IFRS for SMEs (2009) + Q&As

IFRS Foundation: Training Material for the *IFRS® for SMEs*

Module 19 – Business Combinations and Goodwill

IFRS™

IFRS Foundation: Training Material for the *IFRS® for SMEs*

including the full text of
Section 19 *Business Combinations and Goodwill*
of the International Financial Reporting Standard (IFRS)
for Small and Medium-sized Entities (SMEs)
issued by the International Accounting Standards Board in July 2009

with extensive explanations, self-assessment questions and case studies

IFRS Foundation®
30 Cannon Street
London EC4M 6XH
United Kingdom

Telephone: +44 (0)20 7246 6410
Fax: +44 (0)20 7246 6411
Email:info@ifrs.org

Publications Telephone: +44 (0)20 7332 2730
Publications Fax: +44 (0)20 7332 2749
Publications Email: publications@ifrs.org
Web: www.ifrs.org

Contents

This training material has been prepared by IFRS Foundation education staff. It has not been approved by the International Accounting Standards Board (IASB). This training material is designed to assist those training others to implement and consistently apply the *IFRS for SMEs*. For more information about the IFRS education initiative please visit www.ifrs.org/Use+around+the+world/Education/Education.htm.

All rights, including copyright, in the content of this publication are owned by the IFRS Foundation.
Copyright © 2013 IFRS Foundation®
30 Cannon Street | London EC4M 6XH | United Kingdom |Telephone: +44 (0)20 7246 6410
Email: info@ifrs.org | Web: www.ifrs.org

Disclaimer: The IFRS Foundation, the authors and the publishers do not accept any responsibility for any loss caused to any person and/or entity that acted or refrained from acting in reliance on the material in this publication, whether such loss is caused by negligence or otherwise. Any names of individuals, companies and/or places used in this publication are fictitious and any resemblance to real people, entities or places is purely coincidental.

Right of use
Although the IFRS Foundation encourages you to use this training material for educational purposes, you must do so in accordance with the terms of use below. *For details on using our standards please visit www.ifrs.org/IFRSs/Pages/IFRS.aspx*

Please note the use of this training material (as set out in the terms of use) is not subject to the payment of a fee and we reserve the right to change the terms of use from time to time.

Your right (if any) to use this training material will expire:

- when this training material becomes out of date at which time you must cease to use it and/or to make it available; and/or
- if you breach the terms of use.

1. Terms of Use
1.1 This training material may only be used for educational purposes and in accordance with these terms. If you require any other use, please contact us as you will need a written licence which we may or may not grant.

Printed Use.
1.2 Unless you are reproducing the training material in whole or in part to be used in a hard copy stand-alone document, you must not use or reproduce, or allow anyone else to use or reproduce, any trademarks that appear on or in the training material.
1.3 For the avoidance of any doubt, you must not use or reproduce any trademark that appears on or in the training material if you are using all or part of the training material to incorporate into your own documentation.
1.4 The trademarks include, but are not limited to, the IFRS Foundation and IASB names and logos.
1.5 When you copy any extract, in whole or in part, from this publication in print form, you must ensure that:

- the documentation includes a copyright acknowledgement;
- the documentation includes a statement that the IFRS Foundation is the source of the material;
- the documentation includes an appropriate disclaimer;
- our status as the author(s) of the teaching materials is acknowledged;
- the extract is shown accurately; and
- the extract is not used in a misleading context.

Electronic Use.
1.6 In relation to any electronic use of this training material:

- if you intend to provide this training material (in whole) through your website you may only do so by providing a link to our website. Please see www.ifrs.org/Pages/Terms-and-Conditions.aspx for details of how you can link to our website
- if you intend to include any part of this training material on your website free of charge or in a slide pack for an educational course you must comply with the provisions listed at paragraph 1.5 and you must not use or reproduce, or allow anyone else to use or reproduce, any trademarks that appear on or in the training material
- if you intend to provide any part of this training material electronically for any other purpose please contact us as you will need a written licence which we may or may not grant

If you breach any of these terms of use your right (if any) to use our materials will cease immediately and you must, at our option, return or destroy any copies of the materials you have made.

Please address publication and copyright matters to:
IFRS Foundation Publications Department | 30 Cannon Street | London EC4M 6XH | United Kingdom | Telephone: +44 (0)20 7332 2730 | Email: publications@ifrs.org Web: www.ifrs.org

Trade Marks

The IFRS Foundation logo, the IASB logo, the IFRS for SMEs logo, the 'Hexagon Device', 'IFRS Foundation', 'eIFRS', 'IAS', 'IASB', 'IASC Foundation', 'IASCF', 'IFRS for SMEs', 'IASs', 'IFRS', 'IFRSs', 'International Accounting Standards' and 'International Financial Reporting Standards' are Trade Marks of the IFRS Foundation.

Contents

INTRODUCTION 1
Learning objectives 1
IFRS for SMEs 2
Introduction to the requirements 2
REQUIREMENTS AND EXAMPLES 4
Scope of this Section 4
Business combinations defined 10
Accounting 14
Disclosures 51
SIGNIFICANT ESTIMATES AND OTHER JUDGEMENTS 54
COMPARISON WITH FULL IFRS 56
TEST YOUR KNOWLEDGE 58
APPLY YOUR KNOWLEDGE 62
Case study 1 62
Answer to case study 1 64
Case study 2 67
Answer to case study 2 69

Module 19 – Business Combinations and Goodwill

This training material has been prepared by IFRS Foundation education staff and has not been approved by the International Accounting Standards Board (IASB). The accounting requirements applicable to small and medium-sized entities (SMEs) are set out in the International Financial Reporting Standard (IFRS) for SMEs, which was issued by the IASB in July 2009.

INTRODUCTION

This module, issued in May 2013, focuses on the accounting for and the reporting of business combinations and goodwill in accordance with Section 19 *Business Combinations and Goodwill* of the *IFRS for SMEs* that was issued in July 2009 and the related non-mandatory guidance that was subsequently provided by the IFRS Foundation SME Implementation Group. It introduces the learner to the subject, guides the learner through the official text, develops the learner's understanding of the requirements through the use of examples and indicates significant judgements that are required in accounting for business combinations and goodwill. Furthermore, the module includes questions that are designed to test the learner's knowledge of the requirements and case studies to develop the learner's ability to account for business combinations and goodwill in accordance with the *IFRS for SMEs*.

Learning objectives

Upon successful completion of this module you should know the financial reporting requirements for business combinations and goodwill in accordance with the *IFRS for SMEs* as issued in July 2009. Furthermore, through the completion of case studies that simulate aspects of the real-world application of that knowledge, you should have enhanced your competence to account for business combinations and goodwill in accordance with the *IFRS for SMEs*. In particular you should, in the context of the *IFRS for SMEs*, be able to:

- identify a business combination;
- identify the acquirer in a business combination;
- recognise and measure the cost of a business combination;
- recognise and measure the identifiable assets acquired, the liabilities and contingent liabilities assumed and any non-controlling interest in the acquiree;
- recognise and measure any goodwill acquired in a business combination or any gain on a bargain purchase;
- account for goodwill after its initial recognition;
- determine what information should be disclosed to enable users of the financial statements to evaluate the nature and financial effects of a business combination; and
- demonstrate an understanding of the significant judgements that are required in accounting for business combinations and goodwill.

Module 19 – Business Combinations and Goodwill

IFRS for SMEs

The *IFRS for SMEs* is intended to be applied to the general purpose financial statements of entities that do not have public accountability (see Section 1 *Small and Medium-sized Entities*).

The *IFRS for SMEs* includes mandatory requirements and other, non-mandatory, material.

The non-mandatory material includes:

- a preface, which provides a general introduction to the *IFRS for SMEs* and explains its purpose, structure and authority;
- implementation guidance, which includes illustrative financial statements and a disclosure checklist;
- the Basis for Conclusions, which summarises the IASB's main considerations in reaching its conclusions in the *IFRS for SMEs*; and
- the dissenting opinion of an IASB member who did not agree with the publication of the *IFRS for SMEs*.

In the *IFRS for SMEs* the *Glossary* is part of the mandatory requirements.

In the *IFRS for SMEs* there are appendices in Section 21 *Provisions and Contingencies*, Section 22 *Liabilities and Equity* and Section 23 *Revenue*. Those appendices are non-mandatory guidance.

Further non-mandatory guidance was subsequently published by the IFRS Foundation SME Implementation Group (SMEIG) in the form of Q&As. The Q&As are intended to provide non-mandatory and timely guidance on specific accounting questions that are being raised with the SMEIG by users implementing the *IFRS for SMEs*.

When the *IFRS for SMEs* was issued in July 2009, the IASB undertook to assess entities' experience of applying the *IFRS for SMEs* following the first two years of application. To this end, in June 2012 it issued a *Request for Information: Comprehensive Review of the IFRS for SMEs*. Currently it is expected that an Exposure Draft proposing amendments to the *IFRS for SMEs* will be issued in the first half of 2013.

Introduction to the requirements

The objective of general purpose financial statements of an SME is to provide information about the entity's financial position, financial performance and cash flows that is useful for economic decision-making by a broad range of users (eg owners who are not involved in managing the business, potential owners, existing and potential lenders and other creditors) who are not in a position to demand reports tailored to meet their particular information needs.

Section 19 prescribes the accounting treatment for business combinations and goodwill so that users of the financial statements are presented with financial statements that reflect the economic substance of a business combination and its effects. The main issues that arise are:

- identifying the acquirer;
- measuring the cost of the business combination; and
- measuring the assets acquired and the liabilities and contingent liabilities assumed in the business combination.

The acquirer measures the goodwill acquired in a business combination at cost less any accumulated depreciation and impairment losses. Goodwill is considered to have a finite useful life and is amortised over that finite period; if an entity is unable to make a reliable estimate of the useful life of goodwill, the useful life is presumed to be ten years.

This section also specifies disclosure requirements for business combinations that were effected in the reporting period and for goodwill that was recognised in the statement of financial position.

Module 19 – Business Combinations and Goodwill

REQUIREMENTS AND EXAMPLES

The contents of Section 19 *Business Combinations and Goodwill* of the *IFRS for SMEs* are set out below and shaded grey. Terms defined in the *Glossary* of the *IFRS for SMEs* are also part of the requirements. Those terms are in **bold type** the first time they appear in the text of Section 19. The notes and examples inserted by the IFRS Foundation education staff are not shaded. The insertions made by the staff do not form part of the *IFRS for SMEs* and have not been approved by the IASB.

Scope of this section

19.1 This section applies to accounting for **business combinations**. It provides guidance on identifying the acquirer, measuring the cost of the business combination, and allocating that cost to the assets acquired and liabilities and provisions for **contingent liabilities** assumed. It also addresses accounting for **goodwill** both at the time of a business combination and subsequently.

Notes

A business combination is the bringing together of separate entities or businesses into one reporting entity (see the *Glossary*).

When considering whether a particular transaction is a business combination, an entity must determine whether the assets acquired and the liabilities assumed constitute a business.

A business is an integrated set of activities and assets that are conducted and managed for the purpose of providing:

(a) a return to investors; or

(b) lower costs or other economic benefits directly and proportionately to policyholders or participants.

A business generally consists of inputs, processes applied to those inputs, and resulting outputs that are, or will be, used to generate revenues. If goodwill is present in a transferred set of activities and assets, the transferred set shall be presumed to be a business (see the *Glossary*).

Although the terms ‘inputs’, ‘processes’ and ‘outputs’ are not defined in the *IFRS for SMEs*, they can be given the meanings set out below, which are taken from paragraphs B7–B8 of IFRS 3 *Business Combinations*, as issued in January 2008.[1]

An input is any economic resource that creates, or has the ability to create, outputs when one or more processes are applied to it. Examples include non-current assets (including intangible assets or rights to use non-current assets), intellectual property, the ability to obtain access to necessary materials or rights and employees.

A process is any system, standard, protocol, convention or rule that, when applied to an input or inputs, creates, or has the ability to create, outputs. Examples include strategic management processes, operational processes and resource management

[1] In the absence of explicit guidance in the *IFRS for SMEs* an entity can, but is not required to, in accordance with paragraph 10.6, consider the requirements and guidance in full IFRS.

processes. These processes are typically documented, but an organised workforce having the necessary skills and experience following rules and conventions may provide the necessary processes that are capable of being applied to inputs to create outputs. Accounting, billing, payroll and other administrative systems are typically not processes used to create outputs.

An output is the result of inputs and processes applied to those inputs that provide or have the ability to provide a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants.

To be capable of being conducted and managed for the purposes defined, an integrated set of activities and assets requires two essential elements—inputs and processes applied to those inputs, which together are, or will be, used to create outputs.

Although businesses usually have outputs, they are not required for an integrated set of activities and assets to qualify as a business. For example, a business in the development stage might not have outputs. Paragraph B11 of IFRS 3 states: "determining whether a particular set of assets and activities is a business should be based on whether the integrated set is capable of being conducted and managed as a business by a market participant. Thus, in evaluating whether a particular set is a business, it is not relevant whether a seller operated the set as a business or whether the acquirer intends to operate the set as a business". [2]

Examples—a business

Ex 1 **SME A is an IT company that develops accounting software and sells it directly to customers. It has the intellectual property, staff and non-current assets that are needed to develop and sell software. SME A has many software licensing contracts as well as several purchase orders from customers.**

SME A's operation is a business—the set of assets (including intellectual property and non-current assets) and activities (managed computer programing processes to develop accounting software for sale to customers) is being managed by SME A as a business. The business clearly has inputs (for example, intellectual property, staff and non-current assets) and processes (managed computer programing processes to develop accounting software) that result in outputs (accounting software).

Ex 2 **SME A develops new accounting software. Its current activities include researching and developing its first product and developing a market for the product. It has the intellectual property, staff and equipment that are needed to develop and sell software. However, since its inception, SME A has produced no revenues because it is yet to release its accounting software. SME A continues to fund its operations through funding from third parties who are convinced of the future profitability of the entity. SME A anticipates releasing its first commercial accounting software within three months.**

SME A's operation is a business—the operation uses inputs (intellectual property, staff and equipment) in a managed computer programing process to develop accounting software for sale.

The operation includes all of the inputs and processes that are necessary to manage and produce outputs. In order for an operation to be a business, outputs themselves are not

[2] In the absence of explicit guidance in the *IFRS for SMEs* an entity can, but is not required to, in accordance with paragraph 10.6, consider the requirements and guidance in full IFRS.

necessary. It is only necessary that the set of assets and activities is capable of being conducted and managed as a business by a market participant.

Ex 3 **SME A manufactures medicines for human ailments. A few years ago it discovered, developed and patented a cure for the common cold. Recently, SME A began manufacturing and marketing the drug on a commercial scale. Shortly after, SME B acquired SME A and immediately and indefinitely suspended the manufacture of the drug and all of SME A's operations in order to protect the market for its own remedies.**

SME A's operation is a business—SME A uses inputs (pre-existing intellectual property, staff and property, plant and equipment) in a managed production process to develop and manufacture medicines for sale. This provides evidence that the integrated set of activities and assets that is SME A's operations is clearly capable of being conducted and managed as a business by a market participant.

In evaluating whether SME A's activities and assets comprise a business, it is not relevant that SME B does not intend to operate the set of activities and assets acquired as a business.

Ex 4 **SME A has three operations—an opencast copper mine, a steel mill (steel manufacturing plant) and a petroleum retail outlet. Each operation operates using dedicated property, plant and equipment and has separate contracts with third parties, management, employees, information technology systems and sales departments. However, all sales are carried out under a common brand name.**

Each of the three operations that together comprise SME A is a separate business—each operation has distinct inputs (buildings and equipment, management, employees, information technology systems), processes (strategic management processes, operational processes and resource management processes) and outputs (copper ore, steel and petroleum).

The fact that the sales are carried out under a common brand name is irrelevant in the determination of whether or not each operation is a business.

Ex 5 **SME A acquired a hotel operation—the hotel's employees, the franchise agreement, inventory, reservations system and all 'back office' operations.**

SME A acquired a business—the acquired set has all three components of a business (inputs, processes and outputs) and is capable of providing a return to its owners.

Example—not a business

Ex 6 **SME A recently stopped manufacturing cameras. It has disposed of its manufacturing equipment and made all its employees redundant. SME A's only remaining asset is an empty factory building (and the land upon which the factory is built). SME A does not intend to resume the production process and is actively seeking a buyer for the building.**

Neither SME A nor its building is a business. There is no integrated set of activities or processes to apply to the building to create outputs. Consequently, the building on its own is not capable of being conducted and managed as a business by a market participant.

Notes—not all of the processes are transferred

A business need not include all of the inputs or processes that the seller used in operating that business if market participants are capable of acquiring the business and continuing to produce outputs, for example, by integrating the business with their own inputs and processes (see paragraph B8 of IFRS 3).[3]

Example—not all of the processes are transferred

Ex 7 **SME A recently purchased the trade and assets of SME B's telescope division. Before this transaction, SME B comprised three divisions: cameras; binoculars and telescopes. SME B manufactured and sold each of these products and, although there were three separate manufacturing sites (one for each product), SME B had just one marketing department selling products from all three divisions.**
When SME B sold the telescope division to SME A it retained its entire marketing department as it planned to expand its camera division. SME A has slightly increased the size of its own marketing department following the acquisition of the division. The employees that were previously employed by SME B to manufacture telescopes transferred to SME A as part of the transfer of the division.
The machinery used to manufacture the telescopes and the premises used for the manufacturing were also transferred along with the customer lists and other net assets.

SME A acquired a business—the acquired division has all three components of a business (inputs, processes and outputs) and is capable of providing a return to its owners.
The fact that the marketing department was not transferred does not preclude the division being a business.

19.2 This section specifies the accounting for all business combinations except:

(a) combinations of entities or **businesses** under common **control**. Common control means that all of the combining entities or businesses are ultimately controlled by the same party both before and after the business combination, and that control is not transitory.

(b) the formation of a **joint venture**.

(c) acquisition of a group of assets that do not constitute a business.

Notes

Combinations under common control

Paragraph 19.2(a) excludes combinations of entities under common control from the scope of Section 19. Because the *IFRS for SMEs* does not specify how to account for such combinations, the management of an entity must, in accordance with paragraph 10.4, use its judgement in developing and applying an accounting policy that results in information that is relevant to the economic decision-making needs of users and that is reliable (ie results in financial statements that: (i) represent faithfully the financial position, financial performance and cash flows of the entity; (ii) reflect the economic substance of transactions, other events and conditions, and not merely the legal form;

[3] In the absence of explicit guidance in the *IFRS for SMEs* an entity can, but is not required to, in accordance with paragraph 10.6, consider the requirements and guidance in full IFRS.

(iii) are neutral, ie free from bias; (iv) are prudent; and (v) are complete in all material respects).

In doing so management must refer to, and consider the applicability of, the following sources in descending order:

(a) the requirements and guidance in the *IFRS for SMEs* dealing with similar and related issues; and

(b) the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses and the pervasive principles in Section 2 *Concepts and Pervasive Principles*.

In these circumstances, the *IFRS for SMEs* also permits management to look to the requirements and guidance in full IFRS (see paragraph 10.6). Full IFRS has the same exclusion for combinations of entities under common control, in IFRS 3, and so does not provide any additional guidance.

The scope exception in paragraph 19.2(a) does not preclude an entity from applying Section 19 to a business combination under common control. The exception means that it is not mandatory to do so. In exercising its judgement, management could decide to apply, by analogy, the requirements of Section 19. Alternatively, an SME could look to see how non-SMEs in its local jurisdiction would account in such circumstances. This might be full acquisition accounting, applying IFRS 3, or an alternative method such as a pooling of interests.

Joint ventures

A joint venture is a contractual arrangement whereby two or more parties undertake an economic activity that is subject to joint control. Joint ventures can take the form of jointly controlled operations, jointly controlled assets, or jointly controlled entities (see the *Glossary*). Joint ventures are accounted for in accordance with Section 15 *Investments in Joint Ventures* (see Module 15).

A group of assets

The acquisition of a group of assets that does not constitute a business is accounted for in accordance with other Sections of the *IFRS for SMEs*, ie each asset will be accounted for in accordance with the relevant section, for example, Section 17 *Property, Plant and Equipment*.

Examples—scope of Section 19

Ex 8 **SME A acquired a petrol station from SME B, which had been closed 18 months before the acquisition date. SME A did not acquire the rights to any trade name from SME B. SME A also did not acquire any processes to run the station from SME B nor did it 'take on' any of SME B's employees (ie it only purchased the property, plant and equipment).**

This transaction is not a business combination. SME A merely acquired a group of assets without accompanying processes. In other words, in the absence of processes and outputs the inputs on their own cannot constitute a business. Consequently, SME A accounts for the acquisition of the petrol station assets in accordance with Section 17 rather than Section 19.

Ex 9 SME A and SME B each acquired 50 per cent of SME C's ordinary shares that carry voting rights at a general meeting of shareholders. SME C manufactures plastic containers that are mainly used to contain edible oils, which it sells to several third party entities. The terms of the contractual arrangement between SME A and SME B specify that strategic decisions in SME C require approval of both SME A and SME B.

This transaction is not a business combination. Instead, it represents a formation of a joint venture—SME A and SME B have contractually agreed to share control of SME C (ie as a result of this transaction SME C is a jointly controlled entity). Consequently, SME A and SME B account for their investment in SME C in accordance with Section 15 *Investments in Joint Ventures* rather than Section 19.

Ex 10 SME A operates a painting and decorating business and is owned entirely by Mr X. Also owned by Mr X is SME B, which operates a garden maintenance business. Both businesses have been operating successfully for 10 years when Mr X decided to transfer his shares in SME B to SME A in exchange for additional shares in SME A.

After the transaction Mr X owns all of SME A (as he did before) but SME A now has a subsidiary, SME B. Mr X no longer has a direct interest in SME B.

Before, and after, the transaction SME A and SME B are both controlled by Mr X. Accordingly this is a combination of businesses under common control and the acquisition is outside the scope of Section 19. It does not matter that the common control is by an individual rather than by an entity; the scope exemption applies regardless.

SME A must, in accordance with paragraph 10.4, use its judgement in developing and applying an appropriate accounting policy. SME A might consider using the purchase method of accounting (ie in accordance with the method set out in Section 19). Alternatively, SME A could look to how non-SMEs in its local jurisdiction would account in such circumstances. This might be full acquisition accounting, applying IFRS 3, or an alternative method such as a pooling of interests.

Ex 11 SME A formed a new entity (SME B) in which it holds all of the equity. SME B then acquired five pre-existing subsidiaries of SME A. SME A has two other pre-existing subsidiaries and these are not involved in the restructuring of the group.

Unless SME A prepares consolidated financial statements in accordance with full IFRS or the *IFRS for SMEs,* SME B will be required to prepare consolidated financial statements. SME B's acquisition of the five pre-existing subsidiaries of SME A is a combination of entities under common control—all of the combining entities are ultimately controlled by the same party both before and after the transaction. Such combinations are excluded from the scope of Section 19 (see paragraph 19.2(a)). Accordingly, SME B must, in accordance with paragraph 10.4, use its judgement in developing and applying an appropriate accounting policy.

SME B might consider using the purchase method of accounting (ie in accordance with the method set out in Section 19). Alternatively, SME B could look to how non-SMEs in its local jurisdiction would account in such circumstances. This might be full acquisition accounting, applying IFRS 3, or an alternative method such as a pooling of interests.

Module 19 – Business Combinations and Goodwill

Business combinations defined

19.3 A business combination is the bringing together of separate entities or businesses into one reporting entity. The result of nearly all business combinations is that one entity, the acquirer, obtains control of one or more other businesses, the acquiree. The acquisition date is the date on which the acquirer effectively obtains control of the acquiree.

Notes

For all business combinations, the acquirer must identify the acquisition date—the date on which the acquirer effectively obtains control of the acquiree. The acquisition date is often the date on which the acquirer legally transfers the consideration, acquires the assets and assumes the liabilities of the acquiree—the closing date. However, the acquisition date is not necessarily the closing date; it may be before or after the closing date. It is necessary to consider all pertinent facts and circumstances in identifying the acquisition date. It may not be what is written in a document; it is when the acquirer effectively obtains control of the acquiree.

Deloitte lists some indicators that might be relevant in determining the acquisition date.[(4)] They include:

- the date that the acquirer commences direction of the operating and financial policies of the acquiree;
- the date from which the flow of economic benefit changes;
- the appointment of the majority of the board of directors (or equivalent governing body) of the acquiree (although this may indicate the latest date on which control could have passed).

Examples—date of acquisition

Ex 12 **On 15 January 20X1, SME A signed an agreement for the purchase of 100 per cent of SME B for cash. The purchase agreement specifies that the acquisition date is 1 April 20X1. However, SME A can, with effect from 15 January 20X1, remove any of SME B's directors and appoint directors of its choice. On 1 March 20X1 SME A removed all of the existing directors of SME A and appointed directors of its choice. On 1 April 20X1 ownership of all of the shares in SME B is transferred to SME A and the consideration is paid in cash.**

In the absence of evidence to the contrary, the acquisition date is 15 January 20X1—the date on which SME A first obtained the power to govern SME B's financial and operating policies through its ability to remove and appoint all of the members of SME B's Board.

Ex 13 **On 1 January 20X1 SME A and SME B commenced negotiations relating to the acquisition of 100 per cent of SME B's voting shares by SME A. On 1 April 20X1 the final agreement was signed and SME A obtained control of SME B. The agreement states that the acquisition is effective from 1 January 20X1 and SME A is entitled to all profits earned by SME B after this date. Consideration was transferred on 1 April 20X1 and the acquisition price was based on the net assets of SME B on 1 January 20X1.**

---

(4) Deloitte iGAAP 2011, LexisNexis, London, chapter 36, paragraph 6.4, page 2446.

Notwithstanding that the price is based on the net assets at 1 January 20X1 and that the former owners of SME B are not entitled to any dividends after that date, in the absence of evidence to the contrary, the acquisition date is 1 April 20X1—the date on which SME A first obtained control of SME B.

Ex 14 **On 1 January 20X1 SME A makes an offer to acquire 100 per cent of SME B's voting shares. The amount offered is based on SME B's net assets at that date. The offer is subject to satisfactory completion of due diligence. Until this is completed, SME A must be consulted before any major decision in SME B is made. SME A will be entitled to all profits of SME B after 1 January 20X1 if the acquisition is successfully completed. On 15 February 20X1 the due diligence is successfully completed, and the consideration and shares are transferred.**

In the absence of evidence to the contrary, the acquisition date is 15 February 20X1—the date on which SME A obtains control of SME B. Although SME A has to be consulted in any major decision made in relation to SME B after 1 January 20X1, this does not in itself mean that SME A has the power to govern the financial and operating policies of SME B. The consultation is likely to be a protective right for SME A, because the price has been determined based on net assets at 1 January 20X1, and the agreement between the parties may make this clear.

Ex 15 **On 1 January 20X1 SME A acquired 1,000 of SME B's 3,000 voting shares. That voting interest gives SME A the power to participate in the financial and operating policies of SME B (ie significant influence), but not to control it.**

On 30 June 20X2 SME B repurchased and cancelled 1,500 of its own shares from parties other than SME A.

SME A has obtained control over SME B through its ability to cast the votes attaching to 1,000 of the remaining 1,500 shares in issue of SME B.

In the absence of evidence to the contrary, on 30 June 20X2 SME A obtains control of SME B through its ability to cast the majority of the votes at a general meeting of shareholders (ie 1,000 of the remaining 1,500 shares in SME B). Even though SME A took no action on 30 June 20X2, it gained control over SME B on that date as a result of SME B's repurchase of its own shares. Consequently, 30 June 20X2 is the date of acquisition.

Ex 16 **On 1 January 20X1 SME A purchased the majority share of SME B's voting equity interests, but is precluded from exercising control over SME B due to contractual rights that are held by the other investors in SME B (for example, veto rights, board membership rights or other substantive participation rights) for a period of time. All restrictive rights lapse on 1 July 20X2.**

In the absence of evidence to the contrary, on 1 July 20X2, when the restrictive rights lapse, SME A will obtain control of SME B through its ability to cast the majority of the voting rights in SME B. The date of acquisition is 1 July 20X2.

19.4 A business combination may be structured in a variety of ways for legal, taxation or other reasons. It may involve the purchase by an entity of the equity of another entity, the purchase of all the net assets of another entity, the assumption of the liabilities of another entity, or the purchase of some of the net assets of another entity that together form one or more businesses.

19.5 A business combination may be effected by the issue of equity instruments, the transfer of cash, **cash equivalents** or other assets, or a mixture of these. The transaction may be between the shareholders of the combining entities or between one entity and the shareholders of another entity. It may involve the establishment of a new entity to control the combining entities or net assets transferred, or the restructuring of one or more of the combining entities.

Notes

Section 19 of the *IFRS for SMEs* applies to business combinations regardless of the form of the transaction. Possible structures include:

- an acquirer obtains the equity of another business such that the business becomes a subsidiary of the acquirer;
- one or more unincorporated businesses are purchased by an acquirer without becoming its subsidiary; and
- two or more entities combine by transferring their equity interests or net assets to a newly formed entity.

The form of the consideration can be varied (for example, equity instruments, cash, cash equivalents, other assets, or a combination of any of these). Cash equivalents, referred to in paragraph 19.5, means short-term, highly liquid investments that are readily convertible to known amounts of cash and that are subject to an insignificant risk of changes in value (see the *Glossary*). Other assets are wide-ranging and include tangible assets, such as the transfer of a property, and intangible assets, such as the transfer of a patent.

Examples—ways of effecting a business combination

Ex 17 **SME A delivers CU375,000 cash in exchange for receiving all of the equity interests in SME B, a company operating a car hire business.**[5]

This transaction is a business combination that is effected by the transfer of cash to the previous owners of the shares in SME B.

Ex 18 **SME A delivers CU300,000 cash in exchange for receiving 80 per cent of the equity interests in SME B, a company operating an IT business.**

This transaction is a business combination that is effected by the transfer of cash to the previous owners of the shares in SME B.

Ex 19 **SME A issues 10,000 new shares in itself in exchange for receiving 80 per cent of the equity interests in SME B, a company operating a construction business. Before this transaction SME A had 100,000 shares in issue.**

This transaction is a business combination that is effected by the transfer of SME A's equity instruments to the previous owners of the shares in SME B.

[5] In this example, and in all other examples in this module, monetary amounts are denominated in 'currency units' (CU).

Ex 20 **SME A acquires 100 per cent of the equity interests in SME B, a company operating a clothes retailing business, in exchange for:**

- **cash of CU10,000;**
- **an office building;**
- **two gold bars;**
- **10 per cent of equity instruments of SME A; and**
- **1,000 shares in Entity C.**

This transaction is a business combination that is effected by the transfer of the various assets specified.

Ex 21 **SME A has two divisions: manufacturing shoes and manufacturing handbags. Both divisions are businesses, although they are structured within one legal entity. SME B agrees to buy the handbag manufacturing division from SME A in exchange for cash of CU100,000.**

SME B forms a new entity, SME C, in which it owns all the equity. SME C has cash of CU100,000 and equity of CU100,000.

SME C pays cash of CU100,000 to SME A in exchange for the trade and net assets of SME A's handbag division.

This transaction is a business combination that is effected by the transfer of cash to the previous owners of the business.

Ex 22 **SME A and SME B enter into an agreement to merge their businesses. The way that SME A and SME B affect this is by SME A issuing equity instruments in itself to the equity holders of SME B in exchange for their equity instruments in SME B. As a result, SME A acquires a subsidiary (SME B) and the former equity holders in SME B are now owners, along with the original owners of SME A, of SME A.**

This transaction is a business combination that is effected by the transfer of SME A's equity instruments to the previous owners of the equity instruments in SME B.

Ex 23 **SME A and SME B enter into an agreement to merge their businesses. The way that SME A and SME B affect this is by forming a new entity, SME C, which issues equity instruments in itself to the equity holders of SME A and SME B in exchange for their equity instruments in SME A and SME B. As a result, SME C has two subsidiaries, SME A and SME B. The former equity holders in SME A and SME B are now both part owners of SME C.**

This transaction is a business combination that is effected by the transfer of equity instruments in a new entity to the previous owners of the equity instruments in SME A and SME B.

Module 19 – Business Combinations and Goodwill

Accounting

19.6 All business combinations shall be accounted for by applying the purchase method.

19.7 Applying the purchase method involves the following steps:

(a) identifying an acquirer.

(b) measuring the cost of the business combination.

(c) allocating, at the acquisition date, the cost of the business combination to the assets acquired and liabilities and provisions for **contingent liabilities** assumed.

Notes

All business combinations within the scope of Section 19 must be accounted for using the purchase method, which is sometimes also known as the acquisition method.

Users of financial statements are better able to assess the initial investments made and the subsequent performance of those investments and compare them with the performance of other entities because the acquired net assets, including those not previously recognised by the acquiree, are recognised in the acquirer's consolidated financial statements.

Moreover, by measuring the assets acquired and the liabilities and contingent liabilities assumed in a business combination at their respective fair values, the purchase method includes in the financial statements more information about the market's expectation of the value of the future cash flows associated with those assets and liabilities—this enhances the relevance of that information (see paragraph BC45 of IFRS 3 (2004)).

Like full IFRS, the *IFRS for SMEs* does not permit the use of the pooling of interests method of accounting for a business combination within the scope of Section 19. The pooling of interests method combines, unchanged, the pre-business combination carrying amounts of assets, liabilities, and the reserves of the combining entities or businesses.

Each of the three steps involved in the purchase method is dealt with in subsequent paragraphs of the *IFRS for SMEs*:

- paragraphs 19.8–19.10 contain guidance on identifying the acquirer;
- paragraphs 19.11–19.13 deal with measuring the cost of the business combination; and
- paragraphs 19.14–19.15, and 19.17–19.19 explain how the cost of a business combination is allocated to the assets acquired and the liabilities and contingent liabilities assumed.

Before discussing these three steps in turn, two examples are set out below to illustrate the basic mechanics of applying the purchase method of accounting for a business combination.

Examples—applying the purchase method[6]

Ex 24 **SME A purchased a competitor's (SME B) taxi business for CU42,000, which was paid in cash on the date of acquisition. The business combination was effected by the assets, obligations and operations of the taxi business being transferred to SME A.**

Information about the assets, liabilities and contingent liabilities of the acquired business at the acquisition date:

	Carrying amount in SME B's financial statements	*Fair value*
	CU	CU
Taxis	15,000	20,000
Taxi licences	5,000	15,000
Brand (registered trade name)	–	6,000
Possible obligation for a court case	–	(1,000)
Total	20,000	40,000

SME A (the acquirer) accounts for the business combination by recognising the cost of the business combination, CU42,000, and by recognising the identifiable assets acquired (the taxis, taxi licences and brand) and the liabilities and contingent liabilities assumed (the possible obligation for the court case ie a contingent liability for which a fair value can be determined), at their respective fair values at the date of acquisition with the following journal entries:

		CU	CU
Dr	Property, plant and equipment—taxis	20,000	
Dr	Intangible assets—taxi licences	15,000	
Dr	Intangible asset—brand	6,000	
Dr	Intangible asset—goodwill[a]	2,000	
	Cr Contingent liability—court case		1,000
	Cr Cash		42,000

To recognise the acquisition of SME B's taxi business.

[a] Balancing figure (see paragraph 19.14).

In this instance SME A purchased the trade and assets from SME B. Accordingly the above journal entry is made directly in the accounting records of SME A because, for example, SME A now directly owns the taxis, rather than indirectly (for example, having a subsidiary that owns them and the other assets and liabilities).

[6] In this example, and in all other examples in this module (unless otherwise stated), income tax has been ignored.

Immediately before the acquisition, SME A's statement of financial position was as follows:

	SME A *Carrying amount* CU
Assets	
Non-current assets	
Property, plant and equipment—taxis	35,000
Intangible asset—taxi licences	10,000
	45,000
Current assets	
Cash	60,000
	60,000
Total assets	**105,000**
Equity	
Share capital	5,000
Reserves	100,000
Total equity	**105,000**

Therefore, immediately after the acquisition, SME A's statement of financial position was as follows:

		SME A	
	Before acquisition	*Effect of acquisition*	*After acquisition*
	CU	CU	CU
Assets			
Non-current assets			
Property, plant and equipment—taxis	35,000	20,000	55,000
Intangible asset—goodwill	–	2,000	2,000
Intangible asset—taxi licences	10,000	15,000	25,000
Intangible asset—brand	–	6,000	6,000
	45,000	43,000	88,000
Current assets			
Cash	60,000	(42,000)	18,000
	60,000	(42,000)	18,000
Current liabilities			
Liability—court case	–	(1,000)	(1,000)
	–	(1,000)	(1,000)
Total net assets	**105,000**	**–**	**105,000**
Equity			
Share capital	5,000	–	5,000
Reserves	100,000	–	100,000
Total equity	**105,000**	**–**	**105,000**

Ex 25 The facts are the same as in Example 24. However, in this example, the business combination was effected by SME A, the acquirer, buying all of the shares in issue of SME B (SME B's only business is its taxi business). In SME A's separate financial statements (and its general ledger) it accounts for the investment in SME B using the cost model, at CU42,000.

SME A prepares its consolidated financial statements by combining the financial statements of the parent and its subsidiaries line by line by adding together like items of assets, liabilities, equity, income and expenses and then making consolidation adjustments.

In the consolidated statement of financial position at the acquisition date, the assets and liabilities of SME B are measured as follows:

	CU
Property, plant and equipment—taxis	20,000
Intangible assets—taxi licences	15,000
Intangible asset—brand	6,000
Intangible asset—goodwill	2,000
Contingent liability—court case	(1,000)

In preparing SME A's consolidated statement of financial position at the acquisition date (after combining the financial statements of SME A and SME B line by line by adding together like items of assets, liabilities and equity) management would use the following consolidation adjustments:

		CU	CU
Dr	Property, plant and equipment–taxis	5,000	
Dr	Intangible assets—taxi licences	10,000	
Dr	Intangible asset—brand	6,000	
Dr	Intangible asset—goodwill	2,000	
Dr	Equity (SME B's pre-acquisition equity)	20,000	
	Cr Contingent liability—court case		1,000
	Cr SME A's investment in SME B		42,000

SME A's consolidated statement of financial position at 31 December 20X1 would be calculated as follows (assuming SME B had share capital of CU1,000 and reserves of CU19,000):

A	B	C	D	E
	SME A	**SME B**	**Consolidation adjustments**	**Consolidated** *(ie Column B + Column C + Column D)*
	Carrying amount	*Carrying amount*		
	CU	CU	CU	CU
Assets				
Non-current assets				
Property, plant and equipment—taxis	35,000	15,000	5,000	55,000
Intangible asset—goodwill	–	–	2,000	2,000
Intangible asset—taxi licenses	10,000	5,000	10,000	25,000
Intangible asset—brand	–	–	6,000	6,000
	45,000	20,000	23,000	88,000
Current assets				
Cash	60,000	–	(42,000)	18,000
	60,000	–	(42,000)	18,000
Current liabilities				
Liability—court case	–	–	(1,000)	(1,000)
	–	–	(1,000)	(1,000)
Total net assets	**105,000**	**20,000**	**(20,000)**	**105,000**
Equity				
Share capital	5,000	1,000	(1,000)	5,000
Reserves	100,000	19,000	(19,000)	100,000
Total equity	**105,000**	**20,000**	**(20,000)**	**105,000**

Identifying the acquirer

19.8 An acquirer shall be identified for all business combinations. The acquirer is the combining entity that obtains control of the other combining entities or businesses.

Notes

The purchase method views a business combination from the acquirer's perspective. In many cases identifying the acquirer will be straightforward. However, in some cases it might be difficult to identify the acquirer, especially for combinations that are sometimes referred to as 'mergers of equals'. Despite this, accounting for a business combination in accordance with the *IFRS for SMEs* requires the identification of the acquirer.

The key to identifying the acquirer is first to establish which entity has control over another. The party that obtains control of the other combining entities or businesses is the acquirer for accounting purposes.

19.9 Control is the power to govern the financial and operating policies of an entity or business so as to obtain benefits from its activities. Control of one entity by another is described in Section 9 *Consolidated and Separate Financial Statements*.

Notes

For more information about control, including mandatory application guidance, see Section 9.

In assessing whether one entity controls another, all the facts and circumstances are considered. The main judgements in determining control are set out in Module 9 *Consolidated and Separate Financial Statements* of this training material.

19.10 Although it may sometimes be difficult to identify an acquirer, there are usually indications that one exists. For example:

(a) if the **fair value** of one of the combining entities is significantly greater than that of the other combining entity, the entity with the greater fair value is likely to be the acquirer.

(b) if the business combination is effected through an exchange of voting ordinary equity instruments for cash or other assets, the entity giving up cash or other assets is likely to be the acquirer.

(c) if the business combination results in the management of one of the combining entities being able to dominate the selection of the management team of the resulting combined entity, the entity whose management is able so to dominate is likely to be the acquirer.

Notes

All relevant facts and circumstances are considered when identifying the acquirer—the combining entity that obtains control of the other combining entities or businesses. Paragraphs 9.5 and 19.10 provide some guidance in identifying the acquirer.

IFRS 3 also provides useful and more detailed application guidance in identifying the acquirer in a business combination. The following is based on the guidance in IFRS 3 (2008). [7]

In a business combination that is effected primarily by exchanging equity interests, the acquirer is usually (but not always) the entity that issues its equity interests. Other pertinent facts and circumstances must also be considered in identifying the acquirer in a business combination that is effected by exchanging equity interests, including:

(a) the relative voting rights in the combined entity after the business combination. The acquirer is usually the combining entity whose owners as a group retains or receives the largest portion of the voting rights in the combined entity.
In determining which group of owners retains or receives the largest portion of the voting rights, an entity shall consider the existence of any unusual or special voting arrangements and options, warrants or convertible securities.

(b) the composition of the governing body of the combined entity. The acquirer is generally the combining entity whose owners have the ability to elect, appoint or remove a majority of the members of the board of directors or other governing

[7] In the absence of explicit guidance in the *IFRS for SMEs* an entity can, but is not required to, in accordance with paragraph10.6, consider the requirements and guidance in full IFRS.

body of the combined entity.

(c) the terms of the exchange of equity interests. The acquirer is usually the combining entity that pays a premium over the pre-combination fair value of the equity interests in the other combining entity or entities.

The acquirer is usually the combining entity whose relative size (measured in, for example, assets, revenues or profit) is significantly greater than that of the other combining entity or entities.

In a business combination that involves more than two entities, determining the acquirer includes a consideration of, among other things, which of the combining entities initiated the combination, as well as the relative size of the combining entities.

The acquirer is usually the combining entity whose management dominates the management of the combined entity. This can be particularly tricky to assess if two owner-managed businesses combine and the former owners continue working in, and managing, the business. However, despite both continuing to work and be managers, one may nevertheless report to the other and/or the other factors discussed in these paragraphs may indicate which entity is the acquirer.

A new entity that is formed to effect a business combination is not necessarily the acquirer. If a new entity is formed to issue equity interests to effect a business combination, one of the combining entities that existed before the business combination shall be identified as the acquirer by applying the guidance in the previous paragraphs. In contrast, a new entity that transfers cash or other assets or incurs liabilities as consideration may be the acquirer.

Examples—identifying the acquirer

Ex 26 **Two previously independent entities (SME A and SME B) are to be combined. To effect the business combination, a new entity (SME C) is formed. SME C issues shares to the owners of SME A and SME B in exchange for all the shares of both SME A and SME B. SME C is created solely to formalise the organisational structure.**

Because SME C is created solely to formalise the combining entities organisational structure and does so by issuing shares, it is not the acquirer although it is the legal parent of both of the other entities. One of the entities that existed prior to the combination, SME A or SME B, must be identified as the acquirer based upon all relevant facts and circumstances. This is explored further in the next two examples.

Ex 27 **The facts are the same as in Example 26. However, in this example, SME A is significantly larger (measured by reference to the fair value of each of the combining entities) than SME B and SME A’s former shareholders hold a larger proportion of SME C than SME B’s former shareholders. In addition, it was SME A that approached the owners of SME B to initiate the combination and that carried out due diligence on SME B.**

In the absence of evidence to the contrary, SME A is the acquirer.

Ex 28 **The facts are the same as in Example 26. However, in this example, although SME A and SME B are approximately the same size (measured by reference to the fair value of each of the combining entities), the former shareholders of SME B have the power to appoint the majority of SME C’s key management personnel.**

In the absence of evidence to the contrary, SME B is the acquirer.

Ex 29 On 31 December 20X0 SME A had 100 shares in issue. On 1 January 20X1 SME A acquired 100 per cent of the equity interests in SME B. SME A issued 200 new shares to the owners of SME B in exchange for all of the shares in SME B.

In law SME A acquired all the shares in SME B. As a consequence of the business combination the former shareholders of SME B hold two-thirds of the shares in SME A. For the purposes of applying Section 19 of the *IFRS for SMEs*, SME B is the acquirer because the former shareholders of SME B obtained control of the combined entities in the business combination through their 67 per cent shareholding in SME A (ie 200/300 shares). Consequently, in the absence of evidence to the contrary, SME B is the acquirer.

Cost of a business combination

19.11 The acquirer shall measure the cost of a business combination as the aggregate of:

(a) the fair values, at the date of exchange, of assets given, liabilities incurred or assumed, and equity instruments issued by the acquirer, in exchange for control of the acquiree, plus

(b) any costs directly attributable to the business combination.

Notes—date of exchange

Paragraph 19.11 of the *IFRS for SMEs* refers to the fair value of the consideration "at the date of exchange" whereas the current version of IFRS 3 (the 2008 version of IFRS 3) refers to "acquisition-date fair values" of the consideration. The date of exchange is not defined in the *IFRS for SMEs*. The 2004 version of IFRS 3 (being the one on which Section 19 is generally based), however, referred to the fair value of the consideration "at the date of exchange". It explained that the "date of exchange" coincided with the acquisition date when control was achieved in a single transaction, such as one entity purchasing all of the issued share capital of another entity from the sole shareholder in that other entity. By contrast, if control of another entity is gained in stages, the date of exchange is several dates; being the dates that each of the stages is acquired.

Examples—date of exchange

Ex 30 On 1 January 20X1 SME A acquired 100 per cent of the equity interests in SME B in exchange for cash of CU30,000.

The date of exchange is 1 January 20X1, being the date that the transaction is recognised in the financial statements. In this example, the date of acquisition (being the date that the acquirer effectively obtains control of the acquiree) is also 1 January 20X1.

Ex 31 The shares in SME B are owned by three individuals, X, Y and Z. On 1 January 20X1 SME A acquired the shares in SME B that were owned by X in exchange for cash of CU10,000. On 1 March 20X2 SME A gained control of SME B when it acquired the shares in SME B that were owned by Y in exchange for cash of CU11,200.

The dates of exchange are 1 January 20X1 and 1 March 20X2, being the dates that the transactions are recognised in the financial statements. The date of acquisition (being the date that the acquirer effectively obtains control of the acquiree) is 1 March 20X2.

Notes—fair value

Fair value is the amount for which an asset could be exchanged, a liability settled, or an equity instrument granted could be exchanged, between knowledgeable, willing parties in an arm's length transaction (see the *Glossary*).

Consideration given that is not in the form of cash requires a value to be put on it in order for the acquirer to calculate exactly how much it paid for the business acquired; the fair value of what is given is used. Even consideration in the form of cash may need to be adjusted. If an entity paid CU100,000 to acquire all of the equity in another entity, the cost of acquisition is the fair value of the cash transferred. If it is paid to the former owners immediately the fair value will be the nominal value, ie CU100,000. If, instead, the cash of CU100,000 is paid one year after the acquisition date and interest rates are 5 per cent per annum, the present value of the cash at acquisition date, ie CU95,238 (being CU100,000 discounted at 5 per cent) will be the cost of acquisition.

When the consideration transferred in a business combination includes one or more of the following: non-cash monetary assets; non-monetary assets; liabilities incurred or assumed; and equity instruments, measurement of the exchange date fair value of those forms of payment may require estimates and judgements.

Section 19 does not provide application guidance on how to measure fair value.

In the absence of explicit guidance, in accordance with paragraph 10.4, an entity uses its judgement in developing and applying an accounting policy that results in information that is relevant and reliable. In making that judgement management refers to the requirements and guidance in the *IFRS for SMEs* dealing with similar and related issues (see paragraph 10.5) and it can, but is not required to, consider the requirements and guidance in full IFRS (see paragraph 10.6).

Section 11 *Basic Financial Instruments* provides some fair value measurement guidance of financial instruments. That guidance includes a hierarchy to estimate fair value (see paragraph 11.27).

In May 2011 (almost two years after the *IFRS for SMEs* was issued), to improve consistency across fair value measurement requirements, the IASB issued IFRS 13 *Fair Value Measurement*.

Consequently, when measuring the cost of a business combination in accordance with paragraph 19.11, an entity would refer to Section 11 and it could, but is not required to, also refer to the comprehensive application guidance in IFRS 13. In the introduction to IFRS 13 the IASB explains that fair value is a market-based, not entity-specific, measurement (see paragraph IN9), so is established using the assumptions that market participants would use when pricing the asset under current market conditions, and that fair value measurement requires an entity to determine the following (see paragraph IN10):

(a) the particular asset or liability being measured, considering, when relevant to the fair value, factors such as the location and condition of the asset and any restrictions on its sale or use;

(b) for a non-financial asset, the highest and best use of the asset and whether the asset is used in combination with other assets or on a stand-alone basis;

(c) the market in which an orderly transaction would take place for the asset or liability; and

(d) the appropriate valuation technique(s) to use when measuring fair value. The valuation technique(s) used should maximise the use of relevant observable inputs and minimise unobservable inputs. Those inputs should be consistent with the inputs that a market participant would use when pricing the asset or liability.

To assist in measuring fair value, the IASB developed a 'fair value hierarchy', which consists of three levels of inputs as follows:

- Level 1 inputs—quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the measurement date.
- Level 2 inputs—inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly (for example, quoted prices for similar assets or liabilities in active markets and quoted prices for identical or similar assets or liabilities in markets that are not active).
- Level 3 inputs—unobservable inputs for the asset or liability.

If Level 1 inputs are not available, the entity measures fair value by adjusting Level 2 inputs that occur at or near the measurement date. Adjustments to Level 2 inputs will vary depending on factors that are specific to the asset or liability. Those factors include the following (see paragraph 83 of IFRS 13):

(a) the condition or location of the asset;

(b) the extent to which inputs relate to items that are comparable to the asset or liability (including those factors described in paragraph 39 of IFRS 13); and

(c) the volume or level of activity in the markets within which the inputs are observed.

Unobservable inputs (Level 3 inputs) are only used to measure fair value to the extent that relevant observable inputs (Level 1 and Level 2 inputs) are not available. Using unobservable inputs allows for situations in which there is little, if any, market activity for the asset or liability at the measurement date. However, the fair value measurement objective remains the same (ie an exit price at the measurement date from the perspective of a market participant that holds the asset or owes the liability). Therefore, unobservable inputs must reflect the assumptions that market participants would use when pricing the asset or liability, including assumptions about risk (see paragraph 87 of IFRS 13).

Different levels of valuation might apply to different parts of the consideration given by an entity to acquire another entity. For example, Level 1 inputs will be available if part of the consideration given is shares that the acquirer had held as an investment and they are listed. On the other hand, if an entity issues its own shares to be used as consideration, Level 1 inputs will not be available as the definition of an SME excludes an entity whose debt or equity instruments are traded in a public market.

Example—non-monetary assets and equity instruments

Ex 32 **SME A acquires 100 per cent of the equity interests in SME B, a company operating a clothes retailing business, in exchange for:**

- **cash of CU10,000, paid on the acquisition date;**
- **an office building (acquisition-date fair value measured using the price per square metre for the building derived from prices in observed transactions involving similar buildings in similar locations = CU50,000);**
- **two gold bars (acquisition-date fair value measured using the spot quotation by the London Bullion Market Association = CU1,000 per gold bar);**
- **10 per cent of equity instruments of SME A (share capital of SME A consists of 10,000 ordinary, fully paid shares; the fair value of each at the acquisition date was CU10—the fair value was measured using an income approach (discounted cash flows) using market participant assumptions); and**
- **1,000 shares of a third party (Entity C). Entity C's shares are actively traded on the London Stock Exchange (acquisition-date fair value = CU6 per share).**

The cost of the business combination is CU78,000.

Calculation:

	Valuation input level	*CU*
Cash paid immediately	1	10,000
Fair value of the office building	2	50,000
Fair value of two gold bars	1	2,000
Equity instruments of SME A	3	10,000
Equity instruments of Entity C	1	6,000
Total		**78,000**

Notes—deferred payment

When settlement of the cost of the business combination is deferred the fair value of a deferred component is measured at its present value.

Example—deferred payment

Ex 33 **On 1 January 20X1 SME A acquired 100 per cent of the equity interests in SME B in exchange for cash of CU30,000 to be paid two years later on 31 December 20X2.**

SME A's incremental borrowing rate is 5 per cent per year.

The cost of the business combination is CU27,211,[a] which is the present value of the CU30,000 deferred payment discounted by 5 per cent per annum for two years.

[a] CU27,211 = future value / [(1 + discount rate per annum) ^ number of years discounted] = 30,000 / [(1 + 0.05)2]

Notes—costs directly attributable to the business combination

Costs directly attributable to the business combination are costs that the acquirer incurs directly to effect a business combination. These are added to the consideration paid and regarded as an integral part of the cost of the business combination and consequently affect the calculation of goodwill (rather than being directly charged in arriving at profit or loss for the year in the year of acquisition). The costs include finders' fees and advisory, legal, accounting, valuation and other professional or consulting fees. General administrative costs, including the costs of maintaining an internal acquisitions department, are not directly attributable; they would have been incurred regardless of whether the business combination goes ahead.

Costs of registering and issuing debt and equity securities issued as part of the consideration are recognised as part of the debt and equity instruments in accordance with paragraphs 11.13 and 22.8 of the *IFRS for SMEs*; they are not treated as part of the costs that are directly attributable to the business combination.

Examples—directly attributable costs

Ex 34 **SME A acquires 100 per cent of the equity interests in SME B in exchange for cash of CU30,000. In addition, SME A paid the following costs that are related directly to the business combination:**

- **advisory: CU1,250;**
- **legal: CU500;**
- **accounting: CU150; and**
- **valuation: CU100.**

The cost of the business combination is CU32,000. It includes the cash consideration and all costs that are directly attributable to the acquisition.

Ex 35 **The facts are the same as in Example 34. However, in this example, SME A acquires 100 per cent of the equity interests in SME B in exchange for issuing shares worth CU30,000 rather than paying cash of CU30,000. In addition to the costs related directly to the business combination above, SME A incurred share issue costs of CU300.**

The cost of the business combination is CU32,000. It includes the fair value of the share consideration and all costs directly attributable to the acquisition. The share issue costs will be recognised in equity when recording the shares issued.

Adjustments to the cost of a business combination contingent on future events

19.12 When a business combination agreement provides for an adjustment to the cost of the combination contingent on future events, the acquirer shall include the estimated amount of that adjustment in the cost of the combination at the acquisition date if the adjustment is **probable** and can be measured reliably.

Notes

Contingent consideration represents an obligation of the acquirer to transfer additional assets or equity interests to the former owners of the acquiree if specified future events occur or conditions are met.

Examples of future events or factors that may lead to additional payments are:

- earnings (or particular components of earnings) are above an agreed target over an agreed period;
- approval of a licence or patent in an agreed period;
- completion of specified contract negotiations in an agreed period; and
- cash flow that arises from specified assets is above an agreed target over an agreed period.

An arrangement could have a combination of any of the above and/or any other factors.

If it is probable (more likely than not—see the *Glossary*) that the conditions will be met, an acquirer's obligation to pay contingent consideration is recognised (if it can be measured reliably) as either a liability or equity (based on the character of the future payment).

In determining whether the payment of contingent consideration is probable, the assessment is based on all facts and circumstances at the acquisition date.

Once it has been determined that a payment is probable and it can be measured reliably, it is included in the cost of the business combination and therefore the amount, like non-contingent consideration, is measured at its fair value. For example, if it is probable that a payment of CU200,000 will be made two years after the acquisition date, the present value of the CU200,000 is included in the cost of acquisition. The difference between the nominal value and the present value of the CU200,000 is recognised as interest expense in arriving at profit or loss for the year. In other words, only the present value of the CU200,000 (and not the full CU200,000) affects the calculation of goodwill.

Example—contingent consideration

Ex 36 **On 1 January 20X3 SME A acquired 100 per cent of the equity interests in SME B in exchange for cash of CU30,000. SME A agreed to pay a further CU4,000 if the weighted average return on assets (ROA) of SME B for the following three years was between 6 and 14 per cent, CU7,000 if the weighted average ROA was higher than 14 per cent, CU1,000 if the weighted average ROA was positive but lower than 6 per cent and nothing if the weighted average ROA was negative. The contingent consideration, if required, will be paid on 1 January 20X7.**

After careful consideration, taking account, inter alia, of budgets for 20X3, 20X4 and 20X5, SME A estimated that ROA would be between 6 and 14 per cent and, therefore, at the acquisition date, it was probable that a payment of CU4,000 would be made on 1 January 20X7. SME A measured the present value of the estimated contingent consideration at CU3,291.

Because the adjustment to the cost of combination at the acquisition date was probable and could be measured reliably, SME A must recognise total consideration of CU33,291 (ie CU30,000 cash payment and CU3,291 present value of the estimated contingent consideration).

Assuming that the weighted average ROA of SME B for the three years post-acquisition was 11 per cent, SME A would pay the additional consideration of CU4,000 on 1 January 20X7. The difference between the nominal amount paid, CU4,000, and its present value, CU3,291, (ie CU709) is recognised, as interest expense, in arriving at profit or loss over the four years to 31 December 20X6; CU164 in the first year and CU173, CU182 and CU190 in the second, third and fourth years respectively.

19.13 However, if the potential adjustment is not recognised at the acquisition date but subsequently becomes probable and can be measured reliably, the additional consideration shall be treated as an adjustment to the cost of the combination.

Note

The adjustment to the cost of the business combination will affect the amount of goodwill recognised in respect of the business combination. The adjustment should be made as soon as the acquirer's estimates are reliable and consideration becomes probable.

Similarly, if contingent consideration is included in the accounting for the cost of the business combination by the acquirer at the date of acquisition, but subsequently the targets that would trigger its payment are not met (or it is no longer probable that they would be met), the acquirer must adjust the accounting for the business combination by removing such contingent consideration.

Example—contingent consideration not recognised at the acquisition date

Ex 37 **SME A paid CU1,000 to acquire SME B and agreed to pay a further CU500 four years after the acquisition date if a specified profit target is met for the three years following the acquisition date. No further consideration is due if the targets are not met. Meeting the targets was considered probable (more likely than not) for the first time at the end of the second year after the acquisition date.**

At the acquisition date SME A recorded the cost of the acquisition as CU1,000. At the end of the second year, SME A increases the cost of the acquisition by the present value of CU500 (ie SME A increases the amount of goodwill and recognises a liability for the obligation to pay the contingent consideration).

The present value of CU500 at the acquisition date would be CU411, assuming a discount rate of 5 per cent. Two years after the acquisition date the present value would be CU453. The difference between the two is due to interest and the unwinding of the discount.

If the contingent consideration were recognised at the date of acquisition, goodwill would be affected by CU411 with CU89 being recognised as an interest expense over the four years following the acquisition. If at the end of year 2 the adjustment to goodwill is CU453, goodwill will be a different amount to what it would have been had the contingent consideration been recognised at the date of acquisition. There is no guidance in Section 19 of the *IFRS for SMEs* on whether to adjust goodwill by CU453 or by CU411, in either case as adjusted for two years amortisation of that amount.
PwC commented that adjusting by CU453 would be consistent with the prospective adjustment to accounting estimates required by paragraphs 10.16 and 10.17 of the *IFRS for SMEs*.[8]

Allocating the cost of a business combination to the assets acquired and liabilities and contingent liabilities assumed

19.14 The acquirer shall, at the acquisition date, allocate the cost of a business combination by recognising the acquiree's identifiable assets and liabilities and a provision for those contingent liabilities that satisfy the recognition criteria in paragraph 19.20 at their fair values at that date. Any difference between the cost of the business combination and the acquirer's interest in the net fair value of the identifiable assets, liabilities and provisions for contingent liabilities so recognised shall be accounted for in accordance with paragraphs 19.22–19.24 (as goodwill or so-called 'negative goodwill').

Notes

The allocation of the cost of a business combination to the assets and liabilities in the acquiree is made as at the acquisition date. It is necessary to recognise all identifiable assets (tangible or intangible), liabilities and contingent liabilities that satisfy the recognition criteria, regardless of whether they were recognised in the acquiree's separate financial statements.

(8) PwC manual of Accounting–IFRS for the UK, 2006 edition, paragraphs 25.160.2 and 25.163.

The *IFRS for SMEs* does not define "identifiable". However, it is defined in IFRS 3, which explains that an asset is identifiable if it either:[9]

(a) is separable, ie capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, identifiable assets or liability, regardless of whether the entity intends to do so; or

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

The identifiable assets, liabilities and provisions for contingent liabilities are recognised at their fair values on the acquisition date; this is presumed to be their cost to the acquirer on the date that it acquires them.

As discussed above (in the notes on "fair value" that follow paragraph 19.11) in May 2011, almost two years after the *IFRS for SMEs* was issued, to improve consistency across fair value measurement requirements, the IASB issued IFRS 13. A summary of the approach in IFRS 13 is set out above. In determining the fair values of identifiable assets and liabilities, an entity could refer to the comprehensive application guidance in IFRS 13. In addition, the 2004 version of IFRS 3 set out guidance for determining the fair value of particular identifiable assets and liabilities. The guidance below is taken from this.

Identifiable tangible assets

The table below provides examples of the fair value measures for particular identifiable tangible assets at the date of the acquisition:[10]

Land and buildings	The acquirer uses market values.
Plant and equipment	The acquirer uses market values. When there is no evidence of a market value, the acquirer uses an income or a depreciated replacement cost approach.

Identifiable intangible assets

An essential part of the purchase method is the recognition and measurement of identifiable intangible assets. Such items must be recognised separately from goodwill. Accounting for intangible assets that are acquired in a business combination is covered in Section 18 *Intangible Assets other than Goodwill* (see paragraphs 18.8 and 18.11).

The meaning of identifiable is significant in identifying which intangible assets to recognise. As stated above, an asset is identifiable if it either is separable or arises from contractual or other legal rights.

Examples of items that are not identifiable include:

- an assembled workforce (an existing collection of employees that permits the acquirer to continue to operate an acquired business from the acquisition date) of the acquiree;

---

[9] In the absence of explicit guidance in the *IFRS for SMEs* an entity can, but is not required to, in accordance with paragraph 10.6, consider the requirements and guidance in full IFRS.

[10] Examples of measurement of tangible assets were extracted from IFRS 3 (2004). In the absence of explicit guidance in the IFRS for SMEs an entity can, but is not required to, in accordance with paragraph 10.6, consider the requirements and guidance in full IFRS.

- synergies from combining the acquiree's net assets with those of the acquirer; and
- greater or enhanced market share.

The tables below show the intangible assets that typically meet the recognition criteria and are recognised separately from goodwill in a business combination (see paragraphs IE16–IE44 of IFRS 3):[11]

Marketing related	Trademarks, trade names.
	Service marks, collective marks, certification marks.
	Trade dress (unique colour, shape, or package design).
	Newspaper mastheads.
	Internet domain names.
	Non-competition agreements.

Customer-related	Customer lists.
	Order or production backlog.
	Customer contracts and related customer relationships.
	Non-contractual customer relationships.

Artistic-related	Plays, operas, ballets.
	Books, magazines, newspapers, other literary works.
	Musical works, such as compositions, song lyrics, advertising jingles.
	Pictures, photographs.
	Video and audiovisual material, including motion pictures or films, music videos, television programmes.

Contract based	Licensing, royalty, standstill agreements.
	Advertising, construction, management, service or supply contracts.
	Lease agreements.
	Construction permits.
	Franchise agreements.
	Operating and broadcast rights.
	Use rights, such as drilling, water, air, timber cutting, and route authorities.
	Servicing contracts.
	Employment contracts.

Technology-based	Patented technology.
	Computer software and mask works.
	Unpatented technology.
	Databases, including title plants.
	Trade secrets, such as secret formulas, processes, recipes.

Paragraph 18.8 of the *IFRS for SMEs* explains that the fair value of intangible assets acquired in a business combination can normally be measured with sufficient reliability to allow them to be recognised. In other words, while this might prevent recognising an internally-generated intangible asset it should not prevent recognising an intangible asset acquired in a business combination. However, the paragraph considers that separate recognition is not possible when the intangible asset arises from legal or other contractual rights and its fair value cannot be measured reliably because the asset either:

- is not separable from goodwill; or

[11] In the absence of explicit guidance in the *IFRS for SMEs* an entity can, but is not required to, in accordance with paragraph 10.6, consider the requirements and guidance in full IFRS.

- is separable from goodwill, but there is no history or evidence of exchange transactions for the same or similar assets, and estimating the fair value otherwise would be dependent on immeasurable variables.

Financial and similar assets

The table below shows examples for measuring financial and similar assets at their fair value at the acquisition date:[12]

Financial instruments traded in an active market	The acquirer uses current market values.
Financial instruments not traded in an active market	The acquirer uses estimated values that take into account features such as price-earnings ratios, dividend yields and expected growth rates of comparable securities.
Emission rights	The acquirer determines the fair value by reference to an active market for emission rights.
Receivables, beneficial contracts	The acquirer uses the present values of the amounts to be received, determined at appropriate current interest rates, less allowances for uncollectability and collection costs. For short-term receivables, discounting is not required if not material.
Net employee benefit assets for defined benefit plans	The acquirer uses the fair value of any plan assets less the present value of the defined benefit plan obligation. However, an asset cannot be recognised unless it is probable that it will be available to the acquirer in the form of refunds or a reduction of future contributions.
Tax assets	The acquirer uses the amount of the tax benefit assessed from the perspective of the combined entity. The tax asset is determined after allowing for the tax effect of restating identifiable assets, liabilities and contingent liabilities to their fair values. Tax assets are not discounted.

Liabilities

The table below provides some guidance for the measurement of liabilities at the date of acquisition:

Net employee benefit liabilities for defined benefit plans	The acquirer uses the present value of the defined benefit plan obligation less the fair value of any plan assets.
Tax liabilities	The acquirer uses the amount of the tax obligation assessed from the perspective of the combined entity. The tax liability is determined after allowing for the tax effect of restating identifiable assets, liabilities and contingent liabilities to their fair values. Tax liabilities are not discounted.
Accounts and notes payable, long term debts, accruals and claims payable	The acquirer uses the present values of the amounts to be paid, determined at the appropriate current interest rate, for example, if a debt was repayable five years after it was incurred and the acquisition date is two years after the debt was incurred, the outstanding contractual cash flows would be discounted using a current market rate of interest for a three-year loan. For short-term liabilities, discounting is not required if it is not material.
Onerous contracts	The acquirer uses the present values of the amounts to be disbursed in meeting the obligation determined at the appropriate current interest rate.

Contingent liabilities

Section 21 states that a contingent liability is either a possible but uncertain obligation or a present obligation that is not recognised because it is not probable that there will be a transfer of economic benefits and/or the amount of the obligation cannot be estimated

[12] Examples of measurement of financial assets and similar and liabilities were extracted from IFRS 3 (2004). In the absence of explicit guidance in the *IFRS for SMEs* an entity can, but is not required to, in accordance with paragraph 10.6, consider the requirements and guidance in full IFRS.

reliably (see paragraph 21.12). Consequently an entity must not recognise a contingent liability in its statement of financial position. However, the exception to this is that an acquirer recognises contingent liabilities of an acquiree when it is accounting for the business combination. The thinking behind this is that despite not being recognised on the acquiree's statement of financial position, the contingent liability exists and will affect the amount that someone would pay for the business and it has been acquired as part of acquiring the business and, therefore, should be recognised as if it had been acquired directly. In accordance with paragraph 19.20, a contingent liability that is assumed in a business combination is recognised at the acquisition date only if its fair value can be measured reliably.

The acquirer recognises, as a liability, a contingent liability assumed in a business combination at the date of the acquisition even if it is not probable that the entity will be required to transfer economic benefits in settlement of that contingent liability. This often results in the recognition of liabilities that do not qualify for recognition under Section 21. In other words, contingent liabilities that are not recognised in the records of the acquiree may be recognised in the records of the acquirer as a result of the business combination. Paragraph 19.21 contains guidance on the subsequent accounting for contingent liabilities recognised in accordance with paragraph 19.14—see Example 53 below.

19.15 The acquirer shall recognise separately the acquiree's identifiable assets, liabilities and contingent liabilities at the acquisition date only if they satisfy the following criteria at that date:

(a) In the case of an asset other than an intangible asset, it is probable that any associated future economic benefits will flow to the acquirer, and its fair value can be measured reliably.

(b) In the case of a liability other than a contingent liability, it is probable that an outflow of resources will be required to settle the obligation, and its fair value can be measured reliably.

(c) In the case of an intangible asset or a contingent liability, its fair value can be measured reliably.

Notes

In accordance with Section 2, there are two criteria to be met to recognise an element—asset, liability, income or expense (see paragraph 2.27):

- it is probable that any future economic benefit associated with the item will flow to or from the entity; and
- the item has a cost or value that can be measured reliably.

Those recognition concepts underpin the recognition principles in paragraph 19.15. However, for intangible assets acquired and contingent liabilities assumed in a business combination, the probable benefit flow criterion is assumed to be satisfied.

This is because, for intangible assets and contingent liabilities, as explained in the Basis for Conclusions on IFRS 3 (2004), the fair value of an intangible asset reflects market expectations about the probability that the future economic benefits associated with the intangible asset will flow to the acquirer (see paragraph BC96) and the fair value of a contingent liability reflects market expectations about any uncertainty surrounding the possibility that an outflow of resources embodying economic benefits will be required to settle the possible or present obligation (see paragraph BC111).

By requiring intangible assets and contingent liabilities acquired in a business combination to be recognised at fair value, the effect of probability is reflected.

Thus, in a business combination, the reliability of measurement criteria is the only recognition criteria for the acquiree's intangible assets and contingent liabilities and, as explained above, paragraph 18.8 of the *IFRS for SMEs* explains that the fair value of intangible assets acquired in a business combination can normally (subject to two exceptions) be measured with sufficient reliability to allow them to be recognised (see paragraph BC100).

Consequently, internally generated intangible assets and contingent liabilities that are not recognised in the records of the acquiree are usually recognised in the financial statements of the acquirer when acquired in a business combination.

Examples

Ex 38 **SME A acquired all of the equity interests in SME B. Both SME A and SME B are executive education institutions that provide technical updates to market practitioners in accounting matters. SME B has a database of customers (ie former participants) that includes names, contact information, history of prior training sessions attended and feedback regarding subjects of interest. In accordance with paragraph 18.4 of the *IFRS for SMEs*, SME B does not recognise the database as an asset because it has been generated internally.**

From SME A's point of view, the database is not generated internally. SME A acquired the database in a business combination. Customer databases generally do not arise from contractual or other legal rights, but frequently are sold, leased or exchanged. Consequently, SME A recognises the database separately from goodwill in its consolidated financial statements providing the terms of confidentiality or other agreements do not prohibit SME B from selling, leasing or otherwise exchanging information about its customers (see paragraph B33 of IFRS 3(2008)). Had SME A acquired the trade and assets of SME B (rather than buying the shares in SME B), SME A would still recognise the database in its individual entity statement of financial position because it would still be acquired in a business combination.

Ex 39 **SME A acquired all of the equity interests in SME B. Both SME A and SME B are pharmaceutical businesses. SME B has developed a number of drugs for which it has received regulatory approval and registered patents. SME B has not recognised the intangible assets in connection with the patents, because all development costs have to be expensed in accordance with Section 18 of the *IFRS for SMEs*.**

SME A has also developed a number of drugs for which it has received regulatory approval and registered patents and, like SME B, has not recognised the intangible assets (for the same reason).

In its consolidated statement of financial position, the group must recognise the intangible assets in connection with SME B's patents at the date of the acquisition, if they satisfy the recognition criteria in paragraph 19.15. The patents arise from contractual or other legal rights. Consequently, SME A recognises the patents separately from goodwill unless there is no history or evidence of exchange transactions for similar patents, and estimating fair value is dependent on immeasurable variables (see paragraph 18.8). Any drugs that SME B develops after the date of acquisition cannot be recognised in SME A's consolidated statement of financial position; these would be internally developed (by the group) and thus not qualify for recognition.

SME A is still precluded from recognising the intangible assets in connection with its own developed patents, both in its consolidated financial statements and in its own individual entity financial statements.

Had SME A acquired the trade and assets of SME B (rather than buying the shares in SME B), SME A would still recognise SME B's patents in its individual entity statement of financial position (assuming they met the recognition criteria in paragraphs 18.8 and 19.15) because they were acquired in a business combination. SME A would still be precluded from recognising the intangible assets in connection with its own developed patents in its own individual entity statement of financial position.

Ex 40 **SME A acquired SME B. SME B has a five-year agreement to supply goods to SME C.**

The supply agreement (whether cancellable or not) meets the recognition criteria for identification as an intangible asset. The contract is recognised separately from goodwill, unless there is no history or evidence of exchange transactions for similar agreements, and estimating fair value is dependent on immeasurable variables (see paragraph 18.8).

Ex 41 **SME A acquired SME B. In a lawsuit brought against SME B before the acquisition, members of the local community are seeking compensation for damages to their health as a result of the contamination of the groundwater at SME B's plant. The lawyers estimated that SME B has only a 25 per cent chance of being ordered to pay the compensation. Consequently, SME B did not recognise a provision in the statement of financial position and only disclosed a contingent liability.**

According to paragraph 19.15, in the case of contingent liabilities assumed in a business combination, the only test to be met for separate recognition is the reliability of measurement. Therefore, a provision for the contingent liability must be recognised as a result of the business combination, even if it is not probable that SME B will be required to transfer economic benefits in a possible future settlement.

Notes—applying the purchase method

The above analyses each of the three steps involved in applying the purchase method. Before moving on to look at the consolidated statement of comprehensive income, the following example pulls these three steps together.

Example—applying the purchase method

Ex 42 On 31 December 20X1 SME A acquired all of SME B's ordinary shares that carry voting rights at a general meeting of shareholders. The consideration for SME B's shares was 500 shares in SME A and CU2,750 in cash. SME A incurred CU150 expenses for issuing the shares and CU150 legal and other advisers fees in connection with the acquisition. SME A is the acquirer and it estimated the fair value of its shares at the date of acquisition to be CU6 per share. The acquisition date statements of financial position of SME A and SME B and the fair values of the identifiable assets and liabilities of SME B were:[13]

	SME A	SME B	
	Carrying amount	*Carrying amount*	*Fair value*
	CU	CU	CU
Assets			
Non-current assets			
Building and other property, plant and equipment	7,000	3,000	3,300
Intangible asset (customer list)	–	–	400
Investment in SME B	5,900[a]	–	
	12,900	3,000	
Current assets			
Inventories	700	500	600
Trade receivables	400	250	250
Cash	1,500	700	700
	2,600	1,450	
Total assets	**15,500**	**4,450**	
Equity and liabilities			
Equity			
Share capital	5,000	2,000	
Retained earnings[b]	10,200	2,300	
Total equity	15,200	4,300	
Current liabilities			
Trade payables	300	150	150
	300	150	
Total liabilities and equity	**15,500**	**4,450**	

[a] Cost of acquisition = CU3,000 (500 shares × fair value per share of CU6) + CU2,750 (cash – not discounted because paid on date of acquisition) + CU150 (acquisition expenses).

[b] SME A has retained earnings of CU10,200 after deducting share issue costs of CU150.

[13] In this example, and in all other examples in this module (unless specified otherwise) for simplicity income tax has been ignored.

SME A's consolidated statement of financial position at 31 December 20X1 will be calculated as follows:

A	B SME A *Carrying amount* CU	C SME B *Carrying amount* CU	D Consolidation adjustments CU	E Consolidated *(ie Column B + Column C + Column D)* CU
Assets				
Non-current assets				
Goodwill	–	–	800[(c)]	800
Buildings and other property, plant and equipment	7,000	3,000	300	10,300
Intangible asset (customer list)	–	–	400	400
Investment in Entity B	5,900	–	(5,900)	–
	12,900	3,000	(4,400)	11,500
Current assets				
Inventories	700	500	100	1,300
Trade receivables	400	250	–	650
Cash	1,500	700	–	2,200
	2,600	1,450	100	4,150
Total assets	**15,500**	**4,450**	**(4,300)**	**15,650**
Equity and liabilities				
Equity				
Share capital	5,000	2,000	(2,000)	5,000
Reserves	10,200	2,300	(2,300)	10,200
Total equity	15,200	4,300	(4,300)	15,200
Current liabilities				
Trade payables	300	150	–	450
	300	150	–	450
Total liabilities and equity	**15,500**	**4,450**	(4,300)	**15,650**

Consolidation involves:

1. Adding the statement of financial position of the parent and its subsidiary (columns B and C) together line by line in accordance with paragraph 9.13(a).
2. In accordance with paragraph 9.13(b), eliminating the carrying amount of the parent's investment in the subsidiary (because the group cannot have an investment in itself) and the pre-acquisition equity of the subsidiary (because that equity was not earned by the group but is part of what was purchased) and recognising the fair value adjustments together with the goodwill asset that arose on acquisition of the subsidiary. See the consolidation adjustments required for preparing the consolidated financial statements at 31 December 20X1 set out on the next page (these have been presented in column D above):

Consolidation adjustments	CU	CU
Asset—goodwill	800[(c)]	
Asset—buildings & other PPE	300	
Asset—customer list	400	
Asset—inventories	100	
Equity—share capital (SME B)	2,000	
Equity—reserves (SME B)	2,300	
Asset—Investment in Entity B (SME A)		5,900

To eliminate the carrying amount of the parent's investment in its subsidiary and the equity in the subsidiary at the date of acquisition and to recognise the fair value adjustments and goodwill arising on the business combination.

[(c)] Goodwill = CU5,900 (cost of acquisition) – CU5,100 (acquisition date fair value of SME B's net assets).[(d)]

[(d)] CU5,100 acquisition date fair value of SME B's assets = CU3,300 buildings and other PPE + CU400 customer list + CU600 inventories + CU250 trade receivables + CU700 cash – CU150 trade payables.

19.16 The acquirer's statement of comprehensive income shall incorporate the acquiree's profits and losses after the acquisition date by including the acquiree's income and expenses based on the cost of the business combination to the acquirer. For example, depreciation expense included after the acquisition date in the acquirer's statement of comprehensive income that relates to the acquiree's depreciable assets shall be based on the fair values of those depreciable assets at the acquisition date, ie their cost to the acquirer.

Notes

As seen above, recognising a business combination might result in the consolidated statement of financial position at the date of acquisition, including:

- some assets, liabilities and contingent liabilities that are not recognised in the individual statement of financial position of the acquiree; and
- some assets, liabilities and contingent liabilities at an amount that may differ (higher or lower) from the those in the individual statement of financial position of the acquiree.

These adjustments have to be made in subsequent consolidated financial statements until the relevant assets, liabilities and contingent liabilities are derecognised.
The adjustments flow through to the consolidated statement of comprehensive income as this must be prepared on a consistent basis.

Examples—impact of differences in measurement

Ex 43 **SME A acquired all of the equity interests in SME B on 1 January 20X1. At the date of the acquisition, SME B owned a plot of land that was recognised in its statement of financial position at a cost of CU100. The fair value of the land at the date of the acquisition was CU150. During December 20X1 the land was sold to a third party for CU180.**

The gain from the sale of the land included in the consolidated statement of comprehensive income must be based on the fair value of the land at the acquisition date, ie its cost to the group. Consequently, the consolidated statement of comprehensive income for the year ended 31 December 20X1 includes a gain of CU30 (ie CU180 selling price less CU150 fair value of the land at the date of the acquisition—its cost to the group).

The gain on disposal of the land recognised in the individual statement of comprehensive income of SME B is CU80 (ie CU180 selling price less CU100 carrying value in SME B's statement of financial position). On consolidation an adjusting entry would be passed reducing this gain to CU30 (ie the group profit on sale).

Plot of land:	*Consolidated financial statements*	*Individual entities' financial statements*		*Difference*
		SME A	*SME B*	
	CU	CU	CU	CU
1 January 20X1—carrying value	150	–	100	50
December 20X1—sales proceeds	(180)	–	(180)	–
Profit on sale	**(30)**	**–**	**(80)**	**50**

Ex 44 **SME A acquired all of the equity interests in SME B on 1 January 20X1. At the date of the acquisition, SME B owned a plot of land that was recognised in its statement of financial position at a cost of CU100. The fair value of the land at the date of the acquisition was CU150. At the end of December 20X1 an impairment test was performed in accordance with Section 27 *Impairment of Assets* and the recoverable amount of the land was CU130.**

The acquirer's (SME A's) consolidated statement of comprehensive income for the year ended 31 December 20X1 will include an impairment expense of CU20 (ie the fair value at the date of acquisition (CU150) less the recoverable amount (CU130)).

There would be no impairment expense recognised in the separate statement of comprehensive income of SME B, as the recoverable amount of the land (CU130) is greater than the amount recognised in the separate statement of financial position (CU100).

Plot of land:	*Consolidated financial statements*	*Individual entities' financial statements*		*Difference*
		SME A	*SME B*	
	CU	CU	CU	CU
1 January 20X1—carrying value	150	–	100	50
December 20X1—impairment test recoverable amount	(130)	–	(130)	–
Impairment	(20)		–	(20)
Carrying amount after impairment	**130**	**–**	**100**	**30**

Ex 45 **SME A acquired all of the equity interests in SME B on 1 January 20X1. At the date of the acquisition, SME B owned an administration building recognised in its statement of financial position with a carrying amount of CU200. The remaining useful life of the building from the date of the acquisition was estimated to be 20 years and it is depreciated on a straight-line basis (the residual value is estimated to be nil). The fair value of the building at the date of the acquisition was CU300.**

Depreciation expense after the acquisition date in the group's consolidated statement of comprehensive income relating to the acquiree's depreciable assets must be based on the fair values of those depreciable assets at the acquisition date, ie their cost to the group. Consequently, SME A's consolidated statement of comprehensive income for the year ended 31 December 20X1 recognises depreciation of CU15 (CU300 depreciable amount (fair value at the date of the acquisition) ÷ 20 years).

The depreciation expense recognised in SME B's separate statement of comprehensive income for the year ended 31 December 20X1 in respect of the building will be CU10 (CU200 depreciable amount ÷ 20 years).

Administration building:	*Consolidated financial statements*	*Individual entities' financial statements*		*Difference*
		SME A	*SME B*	
	CU	CU	CU	CU
1 January 20X1—carrying value	300	–	200	100
Depreciation for 20X2	(15)	–	(10)	(5)
31 December 20X1—carrying value	**285**	**–**	**190**	**95**

Ex 46 **SME A acquired all of the equity interests in SME B on 1 January 20X1. At the date of the acquisition, SME B held inventory recognised in its statement of financial position at cost of CU50. The fair value of the inventory at the date of the acquisition was CU75. During February 20X1, the entire inventory was sold to an independent third party for CU80.**

The profit included in the consolidated statement of comprehensive income from the sale of the acquiree's acquisition date inventory must be based on the fair value of the inventory at the acquisition date, ie its cost to the group. Consequently SME A's consolidated statement of comprehensive income for the year ended 31 December 20X1 recognises profit from the sale of inventory of CU5 (CU80 revenue less CU75 cost of goods sold).

The profit on sale of the inventory recognised in SME B's individual statement of comprehensive income for the year ended 31 December 20X1 is CU30 (CU80 revenue less CU50 cost of goods sold). On consolidation an adjusting entry would be passed reducing this profit to CU5 (ie the group profit on sale).

Inventory:	*Consolidated financial statements*	*Individual entities' financial statements*		*Difference*
		SME A	*SME B*	
	CU	CU	CU	CU
1 January 20X1—carrying value	75	–	50	25
February 20X1—sales proceeds	(80)	–	(80)	–
Profit on sale	**(5)**	**–**	**(30)**	**25**

Ex 47 **SME A acquired all of the equity interests in SME B on 1 January 20X1. At the date of the acquisition, SME B held a patent under which it produced a certain drug. The patent was developed internally by SME B and had not been recognised as an intangible asset in accordance with Section 18. At the date of acquisition, the fair value of the patent was CU100. The patent is due to expire on 31 December 20X5 and cannot be renewed.**

Amortisation expense included after the acquisition date in the group's consolidated financial statements must be based on the fair value of the asset at the acquisition date, ie its cost to the group. Consequently, the cost of drugs produced during the year ended 31 December 20X1, ie in the year after the date of acquisition, must include the amortisation of the patent of CU20 (CU100 fair value at the date of the acquisition ÷ 5 years), assuming that management determined that the amortisation should be straight-line to a nil residual value.

Patent:	*Consolidated financial statements*	*Individual entities' financial statements*		*Difference*
		SME A	*SME B*	
	CU	CU	CU	CU
1 January 20X1—carrying value	100	–	–	100
Depreciation for 20X2	(20)	–	–	(20)
31 December 20X1—carrying value	**80**	**–**	**–**	**80**

19.17 Application of the purchase method starts from the acquisition date, which is the date on which the acquirer obtains control of the acquiree. Because control is the power to govern the financial and operating policies of an entity or business so as to obtain benefits from its activities, it is not necessary for a transaction to be closed or finalised at law before the acquirer obtains control. All pertinent facts and circumstances surrounding a business combination shall be considered in assessing when the acquirer has obtained control.

19.18 In accordance with paragraph 19.14, the acquirer recognises separately only the identifiable assets, liabilities and contingent liabilities of the acquiree that existed at the acquisition date and satisfy the recognition criteria in paragraph 19.15. Therefore:

(a) the acquirer shall recognise liabilities for terminating or reducing the activities of the acquiree as part of allocating the cost of the combination only when the acquiree has, at the acquisition date, an existing liability for restructuring recognised in accordance with Section 21 *Provisions and Contingencies*; and

(b) the acquirer, when allocating the cost of the combination, shall not recognise liabilities for future losses or other costs expected to be incurred as a result of the business combination.

Notes

Paragraph 19.18 specifies that the acquirer must recognise liabilities for restructuring or exit activities in the acquired business only if they meet the definition of a liability at the date of acquisition and the acquiree has at that date an existing liability for restructuring. Costs associated with restructuring or exiting an acquiree's activities that are not liabilities at the date of acquisition are recognised as post-combination expenses.

The exercise of allocating the cost of a business combination to the acquiree's identifiable assets, liabilities and contingent liabilities is to determine the cost (to the acquirer) of each item acquired. It follows from this that if a liability did not exist at the date of acquisition no part of the consideration can be allocated to it; it is not part of what was acquired. Similarly, if an acquirer intends to restructure the acquired business after the acquisition the cost of this cannot be part of what was acquired. It is only if an acquiree has already satisfied the criteria for recognising a provision for restructuring in its pre-acquisition statement of financial position (and thus has a liability) that a provision for restructuring (namely, the one already recognised) can be included in the acquisition-date fair values.

Examples

Ex 48 **SME A acquired all of the equity interests in SME B on 1 January 20X1. SME B is a manufacturing company that has a head office in the city centre and a manufacturing plant in an industrial area. As a part of the acquisition plans, SME A decided to close SME B's head office premises and move SME B's staff to SME A's own city head office premises. SME B will be paying for the office closure costs. The cost of closing SME B's office premises is expected to be CU100. Goodwill of CU1,000 was calculated for this business combination before any consideration of these restructuring costs.**

When determining the fair value of the net identifiable assets acquired in SME B, SME A must not include the restructuring provision because, at the acquisition date, SME B did not have an existing liability for restructuring. It is irrelevant that SME B will be funding the restructuring and that SME A might have taken the decision (to close SME B's head office) prior to the acquisition date; it is a decision taken by SME A and thus is not a liability that existed at the date of acquisition. Consequently, goodwill arising on the business combination will remain CU1,000.

Ex 49 **SME A acquired all of the equity interests in SME B on 1 January 20X1. SME B is a manufacturing company that has a head office in the city centre and a manufacturing plant in an industrial area. Before the date of acquisition, SME B had decided to close its head office premises and move its staff and head office function to its manufacturing site where there is surplus office space. SME B had told its staff about these plans, including giving notice of the termination of employment to those members of its staff that will be made redundant when the move is made, and had instructed an agency to market the city centre premises before the approach by SME A. The cost of closing SME B's office premises is expected to be CU100. Goodwill is CU1,000 if these restructuring costs cannot be reflected in the calculation and is CU1,100 if a provision for these restructuring costs is included in the identifiable net assets acquired.**

Because SME B had, at the acquisition date, an existing liability for restructuring, SME A, when determining the fair value of the net identifiable assets acquired in SME B, must include the restructuring provision (a recognised liability).

Accordingly, goodwill arising on the business combination will be CU1,100.

Ex 50 **SME A acquired all of the equity interests in SME B on 1 January 20X1. As part of the acquisition plans, SME A decided to hire outside consultants to identify future corporate goals and strategies for its organisational structure.**

In determining the fair value of the net identifiable assets acquired in SME B, SME A will not include any provision associated with these costs because, at the acquisition date, SME B did not have an existing liability for this expenditure. The consultants' costs are not part of what was acquired; they are incurred as a result of the business combination but do not form part of the combination itself.

19.19 If the initial accounting for a business combination is incomplete by the end of the reporting period in which the combination occurs, the acquirer shall recognise in its financial statements provisional amounts for the items for which the accounting is incomplete. Within twelve months after the acquisition date, the acquirer shall retrospectively adjust the provisional amounts recognised as assets and liabilities at the acquisition date (ie account for them as if they were made at the acquisition date) to reflect new information obtained. Beyond twelve months after the acquisition date, adjustments to the initial accounting for a business combination shall be recognised only to correct an error in accordance with Section 10 *Accounting Policies, Estimates and Errors*.

Notes

The initial accounting for a business combination requires the determination of the fair value of the consideration for the business combination as well as of the identifiable assets, liabilities and contingent liabilities acquired in the business combination. The acquisition-date fair values of the acquiree's assets and liabilities may not be finalised by the end of the financial period in which the business combination took place. In other words, these amounts may only have been provisionally determined by that date. Additional information that relates to the business combination may be obtained by the acquirer after that date. If the information results in revision of provisionally determined amounts and is based upon facts and circumstances that existed at the acquisition date, and that became known to the acquirer within the measurement period (which may be a maximum of one year from the date of

acquisition) any adjustments made will have an impact upon the goodwill or bargain purchase gain (also known as negative goodwill) recognised. Any adjustments that arise after the measurement period has elapsed are to be accounted for in accordance with Section 10.

Example

Ex 51 **At 30 September 20X5 SME A acquired 100 per cent of the equity interests in SME B in exchange for cash of CU50,000. The valuation of an item of property, plant and equipment of SME B was incomplete at the date that SME A authorised for issue its consolidated financial statements for the year ended 31 December 20X5. In its 20X5 financial statements, SME A recognised a provisional fair value for the asset of CU10,000. At the acquisition date, the item of property, plant and equipment had an estimated remaining useful life of five years and an estimated residual value of nil.**

At the date of acquisition, SME A recognised goodwill of CU5,000. Goodwill is amortised on a straight-line basis over a period of ten years.

Six months after the acquisition date, SME A received an independent valuation, which estimated the fair value of the item of property, plant and equipment at the acquisition date as CU13,000.

In its financial statements for the year ended 31 December 20X6, SME A must retrospectively adjust prior year information. The necessary adjustments to be made are as follows:

- Depreciation expense is increased by CU150. This is the additional depreciation for three months assuming an initial cost to the group of CU13,000 (an increase in the cost of CU3,000).
- The carrying amount of property, plant and equipment at 31 December 20X5 is increased by CU2,850. The adjustment is measured as the increased fair value at the acquisition date of CU3,000 less the additional depreciation that would have been recognised if the asset's fair value at the acquisition date had been recognised from that date.
- The carrying amount of goodwill is decreased by CU2,925. That adjustment is measured as the fair value adjustment at the acquisition date of CU3,000 less the decrease in amortisation of CU75 (ie CU3,000 ÷ 10 years ÷ 12 months × 3 for three months' amortisation).
- Amortisation expense for goodwill is decreased by CU75.

Contingent liabilities

19.20 Paragraph 19.14 specifies that the acquirer recognises separately a provision for a contingent liability of the acquiree only if its fair value can be measured reliably. If its fair value cannot be measured reliably:

(a) there is a resulting effect on the amount recognised as goodwill or accounted for in accordance with paragraph 19.24; and

(b) the acquirer shall disclose the information about that contingent liability as required by Section 21.

Example

Ex 52 **SME A acquired all of the equity interests in SME B. At the date of acquisition, SME B was being sued by a third party. SME A is unable to reliably measure the amount of the claim.**

As the provision for contingent liability cannot be measured reliably, no liability is recognised in accounting for the business combination. Therefore, the effect on the amount recognised as goodwill or excess over the cost of the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities, is that the goodwill will be smaller. SME A must disclose the fact that no amount had been taken into account, as such an amount could not be measured reliably (see paragraph 21.15).

19.21 After their initial recognition, the acquirer shall measure contingent liabilities that are recognised separately in accordance with paragraph 19.14 at the higher of:

(a) the amount that would be recognised in accordance with Section 21, and

(b) the amount initially recognised less amounts previously recognised as revenue in accordance with Section 23 *Revenue*.

Example

Ex 53 **SME A acquired all of the equity interests in SME B in May 20X0. At the date of acquisition, SME B was being sued by a third party for breach of contract. A provision for the contingent liability of CU100 was recognised at the date of acquisition. At 31 December 20X1 SME A reassesses the claim. Management now believes that settlement is probable; the recognition criteria in Section 21 are met. The amount required to settle the claim is estimated to be CU180.**

As stated above, according to paragraph 19.15, in the case of contingent liabilities assumed in a business combination, the only test to be met for separate recognition in a business combination is reliability of measurement. Therefore, the contingent liability is recognised at its acquisition date fair value of CU100 as a result of the business combination, even though it was not probable that SME B would be required to transfer economic benefits in a possible future settlement.

At 31 December 20X1 the liability must be measured in the consolidated financial statements at CU180 (as this is higher than the original amount recognised at the time of the business combination). The increase in provision of CU80 is charged in arriving at profit or loss for the period.

In SME B's individual financial statements the liability is recognised for the first time at 31 December 20X1 and measured at CU180.

Module 19 – Business Combinations and Goodwill

Goodwill

19.22 The acquirer shall, at the acquisition date:

(a) recognise goodwill acquired in a business combination as an asset, and

(b) initially measure that goodwill at its cost, being the excess of the cost of the business combination over the acquirer's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities recognised in accordance with paragraph 19.14.

Notes

Goodwill is defined as the future economic benefits arising from assets that are not capable of being individually identified and separately recognised (see the *Glossary*). Goodwill is calculated as the excess of the cost of the business combination over the acquirer's interest in the fair value of the net identifiable assets, liabilities and contingent liabilities of the acquiree. In order to calculate goodwill, it is necessary to calculate the cost of the business combination (being the sum of the fair value of the consideration paid or to be paid and any directly attributable costs) and to determine the fair value of the identifiable assets, liabilities and contingent liabilities acquired. Goodwill is then the residual amount, after the acquirer's interest in the identifiable assets, liabilities and contingent liabilities of the acquiree is recognised.

Examples

Ex 54 **At 1 January 20X5 SME A acquired 100 per cent of the equity interests in SME B in exchange for cash of CU30,000. The fair value of SME B's identifiable assets acquired and liabilities assumed are as follows (no contingent liabilities exist):**

	CU
Equipment	20,000
Inventory	10,000
Accounts receivable	7,000
Patents	8,000
Fair value of assets acquired	**45,000**
Less: Accounts payable at fair value	(18,000)
Fair value of net assets acquired	**27,000**

SME A must recognise goodwill of CU3,000.

Calculation:

CU3,000 = CU30,000 (cost of the business combination) less CU27,000 (identifiable net assets at fair value at the date of acquisition).

Ex 55 **The facts are the same as in Example 54. However, in this case SME A acquired only 80 per cent of the equity interests in SME B for cash of CU24,000.**

SME A must recognise goodwill of CU2,400.

Calculation:

CU2,400 = CU24,000 (cost of the business combination) less CU21,600 (SME A's interest in the net assets at fair value at the date of acquisition, ie 80 per cent × CU27,000).

Note: SME B's full identifiable net assets of CU27,000 (and not just SME A's 80 per cent share) are recognised in the consolidated statement of financial position. Equity is

accordingly higher by the non-controlling interest's share of those net assets, CU5,400 (20 per cent of CU27,000) at the date of acquisition, and this is presented separately in equity from the equity attributable to the owners of SME A. See Module 9 and Section 9 for a fuller discussion of non-controlling interest.

Ex 56 **At 1 January 20X5 SME A acquired 100 per cent of the equity interests in SME B in exchange for cash of CU1,500. At the acquisition date, the statement of financial position of SME B and the fair values of SME B's assets and liabilities were as follows:**

	Carrying amount	*Fair value*
	CU	CU
Assets		
Non-current assets		
Land	300	500
Equipment, net	500	550
	800	1,050
Current assets		
Inventory	200	250
Cash	100	100
	300	350
Total assets	**1,100**	**1,400**
Equity and liabilities		
Equity		
Share capital	400	
Retained earnings	260	
Total equity	**660**	
Liabilities		
Non-current liabilities		
Provisions (long-term)	150	170
	150	170
Current liabilities		
Payables	250	250
Current tax liability	40	40
	290	290
Total liabilities	**440**	**460**
Total equity and liabilities	**1,100**	

SME A must recognise goodwill of CU560.

Calculation:

CU560 = CU1,500 (cost of the business combination) less CU940 (SME B's net assets at fair value at the date of acquisition, ie CU1,400 of assets at fair value less CU460 of liabilities at fair value).

Note—deferred tax on fair value adjustments

In accordance with Section 29 *Income Tax*, entities are required to recognise a deferred tax asset or liability in respect of tax recoverable or payable in future periods as result of past transactions or events. Deferred tax is recognised on the difference between the carrying amount of an asset or liability and the tax basis of that asset or liability.[14] Accordingly, when, upon acquisition, adjustments are made to the carrying amounts of assets, liabilities and contingent liabilities for inclusion in the group's consolidated statement of financial position (and thus the group carrying amount differs from the carrying amount in the subsidiary's individual financial statements) without similar adjustments being made for tax purposes, a deferred tax asset or liability must be recognised.

Example

Ex 57 **The facts are the same as in Example 56. In addition, at the date of acquisition, SME B had an unrecognised patent (ie a patent that was not recognised in SME B's statement of financial position) with a fair value of CU700 and an unrecognised contingent liability with a fair value of CU300.**

In this example, taxation is not ignored. The applicable tax rate is 20 per cent.

SME A must recognise goodwill of CU296.

Calculation of goodwill: CU296 = CU1,500 (cost of the business combination) less CU1,204 (SME B's net assets at fair value).

Calculation of net assets acquired at fair value at the date of acquisition: CU1,204 = CU2,100 (fair value of assets acquired) less CU896 (fair value of liabilities and contingent liabilities, including the net deferred tax liability, ie CU760 add CU136[a]).

[a] The net deferred tax liability is CU200 (total deferred tax liabilities on fair value adjustments, see below) less CU64 (total deferred tax assets on fair value adjustments, see below) = CU136, assuming that the tax basis of the acquiree's assets and liabilities are equal to their carrying amounts. Although the group carrying amount of goodwill (CU296) exceeds its tax basis (nil), no deferred taxation arises from this temporary difference because it is exempt from deferred tax (see paragraph 29.16(b)).

[14] In accordance with Section 29, the tax basis of an asset equals the amount that would be deductible for tax purposes if the asset were sold at the end of the reporting period (or equals carrying amount if a sale would not increase taxable profit) and the tax basis of a liability equals its carrying amount less any amounts that would be deductible in determining taxable profit if the liability were settled at its carrying amount at the end of the reporting period.

	Carrying amount	Fair value	Difference	Tax (20%) on difference
	CU	CU	CU	CU
Patent	–	700	700	140
Land	300	500	200	40
Equipment	500	550	50	10
Inventory	200	250	50	10
Cash	100	100	0	0
	1,100	**2,100**	**1,000**	
Total deferred tax liabilities on fair value adjustments				**200**
Provisions (long-term)	150	170	20	4
Provision for contingent liability	0	300	300	60
Payables	250	250	0	0
Current tax liability	40	40	0	0
	440	**760**	**320**	
Total deferred tax assets on fair value adjustments				**64**

19.23 After initial recognition, the acquirer shall measure goodwill acquired in a business combination at cost less accumulated **amortisation** and accumulated **impairment** losses:

(a) An entity shall follow the principles in paragraphs 18.19–18.24 for amortisation of goodwill. If an entity is unable to make a reliable estimate of the useful life of goodwill, the life shall be presumed to be ten years.

(b) An entity shall follow Section 27 *Impairment of Assets* for recognising and measuring the impairment of goodwill.

Note

Amortisation

In accordance with the *IFRS for SMEs*, all intangible assets are considered to have a finite useful life. Therefore, goodwill must be amortised on a systematic basis over its estimated useful life; amortisation for each period is recognised as an expense in that period. An acquirer chooses the amortisation method that reflects the pattern in which it expects to consume the future economic benefits of the goodwill. If an acquirer cannot determine that pattern reliably, it is required to use the straight-line method (see paragraph 18.22).

If an acquirer is unable to make a reliable estimate of the useful life of goodwill, the *IFRS for SMEs* requires that the life shall be presumed to be ten years.

Whenever the expected useful life of goodwill is assessed to have changed from original estimates, the amortisation period must be adjusted accordingly. Such changes are accounted for as changes in accounting estimates in accordance with Section 10.

Impairment

Goodwill cannot be sold, nor does it generate cash flows to an entity that are independent of the cash flows of other assets. As a consequence, the recoverable amount of goodwill cannot be measured directly and must be derived from the measurement of the recoverable amount of the cash-generating unit(s) of which the goodwill is a part.

Section 27 requires that, for the purpose of impairment testing, goodwill acquired in a business combination is, from the date of acquisition, to be allocated to each of the acquirer's cash generating units or to a group of cash generating units that are expected to benefit from the combination, irrespective of whether other assets or liabilities of the acquiree are assigned to those units.

Excess over cost of acquirer's interest in the net fair value of acquirees's identifiable assets, liabilities and contingent liabilities

19.24 If the acquirer's interest in the net fair value of the identifiable assets, liabilities and provisions for contingent liabilities recognised in accordance with paragraph 19.14 exceeds the cost of the business combination (sometimes referred to as 'negative goodwill'), the acquirer shall:

(a) reassess the identification and measurement of the acquiree's assets, liabilities and provisions for contingent liabilities and the measurement of the cost of the combination, and

(b) recognise immediately in profit or loss any excess remaining after that reassessment.

Note

When the cost of the business combination is greater than the acquirer's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities of the acquiree, goodwill is recognised (see paragraph 19.22). When the opposite occurs (that is, when the cost of the business combination is less than the acquirer's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities of the acquiree), the acquirer must reassess the identification and measurement of the acquiree's assets, liabilities and provisions for contingent liabilities and the measurement of the cost of the combination. Any excess remaining after that reassessment is immediately recognised as a gain in profit or loss.

The existence of an excess is due to one or more of the following factors:

- errors in measuring the fair value of either the cost of the business combination, the assets acquired or the liabilities and contingent liabilities assumed;
- despite the *IFRS for SMEs* being applied, an identifiable asset or liability might not be recognised at fair value, for example, a contingent liability of the acquiree might not be capable of reliable measurement at the acquisition date and so might not be recognised;
- the price paid by the acquirer reflects the fact that the business acquired is in need of restructuring but the conditions for recognising a restructuring provision (when recognising the identifiable assets, liabilities and contingent liabilities) are not met;
- a bargain purchase due to the acquirer's negotiation skills; and
- a bargain purchase due to the seller's motivation for the sale being other than for economic reasons or if the seller is forced to sell because of specific circumstances such as financial distress.

The first step in accounting for an 'excess' is to reassess the identification exercise and the measurements used in the acquisition analysis; is there an asset that was not identified initially or was the fair value of an asset or liability incorrectly calculated? If after this an 'excess' still exists (either the original excess or a reduced one) then the combination is a bargain purchase. Consequently, the acquirer recognises the excess as income in profit or loss immediately.

Example

Ex 58 **At 1 January 20X5 SME A acquired 100 per cent of the equity interests in SME B in exchange for cash of CU25,000. The fair value of SME B's identifiable assets, liabilities and contingent liabilities was measured as follows:**

	CU
Equipment	20,000
Inventory	10,000
Accounts receivable	7,000
Patents	8,000
Acquired assets at fair value	**45,000**
Accounts payable at fair value	(16,000)
Contingent liability	(2,000)
Net assets acquired at fair value	**27,000**

The calculation of "goodwill" gives rise to an excess of CU2,000. This is calculated as CU27,000 net identifiable assets at fair value at the date of acquisition less CU25,000 cost of the business combination.

SME A reassesses the fair value of each of the identifiable assets, liabilities and contingent liabilities and concludes that the equipment's fair value is CU19,800, not CU20,000.

The revised calculation of "goodwill" gives rise to an excess of CU1,800. This is calculated as CU26,800 net identifiable assets at fair value at the date of acquisition less CU25,000 cost of the business combination.

SME A recognises immediately the excess of CU1,800 as income in profit or loss.

Disclosures

For business combination(s) effected during the reporting period

19.25 For each business combination that was effected during the period, the acquirer shall disclose the following:

(a) the names and descriptions of the combining entities or businesses.

(b) the acquisition date.

(c) the percentage of voting equity instruments acquired.

(d) the cost of the combination and a description of the components of that cost (such as cash, equity instruments and debt instruments).

(e) the amounts recognised at the acquisition date for each class of the acquiree's assets, liabilities and contingent liabilities, including goodwill.

(f) the amount of any excess recognised in profit or loss in accordance with paragraph 19.24, and the line item in the statement of comprehensive income (and in the income statement, if presented) in which the excess is recognised.

Example

Ex 59 **The following example illustrates one way of satisfying the disclosure requirements above. The example disclosure presented is an extract from the consolidated financial statements of SME A for the year ended 31 December 20X0. At 31 December 20X0 SME A has two subsidiaries, SME B and SME C.**

14 Acquisition of business

On 1 November 20X0, SME A acquired 100 per cent of the voting equity in SME C, through its subsidiary, SME B, in a cash transaction. The acquisition has been accounted for using the purchase method at the date of acquisition. The fair value of the consideration given for the acquisition of SME B, including directly attributable expenses of CU500, was CU10,500.

SME C, like SME B, is a solar technology company focusing on the concentrated solar power market. SME C develops, designs, manufactures and installs equipment for solar thermal power plants.

The amounts recognised at the acquisition date for each class of SME C's assets, liabilities and contingent liabilities, together with the fair value of the consideration paid and the resulting balance of goodwill is as follows:

	Fair value CU
Intangible assets	5,000
Property, plant and equipment	15,000
Inventory	5,000
Receivables	3,500
	28,500
Provision for contingent liability	(14,000)
Payables	(6,000)
Fair value of net identifiable assets acquired	8,500
Goodwill	2,000
Cost of the business combination	10,500

For all business combinations

19.26 An acquirer shall disclose a reconciliation of the carrying amount of goodwill at the beginning and end of the reporting period, showing separately:

(a) changes arising from new business combinations.

(b) impairment losses.

(c) disposals of previously acquired businesses.

(d) other changes.

This reconciliation need not be presented for prior periods.

Example

Ex 60 The following example illustrates the disclosure requirements above.
The example disclosure presented is an extract from the consolidated financial statements of SME A for the year ended 31 December 20X0.

X Goodwill

	Note	***Cost***	***Accumulated amortisation and impairment***	***Carrying amount***
		CU	CU	CU
1 January 20X0		**X**	**(X)**	**X**
Acquired in the business combination	z	X	–	X
Amortisation—20X0		–	(X)	(X)
Impairment loss		–	(X)	(X)
Disposal of subsidiary		(X)	X	(X)
Translation differences		(X)	X	(X)
31 December 20X0		**X**	**(X)**	**X**

SIGNIFICANT ESTIMATES AND OTHER JUDGEMENTS

Applying the requirements of the *IFRS for SMEs* to transactions and events often requires judgement. Information about significant judgements and key sources of estimation uncertainty is useful in assessing the financial position, performance and cash flows of an entity. Consequently, in accordance with paragraph 8.6, an entity must disclose the judgements that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements. Furthermore, in accordance with paragraph 8.7, an entity must disclose information about the key assumptions concerning the future, and other key sources of estimation uncertainty at the reporting date, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year.

Other sections of the *IFRS for SMEs* require disclosure of information about particular judgements and estimation uncertainties. Some of the more important judgements that may be made in applying Section 19 are set out below.

Identifying the acquirer

The purchase method requires the identification of an acquirer in a business combination. In many cases little difficulty is encountered in determining the acquirer. However, in some cases significant judgement is required in determining the acquirer. The acquirer is the entity that obtains control of the acquiree. If the business combination does not clearly indicate which of the combining entities is the acquirer, other factors should be considered in making the determination, such as the relative voting rights in the combined entity after the business combination, the composition of the governing body of the combined entity, the composition of the senior management of the combined entity, the terms of the exchange of equity interests and the relative size of the combining entities among others. All facts and circumstances must be considered in determining the acquirer.

Cost of a business combination

The cost of a business combination is measured by determining the fair values of the consideration given by the acquirer. The cost is the sum of the fair values of the various forms of consideration plus the directly attributable costs. Consideration paid for the acquiree may comprise a number of items such as cash and other monetary assets, non-monetary assets, equity instruments, liabilities undertaken, a business or a subsidiary of the acquirer and options, among others. Furthermore, payment, or part of the payment, is often deferred or includes a component that is contingent on future events. Significant judgements may be required in determining the fair value of some forms of the consideration (for example, shares of the acquirer or assets for which there is not an active market) and in determining whether payment of contingent consideration is probable and/or can be measured reliably.

Significant judgement may also be required in determining whether a payment is contingent consideration or post-acquisition management remuneration. Where an owner-managed business has been acquired and the previous owner continues to be involved, as an employee, in the newly acquired subsidiary, an agreement to make future variable payments to the individual needs careful analysis to determine whether it is performance related remuneration (and thus charged in arriving at profit or loss) or contingent consideration, in

which case it is included in the cost of the business combination at the date of acquisition if payment is probable and can be measured reliably.

Determining which are acquisition expenses (directly attributable costs of the business combination) and which are not, may also require judgement in some instances.

Recognising particular assets acquired and liabilities assumed

At the date of acquisition, the acquirer must recognise, separately from goodwill, the identifiable assets acquired, liabilities assumed and contingent liabilities recognised as a result of the business combination. All of these items are measured at their respective fair values. Significant judgements are required in determining the fair value of the items to be measured, for example, contingent liabilities and unique intangible assets.

Module 19 – Business Combinations and Goodwill

COMPARISON WITH FULL IFRS

Full IFRS and the *IFRS for SMEs* both require the use of the acquisition, or purchase, method of accounting for a business combination. The requirements of the *IFRS for SMEs* are based on an earlier version of IFRS 3. Consequently, there are some differences between the *IFRS for SMEs* business combinations' requirements and IFRS 3 (as revised in 2008 and applicable for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after 1 July 2009).

Cost of business combination

In accordance with paragraph 19.11(b) of the *IFRS for SMEs*, the cost of a business combination includes any costs directly attributable to the business combination (for example, finder's fees and advisory, legal, accounting, valuation and other professional or consulting fees that are directly attributable to the business combination). By contrast, IFRS 3 explicitly excludes such costs from the cost of a business combination (see paragraph 53). Consequently, such costs generally form part of the asset goodwill under the *IFRS for SMEs*, whereas under IFRS 3 they are recognised as expenses in the period in which the costs are incurred and the services are received.

If a business combination is acquired in stages, the consideration paid is all measured at the acquisition date fair value in accordance with full IFRS (see paragraphs 41−42 of IFRS 3), whereas, in accordance with Section 19 of the *IFRS for SMEs*, the consideration given for each stage is measured at its fair value at the date that the stage was recognised in the financial statements (see paragraph 19.11).

Contingent consideration

Contingent consideration is included in the cost of a business combination, in accordance with the *IFRS for SMEs*, if its payment is probable and the amount can be measured reliably (see paragraph 19.12). IFRS 3, on the other hand, requires the fair value of contingent consideration to be included in the cost of a business combination regardless of whether payment is probable; its fair value being determined by considering the different possible outcomes and estimating the probability of each (see paragraph 39).

In accordance with the *IFRS for SMEs*, if, at the acquisition date, the probability of the contingent consideration becoming payable is 50 per cent or less (or it cannot be measured reliably) nothing is included in the cost of the business combination in respect of that contingent consideration. If, subsequently, it becomes probable and can be measured reliably (or can be measured reliably for the first time, having been probable from the outset), the amount is treated as an adjustment to the cost of the business combination (see paragraph 19.12).

In accordance with IFRS 3, subsequent changes to the fair value of contingent consideration are divided into two categories (see paragraph 58):

(a) changes arising as a result of post-acquisition information, that comes to light within one year of the acquisition date, about facts and circumstances that existed at the acquisition date—these result in an adjustment to the cost of the business combination and thus to the goodwill that arises on the business combination; and

(b) changes resulting from events after the acquisition date, such as meeting an earnings target—these do not affect the cost of the business combination and so do not affect the goodwill that arises on the business combination.

Goodwill

After initial recognition, in accordance with the *IFRS for SMEs*, goodwill is measured at cost less accumulated amortisation and any accumulated impairment losses. Goodwill is amortised over its useful life. If an entity is unable to make a reliable estimate of the useful life of goodwill, it is presumed to be ten years (see paragraph 19.23).

In accordance with full IFRS goodwill is not amortised. However, it is subject to an impairment test at least annually and, additionally, when there is an indication of impairment (see paragraphs 10(b) and 90 of IAS 36).

Non-controlling interest

In accordance with the *IFRS for SMEs* (see paragraphs 9.13(d) and 19.14–19.15), non-controlling interest is measured at its proportionate share of the group carrying amounts of the subsidiary's identifiable net assets (sometimes called the proportionate share method). Using this method, goodwill is not included in the carrying amount of non-controlling interest.

In accordance with IFRS 3 (see paragraph 19), non-controlling interest is measured using either the fair value method or the proportionate share method. The difference between the two is that with the fair value method, in calculating acquisition date goodwill, the non-controlling interest's stake in the entity is valued at fair value and this is used, along with what the parent paid to acquire its stake in the subsidiary, to calculate the goodwill arising on 100 per cent of the subsidiary. The full goodwill is recognised in the consolidated financial statements and the part of the goodwill that is attributable to the equity owned by the non-controlling interest is included in the measurement of the non-controlling interest.

If the fair value method is used, at the acquisition date of a partly owned subsidiary, both goodwill and non-controlling interest are different from those calculated in accordance with the *IFRS for SMEs*.

In general, the *IFRS for SMEs* is drafted in simple language and includes less guidance on how to apply the principles.

Module 19 – Business Combinations and Goodwill

TEST YOUR KNOWLEDGE

Test your knowledge of the requirements for accounting and reporting business combinations and goodwill in accordance with the *IFRS for SMEs* by answering the questions below.

Once you have completed the test, check your answers against those set out below this test.

Assume all amounts are material.

Mark the box next to the most correct statement.

Question 1

SME A acquires 100 per cent of the voting shares of SME B. SME B has only two assets, a piece of land where SME A will construct a building in the future and an empty building. SME B is a so-called 'shell company', ie it has no employees and no production or managerial processes. This transaction:

☐ (a) is a business combination.

☐ (b) could be a business combination.

☐ (c) is not a business combination.

Question 2

The acquisition date is the date on which:

☐ (a) the acquirer effectively obtains control of the acquiree.

☐ (b) more than 50 per cent of the consideration is paid.

☐ (c) a substantive agreement between the combining parties is reached.

Question 3

In accordance with the *IFRS for SMEs*, business combinations must be accounted for by applying:

☐ (a) the pooling of interests (or merger) method.

☐ (b) the purchase method.

☐ (c) the fresh-start method.

☐ (d) either the pooling of interests (or merger method) or the purchase method.

☐ (e) either the pooling of interests (or merger method) or the purchase method or the fresh-start method.

Question 4

The acquirer is always the combining entity:

☐ (a) whose relative size is significantly greater than that of the other combining entity or entities.

☐ (b) that obtains control of the other combining entity or entities.

☐ (c) that obtains more than 50 per cent of the voting equity of the other combining entity or entities.

☐ (d) that initiated the combination.

Question 5

Advisory, legal, tax, due diligence and valuation costs directly attributable to a business combination:

☐ (a) are part of the cost of the business combination.

☐ (b) are recognised as expenses.

☐ (c) are accounted for as a deduction from the equity issued.

Question 6

Costs directly attributable to issuing shares that are part of the consideration for a business combination:

☐ (a) are part of the cost of the business combination.

☐ (b) are recognised as expenses.

☐ (c) are accounted for as a deduction from equity.

Question 7

An acquirer must, at the acquisition date, recognise goodwill acquired in a business combination:

☐ (a) as an asset.

☐ (b) as an expense.

☐ (c) as a deduction from equity.

Question 8

After initial recognition the acquirer must measure goodwill acquired in a business combination:

☐ (a) at cost less accumulated amortisation and accumulated impairment.

☐ (b) at cost less accumulated amortisation.

☐ (c) at cost less accumulated impairment.

☐ (d) at fair value.

Question 9

Goodwill is amortised:

☐ (a) over its estimated useful life, which can be indefinite.

☐ (b) over ten years.

☐ (c) over its estimated useful life. If an entity is unable to make a reliable estimate of the useful life of goodwill, the life is presumed to be ten years.

☐ (d) over its estimated useful life. If an entity is unable to make a reliable estimate of the useful life of goodwill, no amortisation is required.

Question 10

On 18 February 20X1 SME A purchased all of the equity interests in SME B. The consideration payable was CU100,000 at the date of acquisition and a further amount that was dependent upon post-acquisition sales; either zero, CU5,000 or CU10,000, depending on the sales recognised by SME B during the three years to 31 December 20X3. At the date of acquisition, SME A estimated that CU5,000 would be payable (ie it is more likely than not that only CU5,000 will be paid). Also, at the date of acquisition, SME B was being sued by a third party. In accounting for the acquisition of SME B in its consolidated financial statements, SME A estimated that there was a less than even chance of losing the court case and that the acquisition-date fair value of the contingent liability is about CU2,000.

On 31 December 20X2, SME B:

- revised upwards its estimate of the amount of further consideration payable to CU10,000 (ie it is more likely than not the CU10,000 will be paid); and
- concluded that it is more likely than not that it will lose the court case and that the best estimate to settle the case at 31 December 20X2 is CU12,500.

In its consolidated financial statements for the year ended 31 December 20X2, SME A should:

☐ (a) adjust goodwill for the change in estimate of contingent consideration and for the change in estimate for the provision for the court case.

☐ (b) adjust goodwill for the change in estimate of contingent consideration and recognise the change in estimate for the provision for the court case as an expense in arriving at profit or loss.

☐ (c) recognise the change in estimate for the contingent consideration as an expense in arriving at profit or loss and adjust goodwill for the change in estimate for the provision for the court case.

☐ (d) recognise as an expense in arriving at profit or loss the change in estimate for the contingent consideration and the change in estimate for the provision for the court case.

Answers

Q1	(c) The assets purchased in the transaction do not constitute a business as defined.
Q2	(a) See paragraph 19.3
Q3	(b) See paragraph 19.6
Q4	(b) See paragraph 19.8
Q5	(a) See paragraph 19.11(b)
Q6	(c) See paragraphs 22.8 and 22.9
Q7	(a) See paragraph 19.22(a)
Q8	(a) See paragraph 19.23
Q9	(c) See paragraph 19.23(a)
Q10	(b) See paragraphs 19.13, 19.19 and 19.21

APPLY YOUR KNOWLEDGE

Apply your knowledge of the requirements for accounting and reporting business combinations and goodwill in accordance with the *IFRS for SMEs* by solving the case studies below.

Once you have completed the case studies check your answers against those set out at the end of each case study.

Case study 1

SME A's major business is in the children's food industry. It makes baby food and drink. On 20 February 20X1 SME A began negotiations with the owners of SME B (which makes sweets) to acquire 100 per cent of the issued capital of SME B. After months of discussion, an agreement was reached on 25 August 20X1. In accordance with the agreement, legal ownership of SME B passes to SME A on 30 September 20X1. However, from 1 September 20X1 SME A has the power to remove and appoint all of the directors of SME B. On 15 September 20X1 SME A appointed new directors to replace the majority of the existing directors of SME B.

The carrying amount and fair value of the assets and liabilities that were recognised in SME B's statement of financial position at the date of acquisition were as follows:

	Carrying amount	*Fair value*
	CU	CU
Plant and equipment	1,000	1,300
Land	1,500	2,000
Motor vehicles	300	320
Inventory	200	280
Accounts receivable	150	130
Total assets	**3,150**	**4,030**
Accounts payable	700	700
Bank loan	1,200	1,150
Provisions (short term)	250	270
Total liabilities	**2,150**	**2,120**

At the date of acquisition SME B had unrecorded recipes for sweet making. The fair value of the recipes at the date of acquisition was CU800.

At the date of acquisition, SME B was being sued for damages relating to a claim by a parent of a child that possibly could have had food poisoning from consuming the sweets made by SME B. If SME B loses the court case it is expected that damages of CU1,000 will be awarded to the plaintiff. Lawyers estimated that the chance of losing the case can be estimated to be remote. SME A estimates that the fair value of the potential liability is CU100.

Details of the consideration SME A agreed to provide in exchange for the issued capital of SME B are described below:

- 100 shares in SME A— the fair value at the date of acquisition is CU14 per share;
- cash of CU1,000; half to be paid at the date of acquisition and half to be paid one year later;
- a further payment of CU500 after two years if SME B's profit before interest and tax (EBIT) for the first year following the acquisition exceeds CU2,500, or a further payment

of CU700 after two years if SME B's profit before interest and tax (EBIT) for the first year following the acquisition exceeds CU4,000. SME A believed that it was probable that EBIT will be higher than CU2,500 but lower than CU4,000; and

- supply of a patent that had a fair value of CU500 at the date of acquisition.

Directly attributable costs paid by SME A in relation to the acquisition (including the costs of issuing the shares of CU20) amounted to CU60.

The incremental borrowing rate of SME A is 10 per cent.

Required:

You are to ignore income tax effects when answering Parts A–D of this case study. The income tax effects are the subject of Part E of this case study.

Part A

Determine the date of acquisition.

Part B

Determine the fair value of net identifiable assets acquired by SME A at the date of acquisition.

Part C

Determine the cost of the business combination.

Part D

Determine the amount, if any, of goodwill to be recognised as a result of the business combination.

Part E

Recalculate the amount, if any, of goodwill to be recognised as a result of the business combination using the following assumptions:

- the applicable income tax rate is 20 per cent;
- the tax basis of the assets and liabilities recognised by SME B in its individual accounting records is equal to their respective carrying amounts; and
- the amortisation of goodwill is not tax deductible in determining taxable profit.

Answer to case study 1

Part A

The date of acquisition is the date on which the acquirer effectively obtains the control of the acquiree.

In this case, although SME A did not appoint new directors until 15 September 20X1 and legal ownership did not occur until 30 September 20X1, SME A had the power to appoint all of the directors of SME B from 1 September 20X1. All other facts and circumstances would also be considered. In the absence of further facts or circumstances that might indicate otherwise, the date of acquisition is 1 September 20X1.

Part B

The fair value of the net identifiable assets acquired by SME A is CU2,610 (ie CU4,830 fair value of assets acquired less CU2,220 fair value of liabilities and contingent liabilities assumed).

Calculation of net identifiable assets:

	Fair value
	CU
Intangible assets (recipes)	800
Plant and equipment	1,300
Land	2,000
Motor vehicles	320
Inventory	280
Accounts receivable	130
Total assets	4,830
Accounts payable	700
Bank loan	1,150
Provisions (short term)	270
Contingent liability	100
Total liabilities	2,220
Net identifiable assets acquired	**2,610**

Part C

The cost of the business combination is CU3,308.

Working:

Purchase consideration

		CU
Shares	100 SME A shares × CU14	1,400
Cash paid on the date of acquisition		500
Deferred cash payment	CU500 × 1/1.1	455
Contingent consideration (EBIT targets)	CU500 × $1/(1.1)^2$	413
Patent		500
Directly attributable costs (excluding share issue costs)		40
Total cost of the business combination		**3,308**

Part D

The amount of goodwill recognised as an asset as a result of the business combination is CU698.

Calculation: CU3,308 cost of the business combination (Part C) less net assets acquired CU2,610 (Part B) = CU698.

Part E

After taking account of income tax effects, the amount of goodwill recognised as an asset as a result of the business combination is CU1,020.

Calculation: CU3,308 cost of the business combination less fair value of net identifiable assets acquired CU2,288 (see calculation below) = CU1,020 goodwill.

The fair value of the net identifiable assets acquired by SME A is CU2,288:

	Fair value CU
Net identifiable assets acquired before tax effects (Part B)	**2,610**
Deferred tax liability (see below)	(322)
Net identifiable assets acquired	**2,288**

Calculation for the deferred tax liability:

	Individual entity (SME B) carrying amount	*Group acquisition date carrying amount (ie fair value)*	*Difference*	*Deferred tax 20%*
	CU	CU	CU	CU
Intangible assets (recipes)	–	800	800	(160)
Plant and equipment	1,000	1,300	300	(60)
Land	1,500	2,000	500	(100)
Motor vehicles	300	320	20	(4)
Inventory	200	280	80	(16)
Accounts receivable	150	130	(20)	4
Accounts payable	(700)	(700)	–	–
Bank loan	(1,200)	(1,150)	50	(10)
Provisions (short term)	(250)	(270)	(20)	4
Contingent liability	–	(100)	(100)	20
Total	1,000	2,610	1,610	
Total deferred tax liability				**(322)**

Note: ( ) indicates a liability, while a positive amount indicates an asset.

Case study 2

On 1 June 20X1 SME A, a retail company, acquired 75 per cent of the issued share capital, and control, of SME B, another retail company. The consideration for the business combination was CU3,765 in cash and CU30 of costs directly attributable to the business combination. At the date of acquisition, the statements of financial position of SME A and SME B, and the fair values of the assets and liabilities recognised on SME B's statement of financial position, were as follows:

	SME A	*SME B*	
	Carrying amount	*Carrying amount*	*Fair value*
	CU	CU	CU
Assets			
Non-current assets			
Land	4,000	1,800	2,500
Equipment	2,000	500	550
Investment in SME B	3,795	–	–
	9,795	2,300	
Current assets			
Inventory	500	300	400
Cash	700	100	100
	1,200	400	
Total assets	**10,995**	**2,700**	
Liabilities and equity			
Equity			
Share capital	5,000	1,500	
Retained earnings	4,195	600	
Total equity	9,195	2,100	
Liabilities			
Non-current liabilities			
Provisions (long-term)	800	200	210
	800	200	
Current liabilities			
Payables	600	180	180
Provisions (short-term)	400	220	220
	1,000	400	
Total liabilities	1,800	600	
Total liabilities and equity	**10,995**	**2,700**	

At the date of acquisition, SME B had an unrecorded patent with a fair value of CU2,000.

Tax effects are to be reflected using the following assumptions:

- the applicable income tax rate is 20 per cent;
- the tax basis of the assets and liabilities recognised by SME B in its individual accounting records is equal to their respective carrying amounts; and
- the amortisation of goodwill is not tax deductible in determining taxable profit.

Required:

Part A

Calculate the goodwill, if any, to be recognised.

Part B

Prepare the SME A Group's consolidated statement of financial position at 1 June 20X1.

Part C

Prepare the disclosures necessary to be presented relating to the business combination that would be included in SME A Group's consolidated financial statements for the year ended 31 December 20X1.

Answer to case study 2

Part A

SME A recognises goodwill of CU516 (ie cost of the business combination CU3,795 (CU3,765 + CU30) less 75 per cent of net identifiable assets acquired CU3,279 (0.75 × CU4,372)).

Fair value of net identifiable assets acquired:

	Fair value
	CU
Intangible assets (patent)	2,000
Land	2,500
Equipment	550
Inventory	400
Cash	100
Total assets	**5,550**
Provisions (long-term)	210
Payables	180
Provisions (short-term)	220
Deferred tax liability (see below)	568
Total liabilities	**1,178**
Net identifiable assets acquired	**4,372**

Calculation for the deferred tax liability:

	Carrying amount SME B	*Carrying amount Group fair value*	*Difference*	*Tax 20 per cent*
	CU	CU	CU	CU
Intangible assets (patent)	–	2,000	2,000	(400)
Land	1,800	2,500	700	(140)
Equipment	500	550	50	(10)
Inventory	300	400	100	(20)
Cash	100	100	–	–
Provisions (long-term)	(200)	(210)	(10)	2
Payables	(180)	(180)	–	–
Provisions (short-term)	(220)	(220)	–	–
Total	2,100	4,940	2,840	
Total deferred tax liability				**(568)**

Notes:
( ) indicates a liability, while a positive amount indicates an asset.

Although the group carrying amount of goodwill (CU516) exceeds its tax basis (nil), no deferred taxation arises from this temporary difference because it is exempt from deferred tax (see paragraph 29.16(b)).

Part B

SME A's consolidated statement of financial position at 1 June 20X1

	CU	CU	CU
Assets			
Non-current assets			
Goodwill		516	
Patent		2,000	
Land		6,500	
Equipment		2,550	
			11,566
Current assets			
Inventory		900	
Cash		800	
			1,700
Total assets			**13,266**
Liabilities and equity			
Equity attributable to owners of the parent			
Share capital		5,000	
Retained earnings		4,195	
		9,195	
Non-controlling interests		**1,093**[a]	
Total equity			10,288
Liabilities			
Non-current liabilities			
Provisions (long-term)		1,010	
Deferred tax liability		568	
		1,578	
Current liabilities			
Payables	780		
Provisions (short-term)	620		
		1,400	
Total liabilities			**2,978**
Total liabilities and equity			**13,266**

[a] 25 per cent of CU4,372 acquisition date fair value of the net identifiable assets of SME B (see Part A).

Workings:

	SME A	*SME B*	*Adjustments*	*Consolidation*
	CU	CU	CU	CU
Assets				
Goodwill	–	–	516	516
Patent	–	–	2,000	2.000
Land	4,000	1,800	700	6,500
Equipment	2,000	500	50	2,550
Investment in SME B	3,795	–	(3,795)	–
Inventory	500	300	100	900
Cash	700	100	–	800
Total assets	**10,995**	**2,700**	**(429)**	**13,266**
Liabilities and equity				
Equity				
Share capital	5,000	1,500	(1,500)	5,000
Retained earnings	4,195	600	(600)	4,195
Non-controlling interests	–	–	1,093	1,093
Liabilities				
Provisions (long-term)	800	200	10	1,010
Deferred tax liability	–	–	568	568
Payables	600	180	–	780
Provisions (short-term)	400	220	–	620
Total liabilities and equity	**10,995**	**2,700**	**(429)**	**13,266**

Part C

Disclosures to be included in SME A's consolidated financial statements for the year ended 31 December 20X1:

J. Goodwill

	Note	**Cost**	***Accumulated amortisation and impairment***	***Carrying amount***
		CU	CU	CU
1 January 20X0		**–**	**–**	**–**
Acquired in the business combination	Z	516	–	516
Annual amortisation		–	(30)	(30)
31 December 20X0		**516**	**(30)**	**486**

Working for goodwill amortisation:

Amortisation = $(516 \div 10) \times {}^{7}/_{12}$

A 10 year life has been assumed and the acquisition is seven months before the end of the year.

Z. Acquisitions

On 1 June 20X1, SME A acquired 75 per cent of the issued share capital and control of SME B, in a cash transaction. This acquisition has been accounted for under the purchase method and has been included in the consolidated financial statements from the date of acquisition.

SME B is a retailer specialising in casual clothes for children and teenagers, which complements SME A's retail business supplying women's clothing.

The amounts recognised, at fair value, as a result of the business combination at the acquisition date are as follows:

	Note	CU	CU
Net identifiable assets acquired:			
Patent		2,000	
Land		2,500	
Equipment		550	
Inventory		400	
Cash		100	
			5,550
Payables		(180)	
Provisions (short-term)		(220)	
Provisions (long-term)		(210)	
Deferred tax liability		(568)	
			(1,178)
Total identifiable net assets			4,372
Non-controlling interest			(1,093)
Goodwill	J		516
Cost of business combination			3,795