CHAPTER 26

BUSINESS COMBINATIONS AND CONSOLIDATED FINANCIAL STATEMENTS

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26.1 INTRODUCTION

- For a variety of legal, tax and other reasons, undertakings often choose to conduct their activities not through a single legal entity but through several undertakings under the ultimate ***control*** of the ***parent undertaking*** of the group
- ***Control*** is the power to govern accounting and financial policies
- A ***parent undertaking*** is an entity that has one or more ***subsidiaries***, with a subsidiary being an entity that is controlled by another (i.e. the parent)
- ***Consolidated financial statements*** are the financial statements of a group presented as those of a single economic entity

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26.1 INTRODUCTION

Consolidation Accounting Standards

- IAS 27 *Separate Financial Statements (Section 26.2)*
- IFRS 10 *Consolidated Financial Statements (Section 26.3)*
- IFRS 12 *Disclosure of Interests in Other Entities (Section 26.3)*
- IFRS 3 *Business Combinations (Section 26.4)*
- IAS 28 *Investments in Associates and Joint Ventures (Chapter 29)*
- IFRS 11 *Joint Arrangements (Chapter 30)*
- IAS 21 *The Effects of Changes in Foreign Exchange Rates (Chapter 31)*
- IAS 29 *Financial Reporting in Hyperinflationary Economies (Chapter 31)*
- IAS 7 *Statement of Cash Flows (Chapter 33)*

Table 26.1 Respective scope of consolidation standards

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Table 26.2: Types of interest in other entities

	Subsidiary Interest	Associate Interest	Joint Arrangement	Investment Interest
Ownership	≥50%	20% - 49%	Joint	< 20%
Accounting Standards	IFRS 3	IAS 28	IFRS 11	IFRS 9
Accounting Treatment	Control = Consolidation	Significant influence = Equity method	Joint operation = in accordance with relevant IASs/IFRSs; Joint venture = equity method.	At fair value. Separate financial statements are not required.
Relevant Reading	Chapter 26, Section 26.3 and 26.4	Chapter 29	Chapter 30	For example, Chapter 20

26.3 PREPARATION AND PRESENTATION OF CONSOLIDATED FINANCIAL STATEMENTS

- IFRS 10 *Consolidated Financial Statements*
- IFRS 12 *Disclosure of Interests in Other Entities*

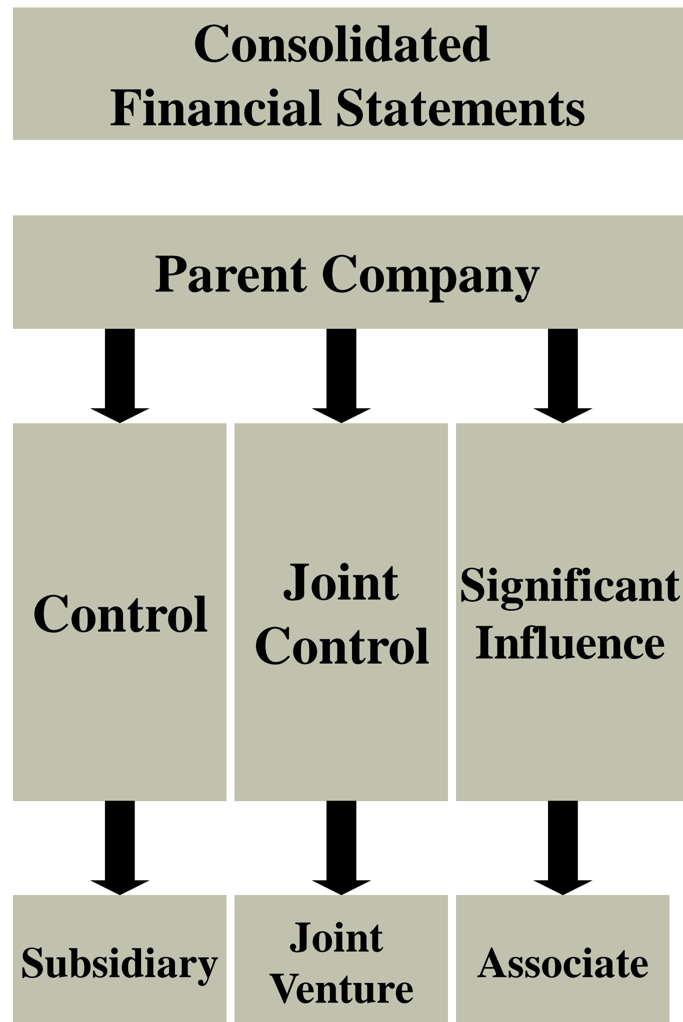
IFRS 10 *Consolidated Financial Statements*

- A company is a subsidiary of another, if that other company (the '**parent**') is in a position to exercise **control**
- A parent should prepare and present **consolidated financial statements**, ***except*** if it meets ***all*** of the following conditions:
  - it is a wholly-owned subsidiary or is a partially-owned subsidiary of another entity and its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the parent not presenting consolidated financial statements
  - its debt or equity instruments are not traded in a domestic or foreign public market (i.e. stock exchange)
  - it did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market
  - its ultimate or any intermediate parent of the parent produces consolidated financial statements available for public use that comply with IFRSs

Control is key

- Hold 50%+ of votes
- Power over 50%+ of votes by virtue of agreement
- Power to govern financial & operating policies under statute or agreement
- Power to appoint or remove majority of board
- Power to cast the majority of votes at board meetings

In summary so far



Prepare consolidated FS unless:

- Parent itself is wholly-owned

or

- Parent itself is a partially owned subsidiary of another entity & owners have been informed and do not object, and
- Parent's debt or equity is neither traded in a public market nor in the process of being issued, and
- Ultimate or intermediate parent produces consolidated financial statements that comply with IFRS

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Key consolidation issues

- Date of acquisition – 'control'
- Line by line basis – combine assets, liabilities, income and expenses
- Intra-group transactions and balances
  - Profits and losses on transactions between group members should be eliminated
  - Profits which are reflected in the value of assets to be included in the consolidation should be eliminated
- Uniformity of accounting policies
  - Uniform accounting policies should be used for all entities included in the consolidation for like transactions and other events in similar circumstances

Key consolidation issues

- Non-coterminous year ends
  - As far as possible the financial statements for all entities included in the consolidation should be prepared for the same period and to the same date
  - Appropriate adjustments should be made to information prepared to an earlier date
  - Financial statements over three months before the group's reporting date should not be used
- Non-controlling interests should be shown in equity separately from liabilities and parent's equity
- De-consolidation on date of ceasing to meet definitions of subsidiary
- Full disclosure should be given for all departures from IASs / IFRSs

Key consolidation issues

- Control intended to be temporary (i.e. sale foreseen within 12 months) = IFRS 5 (*See Chapter 20*)
- Control lost = IAS 28 or IFRS 11
- Dissimilar activities is ***not a valid reason*** for exclusion under any circumstances
- If an entity is operating under severe long-term restrictions it is ***not reason enough*** to exclude it from consolidation

IFRS 12 *Disclosure of Interests in Other Entities*

IFRS 12 specifies the disclosures for:

- Interests in subsidiaries;
- Interests in associates and joint arrangements (see *Chapter 29* and *Chapter 30* respectively); and
- Interests in unconsolidated structured entities.

In summary, the disclosures should enable users to understand the nature and extent of the interest and the risks associated with it, together with consequences of any changes during the period.

Separate financial statements

Subsidiaries can be accounted for at cost, or in accordance with IFRS 9 *Financial Instruments* (*See Chapter 25*)

26.4 IFRS 3 *BUSINESS COMBINATIONS*

- A ***business combination*** is the bringing together of separate entities into one reporting entity
- ***Control*** is the power to govern the financial and operating policies of an entity or business so as to obtain benefits from its activities
- The ***acquisition date*** is the date on which the acquirer effectively obtains ***control*** of the acquiree

Accounting for business combinations

- IFRS 3 deals with accounting for business combinations and the ongoing treatment of goodwill
- Must use ***acquisition method***
- Thus the acquirer recognises acquiree's identifiable assets, liabilities and contingent liabilities at their ***fair values*** at the acquisition date, and also recognises ***goodwill***, which is subsequently tested for impairment (rather than amortised)
- The following steps should be undertaken in applying the acquisition method:
  1. Identify the acquirer;
  2. Determine the acquisition date;
  3. Recognise and measure the identifiable net assets acquired;
  4. Recognise and measure any non-controlling interest; and
  5. Recognise and measure goodwill or gain from a bargain purchase.

1. Identify the acquirer

In nearly all business combinations, one entity obtains ***control*** over the other

>50% of votes

Power to govern by law or agreement

Power to appoint or remove majority of board

Voting control by agreement

Power over voting control at board meetings

1. Identify the acquirer (cont'd)

It can sometimes be difficult to identify an acquirer but normally there are indicators that one exists

Fair value of one enterprise significantly greater than the other

Exchange of voting rights for cash

Management of one enterprise dominates selection of combined team

2. Determine the acquisition date

i.e. the date on which the acquirer obtains ***control*** of the acquiree

3. Recognise and measure the identifiable net assets acquired

- At acquisition date, allocate the cost of a business combination by ***recognising*** the acquiree's identifiable net assets at their acquisition-date ***fair value***
- Any difference between the cost of the combination and the acquirer's interest in the fair value of the net assets acquired should be accounted for as ***goodwill***

3. Recognise and measure the identifiable net assets acquired (cont'd)

- ***Recognition criteria*** for assets and liabilities that existed at the acquisition date:
  - Assets other than intangibles – probable that associated future economic benefits will flow to the acquirer, and fair value can be measured reliably
  - Intangible assets – fair value can be measured reliably
  - Liabilities other than contingent liabilities – probable outflow of economic benefits, and fair value can be measured reliably; not future losses or restructuring costs unless previously recognised by acquiree
  - Contingent liabilities – fair value can be measured reliably

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3. Recognise and measure the identifiable net assets acquired (cont'd)

- The ***fair values*** at the date of exchange, of assets given, liabilities incurred, and equity instruments issued:
  - Deferred amounts discounted to present value
  - Published price of shares at date of exchange
  - No provision for future losses or expected costs
  - For contingent consideration, provide probable amount
- Any costs directly attributable to the business combination are ***excluded*** e.g. professional fees, allocation of admin costs, etc.

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4. Recognise and measure any non-controlling interest

IFRS 3 has an explicit ***option*** on a transaction-by-transaction basis to measure NCI ***at the date of acquisition*** at either:

- fair value (***new method***) e.g. if available, share price of NCI equity shares; or using other valuation techniques if not publicly traded;

or

- NCI's proportionate share of the net identifiable assets of the entity acquired (***old method***).

- Argued that old method of calculating goodwill only recognises the goodwill acquired by the parent i.e. any goodwill attributable to NCI is not recognised.
- But problem with new method is that goodwill is a very complex item. While NCI can legitimately lay claim to its share of the more traditional aspects of goodwill, it is unlikely to benefit from other aspects as they relate to the ability to control the subsidiary.

Example 26.1: NCI (Old method)

Parent pays €100m for 80% of Subsidiary which has net assets with a fair value of €75m. Goodwill of €40m (€100m – (80% x €75m)) would be recognised, and the non-controlling interests would be €15m (20% x €75m).

		€m
Cost of acquisition		100
Fair value of net assets	€75m	
Group share of net assets	80%	(60)
Goodwill		40

If we assume that purchasing 100% of Subsidiary would have cost proportionately more, the consideration would have been €125m (€100m/80%) and goodwill would then be €50m (€125m - €75m) and there would be no non-controlling interests. This demonstrates that, where a non-controlling interest exists, the traditional consolidation method only records the parent's share of the goodwill, and the non-controlling interest is carried at its proportionate share of the fair value of the subsidiary's net assets (which excludes any attributable goodwill). The argument goes that as we consolidate the whole of a subsidiary's other assets (and liabilities), why should goodwill be any different? After all, it is an asset!

Example 26.2: NCI (New method)

Developing ***Example 26.1***, and assuming that the value of the goodwill of the non-controlling interest is proportionate to that of the parent, therefore consolidated goodwill of €50m would be recognised (this includes both the controlling (€40m) and the non-controlling interest (€10m) in goodwill) and the non-controlling interest would be €25m (€15m + €10m attributed goodwill).

In effect, consolidated goodwill and the non-controlling interest are 'grossed up' by the non-controlling interest's share of goodwill (€10m in this case). Although this may seem new, it is in fact an extension of the methodology in IAS 36 *Impairment of Assets* when calculating the impairment of goodwill of a cash-generating unit where there is a non-controlling interest (See *Chapter 10*).

Example 26.3: NCI (Old and new methods)

P pays €800m to purchase 80% of the shares of S. The fair value of 100% of S's identifiable net assets is €600m.

If P elects to measure non-controlling interests at their proportionate interest in net assets of S of €120m (20% x €600m), the consolidated financial statements show goodwill of €320 (€800m + €120m – €600m).

If P elects to measure non-controlling interests at fair value and determines that fair value to be €185m, then goodwill of €385m is recognised (€800m + €185m – €600m). The fair value of the 20% non-controlling interest in S will not necessarily be proportionate to the price paid by P for its 80%, primarily due to control premium or discount.

5. Recognise and measure goodwill or gain from a bargain purchase

Goodwill is measured as the difference between:

- the aggregate of:
  - the acquisition-date ***fair value*** of the consideration transferred;
  - the amount of any ***non-controlling interest*** in the entity acquired (***two measurement options***); and
  - in a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously-held equity interest in the entity acquired; and
- the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed, both measured in accordance with IFRS 3

Goodwill

- In simple terms, Goodwill = Consideration paid by parent + Non-controlling Interest – Fair Value of subsidiary's net assets
- Can be positive or gain on a bargain purchase (i.e. negative)

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Positive goodwill

- Recognise as asset from date of acquisition
- Do not amortise
- Subject to annual impairment testing or more frequently if events or circumstances dictate (*See Chapter 10*)

Gain on a bargain purchase

(i.e. negative goodwill)

- Treated as immediate income i.e. ‘credit SPLOCI – P/L’ in arriving at profit or loss

- Adjustments can be made within 12 months if have used provisional figures, but must account for new values as if recognised at acquisition date

Purchased intangibles

Intangibles acquired in a business combination must be recognised separately from goodwill if:

- Separable or arise from contractual or other legal rights; and
- Fair value can be reliably measured.

Normal test for 'probability of future economic benefits' deemed to be satisfied for acquired intangibles

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Costs of a business combination

- All ***acquisition-related costs*** (e.g. advisory, legal, accounting, valuation, other professional fees and general administrative costs) are recognised as ***period expenses*** in accordance with the appropriate IFRS.
- Costs incurred to issue debt or equity securities should be recognised in accordance with the standards on financial instruments.

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Costs of a business combination

- Consideration for an acquisition should be measured at fair value at the acquisition date, including any ***contingent consideration*** payable.
- IFRS 3 only permits changes to this measurement if additional information about facts that existed at the acquisition date become available.
- All other changes (e.g. changes resulting from events after the acquisition date such as the acquiree meeting an earnings target, reaching a specified share price or meeting a milestone on a R&D project) are recognised in profit or loss.

In an exam question, the acquisition date fair value (or how to calculate it) of any contingent consideration would be given. The payment of contingent consideration may be in the form of equity or a liability (issuing a debt instrument or cash).

Provisional accounting

- Correction of provisional fair values

If done ***within 12 months*** of acquisition:

- Restate assets, depreciation, goodwill retrospectively from acquisition date
- Adjust comparatives

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Provisional accounting

- If done ***more than 12 months after*** acquisition
  - Only restate retrospectively for errors
  - Changes in estimates recognised in current and future periods
  - If deferred tax asset not initially recognised, but is later realised, recognise this as income, but reduce goodwill to level if DT asset had been initially recognised, and treat as expense
- Cannot create or augment negative goodwill

Disclosures

An acquirer should disclose information that enables users to evaluate the ***nature and financial effect of business combinations*** that were affected. This information will include:

(a) The names and descriptions of the combining entities;
(b) The acquisition date;
(c) The percentage of voting equity instruments acquired;
(d) Primary reasons for the business combination;
(e) The cost of the combination and the components of that cost;
(f) Details of operations that the entity has decided to dispose of;
(g) The amounts recognised for each class of the acquiree's net assets at acquisition date together with their carrying amounts immediately prior to the combination;
(h) The amount of any excess recognised in profit or loss on creation of negative goodwill;
(i) A description of the factors contributing to the recognition of goodwill; and
(j) The amount of the acquiree's profit or loss since the acquisition date included in the acquirer's profit or loss for the period, unless impracticable. If impracticable, fact must be disclosed.

See Chapter 26, Example 26.4: Goodwill and non-controlling interests

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