Chapter 8
Business Combinations

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What is a business combination and what forms do they have?

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The nature of a business combination

- AASB 3 defines a business combination as:
  ‘the bringing together of separate entities or businesses into one reporting entity’

- A ‘business’ is not just a group of assets, rather, it is an entity able to produce output
The nature of a business combination

Three general forms of business combination are as follows (assuming the existence of two companies – A Ltd and B Ltd):

1. A Ltd acquires all assets and liabilities of B Ltd
   B Ltd continues as a company, holding shares in A Ltd
2. A Ltd acquires all assets and liabilities of B Ltd
   B Ltd liquidates
3. C Ltd is formed to acquire all assets and liabilities of A Ltd and B Ltd
   A Ltd and B Ltd liquidate

Refer to figure 8.2 of text for key steps involved under each of the above scenarios

When a business is seeking to acquire another, at what stage should accounting advice be sought?

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Accounting for business combinations: Basic principles

AASB 3 prescribes the acquisition method in accounting for a business combination. The key steps in this method are:

1. Identify an acquirer
2. Determine the acquisition date
3. Recognise and measure the identifiable assets acquired, the liabilities assumed, and any non-controlling interest in the acquirer; and
4. Recognise and measure goodwill or a gain from bargain purchase.
Accounting for business combinations: Identifying the acquire

- The business combination is viewed from the perspective of the acquire
- The acquire is the entity that obtains control of the acquiree
- In most cases this step is straight forward. In other cases judgement may be required e.g. where two existing entities (A & B) combine and a new entity (C) is formed to acquire all the shares of the existing entities
- Who is the acquire? Cannot be C
- Indicative factors contained within Appendix B of AASB 3 to assist in identifying the acquire

When acquiring an entity what issues need to be considered, both on and off the balance sheet?

- Acquisition date is the date that the acquire obtains control of the acquiree
- Determining the correct acquisition date is important as the following are affected by the choice of acquisition date:
  - The fair values of net assets acquired
  - Consideration given, where the consideration takes a non-cash form
  - Measurement of the non-controlling interest
Allocating in the records of the acquirer: assets acquired and liabilities assumed

Fair value allocation occurs at acquisition date and requires the recognition of:
• Identifiable tangible and intangible assets
• Liabilities
• Contingent liabilities
• Any non-controlling interest in the acquiree
• Goodwill

FVINA = fair value of identifiable net assets (incl. contingent liabilities)

Accounting in the records of the acquirer: assets acquired and liabilities assumed: contingent liabilities

- AASB 3 requires that contingent liabilities which can be measured reliably are recognised by the acquirer
- The above requirement does not consider issues of probability
- Therefore contingent liabilities where a present obligation exists but that do not qualify for recognition in the acquiree’s books under AASB 137 may be recognised by the acquirer as part of a business combination
- The fair value of a contingent liability is the amount that a third party would charge to assume those contingent liabilities. Such an amount reflects the expectations about possible cash flows. This is not simply the expected maximum/minimum cash flow

Accounting in the records of the acquirer: intangible assets

- AASB 3 requires the acquirer to recognise intangible assets where their fair value can be measured reliably
- Figure 8.3 contains a list of intangibles that the AASB consider would meet the definition of an intangible for the purposes of accounting for a business combination
- Examples include trademarks, customer lists, royalty agreements, patented technology etc.
- The fair value of an intangible reflects market expectations about the probability of future economic benefits flowing to the entity
- Eg > if the expected benefits are $1,000 and the probability of receiving the benefits is 90%, the fair value will be $900
Accounting in the records of the acquirer: measurement

- AASB 3 requires that assets acquired and liabilities and contingent liabilities assumed are measured at fair value
- Fair value is basically market value
- Fair value is determined by judgement, estimation and a three-level 'fair value hierarchy'

Fair value hierarchy

1. By reference to observable prices of market transactions for identical assets or liabilities
2. By adjusting observable prices of market transactions for similar assets or liabilities
   - A similar asset or liability is one that is reasonably comparable. By a similar asset may be identical in all respects except for location
3. By using other valuation techniques
   - Where such techniques are adopted, the used market inputs should be maximised and the used internal estimates minimised
   - Note the similarities between these requirements and those of AASB 138, relating to intangible assets.

Accounting in the records of the acquirer: consideration transferred

The acquirer measures the consideration transferred as the fair values at the date of acquisition of

- Assets given
- Liabilities (including contingent liabilities) assumed
- Equity instruments
A business combination involves the consideration and measure of fair value of the acquiree, how can this be accurately measured?

Accounting in the records of the acquirer: consideration transferred

- The consideration paid by the acquirer may consist of one or a number of the following forms of consideration:
  - Cash
  - Non-monetary assets
  - Equity instruments
  - Liabilities undertaken
  - Cost of issuing debt/equity instruments
  - Contingencies

Accounting in the records of the acquirer: consideration transferred

Cash
- Where the settlement is deferred, the cash must be discounted to present value as at the date of acquisition
- The discount rate used is the entity’s incremental borrowing rate

Equity instruments
- Where an acquirer issues their own shares as consideration they need to determine the fair value of the shares as at the date of exchange
- If listed, the fair value is the quoted market price of the shares (with a few limited exceptions)
Costs of issuing debt and equity instruments

- Transaction costs such as stamp duties, underwriting fees and brokers fees may be incurred in issuing equity instruments
- Such costs are considered to be an integral part of the equity transaction and should be recognised directly in equity
- Journal entry required would be:
  - Dr Share Capital xx
  - Cr Cash xx
- Costs associated with the issue of debt instruments are included in the measurement of the liability

Contingencies

- In some cases the agreement will provide for an adjustment to the cost of the combination contingent on a future event
- Example - where an acquirer issues shares as part of their consideration, the agreement may require an additional payment of the value of the shares falls below a certain amount within a specified period of time
- If the adjustment is probable and can be measured reliably, then the amount should be included in the calculation of the cost of acquisition

Acquisition related costs that are directly attributable to a business combination not form part of the consideration transferred, rather they are expensed as incurred.
Calculating consideration transferred: example

On 1 January 2009 A Ltd acquired all the assets and liabilities of B Ltd. Details of the consideration transferred are as follows:
- Cash of $400,000, half to be paid on 1 January 2009, with the balance due on 1 January 2010. The incremental borrowing rate for A Ltd is 10%
- 100,000 shares in A Ltd were issued. The share price on 1 January 2009 was $1.50 per share. This price represented a six-month high. Costs of issuing the shares was $1,000.
- Due to doubts as to whether the share price would remain at or above the $1.50 level, A Ltd agreed to supply cash to the value of any decrease in the share price below $1.50. This guarantee was valid for a period of 3 months (to 31 March 2009). A Ltd believed that there was a 75% chance that the share price would remain at or above $1.50 until 31 March 2009 (and a 25% chance that it would fall to $1.40)
- Supply of a patent to B Ltd. The FV of the patent is $60,000. As the patent was internally generated it has not been recognised in A Ltd’s books.
- Legal fees and associated with the acquisition totalled $5,000.

<table>
<thead>
<tr>
<th>Required: Calculate the consideration transferred</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Cash</strong></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td><strong>Shares</strong></td>
</tr>
<tr>
<td><strong>Guarantee</strong></td>
</tr>
<tr>
<td><strong>Patent</strong></td>
</tr>
</tbody>
</table>

Note that share issue costs, legal fees and stamp duty are excluded from the acquisition.

Total cost of acquisition $544,318

Accounting in the records of the acquirer: Goodwill

- When a business combination results in goodwill, AASB 3 requires that the goodwill is:
  - recognised as an asset
  - initially measured at its cost at the date of acquisition

  - Goodwill = consideration transferred - acquirer’s interest in the FVINA

- Goodwill is considered to be a residual interest

- Goodwill is an unidentifiable asset which is incapable of being individually identified and separately recognised
Example
Details of B Ltd’s assets and liabilities acquired by A Ltd are as follows:

<table>
<thead>
<tr>
<th></th>
<th>CA</th>
<th>FV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Plant &amp; equipment</td>
<td>360,000</td>
<td>367,000</td>
</tr>
<tr>
<td>Land</td>
<td>170,000</td>
<td>175,000</td>
</tr>
<tr>
<td>Motor vehicles</td>
<td>90,000</td>
<td>82,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>24,000</td>
<td>30,000</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>18,000</td>
<td>16,000</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>(35,000)</td>
<td>(35,000)</td>
</tr>
<tr>
<td>Bank overdraft</td>
<td>(55,000)</td>
<td>(55,000)</td>
</tr>
<tr>
<td>Net assets</td>
<td>572,000</td>
<td>580,000</td>
</tr>
</tbody>
</table>

B Ltd is currently being sued by a previous customer. The expected damages is $50,000. Lawyers estimate that there is a 20% chance of losing the case.

Required:

a) Calculate the FVINA acquired and determine the amount of goodwill on acquisition.

b) Prepare the journal entry in the books of A Ltd to account for the acquisition.

Fair value of recorded net assets = 580,000

Cost of acquisition: 20% of damages to A

Less: Contingent liability re damages = (10,000)  
($50,000 x 20%)

FVINA = 570,000

Cost of acquisition = 594,318

Goodwill on acquisition = 24,318

Accounting in the records of the acquirer: Goodwill

Journal entry in the books of A Ltd to account for the acquisition:

Dr Plant & equipment 367,000  
Dr Land 175,000  
Dr Motor vehicles 82,000  
Dr Inventory 30,000  
Dr Accounts receivable 16,000  
Dr Legal fee expenses 5,000  
Dr Goodwill 24,318  
Cr Accounts payable 35,000  
Cr Bank overdraft 55,000  
Cr Provision for damages 10,000  
Cr Cash 206,000  
Cr Deferred consideration payable 181,818  
Cr Share capital 149,000  
Cr Prov for loss in value of shares 1,000  
Cr Gain on sale of patent 60,000  

Components of cost of acq's

- FV of shares issued
- 1/108 Share issue costs
- 1/108 of shares issued
- FV of shares issued

- FV of shares issued
- 1/108 Share issue costs
Accounting in the records of the acquirer: Gain from bargain purchase

- Where the acquirer’s interest in the FVIMA exceeds the consideration transferred, negative goodwill arises – this is referred to as a gain on bargain purchase.
- A gain on bargain purchase for the acquirer arises from:
  - Errors in measuring fair value
  - Another standard’s requirements
  - Superior negotiating skills
- The existence of a gain on bargain purchase is a rare event.
- In the event of a gain on bargain purchase the acquirer is required to recognise any gain immediately in the profit & loss

Refer to example 8.3 of text.

Accounting by the acquirer: shares acquired

- When shares are acquired the entry required is

  Dr Investment in A        XX
  Cr Cash                  XX

- Transaction costs (such as stamp duty) are included in the measurement of the cost of investments.

Pre acquisition equity and pre-acquisition dividends

- Dividends are paid from equity earned. Where the retained earnings in respect of which a dividend is paid from was generated prior to the acquisition of the entity, such dividends are referred to as pre-acquisition dividends.
- Pre-acquisition dividends = reduction in the investment account – represent a return of cash paid to acquire the investment

  Dr Cash          xx
  Cr Investment in A       xx

- Post-acquisition dividends = revenue to the acquirer

  Dr Cash          xx
  Cr Dividend revenue xx
Accounting in the records of the acquiree

- If acquiree does not liquidate, it recognises a gain or loss on the sale of the assets and liabilities that formed the part of the business being sold
- If acquiree liquidates, its accounts are transferred to a liquidation and a shareholders’ distribution account
- No entries needed if acquiree only parts with shares

Subsequent adjustments to the initial accounting for business combinations

- Acquirer has 12 months from acquisition date to determine fair values
- At first balance date after acquisition the fair values may only be provisionally determined
- Later changes (ie > 12 months after acquisition) can only be retrospective adjustments to correct an error, unless the adjustment relates to one of the three exceptions on the following slide
- Such later changes result in the cost being adjusted with a corresponding adjustment to goodwill

Subsequent adjustments: Exceptions to 12 month rule

1. Where the cost of the business combination included a contingent future event and that event has not occurred or the estimate need to be revised
   - > eg. A component of the consideration was dependent on the future profitability of the acquirer
2. Where the adjustment was not included in the original calculation of the cost of the business combination because the measurement criteria were not met
3. Where the acquirer is required to make a subsequent payment to the acquirer as compensation for a reduction in assets given/equity issued
Disclosures

- AASB 3 contains extensive disclosure requirements in relation to business combinations
- Figure 8.19 provides a sample of the disclosures