Gradual Acquisition as a Process to Achieve a Business Combination

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Abstract: *Business combinations can be achieved in a number of different ways. One such option is gradual acquisition. In the case of a gradual acquisition, shares or voting rights are obtained by the acquirer. The acquirer gains control of the business when it has a majority of shares or voting rights. International standard IFRS 3 Business Combinations deals with business combinations. However, in the case of a gradual acquisition, it is important to consider other International Financial Reporting Standards, as the acquirer may not obtain control immediately, but only over time in gradual steps. The aim of this paper is to analyse gradual acquisition and its relation to individual International Financial Reporting Standards, primarily using practical examples based on the provisions of the standards.*

Keywords: *gradual acquisition, business combinations, control*

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1 Introduction

Business combinations are a broad issue which is addressed in the International Standard Financial Statements. Groups of companies consisting of subsidiaries owned by a single parent company is the most common form business structure worldwide (Almeida et al., 2011). Within the defined terms, International Standard IFRS 3 Business Combinations (hereinafter "IFRS 3") defines a business combination as a transaction or some other set of circumstances which enables the acquirer to gain control over a company, or several companies (IASB, 2008). In order to ensure company growth or, as a minimum, its survival, managers often utilise restructuring strategies during business combinations (Moisescu and Golomoz, 2018). IFRS 3 was revised in 2008 with the aim of improving some parameters of the 2004 version, which also impacts on gradual acquisitions (Weissova, 2015).

One way to achieve a business combination is gradual acquisition. In a gradual acquisition, control is achieved only when the acquirer obtains a majority of shares or voting rights in the acquiree. The gradual acquisition process is a gradual capital investment. Based on the investment, the investing company acquires a certain level of shareholding. The investment cost cannot be too high, as this could indicate a conflict of interest on the part of the investor (Bodt et al., 2018). From accounting perspective, it is important to distinguish between the investor's level of ownership and its influence as shown in Table 1:

Table 1 Accounting for Equity Investments

Ownership	Degree of Influence	Accounting Treatments
Less than 20%	No Significant Influence	Equity Investments
20% - 50%	Significant Influence	Equity Method
More than 50%	Control	Consolidation (Acquisition Method)
50/50 Interests	Common/Joint Control	Equity Method

Source: Olumuyiwa, A. (2017)

Companies are able to generate know-how internally, or they can obtain it from external sources through mergers and acquisitions, strategic alliances, joint ventures or other forms of collaborations (Martinkenaite, 2012). The value of shares acquired through capital investments determines what accounting treatments are used. If the ownership is less than 20%, it is deemed to be an equity investment with no significant influence, treatment of which is governed by IFRS 9 Financial Instruments (hereinafter "IFRS 9"). IFRS 9 sets out the principles for the financial reporting of assets and liabilities (IASB, 2014). Ownership between 20% and 50% is deemed to have a significant influence and uses the equity method in accordance with IAS 28 Investments in Associates and Joint Ventures (hereinafter "IAS 28"). When using the equity method, the investment is initially recognised at cost, and subsequently adjusted to reflect any post-acquisition changes in the investor's share of the investee's net assets (IASB, 2011). Ownership above 50% represents control, i.e. we are talking about a business combination, for which the acquisition method in accordance with IFRS 3 is used. Accounting for business combinations is subject to the identification of possible input parameters (Detzen et al., 2013). Ownership distributed among several investors in equal proportions represent joint control and the equity method of IAS 28 is also used (Bradbury, 2018).

The aim of our paper is to examine gradual acquisition from the perspective of a number of International Financial Reporting Standards. Gradual acquisition is a process of capital investment in several successive steps, with the investor buying shares or acquiring them in some other way. If the acquisition takes place gradually, the investor reports shares or voting rights at the value they own at that point in time (Aminadav and Papaioannou, 2020). The moment the acquirer has control, we are talking about a business combination. A business combination refers to the manner in which an investor may directly or indirectly exercise influence over another entity (Xu, 2016). Once a business combination is complete, the company accounts for each business combination using the acquisition method in which both the acquirer and the acquisition date are established (Frii, Hamberg, 2021).

2 Methodology and Data

The object of the research of this paper is gradual acquisition. Gradual acquisition takes place in a number of steps, during which it is important to use the correct accounting methods based on different International Financial Reporting Standards. Our aim is to clarify the issue using practical examples, which achieve business combinations.

We will apply our theoretical knowledge to two practical examples, the first of which will deal with a gradual acquisition through shares and the second with a gradual acquisition through voting rights. The accounting entities used in these examples are fictitious.

The individual procedures are based on the provisions of selected International Financial Reporting Standards, in particular IAS 28, IFRS 3 and IFRS 9. We gained further knowledge from various specialised publications in the given field.

In our paper we use mainly two methods - analysis and comparison. Analysis is used for theoretical knowledge about gradual acquisition, but also about business combinations. Comparison is the main method used for practical examples, which outline two ways of achieving gradual acquisition.

3 Results and Discussion

We will illustrate gradual acquisition on practical examples utilising fictitious entities. We will compare the process of gradual acquisition through shares and through voting rights, which will ultimately achieve business combination.

3.1 Gradual Acquisition through Shares

From 2019 to 2021, Company A gradually purchased shares in Company B, which had voting rights equivalent to the value of the shares. Individual purchases were made as follows: in 2019, it purchased a share capital of 15%; then purchased another tranche of share capital of 20% in 2020; and in 2021 it bought the final portion of share capital of 40%.

Based on the acquired shares, we can see that there is a gradual acquisition.

In 2019, Company A acquired 15% of shares in Company B, having no existing shares previously. In 2019, this represented an equity investment for Company A without significant influence, i.e. it would follow IFRS 9.

In 2020, the share ownership in Company B increased by 20%, which cumulatively represents 35% of shares. In this case, there is significant influence, i.e. the share will be accounted for from 2020 using the equity method based on IAS 28.

In 2021, Company A purchased the final 40% of shares. Its cumulative share is therefore 75% and it achieves control. At this point, we can talk about a business combination, which falls within the scope of IFRS 3, so it proceeds using the acquisition method.

3.2 Gradual Acquisition through Voting Rights

In 2020, Company A purchased 25% of shares in Company Z, which gave it 25% of voting rights. In addition to Company A, there are two other shareholders in Company Z - Company B has 35% of shares (i.e. 35% of voting rights) and Company C has 40% of shares (i.e. 40% of voting rights). In 2021, Company A entered into an agreement with Company C, under which Company A may have all the voting rights of Company C.

Based on the acquired voting rights, we can see that there is a gradual acquisition.

In 2020, Company A purchased a share in Company Z through an investment, thereby acquiring 25% of the value of the share capital and at the same time 25% of the voting rights. This is significant influence, i.e. Company A will proceed using the equity method in accordance with IAS 28.

In 2021, Company A acquired an additional 40% of voting rights under an agreement with Company C. Cumulative voting rights represent 65%, on the basis of which Company A has acquired control. From now on, we can talk about a business combination, with Company A proceeding through the acquisition method according to IFRS 3.

Conclusions

Based on practical examples, we have presented the process of gradual acquisition in two examples. The first scenario involved series of share purchases, which included voting rights of the same value. Using this method of gradual acquisition, various International Financial Reporting Standards are used based on the value of shares, resp. voting rights achieved, at that time. In the second scenario, the gradual acquisition process results solely from the acquisition of voting rights. In this case, the effect on the acquiree no longer depends on the amount of shares, but only on the proportion of voting rights. A comparison of these two examples shows that the most important are the voting rights by which the acquirer acquires influence over the acquiree. In the first example, there were shares and also voting rights, and in the second example, there were only voting works. However, if the voting rights were absent in the first example, the shares would still mean nothing to the acquirer and we would not be able to indicate the acquisition of control by a business combination as a result. For this reason, we state that voting rights are a decisive factor for the purposes of acquiring control.

In practice, there are a number of different ways of achieving business combinations. Our goal was to analyse the gradual acquisition process. However, this is not the only process that can culminate in a business combination. Business combinations are achieved by purchasing shares with voting rights, but they may also result from the creation of a new entity established by the acquirer. However, these are not even remotely all the ways that can be used in business combinations.

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