Corporate Reporting

Lecture 6

Accounting for business combination

Accounting for revaluation of non-current assets

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Objectives

- Nature of business combination
- Accounting for business combination
  - Direct acquisitions
  - Indirect acquisitions
- Accounting for goodwill
- Accounting for revaluation of non-current assets

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Business Combination

- One entity (known as the acquirer) obtains control of one or more other businesses (known as the acquiree).
- Different to purchase individual assets or groups of assets (AASB 116 Property, Plant and Equipment)

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Business Combination

- Direct acquisition
  - acquire the assets & liabilities of a company directly
- Indirect acquisition
  - control via share ownership
    - offer
    - stock market

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Accounting for Direct Acquisitions By Acquirer

Dr	Assets acquired	xx	
Cr	Liabilities acquired		xx
Cr	Cost of acquisition		xx
	(Business combination)		

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Cost of business combination (acquisition)

The cost of the business combination as the aggregate of :

- The fair value, 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 acquiree.

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Other acquisition related costs

- Costs directly attributable to the acquisition
  - These costs are costs that acquirer incurs to conduct a business combination. For examples: finders' fee; advisory, legal, accounting, valuation and other professional or consulting fees. Old version of AASB3 suggests that these costs should be treated as cost of business combination
  - **Effective on 1 July 2009, new version of AASB3** prescribes that the acquirer should treat acquisition related-costs as **expenses.** *In other words these expenses are not part of purchase consideration or cost of business combination*

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Fair Value

- Fair value:

  … the amount for which an asset could be exchanged,or a liability settled, between a knowledgeable, willing parties in an arm's length transaction.

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Purchase Difference

Purchase Difference [Goodwill (Discount)]

=

Cost of Acquisition

-

Fair Value of Net Assets Acquired

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What is goodwill?

- An unidentifiable intangible asset that cannot be individually identified and is an intrinsic part of the business;
- Could be built up over a number periods or obtained by acquiring an existing business;
- Cannot be purchased or sold separately, but only as part of an entity in its entirety;
- Represents the future economic benefits associated with an existing customer base, efficient management, reliable suppliers, etc.

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Internally generated versus purchased goodwill

Goodwill may be internally generated or acquired by purchasing an existing business

- Only purchased goodwill is permitted to be recorded
  - Purchased goodwill can be measured more reliably than internally generated goodwill, based on the amount paid
- Internally generated goodwill cannot be brought to account

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How is goodwill measured?

- Purchased goodwill is measured as the excess of the cost of acquisition (purchase consideration plus incidental expenses) incurred by the acquirer over the fair value of the identifiable net assets acquired.

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Amortisation of goodwill

- There was a requirement to amortise over a period not exceeding 20 years in the old AASB 1013
- With the release of AASB 3 'Business Combinations', as part of the process of adopting IFRSs by 2005, the requirement to systematically amortise goodwill has been **abandoned**

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Impairment Testing

- Now, Goodwill is subject to annual 'impairment testing'
  - Goodwill acquired in a business combination shall not be amortised. Instead, the acquirer shall test it for impairment annually, or more frequently if events or changes in circumstances indicate that it might be impaired, in accordance with AASB 136 'Impairment of Assets'
  - An impairment loss recognised for goodwill shall not be reversed in a subsequent period

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Impairment Loss

Impairment loss (under AASB 136)

- The amount by which the carrying amount of an asset or cash-generating unit (a group of assets, e.g. car assembly line) exceeds its recoverable amount

Recoverable amount of an asset (under AASB 136)

- The higher of its fair value less costs to sell and its value in use

Value in use

- Present value of the future cash flows expected to be derived from an asset or cash-generating unit.

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Impairment Loss (cont.)

If the recoverable amount of an asset is lower than the carrying amount (amount at which asset is recognised in the balance sheet), an impairment loss should be recognized

Accounting for impairment loss

Dr Impairment loss

Cr Asset (Goodwill)

Note:

Prohibition on revaluing goodwill—if the recoverable amount of goodwill is assessed as being greater than the carrying value then *no* revaluation may be made

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Negative Goodwill (Discount) on Acquisition

Negative Goodwill = Sum of the fair value of net assets acquired

Greater than (minus)

Cost of acquisition

Negative goodwill (Discount) shall be recognised as a gain

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Example 1

Big Ltd agrees to purchase assets & liabilities of Small Ltd for:

$400,000 Cash

50,000 $1 ordinary shares in Big Ltd

Big's shares are currently trading for $4.50 each, the proposed issue is not expected to affect the market trading price. Small's balance sheet at the date of purchase is

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Assets	$,000	*Liabilities*	$,000
Debtors	100	Bank overdraft	30
Stock	220	Creditors	75
Land and Buildings (net of depreciation)	550	Loans	325
Patents	80		430
		Shareholders funds	
		Retained profits	420
		Paid up capital ($1*100,000)	100
			520
Total	950	Total	950

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Big has determined the following fair values in the process of price negotiation:

Debtors	95,000
Stock	200,000
Land & buildings	600,000
Patents	100,000
Bank Overdraft	30,000
Creditors	75,000
Loan	325,000

(1) Prepare the general journal entry to reflect the acquisition of Small's assets and liabilities by Big Ltd.

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Solution:

Purchase consideration:		
Cash	$400,000	
Shares ($4.50 * 50,000)	$225,000	
		$625,000
Fair value of Assets:		
Debtors	$95,000	
Stock	200,000	
Land and buildings	600,000	
Patents	100,000	
	$995,000	

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Fair Value of Liabilities:			
Bank Overdraft	$30,000		
Creditors	75,000		
Loan	325,000		
		$430,000	
Fair Value of Net Assets			$565,000
Goodwill			60,000

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(2) Using the previous example, assume the purchase consideration had been $520,000. Provide a pro forma general journal entry to reflect the acquisition

Solution:

Purchase consideration:		
Cash		$520,000
Fair value of Assets:		
Debtors	$95,000	
Sotck	200,000	
Land and buildings	600,000	
Petents	100,000	
	$995,000	

Fair Value of Liabilities:			
Bank Overdraft	$30,000		
Creditors	75,000		
Loan	325,000		
		$430,000	
Fair Value of Net Assets			$565,000
Negative Goodwill			45,000

Negative goodwill (discount) should be recognised as a gain

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(3) Using Example 1, assume the impairment loss on goodwill is 3,000 for the current year

Solution:

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Indirect Acquisition

- Equity purchase
- Objective -> control!
- 20% without regulation
  - 3% every 6 months
  - formal offer
  - takeover announcement

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Accounting for Indirect Acquisitions

- Investment will be stated in investor's account as the fair value of the shares purchased
- Goodwill & discount is adjusted on consolidation

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Example 2: Indirect Company acquisition

Use the same information as in Example 1, except that Big Ltd purchase 100% Small Ltd shares directly on the stock exchange at $6.85 per share. Prepare journal entries in Big Ltd.

Dr.	Investment	685,000	
Cr.	Cash		685,000

Cost of acquisition	685,000
Fair value of net assets acquired	565,000
Goodwill	120,000

Goodwill is not shown in Big Ltd account, it will be accounted in **Consolidation**.

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Accounting for Revaluation of Non-current Assets

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Relevant accounting standards

1. AASB 116 'Property, Plant and Equipment' Requirements for revaluations, depreciation and determining acquisition cost of property, plant and equipment
2. AASB 138 'Intangible Assets' Revaluation of intangible assets and other issues
3. AASB 136 'Impairment of Assets'

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Introduction

- In Australia, entities may revalue many non-current assets
  - AASB 138 specifically excludes the revaluation of some intangibles
- **Asset revaluations**
  - Recognising a reassessment of the carrying amount of a non-current asset to fair value as at a particular date
  - Excludes recoverable amount write-downs (i.e. impairment losses)

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Carrying amount of assets

↕

Fair value of the assets

↓

Asset Revaluation

AASB 116
AASB 138

Carrying amount of assets

↕

Recoverable amount

↓

Impairment Test

AASB 136

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Introduction

- If a non-current asset's carrying amount exceeds its **recoverable amount** it must be written down to its recoverable amount (AASB 136)
  - The write-down is called an **impairment loss**
  - **Carrying amount:** cost of asset less accumulated depreciation or impairment losses
  - **Recoverable amount:** higher of an asset's net selling price and value in use

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Introduction (cont.)

- **Net selling price:** amount obtained from the sale of an asset (Market price) in an arm's length transaction between knowledgeable, willing parties less the costs of disposal
- **Value in use:** present value of the future cash flows expected from an asset

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Example

- A Ltd has a piece of land, and the carrying amount is $1,000,000
- Net selling price is 900,000
- Value in use is 980,000
- Market value is 950,000
- What are differences b/w A Ltd writes land down to its recoverable amount and A Ltd revalues land to its fair value?

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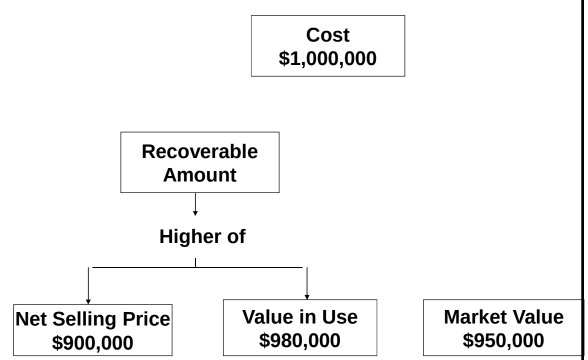

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Impairment Test

Revaluation Decrement

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Measuring property, plant and equipment at cost or fair value

- AASB 116 requires each class of property, plant and equipment to be measured at either cost or fair value
  - Examples of classes are land and buildings, machinery and motor vehicles
- Some classes can be measured at cost and others at fair value

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Measuring property, plant and equipment at cost or fair value (cont.)

- With a mix of measurement methods, is the total balance of non-current assets meaningful?
- Entities may switch from fair value to cost for justifiable reasons and provided adequate disclosures are made (AASB 116)

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Measuring property, plant and equipment at cost or fair value (cont.)

- Where an entity changes from cost to fair value for a class of non-current assets and there was a previous impairment loss (AASB 116):
  - any increase in an asset's carrying amount is first recognised as income; and
  - any excess above the amount if no impairment loss was recognised is transferred to a revaluation reserve

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- If a class of non-current assets is measured at cost, AASB 136 is to be applied
  - If an asset's carrying amount is greater than its recoverable amount, an 'impairment loss' must be recognised
  - This is not a revaluation

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The use of fair values

- Any revaluation of non-current assets must be to **fair value** (AASB 116)
- Fair value is the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction
- Fair value is determined on the assumption that the entity is a going concern
- **Market price** is to be used where an active and liquid market exists for the asset

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The required disclosures regarding asset revaluations (AASB 116)

– effective date of revaluation
– whether an independent valuer was involved
– methods and assumptions applied
– extent to which fair values were determined, with reference to observable prices in active markets or recent market transactions
– for each revalued class, the carrying amount if the cost model was used
– the revaluation reserve, indicating change for the period and any restrictions on distribution of the balance to shareholders

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How often should assets be revalued?

- Revaluations must be made with sufficient regularity so the carrying amount of each asset in the class does not differ materially from its fair value (AASB 116)
- If values change regularly and changes are material, revaluations might be necessary each reporting period
- Otherwise every three to five years is sufficient

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1.Revaluation increments

- General procedure (AASB 116):
  Dr. Asset
  Cr. Revaluation surplus
  Dr. Revaluation surplus
  Cr. Deferred tax liability
- Note: no tax effect has been considered in chapter 6 of Deggan's book
- Revaluation surplus is part of shareholders' funds (owners' equity)
- Directors may approve cash distributions to shareholders from revaluation surplus but they must exercise extreme caution

Revaluation decrements

- In line with the concept of conservatism, revaluation decrements are recognised as a loss in the profit and loss account
- Journal entry (AASB 116):

  Dr. Loss on revaluation of asset
  Cr. Asset

Example 1

Fox Ltd acquired a block of land at Victoria Harbour for 1.2 million in 2000. At 30 June 2001, the market value of the land at Victoria Harbour is assessed as 1.5 million. Income tax rate is 30%

2. Revaluation of depreciable assets

- If a revalued asset is a depreciable asset, any balance of accumulated depreciation is credited to the asset account prior to revaluation (AASB 116)
- Journal entry (net-amount method):

Dr.	Accumulated depreciation	
	Cr.	Asset

- Subsequent depreciation is to be based on the revalued amount of the asset

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Example 2

- At 30 June 2001, The cost of machinery in Blacksmith Ltd is $100,000, the accumulated depreciation is $20,000. The useful life is 5 years. All machinery is depreciated using the straight-line method, with a zero residual value.
- At 30 June 2001, directors in Blacksmith Ltd estimate that the fair value of the machinery is $90,000. Income tax rate is 30%

Required: prepare relevant revaluation journal entry as at 30 June 2001.

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Treatment of balances of accumulated depreciation upon revaluation (cont.)

- Alternative method (AASB 116) (Study after lecture by yourself!)
  - Accumulated depreciation may be restated proportionately with the change in gross carrying amount of the asset, so the carrying amount after revaluation equals the revalued amount
  - This is referred to as the gross method
- Journal entry:

Dr. Asset
    Cr. Accumulated depreciation
    Cr. Revaluation surplus
Dr. Revaluation surplus
    Cr. Deferred tax liability

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Example 3

Use the same information in example 4, prepare relevant revaluation journal entries by using the gross method.

Dr Machinery 12,500 [112,500 −100,000]
    Cr Accumulated Depreciation 2,500 [112,500/5 −20,000]
    Cr Revaluation surplus 10,000

Dr Revaluation surplus 3,000
    Cr Deferred tax liability 3,000

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<u>Net amount of the Machinery</u>

80,000 revalue to 90,000

Increased by 90,000/80,000= 1.125, that is 12.5%

<u>Gross carrying amount of the Machinery</u>

100,000 revalue to X?

Both gross carrying amount and accumulated depreciation should also increase by 12.5%.

X = 100,000 *(90,000/80,000) = 112,500

Accumulated depreciation = 20,000 *(1+12.5%)= 22,500

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Machinery (100,000 +12,500)	112,500
Accumulated Depreciation (20,000+2,500)	<u>22,500</u>
Net amount	90,000

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Example 4

At 30 June 2001, the cost of motor vehicles in Southerncab Ltd is \$200,000, and the accumulated depreciation is \$40,000. Motor vehicles are depreciated by using straight-line method and the useful life is five years.

At 30 June 2001, directors in the company believe that the fair value of motor vehicles is \$120,000.

Required: prepare relevant revaluation journal entry as at 30 June 2001. (Income tax rate is 30%)

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3. Reversal of revaluation decrements and increments

- Revaluation should be carried out regularly;
- If a revaluation decrement reverses a previous increment for the same asset;
- The initial revaluation increment entries shall be reversed.

- Year 1: Revaluation increment 20,000
- Year 2: Revaluation decrement 30,000

<u>Journal entries in year 2:</u>

Dr	Revaluation surplus	20,000	
Dr	Loss on revaluation (any excess)	10,000	
Cr	Asset		30,000
Dr	Deferred tax liability	6,000	
Cr	Revaluation surplus		6,000

(Assume income tax rate is 30%)

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Reversal of revaluation decrements and increments (cont.)

- If a revaluation increment reverses a previous decrement for the same asset,
- The initial revaluation decrement entries shall be reversed firstly.

- Year 1: Revaluation decrement 30,000
- Year 2: Revaluation Increment 50,000

Journal entries in Year 2:

Dr. Asset			50,000	
	Cr.	Gain on revaluation		30,000
	Cr.	Revaluation surplus (any excess)		20,000
Dr. Revaluation surplus			6,000	
	Cr.	Deferred tax liability		6,000

9Assume income tax rate is 30%)

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Example 5

As discussed in **Example 1**, Fox Ltd acquired a block of land at Victoria Harbour for 1.2 million in 2000. At 30 June 2001, the market value of the land at Victoria Harbour is assessed as 1.5 million. Income tax rate is 30%, How about if the market value becomes 1.3 million at 30 June 2002?

30/6/2002

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Example 6

In previous example, if the market value decreases to 1.1 million at 30 June 2002.

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Accounting for profit on disposal of a revalued non-current asset

- Gain or loss from **derecognition** of an item of property, plant and equipment is to be calculated as the difference between (AASB 116):
  - net disposal proceeds (if any); and
  - the asset's carrying amount
- **Derecognition:**
  - the point in time when an asset is removed from the balance sheet
  - when an asset is sold; or
  - when no future economic benefits are expected from an asset's use or disposal

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Accounting for profit on disposal of a revalued non-current asset (cont.)

- When an asset is sold, any resulting balance in the revaluation reserve (AASB 116):
  - may be transferred directly to retained earnings
  - cannot be transferred to the profit and loss account
- If a non-current asset is revalued upwards, any gain on sale will be less than the gain if the asset was not revalued

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Consideration of present values

- Recoverable amount is the higher of an asset's **net selling price** and its value in use (AASB 136)
- Value in use (AASB 136):
  - is the present value of the future cash flows expected from an asset
- Estimating value in use (AASB 136) involves:
  - estimating future cash inflows and outflows from the continued use and subsequent disposal of the asset; and
  - applying the appropriate discount rate to the future cash flows
- Discounting future cash flows will decrease the calculated recoverable amount

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Offsetting revaluation increments and decrements

- The ‘old’ AASB 1041 required increments and decrements to be offset against each other within **a class** of non-current assets.
- Now, increments and decrements may be **offse**t only to the extent that they relate to a particular asset (AASB 116) on **an asset-by-asset basis.**

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Summary

- If the recoverable amount is below the carrying amount, an impairment loss should be recorded
- For upwards revaluations:
  - assets are to be revalued to fair value
  - any increase is to be transferred to a revaluation surplus, unless it is a reversal
- For downwards revaluations:
  - any decrease is to be treated as an expense, unless it is a reversal

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Summary (cont.)

- When a revaluation is undertaken:
  - any existing accumulated depreciation should be credited against the non-current asset; and
  - the non-current asset should be increased by the amount of the revaluation
- Where a revalued asset is sold, the gain or loss is the difference between the carrying amount and the net disposal proceeds of the asset.

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