

Australian requirement for business combinations



Australian Requirement for Business Combinations Abstract: The issue of accounting for Business Combinations, according to Australian standards, has been a cause of considerable concerns and controversies for both, accountants and academics.

However, due to the enormity of transactions involved in it, it becomes highly important to understand its application. In this research, we will outline various concepts and definitions to business combinations and address some important issues such as reporting entity concept, determination of fair value of assets, nature and treatment of goodwill, fair value approach in determining the cost of business combinations. While doing this, we will keep in mind the major accounting practices applied for various issues related to Business Combinations in Australia. Introduction: 'Growth' is the main objective of any business organization. Top management always triggers growth or expansion as their primary goal.

A company may grow slowly, gradually expanding its product lines, facilities or services, or it may unexpectedly shoot up overnight. Some managers consider growth so important that they say " a company must either grow or die". In past hundred years in US and Australia, many companies have achieved their goal of expansion through business combinations. Such expansion can be of two types: 1) Internal expansion 2) External expansion A firm can expand internally by expanding its research and development. External expansion is when a business tries to expand by acquiring one or more other firms.

This is also termed as Business Combination or Mergers or Acquisitions. This form of expansion is more popular over recent years, as it attracts rapid attention and growth. In addition to this, external expansion holds comparatively higher advantages as compared to internal expansion.

Definition of Business Combination: Business Combinations are events or transactions where two or more business enterprises, or their net assets, are brought together under a common control, as a single accounting entity.

Appendix A of AASB 3 Business Combinations defines business combination as 'bringing together of separate entities or business into one reporting entity'.

However, Exposure Draft (ED) 139 (para. 3) shows proposed amendments to such definition described by AASB 3 Business Combinations. According to this, business combination as 'any transaction or other event in which the acquirer obtains control of one or more businesses'.

REPORTING ENTITY CONCEPT AND ITS SIGNIFICANCE: AASB also provides the concept where separate entities or businesses become a single reporting entity. An appendix in AASB 3 defines a reporting entity as 'an entity in respect of which it is reasonable to expect the existence of users who rely on the entity's general purpose financial report for information that will be useful to them for making and evaluating decisions about the allocation of resources'.

ASIC Reporting entities are required to prepare financial statements in accordance with Chapter 2M of the Corporations Law, and must comply with the recognition and measurement requirements of accounting standards.

AASB 1025 has clearly specified the application of this standard applies to companies in relation to its first financial year that ends on or after 30 June

<https://assignbuster.com/australian-requirement-for-business-combinations/>

1992 and later financial years. Whether a company should be classified as a reporting entity or non-reporting, (which is to be determined by the directors) is an important decision affecting the level of disclosure in a company's financial statements. SAC 1 states that a number of alternative reporting entity concepts are implied in the existing legislation & regulations. These specify which type of entities should prepare general purpose financial reports. This concept includes: · Legal Entity Concept, · Fund Concept and · Concept of Elected Representatives The legal entity concept is employed in legislation to most private sector entities.

In private sectors, companies are obliged to report whenever they have legal status. The public sector largely uses the fund concept of reporting which implies a concern with reporting the results of individual funds. Electoral concept holds a broad concept based on accountability of elected representatives and appointed officials which have been employed in the public sector and preparing general purpose financial reports. Overall, SAC 1 adopts a concept of reporting entity which is tied to the information needs of the users and the nature of general purpose financial reports. In other words, the class of entity defined under these concepts may include some entities by virtue of the existence of users dependent on general purpose financial reports, whether they are identified as reporting or non-reporting.

It should also be noted that the reporting entity concept does not depend on the sector within which the entity operates or the purpose for which it was created. It merely requires all entities, with users depending on their general purpose financial reports, to prepare such reports in accordance to chapter 2M of the Law. IMPLICATIONS OF REQUIREMENTS TO USE PURCHASE

<https://assignbuster.com/australian-requirement-for-business-combinations/>

METHOD OF ACCOUNTING: A Business Combination is handled in two different ways: 1) Pooling of interest method and 2) Purchase method In the pooling of interest method, the consolidated balance sheet merely shows adding together the balance sheets of the combined entities. The purchase method is based on the assumption that a business combination is a transaction in which one entity acquires the net assets of other company, where the acquiring company records net assets received at a fair value as at the date of combination. Any excess of cost over the fair value of net assets is allocated as goodwill and amortised for a maximum period of 40 years. (V.

Sundararajan, 1995) Para 14 of AASB 3 says that “ All business combinations shall be accounted for by using the purchase method of accounting”.

Purchase method is now known as ‘ Acquisition method’. According to the GAAP Guide Level A (2007), if the purchase price exceeds the fair market value of the net assets, goodwill is recorded in the acquisition entry. If the fair market value of identifiable assets exceeds the purchase price, the resulting excess of fair value of acquired net assets over cost, is allocated to reduce all of the acquired assets except (a) financial assets other than investments accounted for by the equity method, (b) assets to be disposed of by sale, (c) deferred income taxes, (d) pre-paid assets related to pension and other post-retirement benefit plans, and (e) any other current assets (FAS 141, para 44). If excess of fair value of acquired net assets over cost remains unallocated, the resulting amount is treated as an extraordinary gain (FAS 141, para 45).

Dagwell, Wines and Lambert (2007) mention that it is very important to follow the four steps involved in the acquisition method (ED 139, para. 9): 1. Identifying the acquirer 2. Determining the acquisition date 3.

Measuring the fair value of the acquiree; and 4. The measuring and recognising of the assets acquired and the liabilities assumed. The acquisition or purchase method involves the acquirer calculating the cost of the business combination and the fair value of the business or businesses acquisition. The individual assets and liabilities must be valued and recognised in the acquisition.

This may include the recognition of goodwill as an asset. DETERMINATIONS OF FAIR VALUE OF ASSETS IN BUSINESS COMBINATIONS: With today's unpredictable world, it is important to determine what the asset is currently worth rather than what it was when it was acquired. As a result, Financial Accounting Standard Board (FASB) increasingly requires the corporations to mark most of the balance sheet items to their 'fair value'. According to the Generally Accepted Accounting Principles (GAAP), the fair value of an asset is the amount at which that asset could be bought or sold in current transactions between willing parties, other than in liquidation.

The core of the new standards is to measure the fair value of the acquired business and all its assets as of the acquisition date. However, it must be noted that the fair value does not include the direct costs of acquiring the business. Fair value applies to all business combinations, whether full or partial, or stage acquisitions. Assets are recorded at the acquisition date fair

value and then, subsequently, at lesser of their acquisition-date fair value or the amount estimated to be realized.

TREATMENT OF DIRECTLY ATTRIBUTABLE COST: A difference between AASB 3 and ED 139 relates to directly attributable costs of a business combination. Such costs include professional fees paid to accountants, solicitors and other advisers, valuation costs, and costs of issuing debt and equity securities as a part of the consideration for the acquisition. Para 24b of AASB 3 includes these directly attributable costs in the cost of a business combination.

According to AASB 3, these costs are capitalised into the value of the net assets acquired, including any goodwill. In contrast to this, ED 139 states that such costs that are incurred in connection with a business combination do not form a part of the consideration transferred (para.

27). Under the ED 139 approach, these costs do not form a component of the fair value of the acquiree or of the actual acquisition transaction. In other words, this leads to directly attributable costs being accounted for 'separately from the business combination'. This is in analogy with IFRS's para.

27. The result of this would be these costs being expensed to the income statement rather than capitalising them with the value of net assets acquired. All together, it should be noted that, such costs are relatively small in comparison with the fair value of the acquiree and the consideration transferred, and hence the treatment of these directly attributable costs would not be very significant. **ACCOUNTING TREATMENT OF BARGAIN**

PURCHASE: In contrast to goodwill situation, it is possible that the cost of an

acquisition is less than the fair value of the identifiable net assets acquired in some circumstances. That is, the consideration transferred for the acquirer's interest in the acquiree is less than the fair value of the interest in net assets acquired.

Such a purchase is referred to as 'bargain purchase'. In other words, assets or goods acquired for materially less than the fair value. A bargain purchase may arise because the selling party wishes to realise the value of its assets quickly in a single sale transaction, or it may reflect factors such as the possibility of temporary future losses or a short term fall in profits. (Dagwell R, et al. 2007, pg 212). Para 8.

1. 1 of AASB 1013 Accounting for goodwill states that where the fair value assigned to the identifiable net assets acquired exceeds the cost of acquisition, the Standard specifies that the difference is discount on acquisition. This discount may reflect a bargain purchase and/or compensation in anticipation of temporary future losses or inadequate future profits. The discount on acquisition (bargain purchase) is to be accounted for by reducing proportionately the fair values of the non-monetary assets acquired until the discount is eliminated.

In the rare circumstance that, after reducing to zero the recorded amounts of the non-monetary assets acquired, some of the discount remains, this discount balance must be recognised as revenue in the profit and loss account. Fair value in excess of cost is first applied to reduce non-current assets on a pro-rata basis; then any remainder is an extraordinary gain.

NATURE AND TREATMENT OF GOODWILL ARISING IN BUSINESS

COMBINATIONS: Goodwill is an intangible asset, hard to measure and difficult to recognize. Goodwill today consists of a much larger part of acquisition prices resulting in a greater impact on financial statements. (V.

Sundararajan, 1995). Goodwill is often characterised by qualities such as reliability, prudence and consistency. Despite of lot of controversies regarding what method should best suit to treat goodwill, there is no specific solution provided. The methods of treating goodwill have changed from time to time.

Goodwill is treated by four different methods and there are different problems associated to all the methods adopted so far: 1) Write off method: Under this method, goodwill is immediately written off against an account in stockholders' equity section, usually in retained earnings. The inconsistencies of this method are that it is not measurable and has no true future value. Adopting this method may also result in distorting the tangible assets and overstating the goodwill. 2) Capitalization method: Under this method, goodwill is capitalized and shown as an asset in the balance sheet.

The problem with capitalizing goodwill is determining the proper value to capitalize. 3) Non-Amortisation method: This method is adopted with a notion that the value of goodwill does not decrease in value, but increases over time. However, capitalizing without amortising may show an overstated goodwill in balance sheet, which can misguide the users of the financial statements.) Amortisation method: Amortisation allows the companies to match the cost of intangible assets over the period deemed to benefit from their acquisition. Main arguments related to this method are unreliability of

earnings without any attempt to recognise the impact. Internally generated Goodwill: Treatment of internally generated goodwill is totally different from all the methods shown above.

Para 4. 1 of AASB 1013 clearly prescribes that “ Goodwill which is internally generated by the entity must not be recognized (as an asset) by that entity. Para 4. 1.

further explains that the goodwill which is not recognised as an asset will either go completely unrecognized or will be recognised as an expense”.

Treating internally generated goodwill is much easier than treating purchased goodwill which has lot of inconsistencies and controversies as to methods adopted in its treatment. CURRENT PROPOSALS TO ADOPT A FAIR VALUE APPROACH IN DETERMINING THE COST OF A BUSINESS

COMBINATION: The development of Accounting Standards reveals that the historical cost accounting, is being replaced by the fair value accounting paradigm. Barlev B & Haddad J, 2002) In determining the cost of a business combination, Para 24 of AASB 3 states that the acquirer shall measure the cost of a business combination as the aggregate of: a) The fair values, at the date of exchange, of assets given, liabilities incurred or assumed, and equity instruments issued by the acquirer, in exchange for control of the acquire; plus b) Any costs directly attributable to the business combination.

Determining the cost of acquisition is similar to determining the cost of assets acquired individually.

Cash payment shall be used to measure the cost of an acquired entity.

Similarly, the fair value of other assets distributed as consideration and the

fair values of liabilities incurred are used to measure to cost of an acquiring entity (FAS-141 para. 20). Exposure Draft 139 refers to the Proposed Amendments to AASB 3, and there have been several supporting as well as disagreements to this. Overall, the main concerns are related to the fair value approach in valuing business combinations, and thereby recognising goodwill relating to the minority interest, will be based on unreliable estimates in many cases. Whether or not these estimates will give a true and fair view as required by the Corporations Act, is also being questioned.

Meanwhile, the costs of implementing these proposals seem to be outweighing the possible benefits. Conclusion: Having evaluated and outlined various aspects of Australian requirements for Accounting for Business Combinations, we cannot ignore the fact that business combinations are an inevitable part of the growth of the economic sector. Though business combinations demand specific compliance with the standards and represent a significant risk, it plays a significant role in changing the face of the acquiring entity's financial resources. REFERENCES: Dagwell, R. , Wines, G.

, Lambert, C. , (2007) Corporate Accounting in Australia (4th edition) University of New South Wales Press, Sydney. CPA Australia (2007) Accounting Handbook, Pearson Education Australia, French Forest: · Australian Accounting Standard Board AASB 3 - Business Combinations Statement of Accounting Concepts SAC 1 - Definition of the Reporting Entity Williams, J. , Carcello, J.

, (2006) GAAP Guide Level A (2007) Restatement and Analysis of Current FASB Standards, CCH. Reporting requirements for non-reporting entities: ASIC Information Release (Issued on: 20 July 2000) Website: www.aasb.com.au/public_docs/aasb_standards/AASB1025_7-91.pdf Acquisitions and Goodwill - First Time application of Accounting Standards, Abstract 34 by Urgent Issues Group (June 2000) retrieved from Website: www.aasb.com.au/public_docs/abstracts/ABS34_6-00.pdf

Fair Value of Equity instruments issued as Purchase Consideration Abstract 41 by Urgent Issues Group (September 2001) retrieved from Website: http://www.aasb.com.au/public_docs/abstracts/ABS41_9-01.pdf

Accounting for Goodwill AASB 1013 (June 1996) retrieved from Website: www.aasb.com.au/public_docs/aasb_standards/AASB1013_6-96.pdf

Sundararajan, V. , (1995), Accounting for Goodwill retrieved from www.aasb.com.au/public_docs/aasb_standards/AASB1013_6-96.pdf

Barlev, B. , Haddad, J. , Fair Value Accounting and Management of the Firm (2002) Jerusalem, Israel retrieved from www.aasb.com.au/public_docs/aasb_standards/AASB1013_6-96.pdf

com>