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Passport to IFRS®

IFRS® Standard 3 Business Combinations

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Why Business Combinations are Needed?

What is the Business Combination?

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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

The Role of Goodwill in a Business Combination

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

Recognition of Business Combination

- 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.

What are the Steps of the Acquisition Method for Business Combination Recognition?

Identification of the business acquired →

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1. Identification of the business acquired
2. Identification of the date of acquisition
3. Assesment and recognition of the assets acquired, liabilities assumed and other non-controlling interests of the acquired business

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Identification of the business acquired

Identification of the date of acquisition

Assesment and recognition of the assets acquired, liabilities assumed and other non-controlling interests of the acquired business

Valuation and recognition of goodwill or gain

What are the Types of Business Combinations?

The entities are merged into one entity

The entities transfer their net assets to a newly-formed entity

Acquisition of the business part

Business Combination – The Entities are Merged into One Entity

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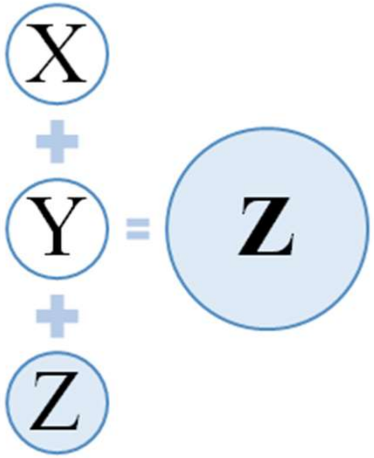

Business Combination – The Entities Transfer Their Net Assets to a Newly-formed Entity

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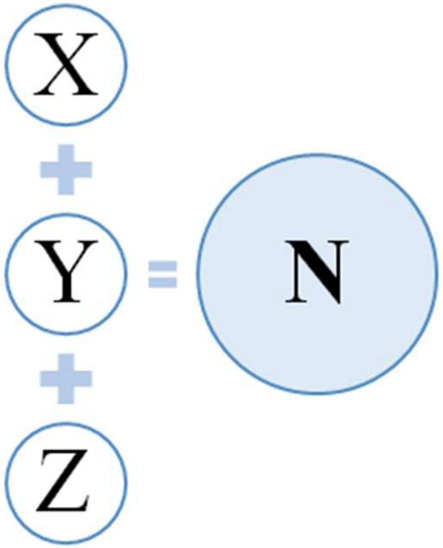
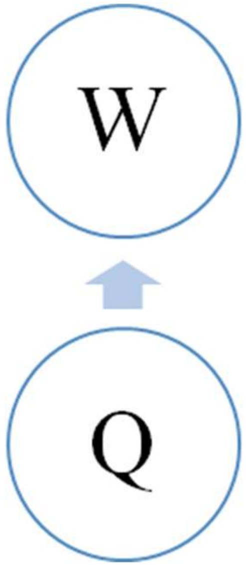


Business Combination – Acquisition of the business part



The Acquisition Method

- 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 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.

The Recognition and Measurement Principles

- The **principle of recognition** is used to identify assets, liabilities and non-controlling interests which are recognized separately from goodwill.

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- The **principle of measurement** means that assets and liabilities are measured at fair value on the business combination acquisition date.

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

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Consideration transferred

Amount of non-controling interests

Fair value of previous equity interests

Net assets recognized

Goodwill

Example of Goodwill Calculation

Situation

Land CU12,000	**Equity CU7,000** **Liabilities CU5,000**

In business combination case, the entity W takes the assets and liabilities. Entity W agrees to pay **CU8,000**.

Example of Goodwill Calculation

Solution

- **Consideration transferred = CU8,000**

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- Consideration transferred = CU8,000
- Net assets recognized = assets CU12,000 – liabilities CU5,000 = CU7,000
- **Goodwill = 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.

Determination the Non-controlling Interest

Example of Non-controlling Interests Amount Calculation

Situation

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.

Example of Non-controlling Interests Amount Calculation

<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

Example of Non-controlling Interests Amount Calculation

Solution (1)

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 is registered:

Dr. Net assets CU90,000

Dr. Goodwill CU52,500

Cr. Consideration CU120,000

Cr. NCI CU22,500

Example of Non-controlling Interests Amount Calculation

Solution (2)

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

Example of Non-controlling Interests Amount Calculation

Solution (2)

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 is registered:

Dr. Net assets CU90,000

Dr. Goodwill CU70,000

Cr. Consideration CU120,000

Cr. NCI CU40,000

Example of Non-controlling Interests Amount Calculation

Article	Solution (1)	Solution (2)
Goodwill	52,500	70,000
NCI	22,500	40,000

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Identification of the amounts of the consideration transferred

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.

Example of Bargain Purchase

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Valuation and recognition of goodwill or gain	The fair value of net asset is CU16,000 (CU20,000 – CU4,000) when for business is paid 14,000. As a result, it is considered a bargain purchase and gain must be measured.

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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 (16,000 – 15,000) bargain purchase gain, which is the difference between the consideration transferred to entity Q and the net asset value.

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- Excludes transactions that are intended to reimburse the acquiree or its former owners for the costs incurred by the acquire.

Disclosures

- **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**

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- 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.**

Disclosures

- Information about the acquiree (name and description)
- Acquisition date
- Percentage of voting equity interests
- Reasons of business combination and description about control
- Factors about the goodwill
- Qualitative information about the goodwill recognition
- The fair value of total consideration transfered
- Information about contingent consideration arrangements and indemnification
- Information about acquired receivables
- Information about the assets acquired and liabilities assumed
- Information about contingent liabilities recognition
- Information about total amount of goodwill
- Information about all separate transactions during business combination
- Details of bargain purchase
- Details of non-controling interests
- Details about business combination stages
- Details of the acquiree revenue and profit (loss)
- Details of confirmed business combination which acquisition date is after the reporting period

Practical example

- **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.

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Practical example

Item	**Entity A, CU**	**Entity B, CU**
Inventory	100,000	50,000
Cash	50,000	10,000
TOTAL ASSETS:	150,000	60,000
Equity (share capital)	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

Practical example

- 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.

Item	**Balance value of Entity B, CU**	**Measured Fair Value of Entity B, CU**
Inventory	50,000	40,000

Practical example

- 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.

Practical example

- 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**

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Practical example

- 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 B would have been cash.

Practical example

- 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

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Practical example

Item	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 (share capital)	120,000	+100,000	220,000	30,000	+50,000	80,000
Profit (Loss)	10,000		10,000	20,000		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

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