CHAPTER THREE
BUSINESS COMBINATIONS

A business combination is a transaction or other event that results in an acquirer obtaining control over one or more businesses. Transactions that are sometimes referred to as “true mergers” or “mergers of equals” are also considered to be business combinations with an acquirer and one or more acquirees.

Reasons for Firms to Combine

As with any other economic activity, business combinations can be part of an overall managerial strategy to maximize shareholder value. Shareholders —the owners of the firm—hire managers to direct resources so that the firm’s value grows over time. In this way, owners receive a return on their investment. Successful firms receive substantial benefits through enhanced share value. Importantly, the managers of successful firms also receive substantial benefits in salaries, especially if their compensation contracts are partly based on stock market performance of the firm’s shares.

If the goal of business activity is to maximize the firm’s value, in what ways do business combinations help achieve that goal? Clearly, the business community is moving rapidly toward business combinations as a strategy for growth and competitiveness.

Although no two business combinations are exactly alike, many share one or more of the following characteristics that potentially enhance profitability:

- Vertical integration of one firm’s output and another firm’s distribution or further processing.
- Cost savings through elimination of duplicate facilities and staff.
- Quick entry for new and existing products into domestic and foreign markets.
- Economies of scale allowing greater efficiency and negotiating power.
- The ability to access financing at more attractive rates. As firm size increases, negotiating power with financial institutions can increase also.
- Diversification of business risk.

Type of Combination	**Action of Acquiring Company**	**Action of Acquired Company**
1. Statutory merger through asset acquisition	Acquires assets and assumes liabilities	Dissolves and goes out of business
2. Statutory merger through capital stock acquisition	Acquires all stock and then transfers assets and liabilities to its own books	Dissolves as a separate corporation, often remaining as a division of the acquiring company

3. Statutory consolidation through capital stock or asset acquisition	Newly created entity receives assets or capital stock of original companies	Original companies may dissolve while remaining as separate divisions of newly created company
4. Acquisition of more than 50 percent of the voting stock.	Acquires stock that is recorded as an investment; controls decision making of acquired company.	Remains in existence as legal corporation, although now a subsidiary of the acquiring company.

The overriding objective of IFRS 3 is to improve the relevance, representational faithfulness, transparency and comparability of information provided in financial statements about business combinations and their effects on the reporting entity by establishing principles and requirements with respect to how an acquirer, in its consolidated financial statements:

1. Recognizes and measures identifiable assets acquired, liabilities assumed and the non controlling interest in the acquiree, if any;
2. Recognizes and measures acquired goodwill or a gain from a bargain purchase;
3. Determines the nature and extent of disclosures sufficient to enable the reader to evaluate the nature of the business combination and its financial effects on the consolidated reporting entity;
4. Accounts for and reports non-controlling interests in subsidiaries; and
5. Deconsolidates a subsidiary when it ceases to hold a controlling interest in it.

Transactions or other events that meet the definition of a business combination are subject to IFRS 3. Excluded from the scope of these standards, however, are:

1. Formation of a joint venture;
2. Acquisition of an asset or group of assets that does not represent a business; and
3. Combinations between entities or businesses under common control.

Mutual entities (i.e., credit unions, co-operatives, etc.), those achieved by contract alone (providing control without ownership—i.e., dual-listed entities, stapled entity structures), those achieved in stages (step acquisitions), those transferring less than 100% ownership and bargain purchases are within the scope of the revised standards.

The revised standard IFRS 3 replaces the cost principle of accounting for business combinations with the fair value principle. The fair value principle means that, upon obtaining control of the subsidiary, the exchange transaction is measured at fair value. All assets, liabilities and equity (except equity acquired by the controlling interest) of the acquired entity

are measured at fair value. However, several exceptions to this principle are provided in IFRS 3.

Determining Fair Values

Accounting for acquisitions requires a determination of the fair value for each of the acquired entity's identifiable tangible and intangible assets and for each of its liabilities at the date of combination (except for assets which are to be resold and which are to be accounted for at fair value less costs to sell under IFRS 5; and for those items to which limited exceptions to recognition and measurement principles apply). IFRS 3 provides illustrative examples of how to treat certain assets, particularly intangibles, but provides no general guidance on determining fair value. The IASB issued IFRS 13, *Fair Value Measurement*, which defines the term *fair value* and sets out in a single standard a framework for measuring fair value and the concomitant disclosures.

Transactions and Events Accounted for as Business Combinations

A business combination results from the occurrence of a transaction or other event that results in an acquirer obtaining control of one or more businesses. This can occur in many different ways that include the following examples individually or in some cases in combination:

1. Transfer of cash, cash equivalents or other assets, including the transfer of assets of another business of the acquirer;
2. Incurring liabilities;
3. Issuance of equity instruments;
4. Providing more than one type of consideration; or
5. By contract alone without the transfer of consideration, such as when:
    a. An acquiree business repurchases enough of its own shares to cause one of its existing investors (the acquirer) to obtain control over it;
    b. There is a lapse of minority veto rights that had previously prevented the acquirer from controlling an acquiree in which it held a majority voting interest; or
    c. An acquirer and acquiree contractually agree to combine their businesses without a transfer of consideration between them.

Qualifying as a Business

Under IFRS 3, in order to be considered a business, an integrated group of activities and assets must be *capable* of being conducted and managed to provide a return directly to investors, *owners, members or participants*. The return can be in the form of dividends, reduced costs or other economic benefits. The word *capable* was added to emphasise the fact that the definition does not preclude a development stage enterprise from qualifying as a business. *Other owners, members or participants* were included to emphasize the applicability of IFRS 3 to mutual entities (e.g., credit unions and co-operatives) that previously used the pooling-of-interests method of accounting for business combinations and to non corporate entities.

The definition and related guidance elaborate further that a business consists of inputs and processes applied to those inputs that have the ability to create outputs. Clarification is provided that, while outputs are usually

present in a business, they are not required to qualify as a business as long as there is the *ability* to create them.
An input is an economic resource that creates or has the ability to create outputs when one or more processes are applied to it. Examples of inputs include property, plant and equipment, intangible rights to use property, plant and equipment, intellectual property or other intangible assets and access to markets in which to hire employees or purchase materials.

Techniques for Structuring Business Combinations
A business combination can be structured in a number of different ways that satisfy the acquirer's strategic, operational, legal, tax and risk management objectives. Some of the more frequently used structures are:

1. One or more businesses become subsidiaries of the acquirer. As subsidiaries, they continue to operate as separate legal entities.
2. The net assets of one or more businesses are legally merged into the acquirer. In this case, the acquiree entity ceases to exist (in legal vernacular, this is referred to as a statutory merger and normally the transaction is subject to approval by a majority of the outstanding voting shares of the acquiree).
3. The owners of the acquiree transfer their equity interests to the acquirer entity or to the owners of the acquirer entity in exchange for equity interests in the acquirer.
4. All of the combining entities transfer their net assets or their owners transfer their equity interests into a new entity formed for the purpose of the transaction. This is sometimes referred to as a roll-up or put-together transaction.
5. A former owner or group of former owners of one of the combining entities obtains control of the combined entities collectively.
6. An acquirer might hold a non-controlling equity interest in an entity and subsequently purchase additional equity interests sufficient to give it control over the investee. These transactions are referred to as step acquisitions or business combinations achieved in stages.

Accounting for Business Combinations under the Acquisition Method
The acquirer is to account for a business combination using the acquisition method. This term represents an expansion of the now-outdated term "purchase method." The change in terminology was made in order to emphasize that a business combination can occur even when a purchase transaction is not involved. The following steps are required to apply the acquisition method:

1. Identify the acquirer;
2. Determine the acquisition date;
3. Identify the assets and liabilities, if any, requiring separate accounting because they result from transactions that are not part of the business combination, and account for them in accordance with their nature and the applicable IFRS;

4. Identify assets and liabilities that require acquisition date classification or designation decisions to facilitate application of IFRS in post-combination financial statements and make those classifications or designations based on:
    a. Contractual terms;
    b. Economic conditions;
    c. Acquirer operating or accounting policies; and
    d. Other pertinent conditions existing at the acquisition date;
5. Recognize and measure the identifiable tangible and intangible assets acquired and liabilities assumed;
6. Recognize and measure any non-controlling interest in the acquiree;
7. Measure the consideration transferred;
8. Recognize and measure goodwill or, if the business combination results in a bargain purchase, recognize a gain from the bargain purchase.

Step 1—Identify the acquirer

IFRS 3 strongly emphasizes the concept that every business combination has an acquirer.

In the "basis for conclusions" that accompanies IFRS 3, the IASB asserts that:

. . . "true mergers" or "mergers of equals" in which none of the combining entities obtain control of the others are so rare as to be virtually non-existent . . . 1

The provisions of IFRS 10, *Consolidated Financial Statements*, should be used to identify the acquirer—the entity that obtains *control* of the acquiree. The acquirer is the combining entity that obtains control of the other combining entities. According to the IASB, using the control concept for identifying the acquirer is consistent with using the control concept in IFRS 10. While IFRS 10 provides that, in general, control is presumed to exist when the parent owns, directly or indirectly, a majority of the voting power of another entity, this is not an absolute rule to be applied in all cases. In fact, IFRS 10 explicitly provides that in exceptional circumstances, it can be clearly demonstrated that majority ownership does not constitute control, but rather that the minority ownership may constitute control

Exceptions to the general majority ownership rule include, but are not limited to, the following situations:

1. An entity that is in legal reorganization or bankruptcy;
2. An entity subject to uncertainties due to government-imposed restrictions, such as foreign exchange restrictions or controls, whose severity casts doubt on the majority owner's ability to control the entity; or
3. If the acquiree is a special-purpose entity (SPE), the creator or sponsor of the SPE is always considered to be the acquirer. Accounting for SPEs is discussed later in this chapter.

Step 2—Determine the acquisition date

By definition, the acquisition date is that date on which the acquirer obtains control of the acquiree. As discussed previously, this concept of control is not always evidenced by ownership of voting rights.

Step 3—Recognise and measure the identifiable tangible and intangible assets acquired and liabilities assumed

In general, the measurement principle is that an acquirer measures the identifiable tangible and intangible assets acquired, and the liabilities assumed, at their fair values on the acquisition date. IFRS 3 provides the acquirer with a choice of two methods to measure non controlling interests arising in a business combination:

1. To measure the non-controlling interest at fair value (recognizing the acquired business at fair value); or
2. To measure the non-controlling interest at the non-controlling interest's share of the acquiree's net assets.

Step 4—Identify assets and liabilities requiring separate accounting

IFRS 3 provides a basic recognition principle that, as of the acquisition date, the acquirer is to recognize, separately from goodwill, the fair values of all identifiable assets acquired (whether tangible or intangible), the liabilities assumed, and, if applicable, any non-controlling interest (previously referred to as "minority interest") in the acquiree. In applying the recognition principle to a business combination, the acquirer may recognize assets and liabilities that had not been recognized by the acquiree in its pre combination financial statements but which meet the definitions of assets and liabilities in the *Conceptual Framework for Financial Reporting* at the acquisition date. IFRS 3 continues to permit recognition of acquired intangibles (e.g., patents, customer lists) that would not be granted recognition if they were internally developed.

1. At the acquisition date, the identifiable assets acquired and liabilities assumed must meet the definitions of assets and liabilities as set forth in the *Conceptual Framework for Financial Reporting*; and
2. The assets and liabilities recognized must be part of the exchange transaction between the acquirer and the acquiree (or the acquiree's former owners) and not part of a separate transaction or transactions.

Step 5—Classify or designate identifiable assets acquired and liabilities assumed

In order to facilitate the combined entity's future application of IFRS in its post combination financial statements, management is required to make decisions on the acquisition date relative to the classification or designation of certain items. These decisions are to be based on the contractual terms, economic and other conditions, and the acquirer's operating and accounting policies as they exist *on the acquisition date*. Examples include, but are not limited to, the following:

1. Classification of particular financial assets and liabilities as measured at fair value through profit or loss or at amortised cost, or as a financial asset measured at fair value through other comprehensive income in accordance with IFRS 9, *Financial Instruments*;

2. Designation of a derivative instrument as a hedging instrument in accordance with IFRS 9; and
3. Assessment of whether an embedded derivative should be separated from a host contract in accordance with IFRS 9 (which is a matter of "classification" as this IFRS uses that term).

Step 6—Recognise and measure any non-controlling interest in the acquiree

The term "non-controlling interest" replaces the term "minority interest" in referring to that portion of the acquiree, if any, not controlled by the parent subsequent to the acquisition. IFRS 3 provides the acquirer with a choice of two methods to measure non-controlling interests at the acquisition date arising in a business combination:

1. To measure the non-controlling interest at *fair value* (also recognizing the acquired business at fair value); or
2. To measure the non-controlling interest at the present ownership instruments' share in the recognized amounts of the acquiree's identifiable net assets (under this approach the only difference is that, in contrast to the approach of measuring the non controlling interest at fair value, no portion of imputed goodwill is allocated to the non-controlling interest).

Measuring non-controlling interest at fair value: IFRS 3 allows the non-controlling interest in the acquiree to be measured at fair value at the acquisition date, determined based on market prices for equity shares not held by the acquirer, or, if not available, by using a valuation technique. If the acquirer is not acquiring all of the shares in the acquiree and there is an active market for the remaining outstanding shares in the acquiree, the acquirer may be able to use the market price to measure the fair value of the non-controlling interest.

Otherwise, the acquirer would measure fair value using other valuation techniques. Under this approach, recognized goodwill represents all of the goodwill of the acquired business, not just the acquirer's share.

Example of measuring non-controlling interest at fair value

Konin Corporation (KC) acquires a 75% interest in Bartovia Corporation (BC), in exchange for cash of €360,000. BC has 25% of its shares traded on an exchange; KCacquired the 60,000 non publicly traded shares outstanding, at €6 per share. The fair value of BC's identifiable net assets is €300,000; the shares of BC at the acquisition date are traded at €5 per share. Under the full fair value approach, the non-controlling interest is measured based on the trading price of the shares of entity BC at the date control is obtained by KC (€5 per share) and a value of €100,000 is assigned to the 25% non-controlling interest, indicating that KC has paid a control premium of €60,000 (€360,000 – [€5 × 60,000]):

Equity−Non-controlling interest in net assets: €5*20,000 = €100,000

It is important to note from this analysis that, from the perspective of the acquirer, the computation of the acquisition-date fair value of the non-controlling interest in the acquiree is not computed by simply multiplying

the same fair value per share that the acquirer paid for its controlling interest. Such a calculation would have yielded a different result:
Equity−Non-controlling interest in net assets €6 * 20,000 = €120,000
If this method had been used, the non-controlling interest would be overvalued by €20,000 (the difference between €120,000 and €100,000).
Under the fair value approach to measure non-controlling interest, the acquired business will be recognized at fair value, with the controlling share of total goodwill assigned to the controlling interest and the non-controlling share allocated to the non-controlling interest.

Measuring non-controlling interest at its share of the identifiable net assets of the acquiree, calculated in accordance with IFRS 3.

Under this approach, non-controlling interest is measured as the non-controlling interest's proportionate interest in the value of the identifiable assets and liabilities of the acquiree, determined under current requirements of IFRS 3.

Example of measuring non-controlling interest at share of net assets of the acquire

Konin Corporation (KC) acquires a 75% interest in Bartovia Corporation (BC), in exchange for cash of €360,000. BC has 25% of its shares traded on an exchange; KC acquired the 60,000 non-publicly traded shares outstanding, at €6 per share. The fair value of BC's identifiable net assets is €300,000; the shares of entity BC at the acquisition date are traded at €5 per share. The consideration transferred indicates that KC has paid a control premium of €60,000 (€360,000 -[€5 × 60,000]) Since KC elects to measure non-controlling interest in BC at its share of the acquiree's net assets, a value of €75,000 is assigned to the 25% non-controlling interest:
Equity−Non-controlling interest in net assets €300,000 * 25% = €75,000
Under this approach to measure non-controlling interest, goodwill recognized will represent only the acquirer's share.

Step 7—Measure the consideration transferred

In general, consideration transferred by the acquiree is measured at its acquisition-date fair value. Examples of consideration that could be transferred include cash, other assets, a business, a subsidiary of the acquirer, contingent consideration, ordinary or preference equity instruments, options, warrants and member interests of mutual entities. The aggregate consideration transferred is the sum of the following elements measured at the acquisition date:

1. The fair value of the assets transferred by the acquirer;
2. The fair value of the liabilities incurred by the acquirer to the former owners of the acquiree; and
3. The fair value of the equity interests issued by the acquirer subject to the measurement exceptions discussed earlier in this chapter for the portion, if applicable, of acquirer share-based payment awards exchanged for awards held by employees of the acquire that is included in consideration transferred.

Contingent consideration: In many business combinations, the acquisition price is not completely fixed at the time of the exchange, but is instead dependent on the outcome of future events. There are two major types of contingent future events that might commonly be used to modify the acquisition price: the performance of the acquired entity (acquiree) and the market value of the consideration initially given for the acquisition.
Contingent consideration arrangements in connection with business combinations can be structured in many different ways and can result in the recognition of either assets or liabilities under IFRS 3. An acquirer may agree to transfer (or receive) cash, additional equity instruments or other assets to (or from) former owners of an acquiree after the acquisition date, if certain specified events occur in the future. In either case, according to IFRS 3 the acquirer is to include contingent assets and liabilities as part of the consideration transferred, measured at acquisition-date fair value. Contingent consideration can only be recognized when the contingency is probable and can be reliably measured.

Step 8—Recognise and measure goodwill or gain from a bargain purchase

The last step in applying the acquisition method is the measurement of goodwill or a gain from a bargain purchase. Goodwill represents an intangible that is not specifically identifiable. It results from situations when the amount the acquirer is willing to pay to obtain its controlling interest exceeds the aggregate recognized values of the net assets acquired, measured following the principles of IFRS 3. It arises largely from the synergies and economies of scale expected from combining the operations of the acquirer and acquiree.
Goodwill's elusive nature as an unidentifiable, residual asset means that it cannot be measured directly but rather can only be measured by reference to the other amounts measured as a part of the business combination. In accordance with IFRS 3, management must select, for each acquisition, the option to measure the non-controlling interest, and consequently the amount recognized as goodwill (or gain on a bargain purchase) will depend on whether non-controlling interest is measured at fair value (option 1) or at the non controlling interest's share of the acquiree's net assets (option 2).

GW = Goodwill.
GBP = Gain from a bargain purchase.
NI = Non-controlling interest in the acquiree, if any, measured at fair value (option 1) or as the non-controlling interest's share of the acquiree's net assets (option 2).
CT = Consideration transferred, generally measured at acquisition-date fair value.
PE = Fair value of the acquirer's previously held interest in the acquiree if the acquisition was achieved in stages.
NA = Net assets acquired—consisting of the acquisition-date fair values (or other amounts recognized under the requirements of IFRS 3[R] as described in the chapter) of the identifiable assets acquired and liabilities

assumed.
GW / GBP = (CT + NI + PE) – NA

Thus, when application of the formula yields an excess of the acquisition-date fair value of the consideration transferred plus the amount of any non-controlling interest and plus fair value of the acquirer's previously held equity interest over the net assets acquired, this means that the acquirer has paid a premium for the acquisition and that premium is characterized as goodwill. When the opposite is true, that is, when the formula yields a negative result, a gain from a bargain purchase (sometimes referred to as negative goodwill) is recognized, since the acquirer has, in fact, obtained a bargain purchase as the value the acquirer obtained in the exchange exceeded the fair value of what it surrendered.

Example of recognizing goodwill—non-controlling interest measured at the non-controlling interest's proportionate share of the acquiree's net assets

Konin Corporation (KC) acquires a 75% interest in Donna Corporation (DC), in exchange for cash of €50,000. DC has 25% of its shares traded on an exchange; KC acquired the 60,000 non publicly traded shares outstanding. The fair value of DC's identifiable net assets is €300,000; the shares of DC at the acquisition date are traded at €5 per share. The consideration transferred indicates that KC has paid a control premium of €50,000 (€350,000 _ [€5 × 60,000]).

Management elects the option to measure non-controlling interest at its share of the acquiree's net assets and a value assigned to the non-controlling interest is €75,000 (€300,000 × 25%).

The amount of goodwill recognised is only €125,000, which is equal to the consideration transferred €350,000 for the controlling interest minus the controlling interest's share in the fair value of the identifiable net assets acquired, €225,000 (€300,000 × 75%). No goodwill is assigned to the non-controlling interest. The acquirer (KC) would record its acquisition of DC in its consolidated financial statement as follows:

Identifiable net assets acquired, at fair value	300,000	
Goodwill (€425,000 – €300,000)	125,000	
Equity—NCI		75,000
Cash		350,000

Under the approach to measure non-controlling interest at the proportionate share of the acquiree's net assets, goodwill recognized

€125,000 (€350,000 + €75,000 _ €300,000) represents only the acquirer's share of the goodwill.

Example of recognizing goodwill—non-controlling interest measured at fair value

Konin Corporation (KC) acquires a 75% interest in Danube Corporation (DC), in exchange for cash of €350,000. DC has 25% of its shares traded on an exchange; KC acquired the 60,000 non-publicly traded shares outstanding. The fair value of DC's identifiable net assets is €300,000; the shares of DC at the acquisition date are traded at €5 per share. The consideration transferred indicates that KC has paid a control premium of €50,000 (€350,000 - [€5 × 60,000]) Management elects the option to measure non-controlling interest at fair value and a value of
€100,000 (€5 × 20,000 non-controlling interest shares) is assigned to the 25% non-controlling interest. The amount of goodwill accruing to the controlling interest is €125,000, which is equal to the consideration transferred, €350,000, for the controlling interest minus the controlling interest's share in the fair value of the identifiable net assets acquired, €225,000 (€300,000 × 75%). The amount of goodwill accruing to the non-controlling interest is €25,000 (€150,000 total goodwill less €125,000 allocated to the controlling interest). The acquirer (KC) would record its acquisition of DC in its consolidated financial statements as follows:

Identifiable net assets acquired, at fair value	300,000	
Goodwill (€450,000 _ €300,000)	150,000	
Equity—NCI		100,000
Cash		350,000

Under the approach to measure non-controlling interest at fair value, the acquired business is recognized at €450,000 (€350,000 + 100,000) fair value and full goodwill (€150,000 = €450,000 €300,000) is recognize. The amount of goodwill associated with the controlling interest is €125,000 (€350,000 - (€300,000 × 75%)), and the amount of goodwill associated with non controlling interest is €25,000 (€150,000 - €125,000).

Bargain purchases. A bargain purchase occurs when the value of net assets acquired is in excess of the acquisition-date fair value of the consideration transferred plus the amount of any non-controlling interest and plus fair value of the acquirer's previously held equity interest. While not common, this can happen, as, for example, in a business combination that is a forced sale, when the seller is acting under compulsion. Under IFRS 3, when a bargain purchase occurs, a gain on acquisition is recognized in profit or loss at the acquisition date, as part of income from continuing operations.

Example of a bargain purchase

On January 1, 20XX, Konin Corporation (KC) acquires 75% of the equity interests of Laska Corporation (LC), a private entity, in exchange for cash of €250,000. The former owners of LC were forced to sell their investments within a short period of time and unable to market LC to multiple potential buyers in the marketplace. The management of KC initially measures at the acquisition date in accordance with IFRS 3 the separately recognizable identifiable assets acquired at €500,000 and liabilities at €100,000. KC engages an independent valuation specialist who determines that the fair value of the 25% non-controlling interest in LC is €110,000. Since the amount of LC's identifiable net assets (€400,000 calculated as €500,000 _ €100,000) exceeds the fair value of the consideration transferred (€250,000) plus the fair value of the non controlling interest (€110,000), the acquisition initially results in a bargain purchase. In accordance with the requirements of IFRS 3,KCmust perform a review to ensure whether all assets, liabilities, consideration transferred and non-controlling interest have been correctly measured. KC concludes that the procedures and resulting measures are correct. The acquirer (KC) recognizes the gain on its acquisition of the 75% interest as follows:

Identifiable net assets acquired, at fair value 400,000
Less: Fair value of CT for 75% interest in LC 250,000
Plus: Fair value of non-controlling interest in LC 110,000 (360,000)
Gain on bargain purchase 40,000

The acquirer (KC) would record its acquisition of LC in its consolidated financial statements as follows:

Identifiable net assets acquired	400,000	
Cash		250,000
Gain on the BGP		40,000
Equity—NCI in LC		110,000

If the acquirer (KC) elects to measure the non-controlling interest in LC on the basis of its proportionate interest in the identifiable net assets of the acquiree, the recognized amount of the non-controlling interest would be €100,000 (€400,000 × 25%); the gain on the bargain purchase would be €50,000 (€400,000 - [€250,000 + €100,000]).