires 75% of the shares of entity Q for CU120,000. The net assets book value of entity Q is CU90,000. The fair value of entity Q net assets was determined at CU90,000.</td></tr>
<tr><td><u>Solution (1):</u>
Non-controlling interests (NCI) = CU90,000 x 25% = CU22,500
Net assets recognized = CU90,000
Goodwill = CU120,000 + CU22,500 – CU90,000 = CU52,500

The record:
Dr. Net assets CU90,000
Dr. Goodwill CU52,500
Cr. Consideration CU120,000
Cr. NCI CU22,500</td><td><u>Solution (2):</u>
Non-controlling interests (NCI) = CU120,000 x 25%/75% = CU40,000
Net assets recognized = CU90,000
Goodwill = CU120,000 + CU40,000 – CU90,000 = CU70,000

The record:
Dr. Net assets CU90,000
Dr. Goodwill CU70,000
Cr. Consideration CU120,000
Cr. NCI CU40,000</td></tr>
</table>

As shown in Table 4, non-controlling interests (also, known as minority interests) may be measured using different methods, which affect the value of the goodwill recognized.

However, not all business combinations generate goodwill. When a business combination price is lower than the estimated net asset value, the entity recognizes a gain on the acquisition. Recognition of a gain requires a reassessment of the value of the assets acquired, liabilities assumed, and review procedures used to measure amounts (see Fig.4).

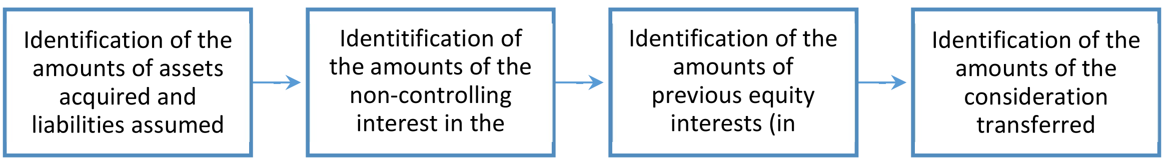


Figure 4. The review procedures in bargain purchase of business combination

If, after performing the procedures presented in Figure 4 the gain surplus remains, then the acquirer shall recognize the purchase result as gain. The bargain purchase can be a case of the forced business combination. Table 5 provides an example of how gains are measured in the case of a bargain purchase.

Table 5. Example of bargain purchase

Stages of a business combination	Examples
Acquisition of a business	Entity Z acquires the assets of entity Q and takes liabilities for CU14,000 in cash. The estimated fair value of the assets is CU20,000 and the value of the assumed liabilities is CU4,000.
Valuation and recognition of goodwill or gain	The fair value of net assets is CU16,000 (CU20,000 – CU4,000) when for business is paid CU14,000. As a result, it is considered a bargain purchase and gain must be measured.
Identification of the amounts of assets acquired and liabilities assumed	The net asset value is reviewed again. Following the review, entity Z adjusted the value of the identifiable net assets acquired to CU15,000.
Recognition of bargain purchase gain	Entity Z should recognize a CU1,000 (CU15,000 – CU14,000) bargain purchase gain, which is the difference between the consideration transferred to entity Q and the net asset value.

It should be noted that costs associated with a business combination, such as consultancy fees, legal or accounting costs, translation or other fees, should be recognized as an expense in the period in which they have incurred.

Fundamental Issues: Derecognition and /or Procedures

In assessing a business combination, it is necessary to consider whether a relationship existed between the acquirer and the acquiree. All amounts that are not related to the business combination must be determined. Under the acquisition method, only the consideration transferred for the business combination and the assets received and liabilities assumed in exchange are recognized. The following transactions are excluded applying the acquisition method:

- Excludes transactions that settle the pre-existing relationships between acquirer and acquiree.
- Excludes transactions that remunerate employees or owners for future services.
- Excludes transactions that are intended to reimburse the acquiree or its former owners for the costs incurred by the acquire.

Following a business combination, the acquirer shall subsequently measure and account the assets acquired, liabilities assumed, and equity instruments issued in accordance with the provisions of other IFRS Standards, taking into account their nature (e.g. reacquired rights, contingent liabilities, contingent consideration, indemnification assets).

The consideration transferred can be adjusted, if changes of costs were provided in the business combination agreement. The consideration transferred is adjusted for future events, if those events are probable in the future and can be measured reliably at the acquisition date. For example, the business combination agreement defines maintaining a certain level of profit in future.

Often, the amount of the cost adjustment can be estimated before accounting for the business combination and without compromising the reliability of the information. However, if future events do not occur and the consideration transferred changes, it shall be adjusted.

A business combination agreement may provide the cases of cost adjustment in which the adjustment is not recognized in accounting for the combination date, if it is not probable or cannot be estimated reliably. An additional adjustment is made when a reliable estimate becomes available or the event becomes probable.

Disclosures

It is necessary to disclose the cases of business combinations to the users of the financial statements. Significant information about acquiring a business is provided for users, so they can assess the nature and the financial effect of the business combination during or after the end of the reporting period but before the financial statements are authorised for issue. Financial statements should disclose the adjustments to the consideration transferred and provide significant information if those adjustments have had an effect on the entity's financial position. There are cases in which a business combination requires to compensate any subsequent impairment as a compensation to the seller. Such compensation is not included in the consideration transferred, but is significant to users of financial statements and must be disclosed.

Business combination information should be disclosed widely to users of financial statements, and Figure 5 presents the information that should be disclosed.

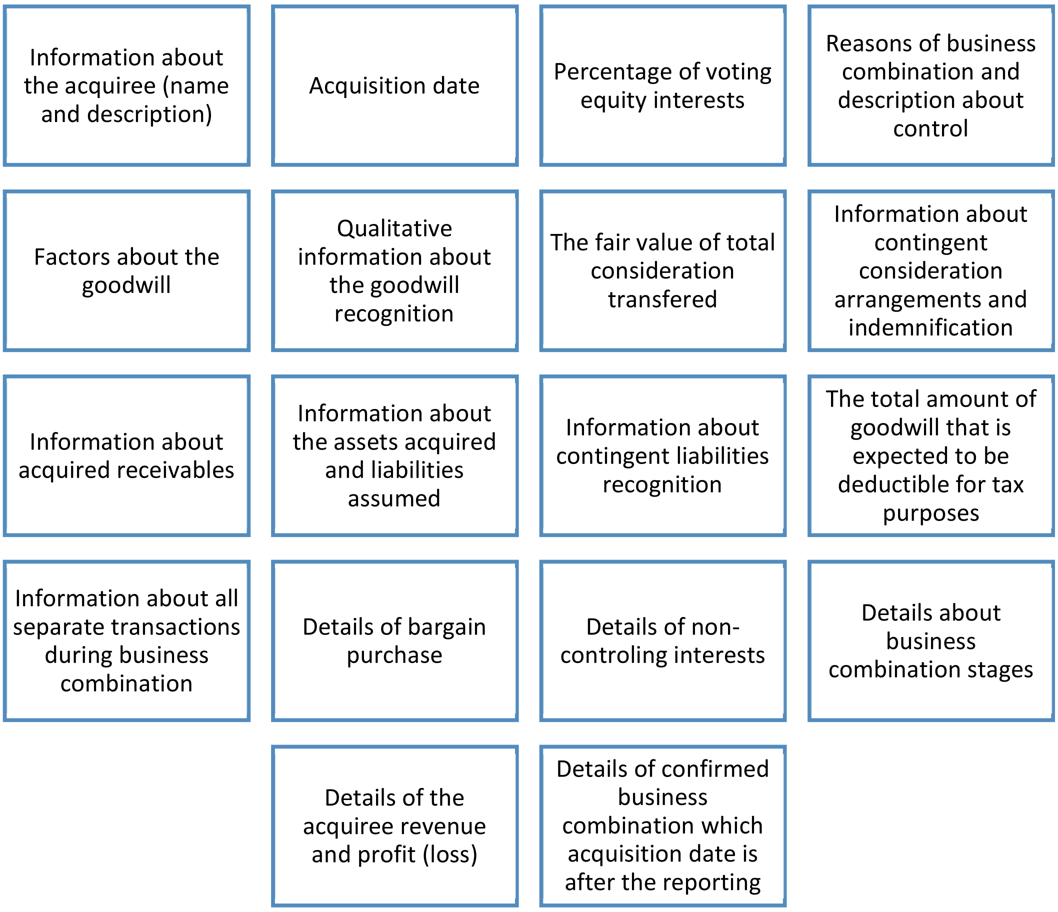


Figure 5. Business combination disclosures in the financial statements

The notes to the financial statements should disclose various details of the business combination, including the fair value of the net assets identified, the goodwill identified and the non-controlling interest. Another relevant information is provided as a bargain purchase or a gradual purchase (in stages). Information about the acquiree of the business must also be disclosed in detail, including name, description, revenue, profit or loss.

Examples

Example No. 1

We have a simple structure of statement of the financial position of entities A and B. Entity A acquires all assets and liabilities of entity B by issuing 10,000 units shares of entity A. Before this agreement, entity A had 90,000 units shares and after the transaction, it will have 100,000 shares in total. According to the agreement, 10% of the shares will be owned by entity B.

In the example below, the statement of the financial positions of both entities are presented on the date of the acquisition:

	Entity A, CU	Entity B, CU
Inventory	100,000	50,000
Cash	50,000	10,000
TOTAL ASSETS:	**150,000**	**60,000**
Equity (shares)	120,000	30,000
Profit (Loss)	10,000	20,000
Short-term liabilities	20,000	10,000
TOTAL EQUITY AND LIABILITIES	**150,000**	**60,000**

In acquiring the business, entity A measured the fair value of the assets acquired and liabilities assumed from entity B. The estimated fair value for inventory was set at CU40,000 and the fair value of the liabilities matched the balance value.

Knowing that the market value of the shares of entity A is CU10, the total acquisition price of the new shares is CU100,000 (10,000 shares x CU10). 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 CU100,000 The net asset fair value of the acquiree is CU40,000 (Inventory CU40,000 + Cash CU10,000 – Liabilities CU10,000) **Goodwill = CU100,000 – CU40,000 = CU60,000**

Meanwhile, the entity B 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. If the transaction had been paid for in cash, the only remaining assets in entity Q would have been cash.

Entity B 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 CU100,000 The net asset balance value is CU50,000 (Inventory CU50,000 + Cash CU10,000 – Liabilities CU10,000) Gain = CU100,000 – CU50,000 = CU50,000

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

	Entity A, CU			Entity B, CU		
	Before transaction	Changes	After transaction	Before transaction	Changes	After transaction
Financial assets (shares)	-			-	+100,000	100,000
Goodwill		+60,000	60,000			-
Inventory	100,000	+40,000	140,000	50,000	-50,000	-
Cash	50,000	+10,000	60,000	10,000	-10,000	-
TOTAL ASSETS:	**150,000**	**+110,000**	**260,000**	**60,000**	+40,000	**100,000**
Equity (shares)	120,000	+100,000	220,000	30,000		80,000
Profit (Loss)	10,000		10,000	20,000	+50,000	20,000
Short-term liabilities	20,000	+10,000	30,000	10,000	-10,000	-
TOTAL EQUITY AND LIABILITIES	**150,000**	**+110,000**	**260,000**	**60,000**	**+40,000**	**100,000**

Depending on the nature of the transaction, entity B could continue its activities or be liquidated.

Example No. 2

Under the agreement made on 31 December 20x0, entity A acquires entity B. Entity B is liquidated after the business acquisition. Entity A agreed to pay CU150,000 to entity B. After the business combination, entity A takes the assets, receivables and liabilities from entity B and the latter the entity B will be liquidated.

In the example below, the statement of the financial positions of both entities are presented:

	Entity A 31 December 20x0, CU	Entity B 31 December 20x0, CU
Land	1,000,000	100,000
Inventory	150,000	-
Receivable amounts	330,000	150,000
Cash	220,800	-
TOTAL ASSETS:	**1,700,800**	**250,000**
Equity (shares)	700,000	55,000
Profit (Loss)	80,000	55,000
Long-term liabilities	500,000	-
Short-term liabilities	420,800	140,000
TOTAL EQUITY AND LIABILITIES	**1,700,800**	**250,000**

It is known that the receivables and liabilities of entity B are presented in the statement of the financial position at fair value. Taking into consideration 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	Payment CU150,000
The net asset fair value of the acquiree	The net asset fair value of the acquiree is CU110,000 (Land CU100,000 + Receivable amounts CU150,000 – Short-term liabilities CU140,000)
Goodwill	Goodwill = CU150,000 – CU110,000 = CU40,000

An entry will be made in the accounts of the acquiring entity A for the date of the business combination:

Dr. Goodwill CU40,000
Dr. Land CU100,000
Dr. Receivable amounts CU150,000
    Cr. Cash CU150,000
    Cr. Short-term liabilities CU140,000

Meanwhile, the entity B selling the business will record the transaction by writing off all of its assets and liabilities and recognizing the gain on the transaction. It should be noted that after the transfer of assets and liabilities, the only remaining assets in entity B is cash.

This transaction is not considered an investment between entities, since entity A acquires assets and liabilities directly rather than by purchasing target shares. Entity B is not considered a subsidiary of entity A. Based on these facts, entity B 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	Payment CU150,000
The net asset balance value	The net asset balance value is CU110,000 (Land CU100,000 + Receivable amounts CU150,000 – Short-term liabilities CU140,000)
Gain	Gain = CU150,000 – CU110,000 = CU40,000

An entry will be made in the accounts of the acquiree entity B for the date of the business combination:

Dr. Cash CU150,000
Dr. Short-term liabilities CU140,000
    Cr. Land CU100,000
    Cr. Receivable amounts CU150,000
    Cr. Gain CU40,000

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

	Entity A 31 December 20x0, CU			Entity B 31 December 20x0, CU		
	Before transaction	Changes	After transaction	Before transaction	Changes	After transaction
Land	1,000,000	+100,000	1,100,000	100,000	-100,000	-
Goodwill	-	+40,000	40,000	-		-
Inventory	150,000		150,000	-		-
Receivable amounts	330,000	+150,000	480,000	150,000	-150,000	-
Cash	220,800	-150,000	70,800	-	+150,000	150,000
TOTAL ASSETS:	**1,700,800**	**+140,000**	**1,840,800**	**250,000**	-100,000	**150,000**
Equity (shares)	700,000		700,000	55,000		95,000
Profit (Loss)	80,000		80,000	55,000	+40,000	55,000
Long-term liabilities	500,000		500,000	-		-
Short-term liabilities	420,800	+140,000	560,800	140,000	-140,000	-
TOTAL EQUITY AND LIABILITIES	**1,700,800**	**+140,000**	**1,840,800**	**250,000**	**-100,000**	**150,000**

Entity B will be liquidated.