

Business Combinations and Purchase Method of Accounting

(Relevant for ATE Paper 7–Advanced Accounting and PBE Paper I–Financial Reporting)

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Introduction

In this article, the key issues of the principles of business combinations and steps involved in the purchase method of accounting and the scope and application of HKFRS 3 “Business Combinations” are explained.

Scope of a Business Combination under HKFRS 3

A business combination, as defined by HKFRS 3, is “the bringing together of separate entities or businesses into one reporting entity”. The result of business combinations is that the acquirer acquires control of the acquiree(s). As a result the following circumstances do not fall within the definition of HKFRS 3 and therefore HKFRS 3 shall not apply:

1. The business combination brings together separate entities or businesses to form a joint venture where the venturers undertake an economic activity that is subject to joint control.
2. All of the combining entities or businesses are under common control; in particular, these entities or businesses are ultimately controlled by the same party and such control is not transitory.
3. The business combination involves two or more mutual entities, which provide economic benefits directly and proportionately to its policyholders or participants.
4. The business combination brings together separate entities or businesses to form a reporting entity when the same group of individuals has, as a result of contractual arrangements, ultimate collective power to govern the financial and operating policies of each of the combining entities so as to obtain benefits from their activities and such ultimate collective power is not transitory.

Nature of Purchase Method of Accounting

HKFRS 3 states that all business combinations shall be accounted for by applying the purchase method so as to demonstrate the effect of one entity (the acquirer) obtaining control of one or more other businesses (the acquiree). The purchase method views a business combination from the perspective of the acquirer such that, at acquisition date, the acquirer purchases net assets. Application of the purchase method starts from the acquisition date, which is the date on which the acquirer effectively obtains control of the acquiree. Therefore, under the purchase method of accounting, the acquirer recognizes the acquiree’s identifiable assets, liabilities and contingent liabilities at their fair value, including those not previously recognized, and also recognizes

goodwill. HKFRS 3 specifies that the application of purchase method of accounting involves the following steps:

1. identifying an acquirer;
2. measuring, at acquisition date, the cost of the business combination at its fair value; and
3. allocating, at the acquisition date, the cost of the business combination to the assets acquired and liabilities and contingent liabilities assumed.

Identifying an Acquirer

The acquirer is the combining entity that obtains control of the other combining entities. Control, in the case of a business combination, refers to an entity’s power to govern the financial and operating policies of another entity so as to obtain benefits from its activities. All pertinent facts and circumstances surrounding a business combination shall be considered in assessing when the acquirer has obtained control.

A combining entity shall be presumed to have obtained control of another combining entity when it acquires more than one-half of that other entity’s voting rights, unless it can be proved otherwise. Even if one of the combining entities does not acquire more than one-half of the voting rights of another combining entity, it might have obtained control of that other entity by virtue of a statute or an agreement with other investors; having power to cast the majority of votes at the other entity’s board meeting; or having control over the composition of members of the other entity’s board of directors or equivalent governing body.

Example 1

On 31 December 20X1, Parson Limited acquired all the issued shares of Submit Limited. The purchase consideration was settled by additional issues of 150,000 shares of \$10 each at date of acquisition and a cash payment of \$330,000 at 31 December 20X2.

In this example, the acquirer is Parson Limited which obtains control of the other combining entities, Submit Limited, through acquiring all its issued shares.

Measuring the Cost of the Business Combination

Date of acquisition

The acquisition date is the date on which the acquirer effectively obtains control of the acquiree. When the business combination is achieved:

1. through a single exchange transaction; the date of exchange coincides with the acquisition date. In the case of Example 1, the dates of both acquisition and of exchange fall in the same date, 31 December 20X1, when Parson Limited acquired all the equity interests of Submit Limited.
2. in stages by successive share purchases, the date of exchange is the date of each exchange transaction while the acquisition date is the date on which the acquirer obtains control of the acquiree.

Recognition of identifiable assets and liabilities

The acquirer shall recognize separately the acquiree's identifiable assets, liabilities and contingent liabilities at the acquisition date only if at that date their fair value can be measured reliably and it is probable that:

1. any associated future economic benefits will flow to the acquirer for an asset other than an intangible asset.
2. an outflow of resources embodying economic benefits will be required to settle the obligation for a liability other than a contingent liability.

Measuring the cost of the business combination at the acquisition date

The cost of the combination is the aggregate cost of the individual transactions. Assets given and liabilities incurred or assumed by the acquirer in exchange for control of the acquiree are to be measured at their fair values at the date of exchange.

Example 2

Using the information in Example 1, extracts from the balance sheet of Submit Limited as at 31 December 20X1 (prior to the business combination) were as follows:

| | |
|--------------------------------|------------------|
| | \$ |
| Property, plant and equipment | 3,600,000 |
| Trade and other receivables | <u>1,000,000</u> |
| Total assets | <u>4,600,000</u> |
| Ordinary shares capital @ \$10 | 1,000,000 |
| Share premium | 700,000 |
| Retained earnings | 1,400,000 |
| Long-term loan | 1,000,000 |
| Trade and other payables | <u>500,000</u> |
| Total equity and liabilities | <u>4,600,000</u> |

The following information is also available:

- (a) The market value of the ordinary shares of Parson Limited at 31 December 20X1 was \$25 per share.
- (b) The discount rate for calculating the present value of the deferred consideration is 10%.
- (c) Both companies have a year end of 31 December 20X1 and apply same accounting policies for all assets and liabilities.

- (d) The out-of-pocket costs of the business combination paid by Parson Limited were:

| | |
|---------------------------------------------------------------------------------|----------------|
| | \$ |
| (i) Consultancy fees to professional accountant legal advisor, valuers, etc. | 105,000 |
| (ii) Legal fees related to business combination | <u>65,000</u> |
| | <u>170,000</u> |

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The journal entries to record the cost of the business combination at the acquisition date are:

| | | |
|------------------------------------------------------|-------------|-------------|
| Dr. Investment in Submit Limited (\$25 x 150,000) | \$3,750,000 | |
| Cr. Share capital | | \$1,500,000 |
| Cr. Share premium | | \$2,250,000 |

To record the additional issues of equity shares as part of the purchase consideration for the acquisition of Submit Limited.

| | | |
|----------------------------------------------------------|-----------|-----------|
| Dr. Investment in Submit Limited (\$330,000/ (1+10%)) | \$300,000 | |
| Dr. Finance costs accrued | \$30,000 | |
| Cr. Deferred considerations payable | | \$330,000 |

To record the deferred payment as part of the purchase consideration for the acquisition of Submit Limited.

| | | |
|----------------------------------|-----------|-----------|
| Dr. Investment in Submit Limited | \$170,000 | |
| Cr. Cash | | \$170,000 |

To record the payment of out-of-pocket costs incurred in the acquisition of Submit Limited that are directly attributable to the acquisition and are recognized as an investment cost.

Adjustments to the cost of a business combination contingent on future events

When a business combination agreement provides for an adjustment to the cost of the combination contingent on future events (for example, costs contingent on a specified level of profit in future periods) the acquirer shall include the amount of that adjustment in the cost of the combination at the acquisition date if the adjustment is probable and can be measured reliably. If the future events do not occur or the estimate needs to be revised, the cost of the business combination shall be adjusted accordingly.

Allocating the Cost of the Business Combination to the Acquiree's Assets and Liabilities

At date of business combination

In accordance with HKFRS 3, the acquirer is required to allocate the cost of a business combination by recognising the acquiree's identifiable assets, liabilities and contingent liabilities at their fair values at the acquisition date, except for non-current assets held for sale and discontinued operations, which shall be recognized at fair value less costs to sell.

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At date of business combination, the difference between the cost of the business combination and the acquirer's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities shall be recognized as goodwill/ negative goodwill:

1. Goodwill, which represents a payment made by the acquirer in anticipation of future economic benefits from assets that are not capable of being individually identified and separately recognized, shall be included as an asset.
2. Negative goodwill, which represents the excess of acquirer's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities over the cost of business combination, shall be charged immediately to profit and loss.

Example 3

Using the information from Examples 1 and 2, the board of directors of Parson Limited determined the fair values of Submit Limited's identifiable assets and liabilities at date of acquisition as follows:

| | |
|-------------------------------|-----------|
| | \$ |
| Property, plant and equipment | 4,000,000 |
| Trade and other receivables | 1,150,000 |
| Long-term loan | 950,000 |
| Trade and other payables | 500,000 |

Calculation of goodwill on business combination:

| | | |
|-----------------------------------------------------------------------------------------------------------|---------------|------------------|
| Total costs of acquiring Submit Limited | \$ | \$ |
| | | 4,220,000 |
| Less: Carrying amount of Submit Limited's identifiable net assets (\$4,600,000 - \$1,000,000 - \$500,000) | 3,100,000 | |
| Excess (deficit) of current fair values of identifiable net assets over carrying amounts: | | |
| - Property, plant and equipment | 400,000 | |
| - Trade and other receivables | 150,000 | |
| - Long-term loan | <u>50,000</u> | <u>3,700,000</u> |
| Goodwill amount | | <u>520,000</u> |

The journal entries needed to allocate the costs of acquiring Submit Limited to identifiable assets and liabilities at the date of acquisition are as follows:

| | | |
|-----------------------------------|-----------|-----------|
| Dr. Property, plant and equipment | \$400,000 | |
| Dr. Trade and other receivables | \$150,000 | |
| Dr. Long-term loan | \$50,000 | |
| Cr. Fair value adjustments | | \$600,000 |

To record the fair value adjustments of the identifiable net assets of Submit Limited.

| | | |
|-----------------------------------|-------------|-------------|
| Dr. Ordinary share capital @ \$10 | \$1,000,000 | |
| Dr. Share premium | \$700,000 | |
| Dr. Retained earnings | \$1,400,000 | |
| Dr. Fair value adjustments | \$600,000 | |
| Dr. Goodwill | \$520,000 | |
| Cr. Investment in Submit Limited | | \$4,220,000 |

To allocate the total cost of acquiring Submit Limited to identifiable assets and liabilities, with the remainder to goodwill.



Subsequent to date of business combination

After initial recognition, the acquirer shall:

1. Measure contingent liabilities that are recognised in accordance with HKAS 37 "Provisions, Contingent Liabilities and Contingent Assets"; and the amount initially recognized less, when appropriate, cumulative amortization recognized.
2. Incorporate the acquiree's profit and losses after the acquisition date by including the acquiree's income and expenses based on the costs of business combination to the acquirer; for example, the depreciation included shall be based on the fair values of assets at date of acquisition.
3. Measure goodwill on business combination at cost less any accumulated impairment losses. The acquirer shall test the goodwill on business combination for impairment at least once a year, or when there are events or changes in circumstances indicate that it might be impaired.

Example 4

Using the information in Example 3, the following information is relevant for recording additional depreciation or impairments of assets for preparing the consolidated financial statements at 31 December 20X2:

1. Property, plant and equipment shall be depreciated at 20% of its depreciable amount.
2. An impairment test was carried out at the year end of 31 December 20X2, at which it was found that the goodwill on business combination had been impaired by \$50,000.
3. No fair value adjustment on assets (other than goodwill) and liabilities were required at 31 December 20X2.

| | | |
|---------------------------------------------------------|-------------------------------------|----------|
| Dr. Depreciation expenses – Property, plant & equipment | \$80,000 | |
| Cr. Accumulated depreciation | | |
| | [20% x (\$4,000,000 - \$3,600,000)] | \$80,000 |

To record the additional depreciation due to the increase in value of property, plant and equipment.

| | | |
|----------------------------------------------|----------|----------|
| Dr. Profit and loss - Impairment of goodwill | \$50,000 | |
| Cr. Accumulated goodwill impairment | | \$50,000 |

To record the impairment of goodwill as at 31 December 20X2.