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BUSINESS COMBINATION ACCORDING TO IFRS 3 AS A TURNING POINT IN ACCOUNTING RECOGNITION AND MEASUREMENT

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Abstract

Researcher discussed in this study business combination according to IFRS 3 as a turning point in accounting recognition and measurement, since at acquisition date – the date that control of the controlling entity over the controlled entity achieved-, many assets, liabilities, income and expenses at that date recognized in spite of IFRSs do not permit to recognize it before.

Researcher discussed this matter in details, since that treatments may be considered as duplicity in accounting procedures, those absented items from financial statements not only not recognized because criteria of recognition not met, but also there are no specific disclosures relate to these absented items, examples of these items goodwill and other internally generated intangible assets, contingent liabilities, gain from bargaining purchase, and the like.

Also, at the acquisition date, assets and liabilities measured at fair value, that resulted in gains or losses from the point view of owners of controlled entity whom sell their interests to the controlling entity, these gains or losses become a losses or gains from the point view of controlling entity such as gain of bargaining purchase.

Researcher concluded to necessity of declaring these facts through recognition, measurement, or through disclosures incases of impossibility of recognition, but avoid full absence of fair presentation or disclosures to facts appear between day and night.

Keywords: business combination, measurement, recognition, disclosure, IFRS 3

Introduction

Accounting figures accompanied all the steps of accounting cycle, since accounting according to monetary unit concept treats with financial transactions only, and ignores the non-financial transactions, that means in order to record any transaction, it must be available to convert it into figures, that is called accounting measurement, which means granting value to specific item or its characteristics (IASB, conceptual framework of financial statements) considering of course accounting recognition and its criteria, however Recognition is the process of incorporating in the statement of financial position or statement of profit or loss and other comprehensive an item that meets the definition of an element and satisfies the following criteria for recognition: It is probable that any future economic benefit associated with the item will flow

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to or from the entity; and The item's cost or value can be measured with reliability(IASB, conceptual framework of financial statements).

One of the main criticisms to financial statements is the absence of many items from it, because International Financial Reporting Standards(IFRSs) that issued by international Accounting Standards Board (IASB) do not permit to recognize these items, or there is no generally accepted measurement can be used to measure these items.

But incase of business combination, many of these items must be considered, through recognizing it, or measuring it in a different way, this procedure took place just because of significant event appeared, that is control of the controlling entity over the controlled entity.

Researcher will investigate matters in accounting for business combination relates to recognition and measurement that constitute exceptions to accounting procedures according to IFRSs.

Problem of the study

Recognition and measurement considered to be the main two serious issues in accounting, since recognition of items in financial statements requires flow to future economic benefits associated with the item to or from the entity, but not all of items in spite of that fact can be recognized because of the second criterion that relates to possibility of measuring its cost or value with reliability.

But incase of business combination, the same items must be recognized and according to IFRS 3: business combination.

The problem may be questioned by the following question: can business combination according to IFRS 3 considered to be a turning point in accounting recognition and measuremen?

According to the question of the study, the following sub questions may be drawn:

1. Are there items can not be recognized according to IFRSs and must be recognized directly after control according to IFRS 3: business combination?
2. Are there items measured according to IFRSs in a different way directly after control according to IFRS 3: business combination?
3. Are there alternatives to measure items included in consolidated financial statements?
4. Is there an intended practices in business combination, its substance may be differed from its form?
5. Could business combination accounting according to IFRS 3 resulted in heterogeneity between accounting figures ?

Literature review

International Financial Reporting Standards (IFRSs) that issued by international Accounting Standards Board (IASB) are a human being efforts to standardize accounting practices to increase creditability of accounting figures that included in financial statements, but that does not mean there are no criticisms to these figures since several matters incorporated with converting financial transactions into quantitative accounting figures.

IASB continue to do its best efforts to reduce the effect of these criticisms or delete it, but that is not easy mission, also other standards setters like Financial Accounting Standards Board (FASB) cooperates and coordinate with IASB in associated efforts and projects to improve the reliability, relevance, comparability creditability, and fairness of financial reporting.

One of these projects is issuing IFRS 3 (2008): business combination. It sets out the principles on the recognition and measurement of acquired assets and liabilities, the determination of goodwill and the necessary disclosures.

IFRS 3 (2008) resulted from a joint project with the US Financial Accounting Standards Board (FASB) and replaced IFRS 3 (2004). FASB issued a similar standard in December 2007 (SFAS 141(R)). The revisions result in a high degree of convergence between IFRSs and US GAAP in the accounting for business combinations, although some potentially significant differences remain(deloitte, IFRS 3).

IFRS 3 focus on fair value to measure assets and liabilities acquired, but fair value as a measurement basis can be considered as arguable measurement basis did not solve all or most of the problems and criticisms relate to accounting measurement, but researchers (Ja'arat, 2017) look to fair value basis enhance the problem of measurement.

Also, some practices in spite of it permitted according to IFRS, but it is illogic, because it mixes between different measurement bases, such as preparation of consolidated financial statements, since assets and liabilities of controlled entity that included in consolidated statement of financial position in its fair value, while assets and liabilities of controlling entity in its carrying amounts mostly in book value according to IFRS 3.

Answering the questions of the study

Since the study relates to accounting measurement and its bases, the researcher will try to answer the questions of the study to improve the quality of financial reporting before business combination .

Question 1: Are there items can not be recognized according to IFRSs and must be recognized directly after control according to IFRS 3: business combination?

The answer simply: yes, the following items can not be recognized according to IFRSs and must be recognized directly after control according to IFRS 3: business combination:

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1. **internally generated goodwill**: One of the important items that can not be recognized in financial statements according to IAS 38: Intangible Assets, internally generated goodwill cannot be recognized except if it relates to controlled entity, the following matters could be raised that may be argued:

a) The goodwill that can be recognized upon purchasing is the same amount that cannot be recognized directly before the significant event(purchasing with control), for example, XXX company controlled by AAA company on Jan, 31st 2016, because of that AAA company recognized goodwill in consolidated statement of financial position in amount of CU 350 000, but XXX cannot recognize goodwill on Jan, 30 2016 since IFRSs do not permit that, related issues to be raised: the first: this treatment expressed inconsistency in accounting for goodwill, because goodwill in spite of unrecognized it, that treatment does not delete its existentialism in reality since its generation cannot be achieved between day and night. The second: the determinant of goodwill recognition is the significant event that relates to purchasing XXX company with control by AAA company, other than its existence, so the unrecognizing of goodwill resulted in decreasing both assets and owner equity of the controlling entity.

b) **Gain from Bargaining Purchase(GBP):** To the contrary of recognizing goodwill, when the fair value of net assets acquired exceeds the cost of purchase, controlling entity has to recognize gain from bargaining purchase(GBP) – previously known as negative goodwill- immediately in its statement of profit or loss and other comprehensive income, but this gain in proportionate of controlling entity's share in controlled entity without paying any consideration to NCI share, in reality, GBP assumed to decrease owner equity of controlled entity, but this treatment prohibited according to IFRSs, in one hand unrecognizing of GBP previously to purchase event overstating owner equity of controlled entity, in other hand and after recognition of GBP that means decreasing owner equity of controlling entity by GBP but by the control percentage, while NCI remains as it without any decreasing, so NCI presented in the consolidated statement of financial position overstated, also fair value of NCI ignored totally, and assumption of pricing owner equity in more than one price is illogic one.

   Other issue can be raised here, that from the point view of controlling entity GBP can be recognized depending on the choice of owners to sell their interests below its fair value, but it is probable that fair value of NCI exceeds their share in carrying amount of net assets, that issue not raised totally in IFRSs.

   These issues can be clarified in the following example:

   AAA company purchased 60% of XXX company, the cost of purchase equal to CU 350 250, direct costs of acquisition equal to CU 2 000, fair value of net assets of XXX company equal to CU 650 000, fair value of NCI equal to CU 165 000

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According to treatment permitted in IFRS 3: Business Combination, GBP calculated as follow:

Cost of purchase	350 250
Fair value of net assets acquired	390 000
GBP	39 750

Fair value of XXX net assets acquired expressed the owner equity that sold in amount of CU 350 250, that means sold in loss, but this loss cannot be recognized before the event of purchasing, indicates the overstatement in owner equity.

In the above example, the owner equity of XXX company that sold in amount of CU 350 250, which generates GBP to controlling entity at the same amount, but the other face of GBP from the point view of owners of XXX is loss.

Also in spite of recognizing GBP by the controlling entity, NCI does not affected and remain overstated, if we assumed the same price of owner equity, then the value of NCI can be calculated as follow:

Percentage of GBP = 39 750/390 000=10.19%

Fair value of net assets (owner equity) of XXX = 390 000/60%=650 000

Assumed cost of purchase to XXX= 350 250/60%=583 750

Gross GBP= 650 000-58 3750=66 250

GBP recognized= 39 750

GBP relates to NCI = 66 250-39 750=26 500

Amount of NCI presented in consolidated statement of financial position=260 000

Amount of NCI after GBP = 260 000 – 26 500=233 500, or

Amount of NCI after GBP = 260 000*89.81%=233 500

But the amount of NCI that presented in consolidated statement of financial position equal to CU 260 000, so the overstatement in NCE is CU 26 500.

C) **Recognition of contingent liabilities as apart of acquisition**: liabilities characterized by certainty of its timeliness, occurrence and value, while contingent liabilities characterized by uncertainty of its timeliness, occurrence and value, because of that the latter one are not permitted to be recognized according to IAS 37: provisions, contingent liabilities and contingent assets.

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But in business combination, contingent liabilities must be recognized and considered in determining the cost of acquisition

Question 2: Are there items measured according to IFRSs in a different way directly after control according to IFRS 3: business combination?

The answer of this question is yes, since all of assets and liabilities of controlled entity must be measured at its fair values, this is the only permitted treatment after stop using pooling of interests as a method of business combination.

Question 3: Are there alternatives to measure items included in consolidated financial statements?

The answer also is yes, the following cases are supporting the answer:

a) Measurement of goodwill: The goodwill recognized by two different methods: gross goodwill or partial goodwill, gross goodwill includes two parts, the first as a part of controlling entity's assets, and the other part relates to NCI, while partial goodwill does include only the interests relates to controlling entity, the different treatments depending on the method of NCI measurement, however, under gross goodwill NCI has to be measured at its fair value which expected to be its value in the financial market, while under partial goodwill NCI measured at its share in fair value of net assets of controlled entity. Related issues to be raised: the first is: under partial method, logically, it is not acceptable to recognize part of goodwill that relates to share of controlling entity in controlled entity, because goodwill as a whole considered to be hidden asset in controlled entity not only expressed the interests of controlling entity, but also the interests of NCI, the second issue relates to faithful representation of measuring goodwill, since the current treatment according to IFRS 3 is measuring gross goodwill by share of controlling entity and difference between fair value of NCI and its share in fair value in net assets in controlling entity, researcher thinks that the faithful representation of goodwill is by dividing partial goodwill according to the percentage of control, this issue can be clarified by the following example:

AAA company purchased 70% of XXX company, the cost of purchase equal to CU 850 000, direct costs of acquisition equal to CU 10 000, fair value of net assets of XXX company equal to CU 920 000, fair value of NCI equal to CU 296 000, AAA company account for goodwill using gross goodwill.

According to treatment permitted in IFRS 3: Business Combination, goodwill calculated as follow:

Cost of purchase	850 000
Fair value of previous investment	0

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Fair value of NCI		296 000
Total		1 146 000
Fair value of XXX net assets	920 000	
Goodwill		226 000

That means the share of NCI in goodwill equal to CU 20 000, it represents the difference between NCI fair value(296 000) and NCI share in fair value of net assets of XXX company (276 000).

But if the partial goodwill divided by control percent, the amount of gross goodwill can be calculated as follow:

Cost of purchase		850 000
Fair value of previous investment		0
Share of NCI in fair value of net assets of XXX	276 000	
Total		1 126 000
Fair value of XXX company net assets	920 000	
Goodwill		206 000
Control percentage		70%
Gross goodwill		294 286

That means the share of NCI in goodwill equal to CU 88 286, it represents the difference between gross goodwill calculated (294 286) and partial goodwill (206 000).

b) **Fair value and its alternatives in measurements**: in spite of the fact that fair value is a measurement basis, but what must be evoked in mind, this basis can not be determined by one method or way.

IFRS 13: fair value measurement identifies three types of markets in which fair value can be determined, those are active market, best advantage market, and principal market, every market has its assumptions and determinants that lead absolutely to different amounts of fair values.

Also according to IFRS 13, fair value can be determined according to hierarchy consists of three levels, every level has its inputs that differ from others, and it is not allowed to use inputs of next level unless inputs of the level before cannot be achieved, the inputs of the first level are quoted prices in active markets for identical assets or liabilities, while the inputs of the second level are inputs other than quoted market prices included within Level 1, that are observable inputs for the asset or liability, either directly or indirectly, finally the inputs of the third level are unobservable inputs for the asset or liability.

In addition to what mentioned above, the valuation techniques to determine fair value are also three, market, cost and income approaches, that means fair value is not a measurement basis, but fair value could be market based, cost based, or income based , this resulted in tenths of values could be called fair values, so instead of minimize the accounting measurement gap, vice versa, fair value according to some researches maximize this gap.

Question 4: Is there an intended practices in business combination its substance may be differed from its form?

The answer also is yes, the following cases are supporting the answer:

a) **The percentage of owner ship of controlling entity** in controlled entity should expressed the percentage of control, however, sometimes, it differs from each other since intention behind purchasing more than 50% not in all cases aims to control, sometimes the intention behind holding these investments is for trading, other times held to maturity, and so on, at the same time the controlling entity should disclose that fact, in order to determine the accounting procedures such as: measurement basis and in case of measuring investments at fair value, where to recognize changes in it, in P/L or in OCI.

   The previous matter had a significant importance during financial crisis 2007-2008 since European Union insisted to amend IAS 39 and IFRS 7 in order to permit reclassifications between different categories of investments so as to defer losses; this pressure resulted in IASB's response by amending IAS 39 and IFRS 7 and applying the amendments retroactively (jaarat).

   But the main issue to be raised is how to determine the reality and actual intention behind holding investments, since it affects accounting figures, and may reflects conflicts in interests, which makes figures meaningless and cannot be considered as usefulness information for making decisions.

   Determination of intention is a fundamental issue, it is reflected in accounting procedures at initial recognition, that means intention could be identified by the procedures followed recognition, because of that, researcher looks to intention must be expressed by actions in order to identify it regardless of its reality, accordingly no need to disclose intention since the accounting practices reflect intention, however, in certain cases of business combination intention is to the contrary of declared or disclosed one, that cases very obvious during financial crisis, since entities faced financial difficulties particularly in European Union because of specific categories and classification of financial instruments especially those measured at fair value, so the solution to get red of or reduce losses is by reclassifying it to another category mainly measured at cost, the question to be asked:

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what is the value and importance of intention since interests could be achieved by change it, that prove the idea of meaningless of intention at initial recognition, also, the accounting practice follows the identification of intention, in spite of the right practice is on the contrary, that means practice must follow intention, according to actual sequence of intentions and actions as researchers indicate (Jaarat and Amro, 2018).

b) **Transfers, movements and reclassifications**: whether in the same category, or between categories of investments (step acquisition): control could be achieved at one step through purchasing more than 50% of owner equity of another entity, or control can be achieved at more than one step, for example in two or three steps, also, loss of control must be resulted in reclassification to other categories, that can be clarify in the following form:

Transfers between categories of investments

Category	(1)	(2)	(3)	(4)
Percentage of interests purchased	< 20%	< 20%	20% - 50%	>50%
Period of holding interests	≤ 3 months	> 3months ≤ 12 months	> 12 months	> 12 months
Objective of interests	Cash management	Trading Held to maturity	Significant influence	Control

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Classification	Cash equivalents	Short terms investments : - FVTPL (fair value through profit or loss). - FVTOCI (fair value through Other Comprehensive Income). - Amortized cost	Investment in associates	Investment in controlled entity

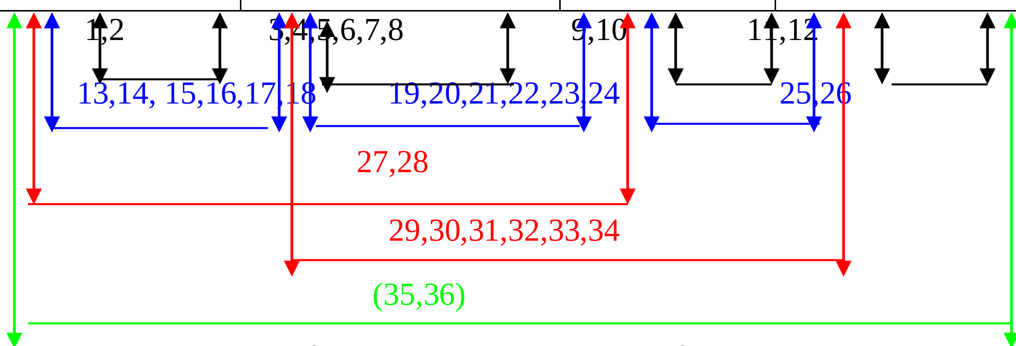

Figure (1): Transfers, movements and reclassifications

The important cases that relate to business combination are those movements in category (4), and reclassifications to or from category (4), can be discussed in the following:

a) Movements in category (4): two cases in this category called partial acquisition(11) and disposals(12), those situation considered as transactions with owners, since control maintained to the controlling entity over the controlled entity, but controlling entity acquires non-controlling interests, that means controlling entity increases its interests by purchasing some or all of non controlling interests, or vice versa controlling entity sells some of its interests over 50% to non-controlling interests, there are a special procedures must be applied like it is not permitted to modify recognized goodwill by increasing or decreasing it as a result of the movements.

b) **Transfers to or from category (4),** those cases are:

b.1. **Situation (25)**: Reclassification from category (3): investments in associates to category(4): business combination, those investments must be measured according to IFRS 3: business combination.

b.2. **Situation (26)**: Reclassification from category(4): business combination to category (3): investments in associates, those investments must be measured according to IAS 28: investments in associates.

b.3. **Situation (29)**: Reclassification from category (2): fair value through profit or loss (FVTPL) to category(4): business combination, those investments must be measured according to IFRS 3: business combination.

b.4. **Situation (30)**: Reclassification from category (2): fair value through other comprehensive income (FVTOCI) to category(4): business combination, those investments must be measured according to IFRS 3: business combination.

b.5. **Situation (31)**: Reclassification from category (2): investments measured at amortized cost to category(4): business combination, those investments must be measured according to IFRS 3: business combination.

b.6. **Situation (32)**: Reclassification from category(4): business combination to category (2): fair value through profit or loss (FVTPL), those investments must be measured according to IFRS 9: financial instruments.

b.7. **Situation (33)**: Reclassification from category(4): business combination to category (2): fair value through other comprehensive income (FVTOCI), those investments must be measured according to IFRS 9: financial instruments.

b.8. **Situation (34)**: Reclassification from category(4): business combination to category (2): investments measured at amortized cost, those investments must be measured according to IFRS 9: financial instruments.

b.9. **Situation (35)**: Reclassification from category (1): cash equivalents to category(4): business combination, those investments must be measured at current value

b.10. **Situation (36)**: Reclassification from category(4): business combination to category (1): cash equivalents, those investments must be measured at current value.

Question 5: Could business combination accounting according to IFRS 3 resulted in heterogeneity between accounting figures ?

The answer also is yes, the following cases are supporting the answer:

b) Other issue to be discussed relates to business combination is consolidated financial statements, which prepared by controlling entity through aggregating separated financial statements of the entities within the group.

What must be considered relate to this issue is separated financial statements of controlling entity include the carrying amounts of assets, liabilities, owner equity, income and expenses, these carrying amounts must not be revalued, while separated financial statements of controlled entity include the assets, liabilities, owner equity, income and expenses which must be revalued and measured at fair values according to IFRS 3.

It was noticed that consolidated financial statements include mixed values at a time that items included in financial statements of controlling entity can be revalued at its fair values, but this procedure prohibited according to IFRS 3, in spite of resulting in a big gap between amounts in consolidated financial statements, also there is no such disclosures relate to revalued amounts of items included in financial statements of controlling entity that may be reduced the gap in inconsistency between accounting figures in consolidated financial statements, the following example can be clarify what included above:

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(A) company acquires 62% of identified net assets of (B) company, paid in cash CU240 000 as a cost, and CU12 000 as an expenses

The financial statement of (A) and (B) directly before acquisition as follow:

the account	(A)	(B)	fair value (A)	fair value (B)
Cash & cash equivalent	300 000	60 000	300 000	60 000
Receivables	480 000	160 000	450 000	140 000
short-term investments	300 000	110 000	250 000	90 000
Inventory	530 000	200 000	550 000	260 000
total assets	1 610 000	530 000	1 550 000	550 000
Payables	190 000	80 000	210 000	70 000
long-term loans	250 000	130 000	250 000	130 000
owner equity	1 170 000	320 000		
total liabilities & owners equity	1 610 000	530 000		

According to IFRS 3, fair values of assets and liabilities of controlling entity(A co.) is totally ignored in terms of preparing consolidation statement of financial position, and the carrying amounts of assets, liabilities and owner equity considered in consolidation, while fair values of assets and liabilities of controlled entity(B) must be considered in consolidation, the statement of financial position to (A) company directly after acquisition and consolidated statement of financial position presented as follow:

the account	(A) Before acquisition	(B)	fair value (B)	(A) after acquisition	Adjustments		Consolidated Financial Statements
					Dr	Cr	
Cash & cash equivalent	300 000	60 000	60 000	48 000	-	-	108 000
Receivables	480 000	160 000	140 000	480 000		20 000	620 000
short-term investments	300 000	110 000	80 000	300 000		30 000	380 000
Inventory	530 000	200 000	260 000	530 000	60 000		790 000

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Investments in B co.				240 000		240 000	0
Goodwill					29 200		29 200
total assets	1 610 000	530 000	550 000	1 598 000			1 927 200
Payables	190 000	80 000	70 000	190 000	10 000		260 000
long-term loans	250 000	130 000	130 000	250 000		-	380 000
owner equity	1 170 000	320 000		1 158 000	320 000		1 158 000
NCI						129 200	129 200
total liabilities & owners equity	1 610 000	530 000		1 598 000	419 200	419 200	1 927 200

Notice that figures in consolidated statement of financial position contains mixed figures, those that relate to controlling entity presented at its carrying amounts, while those relate to controlled entity presented at its fair values, this is really an argument of homogeneity between consolidated figures, beside goodwill included in consolidated statement is an assets generated in controlled entity, while goodwill generated in controlling entity prohibited to be recognized.

Let us now represent consolidated statement of financial position in consideration to fair values of (A) company and internally generated goodwill estimated in amount of CU125 000.

the account	**(A) Before acquisition**	**(B)**	**fair value (B)**	**fair value (A)**	**(A) after acquisition FV**	**Adjustments**		**Consolidated Financial Statements**
						Dr	**Cr**	
Cash & cash equivalent	300 000	60 000	60 000	300 000	48 000	-	-	108 000
Receivables	480 000	160 000	140 000	450 000	450 000		20 000	590 000
short-term investments	300 000	110 000	80 000	250 000	250 000		30 000	330 000

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Inventory	530 000	200 000	260 000	550 000	550 000	60 000		810 000
Investments in B co.					240 000		240 000	0
Goodwill					125 000	29 200		154 200
total assets	1 610 000	530 000	550 000	155 0 000	1 663 000			1 992 200
Payables	190 000	80 000	70 000	210 000	210 000	10 000		280 000
long-term loans	250 000	130 000	130 000	250 000	250 000		-	380000
owner equity	1 170 000	320 000			1 203 000	320 000		120300 0
NCI							129 200	129200
total liabilities & owners equity	1 610 000	530 000			1 663 000	419 200	41 9200	1 992 200

Notice that what is presented in the statement of financial position to A company directly after acquisition and consolidated statement of financial position may be included in the notes of financial statements, and not presented formally, just to attract attention to the facts of achieving homogeneity in figures and amounts presented in the financial statements.

Conclusion

According to the for mentioned discussions of cases relate to business combination according to IFRS 3, this standard includes many exceptions in measurement and recognition from those mentioned in other IFRSS, researcher discussed many of them like: goodwill, gain on a bargaining purchase, contingent liabilities, and concluded to consider business combination as a turning point in accounting recognition and measurement, resulting inconsistency in accounting procedures before and after combination, and misleading financial reporting, also it is a matter that makes fair presentation through financial statements be questioned and argued.

It is not acceptable from accounting profession to continue ignoring the differences in recognitions and absences of assets, liabilities, income and expenses from financial statements and disclosures, and suddenly appeared at the date of acquisition,

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Because of recognitions are not permitted in other IFRS, researcher recommends to enhance reliability of financial statements through disclosures relate to items not permitted to recognize it but at the same time affect financial statements, also disclosures about fair values of assets, liabilities, of controlling entity, so as to avoid big gap between financial position and financial performance before and after combination, also .

Measuring materiality = goodwill and unrecognized items/total assets

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