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THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

CL-25-1 | Corporate Financial Reporting

Corporate Level (2025 – Curriculum)

- Consolidated Financial Statements – Part 2

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SLFRS 3 BUSINESS COMBINATIONS

SLFRS 3 Business combinations provides guidance on the **measurement of net assets** acquired in a business combination and the **calculation of goodwill**.

SLFRS 3 Business Combinations should be applied in conjunction with SLFRS 10 when preparing consolidated financial statements; it provides guidance on:

- The recognition and measurement of assets and liabilities acquired when parent company acquires a subsidiary
- The recognition and measurement of any non-controlling interest in subsidiary
- The recognition and measurement of goodwill on the acquisition
- Disclosures that should be made in order to provide information to evaluate a business combination

DEFINITIONS

Term	Definition
Business combination	A transaction or event in which an acquirer obtains control of one or more businesses.
Business	An **integrated set of activities** and assets that is capable of being conducted and managed for the purpose of providing goods or services to customers, generating investment income (such as dividends or interest) or generating other income from ordinary activities.
Acquirer	The entity that obtains control of the acquiree.
Acquiree	The business or businesses that the acquirer obtains control of in a business combination.
Non-controlling interest **(NCI)**	The equity in a subsidiary not attributable, directly or indirectly, to a parent.
Contingent consideration	Usually, an obligation of the acquirer to transfer additional assets or equity interests to the former owners of an acquiree as part of the exchange for control of the acquiree **if specified future events occur or conditions are met**.
Goodwill	An asset representing the future economic benefits arising from other. Assets acquired in a business combination that are not individually identified and separately recognized.
Identifiable	An asset is identifiable if it either: • Is **separable**, i.e. 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 asset or liability, regardless of whether the entity intends to do so, ***or*** • **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 ACQUISITION METHOD

SLFRS 3 requires that a business combination (such as the acquisition of a subsidiary by a parent company) is accounted for using the acquisition method.

However, if the assets acquired not meet the definition of a business it shall not be accounted as a business combination and need to be accounted as a purchase of assets under relevant standard. (Ex: LKAS 16)

Acquisition method has following four steps approach:

1. Identifying the acquirer.
2. Determining the date of acquisition.
3. Recognizing and measuring the identifiable assets acquired, liabilities assumed and non-controlling interests in the acquiree.
4. Recognizing the Goodwill on acquisition.

1. IDENTIFYING THE ACQUIRER

SLFRS 3 requires that one party is identified as the acquirer, unless a business combination a merger. The entity **that obtains control of the acquiree** is defined as the acquirer in SLFRS 3 and says to use the guidelines in SLFRS 10 on the control for this purpose.

However, if SLFRS 10 does not clearly indicate which of the combining entities is the acquirer the SLFRS 3 has provided the following guidelines for such situations.

a) The acquirer is usually the **entity that transfers the cash** or other assets or incurs the liabilities.
b) In a business combination happened primarily by exchanging equity interests, the acquirer **is usually the entity that issues its equity interests (Ordinary shares)**.
c) The acquirer is usually the **larger in relative size**. (Measured in, for example, assets, revenues or profit)

2. DETERMINING THE DATE OF ACQUISITION

The acquisition date is the date on which the acquirer gains control of the acquiree. This is usually the date on which consideration is transferred and assets and liabilities are acquired.

GOODWILL

Goodwill represents the intangible elements of a business (in this case, a subsidiary) that are acquired by the purchaser (here the parent). These elements may include the reputation of the subsidiary, customer loyalty to it and an existing customer base that can generate future economic benefits to the entire group.

As at the acquisition date, the acquirer shall recognize the goodwill in the consolidated financial statements. It shall be measured as the difference between,

1. The fair value of total consideration transferred *(need to consider every type of consideration can be seen in the situation)* plus the Non-Controlling Interest (NCI) *(measured any of the two methods applicable)* and
2. The fair value of identifiable net assets acquired from the acquiree(FVINA)

Sometimes this goodwill can be a negative goodwill. It is identified as "**Gain on Bargain Purchase**" and recognized as a gain to the acquirer in Parent's (Acquirer's) profit.

This can be calculated using the below tabular approach.

		Rs.
Fair Value of the total consideration transferred	XXX	
+ Non-Controlling Interest (NCI)	XXX	XXX
- Fair Value of Identifiable Net Assets of the Subsidiary		(XXX)
Goodwill/ (Gain on Bargain Purchase)		**XXX/(XXX)**

CALCULATING THE FAIR VALUE OF TOTAL CONSIDERATION TRANSFERRED

When calculating the fair value total consideration transferred (*this can be also named as the cost of the investment*) it may include following.

1. Cash consideration
   - (Fair Value = Face value of cash)
2. Transfer of non-monetary assets
   - (Fair Value = Market Value)
3. Issuing the acquirer's own equity (ordinary) shares
   - (Fair Value = Market Value of the shares at the date of issuance)
4. Deferred Consideration / Postponed Consideration
   - (Fair Value = Present Value of future payment)
5. Contingent Consideration /Conditional Consideration
   - (Fair Value = Probability Weighted Present Value of future payment)

However, the following costs **shall not be included** in the purchase consideration.

a) Acquisition related costs (Transaction Fees)
   - Ex : Legal Fees, Professional Fees, Documentation charges

Deferred Consideration

It is required to get the present value of the agreed future payment as at the acquisition date as the fair value of deferred consideration. Further, when the time lapse in each year, it is required to unwind the interest and recognize it in consolidated financial statements as it is a liability of the parent.

The interest unwinding will be done based on the discount rate used to get the present value and such interest unwind need to be recognized as a finance cost for the period and will result in an increase in the deferred consideration liability recognized at the acquisition date.

Contingent Consideration

A contingent consideration is an agreement to settle in the future provided certain conditions attached to the agreement are met. These conditions vary depending on the terms of the settlement.

Any contingent consideration should be included at **fair value (Probability weighted)**, which will usually be given in the examination. But in case if the information are given to you, then you need to calculate it. . Contingent consideration may occasionally be an asset, for example if the consideration has already been transferred and the acquirer has the right to the return of part of it, an asset may occasionally be recognised in respect of that right.

Post–acquisition, the subsequent accounting for contingent consideration depends on the circumstances:

A. If the change in fair value is due to additional information obtained that affects the position at the acquisition date, goodwill should be re-measured.
B. If the change is due to events which took place after the acquisition date, for example, meeting earnings targets:
    a. Account for under SLFRS 9 if the consideration is in the form of a financial instrument, for example loan notes.
    b. Account for under LKAS 37 if the consideration is in the form of cash.
    c. An equity instrument is not remeasured.

Test Your Understanding 04

Bhawantha purchased 100% of Dushan's 5,000 shares on 1st January 2024. The consideration agreed for this share purchase was as follows.

- Immediate cash payment of Rs. 600,000
- Transferring a motor vehicle on the acquisition date to the previous owner of Dushan at the market value of Rs. 500,000 which had a carrying amount of Rs. 350,000.
- Issuing two shares for every four shares acquired by Bhawantha. The market price per share of Bhawantha and Dushan was Rs.200 and Rs. 250 respectively.
- Further, Bhawantha agreed to pay another Rs. 1,000,000 on 1st January 2026.
- In addition, Bhawantha agreed to pay an additional Rs. 500,000 after 01 year, if the company achieves a profit before tax of Rs.3,500,000 in the first year after the acquisition. They have estimated that there is a 80% of probability of achieving the mentioned PBT target.
- To facilitate this purchase, Bhawantha had to incur a legal fee of Rs.250,000.

You are required to **calculate** the fair value of total consideration transferred. (Incremental Borrowing Rate applicable is 10%)

NON-CONTROLLING INTEREST (NCI)

Non-controlling interest is formed of those parties other than the parent company that hold equity shares in a subsidiary. NCI can be found only when the acquirer acquire the equity of the acquiree below 100%. Hence, where a subsidiary is 100% owned by the parent company, there is no NCI.

As per SLFRS 3, an acquirer has two options (methods) to value NCI. This choice can be applied on a **transaction-by-transaction basis**, and therefore a parent may measure the NCI in one subsidiary using the first method and the NCI in another using the second method.

The two methods are as follows.

01. The proportionate share of net assets basis	Fair Value of Identifiable net assets of the acquiree at acquisition date (FVINA)× NCI %
02. Fair value basis	Total No. of shares of the acquiree × NCI% × Fair value per share of the acquiree (Usually be given at the examination)

This method of measuring the NCI, will have an impact to the goodwill calculated as follows.

Method of NCI	Type of goodwill	Description
Proportionate Share of Identifiable Net Assets	Partial Goodwill	Goodwill is attributable only to parent.
Fair value	Full Goodwill	Goodwill is attributable to both parent and NCI

Test Your Understanding 05

A PLC acquired 80% of the B PLC's total shares of 5,000,000 on 01st January 2024 at a cash consideration of Rs.10,000,000. At the date on acquisition, the Fair Value of B PLC's identifiable net assets was Rs. 12,000,000 and the marker value per share of A and B were Rs. 2 and Rs.2.50.

You are required to **calculate** the NCI based on both methods.

CALCULATING THE FAIR VALUE OF IDENTIFIABLE NET ASSETS OF THE ACQUIREE (FVINA)

SLFRS 3 requires that the net assets of the subsidiary on the acquisition date are measured at **fair value** for inclusion within the consolidated financial statements and the goodwill calculation. The assets and liabilities must:

- Meet the definitions of assets and liabilities in the 2018 Conceptual Framework

- Be part of the business combination transaction rather than the result of separate transactions

Fair value shall be determined in accordance with SLFRS 13 Fair Value Measurement.

Where the carrying amount of the net assets is not equal to fair value, we are required to do the **revaluation** and take the fair value in to the consolidated financial statements as an adjustment.

Exceptions to the recognition principle of FVINA

SLFRS 3 provides limited exceptions to the recognition and measurement principles.

Contingent liabilities	The requirements in **LKAS 37 do not apply** in determining which contingent liabilities to recognize as of the acquisition date. Instead, the **acquirer shall recognize as of 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 recognizes 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.
Deferred Tax	The acquirer shall recognize and measure a deferred tax asset or liability arising from the assets acquired and liabilities assumed in a business combination in accordance with LKAS 12 Income Taxes. Further, the acquirer **shall account for the potential tax effects** of temporary differences and carryforwards of an acquiree **that exist at the acquisition date** or arise as a result of the acquisition in accordance with LKAS 12.
Employee benefits	The acquirer shall recognize and measure a liability (or asset, if any) related to the acquiree's employee benefit arrangements in accordance with LKAS 19 Employee Benefits.
Leases where acquiree is the lessee	The acquirer shall recognize right-of-use assets and lease liabilities for leases identified in accordance with SLFRS 16 in which the acquiree is the lessee. The acquirer shall measure the lease liability at the present value of the remaining lease payments (as defined in SLFRS 16) as if the acquired lease were a new lease at the acquisition date.
Share-based payment transactions	The acquirer shall measure a liability or an equity instrument related to share-based payment transactions of the acquiree or the replacement of an acquiree's share-based payment transactions with share-based payment transactions of the acquirer in accordance with the method in SLFRS 2 Share-based Payment at the acquisition date.

Assets held for sale	The acquirer shall measure an acquired non-current asset (or disposal group) that is classified as held for sale at the acquisition date in accordance with SLFRS 5 at Fair Value less cost of disposal.

Measurement Period Adjustments

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 report in its financial statements provisional amounts for the items for which the accounting is incomplete.

During the measurement period, the acquirer **shall retrospectively adjust** the provisional amounts recognized at the acquisition date to reflect new information obtained about facts and circumstances that existed as of the acquisition date and, if known, would have affected the measurement of the amounts recognized as of that date.

The measurement period is the period after the acquisition date during which the acquirer may adjust the provisional amounts recognized for a business combination. The measurement period provides the acquirer with a reasonable time to obtain the information necessary to identify and measure the actual values of the amounts that are accounted using provisional values rather actual as of the acquisition date.

The measurement period **shall not exceed one year (12 Months)** from the acquisition date.

Test Your Understanding 06

X PLC acquired 60% of the ordinary share capital of Y PLC on 01st January 2024 for Rs.2,400,000. At this date the fair value of net assets of Y PLC were Rs.3,600,000.

What goodwill arises on the acquisition:

I. if the non-controlling interest (NCI) is valued using the proportion of net assets method?
II. if the NCI is valued using the fair value method and the fair value of the NCI on the acquisition date is Rs.1,500,000?

Test Your Understanding 07

Jack acquired 24 million Rs.1 shares (80%) of the ordinary shares of Becky by offering a share-for-share exchange of two shares for every three shares acquired in Becky, and a cash payment of Rs.1 per share payable three years later.

Jack's shares have a nominal value of Rs.1 and a current market value of Rs.2. The cost of capital is 10% and the present value of Rs.1 receivable in 3 years' time can be taken as Rs.0.75.

You are required to:

I. **Calculate** the cost of investment and show the **journals** to record it in Jack's financial statements.

II. **Show** how the discount would be unwound relating to the deferred consideration.

Test Your Understanding 08

Y PLC acquired 75% of Z PLC's 80m shares on 1st January 2024. Y paid Rs. 25 per share and agreed to pay a further Rs. 1,080million on 1st January 2025. The following details are relevant to the acquisition date.

- The fair value of the non-controlling interest was Rs. 250m.
- The carrying amount of the net assets of Z PLC was Rs. 2,300m.
- The fair value of Z PLC's head office was determined to exceed it carrying amount by Rs. 50m.
- Z PLC had not recognized a publishing title in its own statement of financial position; this was deemed to have a fair value of Rs. 8m.
- Z PLC had disclosed a contingent liability resulting from a legal case. This was not recognized as a provision by Z as the probability of payment was estimated to be less than 50%. The maximum exposure was Rs. 25m and the fair value of the contingent liability at the acquisition date was estimated to be Rs. 15m.

The acquirer's (Y) company's cost of capital is 8%.

Required:

I. **Calculate** the goodwill that arises on the acquisition.