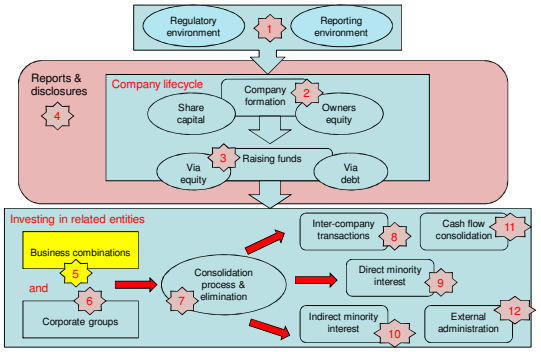
HA2032
Corporate Accounting

HOLMES INSTITUTE

Cum Propris Suis Alis Volat

Topic 5
Business Combinations

Studying Corporate Accounting



Introduction

- Business expansion comes in different forms, including but not limited to:
  - Single-asset acquisition
  - Purchase of a group of assets e.g. equipment
  - Acquiring all assets and liabilities of another business

Business combinations

- Acquisition of businesses is governed by AASB 3: *Business Combinations*
- *Business* is:
  - 'an integrated set of activities and assets conducted and managed for the purpose of providing…a return to investors'
- A *business combination* is defined as:
  - 'the bringing together of separate entities or businesses into one reporting entity.'

(AASB 3 Appendix A)

Business combinations

- Control of a business is usually achieved in one of two ways:
  1. acquiring directly from a vendor a collection of assets that constitutes a business
  2. acquiring sufficient shares (or other equity instruments) to control the board of directors of a company (or other entity) that owns the business

(AASB 3.B5 and B6)

Business combinations (contd)

- Share acquisitions (in a company) when *insufficient* to gain control of a business, but is enough to exert a significant influence, ***is not a business combination***

1. Direct acquisition from a vendor

- Obtain a business by means of acquiring all the assets and liabilities of a vendor (which would be a company in many cases).
- Direct acquisitions is accounted for by applying the *acquisition method*:
  a) identifying the acquirer
  b) determining the acquisition date
  c) recognising and measuring the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree
  d) recognising and measuring goodwill or a bargain purchase gain.

1. Direct acquisition from a vendor contd

a) Identifying the acquirer:
- business combination is recorded from point of view of the acquirer
- normally the acquirer will be entity purchasing business from vendor

b) Identify acquisition date
- date on which the **controller** obtains control of the **acquiree**

1. Direct acquisition from a vendor contd

c) Identify and measure assets and liabilities
- basic recognition principle:
  'As of the acquisition date, the acquirer shall recognise, separately from goodwill, the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree.' (AASB 3.10)
- identifiable assets and liabilities must be measured at their **fair value** (AASB 3.18)

1. Direct acquisition from a vendor contd

d) Recognising and measuring goodwill or from bargain purchase gain (AASB 3.32)
- measured by difference between:
  1. the aggregate of:
     i. the consideration transferred;
     ii. the amount of any NCI in the acquiree; and
     iii. for a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree
  2. the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed

1. Direct acquisition from a vendor contd

d) Recognising and measuring goodwill or from bargain purchase gain (cont.)
- Determination of fair value:
  'The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.'
  (AASB 3, App. A)
- Consideration transferred **does not include** transactions costs: they are recognised as an expense (or deduction from equity if AASB 132.35 applies)

Goodwill

- Definition of goodwill
  'An asset representing the future economic benefits arising from other assets acquired in a **business combination** that are not individually identified and separately recognised.'
  (AASB 3, Appendix A)
- Goodwill recognised through business combination commonly called **'purchased goodwill'**
- Goodwill initially recognised at cost – the amount dictated by the formula
- Bargain purchase gain is not expressly defined
  - arises when acquisition difference is negative

Goodwill

- Process required by AASB 136 is complex
  - goodwill is impaired if **recoverable amount** of CGU is less that sum of (i) fair value of CGU's net assets *plus* (ii) 'purchased goodwill' allocated to the CGU
- Impairment **first allocated to goodwill** then to other assets
- Recoverable amount
  - reflects the present value of the anticipated future cash flows of the CGU (see Chapter 9)

Goodwill (contd)

- Accounting for goodwill

Dr Identified assets	200	
Dr Goodwill	150	
Cr Liabilities		50
Cr Bank (cost of business comb.)		300

Goodwill (contd)

- Journal entry when a goodwill impairment loss is recognised.

Dr Expense – impairment of goodwill	x	
Cr Accumulated goodwill impairment		x

Bargain purchase gain

- Arises when
  - The acquirer's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities exceeds cost of business combination
  - It happens for various reasons
    - e.g. calculation errors in fair value, a bargain price
  - It is recognised immediately by the acquirer as a 'gain' in profit or loss statement

(AASB 3.34)

Excess over cost (contd)

- Accounting for excess over cost (discount on acquisition)

Dr Identified assets	200	
Cr Liabilities		50
Cr Gain – bargain purchase		50
Cr Bank (cost of business comb.)		100

2. Share acquisitions

- An alternate way to obtain control of a business –acquiring the company's shares.
- Acquisition of large number of shares may give the acquirer a *significant influence* or *control* over the acquiree's company.
- Accounting technique for:
  - Significant influence➔ Equity accounting
  - Control➔ Consolidation accounting (Ch.17-24)

Introduction to equity accounting

- Equity accounting is governed by AASB 128
- Significant influence versus control
  - Significant influence
    - Significant influence is defined as:'*...the power to participate in the financial and operating policy decisions of the investee, but is not control or joint control over those policies'.*
      (AASB 128 para. 2)
    - Investor – associate relationship.

Introd to equity accounting (contd)

- Control
  - Control is a stronger type of involvement
  - It is defined as: …'*the power to govern financial and operating policies of an entity so as to obtain benefits from its activities'.*
  - Parent: subsidiary relationship.

Introd to equity accounting (contd)

- Main evidence of significant influence:
  - representation on associate's governing body
  - actual participation in policy making
  - material transactions between investor and associate
  - interchange of management personnel
  - providing the associate with essential technical information.

Introd to equity accounting (contd)

- Ownership interest
  - No magic number to confer significant influence
  - Yet, it is presumed that holding of 20% or more creates significant influence.

Equity accounting techniques

- The investment is measured as the *total change to owners' equity* (e.g. current year profit) reported by the associate.
- The investor recognises *the investor's share of this change by adding or deducting it from the investment's carrying amount.*

Equity accounting - example

- Associate 20%-owned by investor
- Associate:
  - owner's equity start X6 $600 000
  - profit for X6 $80 000
  - no dividends
  - owner's equity end X6 $680 000
- Investor:
  - carrying amount of investment $124 000

Equity accounting - example (contd)

- Journal entry:

Dr Investment in associate	16 000	
Cr Share of associate's profit or loss		16 000
(20% share of associate's reported profit $80 000)		

- Investment has new carrying amount of $140 000
- Investor will report revenue of $16 000

Equity accounting techniques

- The equity method is:
  - not applied in the investor's 'separate financial statements'
  - if a parent, applied in consolidated financial statements
  - if ***not*** a parent, applied in a single entity set of financial statements that are not 'separate financial statements'
  - See figure 11.4

Assessment of equity accounting

- A reflection of investor's ownership interest in the associate.
- Restricts management manipulation.
- Reporting the share of associate profits, not just dividends, inhibits profit-smoothing.
- A more consistent basis for comparing investment revenue with its source.

Criteria for equity accounting

- Significant influence
- Materiality – factors to consider
  - If investments in associates > 10% of investor's non-current assets or relevant 'subsidiary' asset class ➔ material
  - Material difference carrying amount cost method and equity method
- Need both criteria
- Must consider **both** nature and amount

Criteria for equity accounting (contd)

	Cost method		Equity method	
Purchase date				
Dr Investment in associate	**xxx**		**xxx**	
Cr Cash		**xxx**		**xxx**
purchase of investment				
During the year				
Dr Cash	**xx**		**xx**	
Cr Dividend revenue		**xx**		
Cr Investment in associate				**xx**
receipt of dividend				

Criteria for equity accounting (contd)

	Cost method		Equity method	
End of year - associates a/c				
Dr Investment in associate			**xx**	
Cr Share of associate's profit or loss				**xx**
share of associates profits retained by associate				
Dr Dividend receivable	**xx**		**xx**	
Cr Dividend revenue		**xx**		
Cr Investment in associate				**xx**
share of associates declared dividend				

Controlling share investments

- Control can be obtained from the purchasing of sufficient voting shares in a company.
  - Main focus in this book is share acquisitions made via stock exchange.
- Takeover
  - The aim is to purchase as many shares as necessary to obtain control of the target company's board of directors
  - The takeover legislation and the *Corporation Act* regulate any acquisition over 20% of the shares in an entity.

Controlling share investments (contd)

- Three options of increasing the holding in the target company:
  1. Acquisition at a rate of 3% in six months
  2. Off-market bid
  3. On-market bid: listed entities.

Acctg for controlling share investments

Example:

- P Ltd acquires all shares of Q Ltd for $1.40 cash per share
- Paid-up capital of Q Ltd: 50 000 ordinary shares that are fully paid
- Fair value of Q Ltd's net assets at control date $55 000
- Difference on acquisition?
  - Acquisition cost = 50 000 x $1.40 = $70 000
  - Difference = $70 000 – $55 000 = $15 000

Acctg for controlling share investments

- Compare the cost of acquiring the shares with the fair value of the target company's identifiable net assets (i.e. the same way described earlier for direct acquisition).
- Journal entry:

Dr Shares in Q Ltd	70 000	
Cr Bank		70 000

(P Ltd purchase 50 000 Q Ltd ordinary shares for cash @ $1.4 each)

Return of pre-acquisition profits

- Investors recognise share of investee's dividend as dividend revenue
- Dividends from pre-acquisition profits (profits existed before investment was made)
  - Before 2008 amendment to AASB 127:
    - parent (investor) treats it as reducing investment carrying amount (discussed again in Chapter 18)
  - After 2008 amendment to AASB 127:
    - parent (investor) treats it as revenue and dividend payment triggers impairment assessment

Return of pre-acquisition profits

Before 2008 amendment to AASB 127

Dr	Bank	X	
Cr	Investment		X
	Share of investee's dividend paid from pre-acquisition profits		

After 2008 amendment to AASB 127

Dr	Bank	X	
Cr	Dividend revenue		X
	Share of investee's dividend paid from pre-acquisition profits		

Return of pre-acquisition profits

Example:

- A Ltd acquired control of B Ltd on 1 January 20X1
- At control date B Ltd's retained profits were $300 000
- On 15 February 20X1 the directors of B Ltd declared a dividend of $150 000
- A Ltd's owns 60 000 of B Ltd's 100 000 fully paid ordinary shares

Return of pre-acquisition profits

1) Treatment pre-2008 AASB 127 amendment

- A Ltd's share of the dividend
  - = 60% of $150 000
  - = $90 000
- Journal entry:

Dr	Cash	90 000	
Cr	Investment in A Ltd		90 000
	Receipt of dividend from A Ltd paid from pre control profits		

Return of pre-acquisition profits

2) Treatment post-2008 AASB 127 amendment

- A Ltd's share of the dividend
  - = 60% of $150 000
  - = $90 000
- Journal entry:

Dr	Cash	90 000	
Cr	Dividend revenue		90 000
	Receipt of dividend from A Ltd paid from pre control profits		