14 Business combinations

ACCOUNTING STANDARDS IN FOCUS

IFRS 3 ***Business Combinations***

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

1. understand the nature of a business combination and its various forms
2. explain the basic steps in the acquisition method of accounting for a business combination
3. account for a business combination in the records of the acquirer
4. recognise and measure the assets acquired and liabilities assumed in the business combination
5. understand the nature of and the accounting for goodwill and gain from bargain purchase
6. account for shares acquired in the acquiree
7. prepare the accounting records of the acquiree
8. account for subsequent adjustments to the initial accounting for a business combination
9. provide the disclosures required under IFRS 3.

14.1 THE NATURE OF A BUSINESS COMBINATION

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The accounting standard relevant for accounting for business combinations is IFRS 3 *Business Combinations* issued by the International Accounting Standards Board (IASB®) in January 2008.

A business combination is defined in Appendix A to IFRS 3 as:

> A transaction or other event in which an acquirer obtains control of one or more businesses.

The meaning of control is the same as in IFRS 10 *Consolidated Financial Statements*. Control exists when an investor is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.

The term business is defined in Appendix A as:

> An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants.

The purpose of defining a business is to distinguish between the acquisition of a group of assets that does not constitute a business and the acquisition of a business.

Combining two or more separate businesses requires the combination of the assets and liabilities of the acquirer with those acquired from the acquiree(s). This can occur in a number of ways. For example, if A Ltd is to be combined with B Ltd, the following possibilities might arise:

1. A Ltd acquires all the assets and liabilities of B Ltd.
   B Ltd continues as a company, holding shares in A Ltd.
2. A Ltd acquires all the assets and liabilities of B Ltd.
   B Ltd liquidates.
3. C Ltd is formed to acquire all the assets and liabilities of A Ltd and B Ltd.
   A Ltd and B Ltd liquidate.
4. A Ltd acquires a group of net assets of B Ltd, the group of net assets constituting a business, such as a division, branch or segment, of B Ltd.
   B Ltd continues to operate as a company.

These possibilities are covered in this chapter.

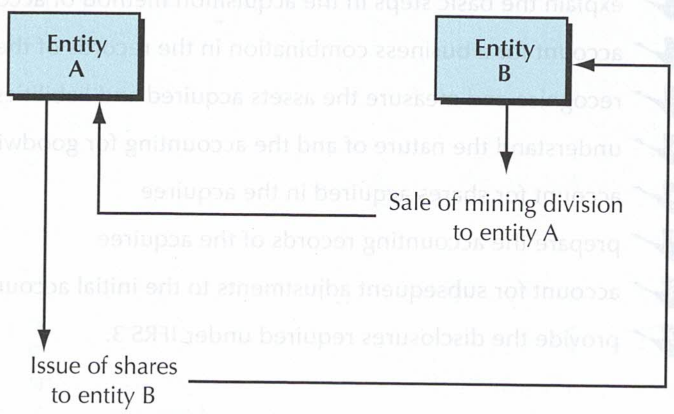

FIGURE 14.1 Identification of a business combination

The most obvious way in which control can be achieved is through one entity acquiring sufficient shares of another entity on the open market to have a controlling interest. Accounting for that form of business combination requires the application of the principles discussed in this chapter, but the application further involves the preparation of consolidated financial statements. *Accounting for these forms of business combinations is discussed in chapters 20 to 24.*

A business combination could also occur without any exchange of assets or equity between the entities involved in the exchange. For example, a business combination could occur where two entities merged under a contract. The shareholders of the two entities could agree to adjust the rights of each of their shareholdings so that they receive a specified share of the profits of both the combined entities. As a result of the contract, both entities would be under the control of a single management group.

There are many other forms of business combinations that can occur, such as A Ltd acquiring the assets only of B Ltd, and B Ltd paying off its liabilities and then liquidating. Alternatively, A Ltd may acquire all of B Ltd's assets and some of its liabilities, followed by B Ltd settlings its remaining liabilities before liquidating. The three approaches identified in figure 14.2 cover most of the arrangements that are likely to occur in practice.

IFRS 3 applies to all business combinations except those listed in paragraph 2 of the standard, namely:

- *Where the business combination results in the formation of a joint venture.* Such a business combination is accounted for under IFRS 11 *Joint Arrangements*.

share capital. If P Ltd formed a new wholly owned entity, X Ltd, that acquired all of B Ltd's equity, then this would simply constitute an internal reconstruction. All of the combining entities would be controlled by P Ltd both before and after the reconstruction.

FIGURE 14.2 General forms of business combinations

Alternative 1

A Ltd acquires net assets of B Ltd	*B Ltd continues, holding shares in A Ltd*
A Ltd: • Receipt of assets and liabilities of B Ltd • Consideration transferred, e.g. shares, cash or other consideration	B Ltd: • Sale of assets and liabilities to A Ltd • Gain or loss on sale • Receipt of consideration transferred, e.g. shares, cash or other consideration

Alternative 2

A Ltd acquires net assets of B Ltd	*B Ltd liquidates*
A Ltd: • As for alternative 1 above, A Ltd	B Ltd: • Liquidation account, including gain/loss on liquidation • Receipt of purchase consideration • Distribution of consideration to appropriate parties, including shareholders via the Shareholders' Distribution account

Alternative 3

C Ltd formed	*A Ltd and B Ltd liquidate*
C Ltd: • Formation of C Ltd with issue of shares • Acquisition of assets and liabilities of A Ltd and B Ltd • Payment for net assets of A Ltd and B Ltd via cash outlays or issue of shares in C Ltd	A Ltd and B Ltd: • As for alternative 2 above, B Ltd

14.2 ACCOUNTING FOR A BUSINESS COMBINATION — BASIC PRINCIPLES

The required method of accounting for a business combination under paragraph 4 of IFRS 3 is the *acquisition method*. The four key steps in this method are noted in paragraph 5 of the standard:

1. Identify the acquirer.
2. Determine the acquisition date.
3. Recognise and measure the identifiable assets acquired, the liabilities assumed, and any non-controlling interest in the acquiree.
4. Recognise and measure goodwill or a gain from a bargain purchase.

The acquisition date is the date that the acquirer obtains control of the acquiree. IFRS 3 deals with the acquisition itself and also with the subsequent measurement and accounting for assets and liabilities recognised initially at acquisition date.

14.2.1 Identifying the acquirer [step 1]

Paragraph 7 of IFRS 3 states that the acquirer is 'the entity that obtains *control* of another entity, i.e. the acquiree'.

The key criterion, then, in identifying an acquirer is that of control. This term is the same as that used in IFRS 10 *Consolidated Financial Statements* for identifying a parent–subsidiary relationship (see chapter 20). It is often straightforward to identify the acquirer. For example, entity A might acquire shares in entity B.

In other situations, identification of an acquirer requires judgement. Consider the situation where entity A combines with entity B. To effect the combination, a new company (entity C) is formed, which issues shares to acquire all the shares of both entities A and B. The subsequent organisational structure is as shown in figure 14.3.

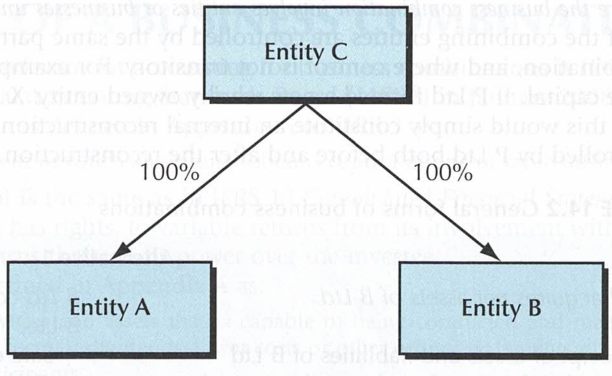

FIGURE 14.3 Example of entity combination and subsequent organisational structure

As entity C is created solely to formalise the organisation structure, it is not the acquirer, even though it is the legal parent of both of the other entities. Paragraph B18 of Appendix B to IFRS 3 states that one of the entities that existed before the combination must be identified as the acquirer. Entity C is not a party to the decisions associated with creating the business combination, it is just a vehicle used to facilitate the combination. If entity A is identified as the acquirer, then entity B's assets and liabilities are measured at fair value at acquisition date.

Paragraphs B14–B18 of Appendix B to IFRS 3 provide some indicators to assist in assessing which entity is the acquirer:

- *What are the relative voting rights in the combined entity after the business combination?* The acquirer is usually the entity whose owners have the largest portion of the voting rights in the combined entity. As noted in paragraph B19, in a reverse acquisition, entity X may issue its shares to acquire the shares of entity Y. However, because of the greater number of X shares given to the former Y shareholders relative to those held by the shareholders in entity X before the combination, the former shareholders in entity Y may have the majority of shares in entity X and be able to determine the operating and financial policies of the combined entities.
- *Is there a large minority voting interest in the combined entity?* The acquirer is usually the entity that has the largest minority voting interest in an entity that has a widely dispersed ownership.
- *What is the composition of the governing body of the combined entity?* The acquirer is usually the combining entity whose owners have the ability to elect or appoint or to remove a majority of the members of the governing body of the combined entity.
- *What is the composition of the senior management that governs the combined entity subsequent to the combination?* This is an important indicator given that the criterion for identification of an acquirer is that of control. If X and Y combine, is the senior management group of the combined entity dominated by former senior managers of X or Y?
- *What are the terms of the exchange of equity interests?* Has one of the combining entities paid a premium over the pre-combination fair value of one of the combining entities, an amount paid in order to gain control?
- *Which entity is the larger?* This could be measured by reference to the fair value of each of the combining entities, or relative revenues or profits. In a takeover, it is normally the larger company that takes over the smaller company (that is, the larger company is the acquirer).
- *Which entity initiated the exchange?* Normally the entity that is the acquirer is the one that undertakes action to take over the acquiree.

Determining the controlling entity is the key to identification of the acquirer. However, doing so may not be straightforward in many business combinations, and the accountant might be required to make a reasoned judgement based on the circumstances.

Paragraph 6 requires an acquirer to be identified in every business combination, even though it may be argued that it is not always possible to do so. In the case of a 'true' merger, neither party would claim to be dominant.

It can also prove difficult to identify an acquirer under a combination achieved by contract alone. Such a combination may not involve the exchange of readily measurable consideration.

The need to identify the acquirer stems from the need to measure the acquiree's assets at fair value, but not those of the acquirer.

14.2.2 Determining the acquisition date [step 2]

The acquisition date is defined in Appendix A to IFRS 3 as:

> [t]he date on which the **acquirer** obtains control of the **acquiree**.

Other dates, such as the date that the contract is signed or the date on which the assets are delivered may be important issues for management, but they do not necessarily reflect the acquisition date. As noted in paragraph 9 of IFRS 3, on the closing date of the combination, the acquirer legally transfers the consideration — cash or shares — and acquires the assets and assumes the liabilities of the acquiree. However, in some cases this may not be the acquisition date.

The definition of acquisition date then relates to the point in time when the net assets of the acquiree become the net assets of the acquirer — in essence, the date on which the acquirer can recognise the net assets acquired in its own records.

Identifying the acquisition date is important because:

- The identifiable assets acquired and liabilities assumed by the acquirer are measured at their fair values on the acquisition date. If markets are volatile then the date could affect the fair value.
- The consideration paid by the acquirer is determined as the sum of the fair values of assets given, equity issued and/or liabilities undertaken in exchange for the net assets or shares of another entity. Share prices can fluctuate daily, so the choice of date can affect the measure of fair value.
- The acquirer may acquire only some of the shares of the acquiree. The owners of the balance of the shares of the acquiree are called the non-controlling interest. This non-controlling interest is measured at fair value at acquisition date.
- The acquirer may have previously held an equity interest in the acquiree prior to obtaining control of the acquiree. For example, entity X may have previously acquired 20% of the shares of entity Y, and now acquires the remaining 80% giving it control of entity Y. The acquisition date is the date when entity X acquired the 80% interest. The 20% share holding will be recorded as an asset in the records of entity X. At acquisition date, the fair value of this investment is measured.

The effect of determining the acquisition date is that the financial position of the combined entity at acquisition date should report the assets and liabilities of the acquiree at that date, and any profits reported as a result of the acquiree's operations within the business combination should reflect profits earned after the acquisition date.

14.3 ACCOUNTING IN THE RECORDS OF THE ACQUIRER

Where the acquirer purchases assets and assumes liabilities of another entity, it has to consider:

(a) the recognition and measurement of the identifiable assets acquired and the liabilities assumed (step 3 of the acquisition method)

(b) the recognition and measurement of goodwill or a gain from a bargain purchase (step 4 of the acquisition method).

Chapters 20 to 24 deal with the preparation of consolidated financial statements for business combinations where the acquirer purchases the shares of the acquiree. The only aspect of such business combinations that will be covered in this chapter is the recognition and measurement of the investment by the acquirer *(see section 14.6)*.

14.4 RECOGNITION AND MEASUREMENT OF ASSETS ACQUIRED AND LIABILITIES ASSUMED [STEP 3]

14.4.1 Recognition

Paragraph 10 of IFRS 3 states:

> 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. Recognition of identifiable assets acquired and liabilities assumed is subject to the conditions specified in paragraphs 11 and 12.

Paragraph 4.38 of the *Conceptual Framework* specifies two recognition criteria for assets and liabilities, stating that recognition occurs if:

- it is probable that any future economic benefit will flow to or from the entity
- the item has a cost or value that can be reliably measured.

The probability criterion does not really apply in the context of a business combination because the use of fair values automatically incorporates the probabilities of future economic benefits into the valuation. For example, an asset whose future expected cash flows were regarded as risky would have a lower fair value.

Paragraph 10 requires the recognition of any non-controlling interest in the acquiree. Non-controlling interests are discussed in chapter 23.

In paragraphs 11 and 12 of IFRS 3, there are two conditions that have to be met prior to the recognition of assets and liabilities acquired in the business combination:

Firstly, at the acquisition date, the assets and liabilities recognised by the acquirer must meet the definitions of assets and liabilities in the *Conceptual Framework*. Any expected future costs cannot be included in the calculation of assets acquired and liabilities assumed.

Secondly, the item acquired or assumed must be part of the business acquired rather than the result of a separate transaction.

The first of these conditions can have implications for the treatment of contingent liabilities. If the liability is contingent upon a future event, such as the outcome of legal action against the acquiree, then nothing needs to be done. If the liability has been treated as contingent because the future outflows are not regarded as 'probable' or because the amounts cannot be measured with sufficient reliability, then it is necessary to attach a fair value, even though it would have been a breach of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* for the acquiree to have recognised the liability in its financial statements before the combination.

The second condition applies substance over form. For example, suppose the acquiree had a claim outstanding against the acquirer before the acquisition date. If the acquirer agrees to settle the claim as part of the combination and part of the consideration includes a sum in settlement of the claim then it would be necessary to account for the acquisition as two transactions and the sum paid in settlement would have to be separated out from the consideration.

Paragraph 13 of IFRS 3 notes that a possible result of applying the principles of IFRS 3 may be the recognition of assets and liabilities as a result of the business combination that were not previously recognised by the acquiree. For example, internally generated intangibles that were not recognised by the acquiree because of the requirements of IAS 38 *Intangible Assets* may have to be recognised by the acquirer at fair value.

Paragraph 15 of IFRS 3 requires that the acquirer classifies or designates assets and liabilities on the basis of the contractual terms, economic conditions, its operating or accounting policies and other pertinent conditions that exist at acquisition date. This could, for example, affect the classification of financial assets at fair value or at amortised cost.

As a part of the illustrative examples accompanying IFRS 3, the IASB provided examples of items acquired in a business combination that would meet the definition of an intangible asset (see figure 14.4).

CLASS	BASIS
Marketing-related intangible assets	
Trademarks, trade names, service marks, collective marks and certification marks	Contractual
Trade dress (unique colour, shape or package design)	Contractual
Newspaper mastheads	Contractual
Internet domain names	Contractual
Non-competition agreements	Contractual
Customer-related intangible assets	
Customer lists	Non-contractual
Order or production backlog	Contractual
Customer contracts and related customer relationships	Contractual
Non-contractual customer relationships	Non-contractual
Artistic-related intangible assets	
Plays, operas and ballets	Contractual
Books, magazines, newspapers and other literary works	Contractual
Musical works such as compositions, song lyrics and advertising jingles	Contractual
Pictures and photographs	Contractual
Video and audiovisual material, including motion pictures or films, music videos and television programs	Contractual
Contract-based intangible assets	
Licensing, royalty and standstill agreements	Contractual
Advertising, construction, management, service or supply contracts	Contractual
Lease agreements (whether the acquiree is the lessee or lessor)	Contractual
Construction permits	Contractual
Franchise agreements	Contractual
Operating and broadcasting rights	Contractual
Servicing contracts such as mortgage servicing contracts	Contractual
Employment contracts	Contractual
Use rights, such as drilling, water, air, timber cutting and route authorities	Contractual
Technology-based intangible assets	
Patented technology	Contractual
Computer software and mask works	Contractual
Unpatented technology	Non-contractual
Databases including title plants	Non-contractual
Trade secrets such as secret formulas, processes and recipes	Contractual

FIGURE 14.4 Intangible assets, IFRS 3 Illustrative Examples

14.4.2 Measurement

Paragraph 18 requires an acquirer to measure the identifiable assets acquired and the liabilities assumed at their fair values on acquisition date.

Fair value is defined in Appendix A to IFRS 3 as follows:

the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Fair value is discussed in detail in chapter 3.

Paragraph BC198 of the Basis for Conclusions on IFRS 3 argues that fair values are relevant, comparable and understandable.

14.5 GOODWILL AND GAIN ON BARGAIN PURCHASE [STEP 4]

Paragraph 32 of IFRS 3 states:

The acquirer shall recognise goodwill as of the acquisition date measured as the excess of (a) over (b) below:

(a) the aggregate of:

(i) the consideration transferred measured in accordance with this IFRS, which generally requires acquisition-date fair value (see paragraph 37);

(ii) the amount of any non-controlling interest in the acquiree measured in accordance with this IFRS; and

(iii) in a business combination achieved in stages (see paragraphs 41 and 42), the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree.

(b) the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed measured in accordance with this IFRS.

In relation to parts (a)(ii) and (iii) in paragraph 32, these will affect calculations only where the acquirer obtains control by acquiring shares in the acquiree. *This is discussed in chapters 20 to 24.* This means that for business combinations discussed in this chapter, goodwill is determined by comparing the consideration transferred by the acquirer with the net fair value of the identifiable assets and liabilities acquired.

The net fair value of the identifiable assets and liabilities acquired is determined as step 3. The first part of step 4 is then the measurement of consideration transferred.

14.5.1 Consideration transferred

According to paragraph 37, the consideration transferred:

- is measured at fair value at acquisition date
- is calculated as the sum of the acquisition-date fair values of the assets transferred by the acquirer, the liabilities incurred by the acquirer to former owners of the acquiree, and the equity interest issued by the acquirer.

In a specific exchange, the consideration transferred to the acquiree could include just one form of consideration, such as cash, but could equally well consist of a number of forms such as cash, other assets, shares and contingent consideration. These are considered in the following pages.

Cash or other monetary assets

The fair value is the amount of cash or cash equivalent dispersed. The amount is usually readily determinable. One problem that may occur arises when the settlement is deferred to a time after the acquisition date. For a deferred payment, the fair value to the acquirer is the amount the entity would have to borrow to settle the debt immediately. The discount rate used is the entity's incremental borrowing rate.

Use of cash, including a deferred payment, to acquire net assets results in the acquirer recording the following form of entry at the acquisition date:

Net assets	Dr	xxx	
Cash	Cr		xxx
Payable to Acquiree	Cr		xxx
(Acquisition of net assets with partially deferred payment)			

When the deferred payment is made to the acquiree, the interest component needs to be recognised:

Payable to Acquiree	Dr	xxx	
Interest Expense	Dr	xxx	
Cash	Cr		xxx
(Payment of deferred amount)			

Non-monetary assets

Non-monetary assets are assets such as property, plant and equipment, investments, licences and patents. *Chapter 3 discusses how fair values are determined.*

The acquirer is effectively selling the non-monetary asset to the acquiree. Hence, it is earning income equal to the fair value on the sale of the asset. Where the carrying amount of the asset in the records of the acquirer is different from fair value, a gain or loss on the asset is recognised at acquisition date. This principle is explained in paragraph 38 of IFRS 3: 'the acquirer shall remeasure the transferred assets or liabilities to their fair values as of the acquisition date and recognise the resulting gains or losses, if any, in profit or loss'.

Use of a non-monetary asset such as plant as part of the consideration to acquire net assets results in the acquirer recording the following entries (assume a cost of plant of $180, a carrying amount of $150 and fair value of $155):

Accumulated Depreciation	Dr	30	
Plant	Cr		25
Gain	Cr		5
(Remeasurement as part of consideration transferred in a business combination)			
Net Assets Acquired	Dr	xxx	
Plant	Cr		155
Other Consideration Payable	Cr		xxx
(Acquisition of net assets)			

The acquirer recognises a gain on the non-current asset and the asset is then included in the consideration transferred at fair value.

Equity instruments

If an acquirer issues its own shares as consideration, it needs to determine the fair value of those shares at the acquisition date. For listed entities, reference is made to the quoted prices of the shares. As noted in paragraph BC342 of the Basis for Conclusions on IFRS 3, 'equity instruments issued as consideration in a business combination should be measured at their fair values on the acquisition date'.

Liabilities assumed

The fair values of liabilities assumed are best measured by the present values of expected future cash outflows. Future losses or other costs expected to be incurred as a result of the combination are not liabilities of the acquirer and are therefore not included in the calculation of the fair value of consideration paid.

Costs of issuing debt and equity instruments

Paragraph 53 of IFRS 3 indicates costs to issue debt and equity instruments are accounted for in accordance with IAS 32 *Financial Instruments: Presentation* and IFRS 9 *Financial Instruments.* In issuing equity instruments such as shares as part of the consideration paid, transaction costs such as stamp duties, professional advisers' fees, underwriting costs and brokerage fees may be incurred. Paragraph 35 of IAS 32 states that these outlays should be treated as a reduction in the share capital of the entity as such costs reduce the proceeds from the equity issue, net of any related income tax benefit. Hence, if costs of $1000 are incurred in issuing shares as part of the consideration paid, the journal entry in the records of the acquirer is:

Share Capital	Dr	1 000	
Cash	Cr		1 000
(Costs of issuing equity instruments)			

Similarly, the costs of arranging and issuing financial liabilities are an integral part of the liability issue transaction. These costs are included in the initial measurement of the liability. *Financial liabilities are discussed further in chapter 7.*

Contingent consideration

Appendix A to IFRS 3 provides the following definition of contingent consideration:

> Usually, an obligation of the **acquirer** to transfer additional assets or **equity interests** to the former owners of an **acquiree** as part of the exchange for **control** of the **acquiree** if specified future events occur or conditions are met. However, contingent consideration also may give the **acquirer** the right to the return of previously transferred consideration if specified conditions are met.

Consider two examples of contingencies. The first is where, because the future income of the acquirer is regarded as uncertain, the agreement contains a clause that requires the acquirer to provide additional consideration to the acquiree if the income of the acquirer is not equal to or exceeds a specified amount over some specified period. The second situation is where the acquirer issues shares to the acquiree and the acquiree is concerned that the issue of these shares may make the market price of the acquirer's shares decline over time. Therefore, the acquirer may offer additional cash or shares if the market price falls below a specified amount over a specified period of time.

According to paragraph 39 of IFRS 3, consistent with other measurements in transferred consideration, the acquirer shall recognise the acquisition-date fair values of contingent consideration as part of the consideration transferred.

14.5.2 Acquisition-related costs

In addition to the consideration transferred by the acquirer to the acquiree, a further item to be considered in determining the cost of the business combination is the costs directly attributable to the combination, which includes costs such as 'finder's fees; advisory, legal, accounting, valuation and other professional or consulting fees; [and] general administrative costs, including the costs of maintaining an internal acquisitions department' (IFRS 3 paragraph 53).

In IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets*, directly attributable costs are considered as a part of the cost of acquisition and capitalised into the cost of the asset acquired. In contrast, the acquisition-related costs associated with a business combination are accounted for as expenses in the periods in which they are incurred and the services are received. The key reasons given for this approach are provided in paragraph BC366 of the Basis for Conclusions on IFRS 3:

- Acquisition-related costs are not part of the fair value exchange between the buyer and seller.
- They are separate transactions for which the buyer pays the fair value for the services received.
- These amounts do not generally represent assets of the acquirer at acquisition date because the benefits obtained are consumed as the services are received.

The IFRS 3 accounting for these outlays is a result of the decision to record the identifiable assets acquired and liabilities assumed at fair value. In contrast, under IAS 16 and IAS 38, the assets acquired are initially recorded at cost.

ILLUSTRATIVE EXAMPLE 14.1 Consideration transferred in a business combination

The trial balance below represents the financial position of Whiting Ltd at 1 January 2016.

WHITING LTD
Trial Balance
as at 1 January 2016

	Debit	Credit
Share capital		
Preference — 6000 fully paid shares		$ 6 000
Ordinary — 30 000 fully paid shares		30 000
Retained earnings		21 500
Equipment	$42 000	
Accumulated depreciation – equipment		10 000
Inventory	18 000	
Accounts receivable	16 000	
Patents	3 500	
Debentures		4 000
Accounts payable		8 000
	$79 500	$79 500

At this date, the business of Whiting Ltd is acquired by Salmon Ltd, with Whiting Ltd going into liquidation. The terms of acquisition are as follows:

1. Salmon Ltd is to take over all the assets of Whiting Ltd as well as the accounts payable of Whiting Ltd.
2. Costs of liquidation of $350 are to be paid by Whiting Ltd with funds supplied by Salmon Ltd.
3. Preference shareholders of Whiting Ltd are to receive two fully paid preference shares in Salmon Ltd for every three shares held or, alternatively, $1 per share in cash payable at acquisition date.
4. Ordinary shareholders of Whiting Ltd are to receive two fully paid ordinary shares in Salmon Ltd for every share held or, alternatively, $2.50 in cash, payable half at the acquisition date and half on 31 December 2016.
5. Debenture holders of Whiting Ltd are to be paid in cash out of funds provided by Salmon Ltd. These debentures have a fair value of $102 per $100 debenture.
6. All shares being issued by Salmon Ltd have a fair value of $1.10 per share. Holders of 3000 preference shares and 5000 ordinary shares elect to receive the cash.

7. Costs of issuing and registering the shares issued by Salmon Ltd amount to $40 for the preference shares and $100 for the ordinary shares.
8. Costs associated with the business combination and incurred by Salmon Ltd were $1000.

The calculation of the consideration transferred in the business combination to Salmon Ltd is shown in figure 14.5. The incremental borrowing rate for Salmon Ltd is 10% p.a.

Consideration transferred:			Fair value
Cash:	Costs of liquidation	$ 350	
	Preference shareholders (3000 × $1.00)	3 000	
	Ordinary shareholders		
	– payable immediately (1/2 × 5000 × $2.50)	6 250	
	– payable later (1/2 × 5000 × $2.50 × 0.909091)*	5 682	
	Debentures, including premium ($4000 × 1.02)	4 080	$19 362
Shares:	Preference shareholders (2000 × $1.10)	2 200	
	Ordinary shareholders (50 000 × $1.10)	55 000	57 200
Consideration transferred			$76 562

* *$5682 is the cash payable in 1 year's time discounted at 10% p.a.*

FIGURE 14.5 Consideration transferred in the business combination

In acquiring the net assets of Whiting Ltd, Salmon Ltd passes the journal entries shown in figure 14.6.

2016				
Jan. 1	Net Assets Acquired	Dr	76 562	
	Consideration Payable	Cr		19 362
	Share Capital – Preference	Cr		2 200
	Share Capital – Ordinary	Cr		55 000
	(Acquisition of the net assets of Whiting Ltd)			
	Consideration Payable	Dr	13 680	
	Cash	Cr		13 680
	(Payment of cash consideration to Whiting Ltd: $19 362 less $5682 payable later)			
	Share Capital – Ordinary	Dr	100	
	Share Capital – Preference	Dr	40	
	Cash	Cr		140
	(Share issue costs)			
	Acquisition-Related Expenses	Dr	1 000	
	Cash	Cr		1 000
	(Acquisition-related expenses)			
Dec. 31	Consideration Payable	Dr	5 682	
	Interest Expense	Dr	568	
	Cash	Cr		6 250
	(Balance of consideration paid)			

FIGURE 14.6 Journal entries in the acquirer's records

14.5.3 Goodwill

As noted at the beginning of section 14.5, goodwill is the excess of the consideration transferred over the net fair value of the identifiable assets acquired and liabilities assumed.

Goodwill = Consideration transferred
less
Acquirer's interest in the net fair value of the acquiree's identifiable assets and liabilities

Goodwill is accounted for as an asset and is defined in Appendix A to IFRS 3 as:

An asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognised.

The criterion of 'being individually identified' relates to the characteristic of 'identifiability' as used in IAS 38 *Intangible Assets* to distinguish intangible assets from goodwill. Note paragraph 11 of IAS 38 in this regard:

> The definition of an intangible asset requires an intangible asset to be identifiable to distinguish it from goodwill. Goodwill recognised in a business combination is an asset representing future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognised. The future economic benefits may result from synergy between the identifiable assets acquired or from assets that, individually, do not qualify for recognition in the financial statements.

In order to be identifiable, an asset must be capable of being separated or divided from the entity, or arise from contractual or other legal rights. The notion of being 'separately recognised' is also then a part of the criterion of 'identifiability'. *This criterion is discussed further in chapter 13.*

Goodwill is then a residual, after the acquirer's interest in the identifiable tangible assets, intangible assets, and liabilities of the acquiree is recognised.

The components of goodwill

Johnson and Petrone (1998, p. 295) identified six components of goodwill:

1. *Excess of the fair values over the book values of the acquiree's recognised assets.* In a business acquisition, as assets acquired are measured at fair value, these excesses should not exist. Subsequent to the acquisition, the acquiree's goodwill could include such excesses where assets are measured at cost.
2. *Fair values of other net assets not recognised by the acquiree.* The assets of concern here are those tangible assets which are incapable of reliable measurement by the acquiree, and non-physical assets that do not meet the identifiability criteria for intangible assets.
3. *Fair value of the 'going concern' element of the acquiree's existing business.* This represents the ability of the acquiree to earn a higher return on an assembled collection of net assets than would be expected from those net assets operating separately. This reflects synergies of the assets, as well as factors relating to market imperfections such as an ability of an entity to earn a monopoly profit, or where there are barriers to competitors entering a particular market.
4. *Fair value from combining the acquirer's and acquiree's businesses and net assets.* This stems from the synergies that result from the combination, the value of which is unique to each combination.
5. *Overvaluation of the consideration paid by the acquirer.* This relates to errors in valuing the consideration paid by the acquirer, and may arise particularly where shares are issued as consideration with differences in prices for small parcels of shares as opposed to controlling parcels of shares. There could also be overvaluation of the fair values of the assets acquired. This component could then relate to all errors in measuring the fair values in the business combination.
6. *Overpayment (or underpayment) by the acquirer.* This may occur if the price is driven up in the course of bidding; conversely, goodwill could be understated if the acquiree's net assets were obtained through a distress or fire sale.

In paragraph BC130 of the Basis for Conclusions on IFRS 3, the IASB recognised that components 1 and 2 are not conceptually part of goodwill. Johnson and Petrone (1998, p. 295) and the IASB (paragraph BC131) recognised that components 5 and 6 in the above list also are not conceptually part of goodwill, but rather relate to measurement errors. The two components that are seen as part of goodwill are components 3 and 4, described by Johnson and Petrone (p. 296) as 'going-concern goodwill' and 'combination goodwill' respectively, with the combination of the components being referred to as 'core goodwill'. This is represented diagrammatically in figure 14.7.

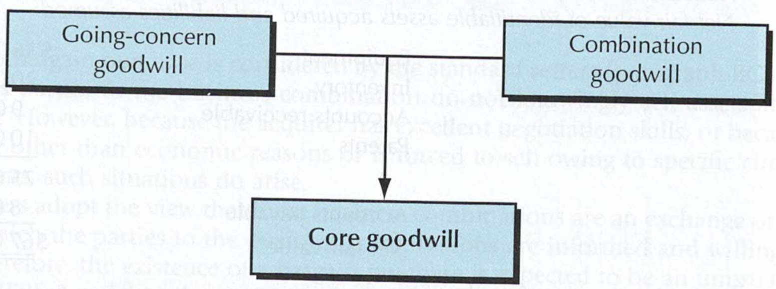

FIGURE 14.7 Core goodwill
Source: Data derived from Johnson and Petrone (1998).

It is this 'core goodwill' that the IASB is concerned with in determining how to account for goodwill. The IASB in paragraph BC137 of the Basis for Conclusions on IFRS 3 notes how IFRS 3 tries to avoid subsuming the first, second and fifth components into the amount calculated as goodwill by requiring an acquirer to make every effort to:

- measure the consideration accurately (eliminating or reducing component 5)
- recognise the identifiable net assets acquired at their fair values rather than their carrying amounts (eliminating or reducing component 1)
- recognise all acquired intangible assets (reducing component 2).

Is goodwill an asset?

IFRS 3 accounts for goodwill as an asset, although it is debatable whether it meets the definition of an asset as set out in the *Conceptual Framework*.

The problem with goodwill is that it is a unique asset. It arises as a residual. As Leo, Hoggett and Radford (1995, pp. 44–7) noted, the key difference between identifiable net assets and goodwill is measurement:

> The difference between the measurement method used for goodwill and that for measurement of all other assets of the business is whether the method involves determining the value of the business as a whole or part thereof.

The authors defined unidentifiable assets (p. 46) as those assets that meet the recognition criteria and cannot be measured without measuring the total net assets of a business entity. The existence of goodwill depends on the measurement of the entity as a whole. In recognising this, the IASB argued in paragraph BC323 of the Basis for Conclusions on IFRS 3:

> control of core goodwill is provided by means of the acquirer's power to direct the policies and management of the acquiree. Therefore, both the IASB and the FASB concluded that core goodwill meets the conceptual definition of an asset.

Accounting for goodwill

As noted earlier, goodwill is calculated as the excess of the consideration transferred in the business combination over the acquirer's interest in the net fair value of the identifiable assets acquired and liabilities assumed from the acquiree. Hence, to calculate goodwill as a part of the acquisition analysis it is necessary to calculate the consideration transferred and the net fair value of the identifiable assets acquired and liabilities assumed. A comparison of these two amounts determines the existence of goodwill. The acquirer then recognises goodwill as an asset in the same way as for all other identifiable assets acquired.

ILLUSTRATIVE EXAMPLE 14.2 Acquisition analysis

Using the figures from illustrative example 14.1, assume that Salmon Ltd assesses the fair values of the identifiable assets and liabilities of Whiting Ltd to be as follows:

Equipment	$36 000
Inventory	20 000
Accounts receivable	9 000
Patents	10 000
Accounts payable	8 000

To determine the entries to be passed by the acquirer, prepare an acquisition analysis that compares the consideration transferred with the net fair value of the identifiable assets, liabilities and contingent liabilities acquired. The analysis for this example is shown in figure 14.8.

Acquisition analysis

Net fair value of identifiable assets acquired and liabilities assumed:

Equipment	$36 000
Inventory	20 000
Accounts receivable	9 000
Patents	10 000
	75 000
Accounts payable	8 000
Net fair value	$67 000

Consideration transferred:

This was calculated in figure 14.5 as $76 562.

Goodwill acquired:

Net fair value acquired	= $67 000
Consideration transferred	= $76 562
Goodwill	= $76 562 − $67 000
	= $9 562

FIGURE 14.8 Acquisition analysis by the acquirer

The journal entries for Salmon Ltd at acquisition date are as shown in figure 14.9.

Equipment	Dr	36 000	
Inventory	Dr	20 000	
Accounts Receivable	Dr	9 000	
Patents	Dr	10 000	
Goodwill	Dr	9 562	
Accounts Payable	Cr		8 000
Consideration Payable	Cr		19 362
Share Capital – Preference	Cr		2 200
Share Capital – Ordinary	Cr		55 000
(Acquisition of the assets and liabilities of Whiting Ltd)			
Consideration Payable	Dr	13 680	
Cash	Cr		13 680
(Payment of cash consideration)			
Acquisition-Related Expenses	Dr	1 000	
Cash	Cr		1 000
(Acquisition-related costs)			
Share Capital – Ordinary	Dr	100	
Share Capital – Preference	Dr	40	
Cash	Cr		140
(Share issue costs)			

FIGURE 14.9 Journal entries of the acquirer, including recognition of goodwill, at acquisition date

14.5.4 Accounting for a gain on a bargain purchase

Where the acquirer's interest in the net fair value of the acquiree's identifiable assets and liabilities is greater than the consideration transferred, the difference is called a gain on a bargain purchase. In equation format, it can be represented as follows:

Gain on bargain purchase = Acquirer's interest in the net fair value of the acquiree's identifiable assets and liabilities
less
Consideration transferred

The existence of a bargain purchase is considered by the standard setters (paragraph BC371) as an anomalous transaction as parties to the business combination do not knowingly sell assets at amounts lower than their fair value. However, because the acquirer has excellent negotiation skills, or because the acquiree has made a sale for other than economic reasons or is forced to sell owing to specific circumstances such as cash flow problems, such situations do arise.

The standard setters adopt the view that most business combinations are an exchange of equal amounts, given markets in which the parties to the business combinations are informed and willing participants in the transaction. Therefore, the existence of a bargain purchase is expected to be an unusual or rare event.

Paragraph 36 of IFRS 3 requires that before a gain is recognised, the acquirer must reassess whether it has correctly:

- identified all the assets acquired and liabilities assumed
- measured at fair value all the assets acquired and liabilities assumed
- measured the consideration transferred.

The objective here is to ensure that all the measurements at acquisition date reflect all the information that is available at that date.

Note that one effect of recognising a bargain purchase is that there is no recognition of goodwill. A gain on bargain purchase and goodwill cannot be recognised in the same business combination.

ILLUSTRATIVE EXAMPLE 14.3 Gain on bargain purchase

Using the information regarding the consideration transferred in a business combination from illustrative examples 14.1 and 14.2, assume the fair values of the identifiable assets and liabilities of Whiting Ltd are assessed to be:

Equipment	$45 000
Inventory	25 000
Accounts receivable	9 000
Patents	11 000
	90 000
Accounts payable	8 000
	$82 000

The acquisition analysis now shows:

Net fair value of assets and liabilities acquired = $82 000
Consideration transferred = $76 562
Gain on bargain purchase = $82 000 − $76 562
= $5438

Assuming that the reassessment process did not result in any changes to the fair values calculated, the first journal entry in Salmon Ltd to record the acquisition of the net assets of Whiting Ltd is:

Equipment	Dr	45 000	
Inventory	Dr	25 000	
Accounts Receivable	Dr	9 000	
Patents	Dr	11 000	
Accounts Payable	Cr		8 000
Consideration Payable	Cr		19 362
Share Capital – Preference	Cr		2 200
Share Capital – Ordinary	Cr		55 000
Gain (Profit or Loss)	Cr		5 438
(Acquisition of assets and liabilities acquired from Whiting Ltd, and the gain on bargain purchase)			

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14.6 SHARES ACQUIRED IN THE ACQUIREE

Where an entity acquires shares in another entity, rather than the net assets of that entity, the measurement of the initial investment in these financial assets is in accordance with IFRS 9 *Financial Instruments* at fair value plus transaction costs.

Accounting for financial assets is covered in chapter 7.

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14.7 ACCOUNTING IN THE RECORDS OF THE ACQUIREE

Where the acquirer purchases the acquiree's assets and liabilities, the acquiree may continue in existence or may liquidate. The acquiree accounts affected by the business combination will differ according to the actions of the acquiree.

14.7.1 Acquiree does not liquidate

In the situation where the acquiree disposes of a business, the journal entries required in the records of the acquiree are shown in figure 14.10. Under IAS 16 *Property, Plant and Equipment*, when an item of property, plant and equipment is sold, gains or losses are recognised in the statement of profit or loss and other comprehensive income. Similarly, on the sale of a business, the acquiree recognises a gain or loss.

Receivable from Acquirer	Dr	xxx	
Liability A	Dr	xxx	
Liability B	Dr	xxx	
Liability C	Dr	xxx	
Asset A	Cr		xxx
Asset B	Cr		xxx
Asset C	Cr		xxx
Gain on Sale of Operation	Cr		xxx
(Sale of operation)			
Shares in Acquirer	Dr	xxx	
Cash	Dr	xxx	
Receivable from Acquirer	Cr		xxx
(Receipt of consideration from acquirer)			

FIGURE 14.10 Journal entries of acquiree on sale of business

14.7.2 Acquiree liquidates

The entries required in the records of the acquiree when it sells *all* its net assets to the acquirer are shown in figure 14.11. The accounts of the acquiree are transferred to two accounts, the Liquidation account and the Shareholders' Distribution account.

To the *Liquidation account* are transferred:

- all assets taken over by the acquirer, including cash if relevant, as well as any assets not taken over and which have a zero value, including goodwill
- all liabilities taken over
- the expenses of liquidation if paid by the acquiree
- additional expenses to be paid by the acquiree but not previously recognised by the acquiree
- consideration from the acquirer as proceeds on sale of net assets
- all reserves, including retained earnings.

The balance of the Liquidation account is then transferred to the Shareholders' Distribution account.

FIGURE 14.11 Journal entries of acquiree on liquidation after sale of net assets

Liquidation	Dr	xxx	
Asset A	Cr		xxx
Asset B	Cr		xxx
Asset C	Cr		xxx
(Transfer of all assets acquired by acquirer, at their carrying amounts)			
Liability A	Dr	xxx	
Liability B	Dr	xxx	
Liability C	Dr	xxx	
Liquidation	Cr		xxx
(Transfer of all liabilities assumed by the acquirer)			
Liquidation	Dr	xxx	
Cash	Cr		xxx
(Liquidation and other expenses not recognised previously, if paid by the acquiree)			
Receivable from Acquirer	Dr	xxx	
Liquidation	Cr		xxx
(Consideration for net assets sold)			
Cash	Dr	xxx	
Shares in Acquirer	Dr	xxx	
Receivable from Acquirer	Cr		xxx
(Receipt of consideration)			
Other Reserves	Dr	xxx	
Retained Earnings	Dr	xxx	
Liquidation	Cr		xxx
(Transfer of reserves)			

(continued)

FIGURE 14.11 *(continued)*

Liquidation	Dr	xxx	
Shareholders' Distribution	Cr		xxx
(Transfer of balance of liquidation)			
Share Capital	Dr	xxx	
Shareholders' Distribution	Cr		xxx
(Transfer of share capital)			
Shareholders' Distribution	Dr	xxx	
Cash	Cr		xxx
Shares in Acquirer	Cr		xxx
(Distribution of consideration to shareholders)			

To the *Shareholders' Distribution* account are transferred:

- the balance of share capital
- the balance of the Liquidation account
- the portion of the consideration received from the acquirer that is distributed to the shareholders.

Some of the consideration received by the acquiree may be used to pay for liabilities not assumed by the acquirer, and for liquidation expenses.

ILLUSTRATIVE EXAMPLE 14.4 Entries in the acquiree's records

Using the information from illustrative example 14.1, the entries in the records of Whiting Ltd are shown in figure 14.12.

FIGURE 14.12 Liquidation of acquiree

Liquidation	Dr	69 500	
Accumulated Depreciation – Equipment	Dr	10 000	
Equipment	Cr		42 000
Inventory	Cr		18 000
Accounts Receivable	Cr		16 000
Patents	Cr		3 500
(Assets taken over)			
Accounts Payable	Dr	8 000	
Liquidation	Cr		8 000
(Liabilities taken over)			
Liquidation	Dr	350	
Liquidation Expenses Payable	Cr		350
(Liquidation expenses payable by acquiree)			
Liquidation	Dr	80	
Debenture Holders Payable	Cr		80
(Premium expense on debentures to be paid on redemption)			
Receivable from Salmon Ltd	Dr	76 562	
Liquidation	Cr		76 562
(Consideration receivable)			
Cash	Dr	13 680	
Shares in Salmon Ltd	Dr	57 200	
Receivable from Salmon Ltd	Cr		70 880
(Receipt of consideration from acquirer)			
Retained Earnings	Dr	21 500	
Liquidation	Cr		21 500
(Transfer of retained earnings)			
Liquidation	Dr	36 132	
Shareholders' Distribution	Cr		36 132
(Balance of Liquidation account transferred to Shareholders' Distribution)			

FIGURE 14.12 *(continued)*

Share Capital – Ordinary	Dr	30 000	
Share Capital – Preference	Dr	6 000	
Shareholders' Distribution	Cr		36 000
(Transfer of share capital)			
Debentures	Dr	4 000	
Debenture Holders Payable	Cr		4 000
(Transfer of debentures to payable account)			
Liquidation Expenses Payable	Dr	350	
Debenture Holders Payable	Dr	4 080	
Cash	Cr		4 430
(Payment of liabilities)			
Shareholders' Distribution	Dr	72 132	
Cash	Cr		9 250
Shares in Salmon Ltd	Cr		57 200
Receivable from Salmon Ltd	Cr		5 682
(Payment to shareholders)			

14.7.3 Acquirer buys only shares in the acquiree

When the acquirer buys only shares in the acquiree, there are no entries in the records of the acquiree because the transaction is between the acquirer and the shareholders of the acquiree entity. The acquiree itself is not involved.

14.8 SUBSEQUENT ADJUSTMENTS TO THE INITIAL ACCOUNTING FOR A BUSINESS COMBINATION

Three areas where adjustments may need to be made subsequent to the initial accounting after acquisition date are:

- goodwill
- contingent liabilities
- contingent consideration.

Goodwill

Having recognised goodwill arising in the business combination, the subsequent accounting is directed from other accounting standards:

- goodwill is not subject to amortisation but is subject to an annual impairment test as detailed in IAS 36 *Impairment of Assets (see chapter 15)*.
- goodwill cannot be revalued because IAS 38 *Intangible Assets* does not allow the recognition of internally generated goodwill.

Contingent liabilities

Having recognised any contingent liabilities of the acquiree as liabilities, the acquirer must then determine a subsequent measurement for the liability. The liability is initially recognised at fair value. Subsequent to acquisition date, according to paragraph 56 of IFRS 3, the liability is measured as the higher of:

(a) the amount that would be recognised in accordance with IAS 37; and
(b) the amount initially recognised less, if appropriate, cumulative amortisation recognised in accordance with IAS 18 *Revenue*.

Under IAS 37 paragraph 36, the liability would be measured at the best estimate of the expenditure required to settle the present obligation at the end of the reporting period. This would be used, for example, where a liability was recognised in relation to a court case. However, the IASB was also concerned about contingent liabilities such as guarantees or other financial liabilities. Under IAS 39 paragraph 47, the subsequent measurement of financial liabilities requires preparers to use the higher of the IAS 37 measurements and the amount initially recognised subject to amortisation in line with IAS 18. In order for IFRS 3 to be consistent with IAS 39, the measurement method to be used in subsequent accounting for contingent liabilities was made the same as that in IAS 39.

Contingent consideration

At acquisition date, the contingent consideration is measured at fair value, and is classified either as equity (e.g. the requirement for the acquirer to issue more shares subject to subsequent events) or as a liability (e.g. the requirement to provide more cash subject to subsequent events). Subsequent to the business combination, paragraph 54 of IFRS 3 requires the accounting for contingent consideration to be in accordance with the accounting standard that would normally apply to these accounts. However, IFRS 3 provides guidance on the measures to be used.

Where the contingent consideration is classified as equity, no remeasurement is required, and the subsequent settlement is accounted for within equity (IFRS 3 paragraph 58(a)). This means that if extra equity instruments are issued they are effectively issued for no consideration and there is no change to share capital.

Where the contingent consideration is a financial liability, it will be accounted for under IAS 39 and measured at fair value with movements being accounted for in accordance with that standard. If it is a liability not within the scope of IAS 39, it is accounted for in accordance with IAS 37. So, if there were changes in the amount of an expected cash outflow, the liability would be adjusted and an amount recognised in profit or loss.

It should be noted that the subsequent accounting for contingent consideration is to treat it as a post-acquisition event; that is, not affecting the measurements made at acquisition date. Hence, any subsequent adjustments do not affect the goodwill calculated at acquisition date.

ILLUSTRATIVE EXAMPLE 14.5 Comprehensive example

Labrador Ltd's major business is in the pet food industry. It makes a number of canned pet foods, mainly for cats and dogs, as well as having a very promising line in dry dog food. It has been interested for some time in the operations of Pelican Ltd, an entity that deals with the processing of grain products for a number of other industries including flour-processing, health foods and, in more recent times, the production of grain products for feeding birds. Given its interest in the pet food industry and its desire to stay as one of the leaders in this area, Labrador Ltd began negotiations with Pelican Ltd to acquire its birdseed product division.

Negotiations began in July 2015. After months of discussion between the relevant parties of both companies, an agreement was reached on 15 February 2016 for Labrador Ltd to acquire the birdseed division. The agreement document was taken to the board of directors of Pelican Ltd who ratified the agreement on 1 March 2016. The net assets were exchanged on this date.

The net assets of the birdseed division at 1 March 2016, showing the carrying amounts at that date and the fair values as estimated by Labrador Ltd from documentation supplied by Pelican Ltd, were as shown below:

	Carrying amount	Fair value
Plant and equipment	$160 000	$167 000
Land	70 000	75 000
Motor vehicles	30 000	32 000
Inventory	24 000	28 000
Accounts receivable	18 000	16 000
Total assets	302 000	318 000
Accounts payable	35 000	35 000
Bank overdraft	55 000	55 000
Total liabilities	90 000	90 000
Net assets	$212 000	$228 000

Details of the consideration Labrador Ltd agreed to provide in exchange for the net assets of the division are described below:

- 100 000 shares in Labrador Ltd — movements in the share price were as follows:

1 July 2015	$1.00
1 October 2015	1.10
1 January 2016	1.15
1 February 2016	1.30
15 February 2016	1.32
16 February 2016	1.45
1 March 2016	1.50

- Because of doubts as to whether it could sustain a share price of at least $1.50, Labrador Ltd agreed to supply cash to the value of any decrease in the share price below $1.50 for the 100 000 shares issued, this guarantee of the share price lasting until 31 July. Labrador Ltd believed that there was a 90% chance that the share price would remain at $1.50 or higher and a 10% chance that it would fall to $1.48.
- Cash of $40 000, half to be paid on the date of acquisition and half in 1 year's time.

- Supply of a patent relating to the manufacture of packing material. This has a fair value of $60 000 but has not been recognised in the records of Labrador Ltd because it resulted from an internally generated research project.
- Pelican Ltd was currently being sued for damages relating to a claim by a bird breeder who had bought some seed from the company, and claimed that this resulted in the death of some prime breeding pigeons. Labrador Ltd agreed to pay any resulting damages in relation to the court case. The expected damages were $40 000. Lawyers estimated that there was only a 20% chance of losing the case.

Labrador Ltd supplied the cash on the acquisition date as well as surrendering the patent. The shares were issued on 5 March, and the costs of issuing the shares amounted to $1000. The incremental borrowing rate for Labrador Ltd is 10% p.a. Acquisition-related costs paid by Labrador Ltd in relation to the acquisition amounted to $5000.

On 31 July the share price of Labrador Ltd's shares was $1.52.

Required

Prepare the journal entries in the records of the acquirer.

Solution

Acquisition analysis

Net fair value of assets acquired and liabilities assumed		
Plant and equipment		$167 000
Land		75 000
Motor vehicles		32 000
Inventory		28 000
Accounts receivable		16 000
		318 000
Accounts payable		35 000
Bank overdraft		55 000
Provision for damages (20% × $40 000)		8 000
		98 000
		$220 000
Consideration transferred		
Purchase consideration:		
Shares: 100 000 × $1.50		$150 000
Guarantee: 10% ($1.50 − $1.48) × 100 000		200
Cash: Payable now		20 000
	Deferred ($20 000 × 0.909 091)	18 182
Patent		60 000
		$248 382
Goodwill ($248 382 − $220 000)		$ 28 382

The journal entries of the acquirer, Labrador Ltd, are shown in figure 14.13.

FIGURE 14.13 Journal entries of the acquirer

2016				
March 1	Plant and Equipment	Dr	167 000	
	Land	Dr	75 000	
	Motor Vehicles	Dr	32 000	
	Inventory	Dr	28 000	
	Accounts Receivable	Dr	16 000	
	Goodwill	Dr	28 382	
	Accounts Payable	Cr		35 000
	Bank Overdraft	Cr		55 000
	Provision for Damages	Cr		8 000
	Share Capital	Cr		150 000
	Provision for Loss in Value of Shares	Cr		200
	Cash	Cr		20 000
	Consideration Payable	Cr		18 182
	Gain on Sale of Patent	Cr		60 000
	(Acquisition of birdseed division from Pelican Ltd)			

(continued)

FIGURE 14.13 *(continued)*

	Acquisition-Related Expenses	Dr	5 000	
	Cash	Cr		5 000
	(Acquisition-related costs)			
March 5	Share Capital	Dr	1 000	
	Cash	Cr		1 000
	(Costs of issuing shares)			
July 31	Provision for Loss in Value of Shares	Dr	200	
	Gain	Cr		200
	(Contingency not having to be paid)			

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14.9 DISCLOSURE — BUSINESS COMBINATIONS

Paragraphs 59–63 of IFRS 3 contain information on disclosures required in relation to business combinations. To meet these disclosure requirements it is necessary to apply Appendix B of IFRS 3, which is an integral part of IFRS 3 containing application guidance.

Paragraph 59 requires entities to disclose information about the nature and financial effect of business combinations occurring during the current reporting period, or after the end of the reporting period but before the financial statements are authorised for issue. Paragraphs B64–B66 contain information to assist preparers to meet the disclosure objective in paragraph 59.

Note the qualitative information required to be disclosed under paragraph B64. In particular, note B64(d) which requires disclosure of the primary reasons for the business combination as well as a description of how the acquirer obtained control of the acquiree. This information should assist users to evaluate the success of the business combination and judge the ability of management to make investment decisions.

Also note that paragraph B64(e) requires disclosure of 'a qualitative description of the factors that make up goodwill recognised, such as expected synergies from combining operations of the acquiree and the acquirer, intangible assets that do not qualify for separate recognition or other factors'. Goodwill is not to be considered just a residual calculation. *As explained in section 14.5.3*, core goodwill can consist of elements such as combination goodwill and going-concern goodwill. An understanding of where the synergies exist will assist management in managing the earnings from goodwill as well as in any later impairment tests of goodwill *(see chapter 15 for more details concerning impairment testing)*. Unrecognised intangible assets may also be included in goodwill *(see chapter 13 for information on accounting for intangible assets in a business combination)*.

Paragraph 61 of IFRS 3 requires the disclosure of information to assist in the evaluation of the financial effects of adjustments recognised in the current period that relate to business combinations occurring in previous periods. Paragraph B67 details disclosures required in meet the information objective in paragraph 61.

An example of the required disclosures is provided in figure 14.14.

FIGURE 14.14 Disclosures required by Labrador Ltd under IFRS 3

26. Business combinations	**IFRS 3 paragraph**
Acquisition of division from Pelican Ltd During the current reporting period, the company acquired the birdseed division of Pelican Ltd. The acquisition date was 1 March 2016. The company has not had to dispose of any operations as a result of this combination. The primary reason for the business combination was to gain synergies in terms of the sales outlets for products sold by both entities.	*B64(a)* *B64(b)* *B64(d)*
The consideration transferred to Pelican Ltd was \$248 382. The components of the cost were:	*B64(f)*
Shares in the company — \$150 000 Cash paid and payable — 38 182 Patent for packaging — 60 000 Guarantee relating to the maintenance of the company's share price — 200	 *B64(g)(i)*
The contingent consideration — the guarantee — was measured at acquisition date at \$200 being based on an analysis of probable movements in share prices and budgeted information on future sales. The company issued 100 000 shares, determining a fair value of \$1.50 based on the current market price of the company at 1 March 2016 as reported by the stock exchange.	*B64(g)(ii)* *B64(f)(iv)*

FIGURE 14.14 *(continued)*

The assets acquired and liabilities assumed from Pelican Ltd were, as at 1 March 2016: *B64(i)*

	Carrying amount	Fair value
Plant and equipment	$160 000	$167 000
Land	70 000	75 000
Motor vehicles	30 000	32 000
Inventory	24 000	28 000
Accounts receivable	18 000	16 000
	302 000	318 000
Accounts payable	35 000	35 000
Bank overdraft	55 000	55 000
	90 000	90 000
Contingent liability acquired	8 000	8 000
		98 000
Net assets acquired		$220 000

Goodwill of $28 382 was recognised in the acquisition, the extra consideration being paid due to the excellent reputation and customer following relating to the quality of the birdseed products. *B64(e)*

An adjustment of $2000 was made to the fair value of the plant and equipment and goodwill subsequent to the acquisition due to the provisional nature of the fair value of some of the specialised equipment determined at acquisition date. *B67(a)*

The contingent liability acquired related to a court case involving a claim from a customer that certain bird food was of poor quality. If the court case were lost, which is not expected, the damages could be $40 000. A present obligation is regarded as existing at the end of the reporting period. *B64(j)*

Subsequent to the end of the reporting period, the provision in relation to the company's guarantee in relation to maintenance of the share price expired. No extra payment was required, as the share price had been maintained. *B64(g)(iii)*

Acquisition-related costs amounted to $5 000, all of which was recognised as an expense against the line item 'operating expenses'. Share issue costs of $1000 were treated as a reduction in share capital. *B64(m)*

Acquisition of shares in Cages Ltd

On 1 August 2015, the company acquired 100% of the shares in Cages Ltd, a company involved mainly in manufacturing bird cages, for $100 000. The primary reason for acquiring the company was to expand the variety of products sold to customers in the same industry. The consideration paid was cash. *B64(a),(b),(c)* *B64(d)* *B64(f)*

The assets and liabilities of Cages Ltd at acquisition date were: *B64(i)*

	Carrying amount	Fair value
Plant and equipment	$ 82 000	$ 88 000
Vehicles	22 000	20 000
Cash	12 000	12 000
Accounts receivable	8 000	7 000
	124 000	127 000
Accounts payable	32 000	32 000
Net assets	$ 92 000	$ 95 000

Goodwill of $5000 was acquired, attributable to a quality, well-trained workforce. *B64(e)*
The consolidated revenue for the consolidated group is $952 000. If the business combinations occurring during the year had occurred on 1 July 2015 instead of during the year, it is estimated that consolidated revenue would have been $985 000. The consolidated profit under the same assumption would have been $322 000 instead of $299 000. *B64(q)*

(continued)

FIGURE 14.14 *(continued)*

27. Goodwill

	2016	2015	
Gross amount at beginning of period	$20 600	$19 600	*B67(d)(i)*
Accumulated impairment losses	500	300	
	20 100	19 300	
Goodwill acquired	35 380	3 000	*B67(d)(ii)*
	55 480	22 300	
Adjustments — tax assets recognised	—	2 000	*B67(d)(iii)*
		20 300	
Impairment losses for current period	—	200	*B67(d)(iv)*
Carrying amount at end of period	$55 480	$20 100	
Consisting of:			*B67(d)(viii)*
Gross amount at end of period	$55 980	$20 600	
Accumulated impairment losses	500	500	
	$55 480	$20 100	

SUMMARY

IFRS 3 was issued in January 2008 on completion of a major project on business combinations undertaken by the IASB. IFRS 3 specifies accounting standards that have implications not only for the exchanges of assets between entities but also for the accounting for subsidiaries and associated entities. The standard specifies how an acquirer accounts for the assets and liabilities acquired as well as the measurement of the consideration transferred. In making these calculations, the acquirer must determine the acquisition date as all fair value measurements are made at acquisition date. The standard interacts with other standards such as IAS 38 *Intangible Assets* and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* because the acquirer has to recognise intangible assets and liabilities acquired in a business combination. The nature and calculation of goodwill is also covered in this accounting standard, as is the treatment of a gain on a bargain purchase.

Entities commonly trade with each other, exchanging one set of assets for another. When a grouping of assets constitutes a business, the accounting for the exchange transaction is determined by IFRS 3. IFRS 3 requires the application of the acquisition method under which the accountant must be able to identify which of the entities involved in the combination is the acquirer. The identifiable assets and liabilities acquired are measured at fair value at the acquisition date.

Goodwill or the gain on a bargain purchase is determined as a residual which, for the business combinations considered in this chapter, is generally determined by comparing the consideration transferred and the net fair value of the identifiable assets and liabilities acquired. Where the acquirer acquires the shares in the acquiree and where the acquirer already holds some shares in the acquiree at the acquisition date, the determination of goodwill is more involved. Understanding the nature of goodwill is essential to understanding how to account for it. With the existence of the accounting standard on impairment of assets, goodwill is not required to be amortised. Where a bargain purchase arises, the gain is recognised in current period income.

DEMONSTRATION PROBLEM 14.1 Acquisition analyses

On 1 January 2016, Trevally Ltd concluded agreements to take over the operations of Mackerel Ltd and to acquire the rest of the shares of Perch Ltd. The statements of financial position of the three companies as at that date were:

	Trevally Ltd	Mackerel Ltd	Perch Ltd
Cash	$ 20 000	$ 1 000	$ 12 500
Accounts receivable	35 000	19 000	30 000
Inventory	52 000	26 500	40 000
Property, plant and equipment (net)	280 500	149 500	107 500
Shares in Perch Ltd (15 000 shares)	19 000	—	—
Debentures in Hangi Ltd	45 000	18 000	—
	$451 500	$214 000	$190 000

	Trevally Ltd	Mackerel Ltd	Perch Ltd
Accounts payable	$ 78 000	$ 76 000	$ 27 500
Loan payable	—	40 000	—
$10 debentures — nominal value	—	—	50 000
Share capital — issued at $1	300 000	80 000	70 000
Retained earnings	73 500	18 000	42 500
	$451 500	$214 000	$190 000

Mackerel Ltd included in the notes to its accounts a contingent liability relating to a guarantee for a loan. Although a present obligation existed, a liability was not recognised by Mackerel Ltd because of the difficulty of measuring the ultimate amount to be paid.

The details of the acquisition agreements are as follows.

Mackerel Ltd

Trevally Ltd is to acquire all the assets (except cash) and all the liabilities of Mackerel Ltd. In exchange for every four shares in Mackerel Ltd, shareholders are to receive three shares in Trevally Ltd and $1.00 in cash. Each share in Trevally Ltd has a fair value of $1.80. Trevally Ltd is to pay additional cash to Mackerel Ltd to cover the total liquidation expenses of Mackerel Ltd which are expected to amount to $6000. The cash already held by Mackerel Ltd is to go towards the liquidation costs. The assets of Mackerel Ltd are all recorded in Mackerel Ltd's records at cost (depreciated if applicable). The fair values of Mackerel Ltd's assets are:

Receivables	$ 17 500
Inventory	32 000
Property, plant and equipment	165 500
Debentures in Hangi Ltd	19 000

Mackerel Ltd had been undertaking research into new manufacturing machinery, and had expensed a total of $10 000 research costs. Trevally Ltd determined that the fair value of this in-process research was $2000 at acquisition date. The contingent liability relating to the guarantee was considered to have a fair value of $1500.

External accounting advice and valuers' fees amounted to $3000.

Perch Ltd

Trevally Ltd is to acquire the remaining issued capital of Perch Ltd. In exchange, the shareholders in Perch Ltd are to receive four shares in Trevally Ltd for every five shares held in Perch Ltd. The shares already held in Perch Ltd are valued at $21 600. They have been measured at fair value with movements in fair value being recognised in profit or loss.

The legal costs incurred by Trevally Ltd in issuing its shares to Mackerel Ltd and Perch Ltd amounted to $1300 and $800 respectively.

Required

Prepare the acquisition analyses and journal entries necessary to record the acquisition of both Mackerel Ltd and Perch Ltd in the records of Trevally Ltd.

Solution

Prepare acquisition analyses and journal entries

The first step is to analyse the nature of the business combination, in particular what happens to each entity involved in the transactions. In this example, Trevally Ltd is the acquirer. It acquires assets and liabilities of Mackerel Ltd, probably with the latter entity going into liquidation. With Perch Ltd, Trevally Ltd acquires only shares in that entity; hence, the transaction is between Trevally Ltd and the shareholders of Perch Ltd and not with Perch Ltd.

Considering the combination between Trevally Ltd and Mackerel Ltd, the first step is to prepare an acquisition analysis. This involves looking at the two sides of the transaction, determining the fair value of the identifiable assets acquired and liabilities assumed and calculating the consideration transferred. The difference between these two amounts will be goodwill or gain on bargain purchase.

1. Acquisition analysis — Trevally Ltd and Mackerel Ltd

Trevally Ltd acquired all the assets except cash, and assumed all the liabilities of Mackerel Ltd. These assets and liabilities are now measured at fair value.

Accounts receivable	$ 17 500
Inventory	32 000
Property, plant and equipment	165 500
Debentures in Hangi Ltd	19 000
In-process research	2 000
	236 000
Provision for guarantee	1 500
Loan payable	40 000
Accounts payable	76 000
	117 500
Net fair value	$ 118 500

Consideration transferred

The consideration transferred is the purchase consideration payable to Mackerel Ltd and is measured as the sum of the fair values of shares issued, liabilities undertaken and assets given up by the acquirer. In this example, Trevally Ltd issues shares and gives up cash. The share price is the fair value of the shares at the acquisition date.

Consideration transferred			
Shares: Share capital of Mackerel Ltd		$80 000	
	Shares issued by Trevally Ltd (3/4)	60 000 × $1.80	$108 000
Cash:	80 000/4 × $1.00	20 000	
	Liquidation costs	6 000	
Less:	Held by Mackerel Ltd	(1 000)	25 000
Consideration transferred			$133 000

The consideration transferred is then compared with the net fair value of the identifiable assets and liabilities acquired to determine whether goodwill or a gain arises. In this case the consideration transferred is greater; hence, goodwill has been acquired.

Goodwill = $133 000 − $118 500 = $14 500

2. Acquisition analysis — Trevally Ltd and Perch Ltd

In this situation, Trevally Ltd acquires the shares in the acquiree rather than the actual assets and liabilities. Note that Trevally Ltd can gain control over the net assets of another entity by either buying the actual net assets or by acquiring a controlling interest in the entity that holds those net assets. The acquisition of the shares as an asset is not a business combination. However, by acquiring the shares, a business combination may have occurred, and a set of consolidated financial statements is prepared for the combined businesses using the principles of IFRS 3.

Cost of shares acquired	
Share capital of Perch Ltd	$ 70 000
Already held by Trevally Ltd	15 000
To acquire	$ 55 000
Trevally Ltd to issue 55 000 × 4/5 × $1.80 =	$ 79 200

The shares already held by Trevally Ltd in Perch Ltd are recorded at $19 000 at acquisition date. The fair value is $21 600. The investment is revalued at acquisition date to fair value, and the difference between these two amounts, $2600, is recorded as a gain.

The general journal entries in Trevally Ltd can then be read from the acquisition analysis. Note that when shares are issued the relevant account is 'Share Capital'.

Accounts Receivable	Dr	17 500	
Inventory	Dr	32 000	
Property, Plant and Equipment	Dr	165 500	
Debentures in Hangi Ltd	Dr	19 000	
In-process Research	Dr	2 000	
Goodwill	Dr	14 500	
Accounts Payable	Cr		76 000
Loan Payable	Cr		40 000
Provision for Guarantee	Cr		1 500
Share Capital	Cr		108 000
Payable to Mackerel Ltd	Cr		25 000
(Acquisition of net assets of Mackerel Ltd)			
Payable to Mackerel Ltd	Dr	25 000	
Cash	Cr		25 000
(Payment of consideration transferred)			
Acquisition-Related Expenses	Dr	3000	
Cash	Cr		3000
(Acquisition-related costs)			
Shares in Perch Ltd	Dr	2 600	
Gain on Revaluation of Investment	Cr		2 600
(Revaluation of investment to fair value)			
Shares in Perch Ltd	Dr	79 200	
Share Capital	Cr		79 200
(Purchase of remaining shares in Perch Ltd)			
Share Capital	Dr	2 100	
Cash	Cr		2 100
(Share issue costs incurred)			

Note that the costs of share issue reduce the Share Capital account which shows the net proceeds from share issues.

DEMONSTRATION PROBLEM 14.2 Acquisition and liquidation

On 1 July 2016, Smetana Ltd and Bay Ltd sign an agreement whereby the operations of Bay Ltd are to be taken over by Smetana Ltd. Bay Ltd will liquidate after the transfer is complete. The statements of financial position of the two companies on that day were as shown below.

	Smetana Ltd	Bay Ltd
Cash	$ 50 000	$ 20 000
Accounts receivable	75 000	56 000
Inventory	46 000	29 000
Land	65 000	—
Plant and equipment	180 000	167 000
Accumulated depreciation — plant and equipment	(60 000)	(40 000)
Patents	10 000	—
Shares in Cape Ltd	—	26 000
Debentures in Brett Ltd (nominal value)	10 000	—
	$376 000	$258 000
Accounts payable	$ 62 000	$ 31 000
Mortgage loan	75 000	21 500
10% debentures (face value)	100 000	30 000
Contributed equity:		
Ordinary shares of $1, fully paid	100 000	—
A class shares of $2, fully paid	—	40 000
B class shares of $1, fully paid	—	60 000
Retained earnings	39 000	75 500
	$376 000	$258 000

Smetana Ltd is to acquire all the assets of Bay Ltd (except for cash). The assets of Bay Ltd are recorded at their fair values except for:

	Carrying amount	Fair value
Inventory	$ 29 000	$ 39 200
Plant and equipment	127 000	155 000
Shares in Cape Ltd	26 000	22 500

In exchange, the A class shareholders of Bay Ltd are to receive one 7% debenture in Smetana Ltd, redeemable on 1 July 2016, for every share held in Bay Ltd. The fair value of each debenture is $3.50. Smetana Ltd will also provide one of its patents to be held jointly by the A class shareholders of Bay Ltd and for which they will receive future royalties. The patent is carried at $4000 in the records of Smetana Ltd, but is considered to have a fair value of $5000.

The B class shareholders of Bay Ltd are to receive two shares in Smetana Ltd for every three shares held in Bay Ltd. The fair value of each Smetana Ltd share is $2.70. Costs to issue these shares amount to $900. Additionally, Smetana Ltd is to provide Bay Ltd with sufficient cash, additional to that already held, to enable Bay Ltd to pay its liabilities. The outstanding debentures are to be redeemed at a 10% premium. Annual leave entitlements of $16 200 outstanding at 1 July 2016 and expected liquidation costs of $5000 have not been recognised by Bay Ltd. Costs incurred in arranging the business combination amounted to $1600.

Required

(a) Prepare the journal entries in the records of Smetana Ltd to record the acquisition of Bay Ltd.
(b) Prepare the Liquidation, Liquidator's Cash and Shareholders' Distribution ledger accounts in the records of Bay Ltd.

Solution

1. *Prepare the journal entries of Smetana Ltd*

The nature of the transaction in this question is that the acquirer, Smetana Ltd, is acquiring the operations (assets and liabilities) of Bay Ltd with the acquiree going into liquidation.

The first step is to prepare the acquisition analysis, which is a comparison of the fair value of the identifiable assets acquired and liabilities assumed with the consideration transferred.

Acquisition analysis — Smetana Ltd and Bay Ltd

Note that all the assets acquired and the liabilities assumed by the acquirer are measured at fair value.

Accounts receivable	$ 56 000
Inventory	39 200
Plant and equipment	155 000
Shares in Cape Ltd	22 500
	$272 700

Consideration transferred

The consideration transferred is measured by calculating the fair value of the assets given up, liabilities undertaken and shares issued by the acquirer. In this example, the acquirer issues shares and debentures in itself, gives up a patent and provides cash.

Purchase consideration			
Shareholders			
Debentures:	A shares of Bay Ltd	20 000	
	Debentures in Smetana (1/1)	20 000 × $3.50	$ 70 000
Shares:	B shares of Bay Ltd	60 000	
	Shares in Smetana (2/3)	40 000 × $2.70	108 000
Patent			5 000
Creditors		30 000	
Cash:	Debentures issued	3 000	
	Plus premium (10%)	33 000	
	Accounts payable	31 000	

Mortgage loan	21 500	
Liquidation costs	5 000	
Annual leave	16 200	
Total cash required	106 700	
Less: Already held	(20 000)	$ 86 700
Total consideration transferred		269 700

Because the total consideration transferred is less than the net fair value of the identifiable assets and liabilities acquired, the acquirer has to assess the measurements undertaken in the acquisition analysis. Having been assured that all relevant assets and liabilities have been included and that the fair values are reliable, the difference is then accounted for as a bargain purchase, and is included in current period income.

Gain on bargain purchase [$272 700 − $269 700]	$3 000

The general journal entries can then be read from the acquisition analysis. Note that when shares are issued the relevant account is 'Share Capital'.

In relation to the patent, prior to accounting for the business combination, the acquirer remeasures the asset to fair value.

Patent	Dr	1000	
Gain	Cr		1000
(Remeasurement to fair value as part of consideration transferred on business combination)			
Accounts Receivable	Dr	56 000	
Inventory	Dr	39 200	
Property, Plant and Equipment	Dr	155 000	
Shares in Cape Ltd	Dr	22 500	
Payable to Bay Ltd	Cr		156 700
Share Capital	Cr		108 000
Patent	Cr		5 000
Gain on Bargain Purchase	Cr		3 000
(Acquisition of Bay Ltd)			
Payable to Bay Ltd	Dr	156 700	
7% Debentures	Cr		70 000
Cash	Cr		86 700
(Payment of consideration)			
Acquisition-Related Expenses	Dr	1 600	
Cash	Cr		1600
(Acquisition-related costs)			
Share Capital	Dr	900	
Cash	Cr		900
(Payment of share issue costs)			

Note that the costs of share issue reduce the share capital issued with the Share Capital account then showing the net proceeds from share issues.

2. *Prepare the ledger accounts of Bay Ltd*

The Liquidation account effectively records the sale of the assets and the receipt of the purchase consideration.

- All items being sold by the acquiree — whether assets or a package of assets and liabilities — are taken at their carrying amount to the Liquidation account.
- Any amounts arising during the liquidation process and not previously recorded by the acquiree are also taken to the Liquidation account. In this example, there are three such items: premium on debentures, annual leave payable and liquidation costs. The relevant amounts are debited to the Liquidation account and liabilities are raised in relation to these items.
- Any reserves recognised by the acquiree — in this example it is retained earnings — are taken to the Liquidation account.
- The consideration transferred is credited to the Liquidation account, with the recognition of assets received, namely cash, patent, shares in Smetana Ltd and debentures in Smetana Ltd.

The balance of the Liquidation account is transferred to the Shareholders' Distribution account.

Liquidation

Receivables	56 000	Retained Earnings	75 500
Inventory	29 000	Accumulated Depreciation	40 000
Plant and Equipment	167 000	Receivable from Smetana Ltd	269 700
Shares in Cape Ltd	26 000		
Debentures – Premium	3 000		
Annual Leave Payable	16 200		
Liquidation Costs Payable	5 000		
Shareholders' Distribution	83 000		
	385 200		385 200

The cash received via the consideration transferred and the balance originally held by the acquiree is used to pay the liabilities of the acquiree, including liabilities such as liquidation costs payable raised during the liquidation process.

Liquidator's Cash

Opening balance	20 000	Accounts Payable	31 000
Receivable from Smetana Ltd	86 700	Debentures	33 000
		Mortgage Loan	21 500
		Liquidation Costs Payable	5 000
		Annual Leave Payable	16 200
	106 700		106 700

The capital balances of the acquiree, in this example the capital relating to both A and B shares issued by the acquiree, are taken to the credit side of the Shareholders' Distribution account. The assets to be distributed to the former shareholders of the acquiree are transferred to the debit side of the account. In this case they consist of the debentures and shares in Smetana Ltd and the patent, all these having been received as part of the consideration transferred from the acquirer. The account balances when the balance transferred from the Liquidation account is included. At this stage, all accounts of the acquiree are closed.

Shareholders' Distribution

Debentures in Smetana Ltd	70 000	Share Capital – A Shares	40 000
Shares in Smetana Ltd	108 000	Share Capital – B Shares	60 000
Patent	5 000	Liquidation	83 000
	183 000		183 000

Discussion questions

1. What is meant by a 'business combination'?
2. Discuss the importance of identifying the acquisition date.
3. What is meant by 'contingent consideration' and how is it accounted for?
4. Explain the key components of 'core' goodwill.
5. What recognition criteria are applied to assets acquired and liabilities assumed in a business combination?
6. How is an acquirer identified?
7. Explain the key steps in the acquisition method.
8. How is the consideration transferred calculated?
9. If an acquiree liquidates, what are the key accounts raised by the acquiree and which accounts are transferred to these accounts?
10. How is a gain on bargain purchase accounted for?
11. Why is it important to identify an acquirer in a business combination?

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