July 2022 Q 3 Answers

(a)

(i) Per Para 42 of SLFRS 3,, in a business combination achieved in stages, the acquirer shall remeasure its previously held equity interest in the acquiree at its acquisition date fair value and recognise the resulting gain or loss, if any, in the P&L or other comprehensive income, as appropriate.

Per Para 22 of LKAS 28 an entity shall discontinue the use of the equity method from the date when its investment ceases to be an associate, if the investment becomes a subsidiary.

Accordingly, the company should compute the gain/loss on derecognition of its equity stake (20%) and recognise the resulting gain/loss in the income statement as follows.

Profit/loss on derecognition of previously held investments		
	Rs. million	**Rs. million**
FV of previously held equity stake at the date of disposal (as given)		90
Less:		
Carrying amount of previously held investment		
Cost of acquiring 20% (as given)	71	
Share of post-acquisition profit from 1 April 2022 to 31 March 2023 Profit based on HS financial statements → Closing RE – Opening RE = Rs. 350 million – Rs. 275 million = Rs. 75 million → Rs. 75 million * 20% = Rs. 15 million	15 (0.4)	~~86~~ 85.6
Gain to be reported in the consolidated income statement		~~**4**~~ 4.4

Rev. loss
(2) x 20%
= (0.4)

(ii) Contingent Consideration

Per Para 39 of SLFRS 3, the consideration the acquirer transfers in exchange for the acquiree includes any asset or liability resulting from a contingent consideration arrangement. The acquirer should recognise the acquisition date fair value of the contingent consideration as part of the consideration transferred in exchange for the acquiree.

Accordingly, Rs. 62 million and Rs. 15 million payable on achieving forecast revenue (highly likely) and the receipt of approval from the Department of Ayurveda respectively shall be recognised as a part of consideration to acquire control of HS.

Per Para 40 of SLFRS 3, the acquirer shall classify an obligation to pay the contingent consideration that meets the definition of a financial instrument as a financial liability or as equity on the basis of the definition of an equity instrument and financial liability in Paragraph 11 of IAS 32 Financial Instruments: Presentation.

Given the fact that the company will have to pay a fixed amount of cash, the said contingent consideration meets the definition of a financial liability.

Per Para 58 of SLFRS 3 (b), a contingent consideration that is within the scope of IFRS 9 should be measured at fair value at each reporting date, and changes in the fair value should be recognised in the P&L in accordance with IFRS 9.

Contingent liability

Per Para 23 of SLFRS 3 the requirements in LKAS 37 do not apply in determining which contingent liabilities to recognise as at the acquisition date. Instead, the acquirer shall recognise as at the acquisition date a contingent liability assumed in a business combination if it is a present obligation that arises from past events and its fair value can be measured reliably.

Therefore, contrary to LKAS 37, the acquirer recognises a contingent liability assumed in a business combination at the acquisition date, even if it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation.

Per Para 56 of SLFRS 3 after initial recognition and until the liability is settled, cancelled or expires, the acquirer shall measure a contingent liability recognised in a business combination at the higher of the amount that would be recognised in accordance with LKAS 37.

Accordingly, the company should recognise a contingent liability of Rs. 12 million in the consolidated statement of financial position. Subsequently that should be reassessed at each reporting date and carried at the higher of the amount recognised or the amount to be recognised as LKAS 37.

Acquisition cost

Per Para 53 of SLFRS 3 acquisition-related costs are costs the acquirer incurs to effect a business combination. The acquirer should account for acquisition-related costs as an expense in the periods in which the costs are incurred and the services are received.

Accordingly, the company should expense the already incurred amount of Rs. 2 million in the current financial year (2022), and the forecast cost of Rs. 1 million should be expensed off/charged to the P&L once it is incurred in 2023.

(iii) **NCI and goodwill computation**

	Rs. million	Rs. million
Consideration:		
Cash	180	
Contingent consideration		
1. Present value of contingent consideration based on revenue	62	
2. Present value of contingent consideration based on the approval of the Department of Ayurveda	15	
As payment is expected to take place in April 2023, the discounting effect is considered immaterial	-	
Total consideration		257
FV of previously held interest (as given in the question)		90
NCI **(Note 1)**		132
		479
Less: FV of net assets acquired **(Note 1)**		442
Goodwill		38
Note 1		
BV of forecast net assets of HS as at 1 April 2023	420	
Increase in FV as predicted by experts (i.e. 8% of forecast net assets) Rs. 420 million * 1.08 OR Rs. 420 million + Rs. 34 million (value of intangible asset not in the forecast/not recognised in the books)	454	
Less: Contingent liability (not provided for in the forecast financial statements)	(12)	
Adjusted FV of net assets	442	
NCI (30% of adjusted net assets of Rs. 442 million)	132	

(iv) Gearing ratio = Interest bearing borrowings / (Shareholders' equity + Interest bearing borrowings)

OR

Gearing ratio = Total debt capital / Total Equity

Liquidity positions can be assessed based on the current ratio and quick ratio.

Current ratio = Current assets / Current liabilities

Quick ratio = Quick assets / Current liabilities

Quick assets = Current assets – Inventory – Prepaid expenses

As computed below, the gearing ratio of the company will increase from 16% to 19% (or 19% to 24%), which is an increase of relative debt capital by 3% (or 5%). The management may consider if the expected gearing is within its expected optimum funding plans.

As computed below, the liquidity position of the company shows an insignificant variance and will remain almost constant in the pre and post-acquisition periods.

Workings

				Rs. million
Current assets	**Parent**	**Subsidiary**	**Adjustment**	**Consolidated**
Inventories	676	120		796
Trade and other receivables	593	144		737
Income tax recoverable	55	0		55
Other financial assets	60	0		60
Cash and cash equivalents	150	8	249	407
Total current assets	1,534	272	249	2,055

Note: The adjustment of Rs. 249 million represents cash receipts from Blue-Rock Capital (Rs. 500 million less Rs. 71 million to acquire 20% and Rs. 180 million payable for proposed acquisition of HS).

Quick assets = Current assets – Inventory – Prepaid expenses

	Rs. million	
Pre	(1,534 – 676)	858
Post	(2,055 – 796)	1,259

				Rs. million
Current liabilities	**Parent**	**Subsidiary**	**Adjustment**	**Consolidated**
Trade and other payables	519	235		754
Loans and borrowings	225	85		310
Contingent consideration payable			77	77
Contingent liability			12	12
Bank overdrafts	20	8		28
Total current liabilities	**764**	**328**	**89**	**1,181**

Adjustments (contingent consideration)

	Rs. million
Discounted contingent consideration based on revenue	62
Contingent consideration based on the approval of the Department of Ayurveda	15
	77
Contingent liability for legal case	12

Current ratio = Current assets / Current liabilities

		Current ratio
Pre	(1,534/764)	2.01
Post	(2,055/1,181)	1.74

Quick ratio = Quick assets/current liabilities

		Quick ratio
Pre	(858/764)	1.12
Post	(1,259/1,181)	1.07

			Rs. million
Equity	**Parent**	**Adjustment**	**Consolidated**
Stated capital	125	500	625
Revaluation reserve	173		173
Retained earnings	1,919	19	1,938
Total equity	**2,217**	**519**	**2,736**

Note: Rs. 500 million represents the capital infusion by Blue-Rock Capital and Rs. 19 million represents Rs. 15 million share of profit of associate and Rs. 4 million gain on derecognition of associate stake.

Gearing ratio = Interest bearing long-term borrowings / (Total equity + Interest-bearing long-term borrowings)

			Rs. million
	Parent	**Subsidiary**	**Consolidated**
Interest bearing borrowings	425	230	655
	Pre	**Post**	
	16%	19%	
	425/(425 + 2,217)	655/(655 + 2,736)	

OR

Gearing ratio = Interest bearing long-term borrowings (debt capital) / Total equity

Pre	Post
19%	24%
425/2,217	655/2,736

Note: If a candidate had considered further expense to be incurred in acquiring HS of Rs. 1 million in arriving at the final numbers for the ratios, due marks were awarded.

(Likely adjustments → Dr: Retained earnings Cr: Cash)