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FINANCIAL REPORTING TECHNICAL ASSISTANCE PROGRAMME

STUDY ON ACCOUNTING REGULATION FOR BUSINESS COMBINATIONS

This document was prepared by:

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CONTENTS

PREFACE

- The study is divided into 9 chapters. Chapter 1 covers the most important issues of Polish commercial and tax law that may influence application of the accounting regulations pertaining to business combinations.
- Issues and costs connected with the application of Polish Act on accounting are described in Chapter 2.
- Chapters 3, 4 and 5 pertain to accounting regulations for business combinations in other legal systems. Provisions of international law and US standards are analyzed in detail. A comparison is also made between international regulations and British and German regulations.
- Chapter 6 presents and analysis of specific accounting methods: pooling of interests, acquisition method and predecessor accounting.
- Author of the study believes that fresh start accounting method applies to reorganization rather than business combinations. Therefore, application of this method was described in a separate chapter 7.
- Provisions covered in chapters 3 - 7 apply to business combinations between for-profit entities, regardless of whether they are public sector enterprises or not. Chapter 8 covers regulations for business combinations between not for profit entities, including public finance entities.
- The last chapter discusses changes to existing provisions of the Act on accounting in scope of business combination proposed by the author, including justification for such.
- Directive 2013/34/EU of the European Parliament and of the Council of 26 June 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings, aims to standardize accounting rules, which should ensure greater comparability. The aim of the directive is also to reduce the costs connected with application of accounting rules. Member states are obligated to implement provisions of the directive by 20th July 2015. Besides ensuring comparability of financial statements, the directive is intended to reduce burdens related to application of accounting regulations by small entities. Provisions of the directive do not introduce significant changes in scope of principles for business combinations described in chapters 1-7. Therefore, potential impact of its implementation shall be discussed in the chapter devoted to recommendations.
- Throughout the text of the study, when discussing regulations applied in other systems, terms “enterprise”, “entity” and “company” are used interchangeably. For the purpose of this study, aforementioned terms signify entities for which application of discussed regulations is mandatory.

This study has been prepared as per Act on accounting as of 4 September 2014, International Financial Reporting Standard 3 "Business Combinations" as published on 10 January 2008 with effective date of 3 June 2009 pursuant to Commission Regulation (EC) No 495/2009 as well as other standards and regulations such as were in force as of 31 December 2013.

1. NATURE AND SCOPE OF BUSINESS COMBINATIONS IN POLISH LEGISLATION

Introduction

1.1 Running a business involves continuous growth. Such growth can be organic, stemming from resources created internally in the enterprise. However, in many cases an external development strategy is adopted, based on acquisition of other entities. Such an acquisition may involve creation of a capital group, within which each of the companies maintains its separate legal personality. However, if a capital group is not the optimal form for the given business activity, acquisition of another entity may take form of a business combination. In such case, assets and liabilities of the acquiree are directly incorporated into the books of the acquirer.

1.2 The overriding principle of accounting regulation is primacy of economic substance over legal format. Pursuant to this principle, economic transactions must be recorded in the accounting records in accordance with their economic nature[1]. In order to determine properly the economic nature of a business combination, an analysis must be performed of economic impacts of such a combination. Economic consequences for merging entities are described in the provisions of commercial law.

Analysis of economic law

1.3 Companies include general partnerships, professional partnerships, limited partnerships and limited joint-stock partnerships, limited liability companies and joint stock companies[2].

1.4 There are two types of companies involved in a business combination. The first is the company transferring assets. The second is the company that acquires the assets.

1.5 Business combination can take place according to two scenarios:

a) the assets and liabilities of one company can be acquired by another company ,

b) combination is effected by creating a new entity, which takes over assets and liabilities of merging companies.

[1] Par. 4.2 of the Act on accounting of 29 September 1994 (consolidated text: Journal of Laws of 2013, item 330), hereinafter referred to as "Act on accounting"

[2] Par. 4 of the Act – Code of Commercial Companies of 15 September 2000 (consolodated text: Journal of Laws of 2013, item 1030), hereinafter referred to as "CCC"

1.6 Business combination may also follow various configurations. This means that the merger can take place between:

a) a corporation and another corporation - as a result of such combination the assets and liabilities of the acquiree are transferred to the acquirer or merging companies transfer their assets to the newly formed corporation,

b) a partnership and a corporation - as a result of such merger partnership's assets and liabilities are transferred to the corporation or the merging companies transfer their assets to the newly formed corporation,

c) a partnership and the other a partnership - as a result of such merger partnership assets transferred to the newly founded corporation[3].

1.7 The business combination is realized on the basis of shareholders' resolution approving the merger and its technical implementation on managerial level is based on the merger plan. The merger plan is drawn up by the boards of both merging companies.

1.8. If the combination takes place between corporations the merger plan should include the valuation of the assets and liabilities of the acquiree. The measurement is to determine the share to net assets exchange ratio and therefore is not performed by accounting methods. The purpose of this valuation is to obtain information about the actual value of the assets of the acquiree[4].

1.9 The merger decision taken by the shareholders is validated by the Registry Court. Registration of the merger in the National Court Register is effected based on documents properly submitted by the boards of the merging companies[5]. Court refuses registration only if the documents relating to the merger are not free from errors.

1.10 On the combination date the acquiree is removed from the register of business entities. If assets and liabilities of the merging companies are transferred to the new company then both merging companies are subject to removal from the register.

1.11 Following the merger, the acquirer continues operations of the acquiree and by virtue of the law becomes its successor in terms of all the rights and obligations. Succession by virtue of the law means that creditors' consent is not required. Following the merger the acquirer becomes the employer for the employees of the acquiree and a party to labor relationship.

1.12 Business combination may include companies which are members of the same capital group or companies that are not members of a capital group.

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[3] par. 491 of CCC
[4] par. 499 of CCC
[5] par. 493 of CCC

1.13 Usually, merger of companies involves payment of a consideration in form of interests of the acquirer transferred to owners of the acquiree. The interests holders of the acquiree become interest holders of the acquirer.

1.14 Provisions of commercial law do not define reverse acquisition. As a result of the reverse acquisition a legal subsidiary obtains control of the legal acquirer. Since in exchange for the assets and liabilities legal parent transfers its interests to owners of legal subsidiary, the definition of the business combination is met.

1.15 According to commercial law, companies in process of liquidation, which have commenced division of their assets, as well as companies undergoing bankruptcy proceedings are not eligible for combinations.

1.16 Succession under commercial law is continued under the tax law.

Provisions of the tax law

1.17 Tax law is autonomous with respect to both commercial law and Act on accounting . This means that in order to properly identify the tax consequences for the merging companies, provisions of the tax law must be analyzed.

1.18 Under the merger, the acquirer purchases the assets of the acquiree. Under the tax law, merger of commercial companies by way of acquisition results in tax succession[6].

1.19 Under the succession provisions, tax rights and obligations of the acquiree are transferred to acquirer.

- The acquirer is entitled to continue the amortization of acquired fixed assets. In such case, fixed assets for income tax purposes are measured at initial value as stated in the acquiree's fixed assets register. The acquirer is obligated to take into account the depreciation write-offs made by the acquiree and to continue using same depreciation method as previously used by the acquiree.
- The acquirer retains the right to deduct from its taxable profit such costs of the acquiree as were not included in the calculation of the acquiree’s tax obligations.
- Payment on acquired receivables, made to acquirer's bank accounts, stemming from acquiree’s earned and taxed revenues, does not give rise to taxable income of the acquirer.
- Interest on loans taken by the acquiree becomes the acquiree’s tax cost or tax income, on condition that payment thereof is effected after the combination date.

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[6] par. 93 of the Tax Ordinance of 29 August 1997 (consolidated text: Journal of Laws of 2012, item 749 as subsequently amended), hereinafter referred to as “the TO”

1.20 The list provided in paragraph 1.19 is only an example.

1.21 The principle of succession tax is limited. The acquirer may not utilize tax losses of the acquiree.

1.22 Tax succession comes into effect upon registration of the combination in the relevant registry court.

1.23 As a result of the merger, the acquiree transfers assets and liabilities to the acquirer. Such transfer is not the same as sale, which would give rise to taxable income. As a result of the combination, the acquiree ceases to exist.

Polish GAAP

1.24 Regulations that govern business combinations are described in Act on accounting.

1.25 Accounting Standards Committee has not issued standard on business combinations yet.

1.26 Polish accounting rules concerning business combinations have been prepared based on International Accounting Standard 22 "Business combinations", which is no longer in force. Two methods for accounting for business combinations are envisaged therein. The main method is the acquisition method. However, in case of combination of entities under common control pooling of interests method may be applied[7].

1.27 Application of provisions concerning business combinations has been restricted in the legislation to commercial law companies only.

1.28 As per provisions of the law, the effective date of the combination is the date of the court registration.

1.29 Should the acquisition method be applied goodwill or negative goodwill may arise.

1.30 Goodwill is to be amortized to profit and loss statement over 5 years. However in justified cases this period may be extended to 20 years. Negative goodwill is to be amortized to profit and loss statement systematically.

1.31 As a principle, business combination involves a requirement of closing the accounting books.

- The acquiree should close its accounting books as of the day of court registration.
- If business combination is effected by forming a new company, accounting books should be closed as of the day preceding the day of court registration.

[7] par. 44a of the Act on accounting.

However if the pooling of interests method is applied, and if the combination does not result in creation of a new entity, closing of accounting books is not required.

1.32 The above described regulations apply to acquisition of an organized part of an enterprise as well.

2. ISSUES AND COSTS CONNECTED WITH APPLICATION OF POLISH ACT ON ACCOUNTING

Definition of entities under common control

2.1 The regulations do not define entities under common control. Many business combinations are effected within the framework of the same capital group. This means, that merging companies have the same owner. It is unclear, therefore, at which point of existence of the capital group the business combination should be accounted for using the acquisition method, and at which point the companies may choose between pooling of interest and acquisition method.

Example 1

In March 2013, company A acquired 100% of shares in company B, at the price of PLN 100,000. On 31 December 2014, management boards of the companies decided to merge, with Company A taking over all assets and liabilities of company B. How should the combination be accounted for?

Since on 31 December 2014 the companies were under common control, the combination can be accounted for using either pooling of interests or acquisition method.

Example 2

In March 2013 company A acquired 100% of shares in company B, at the price of PLN 100,000. On the 31 May 2013, management boards of the companies decided to merge, with company A taking over all assets and liabilities of company B. How should the business combination be accounted for?

As of 31 May 2013 both companies were under common control. Therefore, based on linguistic interpretation of the provisions of Act on accounting, it is possible to apply pooling of interests method to account for the combination.

2.2 Two examples analyzed above may be interpreted in a different way. Since business combination between companies that are not under common control may be accounted for by acquisition method only, it should be deemed that two transactions occurring in a short period of time – acquisition of shares and decision on merger – should be treated as a single transaction of combination of businesses which are not under common control.

2.3 Since time, which should lapse between the moment of acquisition of shares of the acquiree and the moment of combination, is not defined, it is possible to utilize pooling of interests method even if the merging entities are not under common control.

Range of entities to which business combination provisions apply

2.4 Scope of regulations pertaining to business combination is limited to commercial law companies only. Those include general partnerships, professional partnerships, limited partnerships and limited joint-stock partnerships, limited liability companies and joint stock companies.

2.5 Provisions of the Act on accounting apply to a much wider range of entities. Entities obligated to apply provisions of the Act on accounting, besides commercial law companies, include e.g. sole proprietors, entities operating pursuant to Banking Law, other legal persons, as well as entities without legal personality[8].

Example 3

Two sole proprietors, Mr. Jan Kowalski and Mr. Piotr Nowak have to apply Act on accounting due to size of their businesses. On 1 May 20XX the two businesses were combined and a new company, a civil law partnership, was created, with assets of both sole proprietorships contributed in kind[9]. Under the Act on accounting, how should contribution of assets to a joint enterprise in form of civil law partnership be accounted for?

Provisions that govern business combinations are to be applied for commercial companies only, so there may be some doubts as to how a combination of this type should be accounted for. It seems that the restriction on range of entities stems directly from the provisions of commercial law. However, doubts may arise as to application of the Act on accounting to account for commercial transactions, whose economic nature is close to that of a business combination. In this example, the economic nature of the transaction is similar to a combination of two commercial companies. Therefore, provisions of the Act on accounting pertaining to commercial companies should be applied here.

[8] par. 2 of the Act on accounting.

[9] A civil law partnership is not a company, it is formed pursuant to civil law. The most important difference between a company and civil law partnership is that civil law partnership has no legal personality.

Determining the effective date of business combination

2.6 An entity controls another entity if it can determine financial and operating policy thereof in order to achieve economic benefits from its operation[10]. The effective date of business combination is the date on which it is entered into the National Court Register by a registry court[11]. However the registration is only an administrative operation. If the submitted documents are complete and error free, the court cannot refuse registration. It means that the date of taking control of the acquiree is usually different than the date of registration.

Example 4

On 15 December 2013, company A took control of company B. As a result of the combination all assets and liabilities of company B were taken over by company A. The court is going to register the combination on 20 January 2014. How to account for such a business combination?

Since the date of the combination is the date of court registration, even if company A controls company B on 31 December 2013; this means, that the business combination will only be reported in financial statement for 2014. Financial statements of company A for 2013, financial data shall represent only the unit data of company A. Company A should describe the entire transaction in Explanatory Notes to the financial statement.

Example 5

On 1 March 2013, company B decided to make a contribution in kind, transferring an organized part of its enterprise to company A. Business combination was registered on 20 April 2013. Merger plan was prepared as of 1 March 2013. In the period between 1 March 2013 and 20 April 2013, company B has sold some of the assets included in the organized part of the enterprise, subject to contribution. Business combination is accounted for by acquisition method. How should it be accounted for in company A's books?

Assuming, that combination date is the date on which it was registered, it is necessary to re-measure net assets to be transferred as of the combination date. As of the day the assets were sold, company B should de-recognize sold assets from company books and recognize cash inflow. Those assets will not be accounted for within the framework of business combination.

Difference between cash inflow from sales and carrying value of sold assets constitutes profit or loss from sale of non-financial fixed assets. Making the combination date

[10] par. 3.1.35 of the Act on accounting.
[11] par. 44a of the Act on accounting.

dependent on date of registration rather than the date of taking control over acquired net assets may result in discrepancies between the merger plan and accounting books. For the purposes of this study, legal possibility of selling assets included in contribution in kind by the contributing party has not been analyzed.

2.7 It should be noted, however, that in case of some transactions it is difficult to determine the date of assuming control. Since registration of business combination is constitutive in nature, assuming control does not occur later than on the day of registration. In such a case using a specific, easy to define date makes the regulations significantly simpler.

Measuring assets and liabilities at fair value

Method used to account for the combination and its impact on net financial result in periods following the combination

2.8 Measuring assets and liabilities at fair value is costly and in many cases time consuming. On the other side it allows to present true costs of the business combination in financial statement. If pooling of interests method is used, which does not require presenting acquired assets and liabilities at fair value, the real costs of business combination is not represented in profit and loss. As a result, financial statements for periods following business combination accounted for by pooling of interests present higher net result than the ones based on acquisition method.

Pooling of interests

2.9 Applying pooling of interests methods, in particular for combination of smaller entities, is reasonable from the perspective of the capital group and users of financial statements.

Costs of applying current regulations of Act on accounting

2.10 Pooling of interests results in incurring costs related to:

a) recording of assets and liabilities taken over by an acquirer.

2.11 The costs of applying acquisition method are as follows:

a) closing of accounting books of both acquirer and acquiree,

b) recording of assets and liabilities taken over by an acquirer,

c) preparing of consolidated financial statement as at combination date,

d) measuring resources and liabilities of the acquiree at fair value.

Complexity level of preparing the combined financial statement by acquisition method is much higher than in case of pooling of interests.

3. BUSINESS COMBINATION UNDER INTERNATIONAL ACCOUNTING STANDARDS

Introduction

3.1 Until 2004, business combinations were regulated by provisions of International Accounting Standard 22 "Business combinations". In 2004 International Financial Reporting Standard 3 "Business combination" replaced IAS 22. In 2008 IFRS 3 was amended. IFRS 3 is mandatory for all financial statements prepared for financial year starting after 30 June 2009[12].

3.2 The provisions of IFRS 3 are to a large extent consistent with US regulations on business combinations.

Objective and scope of the standard

3.3 IFRS 3 sets forth accounting regulations for business combinations between entities. The standard is intended to improve the relevance, reliability and comparability of information about business combinations presented in financial statements. Provisions of IFRS 3 should be applied to all business combinations except for:

a) joint ventures,

b) acquisition of individual assets or groups of assets that do not meet the definition of a business,

c) combinations of entities under common control[13].

3.4 It means, that IFRS 3 applies to business combinations entailing acquisition of interests in another company, while maintaining its separate legal personality, as well as acquisition of assets of the acquiree.

3.5 A business is defined in the standard as an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants.

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[12] http://www.iasplus.com/en/projects/completed/aip/annual-improvements-2008-2010

[13] Par. 2 of IFRS 3

3.6 Current version of IFRS 3 regulates business combinations of mutual entities. A mutual entity is an entity, other than an investor-owned entity, that provides dividends, lower costs or other economic benefits directly to its owners, members or participants.

3.7 IFRS 3 states, that all business combinations covered by the standard should be accounted for using the acquisition method[14].

3.8 Joint ventures are controlled jointly and identification of the acquirer is not possible.

3.9 IFRS 3 applies to business combinations. Business is defined as inputs and processes applied thereto, such as have the ability to create outputs. Thus, when assessing whether provisions of IFRS 3 apply to a specific transaction, it is essential to assess, whether the transaction involves taking control over economic resources and processes, which used in conjunction ensure creation of, or have the ability to create, outputs. Outputs provide a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants[15].

3.10 Acquisition of processes is not always necessary for the transaction to be a business combination. In some circumstances, acquisition of resources without processes meets the definition of the business combination. It occurs, when the acquirer already has those processes in its enterprise.

3.11 Usually business combination involves acquisition of liabilities. However, lack of liabilities does not preclude application of IFRS 3. The important thing is that the definition of a business is met.

3.12 Definition of a business in IFRS 3 and definition of an organized part of an enterprise are similar. However the business is a broader term[16]. It means that in some cases, the business may not meet the definition of an organized part of the enterprise. Polish tax rules prescribe a specific way of accounting for contributions in kind in form of organized part of the enterprise. This may be of particular importance for entities that apply IFRS 3 and at the same time calculate tax liability under Polish tax law.

Business in a development phase

3.13 IFRS 3 states, that form of the business may be influenced by the industry in which merging entities operate, structure of the business and phase of its development. Entities in

[14] Par. 4 of IFRS 3
[15] Par. B7 of IFRS 3
[16] An organized part of an enterprise is a set of tangible (machines and equipment, tools, produtcion materials in progress, works in progress, other) and intangible (software, know-how, patent and other) assets, that can be used to achieve certain economic targets. In literature it is emphasized that organized part of an enterprise should be able to operate separately from the enterprise itself.

development phase, such as do not generate outputs yet, may be recognized as businesses. However, in order to account for business combination pursuant to IFRS 3, proof must be provided that the acquiree:

a) has commenced its planned core tasks,

b) has employees, intellectual property as well as other inputs and processes that can be applied to such inputs,

c) implements the plan of generating outputs, and

d) will be able to gain access to customers, who would buy the products.

In case of entities in phase of development, it is not necessary for all elements listed in catalog of conditions to be present in order for the transaction to be deemed a business combination.

Goodwill

3.14 IFRS 3 defines the goodwill as assets representing future economic benefits arising from assets acquired in a business combination that cannot be individually identified and separately recognized in financial statement. It arises if the **sum** of:

a) fair value of the purchase consideration

b) fair value of a non-controlling interests and

c) fair value of interests which the acquirer held in the business before the acquisition

is greater than fair value of the net assets acquired (measured in accordance with IFRS 3)[17].

3.15 Identification of goodwill is important for evaluation of economic substance of the transaction and thus application of the proper standard. If within the framework of acquisition of a set of assets and processes goodwill is identified, transaction is deemed acquisition of a business, and business combinations rules apply. As a principle, such transactions should be accounted for using IFRS 3.

3.16 Goodwill may arise in individual financial statement of the acquirer or in consolidated financial statement depending on the legal form on the transaction. If after the combination both acquiree and acquirer operate as separate legal entities, a capital group is created.

3.17 In such circumstances, controlling entity as a principle is obligated to measure goodwill and to prepare a consolidated financial statement.

3.18 However, if under the combination transaction the acquirer takes over assets and liabilities of a business, goodwill is recognized in acquirer's unit financial statement (combined financial statement).

[17] par. 32 of IFRS 3.

3.19 If the acquirer acquires less than 100% of the interests in the acquiree, goodwill may be calculated in two ways which yield different results. Goodwill may be measured using:

a) fair value method or

b) proportionate share in identifiable net assets method.

3.20 Since those methods adopt different approach to valuation of non-controlling interests, it is important to define non-controlling interests.

3.21 Non-controlling interests are defined as equity in a subsidiary which is not attributable directly or indirectly, to a parent[18].

3.22 Proportionate share in identifiable net assets method may be applied only in case of initial recognition of non-controlling interests, which constitute a share in ownership and entitle their holders to a pro-rata share of net assets of a subsidiary in case of its liquidation[19].

3.23 If the non-controlling interests are measured at the fair value, it includes goodwill that belongs to non-controlling owners. Goodwill is the residual value; therefore, if NCI are measured at fair value, goodwill takes into consideration all the interests. If, however, non-controlling interests are measured at proportionate share of acquiree's identifiable net assets, goodwill has no relation to non-controlling interests.

Example 6

Company A acquires 80% of shares in company B for PLN 4,000,000. Fair value of non-controlling interests amounts to PLN 560,000. Fair value of assets and liabilities of company B as of acquisition date, measured in accordance with IFRS 3, amounts to PLN 2,000,000. How much is the goodwill and how to record this transaction in acquirer's books?

a) Goodwill is calculated as the proportionate share in the recognized amounts of the acquiree's identifiable net assets.

Non-controlling interests [PLN]	
fair value of net assets	2,000,000
non-controlling interests	20%
value of non-controlling interests	400,000
Goodwill [PLN]	
fair value of purchase consideration	4,000,000
non-controlling interests	400,000
net assets acquired, fair value	(2,000,000)
goodwill	2,400,000

[18] appendix A to IFRS 3.
[19] http://www.iasplus.com/en/meeting-notes/ifrs-ic/2010/ifric-march-2010/ifrs-3-measurement-of-nci

Entries in accounting books:

Dr Net assets	2,000,000
Dr Goodwill	2,400,000
Cr Current bank account	4,000,000
Cr Non-controlling interests	400,000

b) Goodwill is calculated based on non-controlling interests measured at fair value in the amount of PLN 560,000.

Goodwill [PLN]	
fair value of purchase consideration	4,000,000
fair value non-controlling interests	560,000
net assets acquired, fair value	(2,000,000)
goodwill	2,560,000

Entries in accounting books [PLN]:

Dr Net assets	2,000,000
Dr Goodwill	2,560,000
Cr Current bank account	4,000,000
Cr Non-controlling interests	560,000

3.24 According to IFRS 3 goodwill is not depreciated. At the end of each year the acquirer carries out an impairment test. If the goodwill is impaired, it is usually reflected in operating costs. Unlike other assets, impairment costs on goodwill cannot be reversed in the future even if the conditions for impairment cease to exist. Since the goodwill does not create cash flows by itself, for the purpose of impairment testing it is allocated to assets that generate cash flows[20].

3.25 IFRS 3 allows negative goodwill to be created on business combination. It arises when the **aggregate** of:

a) fair value of the purchase consideration

b) fair value of non-controlling interests and

c) interests held by the acquirer in the acquiree before the business combination

is lower than fair value of net assets acquired, measured in accordance with IFRS 3.

3.26 If negative goodwill arises, under IFRS 3 the acquirer is obligated to verify reassess whether it has correctly identified all of the assets acquired. If that is the case, negative

[20] par. 81 of International Accounting Standard 36 "Impairment of assets".

goodwill is included in profit and loss as an one off item[21].

Identification of business combination

3.27 Business combination is a transaction or other event in which an acquirer takes control over a business or businesses. The transactions known as mergers of equals or true mergers are also business combinations, to which IFRS 3 should be applied.

3.28 True mergers or mergers of equals are transactions, in which both combining entities are of similar size. International Standard Accounting Board decided that such transactions are also business combinations, to which acquisition method should be applied. As a result, acquirer should be identified also in cases of mergers of equals.

3.29 Structure of business combinations may vary. For example:

a) one or more businesses become subsidiaries of an acquirer or the net assets of one or more businesses are legally merged into the acquirer;

b) one combining entity transfers its net assets, or its owners transfer their equity interests, to another combining entity or its owners;

c) all of the combining entities transfer their net assets, or the owners of those entities transfer their equity interests, to a newly formed entity (sometimes referred to as a roll-up or put-together transaction); or

d) a group of former owners of one of the combining entities obtains control of the combined entity[22].

3.30 Acquisition of controlling interest in an entity is the simplest way of achieving business combination. However, assuming control over another entity is not always effected by way of acquisition.

3.31 An example of such situation is a business combination based on a contract between the acquirer and acquiree. The acquirer does not transfer purchase consideration in exchange for control of acquiree and acquirer does not possess equity interests in acquiree as of combination date or earlier. An example of such transaction is a stapling arrangement or forming a dual listed corporation[23].

3.32 Business combination may be achieved through exchange of assets. One party of the transaction takes control of the business and the other party takes control of an asset or group of assets that do not meet the definition of a business.

[21] par. 36 of IFRS 3.
[22] par. B6 of IFRS 3
[23] par. 43 of IFRS 3

3.33 Business combination may be achieved through series of subsequent transactions. For example, acquiree’s operations may have been divided into sections and each section is acquired by the acquirer at different times. In such a case, even if none of the individual transactions constitute purchase of a business, from the economic perspective a business combination has occurred.

Acquisition method

3.34 Each transaction defined in IFRS 3 as business combination should be accounted for using acquisition method. It requires identification of the acquirer and of the combination date.

3.35 An acquirer is the entity that obtains control of the acquiree. The acquiree may be a business or businesses. The acquirer controls of the business or businesses if it has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. It is to be assumed that the entity controls the business if it acquired more than fifty percent of its voting rights[24].

3.36 However in some circumstances the entity that has majority of the voting rights does not control the business. It may be the case when the entity signs away its voting rights for example in a joint venture transaction.

3.37 On the other side acquiring of less than fifty percent of the voting rights may result in obtaining of the control. It may be the case if:

a) shareholders agree on the common voting,

b) the shareholder that possesses less than 50% of the voting rights controls financial and operating policy of the company based on the agreement or company deed,

c) shareholder that possesses less than 50% of the voting rights may appoint or dismiss majority of the members of the entity’s management board.

3.38 The definition of the control is based on the possibilities to gain profits and the term profit should be understood broadly. The profits may flow to the investor in the form of:

a) future or current profits,

b) preventing the competitor from the takeover of the business,

c) preventing the key customers from leaving the company,

d) reducing of costs.

3.39 If it is not possible to identify the acquirer based on above stated analysis, the acquirer is deemed the entity that:

[24] Appendix A to IFRS 3

a) transfers purchase consideration in form of assets or assuming liabilities,

b) if the combination is achieved through exchange of equity interests the acquirer is the entity that issues interests (except for reverse acquisitions); all circumstances of such transaction should be analyzed, in particular whether:

- the acquirer is the combining entity which retains or receives the largest portion of the voting rights however all facts and circumstances concerning voting arrangements such as options, warrants or convertible securities should be analyzed,
- if it is not possible to identify an entity with significant voting interest, acquirer is usually the combining entity whose single owner or organized group of owners holds the largest minority voting interest in the combined entity.
- the acquirer is the combining entity whose owners have the ability to elect or appoint or to remove a majority of the governing body of the combined entity,
- the acquirer is the combining entity whose management dominates the management of the combined entity,
- the acquirer is the combining entity that pays a premium over the pre - combination fair value of the equity interests of the other combining entity or entities,

c) the acquirer is the combining entity whose relative size, measured as value of assets, revenues or profits, is significantly greater than that of other combining entity or entities[25],

d) if the business combination involves more than two entities, the acquirer may be the entity that initiated the combination, while taking into consideration relative size of all combining entities,

e) if a new entity is formed as a result of the combination, this new entity may be the acquirer. In such a case the new entity transfers assets or incurs liabilities. However if a new entity issues equity to effect a business combination then one of the combining entities that existed before the combination should be identified as acquirer.

Example 7

Shareholders of the company A and company B are going to merge. As a result of the combination a new company C is formed. 75% of equity interests issued by company C were taken up by company A and the remaining part 25% were taken up by company B. The percentage of the shares taken up by each company reflected the relative size of the companies. In the agreement the companies appointed company C as the acquirer. Which company is the acquirer according to IFRS 3?

[25] par. B15 of IFRS 3

According to commercial law, company C is the acquirer. However according to IFRS 3, the acquirer is the much bigger company A, which controls majority interest in company C (assuming there are no contractual covenants determining control).

Example 8

The combination of company A and B was effected by creation of a new company C. As a result of the merger, assets and liabilities of companies A and B were transferred to company C. According to commercial law, company C is the acquirer. However, according to IFRS 3 company A is the acquirer (company A has control of the entity in same way as described in Example 1). How should the combined financial statement be prepared?

As a result of the combination company A and B were deleted from the register. It means that the combination should be disclosed in financial statement of company C. Since according to Act on accounting company A is the acquirer, financial statements of companies A and C should be combined using rules applicable to reorganization. This means, that financial statement of company C would present financial data of company A after the merger. Subsequently, financial statement of company B should be added by applying the acquisition method described in IFRS 3.

Date of business combination

3.40 Business combination should be accounted for as of the acquisition date. Acquisition date is the date on which the acquirer takes control of the acquiree[26]. Usually this date is specified in the agreement as date on which the acquirer transfers purchase consideration and takes over assets and liabilities. In some circumstances, assuming control may occur before or after the legal acquisition date. It is not always easy to define acquisition date. In many cases, all facts and circumstances concerning the transaction need to be analyzed.

Example 9

Company A acquires 100% shares of company B. The parties agreed that one off consideration will be paid to previous owners of the company B via bank transfer on 20 April 2013. On that date the company obtains the right to appoint members of company B's management board. What is the acquisition date?

[26] appendix A to IFRS 3

Since on 20 April Company A may control the financial and operating policy of Company B, control is assumed on 20 April 2013. This date should be applied as acquisition date for accounting purposes.

Example 10

Company A acquires 100% of shares in company B. The parties agreed that one off consideration will be paid to previous owners of the company B via bank transfer on 20 April 2013. This date is defined by the agreement as acquisition date. However, as per the agreement, company A obtains the right to appoint the management board of company B on 1 May 2013. What is the combination date?

Combination date is 1 May 2013, as on this day Company A takes control of financial and operating policy of Company B (it is assumed, that that before May 1, despite the former management being in place, A has no possibility of controlling the company's policies). Consideration transfer date does not influence the acquisition date (unless it is specifically regulated in the agreement). Acquisition date defined in the agreement is not binding for accounting purposes. According to IFRS 3, the most important date is the date on which the acquirer obtains control and it may differ from the consideration transfer date.

Example 11

As a result of business combination, company A took over assets of company B. Purchase consideration was paid on 20 April 2013. All documents were signed and sent to registration court on the same day. The court has registered the combination on 15 May 2013. What is the acquisition date?

In this example, the acquirer is obligated to register the combination in court. Registration is just a formality and the court cannot refuse the registration if the documents are free from errors. Registration does not influence the decision of the shareholders. As a result, acquisition date is 20 April 2013 rather than the registration date.

Example 12

Company A acquires 100% of shares in company B. The purchase consideration is paid on escrow account. Upon approval by Competition and Consumer Protection Office the money will be transferred from escrow account to the previous owners of company B automatically. Approval was issued by Competition and Consumers Protection Office on

17 January 2013. The agreements state that the acquisition date is the day on which the purchase consideration was paid into the escrow account, i.e. 15 October 2012.

In this example, approval of a third party is required for the combination to take effect. Competition and Consumers Protection Office's approval is a necessary condition for the combination, so the acquisition date is the date of approval, 17 January 2014.

A similar analysis should be conducted if the combination depends on e.g. the result of ongoing court proceedings.

Date of acquisition for the business combinations without consideration

3.41 In some business combinations acquisition date is not connected with the purchase of shares but with different transaction or event. In such cases the acquisition date is the date of obtaining control through such transactions or events.

Example 13

Company A takes over company B. There are four shareholders of company B: company A, individual 1, individual 2, individual 3. Company A possesses 10% of shares in B. Other shareholders have 30% of voting rights each. Company A purchases shares from the individual shareholders in order to redeem them. As a result of redemption, company A obtains 65% of voting rights in company B.

Table below presents the structure of shareholders of company B before and after redemption of shares

	Before redemption of shares		After redemption of shares	
	Number of shares	% of ownership	Number of shares	% of ownership
Company A	1,000,000	10%	1,000,000	65%
Individual shareholder 1	3,000,000	30%	179,427	12%
Individual shareholder 2	3,000,000	30%	179,427	12%
Individual shareholder 3	3,000,000	30%	179,427	12%
Total	**10,000,000**	**100%**	**1,538,281**	**100%**

What is the combination date of companies A and B?

Combination date is the date of sale of rights stemming from owned shares. Shareholders lose the rights stemming from shares upon sale of those shares. Therefore, the day shares are sold is the day company A assumes control over company B. From that moment it holds the majority of rights stemming from shares.

Measurement and recording of identifiable assets acquired and liabilities assumed and non-controlling interests.

3.42 According to IFRS 3 the acquirer is obliged to measure goodwill, and separately from goodwill identifiable assets acquired, liabilities assumed and any non-controlling interests. There are some exceptions from this principle, namely:

a) contingent liabilities,

b) tax settlements,

c) employee remuneration,

d) indemnification assets.

3.43 Not all the acquired assets and liabilities can be separated from goodwill and recognized as independent items. In order to be separable, they need to meet the definitions of assets and liabilities described in the Conceptual Framework for International Accounting Standards. For example even if the company has ascertained the probability of future economic benefits from acquiree's employees or the contracts at the negotiation phase they cannot be recognized separately from goodwill. Within the framework of business combination, the acquirer takes over, and intends to realize value of, many resources. However, not all of them meet the definitions described in Conceptual Framework for IASs.

3.44 When the acquired resource should be recognized separately in the financial statement of the acquirer? It should be recognized separately as an asset if:

a) it can be separated or divided from the entity and sold or transferred, licensed, rented or exchanged, etc., regardless of whether the entity intends to do so or,

b) it arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations[27].

3.45 There are also other important conditions that need to be met for the separable recognition of the acquired assets and assumed liabilities. Only the assets and liabilities that were acquired or assumed in the business combination may be recognized separately. They should exist at combination date. Those arisen after the acquisition date, for example future

[27] par. 12 of IFRS 3.

liabilities connected with reorganization of the acquiree are not recognized at the date of business combination. Similarly profits arising from the business combination that will be gained in the future are no recognized separately[28].

3.46 Sometimes the acquirer may enter into arrangements with acquiree that are separate from business combination. Such payments for assets and liabilities in such transactions as do not constitute the purchase consideration are not accounted for as part of the business combination and should be accounted for separately, in accordance with relevant standard[29].

Example 14

Company A acquires company B. Company A has paid for legal and financial due diligence. How should company A account for such payments?

Advisory costs directly connected with business combination do not constitute purchase consideration and should be accounted for separately as other comprehensive income, as of the date they were incurred.

3.47 All identifiable assets and liabilities should recognized separately. It means that there may be such assets or liabilities which require separate recognition in the books of the acquirer, even though the acquiree may have not recognized them despite the fact that as of the day of acquisition they met the definition of assets/liabilities. Such a situation may occur due to mistakes or if the item did not meet the definition of assets and liabilities. For example the acquiree assumed the inflows of economic benefits resulting from the assets were not probable. The reverse may also occur. Some assets and liabilities that were recognized by the acquiree would not be recognized by the acquirer. For example goodwill resulting from previous acquisitions of the acquiree is not recognized in the books of the acquirer. The acquirer recognizes only one goodwill that results from the business combination.

Measurement and fair value

3.48 Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction[30].

3.49 The acquirer should measure all identifiable assets acquired and liabilities assumed at on the date of acquisition, with exception of:

a) employee remunerations,

[28] par. 11 of IFRS 3.
[29] par. 53 of IFRS 3
[30] Appendix A to IFRS 3

b) income tax,

c) indemnification assets,

d) reacquired rights,

e) share-based payments awards,

f) assets held for sale.

3.50 Fair value should be measured by the acquirer based on the amount a market participant would pay in order to obtain the asset[31]. If the asset is depreciated for tax accounting, tax cost benefit should be included in fair value. This rule should be applied for both tangible and intangible assets.

3.51 Tax allowable costs should also increase fair value of the asset if the fair value is measured using valuation techniques for example discounted cash flow methods.

3.52 If the fair value is measured by comparison to the same or similar asset for which an active market exists tax benefits are already included in the value. There is no need to make additional adjustment.

3.53 If the tax benefit should increase the value of the asset then the tax rules of the country in which the asset is used should be applied; it is possible to include tax depreciation in tax calculation as a cost.

3.54 Fair value is measured based on the assumption that are made by market participants. It means that it is not influenced by the way the company is using the asset. If the company uses the asset in a way which does not realize its fair value, or does not intend to use it at all, it does not influence the fair value of the asset[32]. However, the way in which the acquirer is using the asset will have an impact on economic life of the asset and level of permanent impairment write-offs after acquisition date.

Example 15

Companies A and B are manufacturing metal products. Company A acquires company B. Acquired assets include a production line, with fair value of PLN 5,000,000. Company A owns a similar production line. Company B's production will be gradually moved to company A's production line. After two years, Company B’s production line will be closed. How should Company A measure the acquired production line?

Company A should measure the production line at fair value. Closing of the production line may be a premise for an impairment write-off.

[31] par. B43 of IFRS 3
[32] par. B43 of IFRS 3

3.55 Measurement at fair value means, that the acquirer does not recognize impairment separately from the asset.

Example 16

Company A acquires company B. In B's books there are receivables amounting to PLN 100,000, and impairment write-off for PLN 40,000. Carrying value of the receivable after impairment is equal to its fair value. How should the acquirer account for the receivables?

Company A should recognize the receivable at fair value, i.e. PLN 60,000. Separate recognition of gross book value of PLN 100,000 and impairment write-off would be incorrect.

Intangible assets and liabilities arising on acquired contracts

3.56 Acquisition of certain contracts within the framework of business combinations may result in creation of intangible assets or liabilities, depending on whether the terms of such contracts are favorable or unfavorable compared to the market[33]. Such a situation may arise when the acquiree is the lessee under operating lease. The contract should be compared to the market conditions in order to assess whether an asset or a liability arises. If the contract is favorable compared to market, an intangible asset arises. In the reverse situation, if conditions are unfavorable compared to market, a liability arises.

Example 17

Company A, within the framework of business combination, took over an operating lease contract for office space. Contract has been concluded for a period of 5 years and business combination took place in the 3rd year of the lease agreement. The acquirer may extend the contract period for next 5 years. Annual rent amounts to EUR 1,200,000 (indexed by CPI each year) and if the contract is extended, annual cost shall be EUR 1,500,000. At combination date, similar office space may be rented for EUR 2,500,000. It is forecasted that in short term (the next 5 years) office costs will remain at the current level and in future the costs should increase.

The acquired contract is favorable. Both in basic and extended period company A may lease the space below the market price. This means, that in the books of combined companies an asset from lease contract should be recognized. Value of this asset shall

[33] par. B42 IFRS 3

equal the difference between market value of rent on the lease and rent payments resulting from the acquired lease contract.

Example 18

Company A acquired company B together with a lease agreement which is unfavorable compared to the market. How should company A account for the unfavorable contract?

It should be analyzed why company A accepted business combination in spite of unfavorable contract. Probably the purchase consideration was on a level that made the transaction profitable. Company A should recognize the liability from unfavorable contract in the combined financial statement. The liability should be amortized to profit and loss statement over the period of the lease agreement.

Assets on operating lease if the acquiree is a lessee

3.57 The fair value of the acquiree's assets leased under financial lease should include the effect of the contract being favorable or unfavorable compared to the market. No separate asset or liability is recognized. In the period following the business combination the non-market element of the agreement is accounted for as a separate component of the asset and depreciated over the period in which the agreement will be renegotiate to market conditions.

Contracts between acquirer and acquiree entered into before business combination

3.58 The parties may trade with each other before the business combination is affected. If the liabilities resulting from the agreement are higher than forecasted benefits the contract is onerous. However the unprofitable activity of the acquiree is not always an onerous contract. The contract should be recognized as liability measured at fair value if the contract is classified as onerous at combination date. If so the acquirer should be aware of all key assumptions such as: market price, necessary costs of meeting obligations under the contract[34].

[34] par. B52 of IFRS 3.

Example 19

Company A, a sales entity, acquired 100% of shares in company B, a manufacturing entity. Before the acquisition company B was one of many suppliers of company A. Under a contract signed before the combination, company B is obligated to deliver products at a specified price. However at the time of signing the contract, company B made an error in calculating the sales price and products are delivered to Company A at a loss. Unit cost of goods sold is higher than the selling price. Therefore, Company B incurs a loss when selling the products.

Business combination does not change the terms of the contract. Contract for components delivery should be recognized as an onerous contract acquired by company A within the framework of business combination. Since as of acquisition date the above-market contract is terminated, Company A should record the cost of onerous contract.

Intangible assets acquired in the business combination

3.59 An intangible asset is an identifiable non-monetary asset without physical substance[35].

3.60 An asset should be separately recognized if it is capable of being separated or divided from the acquiree and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract even if the acquirer does not intend to do so[36]. The asset does not have to be capable of being sold separately.

Example 20

Company A acquires company B. Assets acquired, as per accounting records, include contracts with customers. Should company A recognize customer contracts as an asset separate from goodwill?

Acquired customer list should be measured at fair value and separately recognized in the financial statement of the combined entities. In order for an asset to be recognized separately, it must be tradable. Customer lists are often licensed. Therefore, unless the combination agreement prohibits trading (sales, leasing) of such customer list, it should be recognized separately.

[35] Appendix A to IFRS 3.
[36] par. B33 of IFRS 3.

3.61 IFRS 3 does not describe in detail how the fair value of intangibles should be measured. Same rules apply as in case of measurement of fair value of tangible assets. It is important to measure fair value from the perspective of market participant and not the company.

Example 21

Company A acquired company B. As part of the business combination company A acquired license agreement for trade mark. The contract for the trade mark allows company B to extend the period of the agreement. The acquirer is not going to use the option.

The option to extend should be included in fair value of the license although the acquirer does not intend to use it. For a market participant the option to extend could be important.

Reacquired rights

3.62 Before the acquisition date, the parties may trade with each other. It may happen that the acquirer acquires right that it had previously granted to the acquiree[37]. For example before the acquisition date, the acquirer had granted the acquiree the license to use the software. At the date of business combination the acquirer reacquires these rights.

3.63 Reacquired rights are intangibles which should be recognized separately from the goodwill. The fair value of the rights should be measured separately so that the profit or loss on the acquisition can be calculated. In order to measure and recognize reacquired rights properly, the acquirer should analyze:

a) the structure of the transaction and its recognition before the acquisition,

b) if the transaction was an one-off sell agreement, whether any deferred revenues arose, how the payment was transferred (in advance, in arrears, monthly), was the transaction effected at arm's length conditions, was the transaction in favor of one of the parties,

c) was it a capital or operating transaction.

3.64 Reacquired rights are not measured at fair value.

3.65 The value of the reacquired rights is measured based on the remaining period of the agreement with the assumption it will not be extended.

3.66 Contracts giving rise to royalties or other fees, after the combination should be compared to market. If terms of the contract are favorable or unfavorable compared to current market prices, profit or loss on reacquired rights is recorded. The value of the profit

[37] par. B35 IFRS 3

or loss should not influence the fair value of the intangible assets stemming from reacquired rights.

Example 22

Company A acquires 100% of shares in company B. Purchase consideration is PLN 100,000,000. Before the acquisition, company A had granted to company B exclusive license for software use, for a period of 8 years. Two years have passed between granting the license and business combination. Payment is made in arrears, after each 12-month period of license use. Termination of the contract by either party involves a penalty fee in the amount equal to license payments for the entire 8-year period, i.e. PLN 800,000. Today, Company A could grant a similar 6 years license for PLN 900,000. How should company A account for the reacquired license?

The license should be accounted for at market value for remaining period, i.e. PLN 900,000. Profit or loss from recognition of the contract is the lower of

a) unfavorable value resulting from the difference between price for the granted license and its market value PLN 300,000 (PLN 900,000 - (PLN 800,000/8) x 6 years)

b) the amount of penalty fee for termination of the contract PLN 800,000

Loss on reacquired contract amounts to PLN 300,000. Due to reacquired rights, the amount paid for business combination is not the purchase consideration. The purchase consideration amounts to PLN 99,700,000. The remaining PLN 300,000 is the loss on the reacquired rights. As of combination date, terms of the contract are unfavorable for the acquirer, therefore a resulting loss needs to be recognized.

3.67 Purchase of reacquired rights may be connected with the purchase of other intangible assets. Such assets need to be recognized separately from reacquired rights and from goodwill.

3.68 Value of reacquired rights should be measured based on the future discounted cash flows (assuming the contract is not renewed). Measurement is not based on fair value, because acquiring rights from a third party is not the same as reacquiring one’s own rights. Fair value measurement involves extension of rights. In case of reacquired rights, it would mean extension of an agreement with oneself. Therefore, in measuring the value of reacquired rights, it should be assumed that the period of economic life of the rights is the period remaining until expiration of the agreement granting such rights.

Fixed assets

3.69 The fixed assets acquired in business combination should be measured at fair value.

3.70 The amount of depreciation included in financial statement of the acquiree is not transferred to the acquirer.

3.71 Fair value of properties is measured based on the market prices.

3.72 Plant and equipment are measured based on market prices. If the market prices are not available they should be measured by replacement cost or revenue method[38].

3.73 If the acquiree has received a government grant to purchase an asset, assets financed by the grant should be measured at fair value, which is not related to the amount of the grant. Terms and conditions of the grant should be analyzed separately in order to determine, whether a separate liability should be recognized.

Example 23

Company B has received a government grant for purchase of a fixed asset. Terms and conditions of the grant require the company to operate for at least 4 years from the purchase of the asset. Business combination between company A and B took place 2 years after the purchase of the asset. Company A was the acquirer. As a result of the business combination, company B ceased to exist and was deleted from the register of companies.

In the combined financial statement company A should recognize the liability resulting from returning the grant.

3.74 The acquirer may purchase assets with long economic use period, which, if used in operations, result in obligation to recultivate. If such an obligation exists, the company should recognize the resulting liability.

Income tax

3.75 Income tax is recognized in accordance with International Accounting Standard 12 Income tax (IAS 12). Income tax assets and liabilities that would be recognized in accordance with IFRS 3 should be recognized in accordance with IAS 12. Different rules might apply only in case of valuation of items. One of such differences may pertain to discounting - income tax assets and liabilities are not subject to discounting.

[38] International Accounting Standard 16 "Property, plant and equipment"

3.76 The acquirer recognizes in its accounting books tax effect resulting from temporary differences that existed at combination date or arise as a result of business combination.

3.77 Deferred tax is calculated for all temporary differences i.e. differences between balance sheet value and tax value of the assets and liabilities. The measurement of the deferred tax is performed from the perspective of the company that may utilize the assets or liability, usually the acquirer[39].

3.78 It is possible that the acquiree does not recognize deferred tax asset stemming from tax loss, due to the fact it would not be able to utilize the loss in the future. However, as a result of business combination, the acquirer might be entitled to utilize the loss and thus might be entitled to recognize the asset on acquired tax loss.

Example 24

Company A acquires 100% of shares in company B. Company B has an unrecognized tax loss. As of the day preceding the combination date, Company B did not recognize a deferred tax asset stemming from tax loss, since it was not capable of achieving revenues sufficient to utilize this loss. Company A, as a result of undertaken reorganization, intends to utilize the tax loss of its subsidiary. How should deferred tax assets on tax loss be recognized in the combined financial statement?

As of the business combination date, it is possible to utilize the tax loss. Therefore, Company A should recognize deferred tax asset from tax loss in the combined financial statement.

3.79 The acquirer may believe, that as a result of business combination it would might be able to realize its own favorable temporary differences or tax loss. Or reversely, as a result of business combination it might become impossible. In such case, the adjustment to deferred tax does not influence the goodwill and should be accounted for in profit and loss.

3.80 IAS 12 does not allow recognition of temporary differences arising on goodwill. If acquired goodwill cannot be recognized as cost of obtaining revenue (write-offs, cost at sale), tax value is nil. In such a situation, temporary differences arise, such as do not constitute a basis for calculation of deferred tax[40].

[39] International Accounting Standard 12 "Income tax" (IAS 12).
[40] par. 15a of IAS 12.

Assets held for sale

3.81 Assets held for sale are measured at fair value less the selling costs. It is an exception from the fair value measurement. Assets might be classified as held for sale if they are sold within 3 months from business combination (IFRS 5 par. 11). A business acquired for the purpose of resale should be recognized as discontinued activity (IFRS 5, par. 32c)[41].

Employee benefits

3.82 Employee benefits are another exemption from fair value measurement. Assets and liabilities arising on employee benefits are measured in accordance with International Accounting Standard 19 "Employee benefits". In some circumstances, IAS 19 does not require measurement of employee benefits at fair value[42].

Financial Instruments

3.83 Financial instruments that are part of identifiable net assets of the acquiree are measured at fair value as of combination date.

3.84 If the acquiree measured its financial instruments at fair value before the acquisition then the acquirer continues the valuation in the combined financial statement. However if the instruments are measured at amortized cost, the acquirer may be required to measure them at fair value.

3.85 Usually the fair value of receivables and short term liabilities is not significantly different from the carrying value. Fair value measurement only applies to cases, in which acquirer assumes that expected inflows or outflows would not equal the carrying value.

Example 25

Company A acquired company B. During the measurement period, a key customer of the acquiree has commenced liquidation process. Company B has had not recorded an impairment write-off before the acquisition. Should company A record impairment write-off in combined books?

The acquirer should not record an impairment write-off in combined books. The receivables should be measured at fair value. Such measurement is usually based on

[41] par. 11, par. 32c International Financial Reporting Standard 5 "Non-current assets held for sale and discontinued operations".
[42] par. 26 of IFRS 3.

discounted cash flows. Fair value measurement will also reflect the client's ongoing liquidation process.

Contingent liabilities

3.86 International Accounting Standard 37 Provisions, Contingent Liabilities and Contingent Assets describes two types of contingent liabilities. The first one is the possible obligation arising on past events whose existence will be confirmed by future event or events that are not within the control of the entity. The second one is the present obligation, which is not recognized because it is not probable that the outflow of resources will be required to settle the obligation or the outflow cannot be measured reliably. The contingent liability is recorded in business combination if it meets the definition of the liability and can be measured reliably[43].

3.87 The first group of liabilities is not recognized in combined financial statement.

3.88 The second type of liabilities is recognized regardless of whether the outflow is probable or not but only if it can be measured reliably. However, departure from recording the liability due to impossibility of valuation can only be applied in exceptional cases. Since the acquirer decides to pay the purchase consideration, it should be assumed that it is capable of measuring all material liabilities of the acquiree. Otherwise the transaction risk would be very high.

Example 26

Company A acquires company B. Both companies provide health services. Company B has been sued for malpractice resulting in patient's death. Company B has not created a provision in its books. Lawyers of company B believe, that probability of winning the case is high. Due to company's reputation and risk of losing the case, management of Company A decided to settle out of court. How should the acquirer account for the contingent liability?

As of acquisition date, in the combined statement Company A should recognize a liability in the amount of expected settlement.

[43] par. 23 of IFRS 3.

Contingent assets

3.89 IFRS 3 does not provide detailed guidance on accounting for contingent assets. Contingent asset arises when the company is not sure whether the asset exists on the acquisition date or not, since its existence will be confirmed or disproved by a future event that is not within the control of the company. Since contingent assets do not meet the definition of the asset included in the conceptual framework for IASs/IFRSs they are not recognized in business combinations, even if their existence is virtually certain.

Indemnification assets

3.90 The seller in a business combination may contractually indemnify the acquirer for the outcome of a contingency or uncertainties related to all or part of a specific asset or liability. Usually the sellers guarantee the payback of the outflows due to liabilities that the acquirer was not aware of and that arose as a result of the sellers' activities. Then, the acquirer recognizes respective indemnification assets[44].

3.91 Indemnification assets are recognized by the acquirer at the same time and pursuant to the same principles as the indemnified item. They are measured by the same method as the indemnified item. If the indemnified asset is measured at fair value then the indemnification asset should also be measured at fair value. Economic nature of such an asset is very similar to that of a receivable. It means that that the asset should be tested for recovery, same as commercial receivables. As a result, it may be necessary to create an impairment provision in the acquirer’s books.

Example 27

Company A is going to acquire company B. Company B is in court dispute with tax office. In similar cases the court of first instance judged in favor of the tax office. Jurisprudence of second instance courts varies. As a result the court of first instance has referred the case to be recognized by an extended panel of judges. The “ruling of seven judges” is to be issued within 6 months from the business combination. In case of the unfavorable judgment, liability of Company B shall amount to PLN 1,200,000 (including interest). The parties intend to include a clause in the agreement, stating, that shareholders of company B are obligated to cover any additional tax liabilities. How should such an event be accounted for in the combined books?

In the combined financial statement, company A should recognize a liability resulting from the court case, in the amount of PLN 1,200,000. At the same time, it should recognize an

[44] par. 27 IFRS 3.

asset from shareholders of company B covering this liability (we assume, that receiving this amount is virtually certain). If probability of realization of this asset decreases, an impairment write-off should be made, in relevant amount. Indemnification assets reduce acquisition price, and, as a result, goodwill.

Reorganization liabilities

3.92 Liabilities stemming from reorganization or liquidation of the acquiree should be recognized at combination date if the acquirer is obligated to incur costs connected with these activities, as per IAS 37.

Deferred revenues

3.93 The acquirer recognizes liabilities resulting from deferred revenues. The value of such liability equals to the liability acquired within the framework of business combination. The liability resulting from deferred revenue should be measured at fair value and may differ from carrying value recognized in financial statements of the acquiree.

Classification of identifiable assets and liabilities

3.94 At the acquisition date, the acquirer shall classify or designate the identifiable assets acquired and liabilities assumed as necessary to apply other IFRSs subsequently. The acquirer shall make those classifications or designations on the basis of the contractual terms, economic conditions, its operating or accounting policies and other pertinent conditions as they exist at the acquisition date[45].

3.95 There are two exceptions from this rule. They pertain to recognition of lease and insurance contracts. Those are classified based on terms and conditions of respective agreements and other circumstances existing at date of signing the agreements. They are not re-measured at combination date unless terms and conditions of the agreement are changed.

[45] par. 15 IFRS 3.

Bargain purchase

3.96 In a bargain purchase the fair value of the net assets acquired exceeds the total of a purchase consideration, the value of the non-controlling interests and the value of shares the acquirer possessed in the acquiree before the acquisition[46].

3.97 Bargain purchase may happen if the seller is forced to sell the business or if he is not aware of the true value of the business.

3.98 Bargain purchase results in a profit which should be accounted for by the acquirer in profit and loss statement. However before the profit is recognized the acquirer should re-measure the acquired assets and liabilities in accordance with IFRS 3. This is predominantly to verify:

a) completeness of the identifiable assets and liabilities ,

b) measurement of separately identifiable assets, liabilities, non-controlling interests, value of acquiree's shares owned by acquirer before the combination, purchase consideration.

3.99 The entire profit resulting from business combination belongs to the acquirer and should not be allocated to non-controlling interests. Usually it should be an element of operating profit. Such presentation should be applied when the costs of the business combination incurred by the acquirer are recognized as operating costs.

Example 28

Company A acquired 95% of shares in company B for PLN 2,000,000, payable by wire transfer at the date of signing the agreement. Fair value of non-controlling interests is PLN 240,000. The value of acquired net assets measured in accordance with IFRS 3 is PLN 2,300,000. How should goodwill be calculated and recognized by the acquirer?

a) accounting entries and the value of the goodwill if non-controlling interests are measured at the fair value.

Fair value of the purchase consideration	PLN	2,000,000
Fair value of non-controlling interests	PLN	240,000
Total	PLN	2,240,000
Fair value of net assets	PLN	(2,300,000)
Negative goodwill (profit from combination)	PLN	60,000

Accounting entries should be as follows:

Dr Net assets	PLN	2,300,000

[46] par. 32 IFRS 3.

Cr Cash	PLN	2,000,000
Cr Non-controlling interests	PLN	240,000
Cr Profit from combination	PLN	60,000

b) accounting entries and the value of the goodwill if non-controlling interests are measured by proportional share.

Fair value of the purchase consideration	PLN	2,000,000
Value of non-controlling interests (2,300,000 x 0.05)	PLN	115,000
Total	PLN	2,115,000
Fair value of net assets	PLN	2,300,000
Negative goodwill (profit from combination)	PLN	185,000

Accounting entries should be as follows:

Dr Net assets	PLN	2,300,000
Cr Cash	PLN	2,000,000
Cr Profit from combination	PLN	185,000
Cr Non-controlling interests	PLN	115,000

Purchase consideration

3.100 Purchase consideration is the total of assets transferred measured at fair value as of combination date, liabilities towards previous owners of the acquiree, assumed by the acquirer and equity instruments issued by the acquirer to previous owners of the acquiree (except for awards paid in form of shares). Purchase consideration may take various forms; it can be cash, shares in a subsidiary or other[47].

3.101 Sometimes acquiree (or its previous owners) and the acquirer only exchange equity interest. In such case, a problem may arise as to how such equity interests should be measured. For example, such a situation may occur if the acquirer is not a publicly traded company. Then the fair value of the acquiree might be more reliable. In such case, the acquirer calculates goodwill based on fair value of acquiree shares as of acquisition date rather than on fair value of transferred equity interests as of the same date.

3.102 Sometimes unconditional purchase consideration is payable not on the date of acquisition but at a future date. Such deferred acquisition price may be expressed in cash,

[47] par. B20 IFRS 3.

equity interests or in other forms. An important characteristic of deferred purchase consideration is that its amount is known. IFRS 3 requires for full purchase consideration to be included in the business combination accounting.

3.103 Purchase consideration should be measured at fair value. It means that if the consideration is paid in cash the fair value is calculated based on discounting techniques. The bonuses and discounts that might be achieved in the future should be included in the calculation.

Example 29

Company A acquires 100% of shares in company B for PLN 100,000,000. PLN 10,000,000 was paid via bank transfer on the date of signing the agreement. The remaining part is to be paid in 4 years as a lump sum.

Economic nature of the purchase consideration is such, that Company A has received from previous owners of Company B a loan in the amount of PLN 90,000,000. This liability should be recognized in books of Company B at fair value, i.e. at present value of future cash flows. Net present value amounts to PLN 74,043,222.73 [PLN 90,000,000 x 1/(1+5%)^4] , with assumed discount rate of 5%. As a result, purchase consideration to be paid by Company A amounts to PLN 84,043,222.73, although a different amount is stated in the agreement. 5% discount rate reflects the interest rate for a four year investment loan which acquirer could get. The difference between purchase consideration and amount actually paid should be recognized in profit and loss statement as a financial cost over the repayment period.

3.104 If deferred consideration is payable in form of equity interests, recognition should be based on International Accounting Standard 32 "Financial instruments: presentation" (IAS 32). If the deferred consideration meets the definition of equity instrument it should be recognized directly in the equity. Interests will be classified as equity instruments if the number of equity interests is constant and the acquirer bears the risk of changes in the value of the interests. It should be disclosed as separate line in equity as interests to be issued in acquirer's equity.

3.105 It is often the case that the consideration is constant and the number of equity interests at the settlement date depends on market price of the shares at that date. Then the equity interests to be issued should be classified as financial liabilities and not as equity.

3.106 It may be the case that before the acquisition employees of the acquiree are entitled to share payments awards. The acquirer may swap the awards payable in acquiree shares for the awards payable in acquirer's shares. Share payment awards in acquirer shares should be measured in accordance with International Financial Reporting Standard 2 "Share payments" instead of fair value. Non-vested replacement awards attributable to pre-combination service are be included in purchase consideration. However non-vested replacement awards attributable to post-combination service should not be included in purchase consideration.

3.107 Purchase consideration may be made in a form of non-monetary assets or liabilities, or a joint venture. Difference between fair value and carrying value of such assets or liabilities is usually recognized as profit or loss in the acquirer's financial statements as of combination date, if the assets and liabilities constitute purchase consideration. If as a result of the transaction the acquirer does not lose control of those assets and liabilities, they are not measured at fair value and no profit on revaluation arises.

3.108 Contingent consideration is the obligation of the acquirer to transfer additional assets or equity interests to previous owners of the acquiree as purchase consideration if the future event or events occur[48]. Contingent consideration is often applied if the acquiree and acquirer cannot agree on the true value of the business.

3.109 In analyzing a business combination agreement including a contingent consideration, payments related to purchase consideration should be separated from indemnification payments.

3.110 Contingent consideration should be measured at fair value. The fair value is calculated based on probability of certain events occurring. As a result contingent consideration is included in business combination only if it is assumed the event would occur. If the acquirer has the right for reimbursement of previously paid amounts, such right should be recognized as an asset in its financial statement.

3.111 Payment of the contingent consideration is measured at the fair value. It means that the adopted way of settlement does not influence goodwill. Accounting for contingent consideration after the business combination may vary and depends on how the consideration was classified at the acquisition date.

3.112 Measurement of the contingent consideration may prove to be a difficult task. However this cannot serve as justification to depart from measuring it at fair value.

Example 30

Company A is big pharmaceutical entity. It acquires a smaller company B that operates in the biotechnology segment in order to gain the access to its research and development projects. Company A agrees to pay a consideration of PLN 20,000,000 to owners of Company B in cash. Additional PLN 5,000,000 will be paid if the office for drug certification

[48] par. 39 of IFRS 3.

approves one of the projects within a period of 10 years. How should company A account for the contingent consideration?

The company should disclose contingent payment as a financial liability measured at fair value as of combination date. Fair value should take into consideration probability of certification being issued.

Example 31

Company A acquires company B. As part of the purchase consideration, company A agrees to issue ordinary shares for owners of Company B, to the value of PLN 3,500,000, on condition that company B achieves a profit of at least PLN 2,000,000 in financial year following the acquisition. How should company A account for contingent consideration?

Company A has committed to issue an equity instrument. Value of the shares is constant and amounts to PLN 3,500,000. Contingent consideration should be recognized as equity measured at the fair value at combination date. Fair value should take into consideration share price as of combination date and probability of payment becoming due. Additionally fair value should be adjusted for all factors that influence the price of the shares, such as are not connected with contingency consideration, such as e.g. payment of dividends in contingency period.

Example 32

Company A and B provide health services. Company A acquires 100% of shares in company B. Company B was sued by a group of patients for malpractice. Value of the claim amounts to PLN 500,000. Purchase consideration consists of two elements: PLN 1,500,000 unconditional payment and PLN 2,000,000 paid if conditions specified in the agreement are met. At combination date, PLN 1,500,000 was transferred to the previous owners of B and remaining PLN 2,000,000 part was paid to escrow account. If the conditions are met, the amount will be transferred to previous owners of B automatically. Company A predicts the conditions will be met. At the same time the sellers have paid the value of the potential claim, PLN 500,000, into escrow to indemnify the acquirer. In case of a unfavorable judgment of the court the amount will be transferred to acquirer's bank account. How the PLN 500,000 related to lost court case should be accounted for?

The PLN 500,000 is not related to refund of the purchase consideration; it is an indemnification asset realized as a result of the court case. Therefore, Company A should recognize a liability from the court case and a matching indemnification asset.

3.113 Accounting for contingent consideration on the balance sheet date depends on how the consideration had been recognized at combination date. The contingent consideration that was classified as part of equity is not subject to revaluation. The consideration classified as asset or liability should be accounted for in accordance with IAS 19 and IAS 37.

3.114 Monetary contingent consideration that the acquirer is supposed to transfer or has the right to refund should be accounted for in accordance with IAS 39. Contingent consideration payable in cash or other financial assets is a financial liability that should be measured on each balance sheet date at fair value. IFRS 3 governs that financial assets and liabilities should be measured at fair value. Any changes in fair value should be recognized in profit and loss statement[49].

3.115 Neither IFRS 3 nor IAS 39 provides any guidance on how to present the gain or loss on revaluation of contingent consideration in the profit and loss statement.

3.116 Fair value may change due to many reasons. For example, such change may stem from unwinding the discount in order to reflect time value of money. Since the standards do not govern how to classify such changes, different rules can be applied.

3.117 Fair value adjustments should be recorded in line with the effects that caused the adjustments. If the adjustment results from change in future profits on which its payment depends, the effect should be included in operating activity. In such a situation, in the combined statement, additional benefits stemming from better operating income of acquired business will be offset by the cost of higher payment. However, if fair value adjustment is connected with unwinding of discount then it should be recognized as part of financial activity.

3.118 The right to refund of contingent consideration in form of cash or other financial assets is an asset and should be accounted for in accordance with IAS 39 as an asset available for sale. Fair value adjustment of financial assets available for sale should be recognized directly in equity unless the change results from impairment test. In such case, the adjustment is recognized directly in profit and loss statement.

Contingent consideration connected with obligation to provide labor

3.119 In same cases the payment of the purchase consideration is conditional upon employee services provided after the acquisition. Such payments should be accounted for as cost of labor after the acquisition. If as a result of termination of the employment contract the

[49] par. 58 of IFRS 3.

contingent consideration is not due, contingent consideration constitutes remuneration for post-combination service.

Example 33

Company A acquires company B. The owners of company B are also members of the management board. The owners are supposed to receive additional consideration if the EBITDA achieves agreed level. If shareholders of Company B are not employees of Company A, contingent consideration will not be due.

Additional payment is connected with rendering services after the acquisition. It should be seen as a reward for achieving targets assumed for the given period. Additional payment should be accounted for as a cost of the period in which the targets are achieved. It is not a contingent consideration.

Measurement of non-controlling interests

3.120 Fair value of the non-controlling interests should be measured at combination date. Its value should be based on prices that come from an active market. If they are not available, fair value should be assessed by other valuation techniques. The standard indicates that the value of a single non-controlling interest may differ from the value of single controlling interest. The difference is the premium for the control or discount for lack of control. The premium results from the ability to influence financial and operating policy of the acquiree and benefits stemming from ability to decide about distribution of profits and appoint management board members.

Business combination without transfer of the consideration

3.121 The acquirer may obtain the control on the business without payment of the consideration. Such a transaction meets the definition of a business combination, because it results in acquirer taking control of the business[50].

3.122 Acquisition method should be applied for such combinations. If the business combination is carried out only on the basis of contract, equity interests in the acquiree held by parties other than the acquirer are recognized in acquirer's statements prepared after the combination as non-controlling interests. In some cases, all of the equity belongs to other

[50] par. 43 of IFRS 3.

parties; in such cases, all those interests are assigned to non-controlling shareholders equity in financial statements of the acquirer.

Determining the elements of a business combination

3.123 Accounting for business combinations includes only purchase consideration, assets acquired and liabilities assumed and non-controlling interests, which the parties exchange in connection with taking control of a business. Transactions between the parties, which are not associated with transfer of control over the business are accounted for separately, in accordance with applicable IFRS. Examples of such separate transactions include:

a) transaction that in effect settles a pre-existing relationship between the acquirer and acquiree,

b) transaction related to remuneration due to employees or former owners of the acquiree for their future services,

c) transaction of reimbursement of business combination costs paid by acquiree or its former owners.

3.124 In determining what constitutes a business combination following items need to be analyzed:

a) the reasons for the transaction;, if the transaction is carried out mainly in favor of the acquirer or the combined entity rather than for the benefit of the acquiree or its previous owners it is unlikely to be an element of a business combination,

b) the originator of the transaction.

Settlement of prior relationship between the parties

3.125 The acquirer and the acquiree may have entered into transactions with each other before the acquisition. The business combination constitutes an ultimate settlement of all such transactions. If the purchase consideration includes amounts that settle such transactions, they should not be accounted for as part of the business combination[51]. Parties to the transaction may enter into contracts for delivery of goods or services.

3.126 Not all prior relationships between the parties are contractual. They may have a different nature, such as when one party is suing the other. In such a case the settlement of such transactions in the business combination results in a gain or loss in acquirer's financial statement, measured at fair value.

[51] par. 51 of IFRS 3

The measurement period

3.127 Accounting for business combination may be complex and lengthy. It may happen that it will not be completed by the end of the reporting period in which the acquisition took place. In such a situation, the acquirer shall present in its financial statements estimated values of those assets and liabilities for which measurement has not been completed. The estimated amounts may be adjusted before the measurement period expires (on the retroactive basis)[52].

3.128 The measurement period ends on the date on which the acquirer receives all the information regarding the circumstances that existed at the acquisition date or learns that he cannot get any additional information. However, this period cannot be longer than one year from the date of acquisition.

Example 34

Company A acquired Company B on 1 October 2014 and made the initial accounting for the acquisition at the end of December 2014. A company recognized the value of the acquired assets in the estimated value of PLN 3,000,000 PLN and estimated goodwill amounting to PLN 10,000,000. The assets have a useful economic life of 5 years since the date of the acquisition. The process of valuation of the acquired factory was completed in June 2015, with the final valuation of assets at PLN 3,800,000. How should company A account for the change in the valuation?

Company A should make adjustments retrospectively. This means that it should adjust the value of fixed assets at the acquisition date in conjunction with the goodwill. Since value of fixed assets has changed, depreciation entries made until the day of completing valuation have to be adjusted. As a result, assuming that there was no impairment of goodwill, it will be reduced by PLN 800,000, down to the amount of PLN 9,200,000. Increase in depreciation cost will depend on adopted depreciation rates.

Business combination in stages

3.129 In some situations, the acquirer takes control of business in which it held shares previously. This is called a business combination in stages[53]. Such combination, similar to all other acquisitions described in IFRS 3, should be accounted for using the acquisition method. At combination date shares held before the acquisition are measured at fair

[52] par. 45 of IFRS 3.
[53] par. 41 of IFRS 3

value. The revaluation surplus is a gain or loss which must be recognized in acquirer's profit and loss statement.

Example 35

Company A has 30% stake in B, which is an associated company. In financial statements, these shares are recognized at PLN 200,000. Company A acquires remaining 70% of the shares in B for the amount of PLN 1,500,000. On the day of acquisition, the fair value of shares held before the acquisition amounted to PLN 320,000. The value of the identifiable net assets of Company B at the acquisition date amounted to PLN 1,100,000. How should company A account for the fair value adjustment?

The combination should be accounted for by acquisition method, therefore Company A is obligated to calculate goodwill.

Fair value of the purchase consideration	PLN	1,500,000
Fair value of shares held before the acquisition	PLN	320,000
Fair value of net assets acquired	PLN	(1,100,000)
Goodwill	PLN	720,000

Gain on revaluation on acquisition date amounted to PLN 120,000 (PLN 320,000 - PLN 200,000)

The entries in the accounting books of Company A should be as follows:

Dr Net assets	PLN	1,100,000
Dr Goodwill	PLN	720,000
Cr Cash	PLN	1,500,000
Cr Gain on revaluation	PLN	120,000
Cr Shares in company B	PLN	200 000

Combination of entities under common control

3.130 If the acquirer or a business are ultimately controlled by the same party or parties both before and after the acquisition then the transaction is called a business combination under common control. IFRS 3 does not govern business combinations under common control[54].

[54] par. B1 of IFRS 3.

Example 36

Company A, being a subsidiary of the Company C is also the parent company for company B. Company A and Company B are going to merge.

This combination meets the definition of a business combination under common control and should not be accounted for in accordance with IFRS 3.

3.131 The current version of IFRS 3 does not contain guidance on the accounting for business combinations under common control. Accounting for this type of combinations has also not been properly addressed in any other accounting standard. This means that provisions of International Accounting Standard 8 "Accounting policies, changes in accounting estimates and errors" should be applied. The provisions of this standard obligate the acquirer to account for such a business combination in accordance with economic substance of the transaction.

3.132 Combination of entities under common control is undoubtedly the business combination. Therefore, since all business combinations are accounted for using the acquisition method, this means that the acquisition method may be applied for such combination as well. However, the acquisition method does not always reflect the economic substance of the transaction. For example, application of the acquisition method may be questioned in a situation where a significant time period has elapsed between acquisition of shares and merger.

3.133 An alternative way to account for business combinations may be the predecessor accounting method. This method was developed as a result of practical accounting for business combinations and does not require measurement of acquired assets and liabilities at fair value. The acquirer uses the carrying amounts of assets and liabilities of the acquiree recognized in the consolidated financial statements of the ultimate parent company. This means that the acquirer in the combined financial statements recognizes the goodwill derived from the consolidated financial statements.

3.134 It may happen, that the consolidated financial statements are not drawn at any level. Then, the acquirer should account for the combination using the carrying amounts recognized in the statement of the acquiree.

3.135 While applying the predecessor accounting method, the acquirer does not calculate the goodwill. Since the ultimate controlling party of the acquired assets is not changed, the goodwill in the combined financial statement may be derived from the consolidated financial statement. The use of predecessor accounting method may result in difference between the net assets imported from the consolidated financial statements and the value of investments in the acquiree. This difference should be recognized as a separate item of acquiree’s equity.

Reverse acquisitions

3.136 An acquirer in a business combination is identified based on the control criterion. In most cases the acquirer is the entity which issues shares as a result of business combination. Sometimes, however, this may not the true and the entity that issued equity instruments that from a legal point of view, is the acquirer for accounting purposes is the acquiree[55]. Reverse acquisition may apply when a private entity wants to become public but does not want to go through the IPO process or register shares in the public market.

Example 37

Company A sells FMCG goods. Company B, which is listed on the stock exchange in Warsaw, entered into an agreement with A. Under this agreement, in December 2013 company B issued shares, which were acquired in exchange for a contribution in kind to A in the form of 97% of its own shares. In December 2013, existing members of the supervisory board and management board of B have resigned. In their place members of the board A were appointed.

In this example, from a legal point of view, the acquirer is the company B because it issues the equity interests and non-public Company A is the acquiree. However, for accounting purposes in accordance with IFRS 3, the primary criterion for determining the acquirer is control. Thus, if the company B meets the definition of a business, company A obtains control and is the acquirer, while company B is the acquiree.

3.137 In the case of reverse acquisitions, the entity, which for accounting purposes is the acquirer, does not transfer purchase consideration. Beneficiaries are the shareholders of the company, which according to commercial law is the acquirer.

Example 38

Company B listed on the stock exchange in Warsaw, entered into a business combination with Company A. The day before the acquisition share capital of Company A was composed of 100,000 shares. Fair value of the single share determined by discounting techniques amounts to PLN 20,000. Share capital of company B consists of 20,000 shares and the market price of one share is PLN 8.50. As a result of the combination agreement, Company B issued 40,000 shares in exchange for 100,000 shares of Company A. After the transaction, shareholders of Company A own 67% (40,000/60,000) shares of the

[55] par. B19 IFRS 3.

combined company and the shareholders of B own 33% (20,000/60,000). What is the purchase consideration?

Purchase consideration is the fair value of consideration transferred. Despite the fact that in accordance with accounting law company A is the acquirer, purchase consideration should be measured by the market value of B's shares, as it is more reliable. Company A acquired 40,000 shares of B with a value of PLN 8.50 each. This means that the price of the acquisition is PLN 340,000.

Consolidated financial statements in the reverse acquisition

3.138 The consolidated financial statements represent a continuation of the financial statements of the legal subsidiary. This means that:

a) the assets and liabilities of the subsidiary (from a legal point of view) recognized and measured at their pre-combination carrying amounts should be combined with:

b) the assets and liabilities of the legal parent that are recognized and measured according to IFRS 3,

c) retained earnings and other equity items should reflect the capital structure of the entity, which before the combination was the legal subsidiary.

3.139 Share capital is determined as the sum of the shares on the day preceding the business combination of the entity that is the legal subsidiary, which for accounting purposes is the acquirer, and the fair value of the entity, which based on IFRS 3 provisions is the subsidiary. The capital structure should reflect the equity structure of the legal parent.

Non-controlling interests in reverse acquisitions

3.140 It could be that some owners of the legal subsidiary do not exchange their shares for shares of the legal parent. These shareholders have the right to participate in the net result and net assets of the legal parent. They have no right to profit or loss and net assets of the combined company. They are treated as non-controlling shareholders in combined financial statement.

Example 39

Company A is going to merge with company B. Prior to the merger, the share capital of Company B consisted of 1,000 shares. Share capital of A consisted of 800 shares, which belonged to four shareholders. As part of the merger, B issued 4 new shares in exchange for each share of Company A. Company A shareholders exchanged in this way 750,000 shares. How to account for this type of transaction under IFRS 3?

In this case we are dealing with a reverse acquisition. Following the transaction, the shareholders of A will have 75% shares in the company B. Unless there are additional agreements in place, regulating the matter of control otherwise, shareholders of Company A control financial and operating policies of company B. As a result of the transaction, non-controlling interests have arisen, since 50 interests in company A were not exchanged for shares of company A.

4. BUSINESS COMBINATIONS UNDER US GAAP

4.1 Accounting Standard Codification 805 "Business Combinations" (hereinafter referred to as ASC 805) governs accounting for business combinations.

4.2 The content of the revised IFRS 3 is to a large extent consistent with the contents of ASC 805

Structure of the standard

4.3 Standard is divided into six main chapters:

- ASC 805-10 Overall,
- ASC 805-20 Identifiable assets and liabilities and any non-controllinginterests,
- ASC 805-30 Goodwill or gain from bargain purchase including consideration transferred,
- ASC 805-40 Reverse acquisition,
- ASC 805-50 Related issues,
- ASC 805-740 Income tax[56].

Purpose and scope of the standard

4.4 The provisions of the standard are applicable to business combinations or acquisitions made by non-profit entities[57]. ASC 805 does not govern:

a) joint ventures,

b) the acquisition of single assets or groups of assets that do not meet the definition of a business or non-profit entity,

c) business combinations under common control[58].

4.5 On the basis of ASC 805 combination is a transaction or other economic events, in which the acquirer obtains control of a specific business or businesses. Usually the subjects of the transaction are net assets or shares in the business[59].

4.6 The business has been defined as an integrated set of processes and assets, which managed in an appropriate manner have the ability to provide returns to investors,

[56] ASC 805-10-20.
[57] ASC 805-15-3.
[58] ASC 805-15-4.
[59] ASC 805-10-20.

shareholders, participants or other owners. The returns may be in the form of payment of dividends, reduce costs or otherwise. It is easy to determine whether the transaction is a business combinations or only to the acquisition of individual assets. Standard provides guidance on how to determine the business in practice.

4.7 A business consists of inputs and processes applied to those inputs that have the ability to create outputs. The three elements of a business are defined as follows:

a) inputs or any economic resource which when applied to the process or processes has the ability to produce outputs,

b) processes i.e. any system, standard, protocol, convention or rule which applied to the inputs may create products,

c) the products or the results of the used inputs and processes that have the ability to provide returns to investors, shareholders, participants or other owners in the form of dividends, reduce costs or otherwise[60].

4.8 Although businesses usually have outputs, outputs are not required for an integrated set to qualify as a business. For example, such a situation could occur if the business is in the development phase. Then deciding whether the acquired assets are business or not it should be considered whether the group of assets:

a) has begun planned major planned activities,

b) has the employees, intangible assets and other inputs and processes that can be applied to those inputs,

c) carries out the plan of producing outputs

d) is able to find customers for these outputs.

4.9 The standard presents premises, based on which companies can decide whether a given transaction is a business combination. However, they are not unequivocal. The standard indicates that the definition of a business can be met even if the business does not have liabilities.

Example 40

Company A and B operate on the market for value added mobile phone services. Company A's operations include call center services. Company B intends to purchase from company A equipment such as workstations (phones, desks, chairs), and the telephone exchange. After the transaction, call center employees of company A will become employees of company B. Until the business combination takes place, remuneration of those employees will be paid by their former employer.

[60] ASC 805-10-55-4

In this example, Company B takes over inputs and processes that jointly are able to create outputs in form call center service. Therefore the transaction is a business combination and as per ASC 805 should be accounted for as such.

Example 41

Company A sells goods. Company B is a logistic entity. So far, the transport of goods from warehouses to stores was provided by company C. Company A has decided to give up the services of C and start its own logistics. For this purpose company A acquired from Company B ten trucks, which were put up for sale due to the difficult financial situation of the company. The companies are not connected.

In this example, company A buys from the other company a group of assets that constitute inputs. No processes are acquired. These types of transactions are excluded from the scope of ASC 805.

4.10 If the purchase price of a group of assets exceeds their fair value at the date of the transaction, the transaction is a business combination. Lack of the surplus does not mean that there was no business combination. Group of assets may also be a business when the purchase price is lower than the fair value.

4.11 In a business combination the acquirer can gain control of the business by:

a) the transfer of cash or other assets (including the business),

b) incurring of liabilities,

c) the issuance of equity instruments,

d) through a combination of a-c

e) without purchase consideration[61].

4.12 Business combination does not always require acquisition of net assets or shares in the joint venture. A business combination may also occur when:

a) shares are repurchased for the purpose of redemption, from all investors except for one, who thus becomes the parent,

b) control of a business is taken over due to weakening of the position of minority shareholders,

[61] ASC 805-10-55-2.

c) two companies enter into a transaction in order to combine their businesses, and as a result one company takes control over the combined business[62].

4.13 The combination involving entities that are approximately of the same size and together control the joint venture is also a business combination, which should be accounted for in accordance with ASC 805. Members of the Financial Accounting Standard Board justified the inclusion of this type of transaction in the range of business combination accounted for using the acquisition method stated, that the combination of relatively equal entities is in practice very rare. In the vast majority of cases it is possible to identify the acquirer. The development of separate rules for transactions occurring very rarely is impractical and could be considered as an alternative to the acquisition method.

4.14 The exchange of assets between the companies (excluding cash) should be accounted for using the acquisition method, if it results in acquisition of a business. In some situations, it is preferable to carry out a business combination by more than one transaction. Such connected transactions leading to acquisition of a business should also be accounted for as a business combination.

Determination of the acquirer

4.15 In the business combination accounted for in accordance with ASC 805, there is always an acquirer. According to the standard, the acquirer is the entity who takes control of the business. An entity that owns more than 50% in the business is acquiring entity, unless the business is a variable interest entity. In such a situation, the entity which includes a variable interest entity in its consolidation is deemed the controlling interest. In case of variable interest entities the acquirer is not always clear.

4.16 The standard indicates, that it is possible to determine an acquirer for each business combination. This is usually the entity that transfers purchase consideration. However, the standard does not provide a clear definition of the acquirer.

4.17 In some cases, there may be difficulties associated with the determination of the acquirer. Then it is necessary to:

a) analyze the size of parties - the acquirer is the entity which is clearly bigger than the other entities involved in the transaction; basis of the comparison may be total assets, revenues, net income,

b) identify the initiator of the business combination; in the case where more than two units are involved, besides the size of the parties the initiator of the transaction should be identified,

[62] ASC 805-10-25-11.

c) indicate one of the companies transferring their assets as the acquirer, if the combination is effected by creation of new entity,

d) determine the company that makes the transfer of benefits as the acquirer when the acquirer does not issue its own shares,

e) indicate the company that issues its own shares as the acquirer when purchase consideration consists of shares,

f) indicate a party that has the right to appoint the management of the combined entities; usually the acquirer is the entity that appoints the key members of management of the combined entities[63,64].

4.18 Additional difficulties in determining the acquirer may arise when a new entity is created as a result of business combination. In some situations, the new entity should be considered the acquiring entity. It is assumed that if the new company is created only to the issue equity interests it may not be considered the acquirer[65].

Example 42

Company A and Company B are related parties. Company C intends to withdraw from a certain market segment and sell the relevant part of its business. Company A and Company B are interested in in developing their activity in the segment, from which the Company C wants to withdraw. Company A and company B have formed a new company D with initial capital of PLN 1,000,000. Company C sells to Company D the part of the company constituting a business, for cash. Which of the companies is the acquirer?

In such a situation, the company D should be considered to be the acquirer.

Date of acquisition

4.19 Day of acquisition is the date on which the acquirer takes control of a specific business. It is worth noting that this definition is met by entities in development stage as well as organized groups of assets that do not meet the definition of an organized part of the enterprise in the understanding of Polish commercial law. Definition of a business is of particular importance here, because accounting for business combinations is different from the acquisition of assets. So a business will include assets and processes which jointly are capable of creating outputs.

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[63] Wiley GAAP 2014, Interpretation and Application of Generally Accepted Accounting Principles, Joanne M. Flood, p. 830 further "Wiley GAAP 2014".
[64] ASC 805-10-55-12
[65] ASC 805-10-55-15.

4.20 The acquirer usually exercises control, if it possesses a majority of voting rights[66]. However, this is not always the case. American standards introduce the concept of variable interest entities[67]. Equity holders of such entity, who possess the majority of voting rights, do not exercise actual control over the business. Such a situation may occur for example when external financing significantly exceeds the equity of the business. In such a situation, operation of the business is financed not by the owners but by external parties, who thus can control the business.

4.21 The combination date is the date on which the acquirer assumes control over the acquired business. As a rule, control is obtained when the assets and liabilities are transferred legally to the acquirer. However, the date of the entry in the court register is not always the date of assuming control. Control may be assumed both before and after court registration. In such a situation, date of assuming control should be determined based on economic substance of the transaction, taking into account all the circumstances of the combination[68].

Identification of assets and liabilities in a business combination

4.22 The acquirer shall recognize in its accounting books all identifiable assets and liabilities separately from goodwill[69].

4.23 In a situation where there are non-controlling interests in the acquiree, the acquirer should recognize them in its financial statement.

4.24 Business combination may lead to disclosure of assets or liabilities that were not recognized in the financial statements at combination date. In such a situation, the acquirer should recognize such assets in the combined financial statement.

4.25 In the combined financial statement, such resources should be recognized as meet the definition of internally created assets. All assets and liabilities recognized in accounting books should meet the definition of assets and liabilities, as presented in the conceptual framework for the codified standards.

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[66] Consolidation of Variable Interest Entities, A roadmap to Applying the Variable Interest Entities Consolidation Model, March 2010 str. 5, www.deloitte.com.

[67] Accounting for variable interests entities is defined in Accounting Standard Codification 810 "Consolidation". It is an entity in which the acquirer has not invested enough resources for the entity to be able to operate without cash inflow from third parties. Shareholders of the variable interests entities: a) cannot influence most important aspects of the operations, b) are not entitled to profits of the entity

[68] Wiley GAAP 2014, page 830.

[69] ASC 805-20-25-1

Example 43

Company A acquires 100% shares in B. Along with B's assets company A acquires customer base. Is the customer base is an asset in the combined financial statement?

Customer relationships developed internally do not meet the definition of the asset. Thus, in unit financial statements of Company B before the combination, expenses incurred for the purpose of building a customer base could not be recognized as assets. Under the business combination, Company A acquired this customer base. The customer base is an element of intangible assets that should be recognized in the combined financial statement.

Example 44

Company A acquires 100% shares in Company B. Company B has been operating on the market for many years and offers its products under a self-developed trademark. Should company A recognize the trademark separately from goodwill in the combined financial statement?

In unit statements before the combination, Company B was not entitled to recognize the expenses related with the development of its own trademark as assets. However under the combination agreement, Company A has purchased the trademark from Company B and in the combined financial statement, the trademark should be recognized separately from goodwill.

4.26 In addition to the business combination the parties may enter into other transactions. Provisions of ASC 805 should not be applied to assets acquired within the framework of such additional transactions.

4.27 Business combination may be associated with restructuring activities. Usually at the combination date future planned outflows resulting from such activities do not meet the definition of liabilities. They should be accounted for by acquirer, if conditions described in Accounting Standard Codification 420 "Exit or disposal costs obligations" are met.

4.28 In some cases both before and during the negotiations on business combinations, the parties entered into other business transactions. These types of transactions are not associated with business combination and should not be covered by the acquisition method. Only the transactions associated with business combination should be accounted for using acquisition method.

4.29 The acquirer is required to analyze the business combination, as well as other transactions with the acquiree, in order to identify those elements of transaction, which determine the acquirer's control of the acquiree. Such an obligation arises from the fact that during the negotiations, before control is assumed, the parties may trade as if they were affiliated entities. As a result, conditions of transactions entered into by acquiree-to-be might be structured in such a way as to achieve, in its combined financial statement after the combination, financial effect desired by the acquirer[70].

4.30 When determining whether a transaction is part of a business combination, it should be assessed which party to the transaction earns benefits from business combination. If the benefits of the transaction that was entered into before the business combination goes to the acquirer and not to the acquiree or its owners, the transaction should be accounted for as part of business combination.

4.31 In making such an assessment, the acquirer should consider:

a) what was the economic objective of the transaction,

b) who initiated the transaction - determination of the entity that initiated the transaction may be helpful in assessing whether the transaction is part of a business combination:

- if the transaction was initiated by the acquirer is less likely that it represents a part of business combination,
- if the transaction was initiated by the acquiree or its pre-combination owners it is more likely that it represents a part of business combination,

c) the time of the transaction - the analysis of the time at which the transaction was entered in can be helpful, for example, if the transaction was concluded at that moment, in which it would benefit the acquirer with high degree of probability[71].

4.32 Transactions that have been concluded during the combination negotiations are the benefit of the acquirer and as such should not be accounted for as part of the business combination. They are separate transactions and principles set out in the other standards should be applied.

4.33 Not all expenses related to the business combination should be accounted for under the acquisition method.

4.34 The costs associated with a business combination should be recognized in profit or loss. These are for example: expenses for legal, accounting, tax advisory, expenditure for the valuation services. There is one exception from the rule. The standard provides that costs of registration and the issuance of shares as well as the costs associated with the issuance of debt securities should be recorded in accordance with other relevant standards. Expenditure

[70] Wiley GAAP 2014, p.. 831.
[71] ASC 805-10-55-18.

for the issuance of shares reduce the inflows from the issuance. Costs of issue of debt securities are deducted from the proceeds of the issue or are recognized as an expense in the period in which they are incurred, or alternatively, it can be amortized to profit and loss over the period of the loan.

Example 45

Company A acquires 100% shares in the company B. As part of the business combination agreement, shareholders of B bear the costs associated with handling this transaction in the amount of PLN 80,000. Purchase consideration amounts to PLN 3,500,000. The parties have agreed that all expenses are paid by the buyer. How to account for such transaction in the books of Company A?

Purchase consideration stated in the agreement amounts to PLN 3,500,000, but part of this amount is the reimbursement of costs incurred by previous owners in connection with the combination. This means that for accounting purposes, purchase consideration is PLN 3,420,000.

4.35 Prior to the business combination the parties may trade with each other. They may supply goods or render services. It is also possible that combining companies are parties to a court dispute. As a result of the business combination, mutual claims are settled. The acquirer should recognize gain or loss on such a settlement as follows:

a) if the claims arise from the ruling of the court, at fair value,

b) if the claims arise from the supply of goods and services, gain or loss should be valued at the lower of:

- the amount by which the contract is favorable or unfavorable for the acquirer
- amount needed to settle the contract.

Example 46

Company A acquires 100% shares in Company B. Two years before the merger companies entered into an agreement for supply of goods. On the business combination day the contract has three years to elapse. Early termination involves a penalty fee amounting to PLN 2,000,000. The total value of the contract is PLN 1,500,000. Purchase consideration is PLN 15,000,000 and fair value of net assets acquired is PLN 12,000,000. Market prices for the delivery of commercial goods have fallen. If on combination date the acquirer enters in the 3 year contract for supply of similar goods with another supplier, the acquirer would save PLN 800,000. How should acquirer account for the business combination in its accounting books?

Accounting for the business combination, the acquirer is required to apply the acquisition method. The amount of the early termination of the contract is greater than the amount by which the contract is unfavorable compared to market conditions. Therefore, the company should account for a loss in the amount of PLN 800,000.

The entries in the books of A are as follows:

Dr Net assets	PLN	12,000,000
Dr Goodwill	PLN	2,200,000
Dr Loss on settlement of the contract with B	PLN	800,000
Cr Cash	PLN	15,000,000

On combination date, the unfavorable contract is settled. Therefore, purchase consideration should be adjusted by the amount of difference between market value and value of the contract with Company B.

Employee services for the acquirer

4.36 The acquirer should assess whether the contingent payments to the former owners or employees of the acquiree are part of the purchase consideration or should be accounted for separately. The assessment should consider the following factors:

a) the reasons why the contingent payments are included in the business combination agreement,

b) who was the initiator of such agreement,

c) when (at what stage of negotiations) the parties entered into an agreement for future payment.

4.37 In order to classify the contingent payments properly, first of all the terms of employment contracts should be analyzed. If the termination of the employment contract cancels contingent payments, they should be regarded as arising from the employment relationship. Opposite situation may indicate that the consideration specified in the contract of employment is part of the purchase consideration. In this case, benefits derived from such an agreement should be accounted for in accordance with ASC 805[72].

4.38 If an employee is required under an employment contract, or similar, to remain in the employment relationship for a period that is equal to or exceeds the amount of contingent payments, it may indicate that contingent payments are part of remuneration and are not part of purchase consideration.

[72] ASC 805-10-55-25.

4.39 If a fixed amount of contingent payments is similar to remuneration received by employees in similar positions in the acquirer it may indicate that it is a salary and not part of the purchase consideration.

4.40 If the contingent consideration for shares, paid to the previous owners who did not become employees are lower than for those who did become employees, it may indicate that additional payments are not part of the purchase consideration.

4.41 If the previous owners own a material number of shares in the acquirer and occupy key positions in the combined company it may mean that contingent payment is in fact a profit sharing agreement, which provides remuneration for post-combination services. If the previous owners have only a small number of shares. However, if contingent consideration is dependent on predefined conditions, it is remuneration for services rendered after termination of employment contract[73].

Assets and liabilities acquired in a business combination

4.42 To allow the acquirer to apply accounting standards in the combined financial statements, management is required to make a decision regarding the classification of net assets acquired as of combination date. Decisions concerning classification should be taken on the basis of the acquirer's accounting policy, economic substance and use of acquired assets and liabilities, as well as provisions of the combination agreement[74]. The standard provides examples on classification which the acquirer should make in its books:

a) classification of individual investments in shares as held for trading, available for sale or held to maturity[75],

b) classification of derivatives as hedging instruments[76],

c) an assessment of whether an embedded derivative should be separated from the main contract or not.

4.43 Classification of assets and liabilities in the books of the acquirer at the date of initial recognition is important, as subsequent measurement is different for different assets and liabilities.

4.44 ASC 805 exempts lease agreements and insurance contracts from classification on the day of business combination[77]. Such contracts should be accounted for in the books of the

[73] par. A87 FAS 141(R).
[74] ASC 805-20-57-7.
[75] FAS 115 par 6.
[76] ASC 815 -10-05-4.
[77] ASC 840-10-25-27.

acquirer in accordance with terms in force at the date of the conclusion by the acquiree and not in accordance with the terms as of the combination date.

4.45 The acquirer measures tangible and intangible assets and liabilities acquired in business combination at fair value. If business combination results in non-controlling interests being acquired, they should also be measured at fair value.

4.46 Regardless of whether the acquiree is the lessor or lessee, acquirer assesses at combination date if acquired lease contract is favorable or unfavorable compared to the market. It should be assessed, whether the same asset could be leased from another company on terms that are more favorable, worse or the same. If terms and conditions of the lease contract are favorable the acquirer should recognize an asset (separately from goodwill). If the terms of the lease are worse than market, the company should recognize a liability.

4.47 Fair value of leased assets owned by the acquiree being a lessor in an operating leasing contract is measured separately from the lease agreement based on which they are being used.

4.48 Fair value takes into account the uncertainties inherent in future cash flows associated with certain assets[78]. Therefore, an impairment write-off should not be recognized separately by the acquirer.

4.49 Fair value measurement is based on the assumption that the assets will be used in the most effective manner. Such an approach should be adopted also for the assets acquired in a business combination even if acquirer does not intend to do so.

Example 47

Company A and Company B are competing in the market of mobile value-added services. Company A acquires the assets and liabilities of B in the business combination. Products of companies A and B marketed to individuals are very similar. Immediately after the acquisition customers of B will be transferred to the company A's platform, and company A products will be withdrawn from the market. Company A acquires the trademark of B but it will not be actively used.

A trademark acquired in a business combination is used to protect company A’s market position. Despite the fact that it will be not actively used, company A should measure the trade mark at fair value at initial recognition. Valuation at subsequent balance sheet date should include an impairment charge.

[78] ASC 820.

4.50 The acquirer should recognize identifiable intangible assets acquired in a business combination separately from goodwill. The initial recognition of intangible assets should be accounted for in accordance with ASC 350. This standard governs the accounting of intangible assets subject to amortization, those without specific useful economic life and goodwill. In a business combination the acquirer should present value of intangible assets if they meet the definition of an asset and can be measured reliably[79]. In addition, these assets must meet one of two criteria:

a) self-reliance - an intangible asset should be separately recognized if it can be separated from the company which is the owner and it may be sold, transferred, licensed, exchanged, regardless of whether the acquirer intends to do so or not,

b) legal - the intangible asset results from contractual or other legal title[80].

4.51 The standard lists intangible assets that are subject to a separate presentation. This list is divided into five groups:

- Intangible assets in form of trademarks, trade names, internet domain names, non-competition agreements, etc.
- Intangible assets in form of customer lists, customer orders, business relations with clients, etc.
- Intangible assets in form of works of art
- Intangible assets resulting from acquired contracts. Examples of such assets include contracts under which the acquirer will be entitled to revenues from licenses, advertising, leasing agreements.
- Intangible assets resulting from technology used by the acquirer. It covers patents, copyrights, databases, processes, production lines, etc.

4.52 The list of intangible assets subject to a separate recognition does not include employees. This stems from lack of a reliable measurement method. In particular, the replacement method does not lead to determining fair value of such an asset.

4.53 Intangible assets are amortized over the useful economic life. Factors that should be taken into account when determining the economic useful life are as follows:

a) contractual and other legal restrictions that affect the length of use of the assets,

b) the possibility of extending the right to use assets

c) the volume of demand, the strength of competitors and other economic factors,

d) the useful economic life of assets cooperating with a given intangible

[79] According to ASC 350 intangibles are measured at cost only, regardless of whether an active market exists or not.

[80] ASC 805-25-20-10.

e) the way intangible and legal assets are used,

f) maintenance costs of an intangible or legal asset.

4.54 If the useful economic life cannot be determined, the asset is not amortized. In certain circumstances, useful economic life of an intangible asset cannot be determined at the business combination date, however on subsequent balance sheet day it may be possible. Reversely, if an asset was subject to depreciation on initial recognition, upon measurement as of subsequent balance sheet date it might no longer be subject to depreciation.

4.55 As a rule, the entire value of the asset will be depreciated. However, in some situations, residual value of an asset should be determined, which will reduce the amount of depreciation. Residual value arises when the useful economic life of the acquired business will be shorter than the useful economic life of intangible assets. The residual value can be determined based on the prices of assets in an active market and it can be reasonably assumed that such a market will exist throughout economic life of the asset. The residual value may also be determined if a third party agreed to acquire the intangible asset from the acquirer at the end of its useful economic life. Amortization method should reflect the pattern in which the asset generates inflows to the company. If it is not possible, straight-line method should be used. The intangible asset is tested against impairment.

4.56 ASC 805 requires all intangible assets used in research and development acquired in the business combination to be to disclosed and measured item by item or grouped.

4.57 Such disclosures should take place even if the acquirer has no other alternative ways of using the assets. Measurement at fair value should be determined as of combination date. Measurement at fair value in accordance with ASC 820 should be made based on same assumptions as would be made by market participants. Assets that will not be used by the acquirer, or that will not be used in the most optimal way, are also measured at fair value.

4.58 Intangible assets associated with research and development are classified as assets that do not have economic useful life. Such a classification continues to the point where R & D will be completed or abandoned. Until the useful economic life is determined, the assets are not amortized. They are subject to impairment tests. When the determining of the economic useful life is possible, the depreciation should be started.

4.59 Business combinations can also include tangible assets used for research and development. Accounting of such assets is done according to their economic nature (e.g., inventories, depreciable assets, etc.).

4.60 ASC 805 introduces exceptions to the general rules for measurement of assets and liabilities at fair value as of combination date.

4.61 Assets held for sale - these types of assets are measured at fair value at the combination date less the costs of sale, in accordance with ASC 360. They are not subject to amortization. The costs of sale do not include losses associated with maintaining assets held for sale or groups of assets held for sale. The costs of sale are cover costs that would be incurred even if the sales transaction did not happen. For example, brokerage fees, taxes and other charges resulting from applicable law.

Contingent assets and liabilities

4.62 In some cases, the acquirer should recognize in its books contingent assets and liabilities of the acquiree. Such disclosure is dependent on whether fair value measurement of the asset is possible on combination date. If so, the acquirer should recognize such contingent assets or liabilities at fair value as of acquisition date[81].

4.63 In a reverse situation, the asset or liability is recognized as of combination date if both following conditions are met:

a) information available before the end of the measurement period indicates that it is likely that the asset or liability existed at combination date,

b) measurement as of the date of initial recognition can be performed reliably[82].

4.64 If these criteria are not met then the acquirer cannot recognize assets or liabilities at combination date.

4.65 In subsequent periods, provisions of relevant standards should be applied for the purpose of accounting for such assets.

4.66 The acquirer is obliged to recognize all contingent contracts of the acquiree taken over within the framework of combination at fair value as of combination date.

4.67 The board of directors of the acquirer should develop such accounting policy for contingent assets and liabilities, as would take into account their economic substance. These principles should be applied continuously.

Indemnification assets

4.68 Typically, agreements on business combinations contain provisions concerning indemnification payments, which the acquirer would receive in case of occurrence of adverse events, known or unknown at balance sheet date. These provisions are designed in such

[81] ASC 805-30-25-5.
[82] ASC 805-20-25.

a way as to reduce to a minimum costs incurred by the acquirer as a result of adverse events, by way of indemnification[83].

4.69 The acquirer is required to recognize and measure indemnification assets in accordance with same accounting principles as applied to indemnified items. Measurement of such assets should take into account all the uncertainties concerning the amount and timing of cash flows.

4.70 If the asset is measured at fair value at combination date, impact of these uncertainties is included in the fair value. Therefore impairment loss is not separately recognized.

4.71 Some of the indemnities relate to assets or liabilities that are not recognized in the financial statement. In particular, they may apply to contingent assets or liabilities that do not meet the conditions relating to the disclosure. Indemnities may be related to the settlement of tax liability of the acquiree. In such a case, the indemnification asset should be recognized and measured in accordance with the rules governing the valuation of indemnified items.

4.72 Uncertainty associated with payment of indemnification in itself is not included in fair value. Therefore, if the inflow of indemnity is not certain, the acquirer should consider provision for impairment.

4.73 At each balance sheet date subsequent to the date of acquisition, the acquirer is obliged to measure indemnification assets applying the same accounting principles as are applied to the indemnified asset, taking into account indemnification provisions of the agreement. If the indemnification asset is not carried at fair value then it should be tested against impairment. An impairment provision may be created if needed.

Reacquired rights

4.74 As part of the business combination the acquirer may acquire assets and liabilities arising from agreements concluded before the combination, such as leases, licenses, franchises. Under agreements concluded prior to the combination, the acquiree paid the acquirer for the use of tangible assets or intangible assets that belong to the acquirer[84].

4.75 In such a situation, the acquirer should recognize a depreciable asset, separately from goodwill. Terms of reacquired rights should be compared with market conditions. If they are beneficial for the acquirer, compared to contracts that could be concluded on similar or identical assets, the acquirer shall recognize gain in the lesser of:

a) the amount by which the contract differs from contracts that could be concluded on the market

[83] ASC 805-20-25-27.
[84] ASC 805-20-25-14.

b) the amount of penalty for termination of the contract by the party, for which it is unfavorable compared to the market.

If conditions are unfavorable then the acquirer should recognize a loss (on the same basis)

4.76 Reacquired rights recognized in the acquirer's balance sheet are amortized over the remaining period of the agreement. Contract expiration date should be used even in a situation in which independent parties would intend to extend the contract.

Income tax

4.77 Measurement of assets and liabilities resulting from income tax is not based on the fair value concept nor the technique of discounting.

4.78 On the date of acquisition the acquirer is required to recognize deferred tax assets or deferred tax liabilities constituting future impacts of temporary differences that existed at the combination date or arose due the business combination[85].

4.79 Measurement of tax liability or tax receivable should be based on Accounting Standard 740 "Income Taxes" (ASC 740). This valuation is used to estimate the taxable profit of the acquiree. The board of directors should adjust the tax bases of assets and liabilities related to the business combination.

4.80 New information related to the tax events and tax circumstances that existed at the combination date and come to light in the later period are recognized as follows:

- If the circumstance affects the carrying value of assets and liabilities within the measurement period, goodwill is adjusted. If this adjustment results in goodwill being reduced to zero, then the remainder of the adjustment is recognized as a gain from the combination.
- If the circumstance affects the measurement in the next period, such change is recognized in accordance with ASC 740.

4.81 Deferred tax assets are written off, when it is more likely that the value of the assets will not be realized than it is likely that the value of the assets will be realized.

4.82 On the day of the business combination all the benefits resulting from temporary differences or future tax allowable losses may be recognized in the financial statements only if the acquirer is entitled to these benefits under the applicable tax law.

[85] ASC 805-740-25.

4.83 These benefits should be recorded in the gross value. If it is more likely that the deferred tax assets will not be realized then it should be written down. It may be the case, when it is expected that the business would not generate income sufficient to realize the tax benefits.

4.84 If national legislation imposes constraints related to the settlement of tax benefits in the combined companies, the constraints will be reflected in the impairment provisions on deferred tax assets.

4.85 In some jurisdictions, it is possible to submit joint tax return of the combined entities and to settle tax losses of the acquirer against the profits generated by the acquiree when the deferred tax assets on the loss was impaired. In such situation, if reversal of the impairment is reasonable then it is not accounted for as part of the business combination. This benefit is recognized as a tax benefit at the combination date.

4.86 Changes in impairment write-off after the combination date, stemming from deferred tax assets arisen as a result of the combination, should be recognized as follows:

a) if the adjustment is in the measurement period (as defined in 805), which does not exceed one year from the date of acquisition, and is due to circumstances which existed at combination date the adjustment influences the goodwill. If the adjustment results in a decrease of goodwill to zero, the acquirer is required to recognize the reversal of impairment loss as a gain on the business combination,

b) if the change in the valuation arises in the period following the measurement period it should be recognized as an adjustment to deferred tax assets in the period in which the change occurred. Standard provides for an exception to this rule for the option plan for employees. In such case the adjustment is recognized directly in equity and not as income tax expense.

4.87 Until 1993, goodwill was not treated as tax deductible item on the basis of U.S. tax law. To the extent that goodwill is not tax deductible temporary differences do not arise and it does not influence deferred tax. Amendment of provisions of the Tax Act from 1993 allows recognition of goodwill in calculation of income tax for a period of 15 years. However, the way goodwill is calculated for tax purposes differs from the one provided by ASC 805 for accounting purposes[86].

4.88 In a situation, in which amortization of goodwill pursuant is considered a cost by tax law, temporary differences between the carrying value and tax value arise. In such situations, impairment write-off based on accounting law does not affect the tax return.

4.89 Goodwill represents the excess of purchase consideration over the separately identifiable assets and liabilities acquired in a business combination. Standard requires the recognition of the goodwill separately from the deferred tax associated with that goodwill.

[86] Wiley GAAP 2014, p. 853.

Measurement and recognition of non-controlling interests

4.90 In the current version of codified standard, the notion of minority interests was replaced by the notion of non-controlling interests. Standard setters decided, that the term "minority interests" in certain circumstances did not describe the situation correctly. According to ASC 805 and ASC 810, an entity may be a majority shareholder in another unit without holding majority of the voting rights. Therefore it would be wrong to use the term "minority shareholders" in relation to the shareholders, who hold the majority of shares.

4.91 ASC 805 requires for non-controlling interests to be measured at fair value based on the prices in an active market on the business combination date. If the acquirer does not acquire all the shares in the acquiree and there is an active market for the remaining part of the shares the acquirer should measure them based on the market prices. If there is no active market the shares should be measured by other methods of valuation. Application of other measurement techniques is likely to result in a situation in which value per share in the control package is different from value per share of non-controlling interests. Such a situation is justified because the investor will want to pay less for the shares, which do not allow him to exercise control over the business than for shares, which give such control[87].

Determination of purchase consideration

4.92 Purchase consideration is measured at fair value at combination date. It may be expressed in cash, other assets, acquirer's subsidiary or acquirer's shares. It may be conditional. The total purchase consideration is the sum of its parts measured at combination date at:

a) fair value of the assets transferred by the acquirer,

b) fair value of liabilities towards previous owners of the acquiree assumed by the acquirer, and

c) fair value of equity instruments issued by the acquirer, including the valuation principles used to account for the option plan for the employees of the acquiree[88].

4.93 Where the purchase consideration consists of assets or liabilities of the acquirer other than cash, the acquirer is required to measure them at fair value. The difference resulting from revaluation is charged to the profit and loss account as of combination date. However if after the combination the components of purchase consideration remain under the control of the acquirer, they are measured at carrying value as of the day preceding the combination

[87] ASC 805-20-6.
[88] ASC 805-30-30-7.

date. Such a situation may occur when the acquirer transfers assets or liabilities to the acquiree and not to its former owners.

4.94 The way the business combination is structured may involve transfer of acquirer's shares to the acquiree or its former owners. If on the combination date fair value of the shares of the acquiree is more reliable than the value of the equity instruments of the acquirer then the value of the acquiree should be used to measure purchase consideration.

Contingent consideration

4.95 Contingent consideration can be determined in many ways. As a result, it may be necessary to recognize either assets or liabilities. In each case, contingent asset or liability should be measured at fair value at combination date[89].

4.96 If the contingent consideration includes obligations for future payments, the obligation should be recognized either as a liability or as part of equity in accordance with ASC 480, ASC 815-40 or other standards.

4.97 The acquirer is required to analyze the information obtained after the conditional consideration is measured. Additional information obtained during the measurement period, pertaining to circumstances existing at the combination date result in an adjustment of contingent consideration in correspondence with goodwill or gain on the combination. Changes that are the result of events occurring after business combination, such as achieving certain level of profits do not constitute a change occurring during the measurement period and should be recognized in the books as:

a) if the contingent consideration was classified as equity, it is not revalued and the difference resulting from the settlement is recognized in equity,

b) if the conditional purchase price was classified as an asset or liability it should be re-measured to fair value at each balance sheet date until the final settlement.

4.98 Changes in the fair value should be recognized as a gain or loss in the current period unless the contract is a hedging instrument; then changes should be recognized in the statement of other comprehensive income (equity).

Measurement of goodwill or gain from transaction

4.99 Acquisition method involves measurement of goodwill or a gain from combination. Goodwill is an intangible asset, that results from the fact that the buyer decides

[89] ASC 805-20-25-15.

to pay more for obtaining control, than market value of the net assets acquired measured in accordance with ASC 805.

4.100 Goodwill is a non-identifiable asset and cannot be measured separately. Its value is derived from the consideration transferred and the value of net assets acquired[90].

4.101 Goodwill

is the sum of:

a) purchase consideration

b) non-controlling interests

c) fair value of the interests in acquiree, owned by the acquirer, in case of business combinations effected in stages.

less:

a) the value of net assets measured in accordance with under ASC 805

4.102 In a reverse situation, i.e. when the purchase consideration is lower than the value of the net assets acquired, negative goodwill is created and the acquirer will recognize a profit on the combination.

4.103 If the acquirer does not transfer purchase consideration, the acquirer is required to apply valuation techniques to determine the value of the shares in the acquiree. Then the value of the shares of the acquiree is the price of the acquisition.

Gain on business combination

4.104 If the combination results in negative goodwill a bargain purchase occurred[91]. In accordance with ASC 805, such bargain purchase should be recognized directly in the profit and loss statement as a one-off gain on business combination at the combination date.

4.105 This profit is not an extraordinary profit and should be recognized as profit from continuing operations.

4.106 Given the complexity of the calculation of goodwill, the FASB recommends the use of a control protocol if negative goodwill arises. Before the negative goodwill is recognized in the books, the management is obligated to:

- Verify the completeness of acquired identifiable tangible assets, intangible assets and liabilities. Identified errors must be corrected before the gain is recognized.

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[90] ASC 805-10-20.

[91] ASC 805-30-25-2.

- Verify the method of measurement of acquired assets and liabilities to make sure that the measurement method takes into account all information available at the acquisition date on:
  a) identified assets and assumed liabilities,
  b) the purchase price,
  c) non-controlling interests,
  d) shares which the acquirer had in the acquiree before the combination.

The measurement period

4.107 Usually, the management of the acquirer does not possess all the necessary information needed to measure acquired assets and liabilities at the combination date, or even at the date of first annual financial statement following the combination[92].

4.108 If the measurement has not been completed before the preparation of the first annual financial statement, the acquirer is obligated to recognize estimated values of assets and liabilities in its financial statement.

4.109 ASC 805 provides the possibility to make retrospective adjustments to those estimated values. Such adjustments result from the circumstances that existed at combination date, but that the board was not aware of at the time of preparing the estimates.

4.110 In assessing whether new information should affect the reported estimates, management of the acquiree should consider all possible circumstances. The most important thing is to determine whether this information applies to facts and circumstances that existed at the time of acquisition or relate to events that took place after that date. Therefore, it will be important to determine:

a) the date on which the board received additional information,

b) whether it is possible to identify the reasons for which this new information affects the estimates.

4.111 In addition to these adjustments to recognized estimate values, the acquirer is allowed to recognize assets and liabilities, which were mistakenly omitted on the date of acquisition. During the measurement period, the assets and liabilities should be valued retrospectively.

4.112 In determining the adjustments to the estimated values of balance sheet items, relationships between assets and liabilities should be analyzed. For example, new information

[92] ASC 805-20-25-19.

will be revealed about indemnified liability; this new value of the liability could affect the indemnification asset. Thus, due to change in value of the liability, value of indemnification asset will change as well.

4.113 Changes in fair value of assets and liabilities may affect the temporary differences, which constitute the basis for calculation of deferred tax assets or provisions.

4.114 Adjustments to the estimates are entered into the accounting records retrospectively, i.e. as if they were recognized on combination date. This rule results in adjustments to comparative data, such as depreciation or changes in equity.

4.115 Measurement period ends on the date on which the acquirer receives all the information regarding the facts and circumstances that existed at the combination date or learns that he will not be able to get any other information in relation to those that he already has, however no later than one year from combination date.

4.116 After the end of the measurement period, adjustments to previously recognized items arising from a business combination may be treated as correction of errors in accordance with Accounting Standard Codification 250 "Accounting changes and error corrections."

Business combinations effected in stages

4.117 Business combination achieved in stages is a combination, in which the acquirer holds interests in the acquiree prior to obtaining control over it[93].

4.118 On the day of combination, the acquirer measures its interest in the acquiree at fair value. Gain or loss on the measurement shall be recognized in the statement of comprehensive income.

4.119 If the acquirer has previously recognized changes in carrying value of interests in the acquiree directly in the statement of other comprehensive income, because e.g. they were designated as assets available for sale, the amount of such change should be re-classified and recognized in calculation of profit or loss from revaluation as of acquisition date.

Reverse acquisitions

4.120 Reverse acquisition occurs when the entity which from the accounting perspective is the acquirer is the entity that from the perspective of commercial law is the acquiree.

[93] ASC 805-10-25-9.

4.121 In the combined financial statement, assets and liabilities of the legal acquiree are measured at carrying value as of the day preceding the combination date and combined with assets and liabilities of the legal acquirer measured in accordance with ASC 805.

4.122 Retained earnings of the legal acquiree are recognized as retained earnings in the combined financial statements.

4.123 Value of the share capital in the combined financial statement is determined based on the sum of the share capital of the legal acquiree at the date preceding the combination date and the fair value of the purchase consideration.

Business combination under common control

4.124 Business combinations accounted for by the pooling of interests was very popular from 1950 to about 2000. Pooling of interests has been developed for combinations of similar size entities with similar activities for which it was difficult to determine which entity is the acquirer, as all or most of the shares in the entity acquiring the assets and assuming liabilities were in hands of the shareholders of the merging companies. With the passing of time, rigid rules that restricted the application of pooling of interests had been loosened. As a result use of the pooling of interests has become possible also in a situation where the merging companies were of different sizes and the identification of the acquiring entity was possible[94].

4.125 The main motivation for the use of the pooling of interests method was to hide the real cost of the combination. No fair value measurement and the lack of goodwill in case of applying the pooling of interests result in the fact, that the true costs of the investment are not recognized either as an asset or as part of the profit and loss account[95].

4.126 Accordingly, the Financial Accounting Standards Board (FASB), with effect from 20 June 2001 ruled out the possibility of applying pooling of interests method in a business combination. Since then, all business combinations should be accounted for using the acquisition method. To justify the change in the method of accounting for business combinations, members of the board admitted that the use of the pooling of interests is appropriate only in cases where the combining entities are of the same size and there is no possibility to identify an acquirer. In practice, this happens very rarely. Leaving the pooling of interests as an alternative to the acquisition method in a situation where its application occurs very rarely would be impractical. In addition it creates the alternative which may be intentionally misused[96].

[94] IAS 2003 Interpretation and Application of International Accounting Standards, Wiley, Barry J. Epstain, Abbas Ali Mirza, p. 417 further "Wiley IAS 2003".
[95] Wiley IAS 2003, str. 418.
[96] Wiley IAS 2003, str. 418

4.127 Regulations in force until 20 June 2001 had authorized the use of the pooling of interests method if 12 criteria were met. However, most of the combinations were designed in such a way as to allow use of pooling of interests. Under the current ASC 805, all business combinations except for non for profit entities and entities under common control should be accounted for using the acquisition method.

4.128 Business Combinations, which have common ownership is not considered a business combination, because there is no transfer of control at the level of ownership.

4.129 Consequently, this type of connection is not regulated in ASC 805.

4.130 Similar to international accounting standards, U.S. regulations do not specify how combinations of businesses under common control should be accounted for. According to analyzed literature, business combination under common control should be accounted for using predecessor accounting method or push down accounting method.

4.131 In the combined financial statement the acquirer recognizes the share of non-controlling interests in equity of the acquiree as of the day preceding combination date.

5. COMPARISON OF INTERNATIONAL STANDARDS WITH AMERICAN, BRITISH AND GERMAN REGULATIONS IN THIS SCOPE

Main differences between the International Accounting Standards (IFRS 3) and American Standards (ASC 805)

Table 1: Main differences between the International Accounting Standards (IFRS 3) and American Standards (ASC 805)

Area	ASC 805	IFRS 3
Scope	Does not cover non-profit entities.	Covers both for-profit and non-profit entities.
Measurement of non-controlling interests	Fair value only.	At fair value or the proportionally as a share in the identifiable net assets of the acquiree.
Initial recognition of contingent liabilities.	Contingent liabilities are recognized when a present obligation results from past events, measured at fair value and the probability of realization is greater than 50%.	Contingent liabilities are valued at fair value.
Recognition of contingent liabilities at the balance sheet date	No guidance relating to measurement as of balance sheet date	Measurement as of balance sheet date based on the provisions of IAS 37
Recognition of asset resulting from operating lease if the acquiree is a lessor	In a situation where the contract terms are favorable relative to market prices, acquirer should recognize intangible asset separately from the asset stemming from leased item.	Assets or liabilities are not recognized.

Area	ASC 805	IFRS 3
Contingent consideration measured at fair value.	At fair value	At fair value or according to the principles described in IAS 37 (technique of discounting)
Contingent designation to liabilities or equity	Recognition in accordance with the guidance described in ASC 480	Recognition in accordance with IAS 32 and 39. The provisions of IAS 32 and 39 are different from the provisions of ASC 480
Definition of control	Control refers to the holding of a majority of voting rights	Control refers to the impact on the financial and operational policy of the entity and the ability to reap the benefits
The definition of fair value	The amount that a seller would receive to sell an asset or price he would have to pay to dispose of the liability under the standard transaction with the market participant	The amount for which an asset could be exchanged or a liability settled, between knowledgeable, willing parties in transaction at arm's length.
Employee benefits	Recognition is based on ASC 715	Recognition is based on IAS 19, which is not in accordance with ASC 715
Share payments awards	Recognition is based on ASC 718	Recognition is based on IFRS 2, which is not in accordance with ASC 718
Determination of the liabilities resulting from share payments award acquired in business combination.	Calculation of the amount is based on indicators calculated as the ratio of period of employment service prior to the combination to the total period of performance.	Calculation of the amount is based on the indicator calculated as the ratio of the benchmark achieved on the day of program (achievements of set in the program benchmarks such as period of employment, appraisal of the services rendered) to total benchmarks of the program.

5.1 Besides above differences, other discrepancies may occur, due to lack of consistency between specific international accounting standards and U.S. standards.

Main differences between IFRS 3 and standards applicable in the UK

5.2 Accounting for business combinations is described in Financial Reporting Standard 6 "Acquisitions and mergers" (FRS 6). Standard was established in 1994 and its significant modification occurred in 2009. Following there are the major differences between FRS 6 and IFRS 3.

Table 2: Major differences between FRS 6 and IFRS 3[97]

Area	IFRS 3	UK GAAP
Business combination under common control	Business combinations under common control are excluded from the scope of the international standard.	If the combination meets criteria specified in the standard then merger accounting is possible (pooling of interests)
Definition of a business	Defined.	UK standard does not contain definition of a business.
Acquisition method	Combinations covered by IFRS 3 are accounted for using the acquisition method.	The acquisition method is used when the pooling of interests method cannot be applied
Pooling of interests	No guidance on the application of pooling of interests.	Pooling of interests may be applied on condition of meeting specified criteria.
Reverse acquisition	Standard defines and provides guidance on accounting for reverse acquisitions.	U.K. standards does not define or contain guidance on reverse acquisitions.
Additional transactions within the framework of business combination	The standard provides guidelines which allow to determine whether the transaction should be accounted for as part of business combination or outside.	No provisions regarding additional transactions.

[97] Source: UK GAAP vs. IFRS The basics, Ernst & Young, 2011

Area	IFRS 3	UK GAAP
Transactions entered into prior to business combination.	Includes guidance on how to account for transactions concluded prior to the business combination.	No provisions regarding transactions prior to acquisition.
Non-controlling interests	Measurement at fair value or by proportionate share method	Minority interests are measured at the proportionate share in fair value of identifiable net assets of the acquiree.
Contingent consideration	Measured at fair value; changes in fair value recognized in profit and loss statement or directly in the statement of equity.	Measurement at fair value and the changes in fair value affects goodwill.
Cost of combination	Should be expensed in the period in which they are incurred except for costs related to the issuance of equity. These costs reduce the proceeds from the issue.	Increase purchase consideration.
Gain on acquisition negative goodwill.	Negative goodwill is recognized in profit and loss statement as one-off item.	Negative goodwill is recognized in the balance sheet and amortized to profit and loss over the period in which the carrying value of non-monetary assets is realized.
Measurement of goodwill	Goodwill is the difference between: a) the fair value of the purchase consideration plus non-controlling interests plus the interests which the acquirer held in the acquiree before the acquisition and b) the fair value of net identifiable assets acquired and liabilities assumed	Goodwill is the difference between: a) fair value of the purchase consideration and b) the fair value of the identifiable net assets acquired.

Area	IFRS 3	UK GAAP
Lease contracts when the acquiree is the lessee	The acquirer recognizes an asset or liability, depending on whether the lease terms are more or less favorable than the market. Asset is recognized if the terms of the lease are favorable. Where the terms of the lease are worse compared to the market, a liability is recognized.	No guidance.
Contingent assets	Cannot be identified	They can be recognized at fair value if it is possible to determine the likelihood of its realization.
Indemnification assets	Recognition and measurement is based on the accounting principles applied to indemnified item.	No guidance.
Reacquired rights	Recognized as intangible assets	No guidance
Business combination achieved in stages.	At combination date the acquirer should measure interests acquired before the combination at fair value. Result on revaluation should be recognized in profit or loss.	Purchase consideration consists of considerations transferred at each stage.
The measurement period	The measurement period is a period up to 12 months.	The measurement period is a period up to 24 months.
Adjustments to fair value during and after the measurement period	During the measurement period retrospective approach should be applied, after the measurement period adjustments should be accounted for as error corrections.	No guidance on accounting for adjustments during the measurement period. After the measurement period, adjustments should be accounted for as error corrections.

5.3 The provisions of the UK GAAP are currently being modified. Financial Reporting Council, which is responsible for creating legislation in scope of accounting, has developed a Financial Reporting Standard 102 "Financial Reporting Standard applicable in the UK and Ireland" (FRS 102). This standard replaces all previous standards. It is based on the provisions contained in International Accounting Standards for small and medium-sized enterprises. However, the standard text in the section on business combinations is not fully consistent with IFRS 3. Mandatory application of FRS 102 starts from 1 January 2015, however early application of its provisions is possible.

German accounting standards

5.4 In 2009, the German parliament adopted amendments for the accounting law. The aim of the reform was to simplify accounting rules and to bring them into alignment with international accounting standards. The table below presents the main differences between the amended provisions of German standards and international accounting standards in scope of business combinations.

Table 3: Main differences between the amended provisions of German standards and international accounting standards in scope of business combinations[98]

Area	IFRS	German Standards
Definition of a business	Business is an integrated set of activities and assets, which, managed in an appropriate manner, can generate benefits such as dividends.	Subject of business combination is an entity. Definition of an entity is similar to definition of an organized part of the enterprise.
Date of acquisition	Is the day in which the acquirer takes control of the acquiree.	Is a day when the acquirer becomes a subsidiary.
Contingent consideration	Measurement at fair value on the day of business combination.	Contingent consideration is an estimate. It is subject to disclosure if it is probable that it will be paid and its measurement is reliable.
Measurement at the balance sheet date.	Adjustments related to measurement of contingent consideration are recognized in the profit and loss statement or	Adjustments to contingent consideration are recognized retrospectively and change the goodwill.

[98] Source: IFRS versus German GAAP (revised) Summary of Similarities and differences, PricewaterhouseCoopers, 2010.

Area	IFRS	German Standards
	in equity, depending on initial recognition.	
Costs related to the combination	Expensed on the date they are incurred, unless they relate to issue of equity. Then these costs reduce the proceeds from the issuance of equity.	Costs of business combination incurred after the decision on the merger are recognized as assets in the balance sheet. All other costs are recognized in profit or loss when incurred.
Restructuring provisions at the combination date	Disclosure in the combined financial statement only if such a provision exists on the books of the acquiree, or if it should be recognized in accordance with IAS 37	Recognized only if general rules on recognition of the provisions are met.
Contracts with clients which do not arise from the contract.	If they meet the definition of assets they should be identified separately from goodwill.	They are not recognized separately from goodwill
Operating lease agreements where the acquiree is the lessor	If the agreement is favorable compared to the market, an asset should be recognized. If the contract is unfavorable, a liability arises.	They are not recognized separately from goodwill.
Contingent liabilities	Can be recognized if the definition of a liability is met and it can measure reliably.	Contingent liabilities may be recognized only if it meets the definition of a liability.
Indemnification assets	In the combined financial statement such assets are recognized on the same basis as the indemnified asset.	No recognition of indemnification assets.
Measurement of non-controlling interests	It can be measured at fair value or proportionate share.	It is measured at proportionate share.
Initial recognition of goodwill	Goodwill is the difference between: a) the fair value of the purchase consideration plus non-controlling interests plus the interests which the acquirer	Goodwill is the difference between the acquisition cost and the fair value of net assets acquired.

Area	IFRS	German Standards
	held in the acquiree before the acquisition and b) the fair value of net identifiable assets acquired and liabilities assumed	
Measurement of goodwill as of balance sheet date	Goodwill is not subject to depreciation. At each balance sheet date, goodwill is subject to impairment tests.	Goodwill is subject to depreciation.
Gain on business combination and negative goodwill	Gain on business combination is recognized in profit and loss.	Gain on business combination is included as separate line directly below equity.
Accounting for negative goodwill after the combination.	Negative goodwill is accounted for on the combination date.	It is amortized to profit or loss upon recognition of estimated losses as of business combination date.
Business combination in stages.	Interests acquired before the combination date are measured at fair value. Result on revaluation should be recognized in profit or loss	Measurement at fair value is recognized outside profit or loss.

6. APPLICATION OF ACQUISITION METHOD, POOLING OF INTERESTS AND PREDECESSOR ACCOUNTING FOR BUSINESS COMBINATIONS

Introduction

6.1 In this chapter, a practical example of accounting for a business combination is presented. In order to be able to present all the accounting methods for business combination, combining entities are under common control.

6.2 Profit or loss is combined in the same way in each method. It is based on the elimination of mutual transactions from the combined financial statement. Such elimination is based on assumption, that a company cannot make a profit from transacting with itself.

6.3 What is different for each method is the consolidation of balance sheet. Therefore, the author of the study restricted the presentation of each method to consolidation of assets, liabilities and equity.

Example 48

Company A and Company B belong to the same capital group. Company A owns 100% of shares in B, which was acquired two years ago. Company C has a 100% shares in the company A. Company C prepares consolidated financial statements. Company A uses the exemption for the preparation of the consolidated financial statements. Company A took over the assets of company B on 31 December 2013. Following the combination, Company B ceases to exist. Company A and B did not trade with each other.

Income statement for 12 months ended on 31 December 2013	Company A	Company B	Company C	Consolidated profit and loss
Revenue from sale of goods and services	4,918,138	1,937,260	15,450,767	22,231,165
Costs of sales	-1,302,617	-584,851	-7,923,735	-9,789,203
Gross profit	***3,615,521***	***1,352,409***	***7,527,032***	***12,441,961***
Wages and salaries and similar	-840,236	-178,437	-1,588,250	-2,606,923
Social security	-168,047	-35,687	-77,895	-281,629
Services	-127,877	-15,592	-136,716	-270,185
IT and telecommunication costs	-23,454	-13,118	-83,137	-119,710
Transport	-114,445	-22,486	-23,436	-160,367
Taxes and fees	-1,223	-20,683	-2,283	-24,189
Office space	-423,335	-234,576	-69,965	-727,876

Other operating costs and revenues	60	34	-231,856	-268,763
Total operating costs excluding costs of sales	***-1,698,557***	***-520,547***	***-2,213,538***	***-4,459,642***
EBITDA	**1,916,964**	**831,862**	**5,313,495**	**7,982,320**
Depreciation	-270,558	-863	-745,786	-1,406,743
Operating profit (EBIT)	**1,646,406**	**830,999**	**4,567,709**	***6,575,577***
Financial activity	-92,948	214	29,794	-62,939
Income tax	-285,836	-143,153	-791,792	-1,220,780
Net profit	**1,267,622**	**688,060**	**3,805,711**	***5,291,858***

Balance sheet as of 31 December 2013 [PLN]	**Company A**	**Company B**	**Company C**	**Consolidated balance sheet of company C**
Non current assets				
Tangibles	555,576	310,744	7,037,254	7,966,808
Intangibles	919,227	514,141	1,729,635	3,308,690
Interests and shares	2,850,678	0	4,144,032	0
Long term loans	0	37,388	125,778	146,320
Deferred tax asset	0	0	324,905	324,905
Goodwill	0	0	0	959,508
Customer list	0	0	0	234,599
Total	**4,325,481**	**862,274**	**13,361,604**	**12,940,830**
Current assets				
Inventories	93,224	644,206	1,247,217	2,036,803
Trade receivables	1,587,439	887,885	709,533	3,159,858
Short term loans	301,761	168,781	567,800	1,038,342
Prepayments	83,940	139	63,484	147,562
Other assets	129,029	72,168	242,784	443,981
Cash	464,918	1,241,466	8,843,324	10,549,707
Total	**2,660,311**	**3,014,645**	**11,674,142**	**17,376,254**
TOTAL ASSETS	**6,985,792**	**3,876,919**	**25,035,746**	**30,317,085**
Equity				
Shareholdings	1,765,019	987,209	3,446,000	3,446,000
Retained profits	548,218	306,629	6,152,271	4,548,522
Profit for the period	1,267,622	688,060	3,805,711	5,291,858
Total	**3,580,859**	**1,981,898**	**13,403,981**	**13,286,380**
Long term liabilities				
Financial liabilities	16,847	0	6,001,223	5,991,223
Other liabilities	0	0	0	0
Deferred tax liabilities	15,174	8,487	0	23,662
Total	**32,022**	**8,487**	**6,001,223**	**6,014,885**
Short term liabilities				
Overdraft	1,549,126	307,137	1,033,247	2,889,510

Trade liabilities	324,482	181,489	2,195,605	2,792,844
Wages and salaries	487,044	272,413	914,676	1,708,699
VAT liabilities	907,316	1,066,798	1,289,550	3,263,663
Other liabilities	24,113	13,487	45,371	82,971
Deferred revenue	80,831	45,210	152,092	278,133
Total	**3,372,911**	**1,886,534**	**5,630,541**	**11,015,820**
TOTAL LIABILITIES AND EQUITY	**6,985,792**	**3,876,919**	**25,035,746**	**30,317,085**

Acquisition method

6.4 Under the acquisition method, balance sheet items of the acquiree measured at fair value should be combined with balance sheet items of the acquirer measured at carrying value. Assets of the acquiree that were not recognized in its unit financial statements should be recognized in the combined financial statement.

Table 4: Assets and liabilities of the acquiree measured at fair value

B's assets and liabilities [PLN]	Book value	*Adjustment to fair value on the acquisition date*	Fair value
Non current assets			
Tangibles	310,744.49	*98,990.66*	409,735.15
Intangibles	514,141.11	*195,760.28*	709,901.39
Interests and shares	0.00		0.00
Long term loans	37,388.02		37,388.02
Deferred tax asset	0.00		0.00
Goodwill	0.00		0.00
Customer list	0.00	*123,478.00*	123,478.00
Total	**862,273.62**	***418,228.94***	**1,280,502.56**
Inventories	644,206.23	*61,135.73*	705,341.96
Trade receivables	887,885.28		887,885.28
Short term loans	168,780.87		168,780.87
Prepayments	138.61		138.61
Other assets	72,168.40		72,168.40
Cash	1,241,466.06		1,241,466.06
Total	**3,014,645.45**	***61,135.73***	**3,075,781.18**
Long term liabilities			
Financial liabilities	0.00		0.00
Other liabilities	0.00		0.00
Deferred tax liabilities	8,487.27		8,487.27
Total	**8,487.27**	***0.00***	**8,487.27**

B's assets and liabilities [PLN]	Book value	*Adjustment to fair value on the acquisition date*	Fair value
Short term liabilities			
Overdraft	307,136.86		307,136.86
Trade liabilities	181,489.27	*96,787.00*	278,276.27
Wages and salaries	272,412.94		272,412.94
VAT liabilities	1,066,798.13		1,066,798.13
Other short term liabilities	13,486.73		13,486.73
Deferred revenue	45,210.05		45,210.05
Total	**1,886,533.98**	***96,787.00***	**1,983,320.98**

6.5 Accounting for a business combination by acquisition method involves determination of goodwill. Goodwill is defined as the difference between the purchase consideration and the net assets acquired at fair value on the acquisition day. The value of the net assets measured at fair value on the combination date is PLN 2,364,475.49 (PLN 1,280,502.56 + PLN 3,075,781.18 + PLN 8,487.27 + PLN 1,983,320.98). When applying the acquisition method for business combinations under common control, purchase consideration is the historical price paid for shares in B. Therefore, purchase consideration will be the carrying value of the shares presented in the statement of A before the merger.

Table 5: Calculation of goodwill as of acquisition date [PLN]

Purchase consideration		2,850,678.00
Fair value of net assets as of acquisition date	2,364,475.49	
Fair value of net assets of company A	100%	2,364,475.49
Goodwill		**486,202.51**

6.6 Goodwill that company A recognizes in its accounting books measured by the acquisition method amounts to PLN 486,202.51.

6.7 Company A, in accounting for the combination, recognizes individual elements of the acquired business (assets and liabilities) to the account *Shares and interests in subsidiaries*, on which value of investment is recorded. As a result, company A should make the following entries in its accounting books:

Table 6: Company A accounting books entries [PLN]

In the acquirer books		
Dr Tangibles	409 735,15	
Cr Shares and interests in subsidiaries		409 735,15
Dr Intangibles	709 901,39	
Cr Shares and interests in subsidiaries		709 901,39
Dr Long term loans	37 388,02	
Cr Shares and interests in subsidiaries		37 388,02
Dr Customer lists	123 478,00	
Cr Shares and interests in subsidiaries		123 478,00
Dr Inventories	705 341,96	
Cr Shares and interests in subsidiaries		705 341,96
Dr Trade receivables	887 885,28	
Cr Shares and interests in subsidiaries		887 885,28
Dr Short term loans	168 780,87	
Cr Shares and interests in subsidiaries		168 780,87
Dr Short term prepayments	138,61	
Cr Shares and interests in subsidiaries		138,61
Dr Other assets	72 168,40	
Cr Shares and interests in subsidiaries		72 168,40
Dr Cash	1 241 466,06	
Cr Shares and interests in subsidiaries		1 241 466,06
Dr Goodwill	486 202,51	
Cr Shares and interests in subsidiaries		486 202,51
Cr Deferred tax liabilities		8 487,27
Dr Shares and interests in subsidiaries	8 487,27	
Cr Overdraft		307 136,86
Dr Shares and interests in subsidiaries	307 136,86	
Cr Trade liabilities		278 276,27
Dr Shares and interests in subsidiaries	278 276,27	
Cr Wages and salaries		272 412,94
Dr Shares and interests in subsidiaries	272 412,94	
Cr VAT liabilities		1 066 798,13
Dr Shares and interests in subsidiaries	1 066 798,13	
Cr Other liabilities		13 486,73
Dr Shares and interests in subsidiaries	13 486,73	
Cr Deferred revenues		45 210,05
Dr Shares and interests in subsidiaries	45 210,05	

6.8 As a result of the entries, Shares and interests in subsidiaries account has a zero balance. The value of the investment in B is replaced by the fair value of acquired assets and liabilities.

Table 7: *Shares and interests in subsidiaries* account on the date of settlement [PLN]

	Dr	Cr
opening balance	2,850,678.00	
settlement of the business combination on 31.12.2013	1,991,808.25	4,842,486.25
	4,842,486.25	4,842,486.25

	Dr	Cr
Shares and interests in subsidiaries account has the balance on the debit side so the entries settling the combination need to be moved		
Dr Shares and interests in subsidiaries	-4,842,486.25	
Cr Shares and interests in subsidiaries		-4,842,486.25
opening balance	2,850,678.00	
settlement of business combination on 31.12.2013	1,991,808.25	4 ,842,486.25
entries settling the combination on the account	-4,842,486.25	-4,842,486.25
closing balance	0.00	0.00

6.9 Since the merger took place on 31 December 2013, combined profit and loss account for 2013 will include only the data of the acquirer. Combined balance sheet will include combined assets and liabilities of Company A measured at fair value as of combination date. Comparative data are the data of the acquirer.

Table 8: Income statement for 12 months ended on 31 December 2013

	Company A	Company B	*Adjustments*	Consolidated
Revenue from sale of goods and services	4,918,138	1,937,260	*-1,937,260*	4,918,138
Costs of sales	-1,302,617	-584,851	*584,851*	-1,302,617
Gross profit	**3,615,521**	**1,352,409**	***-1,352,409***	**3,615,521**
Wages and salaries and similar	-840,236	-178,437	*178,437*	-840,236
Social security	-168,047	-35,687	*35,687*	-168,047
Services	-127,877	-15,592	*15,592*	-127,877
IT and telecommunication costs	-23,454	-13,118	*13,118*	-23,454
Transport	-114,445	-22,486	*22,486*	-114,445
Taxes and fees	-1,223	-20,683	*20,683*	-1,223
Office space	-423,335	-234,576	*234,576*	-423,335
Other operating costs and revenues	60	34	*-34*	60
Total operating costs excluding costs of sales	**-1,698,557**	**-520,547**	***520,547***	**-1,698,557**
EBITDA	**1,916,964**	**831,862**	***-831,862***	**1,916,964**
Depreciation	-270,558	-863	*863*	-270,558
Operating profit (EBIT)	**1,646,406**	**830,999**	***-830,999***	**1,646,406**
Financial activity	-92,948	214	*-214*	-92,948
Income tax	-285,836	-143,153	*143,153*	-285,836
Net profit	**1,267,622**	**688,060**	***-688,060***	**1,267,622**

Table 9: Balance sheet as of 31 December 2013 [PLN]

					Consolidation adjustments					
	Company A	**Company B**	***Adjustments***	**Consolidated balance sheet (A and B)**	Fair value adjustment	Investment in B	Goodwill	Equity adjustment	Retained profits adjustment	Profit for the period adjustment
Non-current assets										
Tangibles	555,576	310,744	*98,991*	965,311	98,991					
Intangibles	919,227	514,141	*195,760*	1,629,128	195,760					
Interests and shares	2,850,678	0	*-2,850,678*	0		-2,850,678				
Long term loans	0	37,388	*0*	37,388						
Deferred tax asset	0	0	*0*	0						
Goodwill	0	0	*486,203*	486,203			486,203			
Customer list			*123,478*	123,478	123,478					
Total	**4,325,481**	**862,274**	***-1,946,247***	**3,241,508**	**294,751**	**-2,850,678**	**486,203**	**0**	**0**	**0**
Current assets										
Inventories	93,224	644,206	*61,136*	798,566	61,136					
Trade receivables	1,587,439	887,885	*0*	2,475,325						
Short term loans	301,761	168,781	*0*	470,542						
Prepayments	83,940	139	*0*	84,078						
Other assets	129,029	72,168	*0*	201,197						
Cash	464,918	1,241,466	*0*	1,706,384						
Total	**2,660,311**	**3,014,645**	***61,136***	**5,736,093**	**61,136**	**0**	**0**	**0**	**0**	**0**
TOTAL ASSETS	**6,985,792**	**3,876,919**	***-1,885,111***	**8,977,601**	**355,887**	**-2,850,678**	**486,203**	**0**	**0**	**0**
Equity										
Shareholdings	1,765,019	987,209	*-987,209*	1,765,019				-987,209		
Retained profits	548,218	306,629	*-306,629*	548,218					-306,629	
Profit for the period	1,267,622	688,060	*-688,060*	1,267,622						-688,060
Total	**3,580,859**	**1,981,898**	***-1,981,898***	**3,580,859**	**0**	**0**	**0**	**-987,209**	**-306,629**	**-688,060**
Long term liabilities										
Financial liabilities	16,847	0	*0*	16,847						
Other liabilities	0	0	*0*	0						
Deferred tax liabilities	15,174	8,487	*0*	23,662						
Total	**32,022**	**8,487**	***0***	**40,509**	**0**	**0**	**0**	**0**	**0**	**0**
Short term liabilities										
Overdraft	1,549,126	307,137	*0*	1,856,263	0					
Trade liabilities	324,482	181,489	*96,787*	602,759	96,787					
Wages and salaries	487,044	272,413	*0*	759,457						
VAT liabilities	907,316	1,066,798	*0*	1,974,114						
Other short term liabilities	24,113	13,487	*0*	37,600						
Deferred revenue	80,831	45,210	*0*	126,041						
Total	**3,372,911**	**1,886,534**	***96,787***	**5,356,232**	**96,787**	**0**	**0**	**0**	**0**	**0**
TOTAL LIABILITIES AND EQUITY	**6,985,792**	**3,876,919**	***-1,885,111***	**8,977,601**	**96,787**	**0**	**0**	**-987,209**	**-306,629**	**-688,060**

6.10 The operations of B are moved to company A. On the basis of the accounting and commercial law company B ceases to exist. This means that it should close its accounts. Company B should make the following entries.

Table 10: Company B entries [PLN]

Movements of equity to shareholders		
Dr Retained earnings	306,629.05	
Cr Shareholders		306,629.05
Dr Profit for the period	688,059.98	
Cr Shareholders		688,059.98
Shareholders account after the movement		
	Dr	**Cr**
opening balance		987,208.79
movement on the closing of accounts day		306,629.05
movement on the closing of accounts day		688,059.98
closing balance	0.00	1,981,897.82

Table 11: Movement of separated assets and liabilities to shareholders account [PLN]

Dr Depreciation of tangibles	123,405.00	
Cr Shareholders		123,405.00
Dr Depreciation of intangibles	85,645.00	
Cr Shareholders		85,645.00
Dr Deferred tax liabilities	8,487.27	
Cr Shareholders		8,487.27
Dr Overdraft	307,136.86	
Cr Shareholders		307,136.86
Dr Trade liabilities	181,489.27	
Cr Shareholders		181,489.27
Dr Wages and salaries	272,412.94	
Cr Shareholders		272,412.94
Dr VAT liabilities	1,066,798.13	
Cr Shareholders		1,066,798.13
Dr Other short term liabilities	13,486.73	
Cr Shareholders		13,486.73
Dr Deferred revenues	45,210.05	
Cr Shareholders		45,210.05
Cr Tangibles		434,149.49
Dr Shareholders	434,149.49	
Cr Intangibles		599,786.11
Dr Shareholders	599,786.11	
Cr Long term loans		37,388.02
Dr Shareholders	37,388.02	

Cr Inventories		644,206.23
Dr Shareholders	644,206.23	
Cr Trade receivables		887,885.28
Dr Shareholders	887,885.28	
Cr Short term loans		168,780.87
Dr Shareholders	168,780.87	
Cr Prepayments		138.61
Dr Shareholders	138.61	
Cr Other assets		72,168.40
Dr Shareholders	72,168.40	
Cr Cash		1,241,466.06
Dr Shareholders	1,241,466.06	

Table 12: Shareholders account on the day of closing of the books

	Dr	Cr
balance after movements	0.00	1,981,897.82
closing of assets and liabilities accounts	4,085,969.07	2,104,071.25
	4,085,969.07	4,085,969.07
Shareholders account has balance on the credit side, so entries on the debit site should be moved		
balance after movements	0.00	1,981,897.82
closing of assets and liabilities	4,085,969.07	2,104,071.25
movements from debit to credit site	-4,085,969.07	-4,085,969.07
closing balance	0.00	0.00

As a result of accounting entries made, balances on all accounts shall be zero.

6.11 Regardless of the applied method of accounting for the combination, entries in the books of the acquiree will be the same.

Pooling of interests

6.12 Pooling of interests method consists of aggregating balance sheet items of the acquirer and acquiree, both at carrying value, determined in accordance with the acquirer's accounting policy. There is no need to measure acquired assets and liabilities at fair value or calculate goodwill. The difference between purchase consideration and the value of net assets acquired is recognized as part of the equity. The entries in the acquirer’s accounting books will be as follows:

Table 13: Acquirer's accounting books entries [PLN]

Dr Tangibles	310 744	
Cr Equity on the combination		310 744
Dr Intangibles	514 141	
Cr Equity on the combination		514 141
Dr Long term loans	37 388	
Cr Equity on the combination		37 388
Dr Inventories	644 206	
Cr Equity on the combination		644 206
Dr Trade receivables	887 885	
Cr Equity on the combination		887 885
Dr Short term loans	168 781	
Cr Equity on the combination		168 781
Dr Short term prepayments	139	
Cr Equity on the combination		139
Dr Other assets	72 168	
Cr Equity on the combination		72 168
Dr Cash	1 241 466	
Cr Equity on the combination		1 241 466
Cr Deferred tax liabilities		8 487
Dr Equity on the combination	8 487	
Cr Overdraft		307 137
Dr Equity on the combination	307 137	
Cr Trade liabilities		181 489
Dr Equity on the combination	181 489	
Cr Wages and salaries		272 413
Dr Equity on the combination	272 413	
Cr VAT liabilities		1 066 798
Dr Equity on the combination	1 066 798	
Cr Other liabilities		13 487
Dr Equity on the combination	13 487	
Cr Deferred revenues		45 210
Dr Equity on the combination	45 210	
Cr Shareholders		987 209
Dr Equity on the combination	987 209	
Cr Retained profits		306 629
Dr Equity on the combination	306 629	
Cr Profit for the period		688 060
Dr Equity on the combination	688 060	
Dr Shareholders	987 209	
Cr Equity on the combination		987 209
Dr Equity on the combination	2 850 678	
Cr Shares and interests in subsidiaries		2 850 678

6.13 As a result of entries made, balance of the Equity on combination account shall amount to PLN 1,863,469.

Table 14: Equity on combination account [PLN]

	Dr	Cr
Opening balance		
Business combination entries	6,727,597	4,864,128
Balance on 31 December 2013	1,863,469	

6.14 Profit and loss statement should be combined starting from the beginning of the year in which the combination took place. Comparative data should be presented as if the combination took place in the previous year.

Table 15: Income statement for 12 months ended on 31 December 2013

	Company A	Company B	Consolidation adjustments	Consolidated profit and loss
Revenue from sale of goods and services	4,918,138	1,937,260	0	6,855,398
Costs of sales	-1,302,617	-584,851	0	-1,887,467
Gross profit	***3,615,521***	***252,409***	***0***	***3,867,930***
Wages and salaries and similar	-840,236	-178,437	0	-1,018,673
Social security	-168,047	-35,687	0	-203,735
Services	-127,877	-15,592	0	-143,469
IT and telecommunication costs	-23,454	-13,118	0	-36,572
Transport	-114,445	-22,486	0	-136,931
Taxes and fees	-1,223	-20,683	0	-21,906
Office space	-423,335	-234,576	0	-657,911
Other operating costs and revenues	60	34	0	93
Total operating costs excluding costs of sales	***-1,698,557***	***-155,764***	***0***	***-1,854,321***
EBITDA	**1,916,964**	**96,645**	**0**	**2,013,609**
Depreciation	-270,558	-863	0	-271,421
Operating profit (EBIT)	**1,646,406**	**95,782**	**0**	**1,742,188**
Financial activity	-92,948	214	0	-92,733
Income tax	-285,836	-143,153	0	-428,990
Net profit	**1,267,622**	**688,060**	**0**	**1,955,682**

6.15 Combined balance sheet will be as follows:

Table 16: Balance sheet as of 31 December 2013 [PLN]

	Company A	Company B	*Adjustments*	Consolidated balance sheet (A and B)	Consolidation adjustments				
					Investment in B	Equity adjustment	Equity on business combination		
Non-current assets									
Tangibles	555,576	310,744	*0*	866,321					
Intangibles	919,227	514,141	*0*	1,433,368					
Interests and shares	2,850,678	0	*-2,850,678*	0	-2,850,678				
Long term loans	0	37,388	*0*	37,388					
Deferred tax asset	0	0	*0*	0					
Goodwill	0	0	*0*	0					
Total	**4,325,481**	**862,274**	***-2,850,678***	**2,337,077**	**-2,850,678**	**0**	**0**	**0**	**0**
Current assets									
Inventories	93,224	644,206	*0*	737,430					
Trade receivables	1,587,439	887,885	*0*	2,475,325					
Short term loans	301,761	168,781	*0*	470,542					
Prepayments	83,940	139	*0*	84,078					
Other assets	129,029	72,168	*0*	201,197					
Cash	464,918	1,241,466	*0*	1,706,384					
Total	**2,660,311**	**3,014,645**	***0***	**5,674,957**	**0**	**0**	**0**	**0**	**0**
TOTAL ASSETS	**6,985,792**	**3,876,919**	***-2,850,678***	**8,012,034**	**-2,850,678**	**0**	**0**	**0**	**0**
Equity									
Shareholdings	1,765,019	987,209	*-987,209*	1,765,019		-987,209			
Retained profits	548,218	306,629	*0*	854,847		0			
Profit for the period	1,267,622	688,060	*0*	1,955,682					
Equity on combination			*-1,863,469*	-1,863,469			-1,863,469		
Total	**3,580,859**	**1,981,898**	***-987,209***	**2,712,079**	**0**	**-987,209**	**-1,863,469**	**0**	**0**
Long term liabilities									
Financial liabilities	16,847	0	*0*	16,847					
Other liabilities	0	0	*0*	0					
Deferred tax liabilities	15,174	8,487	*0*	23,662					
Total	**32,022**	**8,487**	***0***	**40,509**	**0**	**0**	**0**	**0**	**0**
Short term liabilities									
Overdraft	1,549,126	307,137	*0*	1,856,263					
Trade liabilities	324,482	181,489	*0*	505,972					
Wages and salaries	487,044	272,413	*0*	759,457					
VAT liabilities	907,316	1,066,798	*0*	1,974,114					
Other short term liabilities	24,113	13,487	*0*	37,600					
Deferred revenue	80,831	45,210	*0*	126,041					
Total	**3,372,911**	**1,886,534**	***0***	**5,259,445**	**0**	**0**	**0**	**0**	**0**
TOTAL LIABILITIES AND EQUITY	**6,985,792**	**3,876,919**	***-987,209***	**8,012,034**	**0**	**-987,209**	**-1,863,469**	**0**	**0**

Predecessor Accounting

6.16 Predecessor accounting method can be used in situations when the combining entities are under common control. The acquirer, which accounts for the combination using predecessor accounting does not measure assets and liabilities at fair value. The carrying values of the acquirer are combined with the values of the acquiree derived from the consolidated financial statements of the parent company of the capital group. If more than two companies prepare consolidated financial statements, data should be derived from the consolidated financial statements prepared by the ultimate parent company.

6.17 The acquirer does not calculate goodwill. However, application of predecessor accounting method involves recognition of goodwill in the books of the acquirer. Value of goodwill is imported from consolidated financial statements of the ultimate parent company, attributed to the acquiree.

6.18 Under the predecessor accounting there are two possible ways for consolidation of financial result. The acquirer may include in its accounts the financial result for the entire financial year, even though the combination took place during the financial year. In such a situation, the comparative figures should be adjusted so as to take into account the acquiree's data for the previous year. Alternatively, the company recognizes the acquiree's result in its financial statements and books of accounts prospectively, i.e. from the combination date. In such a situation, there is no need for adjustment of comparative data.

6.19 When accounting for a business combination by predecessor accounting method, data from consolidated financial statements should be used.

Table 17: Data of Company B, derived from consolidated financial statement [PLN]

Non-current assets	
Tangibles	434,311
Intangibles	659,829
Interests and shares	0
Long term loans	37,388
Deferred tax asset	0
Goodwill	683,071
Customer list	144,834
Total	**1,959,433**
Current assets	
Inventories	667,662
Trade receivables	887,885
VAT receivables	0
Short term loans	168,781

Prepayments	139
Other assets	72,168
Cash	1,241,466
Total	**3,038,101**
Equity	
Shareholdings	0
Retained profits	0
Profit for the period	0
Total	**0**
Long term loans	
Financial liabilities	0
Other liabilities	0
Deferred tax liabilities	8,487
Total	**8,487**
Short term liabilities	
Overdraft	307,137
Trade liabilities	216,056
Wages and salaries	306,979
VAT liabilities	1,066,798
Other short term liabilities	13,487
Deferred revenue	45,210
Total	**1,955,667**

6.20 When making accounting entries, first the investment in B should be de-recognized, in correspondence with equity [PLN].

Table 18: De-recognition of investment in B [PLN]

Dr Equity on combination	2,850,678.00	
Cr Investment in B		2,850,678.00

6.21 Acquired assets and liabilities should be recognized on equity. Usually a separate account is used and the result is presented either as a separate line within equity or as retained profits.

Table 19: Recognition of acquired assets [PLN]

Dr Tangibles	434 311,49	
Cr Equity on combination		434 311,49
Dr Intangibles	659 828,51	
Cr Equity on combination		659 828,51
Dr Long term loans	37 388,02	
Cr Equity on combination		37 388,02
Dr Goodwill	683 070,53	
Cr Equity on combination		683 070,53
Dr Customer lists	144 834,00	
Cr Equity on combination		144 834,00
Dr Inventories	667 662,23	
Cr Equity on combination		667 662,23
Dr Trade receivables	887 885,28	
Cr Equity on combination		887 885,28
Dr Short term loans	168 780,87	
Cr Equity on combination		168 780,87
Dr Short term prepayments	138,61	
Cr Equity on combination		138,61
Dr Other assets	72 168,40	
Cr Equity on combination		72 168,40
Dr Cash	1 241 466,06	
Cr Equity on combination		1 241 466,06
Dr Equity on combination	8 487,27	
Cr Deferred tax liabilities		8 487,27
Dr Equity on combination	307 136,86	
Cr Overdraft		307 136,86
Dr Equity on combination	216 056,27	
Cr Trade liabilities		216 056,27
Dr Equity on combination	306 978,94	
Cr Wages and salaries		306 978,94
Dr Equity on combination	1 066 798,13	
Cr VAT liabilities		1 066 798,13
Dr Equity on combination	13 486,73	
Cr Other liabilities		13 486,73
Dr Equity on combination	45 210,05	
Cr Deferred revenues		45 210,05

6.22 The difference between investment in B and the value of acquired net assets amounting to PLN 182,701.74 should be presented in the equity.

Table 20: Equity on combination account

	Dr	Cr
opening balance		
entries due to predecessor accounting	4,814,832.25	4,997,534.00
closing balance		182,701.74

6.23 Consolidated profit and loss statement as of combination date:

Table 21: Income statement for 12 months ended on 31 December 2013[PLN]

	Company A	**Net capital of B in consolidated financial statement by C**		**Combined balance sheet of A and B**
Revenue from sale of goods and services	4,918,138	1,937,260	-1,937,260	4,918,138
Costs of sales	-1,302,617	-584,851	584,851	-1,302,617
Gross profit	***3,615,521***	***1,352,409***	***-1,352,409***	***3,615,521***
Wages and salaries and similar	-840,236	-178,437	178,437	-840,236
Social security	-168,047	-35,687	35,687	-168,047
Services	-127,877	-15,592	15,592	-127,877
IT and telecommunication costs	-23,454	-13,118	13,118	-23,454
Transport	-114,445	-22,486	22,486	-114,445
Taxes and fees	-1,223	-20,683	20,683	-1,223
Office space	-423,335	-234,576	234,576	-423,335
Other operating costs and revenues	60	34	-34	60
Total operating costs excluding costs of sales	***-1,698,557***	***-520,547***	***520,547***	***-1,698,557***
EBITDA	**1,916,964**	**831,862**	**-831,862**	**1,916,964**
Depreciation	-270,558	-863	863	-270,558
Operating profit (EBIT)	**1,646,406**	**830,999**	**-830,999**	**1,646,406**
Financial activity	-92,948	214	-214	-92,948
Income tax	-285,836	-143,153	143,153	-285,836
Net profit	**1,267,622**	**688,060**	**-688,060**	**1,267,622**

Consolidated balance sheet as of combination date:

Table 22: Balance sheet as of 31 December 2013 [PLN]

	Company A	Net capital of B in consolidated financial statement by C	*Consolidation adjustments*	Combined balance sheet of A and B	Investment in B	Equity adjustment due to consolidation	
Non-current assets							
Tangibles	555,576	434,311	*0*	989,888			
Intangibles	919,227	659,829	*0*	1,579,055			
Interests and shares	2,850,678	0	*-2,850,678*	0	-2,850,678		
Long term loans	0	37,388	*0*	37,388			
Deferred tax asset	0	0	*0*	0			
Goodwill	0	683,071	*0*	683,071			
Customer list		144,834		144,834			
Total	**4,325,481**	**1,959,433**	***-2,850,678***	**3,434,236**	**-2,850,678**	**0**	**0**
Current assets							
Inventories	93,224	667,662	*0*	760,886			
Trade receivables	1,587,439	887,885	*0*	2,475,325			
Short term loans	301,761	168,781	*0*	470,542			
Prepayments	83,940	139	*0*	84,078			
Other assets	129,029	72,168	*0*	201,197			
Cash	464,918	1,241,466	*0*	1,706,384			
Total	**2,660,311**	**3,038,101**	***0***	**5,698,413**	**0**	**0**	**0**
TOTAL ASSETS	**6,985,792**	**4,997,534**	***-2,850,678***	**9,132,648**	**-2,850,678**	**0**	**0**
Equity							
Shareholdings	1,765,019	0	*0*	1,765,019			
Retained profits	548,218	0	*0*	548,218			
Profit for the period	1,267,622	0	*0*	1,267,622			
Other equity			*182,702*	182,702		182,702	
Total	**3,580,859**	**0**	***0***	**3,763,561**	**0**	**182,702**	**0**
Long term liabilities							
Financial liabilities	16,847	0	*0*	16,847			
Other liabilities	0	0	*0*	0			
Deferred tax liabilities	15,174	8,487	*0*	23,662			
Total	**32,022**	**8,487**	***0***	**40,509**	**0**	**0**	**0**
Short term liabilities							
Overdraft	1,549,126	307,137	*0*	1,856,263			
Trade liabilities	324,482	216,056	*0*	540,539			
Wages and salaries	487,044	306,979	*0*	794,023			
VAT liabilities	907,316	1,066,798	*0*	1,974,114			
Other short term liabilities	24,113	13,487	*0*	37,600			
Deferred revenue	80,831	45,210	*0*	126,041			
Total	**3,372,911**	**1,955,667**	***0***	**5,328,578**	**0**	**0**	**0**
TOTAL LIABILITIES AND EQUITY	**6,985,792**	**1,964,154**	***0***	**9,132,648**	**0**	**182,702**	**0**

Comparison of methods applied

6.24 Acquisition method applied to business combinations results in assets and liabilities recognized at fair value on combination date. Thus depreciation and amortization in the combined financial statement is calculated based on fair value of all identifiable net assets. This method requires recognition of goodwill and its depreciation and/or testing against impairment. Applying this method to account for business combinations under common control results in measurement performed at combination date rather than the date of obtaining control. In case of acquisition method applied for business combinations under common control, the main difficulty lies in determining the moment of taking control. In such transactions, the acquirer obtains control during the period preceding the combination date.

6.25 Pooling of interests applies only to accounting for business combinations under common control. Depreciation in the financial statements is calculated based on the book value of the acquired assets. No goodwill is recognized. This means that the combined financial statements prepared after combination date include depreciation charges lower than in case of the acquisition method. Consequently, in case pooling of interest method is used, profit and loss statement does not reflect the true cost of the business combination. The excess of the costs of obtaining of control over assets acquired is recognized directly in equity.

6.26 If predecessor accounting method is applied, depreciation is calculated based on the values attributed to acquiree’s assets, derived from consolidated financial statements of the ultimate parent. These assets were measured at fair value as of the day of the group assuming control. This means that profit and loss recognizes cost of combination as of the day control over acquired assets was assumed, rather than combination date.

6.27 Two alternative approaches can be applied under the predecessor accounting method:

a) prospective approach - the combined financial statement should take into account acquiree’s data from the combination date onwards,

b) retrospective approach - the combined financial statement should include the data of the acquiree for the entire reporting period in which business combination took place; use of this method requires restatement of comparatives as if the merger occurred in the previous period.

7. FRESH START ACCOUNTING

Introduction

7.1 Fresh start accounting is provided in Accounting Standard Codification 852 "Reorganization". It regulates accounting principles to be followed by companies after reorganization. The underlying assumption of this method is that after bankruptcy procedure is completed, a new company is created – a successor of the restructured company – and this new company applies the fresh start principles[99].

7.2 Pursuant to accounting regulations, a new company is formed, whose assets should be measured separately. This method is similar to acquisition method applied for business combinations. Carrying amount of the assets and liabilities of the company after the reorganization is similar to purchase consideration, is determined in a business combination accounted for using acquisition method.

7.3 Method of fresh start accounting may be applied by companies that prepare their financial statements in accordance with U.S. accounting standards. International accounting standards do not provide for such a possibility.

The criteria for the application of fresh start accounting

7.4 In order to apply the fresh start accounting method, the entity needs to meet certain criteria.

- Reorganization value of the new company immediately prior to court approval for the reorganization plan should be lower than total value of postpetition liabilities and allowed claims.
- Immediately prior to court approval for the reorganization plan, holders of voting rights will have less than 50 % of voting rights in the new company[100].

7.5 U.S. law requires that a reorganization plan is submitted to the court for approval. Only after receiving such approval, entities may apply reorganization principles.

7.6 Reorganization value of an entity is determined in accordance with U.S. reorganization law. This is an approximation of fair value of the entity, excluding liabilities. It is determined in order to determine the price at which the entity could be sold after completion of the reorganization process. The value is usually calculated using discounted cash flows.

[99] Wiley GAAP 2014, str. 1141.
[100] Guide to Accounting for Bankruptcies and Liquidations, PricewaterhouseCoopers 2010, p. 56.

Application of fresh start accounting

7.7 An entity applying fresh start accounting method should adjust its financial statement from the day preceding the date of approval of the reorganization plan by the amount of impact of reorganization plan on liabilities and equity as well as effects of application of fresh start accounting.

Example 49

Company A is in process of reorganization. Reorganization plan was approved by the court. The value of liabilities subject to redemption is PLN 3,100,000. Reorganization value, i.e. value of the company excluding liabilities, is PLN 4,000,000 and has been confirmed by the court. The value of the company after reorganization amounts to PLN 2,600,000. How should fresh start accounting method be applied to reorganization of company A?

Company A is in process of reorganization, therefore, ongoing concern is at risk. In such a situation, the company should present all assets and liabilities as short-term.

Statement of financial position as of 31 December 2013 [PLN]	**Company A**			**Company B**
	Balance sheet of the company undergoing reorganization	Reorganization adjustments	Fresh start accounting adjustments	Successor company of A, created as a result of reorganization
Tangibles	555,576		124,000	679,576
Intangibles	919,227		25,098	944,325
Interests and shares	1,380,561			1,380,561
Goodwill	0		259,346	259,346
Customer list	0		176,709	176,709
Inventories	93,224			93,224
Trade receivables	87,439			87,439
Prepayments	129,029			129,029
Cash	249,790			249,790
Total	**3,414,847**			**4,000,000**
TOTAL ASSETS	**3,414,847**		**585,153**	**4,000,000**
Equity				
Shareholdings	500,000		-500,000	0
Retained profits	-1,585,153	500,000	1,085,153	0
Shareholding resulting from reorganization		*2,600,000*		2,600,000
Total	**-1,085,153**	**3,100,000**	**585,153**	**2,600,000**
Financial liabilities	16,847			16,847
Other liabilities	0			0

Deferred tax liabilities	15,174			15,174
Overdraft	49,126			49,126
Trade liabilities	24,482			24,482
Wages and salaries	787,044			787,044
VAT liabilities	424,017			424,017
Other short term liabilities	2,478			2,478
Liabilities subject to restructuring	3,100,000	-3,100,000		0
Deferred revenue	80,831			80,831
Total	**4,500,000**	**-3,100,000**	**0**	**1,400,000**
TOTAL LIABILITIES AND EQUITY	**3,414,847**	**0**	**585,153**	**4,000,000**

Application of fresh start accounting may result in creation of goodwill. In such a situation, goodwill is the difference between reorganization value and fair value of separately identifiable assets.

Reorganization value	PLN	4,000,000
Fair value of identifiable assets	PLN	3,740 654
Goodwill	PLN	259,346

Application of fresh start accounting method in the company under reorganization should result in following entries.

• **Impact of reorganization**		
Dr Liabilities subject to reorganization	PLN	3,100,000
Cr Shareholder capital after reorganization	PLN	2,600,000
Cr Profit on redemption of liabilities	PLN	500,000
• **Impact of fresh start accounting**		
Dr Tangibles	PLN	124,000
Dr Intangibles	PLN	25,098
Dr Goodwill	PLN	259,346
Dr Customer lists	PLN	176,709
Dr Shareholding capital	PLN	500,000
Cr Retained profits	PLN	1,085,153

8. BUSINESS COMBINATIONS OF NOT-FOR-PROFIT COMPANIES

Introduction

8.1 The objective of private sector entities is to earn profits. However some entities have been created for other purposes. Their goal is to provide goods and services to the public but they are not profit-oriented. Therefore, the position of interest holders in such entities might be different. Not for profit entities might include public sector entities or other organizations.

8.2 Not for profit entities do not provide return in form of profit to interest holders.

8.3 Not for profit entities are obligated to apply generally accepted accounting principles. The basis for keeping books is the Act on accounting. In case of public sector entities, issues related to accounting are also regulated by other legislation, such as the Ordinance on specific principles of accounting in public finance sector entities, as well as Act on public finance.

8.4 Not for profit entities may be combined. This gives rise to certain consequences arising from the provisions of the Act on accounting.

8.5 Since the provisions of the Act on accounting do not regulate non-profit combinations, other rules should be applied in order to comply with the economic nature of the transaction.

8.6 International accounting standards do not regulate combinations of not for profit entities in a manner different from other entities. Given the fact that the position of the owners of such entities is different than in profit oriented entities, application of rules governing accounting for profit oriented entities will not always be consistent with economic nature of the transaction.

8.7 US GAAP refers in detail to business combinations of nonprofit entities.

Business combinations according to Accounting Standard Codification 958 "Not-for-profit entities"

8.8 Combinations of private sector always are commercial in nature. Combinations of non-profit organizations in many cases are not pursued with the desire to make a profit.

8.9 In a business combination of not for profit entities, U.S. regulations distinguish between two types of transactions: mergers and acquisitions.

8.10 Combination of non-profit is a transaction or other event in which the governing bodies of two or more units give control over these units to create a new non-profit entity.

Example 50

The governing bodies of the Museum of City X and the Museum of City Y decided to merge their operations. The merger created the Museum of District X. The director of the Museum of District X is a person who was not a member of the managing body of any of the merging museums.

This type of combination must be accounted for by pooling of interests. Following the merger, the governing bodies of the merging museums ceased to exercise control over the newly established cultural institution.

8.11 Acquisition by a non-profit entity is defined as a transaction or other event in which a non-profit acquirer obtains control over one or more non-profit activities or businesses, and at initial recognition recognizes in its financial statement acquired assets and liabilities.

Example 51

Public hospital in the town of X combines its operations with the public hospital in the town Y. As a result of merger, the hospital in X ceases to exist. Directors of the hospital in town X were incorporated into the governing body in hospital of town Y. Following the merger, the managing body of the hospital Y consists of directors of hospitals X and Y.

This type of connection is an acquisition. The existing managing authorities did not surrender control over the combining entities - the managing hospital Y took control of the hospital X. It is therefore necessary to identify the acquirer and apply the acquisition method of accounting for this type of combination.

8.12 In the case of a business combination of nonprofit entities US GAAP provides for a carryover method, which is similar to a pooling of interests. Using the pooling of interests method, we combine the assets and liabilities as if the merger occurred at the beginning of the financial year and adjust the comparatives. Applying the carryover method the assets and liabilities of the merging entities are combined since the combination date, the comparatives are not adjusted.

8.13 If the entity is a party to acquisition, acquirer should be identified and acquisition method applied.

8.14 Both the acquisition method and the pooling of interests method are presented in Chapter 6 of this report.

8.15 In case of applying the acquisition method for business combination of non-profit entities, goodwill or negative goodwill may arise. The acquirer recognizes goodwill if the acquiree's activity is supported mainly by costs and returns associated with the investment. In case the opposite is true, the non-profit does not recognize the goodwill but the expense in the income statement. Negative goodwill is recognized directly in the income statement.

9. PROPOSALS FOR CHANGES IN THE EXISTING PROVISIONS OF ACT ON ACCOUNTING

9.1 Directive 2013/34/EU of the European Parliament and of the Council of 26 June 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings, distinguishes between entities applying accounting rules for microunits, small units, medium units and large entities. This division takes place, due to their income, total assets and number of employees.

Micro entities

9.2 According to the author of this publication business combinations between micro entities may be accounted for applying simplified rules. Possibility of applying pooling of interests method for micro entities should be considered. Simplified rules for business combinations are allowed by the Directive.

Small and medium entities

9.3. In designing the provisions of the Act on accounting, one must take into consideration the cost of applying regulations, as borne especially by small and medium sized entities. On the other hand, it should be remembered that the role of small and medium enterprises in the economy is growing and therefore so does the importance of financial information presented by those entities in their financial statements. Increased importance of small and medium entities is exemplified by e.g. creation of NewConnect stock market in 2007. Financial statements are the basic source of information about companies listed on that market. Small and medium companies listed on NewConnect market are obligated to prepare and publish their financial statements, both unit and consolidated, in accordance with the Act on accounting (Polish GAAP). This means, that the safety of investors depends largely on reliability of national accounting regulations. It should be remembered, that quality of information contained in the financial statements, while it does not determine the choices made by investors, nonetheless does influence their decisions. When designing amendments to the Act on accounting, facilitating solutions for SMEs should be kept in mind, remembering however, that shares of such entities might be traded on the regulated market. Does that mean that provisions in scope of scope of business combinations should be the same as IFRS rules applied by large entities? I believe not, however such provisions should obligate the medium and small entities to present economic impacts of transactions. Therefore, any provisions not capable of meeting this overriding principle of accounting should be removed from the Act and guidelines should be provided for application of new solutions in the national accounting standards. Therefore, it would seem that small and medium companies would be obligated to increase their efforts in presenting the economic nature of combinations, but a national accounting standard in this scope could effectively mitigate costs related to increased scope of presentation.

9.4 Proposed amendments to provisions in scope of business combinations may involve the need to modify other areas of accounting as well. The scope of this study does not envisage identification of such areas.

Recommendations and justification hereof

9.5 Recommendations were prepared based on provisions of the Act of 29 September 1994 on accounting (consolidated text: Journal of Laws of 2013, item 330 as subsequently amended) and provisions of the Directive. However, it should be noted, that the Directive says very little about the issue of business combinations. Current provisions, which were described in the recommendations, do not raise any doubts with me. In some situations, I recommend maintaining existing regulations, e.g. those pertaining to cost of combinations. In such cases I present a justification anyway, since I had certain doubts with respect to these areas and I believe the readers of this study could have similar doubts.

9.6 Amendment introducing a definition of business combination into the Act.

Current provision	Recommended provision
No definition.	Art. 3 par. 1. A business combination is a transaction or other event through which an acquiring entity takes over control over one or more undertakings. Transactions sometimes referred to as “true mergers” or “merger of equals” also constitute business combinations.

Justification for amendment
Act on accounting uses the term “business combination” but does not provide a definition for it. As a result of lack of statutory definition of business combinations, pursuant to art. 10 par. 3 of the Act on accounting, the entities may (and in practice, should) refer to the provisions of the National Accounting Standard. Absence of a national standard in scope of business combinations results in entities applying the accounting law referring to international regulations. Proposed definition of business combinations was taken from International Financial Reporting Standard 3 "Business Combinations". In the opinion of the author of this study, importing the definition of business combination from the international standards will facilitate application of accounting law and thus reduce the cost of its application. First,

entities applying the national regulations in scope of business combinations would not be forced to familiarize themselves with international regulations. Both the content and structure of those standards may significantly increase time expenditure, and thus costs, related to accounting for the combination. In the current legal system, there is a dynamic connection between national accounting law and international standards. As a result, frequent modifications of international standards have an impact on national accounting law. Therefore, it should be noted, that introducing a definition of business combinations into the national accounting law would change this relation from dynamic to static. Lack of obligation to follow changes in international regulations reduces cost of operations by, for example, reducing the amount of training in this scope. Providing a definition for the term “business combinations” would dispel any doubts with respect to application of combinations accounting also by companies which are not commercial law companies, e.g. by natural persons. Regardless of accounting law, business combinations are regulated by commercial law. It should be noted, that provisions of the commercial code are separate from accounting law. I believe this separation should be maintained, for reasons including the scope of entities covered by Act on accounting and Code of commercial companies respectively. Applying regulations of the Code of commercial companies in the accounting law would be, in the opinion of the author, not beneficial for another reason as well. Namely, in accounting law economic events are interpreted based on the principle of economic substance prevailing over legal format. Based on commercial law, such an interpretation is not always applicable.

9.7 Amendment introducing the definition of a business.

Current provision	Recommended provision
Art. 3 par. 1. No provision.	Art. 3 par. 1. A business is an integrated set of activities and assets that is capable of being operated and managed for the purpose of providing a return in form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants.
Art. 44d. The provisions of Art. 44a-44c apply if an entity acquires an organized part of another entity, including the case of a demerger.	Art. 44d. Provisions of art. 44a-44c shall apply respectively in case of a demerger.

Justification for amendment
Act on accounting uses the term “organized part of another entity". This term is not defined by the Act on accounting. It is also not defined in other branches of the law. Regulations of tax law do define an organized part of an enterprise, however this definition gives rise to

many doubts and disputes. For example, there could be doubts as to whether an autonomous branch without a lease agreement can be considered an organized part of an enterprise. In practice, the term "organized part of another entity" is considered to be the same as the definition of an organized part of an enterprise. Therefore, if based on tax law the object of a transaction meets a definition of an organized part of an enterprise, it is accounted for in accordance with the principles for business combinations as set forth in the Act on accounting. I believe such an approach is not correct. Provisions of the accounting law are separate from the provisions of tax law. Therefore, accounting principles for business combinations should be separated from the definition of an organized part of an enterprise. It can be done by defining business combinations based on a business, and then defining the notion of a business. How would such a change impact the situation of micro, small and medium enterprises? It may increase the cost of application of accounting law. Those would, first and foremost, be related to the need to apply the acquisition method for a larger number of transactions, so more frequent determination of fair value than is the case now. However, thanks to this change, reliability of financial statements would increase, which would have a positive impact on improved situation of users of such statements. As a result, these costs will be compensated by increased useful value of financial statements.

9.8 Amendment introducing definitions of acquirer and acquiree.

Current provision	Recommended provision
No provision.	Art. 3 par. 1. Acquirer is the entity which assumes control over acquiree. Art. 3 par. 1. Acquiree is a business or units over which the acquirer assumes control as a result of business combination.

Justification for amendment
Act on accounting uses the term "acquirer", however it does not define the term. Since the definition of business combinations is taken from IFRS 3, definition of terms has also been taken from international regulations. Defining the acquirer and acquiree makes it easier to apply accounting law, for example in context of reverse combinations.

9.9 Amendment introducing the definition of the date of combination.

Current provision	Recommended provision
Art. 44a par. 3. The business combination date represents the date on which a given business combination is	Art. 44a par. 3. Date of business combination is the

Current provision	Recommended provision
registered in the court register relevant to the registered office of the acquirer or a newly-formed company.	day on which the acquirer takes control of the acquiree.

Justification for amendment
Act on accounting makes the date of combination dependent on the day on which the combination is registered in the relevant court register. As a consequence, acquiree recognizes the acquiree's assets and liabilities in its balance sheet not at the moment of transferring control, but at the moment of performing the administrative action. The moment of initial recognition of the combination is not in line with the general principle stemming from initial recognition of assets and liabilities in other types of transactions. For example, initial recognition of working assets stemming from a purchase transaction is accounted for on the day, on which the seller: a) transferred to the buyer significant risks resulting from ownership rights of the resource; b) ceases to be permanently engaged in managing the resources sold to the extent to which such a function is performed with respect to resources to which one holds ownership rights; and ceases to exert effective control over said resource. Within the framework of a combination transaction, the acquirer company also purchases assists. However, the moment of their initial recognition in the books is dependent on and administrative action, rather than the agreement between the parties. From the perspective of purchasing individual assets, a combination is similar to a purchase transaction. I believe accounting for a combination transaction should be effected on the day of transfer of control, not on the day the combination is registered. Otherwise, assets which are controlled by the entity and liabilities assumed by the entity are not represented in the combined financial statements. Such a presentation might have an impact on reliability of the financial statement.

9.10 Amendment expanding the scope of entities covered by provisions in scope of business combinations.

Current provision	Recommended provision
Title of chapter 4a: Business combinations.	Title of chapter 4a: Combinations of entities.
Art. 44a par. 1. Business combinations of commercial companies (partnerships and companies, hereinafter referred to as "companies") shall be accounted for and recognized as at the business combination date, subject to the provisions of Art. 44b Paragraph	Art. 44a par. 1 Business combination between entities are accounted for and recorded on the combination date in the accounts of acquirer or a new entity resulting from the merger (the newly established entity) - using the

Current provision	Recommended provision
7, in the books of accounts of the company to which the assets of the combining companies (the acquirer) or a new company established as a result of the combination (a newly-formed company) are transferred- under the acquisition method, referred to in art. 44b, with the limitations resulting from paragraph 2.	acquisition method, referred to in art. 44b, with the limitations resulting from paragraph 2. In art. 44a par. 2 - 44d, term “company” should be replaced with “entity”

Justification for amendment
Act on accounting only applies regulations pertaining to business combinations only to commercial companies. Although in my opinion application of overriding accounting principle in the given situation should lead other entities to apply the provisions of chapter 4a, in practice such entities may decide, that since the law explicitly excludes from its scope all entities other than commercial companies, this means such entities should not apply the provisions of chapter 4a. I believe, that including in the scope of this chapter of all the entities applying the Act on accounting would make application of the law easier. In particular, this holds true for a situation in which the smallest entities will be able to apply simplified principles of accounting by applying the pooling of interests method. Moreover, obligating only some of the entities to apply the business combinations provisions in case of acquisition does have an impact on their competitiveness. For example, civil law partnerships and sole proprietorships in such a situation may account for combinations in the same way as for purchase of a group of assets. This reduces cost of doing business and thus increases competitiveness. I believe that simplification of application of accounting regulations should be introduced based on size criterion rather than form of business activity.

9.11 Amendment adjusting the definition of goodwill, eliminating the notion of negative goodwill, and introducing the concept of profit from a bargain purchase.

Current provision	Recommended provision
Art. 33 par. 4 Goodwill is a difference between the cost of acquisition of a specified entity or its organized part and the fair value of acquired net assets. If the cost of acquisition of an entity or its organized part is lower than the fair value of acquired net assets, the difference represents negative goodwill. The methods for accounting for and amortizing both goodwill and negative goodwill are specified in Art. 44b Paragraphs 10-12.	Art. 33 par. 4. Goodwill constitutes the difference between purchase/takeover price of a business and lower fair value of acquired identifiable assets and liabilities. If purchase price of a business is lower than fair value of acquired net assets, difference constitutes profit from bargain purchase. Principles of accounting for goodwill or profit from bargain purchase are set forth in art. 44b par. 10-12.

Justification for amendment
Current definition of goodwill does not include an obligation to identify and separately present assets assumed as a result of combination. As a result, all assets not included on the balance sheet of the acquiree, such as e.g. client lists, increase goodwill. I believe this type of measurement of goodwill does not ensure reliable presentation of the financial situation of the acquirer. Change of the definition is intended to introduce an obligation of separate recognition and presentation also of those assets, which are not recognized in the balance sheet of the acquiree, have an impact on financial assessment of the acquirer and can be practicably identified as separate. I do believe, that cost of separate presentation and measurement of assets stemming from re-acquired rights or assets from assumed leasing contracts in most cases would exceed the benefit of such presentation. Therefore, definition of goodwill provided in IFRS 3 should not be copied. It would result in a correct conviction that all assets described in IFRS 3 should be subject to separate presentation. The phrase "can be practicably identified" is related to ease, practicability and is one of the features distinguishing the definition in the Act from definition included in IFRS 3. Separation of significant identified assets, which as of the day of combination were not recognized in acquiree's balance sheet will include the burdens on entities applying the Act. However, the increase in burden will be offset by increased usefulness of financial statements. Therefore I believe it is justified.

9.12 Amendment eliminating the obligation to depreciate goodwill and introducing the obligation of testing for impairment.

Current provision	Recommended provision
Art. 44b par. 10. An entity shall amortize goodwill over a period not exceeding 5 years. In justified cases, the entity's manager may extend such a period to 20 years. The extension of the amortization period shall be disclosed in the notes to financial statements together with its justification. Amortization shall be recognized as other operating costs on a straight-line basis.	Art. 44b par. 10. Goodwill is not subject to depreciation. As of each balance sheet date, the entity shall test goodwill for impairment. Resulting impairment loss is included in other operating expenses.

Justification for amendment
Accounting law defines depreciation as s systematic and planned distribution of value of a fixed asset or intangible/legal asset over the period of economic life of the asset. Considering the methods for measuring goodwill as of the balance sheet date, one should analyze what goodwill is and compare it to fixed assets and other intangible and legal assets. In accordance with domestic accounting law, intangible and legal assets are property rights acquired by the entity, included in fixed assets, with economic use and expected economic useful life period longer than one year, intended for the entity's own use. Fixed assets are fixed tangible assets and equivalent, with expected economic useful life period

longer than one year, complete, suitable for use and intended for entity's own use. Intangible and legal assets, as well as fixed assets (with some exceptions) are measured as of balance sheet date, reducing their initial value by depreciation write-offs. One common feature of intangible and legal assets and fixed assets subject to depreciation is the possibility of defining their economic useful life period. It should be pointed out here, that there are certain fixed assets which are not subject to depreciation. For example, land is not subject to depreciation as it is not possible to define its economic useful life period. Moreover, market value of land frequently increases over time. Therefore, valuation of land based on depreciation would not reflect its actual use, and thus would bring book value further from real value. Definition of goodwill shows, that it is an asset representing future economic benefits, arising from assets obtained within the framework of business combination, such as were not individually identified or separately recognized. Goodwill is created, when net assets at fair value are lower than purchase price. Thus, purchase consideration reflects the company's reputation, its employees, business contacts etc. Such assets do not have economic useful life. As a result, goodwill does not have economic useful life. Since it is not possible to determine economic useful life of the given asset, it's not possible to determine its depreciation rate. Another argument in favor of rejecting measurement as of balance sheet date based on depreciation is the fact that we are not able to predict, how goodwill is going to change in the future. As in case of land, the company's goodwill may increase in value with time. In my opinion, recommended changes may increase the burdens related to application of accounting law for those entities which despite legal requirement so far did not test goodwill for impairment. Depreciation write-offs have reduced the importance of such testing. As a result of recommended changes, goodwill may be transferred to profit and loss statement only in case of impairment. It is beyond doubt, that entities and auditors auditing their financial statements will have to analyze possibility of impairment with greater attention.

9.13 Amendment allowing accounting for gain from bargain purchase (negative goodwill).

Current provision	Recommended provision
Art. 44b par. 11. Subject to the provisions of Paragraph 12, a surplus of the fair value of the acquiree's net assets over the acquisition cost , i.e. negative goodwill, up to the amount which does not exceed the fair value of the acquired non-current assets, except for long-term financial assets listed on regulated markets, shall be recognized by an entity as deferred income over the period being the weighted average economic useful life of the acquired depreciable assets. The amount of negative goodwill which exceeds the fair value of	Art. 44b par. 11. Gains from bargain purchase are written off to other operating income as a lump sum. Since gains from bargain purchase only arise in exceptional circumstances, accounting for it should be preceded

Current provision	Recommended provision
noncurrent assets, except for long-term financial assets listed on regulated markets, shall be recognized as income as at the business combination date.	by verification[101] of valuation correctness.
Art. 44b par. 12. Negative goodwill is recognized as other operating income up to the amount in which it relates to future losses and costs, determined by the acquirer in a reliable manner as at the business combination date, which do not however represent the liability referred to in Paragraph 2. Such deduction of negative goodwill is recognized in the reporting period in which such losses and costs are recognized in the financial result. If such losses and costs are not incurred in previously expected reporting periods, the related goodwill shall be recognized in a manner specified in Paragraph 11.	Art. 44b par. 12 deleted.

Justification for amendment
Current principles envisage gradual, spread over time accounting for negative goodwill in profit and loss. This accounting is effected via other operating income, so it has an impact on operating result of the acquirer. Period, over which goodwill is accounted for depends on useful economic life of other acquired assets. This method of accounting for negative goodwill indicates, that it can only arise in case of incorrect fair value measurement of acquired assets and constitutes protection for users of financial statements from errors committed by acquirers. This kind of accounting omits business reasons for existence of negative goodwill, such as negotiating position of the acquirer being stronger than that of the acquiree. For example, the acquirer takes advantage of (an opportunity) a difficult situation of the acquiree. Thanks to this advantage, the acquirer achieves a gain from bargain purchase. The gain is a one-off, achieved during negotiations. As per current regulations, this one-off gain is amortized to profit and loss in a long time horizon. From the perspective of users of financial statements, evaluation of financial standing of the company is also performed over a long time period. This means, that for such a user long-term gains are more valuable than one-offs, even if the one-off gain is relatively high. Obligation of spreading one-off gains over a long period may result in erroneous decisions being made based on financial statements. In proposing new regulations in scope of accounting for negative goodwill, nature of errors in measurement of assets needs to be taken into consideration. First of all, it should be analyzed whether such errors could be intentional or do they stem from a mistake. Negative

[101] Verification referred to in the original provision should be understood very broadly. It involves inspection of the entire process which leads to gain from bargain purchase. Inspecteed aspects must include measurement of assets, but also technical verification of goodwill calculation, etc. However, obligation to use external contractors should not be imposed. Entities may fulfill the verification obligatoin using their own resources.

goodwill means that fair value of acquired net assets is higher than fair value of purchase consideration. Therefore, companies which aim to achieve gains from bargain purchase shall aim to overestimate the value of net assets. Overestimated net assets mean that future long term operating costs will be higher, due to e.g. higher depreciation write-offs. Since evaluation of companies is performed in a long time horizon, the companies as a principle would not aim to overestimate the value of assets. They are interested in keeping costs as low as possible in the long time horizon. This means that in most cases overestimation of value of assets would not be intentional, but rather result from a mistake. If errors are not intentional, application of control procedures would be sufficient. Such control procedures should be described in national accounting standard pertaining to business combinations. Additionally, when analyzing existing regulations it should be noted that they involve creation of a complicated algorithm and estimation of future losses. This makes application more difficult. Proposed solution does not have those characteristics. In my opinion proposed changes will not increase burdens related to application of accounting law.

9.14 Clarification of reasons justifying maintaining current regulations in scope of accounting for costs involved in a business combination transaction.

Current provision	Recommended provision
Art. 44b par. 15. Costs incurred directly in relation to a business combination increase the acquisition cost. Setting-up costs incurred during the formation of a new joint stock company or costs related to share capital increase incurred for the purpose of a business combination reduce the supplementary capital of the acquirer or a newly-formed company to the amount of a share premium, whereas the remaining amount is recognized as financial costs.	Art. 44b par. 15. No change.

Justification for amendment
Provisions of International Accounting Standards as well as American GAAP obligate the acquirer to account for costs related to combination directly into profit and loss. Such costs typically include costs of legal, accounting and tax consulting, as well as costs involved in finding the business. They are inextricably linked with the combination transaction. In incurring costs involved in business combination, the acquirer expects that in future they would result in economic benefits stemming from future profits generated by the combined businesses. Thus, definition of an asset is met. However, in the opinion of authors of IFRS 3, this cost should be accounted as a one-off in the profit and loss, as of the date it is incurred. It should not be recognized in the balance sheet as an asset, since: a) seller of the business sells it at a market price, so at fair value, so increasing the purchase consideration by value of costs directly related to the combination results in

the acquired business being measured above fair value in the company's balance sheet; b) cost of additional services increases goodwill. **Analysis of the first argument** Acquirer and acquiree are two different entities, with different resources and skills. As the acquirer effects the investment, it evaluates it for financial feasibility. Financial feasibility analysis includes all expenditures related to combination, including those on legal, and accounting consulting etc. What has market value from the perspective of the acquirer might not be a value from the perspective of the seller. Therefore, it would be difficult to deny the acquirer the right to determine that fair value of the acquired business is higher than just the purchase consideration. **Analysis of the second argument** Expenditures incurred within the framework of business combination are not a separate asset, they are related to every asset acquired, including goodwill. Relating consulting expenditures exclusively to goodwill is indeed a certain simplification. I believe that such a simplification is acceptable, as every acquirer is obligated to conduct impairment testing as of each balance sheet date. If goodwill or any other acquired asset would show value above recoverable amount, such surplus would be removed from the balance sheet and presented in profit and loss as a write down. Possibility of recognizing combination costs as one-off in the profit and loss should also be confronted with principles of capitalization of costs related to purchase of individual assets, or groups of assets, which do not constitute a business. Costs related to purchase of such assets increase the value of the asset. Different recognition of costs related to business combination would thus constitute an exception from definition of purchase price, which in turn could lead to attempts to state that the subject of acquisition is not in fact a business.

9.15 Amendment introducing new regulations pertaining to accounting for combination of businesses under common control.

Current provision	Recommended provision
Art. 44b par. 2. In case of combination of companies which does not result in loss of control by existing interest holders, pooling of interests method can be applied, as described in art. 44c; in particular, this pertains to combination of direct or indirect subsidiaries of the same parent company, as well as in case of	Art. 44b par. 2. In some situations, business combination does not result in existing interest holders losing control over the businesses being combined. Such combinations are known as combinations of businesses under common control. In particular, this pertains to combination of direct or

Current provision	Recommended provision
combination of lower tier parent company with its subsidiary.	indirect subsidiaries of the same parent company, as well as in case of combination of lower tier parent company with its subsidiary.
Art. 45 par. 1 - 6. Combination by pooling of interests consists of adding up equivalent lines of relevant assets and liabilities, as well as revenues and costs, of combined companies, as of combination date, after measuring their value by uniform measurement methods and after effecting exclusions, referred to in par. 2 and 3. Items excluded are the initial capital of the company, whose assets are transferred to another company, or of companies which were deleted from the register as a result of the combination. After the exclusions are effected, relevant items of the company's equity receiving the assets of combined companies, or of the newly created company, are adjusted by the amount of difference between total assets and liabilities. 3. Other items subject to exclusion are: 1) mutual receivables and payables as well as other similar settlements between combined companies; 2) revenues and costs of economic transactions performed in the given financial year before combination of the companies; 3) profits or loss from operations performed before combination of the companies, included in values of assets and liabilities subject to pooling. Exclusions referred to in par. 3 pt 2 and 3 may be omitted if it does not impact reliability and clarity of financial statements of company receiving the assets as a result of combination, or of newly created company. Costs incurred in process of combination, including organization costs incurred in creating the new company, or cost of increasing the equity of the company receiving the assets of combined companies, are included in financial costs. Financial statements of the company receiving the assets of combined	Art. 44b par. 2a. In case of combination of businesses under common control, accounting for the combination consists of adding up individual items of assets and liabilities of the acquirer as per their book value, with relevant items of the acquiree as presented in the consolidated financial statements prepared by the higher tier parent company as of the last balance sheet date preceding the combination. If within the capital group there are at least two higher tier entities preparing consolidated financial statement, data presented in the financial statement of combined entities should be the same as presented in consolidated financial statement of the highest tier entity. If none of highest tier entities prepare consolidated financial statements or the method described above does not reflect economics of the transaction, then acquisition method or pooling of interests method should be used, depending on which one better meets the requirement of art. 4 par. 2. Art. 44b par. 2b. Regardless of provisions of art. 44b par. 2a, if combined entities fall into microentities group, pooling of interests method can be applied. Art. 45 par. 1 - 6 unchanged.

Current provision	Recommended provision
companies, or of the newly created company, prepared as of the end of reporting period during which the combination took place, includes comparative data for the previous financial year, identified in such a way as if the combination was effected at the beginning of the previous financial year, except individual elements of equity as of end of previous year should be represented as a sum of individual components of equity.	

Justification for amendment
Pooling of interests method consists of adding up items of acquired assets and liabilities as per their book value and recognizing the difference between combination price and value of those assets directly in equity. This method can be used only if combined entities are under common control. The main disadvantage of this method is that when it is applied, profit and loss statement for periods after combination represents the cost as lower than cost derived from fair value of acquired assets. It should be pointed out, that no goodwill is created when pooling of interests method is applied. As a result, it can be used to conceal the actual cost of investment and transferring goodwill directly into equity, bypassing profit and loss. In case of entitles under common control application of acquisition method does not always reflect the economics of the transaction. Such a situation occurs when a significant period of time elapses between the moment of purchasing the interests and the day of combination. The method consisting of accounting for the combination based on financial data derived from a consolidated financial statement of a higher tier parent company eliminates this problem. Thanks to this, the combined financial statements do represent goodwill measured as of the day of combination and potential impairment is recognized in profit and loss, in operating costs. Provisions of the amended Directive enable member states to apply the pooling of interests method. In accordance with art. 25 of the Directive, the member state may allow or require that book values of shares or interests included in equity of entity subject to consolidation were offset only in part which represents their proportion in the equity, on condition that the entities being combined are ultimately controlled by the same entity both before and after combination, and the control is not of temporary nature. Keeping in mind the fact, that many companies use the pooling of interests method to eliminate actual costs involved in previous investment from the combined financial statements, application of pooling of interests method should be restricted to micro entities only. I believe that the obligation to measure acquired net assets to fair value in case of micro entities will result in significant

burdens, which in context of limited information presented in the financial statements and limited number of users of such financial statements would be unjustifiable. Therefore, I believe that allowing accounting for combinations between micro entities by pooling of interests method should be considered, regardless of whether the entities combined are under common control or not. In analyzing the changes in this scope, I have considered excluding regulations pertaining to combination of entities under common control from the scope of the Act. Situation would be similar to that in IFRS 3. It should be noted, that many combinations are conducted within capital groups. I do believe that determining the method of accounting for such combinations directly in the law is a solution actually facilitating application of the law. Obviously, the recommended provision does not solve all the problems related to combination of businesses under common control. It seems that a national accounting standard partially devoted to this issue is necessary.

9.16 Amendment introducing new provisions in scope of the moment for measurement of purchase consideration.

Current provision	Recommended provision
Art. 44b par. 5 The acquisition cost shall be as follows: 1) if, for the purpose of the combination, a company delivers (issues) shares - the market price of the shares or their fair value determined in a different manner, if their market price is unknown. In such a case, the surplus of the market value of shares or their fair value determined in a different manner is included in the supplementary capital. The market price of delivered (issued) shares is stated as at the date when all significant conditions of the combination, including share exchange parity, are published. If the market price underwent significant fluctuations in the period, then the average market price in the month which preceded and the month which followed the date when all significant conditions of the combination were published, may be adopted as the market price;	Art. 44b par. 5 Purchase consideration shall be fair value, measured as of the day of acquisition, of assets transferred by the acquirer, liabilities of the acquirer towards previous owners of the acquiree, as well as equity shares issued by the acquirer. Art. 44b par. 5a. If business combination is effected exclusively by way of exchange of equity interests, and if purchase consideration determined by market value of equity interests of the acquiree is more reliable than if based on market value of equity interests of the acquirer, purchase consideration shall be determined by market price of equity interests of the acquiree.

Current provision	Recommended provision
2) if a company acquires own shares for the purpose of an acquisition - the cost of acquisition of own shares; 3) if a company acquires the acquiree's shares - the cost of acquisition of these shares; 4) if, for the purpose of a combination, a company makes a payment in a form other than the one specified in Point 1-3 - the fair value of the object covered by the payment; 5) if, for the purpose of a combination, a company makes a payment in various forms - the total of relevant values referred to in Points 1-4.	

Justification for amendment
The current provision does not obligate the acquirer to determine fair value of purchase consideration as of the day of combination. On the other hand, when purchase of assets method is applied, assets of the acquiree are measured at fair value as of the combination date. What does that mean? It means that some of the assets stemming from combination, e.g. those on the balance sheet of the acquiree, are measured as of combination date, while goodwill is measured on a different date. It should be noted here, that goodwill is determined as of the day of measurement of purchase consideration. I believe this to be a logical inconsistency of the provision. Additionally, it should be noted that current regulations do allow a certain degree of flexibility. For example, they contain a phrase "If the market price underwent significant fluctuations in the period, then the average market price...", without defining what should be deemed significant fluctuations. Such a structure of the provision allows manipulation of purchase consideration. From the perspective of both the buyer and the seller, fair value is the value as of a specific date, it is not an average. I believe this amendment would not introduce additional burdens for companies applying the provisions of the Act.

9.17 Amendment introducing a single definition of goodwill.

Current provision	Recommended provision
Art. 44b par. 6. A surplus of the acquisition cost, referred to in Paragraph 5, over the fair value of the acquiree's net assets shall be presented as goodwill in the assets of the company to which the assets of combined companies or the	Art. 44b par. 6. Goodwill, as specified in art. 33 par. 4 shall be presented in the assets of the acquirer or the company established as a result of the combination.

Current provision	Recommended provision
company established as a result of the combination were transferred.	

Justification for amendment
Goodwill has been defined in art. 33 par. 4 of the Act on accounting. I believe there is no need to introduce a new definition for the purpose of business combination or repeating the definition provided in art. 33.

9.18 Amendment introducing new principles of accounting for contingent price.

Current provision	Recommended provision
Art. 44b par. 9. If the terms and conditions of a business combination allow the acquisition cost to be adjusted as a result of specific future events, then such an adjustment is taken into account during the determination of the acquisition cost as at the acquisition date, if the occurrence of future events underlying such an adjustment is probable, and it is possible to measure an adjustment to the acquisition cost in a reliable manner. If the events which underlie an adjustment to the cost of acquisition do not occur in the following reporting periods, or the actual adjustment is different from the estimated amount, an appropriate adjustment to the acquisition cost and goodwill or negative goodwill shall be made.	Art. 44b par. 9. Acquisition cost, as defined in art. 44b par. 5, includes contingent payment, i.e. payment depending on occurrence of specific events in the future. The acquirer recognizes contingent payment at fair value as of the combination date as part of consideration transferred in exchange for the acquiree. Acquirer identifies the contingent payment obligation as a liability or equity, based on definition of an equity instrument and financial liability. Subsequent settlement of contingent price is recognized in the books depending on reasons for change. If contingent payment is subject to change in connection with new information obtained after the day of combination, adjustment of contingent payment is accounted for in line with provisions of art. 44b par. 8. Art. 44b par. 9a. If adjustment of contingent payment is not accounted for in line with art. 44b par. 8, the adjustment should be accounted for as follows: a) if contingent payment was classified as equity, then adjustment is accounted for within the framework of equity; b) if contingent price was classified in a group of assets or liabilities, it is accounted for in correspondence with revenues or costs from

Current provision	Recommended provision
	operations or financial operations, depending on economic character of the transaction.

Justification for amendment
A method frequently used to determine purchase consideration is the earnout method. It is applied, when the buyer and the seller of a business do not agree as to its market value. Therefore, part of the purchase consideration will be due to owners of the acquiree if the acquiree meets a certain condition in the future. Such a condition may be reaching a certain level of operating profit, level of revenues, etc. Under the current state of law, change in purchase consideration stemming from occurrence of specific events does have an impact on goodwill or negative goodwill. So we have a situation in which, in practice, for many acquirers the actual moment of determining fair value of acquisition cost is deferred in time. Allowing measurement of acquisition cost at a later date means, that in many cases information represented in the financial statements may not reflect actual economic situation of the entity. What will be the impact of the recommended amendment to the provision on accounting for contingent price? It is best illustrated using an example. For the purpose of this justification, let's assume that the contingent price is based on the level of operating profit to be achieved by the business in the future, specified in the agreement. The acquirer has determined fair value of purchase consideration as of the combination date at 70% of maximum purchase consideration. It turned out, that owners of the business have generated a higher operating profit. This means that purchase consideration would be paid in a higher amount than originally assumed. In the combined profit and loss, operating profit stemming from the surplus generated by the business will be represented and offset by operating cost in the amount of higher purchase consideration. Such accounting for the purchase consideration reflects its economics. Since the acquirer had agreed to a higher purchase consideration than fair value as of combination date, it means, that the additional payment is tied to already realized higher operating profit. It does not relate to the possibility of realizing higher than assumed carrying value of net assets in the future. In summary, since the recommended provision transfers accounting for contingent purchase consideration into profit and loss, it will mobilize the users of financial statements to determine fair value of purchase consideration already at the combination date. At the same time, it will allow for accounting for purchase consideration in line with its economic character. The new regulation may result in additional burdens to entities applying the Act. Those will not stem from new regulations, but from forcing application of existing provisions.

9.19 Amendment bringing organized part of an enterprise into the scope of a business.

Current provision	Recommended provision
Art. 44d. The provisions of Art. 44a-44c apply if an entity acquires an organized part of another enterprise, including the case of a demerger.	Art. 44d. Provisions of art. 44a-44c shall apply respectively in case of a demerger.

Justification for amendment
Proposed changes introduce the concept of a business. Organized part of an enterprise does fit into the definition of a business. If business combination regulations pertain to a business, they automatically pertain to an organized part of an enterprise as well. Maintaining the current wording of art. 44d could result in understanding that a business is a narrower concept than an organized part of another entity (in practice, an organized part of an enterprise).

9.20 Amendment separating indemnification assets from goodwill.

Current provision	Recommended provision
Art. 44b. No obligation to represent.	Art. 44b. Within the framework of a business combination transaction the seller may, based on an agreement, determine an indemnification for the acquirer, in connection with unknown result of a contingent event or uncertainty with respect to a specific asset/liability or part thereof. Such indemnification constitutes an asset of the acquirer, which should be recognized separately from goodwill. As of the day of initial recognition such assets are measured based on the same principles as measurement of the indemnified item. Indemnification assets are subject to impairment testing.

Justification for amendment
Business combination transactions are usually preceded by a detailed analysis of acquired business. Such due diligence is intended to, among other things, determine risk areas involved in the acquisition. Identification of risk areas, i.e. events which, if realized in the future, could have an impact on the current value of the enterprise does have a significant impact on the purchase consideration. Often the acquirer has a different estimation of the risk of the contingent event happening than the owners of the acquired business. As a result, the seller provides indemnification to the buyer in case of occurrence of the unfavorable event. Indemnification is specified in the combination agreement, so there are usually no major problems with its identification. Provision of art. 4 par. 2 states, that economic events are recognized in the books in accordance with their economic character. Therefore, economic character of the indemnification needs to be specified. Most certainly, lack of specified indemnification

would increase the risk involved in the combination from the perspective of the acquirer. Therefore, in case of absence of indemnification, purchase consideration will be lower than price with indemnification. From the perspective of the parties, setting up indemnification means an adjustment of the purchase consideration. Since economic character of indemnification constitutes adjustment of purchase consideration, indemnification should not have an impact on goodwill. Therefore, it needs to be measured separately and presented in the combined financial statement as a separate asset. Will the recommended provision result in significant increase of burdens related to its application? I believe not. Both identification – based on the agreement, and measurement – based on indemnified item, should not cause major difficulties.

9.21 Justification for absence of regulation for reverse acquisitions.

Current provision	Recommended provision
No regulation	No regulation

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<tr><th>Justification for amendment</th></tr>
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Current provisions do not regulate directly such business combinations in which the entity which is the acquirer from the perspective of commercial law turns over control over a business to the entity which is the legal acquiree. When analyzing changes to regulation in this scope, I considered three possibilities.
1. Introducing a general provision, for example: "Reverse acquisition occurs, when the entity issuing the securities (legal acquirer) is, pursuant to the provisions of the Act, the acquiree. Reverse acquisitions should be accounted for in accordance with the provisions of the Act."
I believe such a provision does not solve the problem of accounting for business combinations. Regardless whether this provision is introduced to the Act or not, entities which apply the provisions of the Act should, pursuant to art. 2 thereof, register all economic transactions in accordance with the provisions of the Act. Thus, from the perspective of those applying the Act it is irrelevant whether the provision is introduced or not. Therefore, I do not recommend introducing such a change.
2. Definition of reverse acquisitions and direct reference to IFRS 3. "A reverse acquisition occurs when the entity that issues securities (the legal acquirer) is identified as the acquiree for accounting purposes on the basis of the Act. Reverse acquisitions should be accounted for in accordance with provisions of International Financial Reporting Standard No. 3 "Business combinations"
Such a possibility was introduced to the Act by art. 10 par. 3. Moreover, a rigid reference to IFRS 3 resulted in difficulties in applying the Act after a national accounting standard devoted to business combinations was introduced. Therefore, I do not recommend introducing such a change.
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3.	Transferring detailed IFRS 3 based provisions into the Act. Act on accounting is based on a system of principles. Reverse acquisitions are business combinations and should be accounted for in accordance with the provisions of the Act. Introducing detailed regulations for one type of combination only does, in a way, change the construction of the Act. I believe that detailed accounting effects of specific transactions, as described in national accounting standards, are an effective way to explain accounting law. Therefore, I do not recommend introducing IFRS 3 based provisions into the Act. I believe that the most beneficial solution would be to omit the issue of reverse acquisitions from the Act and describe detailed principles of accounting for reverse acquisitions in the national accounting standard pertaining to business combinations.

9.22 Separate presentation of reacquired rights as well as assets and liabilities from operating leasing.

Current provision	Recommended provision
Art. 44b. No regulation	Art. 44b. No regulation

Justification for amendment
In accordance with IFRS 3, reacquired rights are subject to separate identification, and in certain situations, assets or liabilities from acquired operating leasing agreements need to be presented as well. Such an obligation stems from the definition of goodwill, presented in Attachment A to IFRS 3. Recommended modified definition of goodwill does not include an obligation to present all identifiable assets separately. As per proposed definition, separate presentation is required only for those assets, which can be separated out. I believe that the costs involved in measurement at initial recognition, and then measurement as of balance sheet date, of reacquired rights and assets or liabilities from operating leasing in many cases would exceed the resulting benefits. It should also be noted, that some of the users of financial statements could perceive such a presentation as difficult to understand. Therefore I do not recommend separate measurement and presentation of reacquired rights.

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