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Video Transcription: Business Combinations

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If you have an existing business how can you combine that business with another business? And when you do, what are the financial reporting implications? My name is Grant and I'm going to be talking you through these answers at a high level.

Firstly, what is a business? You can look up the dictionary definition but loosely speaking the IFRS definition is an integrated set of activities and assets that is capable of producing a return. If you have a business and acquire another business you will then have a business combination, and as a result you will be able to combine your existing business with the newly acquired business in order to benefit from whatever synergies are available.

To have a business combination you therefore need to acquire a business, which means that you need to acquire control of the integrated activities and assets that make up the business. Remember that the legal form of an agreement is not relevant in determining the accounting. The substance of a business combination is that an entity has acquired control of a business.

So, how can you acquire control of a business? You can acquire all of the assets and perhaps the related liabilities that make up the business. Or, secondly, maybe you can acquire all of the shares in the company that own the assets and liabilities. As the shareholders, you can decide how best to use those assets in combination with your existing business, and therefore have acquired control of the business.

Or rather, thirdly, you could acquire sufficient but not all of the shares of the company that own the assets in order to have the right to make the decisions. Generally this is 50 plus one vote of the shares, which means that you get to make the decisions at shareholder meetings. This will allow you to control the underlying assets and liabilities and therefore have a business combination with additional funding provided by the shareholders of the remaining shares.

To have an asset or liability you have to have control, which implies that you need to be able to decide how that asset will be utilised or in the case of an integrated set of activities and assets, how that business will operate. You can do that by owning the assets directly, option one, or indirectly by owning the shares of the company that owns the assets as in option two and three. In that case of the individual company accounts, the investment in the shares will be recognised and an additional set of group accounts will be prepared, where the cost of the shares will be replaced by the assets, and the liabilities will be controlled. This is a process known as consolidation as it shows the combination or consolidated picture of all of the assets and liabilities that are controlled by the group.

In the case of a company, key decisions such as the appointment of directors, the dividend policy etc are made at shareholder meetings, when you need a majority of votes exercised to make the decisions. If you have the ability to appoint the executive directors of the company you have the ability to control the activities and therefore the business of that company. Generally that requires marginally more than half of the votes in that company. And whether you have 50.1% or 100% of the company your ability to call the shots is the same.

The key issues in a business combination is the identification of when you get control. Acquiring 45% is unlikely to get you control but acquiring another 10% will give you control, similarly having 100% and selling 40% is not likely to lose you control.

This focus on control is critical. A Statement of Financial Position should have all of the assets and liabilities that you control and should never include those that you do not. Typically with the 49% shareholding in a business there is no control of the business and therefore the assets and liabilities are not recognised. If you acquire another two percent however, your 51% shareholding would give you control and therefore 100% of the assets and liabilities would be recognised.

Acquiring a business is different from acquiring an individual asset, as a single payment is negotiated for all of the assets and activities that make up the business. That payment then needs to be allocated to the individual assets and, if any, liabilities that have been acquired as a result of acquiring that business. This is an important process as the individual assets and liabilities are recognised on the group financial statements and not the cost of the investment. This impacts not only on the amounts that are recognised when the businesses are acquired but also the subsequent profits when those assets are consumed or sold.

There needs to be some rational basis for allocating the amount that was paid for the business to the individual components that were required, a process that is sometimes known as the purchase price allocation. When you buy a business you are going to do your homework and find out what the business owns and how much those assets are worth. You will also find out what the business owes and will make your own assessment of exactly what you are acquiring and committing to.

While the existing financial statements may be your starting point in your enquiries, you know that a Statement of Financial Position does not include all of the assets that the company has and nor does it necessarily measure those assets that it does recognise at fair value.

You may be acquiring a business because it has done research on technology that you need. Or it has a good management team that can help you with your group. That type of asset may not be recognised on the company's balance sheet but it is still a factor in what you have agreed to pay for the business, and must be taken into consideration when allocating the amount paid for the business.

Once you have established exactly what assets and liabilities the business has, including those that are not recognised by the business such as any technology that it may have researched, you will allocate the purchase price paid across those assets on the basis of their fair values.

The fair value of, say, property or inventory is the portion of the purchase price that has been allocated to that asset. And that is therefore the amount that was paid for that asset in the business combination. That amount is therefore the cost to the combined group of the asset.

The use of fair value is merely a method of allocating the cost of the business as a whole, to determine the cost of the individual assets and liabilities that have been acquired as part of the business combination.

To express that differently when you acquire a business the individual assets and liabilities that you acquire are measured at cost, determined on the basis of fair value at the dates that you get control as that is the component of the cost of the business that has been allocated to that asset or liability. Cost determined on that basis is then used to calculate the cost of sales, depreciation etc.

When you decide to buy a business you will value the business based on whatever valuation model you think is appropriate. One of the factors that you will take into consideration is the fair value of the existing assets and liabilities, irrespective of how they may be accounted for by the business. You will take into account all of the positive and negative factors relating to that business which could include the existence of a good location, good staff, good reputation, existing customer base or customer relationships. Where it is possible to do so, those individual amounts should be valued and recognised as part of the business combination but not all of the benefits that you have identified from acquiring the business can be recognised as an asset.

For example a skilled team of employees do not satisfy the definition of an asset as you cannot control them and therefore although you may have paid more for the business because of them you cannot allocate some of the cost of the business to something that is not an asset.

The unallocated part of the cost of the business is known as goodwill. Where goodwill is the residual difference between the cost of the business and the fair value of the assets and liabilities that have been recognised, goodwill can only arise from a business combination. It is the difference from what you paid for the business as a whole and the amounts allocated to the individual assets and liabilities. If you bought an asset as opposed to a business, the asset will be recognised at an amount that you paid for it, irrespective of the fair value, therefore there cannot be a goodwill component.

Notice also that if you acquire an asset on its own, it is measured at what you paid for it. If you acquire it as part of a business combination it is measured at fair value as that is what is considered to be the most appropriate basis of allocating the cost of the whole business to the individual assets acquired.

Goodwill is recognised as an asset. If full IFRS is applied it needs to be tested for impairment. In other words, to ensure that it still has value every financial year. And if IFRS for SMEs is applied, it is required to be written off on a systematic basis.

To wrap up, remember that accounting for a business combination may happen in either the group accounts where you have acquired a controlling interest in a company or in an individual company where you have bought a group of assets that constitutes a business. Either way the results should be the same. All the assets and liabilities acquired are measured at fair value at the date of acquisition with any residual of the purchase price recognised as a goodwill asset. Or if applicable at a bargain purchase gain in profit.

Thanks for watching this video; I would now recommend that you watch the video on basic consolidation entries to focus on one aspect of the process of incorporating a business combination into the group accounts (see “Consolidations – The Basic Adjustments”).