1

FINANCIAL ACCOUNTING II

UNDERGRADUATE COURSES: MANAGEMENT, ECONOMICS AND FINANCE

2024/2025

1S

1

2

SYLLABUS

3) BUSINESS COMBINATIONS

Mergers & Acquisitions

Consolidated financial statements

2

3

Business Combinations

Readings: Chapter 13

3

4

Financial investments

Active (value creation)
Long term
Strategic view

≠ financial instruments (marketable securities, passive: “wait and see”, held for a short period of time, measured at fair value)

4

5

Types of investments

Shares in subsidiaries
Shares in associates
Shares in other investments, including joint arrangements and joint ventures
Loans to subsidiaries, associated companies, and other investments

5

6

Business combinations: basic scenarios

Acquisition of shares of a company that remains a separate legal entity

Legal mergers

Acquisition of all outstanding shares of a company which is dissolved; all assets and liabilities are merged in the accounts of the acquirer (statutory merger)

Two companies merge (are dissolved as legal entities) to become a third entity (statutory consolidation)

Creation of a holding entity: joint combination of activities by two companies (neither company is dissolved)

Acquisition of assets of a company that is liquidated; first liabilities are paid and afterwards shareholders get the surplus

The method used to record the above situations is known as "acquisition method"

6

7

Business combinations: acquisition method

IFRS 3

4 STEPS

1. Identifying the “acquirer”
2. Determining the “acquisition date”
3. Recognizing and measuring the identifiable assets and liabilities of the “acquiree”
4. Recognizing and measuring goodwill or a gain from a bargain purchase

7

8

Business combinations: goodwill

Goodwill recognized in a business combination is an asset representing the future economic benefits arising from other assets acquired in a business combination that are not indivdually identified and separately recognized

Subsequent measurement:

No amortization

Annual impairment test (in accordance with IAS 36 Impairment of assets)

No reversal of the impairment loss

8

9

Legal mergers: major accounting issues

1) Determination of the value of each business (fair values)
2) Determination of the rate of exchange of shares
3) Determination of the number of shares to issue
4) Determination of the merger premium

Accounting entries for recording the merger so as to be able to produce a relevant new balance sheet

9

10

Legal mergers – example (1/7)

Merger by incorporation (statutory merger)

Facts of the merger:

Firm A (acquirer) merges with Firm B (acquiree), which is dissolved

The "acquisition method" is applied

Firm B balance sheet items:

In c.u.

Firm B Assets	Book value	Fair value	Difference
Assets	500,000	520,000	20,000 (potential gain on assets)
Other non-recorded or identifiable elements	0	30,000	30,000 (potential goodwill)

Source: Example (Chapter 13) in Stolowy, Ding & Paugam (2024)

10

11

Legal mergers – example (2/7)

Balance sheet of each firm before the merger:

In c.u.

Assets	Firm A	Firm B	SE & L	Firm A	Firm B
Assets	1,500,000	500,000	Capital	400,000	200,000
			Retained E. & Reserves	800,000	50,000
			Liabilities	300,000	250,000
Total Assets	**1,500,000**	**500,000**	**Total SE&L**	**1,500,000**	**500,000**

No. Shares included in the capital	4,000	2,000
Par value	100	100

Source: Table 13.18 from Stolowy, Ding & Paugam (2024)

11

12

Legal mergers – example (3/7)

1) Determination of the fair value of each company:

In c.u.

	Firm A	Firm B
(1) Capital	400,000	200,000
(2) Retained Earnings & Reserves	800,000	50,000
(3) Total Shareholders' Equity (3)=(1)+(2)	1,200,000	250,000
(4) No. shares	4,000	2,000
(5) Book value per share (5)=(3)/(4)	300	125
(6a) Potential gain on assets	0	20,000
(6b) Goodwill	-	30,000
(7) Net assets at fair value (7)=(3)+(6a)+(6b)	1,200,000	300,000
(8) Fair value per share (8)=(7)/(4)	300	150

Source: Table 13.19 from Stolowy, Ding & Paugam (2024)

12

13

Legal mergers – example (4/7)

2) Determination of the rate of exchange of shares:

Acquiree	Fair Value of a share of Firm B	
Acquirer	Fair Value of a share of Firm A	= 150/300 = 1/2

$$\frac{\text{Fair Value of a share of Firm B}}{\text{Fair Value of a share of Firm A}} = 150/300 = 1/2$$

FV of a share of Firm B = 0.5 x FV of a share of Firm A

2 shares of B = 1 share of A

13

14

Legal mergers – example (5/7)

3) Determination of the number of shares to issue:

1 share of A = 2 shares of B

Firm A increases Capital

A should issue = 2,000 (number of shares in B) x 1/2 = **1,000 new shares** to be awarded to the former shareholders of B so they will retain the same value

one share of A has the same value as 2 shares of B: 300 × 1 = 150 × 2

14

15

Legal mergers – example (6/7)

4) Determination of the Merger Premium:

- Capital increase =
  = 100 c.u. (par value shares) × 1,000 (new shares issued by Firm A)
  = 100,000 c.u.

- Merger Premium =
  = Net assets of Firm B at fair value (300,000 c.u.) *minus* Capital increase (100,000 c.u.)
  = 200,000 c.u.

Source: Table 13.20 from Stolowy, Ding & Paugam (2024)

15

16

Legal mergers – example (7/7)

Includes
gain on assets!

5) Accounting for the merger:

In c.u.

	Firm A – Balance Sheet before the merger	Merger entries	Firm A – Balance Sheet after the merger
Assets	1,500,000	520,000	2,020,000
Goodwill		30,000	30,000
Total Assets	**1,500,000**	**550,000**	**2,050,000**
Share Capital	400,000	100,000	500,000
Merger Premium		200,000	200,000
Retained E. & Reserves	800,000		800,000
Liabilities	300,000	250,000	550,000
Total SE & L	**1,500,000**	**550,000**	**2,050,000**

Source: Table 13.21 from Stolowy, Ding & Paugam (2024)

16

17

Definitions related to a Group of companies

IFRS 10

Group: “a parent and all its subsidiaries” (IFRS 10, Appendix A)
Subsidiary: an entity that “is controlled” by a parent company

•Control: power and ability to use its power over the investee, and exposure and right to variable returns regarding the investee

Associate: “an entity over which the investor has significant influence” (IAS 28, § 3)

•Significant influence: power to influence economic decisions, without control (presumed >20% of voting rights)

Joint arrangement (operation / venture): when two or more parties have joint control over the arrangement where decisions require unanimous consent of the parties

17

18

Percentage of control *versus* Percentage of interest (1/3)

Percentage of control:
measures the proportion of voting rights held by the parent
is used to determine which method of consolidation (full consolidation **or** equity method)

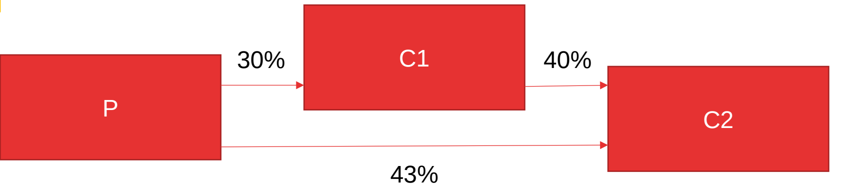
Percentage of interest:
measures the percentage of ownership held by the parent
is used to calculate controlling and non-controlling interests

18

19

Percentage of control *versus* Percentage of interest (2/3)

Example 1



P → C2:

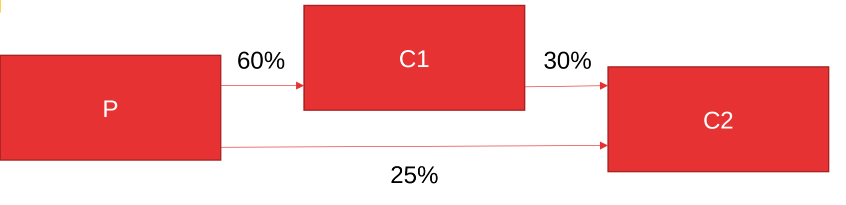
- Percentage of control = 43% [43% + 0%] → C2 is an Associate
- Percentage of interest = 55% [43% + (30 % × 40%)]

19

20

Percentage of control *versus* Percentage of interest (3/3)

Example 2



P → C2:

- Percentage of control = 55% [25% + 30%] → C2 is a Subsidiary
- Percentage of interest = 43% [25% + (60 % × 30%)]

20

21

Consolidated financial statements

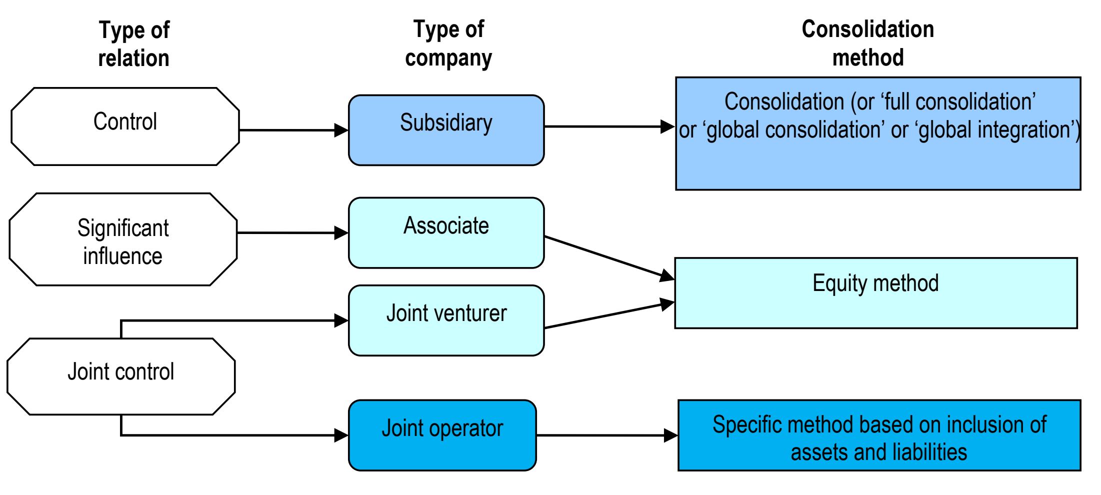
Consolidated financial statements: financial statements of a group (parent + subsidiaries) presented as if the entities were a single economic entity

Consolidation methods: differ depending on the type of relationship between the parent company and the investee (subsidiary, associate or joint arrangement)

21

22

Consolidation methods



Source: Figure 13.2 from Stolowy, Ding & Paugam (2024)

22

23

Full consolidation - phases

1 Add the items of the Balance Sheet and Income Statement of the parent-company and the subsidiaries (“combined” items)

2 Elimination of the investment of the parent-company in the subsidiaries and of the part of the subsidiaries’ equity belonging to the parent-company

→ this step originates “consolidation differences”, namely “valuation differences” and “goodwill”

3 Recognize non-controlling interests (shown separately under “Equity” on the Balance Sheet and also separately on the Income Statement)

4 Elimination of intra-group transactions (ex: sales and services rendered between companies, distribution of dividends)

23

24

Full consolidation – example 1 (1/3)

Price paid for acquisition = book-value of shares of acquired company

<u>In year X1</u>:

Acquisition by Firm P of 90% of the shares of Firm S

Price paid in cash = 288, corresponding to 90% of the book value of shares (Share capital: 200; Retained earnings/reserves: 100; Net income: 20)

10% of Firm S’s shares are in the hands of “non-controlling shareholders”

24

25

Full consolidation – example 1 (2/3)

Source: Table 13.7 from Stolowy, Ding & Paugam (2024)

a) Elimination of the investment of Firm P in Firm S and of the part of Firm S's equity belonging to Firm P and of the consolidation reserve (2)

b) Non-controlling interests = 10% x (Firm S's share capital + retained earnings/reserves + net income) (3)

As at 31 December X3	Firm P (standalone)	Firm S (standalone)	Combined (1)		Elimination entries and adjustments	Consolidated balance sheet
	(1)	(2)	(3)=(1)+(2)		(4)	(5)=(3)+(4)
Assets						
Investment in Firm S	288		288	(a)	−288	0
Other assets (including cash)	1,912	600	2,512			2,512
Total	2,200*	600	2,800		−288	2,512
Equity and liabilities						
Share capital	600	200	800	(a)	−180	
				(b)	−20	600
Retained earnings/Reserves	500	300	800	(a)	−270	
				(b)	−30	500
Consolidation reserve				(a)	162	162
Net income**	50	40	90	(b)	−4	86
Non-controlling interests				(b)	54	54
Liabilities	1,050	60	1,110			1,110
Total	2,200	600	2,800		−288	2,512

Consolidation reserve = (200 + 300) x 90% - 288 = 162

**We assume the shareholders voted not to distribute the income of the period.

Book-value of Firm S in X1

Percentage of interest x Share Capital

Percentage of interest x Retained E./Reserves

25

26

Full consolidation – example 1 (3/3)

Source: Table 13.8 from Stolowy, Ding & Paugam (2024)

Year X3	Firm P (standalone)	Firm S (standalone)	Combined	Eliminations and adjustments	Consolidated income statement
Sales	1,000	400	1,400		1,400
Expenses	−950	−360	−1,310		−1,310
Net income of consolidated entity	50	40	90		90
Non-controlling interests (10%) in subsidiary's net income				−4	−4
Net income of owners of the parent					86

26

27

Full consolidation – example 2 (1/2)

Price paid for acquisition ≠ book-value of shares of acquired company

<u>In year X1</u>:

There are no Non-controlling Interests

Acquisition by Firm P of 100% of the shares of Firm S

Firm S's **book-value = 320** (share capital: 200; retained earnings/reserves: 100; net income: 20)

Firm S's **fair-value** of identifiable assets and liabilities **= 390**

Price paid for Firm S, in cash = 420 (cost of investment)

Valuation difference: difference between fair values and book values of identifiable assets and liabilities =

= (100% x 390) – (100% x 320) = 70

Goodwill: excess value above fair values (due to assets not identifiable such as customer loyalty, know how) =

= 420 – (100% x 390) = 30

27

28

Full consolidation – example 2 (2/2)

Source: Table 13.10 from Stolowy, Ding & Paugam (2024)

a) Elimination of the investment of Firm P in Firm S and of the part of Firm S's equity belonging to Firm P and of the consolidation reserve 2

b) Difference arising on acquisition: Valuation Difference (70) + Goodwill (30) 2

As at 31 December X3	Firm P (standalone)	Firm S (standalone)	Combined 1	Elimination entries and adjustments		Consolidated balance sheet
	(1)	(2)	(3)=(1)+(2)		(4)	(5)=(3)+(4)
Assets						
Investment in Firm S	420	0	420	(a)	–320	
Of which: difference arising on first consolidation (based on fair values dating back to X1)	100			(b)	–100	0
Goodwill				(b)	30	30
Other assets (including cash)	1,780	600	2,380	(b)	70	2,450
Total	2,200*	600	2,800		–320	2,480
Equity and liabilities						
Share capital	600	200	800	(a)	–200	600
Retained earnings/Reserves	500	300	800	(a)	–300	500
Consolidation reserve				(a)	180	180
Net income**	50	40	90		0	90
Liabilities	1,050	60	1,110			1,110
Total	2,200	600	2,800		–320	2,480

Book-value of Firm S in X1

Percentage of interest x (Share Capital + R. Earnings and Reserves)

Consolidation reserve = (200 + 300) x 100% - 320 = 180

**We assume the shareholders voted not to distribute the income of the period.

28

29

Full consolidation – elimination of intra-group transactions

EXAMPLE 1:

Firm P has in the Sales account 200,000 € of sales to Firm S

Firm S sold all of the inventories to customers outside the group for 350,000 €

Firm P has a margin of 30% over the selling price

29

30

Full consolidation – elimination of intra-group transactions

EXAMPLE 1 (cont.):

	Firm P	Firm S	Firm P + Firm S	Group
Sales	200,000	350,000	550,000	350,000
COGS	140,000	200,000	340,000	140,000
Remaining inventories	0	0	0	0

Adjustment entries:

Sales → Debit: 200,000

COGS → Credit: 200,000

30

31

Full consolidation – elimination of intra-group transactions

EXAMPLE 2:

Firm P has in the Sales account 200,000 € (100,000 units at 2€/unit) of sales to Firm S

Firm S is still in possession of the merchandize

Firm P has a margin of 30% over the selling price

31

32

Full consolidation – elimination of intra-group transactions

EXAMPLE 2 (cont.):

	Firm P	Firm S	Firm P + Firm S	Group
Sales	200,000	0	200,000	0
COGS	140,000	0	140,000	0
Remaining inventories	0	200,000	200,000	140,000

Adjustment entries:

Sales → Debit: 200,000

COGS → Credit: 140,000

Inventories (merchandize) → Credit: 60,000

32

33

Full consolidation – elimination of intra-group transactions

EXAMPLE 3:

Firm P → 100% → Firm S

Subsidiary sells to the Parent

Firm S has in the Sales account 100,000 € (10,000 units at 10€/unit) of sales to Firm P

Firm P sold 7,000 units for 15 €/unit and is still in possession of 3,000 units

Firm S has a margin of 30% over the selling price

33

34

Full consolidation – elimination of intra-group transactions

EXAMPLE 3 (cont.):

	Firm S	Firm P	Firm P + Firm S	Group	
Sales	100,000	105,000	205,000	105,000	7,000 x 15€/unit
COGS	70,000	70,000	140,000	49,000	7,000 x 7€/unit
Remaining inventories	0	30,000	30,000	21,000	3,000 x 7€/unit

Adjustment entries:

Sales → Debit: 100,000

COGS → Credit: 91,000

Inventories (merchandize) → Credit: 9,000

34

35

Full consolidation – elimination of intra-group transactions

EXAMPLE 4:

Firm P sold a vehicle to Firm S for 20,000 €

Firm P purchased the vehicle for 50,000 €, depreciated for 2 years at a depreciation rate of 20%

Firm S estimated a useful life of 2 years for the vehicle and depreciates the vehicle on the first year

35

36

Full consolidation – elimination of intra-group transactions

EXAMPLE 4 (cont.):

	Firm P	Firm S	Firm P + Firm S	Group
Sale amount	20,000	-	-	-
Acquisition cost	50,000	20,000	20,000	50,000
Acc. Depreciation	20,000	10,000	10,000	30,000
Carrying amount	30,000	10,000	10,000	20,000
Gain / (Loss)	(10,000)	0	(10,000)	0

PPE → Debit: 30,000

Acc. Depreciation → Credit: 20,000

Other expenses & losses → Credit: 10,000

36

37

Equity method

Method used when the parent company exerts a significant influence in the associate company or when the parent company exerts joint control of a joint venture

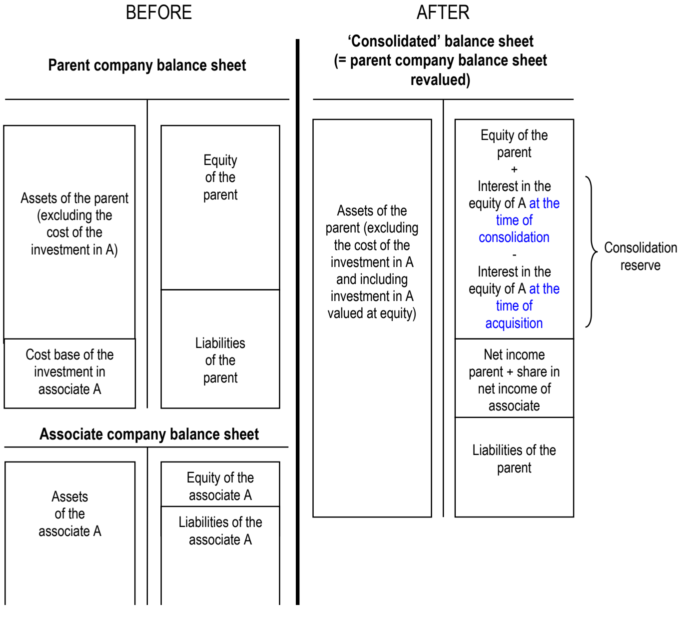
Reevaluation, in the accounts of the parent company, of the investment in the investee

No “consolidation” in the strict sense since there is no accumulation of assets and liabilities

37

38

Equity method



Source: Figure 13.5 from Stolowy, Ding & Paugam (2024)

38

39

Equity method – example (1/4)

Price paid for acquisition = book-value of shares of acquired company

In year X1 (*year of acquisition*):

Acquisition by Firm Investor of 25% of the shares of Firm Investee

Cost of investment =

(Share capital + Retained Earnings/Reserves + Net income) x 25% =

= (200 + 100 + 20) x 25% = 80

39

40

Equity method – example (2/4)

In year X3 (*year of consolidation*):

Percentage of interest in Investee = 25%

(a) Interest in the equity of Firm Investee (excluding net income) at the date of consolidation (year X3) = (200 + 300) x 25% = 125

(b) Interest in the equity of Firm Investee (including net income) at the date of acquisition (year X1) = (200 + 100 + 20) x 25% = 80

Consolidation reserve (year X3) = (a) – (b) = 45

Claim over the net income (year X3) of Firm Investee = 40 x 25% = 10

Value of the investment (year X3) in Firm Investee = 125 + 10 = 135

	Year X1 (date of acquisition)	Year X3 (date of consolidation)
Share Capital	200	200
Retained Earnings / Reserves	100	300
Net Income	20	40

40

41

Equity method – example (3/4)

Source: Table 13.11 from Stolowy, Ding & Paugam (2024)

Balance sheets	Investor with investment valued at cost	Investor with investment valued at equity
Assets		
Investment Firm Investee	80	135*
Other assets (including cash)	2,120	2,120
Total	2,200**	2,255
Equity and liabilities		
Share capital	600	600
Retained earnings/Reserves	500	500
Consolidation reserve		45
Net income***	50	50
Share of Investee's net income resulting from Investor		10
25% of Investee's equity		
Liabilities	1,050	1,050
Total	2,200	2,255
*Valued at equity		

Δ = 55

Δ = 55

41

42

Equity method – example (4/4)

Source: Table 13.12 from Stolowy, Ding & Paugam (2024)

Year X3	Investor (standalone)	Adjustment due to the equity interest in Investee	Consolidated income statement
Sales	1,000		1,000
Expenses	−950		−950
Net income resulting from equity in Investee		10	10
Net income	50	10	60

42

43

FINANCIAL ACCOUNTING II

UNDERGRADUATE COURSES: MANAGEMENT, ECONOMICS AND FINANCE

2024/2025

1S

43