EFFECTS OF RECENT AMENDMENTS
IN ACCOUNTING STANDARDS
ON CONSOLIDATED FINANCIAL STATEMENTS

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ABSTRACT

EFFECTS OF RECENT AMENDMENTS
IN INTERNATIONAL FINANCIAL REPORTING STANDARDS ON
CONSOLIDATED FINANCIAL STATEMENTS

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This thesis evaluates the process of harmonization in accounting world from the perspective of accounting standards. In this context, certain of International Accounting Standards commenced to expose revisions rapidly, on the other hand the other standards commenced to replace with International Financial Reporting Standards. One of these significant amendments occurred in accounting treatment of business combinations, which reflects the consolidated financial statements. Finally, initial effects of amendments on consolidated financial statements that appeared in accounting standards are tried to be disclosed with specific supporting arguments.

Key Words: Business Combinations, Consolidated Financial Statements, International Accounting Standards, International Financial Reporting Standards

ÖZET

MUHASEBE STANDARTLARINDAKİ
SON DEĞİŞİKLİKLERİN
KONSOLİDE FİNANSAL TABLOLARA ETKİLERİ

Erdener, Ece

Avrupa Çalışmaları Yüksek Lisans, Avrupa Çalışmaları Bölümü

Tez Yöneticisi: Prof. Dr. Nejat Tenker

Ağustos 2006, 89 sayfa

Bu çalışma, muhasebe dünyasındaki uyumlaşma sürecini muhasebe standartları açısından inceler. Bu bağlamda, bazı Uluslararası Muhasebe Standartları hızla revize edilirken, diğer bir yandan bazı standartlar Uluslararası Finansal Raporlama Standartlarıyla yer değiştirmeye başlamıştır. Bu değişikliklerden önemli bir tanesi ise işletme birleşmelerinin muhasebeleştirilmesiyle ilgili olup, sonuçları konsolide finansal tablolara yansımıştır. Sonuç olarak, muhasebe standartlarında meydana gelen bu değişikliklerin konsolide finansal tablolara ilk bakıştaki etkileri destekleyici örneklerle de ortaya konulmaya çalışılmıştır.

Anahtar Kelimeler: İşletme Birleşmeleri, Konsolide Finansal Tablolar, Uluslararası Muhasebe Standartları, Uluslar arası Finansal Raporlama Standartları

Dedicated to my father Serdar Erdener…

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ABBREVIATIONS

IASs: International Accounting Standards

IFRSs: International Financial Reporting Standards

IASC: International Accounting Standards Committee

IASB: International Accounting Standards Board

IFAC: International Federation of Accountants

SIC: Standing Interpretations Committee

IASCF: International Accounting Standards Committee Foundation

IFRIC: International Financial Reporting Interpretations Committee

TASB: Turkish Accounting Standards Board

BRSA: Banking Regulation and Supervision Agency

CMBT: Capital Markets Board of Turkey

CGU: Cash-Generated Unit

INTRODUCTION

In a growing and developing world, business organizations had to progress in order to cope with evolution. The best way to deal with such a circumstance was to expand and form business combinations. On the other hand, the necessity of having organized and uniform arrangements in accounting and the presentation of financial statements, improved "International Accounting Standards" and its successor "International Financial Reporting Standards". The combination and interaction of these two factors is the main subject of this study; these are the effects of the last amendments in accounting standards to consolidated financial statements that appear as a result of business combinations.

Rising of IFRSs by far is on the agenda of many concerned parties within the accounting sector. The accommodation of accounting treatments in the world pursued with an intensive study in related fields. The International Accounting Standards Board is revising some of the International Accounting Standards, while subsequently issuing new standards under the name of IFRSs in lieu of some of the IASs. The scope of this study is to examine the standards directly affecting consolidated financial statements. With this aim, constitutions of business combinations are analyzed in details, which disclose the necessity of consolidated financial statements as a result of business combinations. Subsequently the nature of

consolidated financial statements will be analyzed and then will be conveyed to the accounting standards, which are essentially the main subject of our study. However, before examining the related standards within consolidated financial statements, general information about the institutions that issue the standards is given in a historical process.

Our study continued by determining the standards that affect consolidated financial statements, which are IAS 27 Consolidated and Separate Financial Statements, IAS 22 Business Combinations and its successor IFRS 3 Business Combinations. While IAS 22 Business Combinations is superseded by IFRS 3 Business Combinations, IAS 27 remained in force by undergoing a revision. With the help of IAS 27 Consolidated and Separate Financial statements are expressed substantially, then with comparative analysis significant changes between IAS 22 Business Combinations and IFRS 3 Business Combinations are analyzed. In order to determine the initial effects of these changes to consolidated financial statements and to form a guidelines for this study only consolidated balance sheet was taken into consideration when exemplifying the effects of changes. On the other hand examining other consolidated financial statements, such as income statement and cash flow statements, is considered an appropriate subject for further research.

Finally, it should be emphasized that the backbone of this thesis are key amendments, which were implemented by displacing IAS 22 Business Combinations with IFRS 3 Business Combinations. The accounting method changed due to this supersede, the content of acquired assets and liabilities suffered a change with this supersede; moreover, this supersede created a brand new approach to

goodwill and negative goodwill, as well. Thus these points have been chosen as the main guidelines of this study and the challenges that may be encountered while implementing these changes are discussed.

CHAPTER ONE

BUSINESS COMBINATIONS

1.1. Historical Background of Business Combinations

Growth is one of the major objectives of many business organizations. Ever since man started conducting business, he noticed that his own wealth and labor were not sufficient enough to succeed in these interactions. Thus, he realized he had to benefit from others' wealth and labor which means co-operation with others or growing. As a result necessity and willing of growing is the main reason lying under the appearance of business combinations.

Expansion or growth occurs in two basic ways. First one is internal expansion; the other one is the external expansion.

"Internal expansion is the growth of an organization's assets through cash generated internally from either internal financing, appreciation or accretion."[1]

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[1] Internal Expansion, TIAA-CREF Brokerage Services, Investment Glossary, Accessed from http://www.tiaa-crefbrokerage.com/invest_glosry_IntInu.htm on January 26, 2006.

In practice, internal expansion focuses on the firm's product research and development. Firms, which prefer growing internally, tend to emphasize marketing and promotional activities. If a company relies for many years on new product development to maintain and expand its market share, this means this company has chosen the internal method of expansion.

External expansion is growth by acquiring other firms and this constitutes business combinations. It is apparent that external expansion has some advantages when compared to internal expansion, and this topic will subsequently be discussed. In this study the emphasis would be on external expansion, which has increased tremendously in recent years and essentially means business combinations.

In the historical development of business combinations there have been three distinct periods, which are; 1880-1904, 1905-1930, 1945- present. These periods tend to occur as a result of changes in the economy. In the first period, capitalists created huge holding companies, or trusts, in order to establish a monopoly over certain industries. To achieve this goal, companies had to combine within the same industry that; meant horizontal business combinations.[2]

Then, between 1905 and 1930, vertical business combinations were popular. A vertical business combination is a type of combination that occurs between the company and its suppliers or customers. During the first years of this period, there was the First World War and governments supported business combinations to obtain greater standardization of materials and parts and to discourage price

[2]Business Combinations. Historical Perspective, Accessed from http://media.wiley.com/product_data/excerpt/29/04712185/0471218529.pdf on January 26, 2006.

competition. The third and final period began with the end of the Second World War. This period is also known as the "merger-mania" and had ended by mid-2002.[3]

After the war, there were considerable developments in technology and international trade. Consequently, these improvements brought increasing competition and companies had to learn to survive in these conditions. The European countries particularly, which were suffering economical difficulties following the war, had to adopt their structures to the new economic challenges in order to survive. The best way to handle these challenges was to increase market power, which means the combination of businesses or the foundation of new entities.

Business combinations usually occur when one company acquires the control of another company. The companies are said to be affiliated but they remain separate legal entities. As a result, new business groups are formed that have hard business links but different juristic personalities.[4]

It should be mentioned that during the third period a wave of conglomerates appeared in the late 1960s and 1970s. A conglomerate is the combination of companies in unrelated business activities. This formation of businesses was designed to support a company's growth and decrease the variety of its risks.

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[3] Ibid.
[4] Devran, Ali and Aktaş Rafet . (2004), "Konsolide Mali Tablolarla İlgili IFRS Çerçevesinde Hazırlanan Ulusal Düzenlemelerin İncelenmesi", (2006) Gazi Üniversitesi Sosyal Bilimler Araştırmaları E-Dergisi, Yıl 1, Sayı 2, Dönem Eylül, Accessed from http://www.sosbil.gazi.edu.tr/edergi/makale.php?Makale=8 onJanuary 28, 2006.

Executives thought that when a business was down, another would be up and there would eventually be a balance.[5]

1.2. What is a Business Combination?

In order to understand the concept of a business combination, primarily the definition of a "business" should be specified.

According to IFRSs; "A business is an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing either:

(1) a return to investors, or

(2) dividends, lower costs or other economic benefits directly and proportionately to owners, members or participants. [paragraph 3(d)].[6]

We should also specify that the main objective of a business must be to make a profit by providing products or services to customers. These customers can be either in the private or public sectors or individuals in the entire society.[7]

Before examining business combinations, it is necessary to focus on the forms of business organizations. There are three major varieties of business organizations: sole proprietorships, partnerships and corporations.

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[5] Mescon Michael H., Bovee Courtland L., and Thill John V. 2001. *Business Today (10th ed.).* New Jersey: Prentice Hall, page135.

[6] Exposure Draft of Proposed Amendments to IFRS 3, Business Combinations June 2005, Accessed from http://www.iasb.org/uploaded_files/documents/8_38_Proposedamendtoifrs3.pdf on January 26,2006.

[7] Mescon Michael H., Bovee Courtland L., and Thill John V. 2001. *Business Today (10th ed.).* New Jersey: Prentice Hall.. " Business; a profit-seeking activity that provides goods and services that satisfy consumers' needs." page 4.

Sole proprietorships are businesses that are owned by one individual who has complete control, and unlimited personal liability for business debts.

Partnerships are businesses that have two or more owners that share the control equally, unless specified otherwise by any agreement. These owners also share the profits and losses of the business according to the agreed shares. The agreement between owners is to conduct a business as co-owners.

The final one is corporations. This is different from the other two forms. Corporations are artificial persons. Their legal entities are created by state law and usually possess all the rights, privileges and obligations that people have.[8] In corporations the ownership and management of the business are different.[9]

Some terms related to these business forms should also be provided. Any lawful form of business organization is called a firm and the owner of the firm differs according to the form of the business. The owner of the firm can be shareholder in corporations, an individual in a sole proprietorship, and a partner in partnerships.

Within this context it would be beneficial to cover the concept of business combinations. Referring to IASs "a business combination is combining two separate legal enterprises into a single economic entity as a result of one enterprise uniting

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[8] Matulich Serge, Heitger Lester E. 1985. *Financial Accounting (2nd ed.) U.S.A. Mc Graw Hill,* page638.

[9] Mescon Michael H., Bovee Courtland L., and Thill John V. 2001. *Business Today (10th ed.).* New Jersey: Prentice Hall, page 129.

with or obtaining control over net assets and operations of another enterprise. The combination can result in a single legal entity or two separate legal entities." [10]

IFRSs also define a business combination as the bringing together of separate entities or businesses, into one reporting entity." [11]

As businesses exist in order the make a profit, which is, indicated as money, business combinations also occur with the purpose of making a profit by acquiring control of one or more businesses.

When business combinations are realized, the integration of financial, human and organizational resources of corporations occurs. The economic independence of individual corporations or the consolidation of decision-making authorities on business operations is eliminated by combination.[12]

While explaining business combinations we mentioned the terms "control, changing of control or obtaining control". In business combinations, control refers to the continuing power to determine an enterprise's strategic operating, investing and financing policies without the cooperation of others to obtain benefits from its activities.[13]

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[10]Summaries of International Accounting Standards, IAS 22 Business Combinations, [IAS 22.8], Accessed from http://www.iasplus.com/standard/ias22.htm on March 2,2006.
[11]Summaries of International Financial Reporting Standards, IFRS 3 Business Combinations, Accessed from http://www.iasplus.com/standard/ifrs03.htm on March 2,2006.
[12]Restriction on Business Combinations, Accessed from http://ftc.go.kr/data/hwp/combination.doc on January 30, 2006.
[13]Summaries of International Accounting Standards, IAS 22 Business Combinations, Accessed from http://www.iasplus.com/standard/ias22.htm on March 2,2006.

IFRS 3 defines that “The acquirer is the combining entity that obtains control of the other combining entities or businesses”[14]. Consequently, IFRS 3 implies that the acquirer has controlling power.

The company that has the controlling power is the parent company and the company that is controlled by the parent company is the subsidiary. In some cases the parent company can be the acquiring company and in some cases it can be the merging company. The same thing is valid for the subsidiary. The subsidiaries can be the acquired company or the merged company according to the combination. These will be expanded in the following sections while explaining merging and stock acquisition.

As illustrated earlier, two or more businesses may constitute a business combination. In a combination, there is no pre-condition to be sole proprietorships, partnerships or corporations. But it is agreed that corporations the most suitable for business combinations.

For instance, when it is entered combination with a sole proprietorship or a partnership, partners will be responsible for all the debts of the acquired or the merged company as a result of liability exposure of these business organization types. But in corporations, the situation is different. Liabilities of corporate investors are liable for the debts are limited within the amount of their investment. Further discussion concerning with this topic is not included in this study in order not to digress from our basic subject.

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[14]Summaries of International Financial Reporting Standards, IFRS 3 Business Combinations, [IFRS 3.17], Accessed from http://www.iasplus.com/standard/ifrs03.htm on March 2,2006.

1.3. Forms of Business Combinations

Business combinations are described as mergers, reorganizations, acquisitions and consolidations.

1.3.1. Mergers

In a merger or reorganization only one of the combined companies survives, the others lose their separate legal identities. For example, A combines with B. The company A buys all the assets of company B. At this point, company B (the merged company) no longer exists, it loses its separate legal status. Only the merging company A survives. There is no parent-subsidiary relationship among combined businesses and the control is shared equally between combined companies. This can also be called an asset acquisition. The merging company A has the power of control and it assumes all the debts and contractual obligations of the company it acquires.[15]

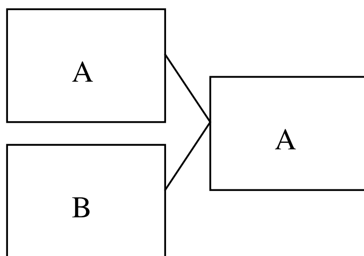

Figure 1: A merger or a reorganization or an asset acquisition

[15] Mescon Michael H., Bovee Courtland L., and Thill John V. 2001. *Business Today (10th ed.)*. New Jersey: Prentice Hall, page135.

1.3.2. Stock Acquisitions

Acquisitions, or stock acquisitions, are different. Company A purchases the stocks of company B which continues to have its separate legal status. Company B still exists after the combination but the point is that the control of this company has transferred to company A. The control of net assets and operations of B has transferred to A. There is a change in the shareholders and the ownerships. Here, A is the acquiring or parent company; B is the subsidiary, or the acquired company. There is a parent-subsidiary relationship. Following the combination, both companies survive.[16]

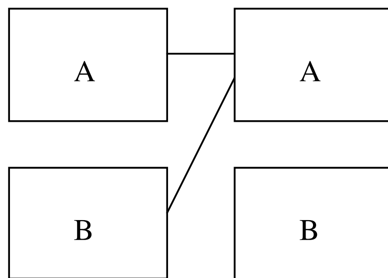

Figure 2: An acquisition or stock acquisition

1.3.3. Consolidations

The third one is consolidations. The combinations of companies A and B results in both companies' terminating their previous legal existence and becoming part of the new firm, for example C. After the combination, no company survives

[16]Business Combinations, Types of business Combinations, Accessed from http://media.wiley.com/product_data/excerpt/29/04712185/0471218529.pdf on March 5, 2006.

and company C retains control. In a consolidation, two or more companies that pool their interests create an entirely new firm.[17]

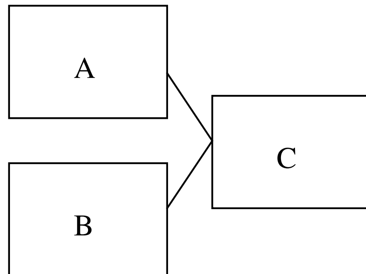

Figure 3: A consolidation

Consequently, while examining business combinations the questions that should be asked are "what is acquired" and "what is relinquished". This will clarify the distinction between a merger or stock acquisition and then the classification will be easier to comprehend. What is acquired? Assets or stocks? Or what is relinquished? Only control of the business, or only assets, or only stocks of the acquired company? If assets are acquired, this is a merger, if stocks are acquired, this is an acquisition (stock acquisition). From the merged or acquired perspective, if assets are relinquished it is a merger, if only the control of assets is relinquished, this is an acquisition. On the other hand if all of them (i.e. control, assets, stocks) are acquired this is a consolidation.

1.4. Classification of Business Combinations

Business combinations can be categorized in accordance to the economic relationships between the combining companies, based upon the nature of the

[17] Mescon Michael H., Bovee Courtland L., and Thill John V. 2001. *Business Today (10th ed.)*. New Jersey: Prentice Hall, page135.

combination, and based upon the method of the combination. All these classifications are examined below;

1.4.1. Classification according to the Nature of the Combination

Business combinations are classified in two types in accordance to their nature; Friendly Combinations and Unfriendly or Hostile Combinations.

1.4.1.1. Friendly Combination

In some cases the boards of directors of both companies (the acquiring company and the acquired company) agree on the terms of a proposed combination. This is called friendly combination. Unless there is any resistance to the merging firm by the merged firm, we can call this combination "friendly". In friendly combinations, when the combination terms are mutually agreed upon the proposal is submitted to the stockholders of the involved companies for their acceptance. The combination will not be valid if the stockholders do not give this acceptance. [18]

1.4.1.2. Unfriendly / Hostile Combination

In some cases the board of directors of the acquired company resists the combination and this case is known as the unfriendly combination. In an unfriendly combination there is resistance from the merged company, which is represented by the largest shareholder or the resolution of the board of directors.[19]

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[18]Business Combinations, Types of business Combinations, Accessed from http://media.wiley.com/product_data/excerpt/29/04712185/0471218529.pdf on March 5, 2006.
[19]Restriction on Business Combinations, Accessed from http://ftc.go.kr/data/hwp/combination.doc on March 5, 2006.

1.4.2. Classification according to the Economic Relationship Between Companies

Business combinations can be classified into horizontal business combinations, vertical business combinations and conglomerates in accordance to the economic relationships between the combining companies.

1.4.2.1. Horizontal Business Combination

A horizontal business combination consists of several companies in a similar line of business. As has been determined in the historical background of business combinations, these types of combinations were very popular between 1880 and 1904 in order to establish a monopoly in certain sectors. Horizontal business combinations are a type of integration of competing firms, which produce identical or similar products at the same level of transaction between producers, wholesalers or retailers.[20]

The main purpose of horizontal business combinations is to achieve the benefits of economies of scale[21] and to decrease competition. But fending off competition by buying enough stock of competing the companies in basic industries may bring a monopoly to the market and may resulted in the closing of small medium sized enterprises in this sector. [22]

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[20]Matulich Serge, Heitger Lester E. 1985. *Financial Accounting (2nd ed.) U.S.A. Mc Graw Hill,* page639.

[21]Economies of scales: "The increase in efficiency of production as the number of goods being produced increases", Accessed from http://www.investopedia.com/terms/e/economiesofscale.asp on March 7,2006.

[22]Mescon Michael H., Bovee Courtland L., and Thill John V. 2001. *Business Today (10th ed.).* New Jersey: Prentice Hall, page135.

In order to clarify it even further, we can provide a current example from Turkey. Koç Holding owns several groups of companies. One of them is related to "Durable Goods". In this group, the holding owns "Arçelik A.Ş." and "Beko A.Ş." and others but these two companies are the best known among others in the group. These companies serve the same industry and they constitute a good example of a horizontal type of combination.

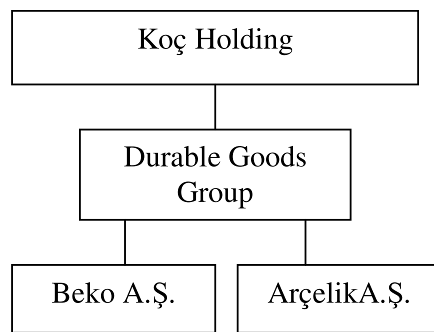

Figure 4: Horizontal business combination

1.4.2.2. Vertical Business Combination

Several companies in related industries that complement the activities of one another illustrate a vertical combination. When a manufacturing company and a retailing company combine this is defined as a vertical combination. [23]

There is a supplier-customer relationship between combined businesses. The combination of a company with its suppliers and sellers constitutes a vertical combination. To guarantee the access to supplies or markets is the aim of a vertical

[23] Matulich Serge, Heitger Lester E. 1985. *Financial Accounting (2nd ed.) U.S.A. Mc Graw Hill,* page 639.

combination.[24] For instance; a steel manufacturing company may acquire a coal mining company in order to guaranty continuous supply for its production.

Lets provide a current example from the same holding: Koç Holding. The holding has "automotive" group. One is the "Tofaş Fiat" group. Tofaş as a manufacturing company produces motor vehicles. On the other hand, Koç Holding owns a retailing company "Birmot A.Ş." to sell Tofaş cars. In this case there is a customer and supplier relationship; Tofaş is the supplier and Birmot is the customer.

This type of combination occurred against monopoly over industries, and this was established by horizontal combinations and allows a better integration of operations, a reduction of cost savings and an improvement competitive positions.

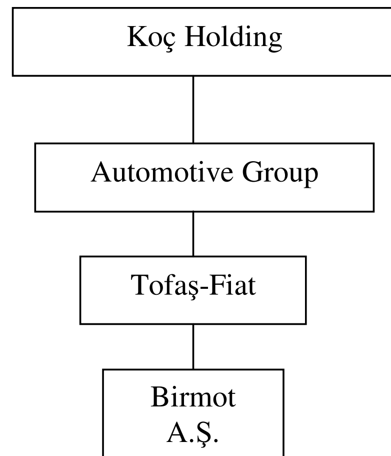

Figure 5: Vertical business combination

1.4.2.3. Conglomerate

If a corporation owns a number of unrelated businesses, this is called a "conglomerate". An example of this is a corporation that sells sporting goods,

[24] Mescon Michael H., Bovee Courtland L., and Thill John V. 2001. *Business Today (10th ed.).* New Jersey: Prentice Hall, page135.

produces automobiles and also owns a company that provides service in the tourism sector. Once again, an appropriate example is again Koç Holding. As shown below the holding owns several groups but we previously showed only two of them. Now based on other businesses we will provide an example of conglomerate.

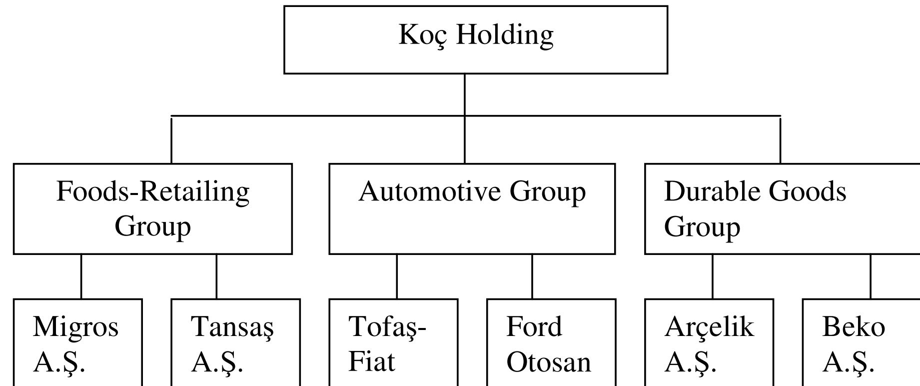

Figure 6: A conglomerate

This is the most suitable example of a conglomerate, as you can see, there are several unrelated businesses combined under the Koç Holding framework.

It is necessary to mention other business combination terms such as; holdings and affiliated companies. Holdings are combinations whose primary purpose is to possess the stock of other companies rather than creating a product or service itself. [25]

The operations of a holding consists only of the management and finances of the various businesses whose stock they own. A holding does not have any function in the businesses' continuing operations; the combined companies conduct these

[25] Definitions of Investing, Legal, & Business Terms, Accessed from www.atozinvestments.com/investing-terms-h.html on March 7,2006.

activities on their own. The holding is responsible for their stocks. Holdings can be also called "stock acquisitions also".[26]

Holdings can be established in vertical or horizontal forms and these are explained in the classification of business combinations. As it is indicated above, the purpose of a holding is to have the power of control on management of the businesses, which have been acquired. In order to attain this aim, a holding should obtain at least 51% of the acquired businesses' capital. [27]

Another term related to business combinations is "affiliated companies". Whether the relation among the combined companies is vertical, horizontal, conglomerate, or a holding-company, all are known as affiliated companies. The operations and financial position of such affiliated companies are usually combined and reported in a single set of consolidated financial statements. To simplify it, it can be said that parent subsidiary relationships are called affiliated companies. In affiliated companies, the legal existence of the acquired company is retained. Their operations and financial positions are combined.[28]

The previous examples in vertical, horizontal and conglomerate indicate that the same system is applied to holdings and affiliated companies. Figure 6 may also provide a sample for the structure of a holding-company and affiliated company.

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[26] Matulich Serge, Heitger Lester E. 1985. *Financial Accounting (2nd ed.) U.S.A. Mc Graw Hill,* page639.
[27] Akdoğan, Nalan and Tenker, Nejat. 2001. *Finansal Tablolar ve Mali Analiz Teknikleri.* Ankara: Gazi Kitabevi, page406.
[28] Matulich Serge, Heitger Lester E. 1985. *Financial Accounting (2nd ed.) U.S.A. Mc Graw Hill,* page640.

In this case Koç Holding owns at least 51% of stocks of each company and only responsible for their management and financing their stocks. The on going operational functions are held by the individual companies. There is a parent subsidiary relationship among these companies and these are known as affiliated companies.

1.4.3. Classification According to the method of Combination

According to IAS 22 a business combination appears when businesses combine their operations in two basic ways. One is the acquisitions; where a business buy another that means control is acquired, and the other one is the uniting of interests; where two existing businesses join together to carry out businesses as one economic entity. These are analyzed below;

1.4.3.1. Acquisitions

22nd standard of IASs indicates that; "a business combination in which one of the enterprises (the acquirer) obtains control over net assets and operations of other enterprises (the acquiree) in exchange for the transfer of assets, incurrence of a liability, or issue of equity is an acquisition."[29] IAS 22 presumes all business combinations as to be acquisitions and accepts the purchase method of accounting except in very limited circumstances, which are cited a uniting of interests. [30]

[29]Summaries of International Accounting Standards, IAS 22 Business Combinations, [IAS 22.8], Accessed from http://www.iasplus.com/standard/ias22.htm on March 7,2006.
[30]IAS 22 Business Combinations, Wikipedia, Accessed from http://en.wikipedia.org/wiki/IAS_22:_Business_Combinations on March 7,2006.

In acquisitions there is an acquirer and an acquiree. The enterprise that obtains control over the net assets and operations of another enterprise is the acquirer. The enterprise, which transfers all its net assets and operations, or the control of them, is the acquiree. In other words acquirer is the parent company and the acquiree is its subsidiary. If there is an asset acquisition and one of the company loses its legal status this is a merger, if there is a stock acquisition this means there is a holding and subsidiary company continues its operations but its stocks are transferred to the acquired holding. So a merger, stock acquisition or an asset acquisition refers to "acquisition" according to the method of business combinations.

In acquisitions the method is purchasing the assets or shares of another business. When a purchase takes place the owners of the subsidiary company give up their interest, and the owners of the parent company obtain an interest in the combined business. The owners of the subsidiary company sell their stock to the new owners (the parent company's owners) and no longer have an interest neither in the subsidiary company nor the consolidated business.

Additional to these explanations it can be said about acquisitions that; one of the enterprise acquires more than one half of the voting rights of the other combining enterprise as a result of an agreement with other investors. Also one enterprise has the power to cast the majority of votes at meetings of the board of directors of the other enterprise. [31]

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[31]Ibid.

For an acquisition, assets and liabilities should be recognized if it is probable that an economic benefit will flow and if there is a reliable measure of cost or fair value. Assets and liabilities of the acquired company are included in the consolidated financial statements at fair value (acquirer's purchase price). Also for an acquisition the existence of goodwill must be determined.

The difference between the cost of the purchase and the fair value of the net assets is recognized as goodwill. If this difference is positive it is called goodwill, if this difference is negative it is called negative goodwill and the difference is generally depends on the subsidiary's reputation. If the purchased business has good reputation in the market goodwill will be positive. As stated in IAS 22 goodwill has a maximum useful life of 20 years. But for uniting of interests no goodwill is recognized. This point will be examined subsequently. [32]

1.4.3.2. Uniting of Interests

"A business combination in which the shareholders of the combining enterprises combine control over the whole of their net assets and operations, to achieve a continuing mutual sharing in the risks and benefits attaching to the combined entity such that neither party can be identified as the acquirer" is defined as an uniting of interest in IAS 22.

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[32]Summaries of International Financial Reporting Standards, IFRS 3 Business Combinations, [IFRS 3.17], Accessed from http://www.iasplus.com/standard/ifrs03.htm on March 10,2006.

Additional to this definition IAS 22 indicates that a uniting of interests is an unusual business combination in which an acquirer cannot be identified and such combinations must be accounted for by the pooling of interests method.

IAS 22 says that an acquirer cannot be identified by uniting of interests because there is no transfer of the control among entities; there is no change in owners. Here, the shareholders of the enterprises come together in order to combine the control of net assets and operations of all businesses and they share the risks and benefits of the combining entity.[33]

Shareholders combine their businesses with their own desires in uniting of interest method. The shareholders of the company give their right of voting and their own shares willingly. This brings together that the substantial majority of voting common shares of the combining enterprises are pooled. The shareholders of each enterprise maintain substantially the same voting rights and interests in the combined entity, relative to each other, after the combination as before. Moreover, the managements of both of the combining enterprises share in the management of the combined entity in this method.

In acquisitions the fair value is valid but in uniting of interests nominal value is used while combining the both company's shares. As a result of using nominal values, no goodwill arises. Thus, there is no decrease in the net income. Because it is presumed that the fair value of one enterprise is not significantly different from other enterprise.

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[33]Summaries of International Accounting Standards, IAS 22 Business Combinations,, Accessed from http://www.iasplus.com/standard/ias22.htm on March 10,2006.

The basic indicator for distinguishing between acquisitions and uniting of interests is lying under the shareholders situation. If the both entities shareholders remain obtaining interests from the combined business, this is the pooling of interests method.

The most suitable method for consolidation is the acquisition method. In uniting of interests method, no goodwill is recognized and this situation causes for consolidated net income determining more than the real and for consolidated assets determining less than the real value. Besides, IFRS 3 accepts only acquisitions as type of business combinations and definitely prohibits uniting of interests as type of business combinations.

1.4.3.3. Summary of Differences between Acquisitions and Uniting of Interests

Acquisitions;

- An acquisition occurs when a business purchase the assets or shares of another business.
- One of the enterprises obtains control over net assets and operations of another business.
- For example there are A and B companies and they decide to combine. According to the method of combination this will be an acquisition. A buys the stocks of the company B. The control of net assets and operations of B has transferred to the company A. From now on A is the parent (acquirer) company and B is its subsidiary (acquiree).
- When we look above it can be said that an acquirer can be identified.

• One of the combining companies should have a bigger share in the stocks of the other company. If A buys at least 51% of the stocks of B this is an acquisition.

• Acquisitions use the purchase of accounting method.

• In acquisitions fair value is valid. One of the combining companies' total values can be more than the other or one of the combining companies' fair values can be less than the other and this is related with that company's reputation in the market and public. So these conditions bring positive or negative goodwill together.

• The owners of the subsidiary company sell their stocks to the new owners (the parent company's owners), and no longer have an interest neither in the subsidiary company nor the combined businesses. This means shareholders of the acquired company no longer exists, there is a change in the ownership.

• As a result to all these explanations the combined either the parent or the subsidiary continue having their separate legal status.

Uniting of Interests;

• A uniting of interests occurs when two existing businesses join together to carry out businesses as one economic entity by the shareholders' of combining companies by their own desires.

• The shareholders of the combining enterprises combine and share control over the whole of their net assets and operations. There is no transfer of control.

• Again assume that there is A and B companies that decided to combine under uniting of interests method. Both companies have the same rights, have the equal power to control, and equally share benefits and risks.

• The concluding explanations to this should be that an acquirer couldn't be identified.

• In this type of combination, which is very unusual, pooling of interests method for accounting is used.

• Neither the company A nor the company B has more shares when compare to each other. Both have 50% equally stocks of the combined company. This means shareholders of both entities remain obtaining equally interests from the combined businesses.

• It is accepted that the fair value of both enterprises is not significantly different from the other so it s not discussed about any goodwill.

• Both companies continue having their separate legal status.

1.5. Results of Business Combinations

1.5.1. Advantages and Disadvantages of Business Combinations

Business combinations the result of external expansion, of course, has some advantages and disadvantages when compare to the internal expansion for the firms.

By combining primarily companies hope to eliminate redundant costs. The cost savings are vital for any kind of business and if a business goes a combination with its major suppliers, (vertical combination), that means if a company acquires one of its major suppliers, this will result with reducing a considerable amount in cost savings. For example before the combination the firm has some costs related with the negotiations, bargaining and coordination between the parties. But after acquiring its supplier the firm does not have to do these negotiations and its cost savings reduce.

Another advantage is related with the operating synergies. It does not matter whether the combination is vertical or horizontal; combination with an existing company generally provides some advantages on operating synergies. Because the existing company, (from now on the acquired company), generally has an established operating unit, and a capable administration with its experienced personnel, regular suppliers, customers, distribution channel, and productive facilities. Companies will use the advantage of the benefits of working together when compare to operating independently of each company.[34]

Furthermore, business combinations provide expansion in financial opportunities that bring increase in buying power as a result of their larger size and competition in the company's operating sector by increasing their market share by combining product lines to provide more extensive offerings, increase revenue by cross selling products to each other's customers and eliminate manufacturing overcapacity.

Business combinations may not always be the best way of expansion, like its advantages, it has also disadvantages from the beginning of the combination. For instance, some decisions about the combination have to be taken such as how the combination will be financed and how the power will be transferred and shared. But if the executives get over this process successfully there will not be any problem. After this process a complication in marketing departments may arise while blending advertising campaigns and sales forces. Other difficulties that companies

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[34]Business Combinations, Advantages of Business Combinations, Accessed from http://media.wiley.com/product_data/excerpt/29/04712185/0471218529.pdf on March 12, 2006.

must deal are layoffs, transfers and changes in job titles and work assignments in the beginning process of the combination.

After the combination process has completed some other disadvantages can be arisen such as; causing communication problems between the sides, a slow decision process, cost arising from the acquisition, monopolization tendencies, and disharmony created by corporate culture differences.[35]

1.5.2. Requirements of Business Combinations

A business combination, of course, must meet certain legal and official requirements, however here we will discuss only from the accounting perspective.

From the accounting perspective, consolidated financial statements are the most important for business combinations. Although details about these statements will be examined in the second chapter, here some brief explanation will be given.

Prior to the appearance of business combinations, companies had their own financial statements, which included an income statement, a balance sheet and a cash flow statement that summarize the financial status for a stated period of time.

However, business combinations require consolidated financial statements in order to satisfy the need of financial information of the society. Thereby, consolidated financial statements were developed and then even today a special standard of IASs cover the problems of consolidated financial statements.

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[35] Mescon Michael H., Bovee Courtland L., and Thill John V. 2001. *Business Today (10th ed.).* New Jersey: Prentice Hall, page434.

In case of mergers, as it is mentioned before there is no parent subsidiary relations, so there is no different two or more companies after merging. So no any company should prepare consolidated financial statements. But at the beginning of course two companies should consolidate its financial statements however, after the combination they do not prepare consolidated financial statements. They are now on a new “one” entity and they prepare only one financial statement of the merged companies.

In case of, acquisitions each company in the combination prepares its own financial statements as they keep their legal identity. The parent company prepares consolidated financial statements by combining all its subsidiaries financial statements.

An investor can own any amount of shares in the investee, but here our topic is concerned with the amount, which is over 51% of shares of the acquired company. After acquiring the amount over 51% of a company, that means control is acquired and a business combination comes into force and the investor and investee or the acquirer and the acquired are referred as a parent and a subsidiary. This brings the necessity of preparing consolidated financial statements by the parent.[36]

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[36] Akdoğan, Nalan and Tenker, Nejat. 2001. *Finansal Tablolar ve Mali Analiz Teknikleri.* Ankara: Gazi Kitabevi, page401.

CHAPTER 2

CONSOLIDATED FINANCIAL STATEMENTS

2.1. Definition of Consolidated Financial Statements

The primary objective of financial reporting is to provide information useful for making investment and lending decisions. In line with this objective the purpose of preparing and presenting financial statements is to provide information about an entity's financial position, financial performance and cash flows.

Consolidated financial statements serve the same purpose as well. But the point is that consolidated financial statements are prepared in order to give general financial information about a business combination and all its subsidiaries as a whole, while financial statements are prepared only for one entity. Also for an entity to disclose financial statements is a legal obligation, but to arrange consolidated financial statements for a business combination is only an economic necessity not a legal obligation. [37]

[37] Akdoğan, Nalan and Tenker, Nejat. 2001. *Finansal Tablolar ve Mali Analiz Teknikleri.* Ankara: Gazi Kitabevi, page397.

A business combination consists of two or more entities in which every single entity has its own financial statements. But their own separate financial statements are not sufficient enough to give desirable financial information of a business combination and all its subsidiaries as a single economic entity. But consolidated financial statements provide this desirable financial information by combining separate financial statements of each entity in the combination on line-by-line basis.

The exact definition of consolidated financial statements is given in IAS 27 as "the financial statements of a group presented as those of a single economic entity". [38]

However, consolidated financial statements do not mean just this. In order to understand the concept clearly, the answers of such questions should be given; what are the principles of preparing consolidated financial statements and to whom they are presented? What are the differences and similarities between financial statements and consolidated financial statements? Why are consolidated financial statements an economic necessity? Are there any disadvantages of consolidated financial statements? What are the rules of preparing consolidated financial statements and are there any arrangements concerned with them?

The basic principle of preparing consolidated financial statements is directly related with having the power of control of a subsidiary by a parent company. Participation to an entity is not an enough cause for preparing consolidated financial

[38]Summaries of International Accounting Standards, IAS 27 Consolidated Financial Statements, [IAS 27.4], Accessed from http://www.iasplus.com/standard/ias27.htm on March 15,2006.

statements. Participation must be permanent and should end with parent-subsidiary relationship. Parent-subsidiary relationship shortly means parent has the power to govern the financial and operating policies of the subsidiary**.**

To mention the existence of control power at least one of the conditions below must be formed;

• For the parent to hold more than 50% stocks and acquire more than half of the voting rights of the subsidiary or,

• To have over more than half of the voting rights by an agreement with other investors or,

• To govern the financial and operating policies of subsidiary under a statute or an agreement or,

• To have the right assign and remove the majority of the members of the board of directors or,

• To control the majority of votes in the meetings of board of directors.[39]

Here there is a point that has to be emphasized. It is not enough for a parent to have one of the items above to prepare consolidated financial statements; furthermore the parent should be closely relevant to economic activities and results of the subsidiary.[40]

For instance Koç Holding has a university named Koç University. Its activities are independent from the holding. This university does not have any

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[39] Ibid.
[40] Akdoğan, Nalan and Tenker, Nejat. 2001. *Finansal Tablolar ve Mali Analiz Teknikleri.* Ankara: Gazi Kitabevi, page409.

economic activities but the finance of university is provided by Koç foundation. So the holding does not include the university in its consolidated financial statements.

Moreover it should be mentioned that the nature of businesses for subsidiaries in a combination may be different. This does not prevent for preparing consolidated financial statements. Also the nature of businesses of subsidiaries may differ from the parent. This is a probable condition also. In both cases the parent entity prepares consolidated financial statements. Again we can give the Koç Holding example. Here below there is a diagram involving just a few subsidiaries of the holding;

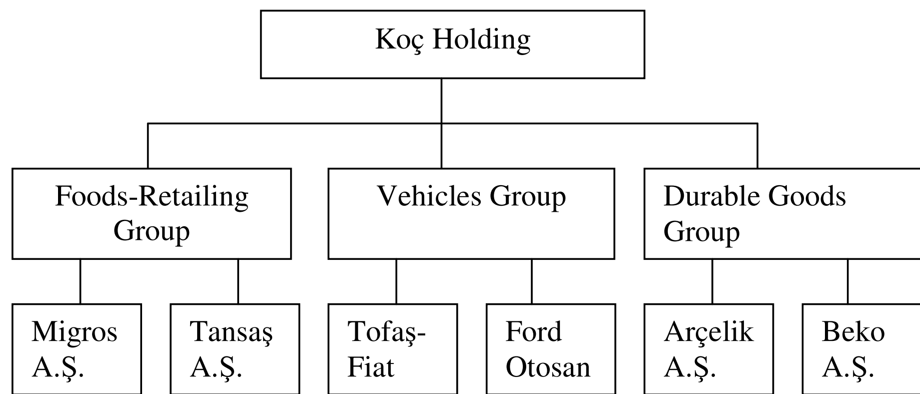

Figure 7: Structure of a holding

As it can be clearly seen, the subsidiaries operate in different sectors and their activities are different from their parent. The objective of a holding company is participating in other entities[41], as other business types and the subsidiaries deal with foods-retailing or durable goods producing and selling or vehicles producing and

[41] Akdoğan, Nalan and Tenker, Nejat. 2001. *Finansal Tablolar ve Mali Analiz Teknikleri.* Ankara: Gazi Kitabevi (Holding is not type of a company, holding is a type of a business administration. Holding deals with participation). page405.

selling. But as a result Koç Holding prepares consolidated financial statements of the combination and its subsidiaries as a whole.

Another principle about consolidated financial statements is related with its preparation. Consolidated financial statements must be prepared and presented on line-by-line basis. While consolidating the balance sheets, income statements and cash flow statements of the parent company plus majority owned subsidiaries, the assets, liabilities, revenues and expenses of each subsidiary are added to the parent's account. For instance, cash balance of the subsidiary is added to the cash balance of the parent and overall sum is reported on the parent's balance sheet. This is consolidation prepared and presented on line-by-line basis.[42]

In particular points consolidated financial statements and separate financial statements resemble to each other and differentiate from each other. The most conspicuous similarity is their aim, which is giving general financial information to interested parties. The main difference is, as known, financial statements are prepared only for one entity but consolidated financial statements are prepared for two or more entities. Other key difference is to prepare financial statements for an entity is a legal obligation, but preparing consolidated financial statements is an economic necessity for the parent entity.

Therefore why are consolidated financial statements an economic necessity? Financial statements only show the financial position of each entity in a combination. But these separate statements do not show the general financial

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[42] Horngren Charles T., Harrison Jr. Walter T., and Bamber Linda Smith. 2005. *Accounting (6th ed.)*. New Jersey: Prentice Hall, page632.

position of the combination. Consequently, when financial statements of each company in the combination are consolidated, financial information about the business combination and all its subsidiaries as a whole is provided; that's why consolidated financial statements are economic necessity.

Consolidated financial statements are an economic necessity primarily for the shareholders and creditors of the parent company. Shareholders want to see their profit or loss and suppliers, banks, and other lenders may want to know if a business is creditworthy or if they will give their money back on time. Managers also need these consolidated reports as a basis for overall control and evaluation of performance. On the other hand financial statements are required for to learn about the performance of company managers and to evaluate the success of the managers. Financial investors or disposal owners also may want to learn about the firm's financial position and operating results. [43]

These insiders and outsiders get the financial information about the combination by consolidated reports. However these statements should have limitations. In some cases consolidated financial reports may be misleading to whom they may concern. In a combination there are several entities in different financial positions, some is good and some is bad. And consolidation is combining of financial results of these good and bad entities. So consolidation ends with average values. Thereby any entity in bad situation or having activity stagnation,

[43]Mescon Michael H., Bovee Courtland L., and Thill John V. 2001. *Business Today (10th ed.).* New Jersey: Prentice Hall, page428.

may pose in good position or its stagnation may disappear in results of other entities.[44]

Besides this, in the combination there may be entities using dissimilar accounting systems and their appraisal methods may differ. This may also mislead to concerned people.

Other probability is related with combinations having subsidiaries in foreign countries. Results of any subsidiary in a foreign country may appear misleading in consolidated reports because of fluctuations in currency rates. [45]

All these information above is briefly the expression of consolidated financial statements. Now, if we go one step further, we will face with IASs and IFRSs. The principles of consolidated financial statements are all arranged with these standards, or any misleading results are tried to be minimized with these standards.

There are International Accounting Standards Board (IASB) and International Accounting Standards Committee (IASC) , which are currently issuing IASs and IFRSs. In the next section we will concentrate on these institutions their subject of existence and then we will pass to the standards.

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[44]Akdoğan, Nalan and Tenker, Nejat. 2001. *Finansal Tablolar ve Mali Analiz Teknikleri*. Ankara: Gazi Kitabevi, page412.
[45]Ibid.

2.2. General Information about the Institutions that issue International Accounting Standards and International Financial Reporting Standards

The reason lying under the existence of IASs is the necessity of organized, uniform arrangements in accounting and to give fair presentation of financial statements. These standards are empowered to show how particular types of transactions and other events should be reflected in financial statements. [46]

In 1973 the IASC was formed through an agreement made by professional accountancy bodies from Australia, Canada, France, Germany, Japan, the Netherlands, the United Kingdom and Ireland, and the United States of America. The aim of that committee was to set the IASs and the standard setting board was known as the IASC Board.

In 1977 the international professional activities of the accountancy bodies were organized under the International Federation of Accountants (IFAC). Then in 1981, it is agreed by IASC and IFAC that IASC would have full and complete autonomy in setting IASs and in publishing discussion documents on international accounting issues. [47]

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[46] International Accounting Standards Board, What are Accounting Standards, Accessed from http://www.iasb.org/about/faq.asp?showPageContent=no&xml=18_13_24_17122003.htm on March 20,2006.

[47] International Accounting Standards Plus, What is the IASB? Accessed from www.iasplus.com/restruct/whatis.htm on March 20,2006.

One of the major components of the old IASC structure was the Standing Interpretations Committee (SIC), which developed and invited public comment on interpretations of IASC Standards, subject to final approval by the IASC Board.

The old structure of IASC continued nearly about 25 years. To perform its role effectively, IASC had to find a way to provide convergence between national accounting standards and practices and high-quality global accounting standards. In order to reach this purpose, IASC saw that it needed to change its structure. Later on, re-examining the structure and strategy commenced and a new IASC Constitution took effect on 1 July 2000.

Restructuring of IASC brought a new body named the International Accounting Standards Committee Foundation (IASCF), which is an independent, non-profit foundation with the aim of overseeing the IASB.[48]

IASB was formed and the new constitution took effect on 1 April 2001. The new IASB took over the responsibility for setting IASs from the IASC. In short IASC was replaced by IASB and operates under the oversight of IASCF.

Together with the restructuring, it is seen that the strategy of the standards had to be renovated also and in this way IFRSs were created.

The standards, which IASB set out, are known as IFRSs. Due to IAS1 Presentation of Financial Statements IFRSs include IFRSs; IASs; and Interpretations

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[48]International Accounting Standards Plus, The IASB Structure, Accessed from http://www.iasplus.com/restruct/restruct.htm#board on Marc 22,2006.

originated by the International Financial Reporting Interpretations Committee (IFRIC) or the former Standing Interpretations Committee (SIC).

IASs say that IFRSs have both a narrow and broad meaning. In narrow meaning IFRSs are only a new number of pronouncements that are set out by IASB different from IAS. But broadly IFRSs refers to the entire body of IASB pronouncements, including standards and interpretations approved by the IASB and IASs and SIC interpretations approved by the predecessor IASC.[49]

On the other hand, in Turkey, Turkish Accounting Standards Board issues Turkish Accounting Standards in accordance with international standards. Turkish Accounting Standards, which attained a legal tender with a notification that issued by Ministry of Finance, became effective for the accounting periods on or after December 31, 2005 and standards take effect on the date that they are issued. [50]

The information above is given in order to understand the concept of accounting standards and financial reporting standards clearly and to examine better the standards concerned with consolidated financial statements. So now we can pass to the standards related with consolidated financial statements that these institutions have issued.

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[49]International Accounting Standards Plus, What is the IASB? Accessed from www.iasplus.com/restruct/whatis.htm on March 20,2006.
[50]Gürdal, Kadir. "Muhasebe Dünyasından Haberler", (2006) Muhasebe ve Denetime Bakış Dergisi .

2.3. Arrangements Concerned with Consolidated Financial Statements

IAS 27 Consolidated Financial Statements, IFRS 3 Business Combinations and its predecessor IAS 22 Business Combinations are currently the main standards, which directly organize Consolidated Financial Statements.

Up to the standards above there had been some steps that passed. First of all IASC has submitted IAS 3 named Consolidated Financial Statements in 1976. Then in 1990 IAS 27 Consolidated Financial Statements and IAS 28 Investments in Associates took effect and IAS 3 has no longer stated in implication.

In 1995 IASB has issued a new standard concerned with Consolidated Financial Statements that is IAS 22 Business Combinations. And in 2005 IAS 22 superseded with IFRS 3 Business Combinations.

2.3.1. Summary of IAS 27 Separate and Consolidated Financial Statements

Reporting of consolidated accounts is the main subject of IAS 27 "Separate and Consolidated Financial Statements" which was issued in December 2003 and applicable to annual periods beginning on or after 1 January 2005. This standard will be applied under the conditions below;

- In the preparation and presentation of consolidated financial statements for a subsidiaries under the control of a parent,

• In the preparation and presentation of separate financial statements for investments in subsidiaries, jointly controlled entities, and associates when an entity elects, or is required by local regulations.[51]

2.3.1.1. Presentation of Consolidated Financial Statements

Referring to IAS 27.9 it should be stated that a parent is required to present consolidated financial statements. However, there are exceptional cases that a parent is not required to (but may) present consolidated financial statements. These exceptional cases are determined in IAS 27.10 and listed as below;

• A parent is not required to (but may) present consolidated financial statements if the parent itself is a wholly-owned subsidiary or is a partially-owned subsidiary.

In order to clarify such a case it would be better to give an example. Assume that the structure of entities X, Y, Z, K and L is illustrated as follows:

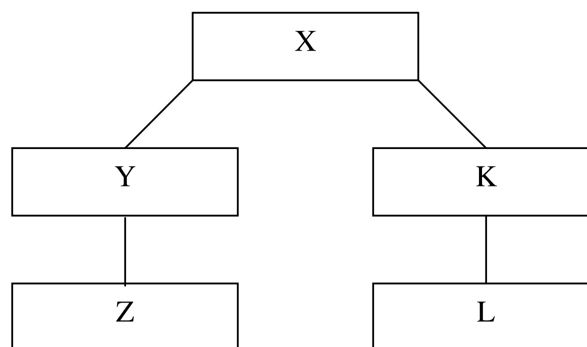

Figure 8: Structure of a wholly owned and partially owned subsidiary

[51]Summaries of International Accounting Standards, IAS 27 Consolidated Financial Statements, Accessed from http://www.iasplus.com/standard/ias27.htm on March 25,2006.

Entity X owns a 100% interest in entity K and entity K owns a 60% interest in entity L. On the other hand entity X owns a 95% interest in entity Y and entity Y owns a 60% interest in entity Z.

In such a case neither the entity Y nor the entity K is required to prepare consolidated financial statements, entity X prepares these statements. Y is not required to prepare consolidated financial statements because it is a wholly owned subsidiary itself. K is not required as well because it is a partially owned subsidiary. Partially wholly owned subsidiary is usually interpreted to mean 90% or more in IAS 27.8 and here X owns 95%of K which makes it its partially owned subsidiary.

• A parent is not required to (but may) present consolidated financial statements if the debt or equity instruments of the parent are not traded in public market.

• A parent is not required to (but may) present consolidated financial statements if the financial statements of the parent has not arranged yet or is in the process of arranging for the purpose of issuing any class of instruments in a public market.

• A parent is not required to (but may) present consolidated financial statements if the ultimate or intermediate parent of the parent prepares consolidated financial statements for public use that comply with IFRSs.[52]

Either there are exemptions for preparation of consolidated financial statements; there are indispensable cases for preparation of consolidated financial statements. Primarily, the parent should include all of the subsidiaries both domestic

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[52]Summaries of International Accounting Standards, IAS 27 Consolidated Financial Statements, Accessed from http://www.iasplus.com/standard/ias27.htm on March 26,2006.

and foreign [IAS 27.12]. The parent does not have the right of preparing consolidated financial statements for its domestic and foreign subsidiaries independently from each other.

On the other hand it should be thought when the nature of the business of a subsidiary is different from the parent's; the parent does not prepare consolidated financial statements. However, IAS 27 indicates that there is no exemption for such a condition. IAS 27 includes that there is no exemption for a subsidiary, which operates under intense long-term restrictions, which significantly impair the subsidiary's ability to transfer funds to the parent.

A subsidiary that had previously been consolidated and now is being held for sale will continue to be consolidated by the parent until it is actually disposed of. However, in March 2004 an amendment of IAS 27 by IFRS 5 (Non Current Assets Held for Sale and Discontinued Operations) resulted by an exemption for a subsidiary for which control is intended to be temporary because the subsidiary was acquired and is held exclusively with a view to its subsequent disposal in the near future. If the sale of such a subsidiary is probable within 12 months the parent should account for its investment in the subsidiary under IFRS 5 as a disposal group held for sale. This means the assets and the liabilities of such a subsidiary will be each presented as a separate line in the consolidated financial statements.[53]

[53] Ibid.

2.3.1.2. Consolidation Procedures

Consolidated financial statements must be prepared on a line-by-line basis using uniform accounting policies for like transactions and other events in similar circumstances. If using uniform accounting policies is not practicable, the facts of applying different accounting policies should be disclosed with footnotes.

Besides, reporting dates of the financial statements of the parent and all its subsidiaries should be the same if it is practicable. In impracticable cases adjustments should be made for significant transactions or events between the different reporting dates and the reason lying under this difference requires disclosure in consolidated financial statements as well. It should be indicated that the difference between the dates should not be longer than 3 months.

For instance, assume that X is the parent and prepares financial statements at 31 January each year and Y, one of its subsidiaries, prepares financial statements at 31 December. On January 30, a gas explosion caused huge damages at one of Y's factories. This event occurred after the preparation of financial statements of Y and not adjusted to balance sheet of the financial statements of Y. In such a case, the parent X should consider the gas explosion and adjust the event in its consolidated financial statements. Here, other considered point is the difference between the financial statements of X and Y. The period does not exceed 3 months, so X can do the adjustment. [54]

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[54]Price Waterhouse Coopers, Applying IFRS Solutions, Different Reporting Dates, Accessed from http://www.pwc.com/gx/eng/about/svcs/corporatereporting/Solution21_7.pdf on March 30,2006.

About minority interests IAS 27 declines that they should be presented in the consolidated balance sheet within the equity, however should be presented separate from the parent's shareholders' equity as minority interests in the profit or loss of the group. [IAS27.33]

After examining the content of consolidated financial statements, business combinations that are the reasons for the formation of consolidated financial statements will be studied in terms of IASs.

2.3.2. Summary of IAS 22 Business Combinations

22nd International Accounting Standard, Business Combinations came into force on 1 January 1995. This standard superseded by 3rd International Financial Reporting Standard, Business Combinations which became effective on 1 January 2005. Despite the renewal of the standard, to examine the amendments for consolidated financial statements not only to study IFRS 3 will be enough, but also its predecessor IAS 22 should be overviewed.

Accounting procedures for business combinations is the objective of IAS 22. The standard approves that a business combination appears in two forms as an acquisition or a uniting of interest. Thus the standard prescribes the accounting treatment for both an acquisition and a uniting of interests.

2.3.2.1. Uniting of Interests – Accounting Procedures

A uniting of interests is a rare situation where the shareholders of the uniting businesses combine control over the entities and share the risks and rewards mutually. Referring to IAS 22.77 the accounting method for a uniting of interests is the pooling of interests.

In order that a uniting of interest is a rare situation there is not so much matter to mention. Particularly the standard accentuates the financial statements of uniting entities should be consolidated on a line by line basis for both the current and prior periods as if they had been united from the beginning of the earliest period presented.

The other point that the standard covers for a uniting of interest is concerned with the amount of share capital. The amount of the share capital of for the combination is the sum of previously outstanding share capital of the combining entities. The result may not be consistent with the legal share capital of the combination. Any differences are shown as a separate adjustment in the shareholders' equity. [55]

[55] Summaries of International Accounting Standards, IAS 27 Consolidated Financial Statements, Accessed from http://www.iasplus.com/standard/ias27.htm on March 30,2006.

2.3.2.2. Acquisitions – Accounting Procedures

IAS 22 adopts that acquisitions should be accounted by the purchase method of accounting and in respect this method, accounting principles can be set out as below;

- The cost of the acquisition is the amount of the cash paid to the acquiree, plus fair value of the other worth given by the acquirer, plus any costs directly imputable to the acquisition. The cost of the acquisition should involve contingent costs at the date of the acquisition. However, the requirement is probable and reliably measured amount of the payment. When an acceptable worth is agreed the cost of the acquisition is adjusted. If there is a deferment in settlement, the cost is the present value of such consideration and not the nominal amount. [IAS 22.21]
- The acquiree's any existed identifiable assets and liabilities at the date of acquisition should be recognized together with any permitted provisions for restructuring costs. However, if it is probable that any combined future economic benefits will flow to or from the acquirer, and their fair value can be measured reliably, restructuring costs should be recognized separately. Furthermore, IAS 22.29 indicates at the date of acquisition liabilities based on the acquirer's intensions or actions; or liabilities for future costs expected to be incurred as a result of the acquisition should not be recognized whether they relate to the acquirer or the acquiree.
- Restructuring costs are recognized only if restructuring is plenary and necessary part of the acquirer's plan for the acquisition and, main characteristics of the

restructuring plan were announced at, or before, the date of the acquisition. Restructuring should terminate or reduce the acquired company's activities.

• For measuring acquiring assets and liabilities IAS 22 provides the benchmark treatment and an alternative treatment. When determining the total value of assets and liabilities according to benchmark treatment, the value of the identifiable assets and liabilities in the area of acquirer's interests and the assets and liabilities ascribed to minority before the acquisition is measured. As an alternative treatment IAS 22 allows the measurement of the assets and liabilities values at their fair value of the assets and liabilities of the minority's interest at the date of the acquisition. The fair values of assets and liabilities are measured by reference of the acquirer.[56]

• Finally, goodwill is a subject of IAS 22 that should be emphasized. As determined in previous chapter goodwill is the difference between the fair value of the net assets and the cost that purchased to acquire an entity. According to IAS 22 goodwill should be recognized as an asset and amortized over its useful life. IAS 22 makes clear that the useful life of goodwill is 20 years. However, "in rare cases" this presumption can be rebuttable and useful life of goodwill may exceed 20 years. This "rare case" means a goodwill that is so clearly related to an identifiable asset or group of identifiable assets, which will provide benefits over the entire life of those related assets. IAS 22 determines amortization s normally done on a straight-line basis. IAS 22 does not permit non-amortization of goodwill that attributes goodwill an infinite life. About negative goodwill IAS 22 declares that it is recognized as an income when future losses and expenses are recognized. This means negative

[56]Summaries of International Accounting Standards, IAS 22 Business Combinations, Accessed from http://www.iasplus.com/standard/ias22.htm on March 30,2006.

goodwill is related to expected future losses and expenses that are identified in the acquirer's acquisition plan.[57]

2.3.3. Summary of IFRS 3 Business Combinations

As it is predecessor IAS 22, the subject of IFRS 3 is to prescribe the accounting treatment for business combinations. IFRS 3 covers all business combinations; however the standard has exclusions as entities under common control, combination of mutual entities, and combination by contract without exchange of ownership interest, and formations of joint ventures.

IFRS 3 places emphasis on all business combinations fall within the scope of the standard, should be accounted for using the purchase method of accounting. IFRS 3 definitely disclaims the pooling of interests method.

Under the purchase method IFRS 3 allows the following accounting treatments for combinations;

- The cost of a business combination is defined as the sum of fair values at the date of exchange, of assets given, liabilities incurred or assumed, equity instruments issued by the acquirer, plus any costs directly attributable to the combination. [58]
- The acquirer recognizes separately, at the date of acquisition, the acquiree's identifiable assets and liabilities without taking into consideration that if they had

[57] Ibid.
[58] Summaries of International Financial Reporting Standards, IFRS 3 Business Combinations, Accessed from http://www.iasplus.com/standard/ifrs03.htm on April 2,2006.

been previously recognized in the acquiree's financial statements. The common criterion for assets and liabilities is the probability of measuring their fair values. Besides that for an asset flowing of any associated future economic benefits from the acquirer should be attended, and for a liability the requirement of an outflow of resources to settle the obligation should be attended. Furthermore IFRS 3 recognizes intangible assets and contingent liabilities if their fair values can be measured reliably.

- When measuring the identifiable assets, liabilities and contingent liabilities, the extent of any minority interest is definitely not taken into consideration. They must be measured at full fair value.
- No restructuring provisions for future losses or restructuring costs expected to be incurred as a result of business combination is accepted in IFRS 3. Restructuring provisions is accepted as post combination expenses, IFRS 3.14 indicates.
- On the other hand, IFRS 3 recognizes intangible items. If an intangible item covers the definition of an asset, and its fair value can be measured reliably, then it should be recognized as an asset separately from the goodwill.
- IFRS 3 designates that "Goodwill is recognized by the acquirer as an asset from the acquisition date and is initially measured as the excess of the cost of the business combination over the acquirer's share of net fair values of the acquiree's identifiable assets, liabilities and contingent liabilities." In other words, IFRS 3 intends goodwill is the excess part of acquirer's share of the net fair values from the acquiree's identifiable assets, liabilities and contingent liabilities.
- Amortization of goodwill is precisely prohibited by IFRS 3. Instead of amortization impairment of goodwill should be done annually in conformity with IAS 36 Impairment of Assets. Besides, negative goodwill that occurs when the net

fair value of acquired assets exceeds the cost of the business combination should be recognized immediately in profit and loss and indicated as a gain in the income statement.[59]

[59] Ibid.

CHAPTER 3

EFFECTS OF RECENT AMENDMENTS IN ACCOUNTING STANDARDS ON CONSOLIDATED FINANCIAL STATEMENTS

As mentioned before, IASs are being revised and new standards as IFRSs are issuing. IAS 22 replaced with IFRS 3 and within the scope of this new standard there are significant changes that will effect consolidated financial statements. The following topics are examined by referring the table below and the effects of last amendments are analyzed in the light of these significant changes. [60]

[60] Ibid.

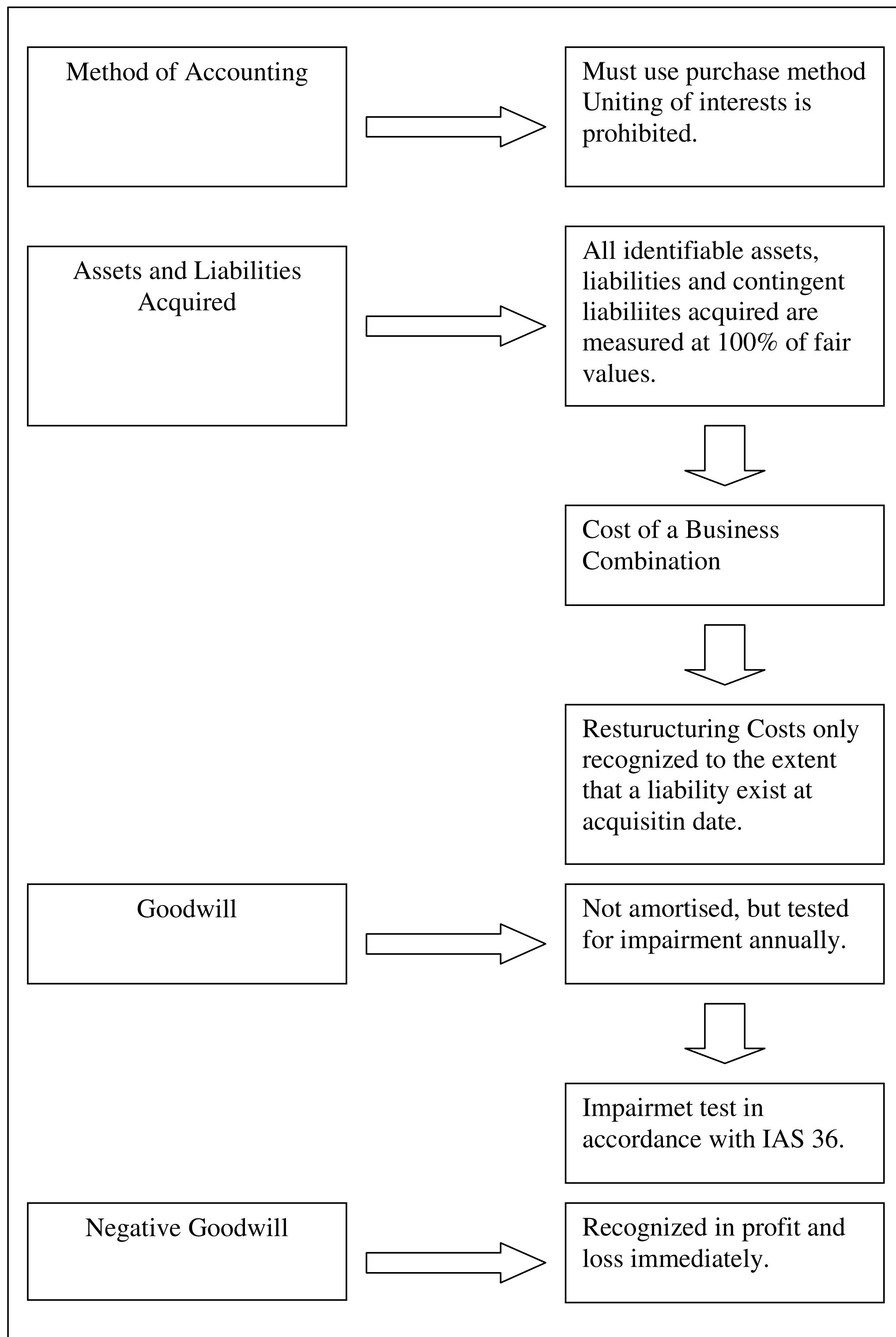

Table 1: Significant Changes in IFRS 3

3.1. The Effects on Method of Accounting

The most pronounced amendment that occurred in accounting standards is related with the method of accounting. As indicated before, IAS 22 accepts both an acquisition and a uniting of interests as forms of a business combination. However, IFRS 3 rejects that a business combination constitutes a uniting of interest. Consequently, the pooling of interests method that used for accounting for a uniting of interests is prohibited in IFRS 3. The standard covers only the purchase method of accounting and accepts only an acquisition as a business combination form.

The change in the concept of a business combination can also be seen in definitions in both standards. IAS 22 defines a business combination as “combining two separate enterprises into a single economic entity as a result of one enterprise uniting with or obtaining control over the net assets and operations of another enterprise.” This definition clearly explains that the standard includes an acquisition and a uniting of interest.

On the other hand, IFRS 3 makes the definition of a business combination as “bringing together of separate entities or businesses into one reporting entity.” This definition makes a point more from the accounting perspective by declining **reporting entity** and does not include any kind of combination as in IAS 22.

IFRS 3.17 declines that an acquirer must be identified for all business combinations. So it is very clear that, the pooling of interests method, where an acquirer cannot be identified, is not accepted in IFRS 3.

Another proof that the new standard disclaims pooling of interests is concerned with the concept of control. IFRS 3 underlines that the acquirer obtains control of the other combining entities or businesses. However, in a pooling of interest control is shared with other partner, which means any part does not have the control power by itself and cannot be identified as the acquirer.

Furthermore, the new standard, IFRS 3, not only prohibited the pooling of interests method, but also brought changes in the purchase method. The main features of the purchase method given above received modifications, as well that results with considerable changes in consolidated financial statements.

3.2. The Effects on Acquired Assets and Liabilities

Before determining recognition and measurement of assets and liabilities acquired, it should be favorable to define the cost of a business combination in both standards, in order to see the changes more evident.

The amount of cash paid, the fair value of the other consideration given by the acquirer, plus any costs directly attributable to the acquisition are the cost of acquisition according to IAS 22 and if the measurement of the contingent consideration amount is reliable and payment is probable, it is also included in the cost of the acquisition at the date of acquisition.

Besides that, IFRS specifies the cost of a business combination as the sum of fair values of assets given, liabilities incurred or assumed, equity instruments issued

by the acquirer, plus any costs directly attributable to the combination. The market price of the equity instruments at the date of exchange is the best determining factor of the fair value. Any cost adjustment contingent on future events should be included in the cost of the combination at the date of the acquisition, if its fair value can be measured reliably and the adjustment is probable as in IAS 22. In case of a reverse situation, the cost is not measured as part of the initial cost of the business combination.

At first side, it can be stared that "the cost of acquisition" shifted with "cost of the business combination". This is the result of banning uniting of interests in IFRS 3. Again a keynote related with the cost of a business combination is that in IFRS 3 any restructuring cost is not included in the cost of a business combination. So, when measuring the acquired assets and liabilities any restructuring provisions permitted for restructuring costs is not taken into account.

The new standard recognizes separately the acquiree's all identifiable assets, liabilities and contingent liabilities at the acquisition date if their fair value can be measured reliably. Moreover, for an identifiable asset the condition is to provide future economic benefits to the acquirer, and for a liability the condition is the probability of an outflow of resources from the acquirer. Liabilities for terminating or reducing the activities of the acquiree, are recognized in IFRS 3, as well. An intangible asset and a contingent liability are also recognized, when their fair values can be measured reliably.

The recognition was different in IAS 22 than IFRS 3.. The standard recognized separately, at the date of acquisition, all identifiable assets and liabilities acquired, together with any permitted provisions for restructuring costs as indicated. IAS 22 permits an acquirer to recognize a provision for terminating or reducing the activities of the acquiree, which were not a liability of the acquiree at the acquisition date. The condition of flowing future economic benefits to or from the acquirer is valid in here, as well. However, IFRS 3 only recognizes restructuring costs to the extent that a liability exists at acquisition date. That means an acquirer recognize the cost of terminating or reducing the activities of the acquiree, only when the acquiree has at the acquisiton date, an existing liability for restructuring in accordance with IAS 37 Provisions, Contingent Liabilities and Contingent Assets. For instance, assume that Entity A acquires Entity B. As part of the acquisition Entity A announces a plan to restructure the activities of Entity B, including terminating the employment contracts 55% of the existing employees of Entity B. In respect of IFRS 3 Entity A is not permitted to recognize the related restructuring costs as an acquired liability. However, if prior to the acquisition, the restructuring provision met the recognition criteria in the books of the acquiree, the acquirer should include the provision in the allocation of the cost of the business combination. [61]

The acquirer at their full fair value does the measurement of identifiable assets, liabilities and contingent liabilities initially. When measuring these items, any minority interest's share of the acquired item is measured at full fair value also.[62]

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[61]Ibid.

[62]Ernst&Young, Global Eye on IFRS, May 2004, Accessed from http://www.eyi.com/global/download.nsf/Finland/Global_EYe_on_IFRS_2004/$file/Global_EYe_on_IFRS_May04_Final.pdf on April 15,2006.

To sum up; IFRS 3 carries forward the general principle of IAS 22 concerned with acquired assets and liabilities. While IAS 22 recognize provisions for terminating and reducing the activities of the acquirer, which were not a liability of the acquiree at the acquisition date, IFRS 3 recognize these provisions only and only for an existing liability at the acquision date, as part of allocating the cost of a business combination.

On the other hand a contingent liability is recognized separately, at acquisition date, if its fair value can be measured reliably, as part of allocating the cost of a business combination. However, IAS 22 did not recognize such contingent liabilities.

Depending on all these, consequences that effects consolidated financial statements arise including goodwill calculation and etc. Therefore, if we continue with a step-by-step example, the effects should be seen more noticeable.

Assume that the entity A purchased the entity B and the transactions for the combination are as below;

- Entity A issues 1000 new shares to the shareholders of Entity B with terms equivalent to those traded n the market and the market price of Entity A’s shares is 400TL.
- Entity A pays 120.000TL in cash to the previous shareholders of Entity B.
- Entity A incurs a liability of 50.000TL to a customer of Entity B in respect of termination supply agreement that was necessitated by the business combination.

• Entity A pays accounting fees in relation to the transaction of 10.000TL and the legal fees of 20.000TL.

• Entity A extents the terms of its finance arrangements in order to obtain the cash required for the transaction. The cost of the extension is 40.000TL.

• Entity A will incur expenditure of 25.000TL on updating Entity B's accounting systems to be consistent with those used by Entity A. [63]

The cost of the combination under this situation is as this; Equity instruments issued 400.000TL+Cash 120.000TL+ Liability 50.000TL+ Accounting fees 10.000TL+ Legal fees 20.000TL=600.000TL

The expenditure for updating accounting systems to be consistent is considered as a restructuring cost and IFRS 3 does not include this item in the cost of the combination. This item should be treated as post combination expense when incurred. On the other hand costs occur in the business structure cannot be included in the scope of the combination cost. [64]

Here, if we included restructuring cost in cost of the business combination, the result would be different and this difference would reflect the referring example.

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[63] Deloitte,Business Combinations, A Guide to IFRS 3, Cost of a Buisness Combination, Accessed from http://www.iasplus.com/dttpubs/ifrs3.pdf#search=%22IFRS3%22 on April 30,2006.

[64] Terzi, Serkan. IFRS 3 İşletme Birleşmeleri,(2006), Accessed from http://www.yasaturk.com/index/index.php?option=com_content&task=view&id=25&Itemid=28 on April 30,2006.

3.3. The Effects on Goodwill

Goodwill can be defined as an asset from the acquisition date that arises when the cost of the business combination exceeds the acquirer’s share of the net fair values of the acquiree’s identifiable assets, liabilities and contingent liabilities in respect of IFRS 3.

On the other hand IAS 22 determines goodwill as the difference between the cost of the acquisition and the acquiring enterprise's share of the fair values of the identifiable assets acquired less liabilities assumed. IAS 22 recognizes goodwill as an asset as well, however requires amortization of goodwill over its useful life that prohibited in IFRS 3.

Instead of amortization of goodwill, IFRS 3 approves impairment of goodwill at least annually in accordance with IAS 36 Impairment of Assets. Besides that another point that should be stresses is “the fair value adjustments” in balance sheet of the acquired entity which is not taken into consideration in IAS 22 but required by IFRS 3 and absolutely changes the goodwill amount.

At first sight, from the definitions of goodwill in IAS 22 and IFRS 3 it is noticeable that the logic of goodwill is same in both standards which means very simply when the payment for a business combination exceeds the acquirer’s share from the acquiree’s identifiable assets, liabilities and contingent liabilities, goodwill appears. However, taking into account the fair value adjustments when calculating the amount of goodwill, and the replacement of impairment test instead of

amortization of goodwill, indicates that there are significant effects of the new standard IFRS 3 on goodwill.

Moreover, it should be reminded that, even though goodwill is recognized as an asset both in IAS 22 and IFRS 3, goodwill is not a tangible asset; goodwill is a prepayment for expected future economic benefits. [65]

After all, the precis of the differences between IAS 22 and IFRS 3 can be pointed out with a diagram below and a sample case by setting out with this diagram will help us to realize these differences efficiently when calculating goodwill and implicating the treatment of goodwill after calculation.

[65]Gücenme, Ümit, and Poroy Aylin. "Konsolidasyon Şerefiyesinin Muhasebeleştirilmesinde Güncel Yaklaşımlar" (2006) XXV. Türkiye Muhasebe Eğitimi Sempozyumu, Hacettepe Üniversitesi Yayınları.

	IAS 22	IFRS 3
Calculating the amount of Goodwill	Fair value adjustments does not taken into consideration	Fair value adjustments are taken into consideration
The treatment after calculating the amount of Goodwill	Requires the amortization of Goodwill over its useful life	Requires impairment test at least annually in accordance with IAS 36 Impairment of Assets

Table 2: Comparison of goodwill treatment between IAS 22 and IFRS 3

For instance; assume that on August 20, 2005 entity A paid 600.000TL for its 70% investment in entity B. The balance sheets of A and B before and after the acquisition are as follows; (Misc. Assets indicates miscellaneous assets and Inv. In Sub. indicates investment in subsidiaries)

Balance sheets before the acquisition;

A

Misc. Assets	1.600.000	Liabilities	200.000
		Capital	1.000.000
		R. Earn.	400.000
	1.600.000		1.600.000

B

Cash	300.000	Liabilities	100.000
A/C Rec.	150.000	Capital	550.000
Machine	300.000	R. Earn.	100.000
	750.000		750.000

As just determined the balance sheets above are the balance sheets of the entities A and B before the acquisition; however A paid 600.000TL for its investment in B and this amount should be reflected to the balance sheet of A which will be used when preparing the consolidated balance sheet. Finally the balance sheet of A reforms after the acquisition. On the other hand it should be emphasized that there is no change in the balance sheet of B after the acquisition.

Balance sheets after the acquisition;

A

Misc. Assets	1.000.000	Liabilities	200.000
Inv. in Sub.	600.000	Capital	1.000.000
		R. Earn.	400.000
	1.600.000		1.600.000

B

Cash	300.000	Liabilities	100.000
A/C Rec.	150.000	Capital	550.000
Machine	300.000	R. Earn.	100.000
	750.000		750.000

In this case, first step is to calculate the amount of goodwill as to IAS 22, then by adding fair value adjustments the amount of goodwill will be calculated in accordance with IFRS 3.

• Calculation of Goodwill in respect of IAS 22;

750.000TL assets – 100.000TL liabilities = 650.000 TL

650.000TL * 0.70 = 455.000TL is the acquiring enterprise's (A) share of the fair values of identifiable assets acquired less liabilities. Difference between this amount and the cost of the combination is the amount of "goodwill" according to IAS 22. So; 600.000TL – 455.000TL = 145.000TL is the result.

• Calculation of Goodwill in respect of IFRS 3;

The data given so far was sufficient enough for us to compute the amount of goodwill as to IAS 22; however IFRS 3 requires fair value adjustments in balance sheet of the acquired entity when calculating the amount of goodwill that already highlighted. So, here below is the balance sheet of the acquired entity B's improved as to fair values;

B			
Cash	300.000	Liabilities	140.000
A/C Rec.	180.000	Capital	550.000
Machine	350.000	R. Earn.	140.000
	830.000		830.000

As indicated, there is no change in the logic of goodwill between two standards. That means the calculation of the amount of goodwill in respect of IFRS 3 can be figured out with the same way that just utilized to reach the amount in IAS 22. However, the outcome will be amended in the wake of fair value adjustments.

830.000 is total assets – 140.000 liabilities = 690.000 TL

690.000TL * 0.70 = 483.000TL is the share of A after fair value corrections in B's balance sheet. So, 600.000TL – 483.000TL = 117.000TL is the result.

Consequently, the difference between two results is very clear. This is the first significant effect of the amendments that came along with the new standard IFRS 3. Furthermore, the procedure to reach these results can be summed up and supported with such a diagram below;

Balance Sheet of B		
Balance Sheet Items	**In respect of IAS 22**	**In respect of IFRS 3**
Cash	300.000	300.000
A/C Rec.	150.000	180.000
Machine	300.000	350.000
Total Assets	750.000	830.000
Liabilities	100.000	140.000
Equity	650.000	690.000
70% of Equity	455.000	483.000
Payment for 70%	600.000	600.000
Goodwill	145.000	117.000

Table 3: Calculation of goodwill in respect of IAS 22 and IFRS 3

3.3.1. Minority Interest and Goodwill

As stated before, minority interest arises as a result of partial ownership in a business combination. If the controlling interest on a subsidiary arises as a consequence of having less than 100% of that subsidiary's stocks that means this is a partially-owned subsidiary. Besides, a parent should have at least 51% of stocks of a subsidiary. Thus, the amount of the stocks that remains from the parent which may

be between 1% and 49% that is hold by outside stockholders comes on the scene as minority interest.

Moreover, minority interest effected from the amendments in standards. Fair value adjustments changed the result of minority interest that takes place in the consolidated balance sheet as well. As in computation of the amount of goodwill, here fair value adjustments do not taken into account when calculating the amount of minority interest in accordance with IAS 22. On the other hand, in accordance with IFRS 3 fair value adjustments are considered when calculating the amount of minority interest. The difference in the results will be evidently seen with our outstanding case in page 60.

• Calculation of Minority Interest in respect of IAS 22;

In order to compute the amount of minority interest in respect of IAS 22, balance sheet of entity B that is required before fair value adjustments is as follows;

B			
Cash	300.000	Liabilities	100.000
A/C Rec.	150.000	Capital	550.000
Machine	300.000	R. Earn.	100.000
	750.000		750.000

As is known, entity A acquired 70% stocks of entity B and the remainder 30% stocks come on the scene as the minority interest portion. To express this portion in figures the following transactions are performed;

550.000*0.30 = 165.000 from capital and 100.000*0.30 = 30.000 from retained earnings. So the total amount of minority interest is 165.000 + 30.000 = 195.000TL as to IAS 22.

• Calculation of Minority Interest in respect of IFRS 3;

Here, to compute the amount of minority interest balance sheet of B after fair value adjustments is required which is given as below;

B			
Cash	300.000	Liabilities	140.000
A/C Rec.	180.000	Capital	550.000
Machine	350.000	R. Earn.	140.000
	830.000		830.000

In this context, transactions should be as follows by pursuing the same way that implicated just in IAS 22;

550.000 * 0.30 = 165.000 from capital and 140.000 * 0.30 = 42.000 from retained earnings. So the total amount of minority interest is 165.000 + 42.000 = 207.000TL

These results evidently indicate that fair value adjustments do not only effects goodwill, but also effects minority interest amount. Again these results can be briefly shown and supported with such a diagram below;

Balance Sheet of B		
Balance Sheet Items	**In respect of IAS 22**	**In respect of IFRS 3**
Capital	550.000	550.000
Retained Earnings	100.000	140.000
30% of Capital	165.000	165.000
30% of R. Earn.	30.000	42.000
Minority Interest	195.000	207.000

Table 4: Calculation of Minority Interests in respect of IAS 22 and IFRS 3

Finally, in respect of IFRS 3 fair value adjustments not only affected the amount of goodwill but also affected the amount of minority interest. To see the reflection of these results, we proceed a step further and prepare consolidated balance sheets at acquisition date in accordance with IAS 22 and IFRS 3 separately.

Firstly, consolidated balance sheet in respect of IAS 22 without any fair value adjustments will be presented and elimination transactions will be determined. Then, consolidated balance sheet in respect of IFRS 3 will be presented by taking into consideration the fair value adjustments and elimination transactions will be determined as well.

Consolidated balance sheet at acquisition date in accordance with IAS 22;

Balance Sheet Items	Entity A	Entity B	Elimination Transactions		Consolidated Balance Sheet
			Debit	Credit	
Misc. Assets	1.000.000	750.000	-	-	1.750.000
Inv. In Sub.	600.000	-	-	600.000(1)	
Goodwill	-	-	145.000(1)	-	145.000
Total Assets	1.600.000	750.000			1.895.000
Liabilities	200.000	100.000	-	-	300.000
Capital	1.000.000	550.000	550.000(1)	-	1.000.000
R. Earn.	400.000	100.000	100.000(1)	-	400.000
Minority Interests	-	-	-	195.000(2)	195.000
Total Liabilities	1.600.000	750.000	795.000	795.000	1.895.000

Table 5: Consolidated balance sheet in accordance with IAS 22

Explanation of Elimination Transactions;

(1) Investment in subsidiaries that exist in the acquirer's balance sheet, does not take place in the consolidated balance sheet. This is because in elimination transactions investment in subsidiaries are eliminated with A's portion in B's equity and goodwill. In fact, 600.00TL investment in subsidiaries is paid in exchange for A's portion in B's capital which is 385.000TL, again A's portion in B's retained earnings which is 70.000TL and 145.000TL which is the amount of goodwill. On the other hand, in addition to investment in subsidiaries, capital and retained earnings of the acquiree do not take place in the consolidated balance sheet as well. Reflecting investment in subsidiaries, acquiree's capital and acquiree's retained earnings to the consolidated balance sheet would result with double posting of these amounts.

(2) Minority interest takes place in the consolidated balance sheet as 195.000TL in credit side. As emphasized in IAS 27 that minority interest should be presented in consolidated balance sheet within equity, but separate from the parent's shareholders' equity, here the amount is shown within the equity but separate from the A's share in the equity. Besides, as an addition to previous item, minority interest is the remainder amount from the acquirer's portion in the acquiree's equity. So not taking into account the acquiree's capital and retained earnings in the consolidated balance sheet can be supported with minority interest as well.

Finally elimination transactions expressed all above can be represented with following records as additional information;

Capital	550.000		
Retained Earnings	100.000		
Goodwill	100.000		
		Subsidiaries	600.000
		Minority Interests	195.000

Consolidated balance sheet in accordance with IFRS 3;

Balance Sheet Items	**Entity A**	**Entity B**	**Elimination Transactions**		**Consolidated Balance Sheet**
			Debit	**Credit**	
Misc. Assets	1.000.000	830.000	-	-	1.830.000
Inv. In Sub.	600.000	-	-	600.000(1)	
Goodwill	-	-	117.000(1)	-	117.000
Total Assets	1.600.000	830.000			1.947.000
Liabilities	200.000	140.000	-	-	340.000
Capital	1.000.000	550.000	550.000(1)	-	1.000.000
R. Earn.	400.000	140.000	140.000(1)	-	400.000
Minority Interests	-	-	-	207.000(2)	207.000
Total Liabilities	1.600.000	830.000	807.000	807.000	1.947.000

Table 6: Consolidated balance sheet in accordance with IFRS 3

Explanation of Elimination Transactions;

The way that should be followed in elimination transactions is the same with performed in consolidated balance sheet, which prepared in accordance with IAS 22 before fair value transactions.

(1) Investment in subsidiaries is eliminated with A's portion in B's equity and goodwill. The acquirer's investment in subsidiaries 600.000TL corresponds to the acquiree's 385.000TL from capital, 98.000TL from retained earnings and 117.000TL goodwill. So 600.000 is eliminated with these amounts and does not take place in the consolidated balance sheet.

(2) Minority interests again considered in the consolidated balance sheet within the equity, but separate from the parent's shareholders' equity as to IAS 27. So the amount of minority interests 207.000TL takes place in the consolidated balance sheet as sighted above in the worksheet. Moreover, 207.000TL corresponds to 30% of the acquiree's capital and retained earnings and also as indicated in the previous item acquirer's portion from the acquiree's equity is eliminated with 600.000TL; so 550.000TL capital and 140.000TL retained earnings do not exist in the consolidated balance sheet in order to prevent double posting of these amounts. With records below the statement should be summarized as;

Capital		550.000	
Retained Earnings		140.000	
Goodwill		117.000	
	Subsidiaries		600.000
	Minority Interests		207.000

To sum up, elimination transactions that pursued in the way of forming consolidated balance sheet is absolutely the same in IAS 22 and IFRS 3. The significant point that should be emphasized is the change in the amounts of results and the change in following stage, which is interpretation of consolidated balance sheet.

In the consolidated balance sheet that formed in accordance with IAS 22 the amount of goodwill is 145.000TL, however in the consolidated balance sheet formed in accordance with amount of goodwill is 117.000TL. Besides, minority interests in the first situation is less than in the second situation. While goodwill is decreasing, minority, interest is increasing in our case. Several circumstances can be formed as a result of differences between two standards. Finally, interpretations relating to their results will be discussed in conclusion part.

3.3.2. Impairment Test of Goodwill

Goodwill is recognized as an asset and impairment test of assets is implicated in accordance with 36th standard of IASs. Anyway, IFRS 3 approves at least annually impairment test of goodwill.

On March 2004 revised IAS 36 Impairment of Assets was issued. The scope of the revision was only the changes related to its decisions in the business combination project that resulted with the issuance of IFRS 3 Business

Combinations. Thus, it should be added that with adoption of IFRS 3 another asset "goodwill" will be recorded and will be subject to impairment testing. [66]

In respect of IAS 36 if an asset's carrying amount exceeds its recoverable amount, this means that asset is impaired. Carrying amount of an asset is the amount that is recorded in the balance sheet. Recoverable amount is the net selling price or the value in use of the asset. The higher one from the net selling price or the value in use is accepted as the recoverable amount.[67]

Impairment model according to IAS 36 is as below; (Ernst&Young, 2004:2).

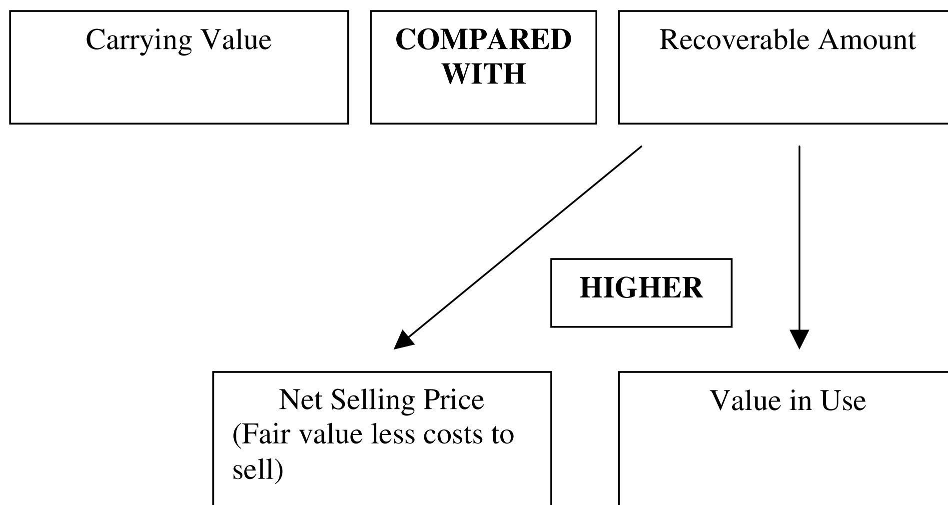

Figure 9: Impairment Model according to IAS 36

At this point, a complication about measuring the recoverable amount of goodwill appears. Goodwill does not have its own value in use because there is no cash flow directly to goodwill; on the other hand goodwill does not have a net

[66]Ernst&Young, Global Eye on IFRS, May 2004, Accessed from http://www.ey.com/global/download.nsf/International/IAS36_ImpairmentofAssets.pdf/$file/IAS36_ImpairmentofAssets.pdf on May 5,2006.
[67]Summaries of International Financial Reporting Standards, IAS 36 Impairment of Assets, Accessed from http://www.iasplus.com/standard/ias36.htm on May 5,2006.

selling price because goodwill cannot be sold independent from the asset it is concerned. In this context, recoverable amount is determined for the cash-generating unit (CGU) that goodwill is belonging which is the acquired entity. [68]

To determine the recoverable amount for a CGU, net present values of future cash flows is anticipated. Contemporaneously with this, factors for net present values should be regarded. However, in our presently example when estimating the recoverable amount for the CGU, we will not specialize in this factors for not tom depart from the main subject.

On the other hand, the carrying value for a CGU is the sum of carrying amounts of all assets, not liabilities. For instance assets in an acquired entity are 700.000TL, liabilities are 300.000TL, and goodwill is 250.000TL. 700.000+250.000 = 950.000TL is the carrying amount; liabilities are not taken into account. [69]

After setting out the recoverable amount and carrying value of a CGU, comparison of these two senses is done. If carrying value is bigger than the recoverable amount that indicates us CGU is impaired. Such an impairment test for goodwill should be done at least annually, but at the same time of each year. Furthermore, goodwill shall be tested for impairment whenever an indicator of impairment is present.[70]

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[68] Ibid.

[69] Gücenme, Ümit, and Poroy Aylin. "Konsolidasyon Şerefiyesinin Muhasebeleştirilmesinde Güncel Yaklaşımlar" (2006) XXV. Türkiye Muhasebe Eğitimi Sempozyumu, Hacettepe Üniversitesi Yayınları.

[70] KPMG Norway, Quick Summary-Impairment-IAS36, Accessed from http://www.kpmg.no/download/202437/113631/quicksum-impairment.pdf on May 8,2006.

As a result of this impairment test, if an impairment loss is found out, in accordance with IAS 36 the carrying amount of any goodwill allocated to CGU should be reduced, then carrying amount of the other assets should be reduced pro rata on the basis. This means first of all any impairment loss should be allocated to goodwill which has been allocated to CGU; secondarily any remaining excess is allocated to other assets on pro rata carrying amount basis. Finally the next treatment after allocating impairment loss is to recognize these amounts in income statement. All these steps can be summarized with such a diagram below; (source: Quick Summary, Impairment IAS 36, KPMG),

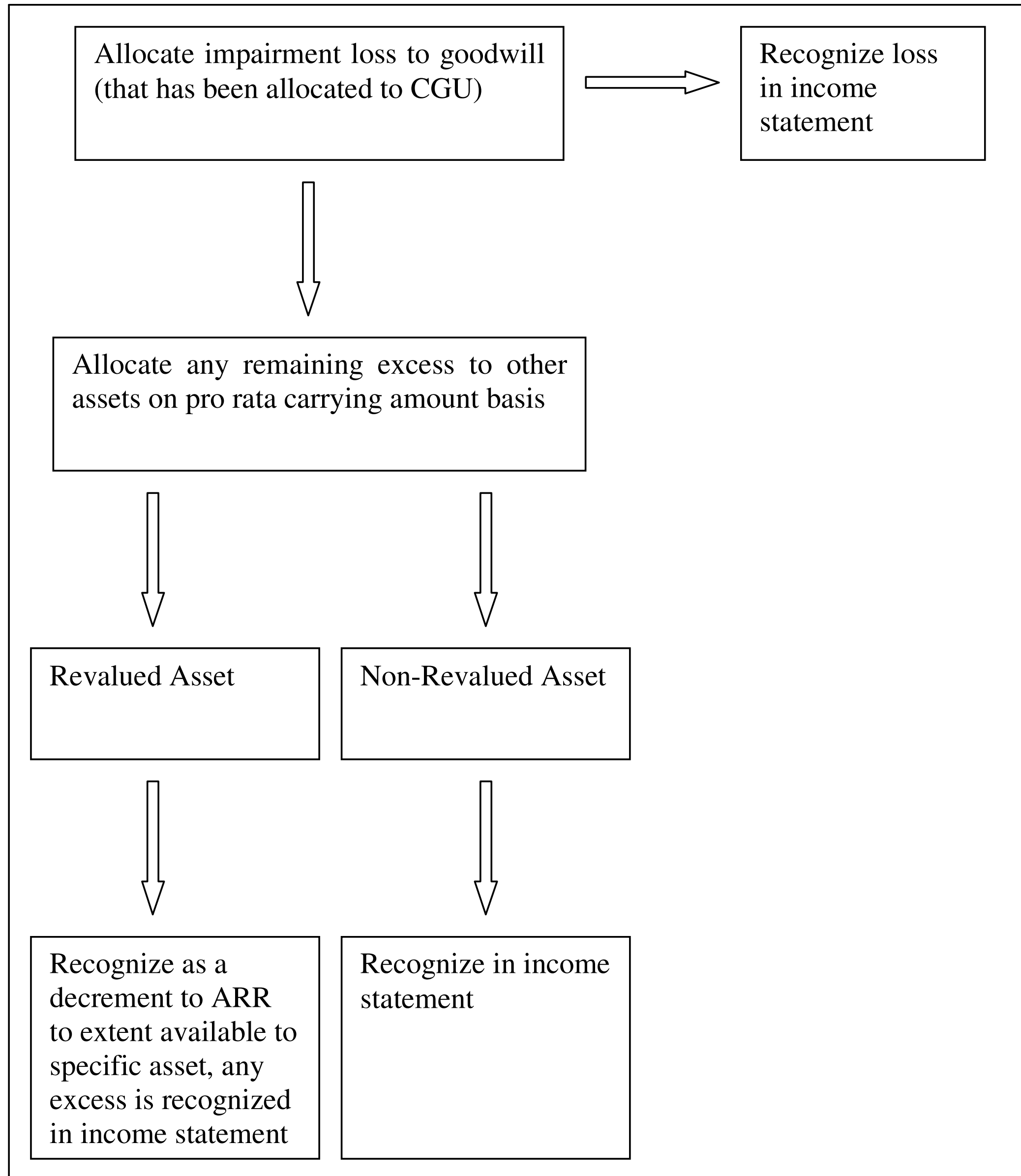

Figure 10: Allocation of Impairment Loss, (ARR: Asset Revaluation Reserve)

For impairment test and its adjustments to financial statements it should be better to continue with an example. Assume that A acquired B in 2005. At consolidation date the assets of B and goodwill amount is as below;

	Carrying Amount
Machine	300.000TL
Buildings	500.000TL
Goodwill	200.000TL
Total	**1.000.000TL**

Entity B is cash generating unit and its useful life is estimated as 15 years. In order to measure the entity B's value in use, net present values of future cash flows that is attended from B is calculated and the result is founded as 600.000TL.

When compare recoverable amount and the carrying amount of this cash generating unit, it is stared that carrying amount exceeds recoverable amount, which means there is impairment and this should be taken into accounts. 1.000.000 – 600.000 = **400.000 is the impairment amount**.

For such a situation IAS 22 emphasize that; "first, reduce the carrying amount of any goodwill allocated to the cash-generating unit (group of units); and then, reduce the carrying amounts of the other assets of the unit (group of units) pro rata on the basis." [71]

Impairment Loss	200.000	
Goodwill		200.000

[71] Summaries of International Financial Reporting Standards, IAS 36 Impairment of Assets, Accessed from http://www.iasplus.com/standard/ias36.htm on May 8,2006.

Remainder is 400.000TL – 200.000TL = 200.000TL

500.000TL + 300.000TL = 800.000TL

500.000TL is 62% of 800.000TL and 300.000TL is 38% of 800.000TL

Asset	Carrying Amount	%	Impairment
Machine	300.000TL	%62	124.000TL
Building	500.000TL	%38	76.000TL

Impairment Loss		200.000	
	Machine		124.000
	Building		76.000

In conclusion, the results will be reflected to income statement as loss, however as determined previously, this study emphasize on only consolidated balance sheet among consolidated financial statements. So here it would be sufficient enough to determine that these results will be recognized in income statement. Reflecting them to income statement is a part of a further analysis.

3.4. The Effects on Negative Goodwill

When the payment that the acquirer makes for a business combination is less than the amount of acquirer's interest in the fair value of the acquired assets, liabilities and contingent liabilities, negative goodwill appears.

IFRS 3 defines that when the amount of acquirer's interest in the fair value of the acquired identifiable net assets, liabilities and contingent liabilities exceeds the cost of the business combination, the difference is called as negative goodwill.[72]

In IAS 22, if negative goodwill is related to expected future losses and expenses, when these losses and expenses incurred, they are adjusted as loss and negative goodwill is adjusted as profit.

Besides, negative goodwill may not be related with future losses and expenses. In such a situation, first of all the amount of negative goodwill that does not exceed fair value of identifiable non-monetary assets are recognized, then this amount is amortized over the average useful life of those non-monetary assets. The amount that exceeds the fair value of non-monetary assets is recognized as income immediately.

IFRS 3 indicates that negative goodwill must be recognized immediately in the income statement as a gain. However, before that the standard requires the reassessment of the items, which cause negative goodwill. After reassessment, the excess amount is adjusted to income.

The new standard brings a very different approach to treatment of goodwill and negative goodwill. IFRS 3 completely eliminates the negative goodwill concept. This can be supported with the article indicated in the footnote as well. [73]

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[72] Summaries of International Financial Reporting Standards, IFRS 3 Business Combinations, Accessed from http://www.iasplus.com/standard/ifrs03.htm on June 2,2006.

[73] Gücenme, Ümit, and Poroy Aylin. "Konsolidasyon Şerefiyesinin Muhasebeleştirilmesinde Güncel Yaklaşımlar" (2006) XXV. Türkiye Muhasebe Eğitimi Sempozyumu, Hacettepe Üniversitesi Yayınları.

CHAPTER 4

CONCLUDING REMARKS: AFFECTED CONSOLIDATED FINANCIAL STATEMENTS FROM THE AMENDMENTS IN INTERNATIONAL FINANCIAL REPORTING STANDARDS

Replacement of IASC with IASB has brought a brand new perspective to accounting world. Existing IASs for many years, which are issued by IASC, commenced to replace with IFRSs or exposed with revisions. IASs were issued by the IASC from 1973 to 2000. The IASB replaced the IASC in 2001. Since then, the IASB has amended some IASs, has proposed to amend other IASs, has proposed to replace some IASs with new IFRSs, and has adopted or proposed certain new IFRSs on topics for which there was no previous IAS. In this study we have analyzed the initial effects of these amendments to consolidated financial statements, which faced us with IAS 27 Consolidated and Separate Financial Statements, IAS 22 Business Combinations, IFRS 3 Business Combinations and IAS 36 Impairment of Assets.

On January 1, 2005 revised IAS 27 Consolidated and Separate Financial Statements was issued. This standard discloses preparation and presentation of consolidated and separate financial standards. However, in this study we have examined this standard only from consolidated financial statements framework. According to this standard an entity is required to consolidate all its subsidiaries, covering a subsidiary under severe long-term restrictions, which limit its ability to transfer funds to the parent. Moreover a parent is required to consolidate a subsidiary, which is acquired and held exclusively with a view to its subsequent disposal. Only and only subsidiaries are allowed to exclude from the consolidation if control by the parent is lost. On the other hand, IAS 27 requires using uniform accounting policies for like transactions and events. Therefore, if a subsidiary uses different accounting policies from those applied to consolidated financial statements, appropriate consolidation adjustments should be done to align accounting policies. Another highlighted point in IAS 27 is related with minority interests. The standard requires minority interests presenting within the equity but separate from the parent's shareholders' equity. These are the basic rules of preparing and presenting consolidated financial statements in general terms as to IAS 27. Per contra significant changes that affect consolidated financial statements came on the scene with superseding IFRS 3 in lieu of IAS 22.

On March 31, 2004 IFRS 3 superseded by IAS 22 and became effective for business combinations beginning from this date. The standard performed significant changes in accounting treatments for business combinations. First of all, all business combinations are accounted for using the purchase method. Uniting of interests method is prohibited within the scope of IFRS 3. That means the acquirer, which is

the combining entity, that obtains control of the other combining entities or businesses must be identified.

Another amendment occurred in the content of the business combination. Future losses or other costs expected to be incurred due to acquisition are not accepted as part of a cost of a business combination. The cost of a business combination includes liabilities incurred or assumed by the acquirer in exchange for the control of the acquiree. For instance while IAS 22 was allowing to include restructuring provisions in the goodwill calculation, IFRS 3 no longer permits this. IFRS 3 emphasize about restructuring provision that they can be only included in the goodwill calculation when they represent a liability recognized by the acquiree at the acquisition date. Also, any restructuring plans that the acquirer has in the mind for the acquiree, will have to be recognized in the income statement, not in the cost of the business combination. However, recognition in the income statements is of course is a step after initial recognition in the balance sheet. Furthermore, the acquirer not only recognizes the acquiree's identifiable assets and liabilities but also recognizes any acquired contingent liabilities at their fair values. A contingent liability of an entity is a payment that an entity is required to make in the event of a business combination. An outflow of resources is made by the business combination to settle the obligation. Therefore, a liability is recognized as an identifiable liability on the acquisition.

After initial recognition, goodwill calculation is a considerable matter in this new standard. In accordance with IFRS 3 goodwill is the subject of impairment test at least annually. Before that IFRS 3 figures out the amount of goodwill, which takes place in consolidated balance sheet, in accordance with net fair values of the

acquired entity. In the meantime, these net fair value adjustments affect minority interest results as well. Then impairment test for goodwill comes on the scene, which is determined with comparing the recoverable amount and carrying value of the cash-generating unit that goodwill belongs to. Instead of amortizing goodwill by estimating a useful life by the acquiree at acquisition date, every year to process goodwill such an impairment test should be more favorable. Although, it should be reminded that there might be complications when fixing the recoverable amount of cash generating unit (the acquiree). Furthermore, IFRS 3 attributes a different denotation to negative goodwill. The standard completely abrogates the extent of negative goodwill, and requires recognizing goodwill as a gain in the income statement immediately.

The above amendments are the results of harmonization movement in accounting world in recent years. In this context, IASC has developed its structure and left its place to a new body IASB. So, harmonization movement in accounting resulted with the issue of IFRSs and revision of IASs. In the framework of this adoption process Turkey has taken significant steps with the studies of Banking Regulation and Supervision Agency, Capital Markets Board of Turkey and Turkish Accounting Standards Board. While TASB is translating and issuing IFRSs, CMBT and BRSA publishes notifications related with the standards. However; translating the accounting standards is not sufficient enough for harmonization, revisions rather frequently applied to these standards should be examined and should be carried out related the arrangements in Turkey.[74]

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[74] Gücenme, Ümit, and Poroy Aylin. "Konsolidasyon Şerefiyesinin Muhasebeleştirilmesinde Güncel Yaklaşımlar" (2006) XXV. Türkiye Muhasebe Eğitimi Sempozyumu, Hacettepe Üniversitesi Yayınları.

In addition to this, Turkey provided progress in the way of constituting governmental accounting in line with International Accounting Standards.[75]

Finally, it should be emphasized that European Union (EU) listed companies must follow standards issued by the IASB from 2005 onwards. Thus, adopting IASs is important for Turkey, which is being in the process of accessing the EU.

[75] Çalış, Ercan. " Türk Devlet Muhasebe Sisteminde Reform Çalışmaları" (2005) Analiz- Muhasebe Finansman Araştırma ve Uygulama Dergisi, Cilt:5, Yıl:14, Sayı:14.
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