

# ***Research on Enterprise Combination Accounting***

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**Abstract:** With the development of the global economy and the intensification of competition, corporate mergers have become an important trend in the development of modern enterprises, and accounting, as an important part of enterprise management, has received wide attention. In China, corporate mergers adopt the purchase method and the equity combination method. This paper first compares the purchase method and the equity combination method through literature analysis, and secondly analyzes the financial status and operating results of corporate mergers under the two methods of accounting, and further proposes that the imperfect capital markets system and unreasonable goodwill recognition measurement process have an adverse impact on the accounting under the purchase method, and points out the decline in the quality of accounting information and the possible profit manipulation space under the equity combination method. This paper finds that goodwill is the main reason for the difference between the purchase method and the equity combination method, and for the asset scale and net profit of the merged enterprise, the results calculated by the purchase method are greater than the results calculated by the equity combination method.

**Keywords:** business consolidation, accounting, goodwill, fair value

## **1. Introduction**

Business combination specifically refers to the behavior process in which two or more enterprises form a new enterprise by entering into a merger agreement and combining their assets into one in accordance with the provisions of relevant laws and regulations. Due to the fast speed of Mergers and Acquisitions, higher profits and competitive advantages can be realized after the merger, and more and more enterprises choose to merge. In this process, finance plays a crucial role in an enterprise. However, the merger process is more complicated, and accounting for business combinations has always been a difficult problem in the accounting practice field. There are many problems in daily accounting treatment and practical application, which leads some enterprises to seize loopholes to manipulate profits, causing harm to other enterprises and shareholders, and undermining the country's economic development security. The reasons need to be paid attention to urgently. Through reading and studying a large number of documents, this paper explores the differences between the purchase method and the equity combination method and analyzes the possible problems under the two accounting methods. It is convenient for future scholars to study the solutions to business combination profit manipulation.

## **2. The Economic Substance and Accounting Standards of Business Combinations**

### **2.1. Economic Substance**

The internal essence of accounting treatment is studied through the superficial phenomenon of enterprise economic activities, that is, economic essence. Enterprise merger refers to the transaction or event that combines two or more separate enterprises to form a reporting subject. Enterprise mergers can be divided into enterprise mergers under the same control and enterprise mergers under the non-same control. Enterprises need to implement corresponding internal accounting and accounting treatment in accordance with the provisions of the latest "Accounting Standards for Business Enterprises". The situation that enterprises participating in the merger are under the final control of the same party or the same multiple parties before and after the merger and the control is not temporary is a business combination under the same control; and the situation that the parties participating in the merger are not under the final control of the same party or the same multiple parties before and after the merger is a business combination under non-same control.

### **2.2. Accounting Standards**

There are three main principles of the accounting standards for business combinations: first, the principle of financial statement analysis, that is, changes in the aspects of acquisition or merger must be reflected in the income statement of the year of merger; The second is the investor expectation principle, that is, such business changes must be measured accurately and in real-time to estimate operating income, expenses and profits according to the principle that investors can harvest their expected benefits. The third is the principle of comparability, that is, the merger of enterprises does not increase profitability.

The implementation requirements of the accounting standards for business combinations are: first, clear reporting standards; Second, reasonable and complete reporting standards for reporting services; Third, confirmation of principles and implementation; Fourth, the adoption of special standards by enterprises; Fifth, the issuance of accounting standards for business combinations, including group reports and acquired company reports.

## **3. Classification and Comparison of Accounting Methods for the Business Combination**

### **3.1. Classification**

The purchase method and the equity combination method are two accounting treatment methods for business combinations. The business combination standards divide business combinations into business combinations under the same control and business combinations under the same control. The former adopts the similar equity combination method and the latter adopts the purchase method.

The transaction in which one enterprise purchases another enterprise is accounted for in accordance with the purchase method, and the acquired assets and liabilities are recognized according to the fair value. The purchase method regards the merger as a purchase behavior and pays attention to the actual value of assets and liabilities on the completion date of the merger.

The equity combination method means that the assets and liabilities of the merged party are recognized according to the original carrying value, not adjusted according to the fair value, and goodwill is not formed. The difference between the merger consideration and the share of net assets acquired in the merger adjusts equity items. Under the equity combination method, the business combination is regarded as a combination of corporate equity rather than a purchase transaction. All parties involved in the merger are merged according to the carrying value of their net assets. After the

merger, the rights and interests of each merged entity cannot be increased or decreased due to the business combination.

### **3.2. Comparison**

There are many differences between the two accounting methods in goodwill recognition, merger expense treatment, valuation basis and accounting information quality.

Under the purchase method, the merging enterprise shall record the assets received and the liabilities assumed according to the fair value, and the difference between the merger cost and the fair value of the identifiable net assets shall be recognized as goodwill. Under the equity combination method, its valuation basis remains unchanged, and the accounting value of net assets is determined according to its carrying value. There is no recognition problem of goodwill.

For all kinds of direct and indirect expenses incurred in the merger process, under the purchase method, the direct expenses increase the purchase cost and the indirect expenses are included in the period expenses; Under the equity combination method, both direct expenses and indirect expenses are included in the period expenses.

The purchase method believes that the continuous operation of the merged enterprise is affected, and this assumption is no longer applicable, so assets and liabilities should be revalued and recorded at their fair value. The equity combination method believes that the owner's equity of the merged enterprise still exists, the owner has not changed, and the assumption of continuous operation is still applicable. Therefore, the valuation basis will not be changed, and the original carrying value will be recorded.

Under the equity combination method, the assets and liabilities of the merged enterprise are reflected according to the historical cost, so the reliability of its accounting information is higher, and the comparability of accounting information before and after the merger of enterprises is strong, but compared with fair value It obviously lacks decision-making relevance; under the purchase method, due to the use of fair value, it leaves a lot of room for artificial adjustment of profits, and the reliability of its information is poor, and the information before and after the merger of enterprises lacks comparability, but the information it provides has a greater correlation. The accounting information between enterprises is also horizontally comparable.

## **4. The Economic Results under Different Accounting Methods of Enterprise Combination**

### **4.1. Financial Position**

The reason for the difference between the purchase method and the equity combination method mainly focuses on goodwill. Under the purchase method, the fair value on the purchase date is used as the accounting standard for the actual assets and liabilities of the merged enterprise. If the total cost exceeds the value difference higher than the assets and liabilities, it is recognized as goodwill [1]. Under the equity combination method, the actual assets and liabilities acquired by the merging party should refer to the carrying value on the purchase date, but even if the amount paid exceeds the carrying value, it cannot be recognized as goodwill, and can only be adjusted through capital reserves and retained earnings.

Therefore, for the premium part of the merger consideration, the purchase method will be recognized as the assets acquired in the merger. However, under the equity combination method, the assets are not affected by the excess value, which results in the acquisition method. The scale of assets obtained by the merged enterprises is often larger than that of the enterprises using the equity combination method.

## 4.2. Operating Results

Under the equity combination method, the difference in value between the total cost of the business combination and the assets and liabilities will be included in the current profit and loss of the merging party and will be accounted for through the non-operating income account [2]. However, under the purchase method, this difference in value cannot be included in the current profit and loss, but can only be adjusted through the relevant account of the owner's equity. Obviously, in the current year of the business combination, the net profit of the merged enterprise under the purchase method will be higher than the calculation result under the equity combination method.

## 5. Problems in Enterprise Combination Accounting

### 5.1. Issues under the Purchase Method of Accounting

The imperfect capital markets system affects the application of the purchase method. The transaction basis under the purchase method is the fair value of the assets and liabilities of the merged enterprise. However, China's capital markets only officially appeared in 1990. The imperfect system has led to listed companies unable to obtain reliable data to calculate fair value, which in turn affects the accuracy of fair value [3]. And the actual operation of fair value measurement is relatively large. At this stage, China's financial market is not well developed, and there may be a lack of evaluation standards and other relevant conditions when using fair value measurement. In addition, professional judgment has an important impact on fair value. At present, China's evaluation system lacks effective supervision, and the overall professional judgment ability of accountants is not strong. Subjectively eliminating the motivation of profit manipulation is also an issue that needs urgent attention.

The initial recognition and subsequent measurement of goodwill are unreasonable. Under the purchase method, goodwill is equal to the merger cost minus the fair value of the purchaser's identifiable net assets, and for an enterprise, the conditions for accurate acquisition of fair value are not fully met. In addition, the current accounting standards in China stipulate that only year-end impairment provisions can be made in the subsequent measurement of goodwill, and the impairment loss of assets of enterprises is irreversible, and China's accounting standards do not specify the upper limit of this value [4]. Many managers use this defect to accrue a large amount of goodwill impairment provisions, thus increasing asset impairment losses. At the same time, the pre-tax profits of enterprises will be affected, and managers will further achieve the purpose of controlling the year-end profits of enterprises.

### 5.2. Problems in Equity Combination Accounting

There may be some room for profit manipulation in the actual operation of enterprises. No matter when the enterprise merges, the profit and loss of the final merging party will include all the operating data of this year, which causes some enterprises to deliberately choose some enterprises with good operating performance, use their retained earnings to hide their own operating conditions, and carry out business mergers at the end of the year, deliberately delaying the time of business mergers, so as to whitewash the operating performance and improve the base profit of the enterprise [5]. However, in the stock market, some investors pay too much attention to the profit data at the end of the year of the enterprise, ignore the actual analysis, and are easily blinded by the inflated data manipulated by the merged enterprise, resulting in a situation where a large amount of capital is invested but a large loss is incurred.

The quality of accounting information of enterprises is reduced. Under the equity combination method, the assets and liabilities of participating enterprises are accounted for according to their original carrying value, while under the purchase method, fair value is used for measurement. Fair

value is based on the market and can change with changes in market conditions, and as long as both parties to the transaction reach an agreed negotiated result, it can be considered a fair result; carrying value is from a historical perspective, helping investors to better understand the assets and liabilities of enterprises [6]. It is not difficult to see that fair value can more effectively reflect the latest development of the market than carrying value, and can provide investors with more relevant and comprehensive accounting information [7].

## 6. Further Discussion on the Combination of Interests Law

At present, in the "International Financial Reporting Standards No. 22 - Business Combinations", it is stipulated that the accounting method for business combinations only adopts the purchase method, and in the "Accounting Standards for Business Enterprises No. 20 - Business Combinations" promulgated by the Ministry of Finance of China, it explains in detail the accounting standards under the same control and non-same control, that is, the former adopts the equity combination method and the latter uses the purchase method. The difference in systems will cause many Chinese and foreign enterprises to face many difficulties and obstacles under the data Horizontal comparison, even if convergence with the international is an inevitable trend in economic development, many scholars have also put forward the idea of abolishing the equity combination method [8]. But China should pay attention to and think about its national conditions and economic environment. The current market economic system is not perfect, and it is difficult to account completely according to fair value. Under the equity combination method, it can promote the overall listing of state-owned groups. The assets and liabilities of the merged units are accounted for according to carrying value, and there is no need to recognize the value-added part of the assets. In future years, less depreciation or amortization.

## 7. Conclusion

This paper mainly discusses the characteristics of the purchase method and the equity combination method, and analyzes the economic results brought about by different methods. Based on this, it puts forward the possible problems of the two in China's accounting. Under the purchase method, it is easy to be affected by the capital markets system and goodwill. Under the equity combination method, there may be problems of profit manipulation space and low quality of accounting information. However, in terms of countermeasures to accounting problems, this paper has not been discussed in depth. With the convergence of International Financial Reporting Standards, many enterprises gradually adopt the same accounting method, which will become an inevitable trend of social and economic development in the long run. In short, in China, whether or when to abandon the equity combination method still needs attention and attention.

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