Consolidated Financial Statements

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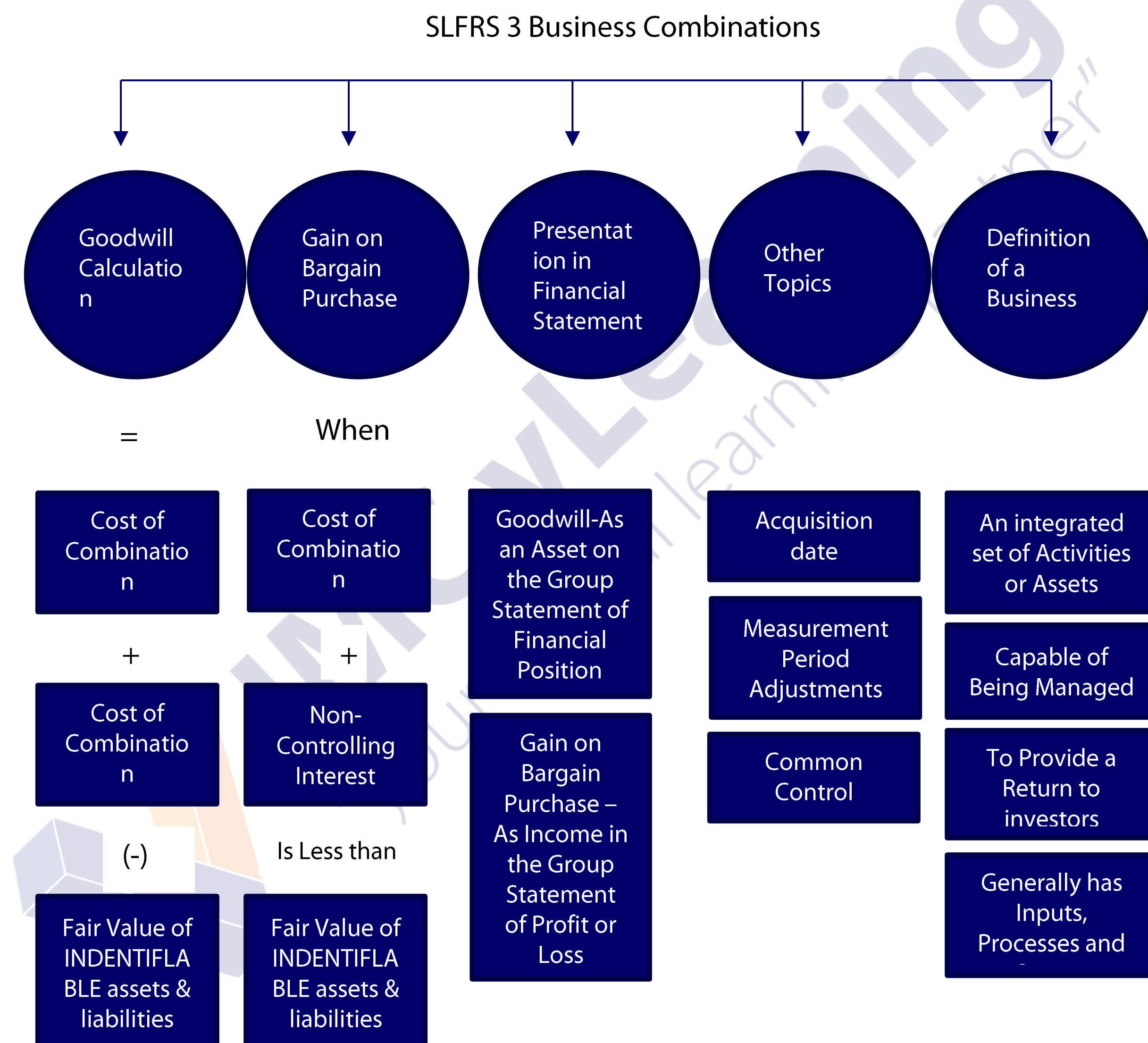
Accounting Standards to be discussed in preparing Consolidated Financial Statements

1) SLFRS 3 Business Combinations
2) SLFRS 10 Consolidated Financial Statements
3) LKAS 28 Investments in Associates
4) SLFRS 11 Joint Arrangements
5) LKAS 21 Effects of Changes in Foreign Exchange Rates [Foreign subsidiary consolidation]
6) LKAS 27 Separate Financial Statements



1) Scope and definitions

➢ Apply to all transactions or other events that meet the definition of a business combination, except:

- Formation of joint venture
- Acquisition of an asset (or group of assets) that does not constitute a business

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- Combination of entities or businesses under common control

➢ Acquisition method is applied to all business combinations within its scope

Definition – Business Combination

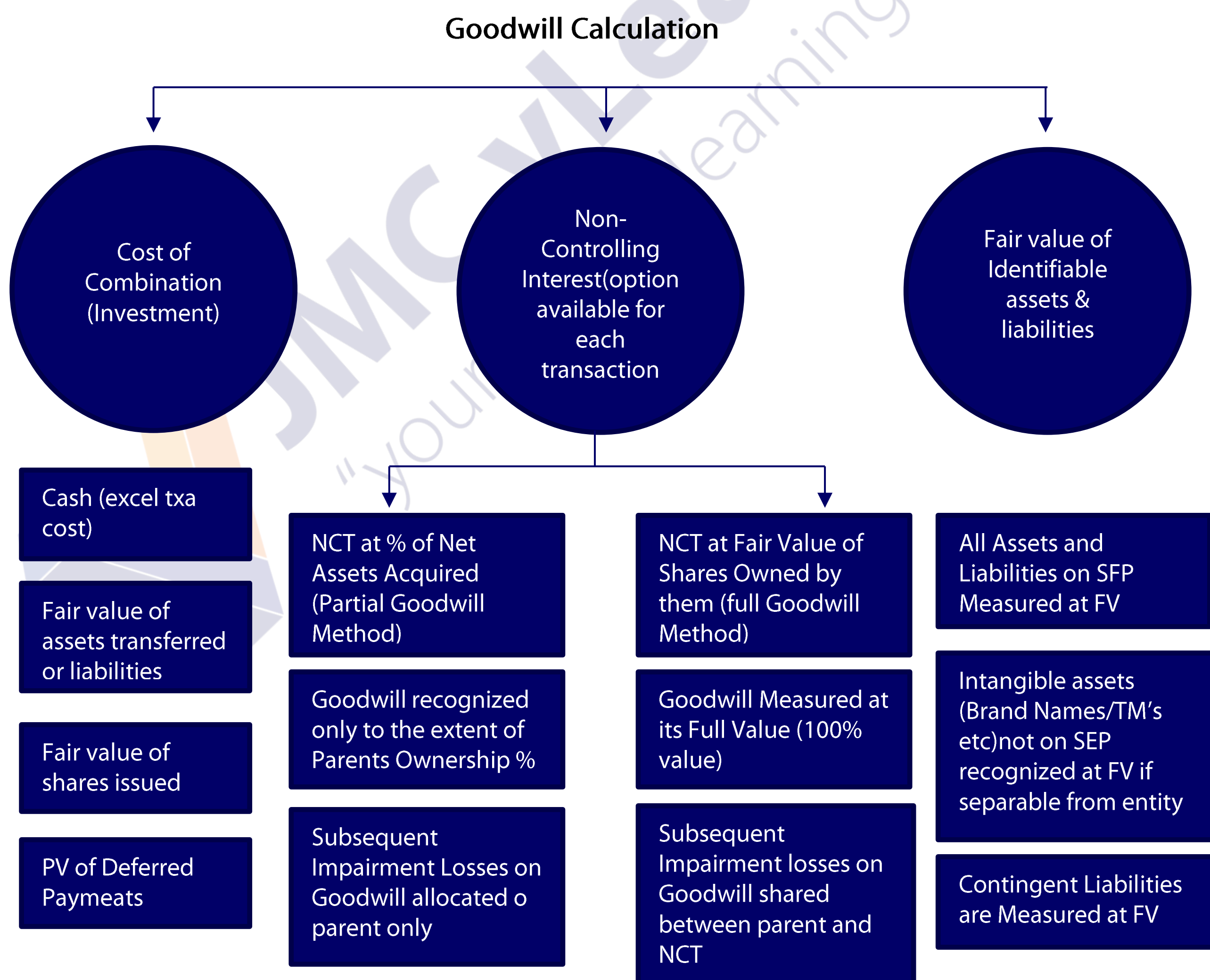
➢ A transaction or other event in which an acquirer obtains control of one or more businesses.

Definition – Business

➢ An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants.

- Generally consists of inputs, processes and the ability to create outputs
- Outputs are not required to qualify as a business
- Rebuttable presumption that a group of assets in which goodwill is present is a business
- Determination from the view of a market participant, rather than the specific acquirer

Goodwill Calculation



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Acquisition Method

Step 1 – Identify acquirer and determine acquisition date

Step 2 – Identify and measure consideration transferred

Step 3 – Identify and measure identifiable assets and liabilities

Step 4 – Measure non-controlling interests

Step 5 – Determine Goodwill or a Gain on a bargain purchase

2) Acquirer and the acquisition date

- Identifying the acquirer - Entity that obtains control of businesses
- Acquisition date - Date on which the acquirer obtains control of the acquire

3) Consideration transferred

- Consideration transferred may include:
  - Assets transferred
  - Liabilities incurred to previous owners
  - Equity instruments issued

- Measure at fair value at the acquisition date
- Required to identify any items that are not part of the business combination and account for such items separately from business combination

Contingent Consideration

- Obligation by the acquirer to transfer additional assets or equity interest to the former owners of acquire as part of the exchange for control if specified future events occur or conditions are met
- Recognized at fair value at acquisition date

Acquisition - related costs

- Expensed as incurred
- Except for those costs related to the issues of debt or equity instruments - Those costs are recognized in accordance with LKAS 32 and LKAS 39

4) Identifiable assets acquired and liabilities assumed

- General recognition principle
  - Must meet definition of assets or liabilities at acquisition date
  - Must be exchanged as part of acquisition

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- General measurement principle
  - Must be measured at fair value at acquisition date

Exception to recognition principle

a) Contingent liabilities

- A contingent liability acquired is recognized if
  - It is a present obligation from a past event and;
  - Fair value can be measured reliably

5) Non-Controlling Interest (NCI) and Goodwill or a gain on a bargain purchase

Non-controlling Interest (NCI)

- Measured at
  - Proportionate interest in fair value of identifiable net assets; or
  - Fair value
- On a transaction-by-transaction basis

Goodwill

- Measured as the difference between
  - Sum of
    - ✓ Fair value of consideration transferred
    - ✓ Recognized amount of any NCI in acquire
    - ✓ Fair value of any previously held equity interest in the acquire (for a business combination achieved in stages – see separate topic)
  - Recognized amount (generally fair value) of the identifiable assets acquired and liabilities assumed.
- "Bargain Purchase" if fair value of net assets and NCI exceeds consideration transferred
  - recognized in profit or loss after reassessment of fair values

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Illustration 1

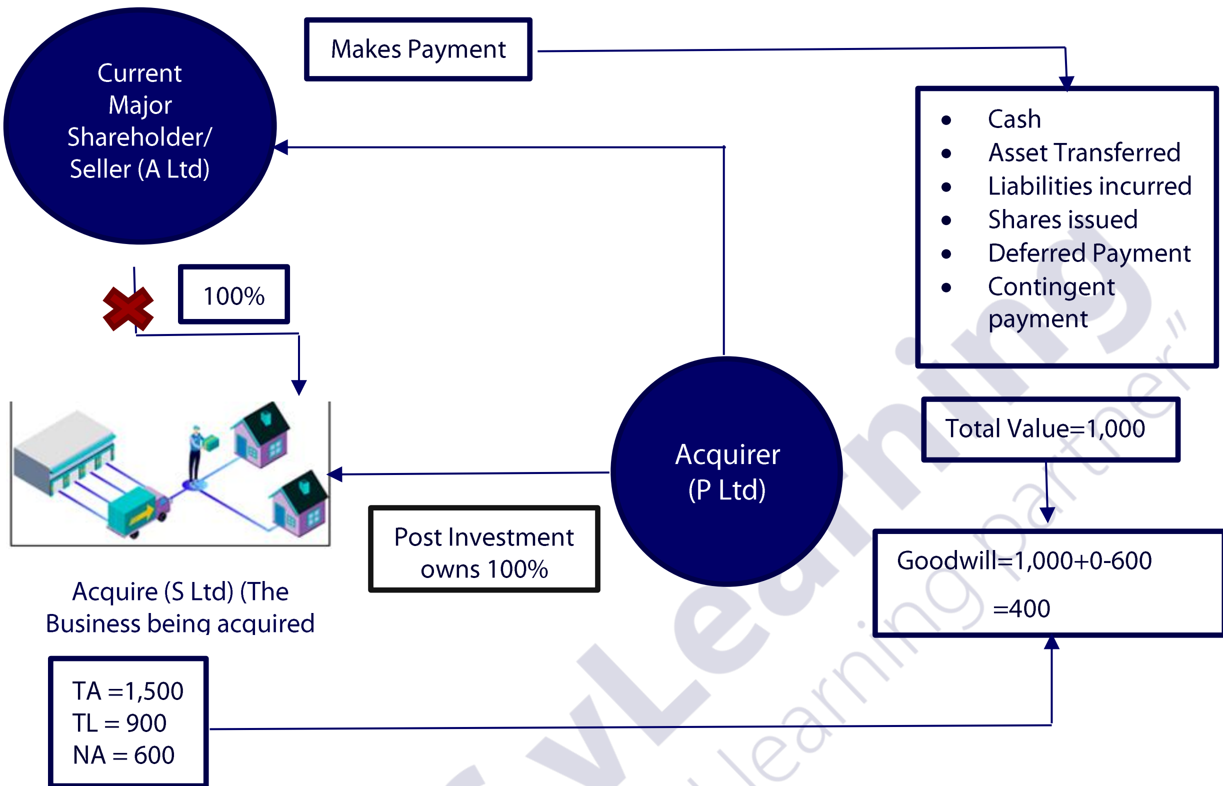
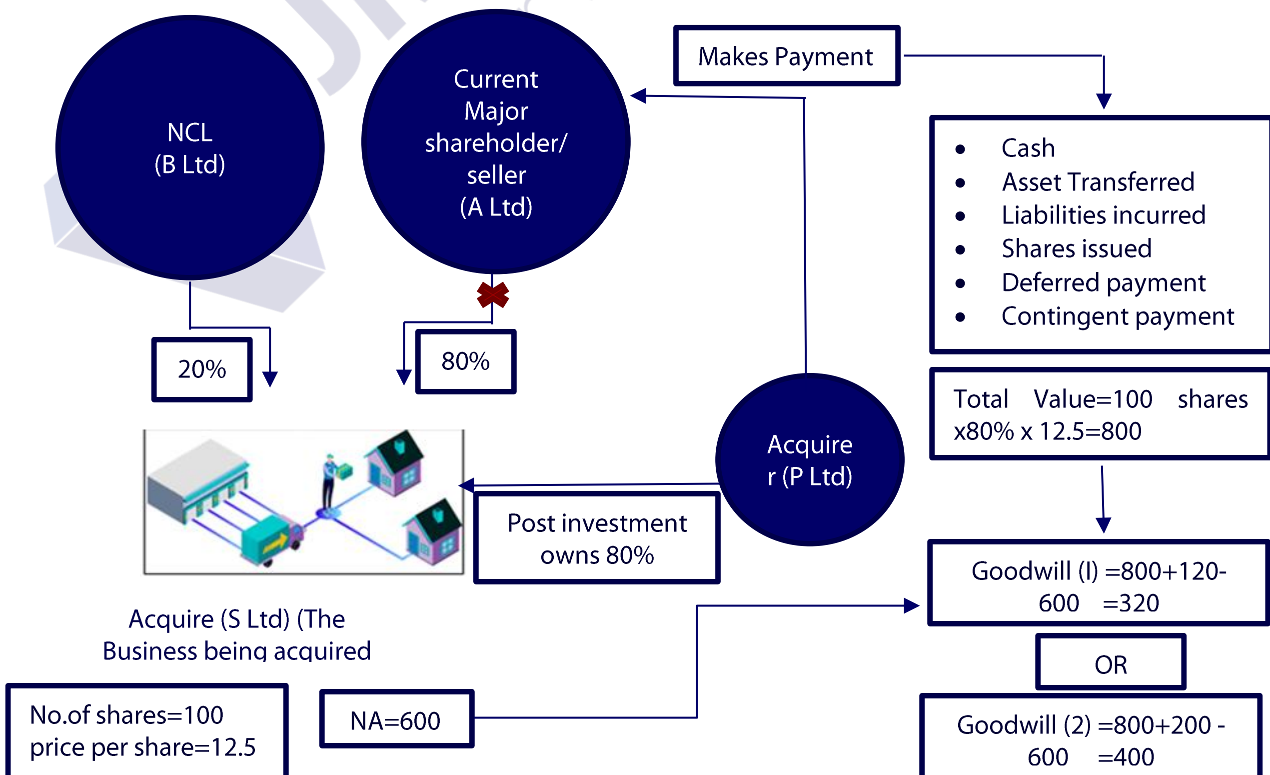


Illustration 2



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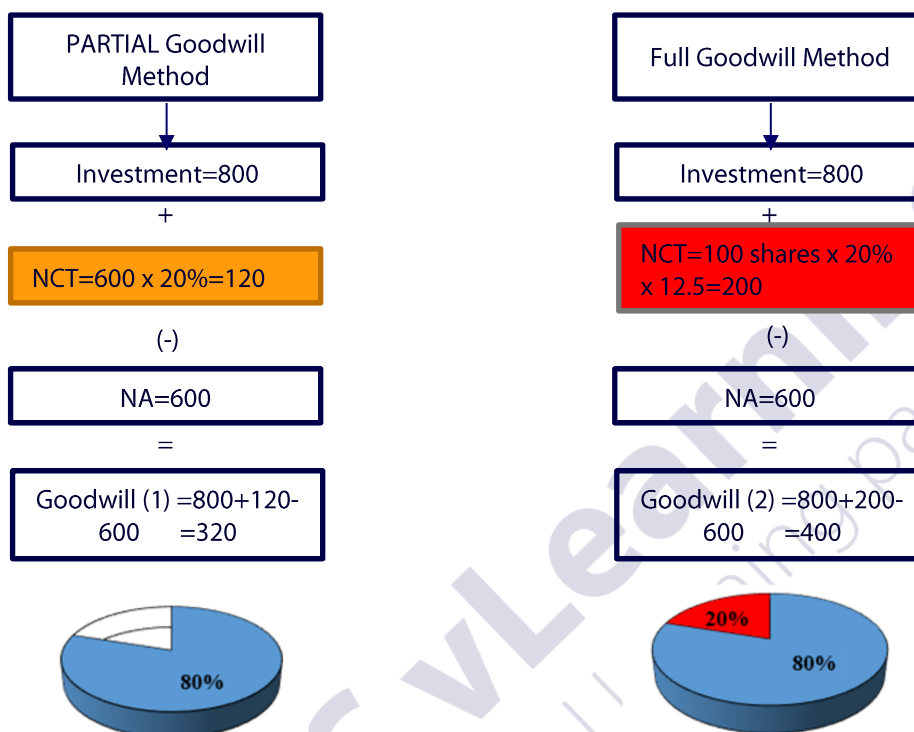
Analysis of Illustration 2

Goodwill Calculation Illustration



6) Measurement after the initial accounting

- ➢ Period after acquisition date when entity can adjust preliminary business combination accounting
    - If new information obtained about facts and circumstances that existed as of acquisition date
    - Ends when information obtained or determined not available
    - Cannot exceed one year
- ➢ Retrospective adjustment
- ➢ Once measurement period elapses any business combination accounting adjustment is correction of error (LKAS 8)

7) Acquisition in Stages

- ➢ Remeasure previously acquired non-controlling equity investment (NCEI) at fair value
    - Adjustment in profit or loss
- ➢ If changes in NCEI recognized in other comprehensive income
    - Account as it was disposed
- ➢ Goodwill from previous acquisitions is ignored

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Exercises

Exercises relating to goodwill calculation

1. A ltd purchased the entire share capital of B ltd on 1st Jan 2017. On this date the Statement of Financial Position of B was as follows.

B Ltd

	Rs.'000
PPE	60
Trade receivable	7
Cash	3
Total assets	70
Stated capital	20
Retained earnings	20
Liabilities	30
Total equity and liabilities	70

A Ltd paid Rs. 50,000 to acquire B ltd and incurred Rs. 2,000 on legal charges to complete the formalities. Further A also transferred the ownership of a land it owned to the previous owner of B. This land had a carrying amount (book value) of Rs. 3,000 and a fair value of Rs.4, 000.

Further, A issued 4 shares in exchange for every 10 shares of B. B's shares were trading in the market at a value of Rs.4 each and A's shares were trading at a value of Rs.6 each. B had 1000 shares in issue before the acquisition took place.

A also entered into an agreement with B's previous owner to pay an additional Rs.242 on 1st Jan 2019, in relation to this acquisition. Assume a discount rate of 10%.

A Further agreed that if B makes profits above Rs.5, 000 per annum for the next 2 years it will make an additional payment on 1st Jan 2019 amounting to Rs.3, 000. The fair value of this amount on 1st January 2017 was Rs.2, 200 and on 31st December 2017 was Rs.2, 600.

Required

- **Calculate the cost of combination**
- **Calculate the Goodwill on the acquisition**

2. P acquired the entire share capital of S on 1st April 2017 by paying Rs.100, 000 in cash. The expenses on the acquisition amounted to Rs.1, 000. P also agreed to pay Rs.7, 406 after 3 years. Assume a discount rate of 15%. The Statement of Financial Position as at 1st April 2017 of S Ltd was as follows.

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S Ltd

	Rs.'000
PPE	80
Trade receivables	15
Cash	5
Total assets	100
Stated capital	50
Retained earing	20
Liabilities	30
Total equity and liabilities	100

On this date the PPE of S Ltd included a land carried at a value of Rs.30, 000 which had a fair value of Rs.45, 000. S Ltd also possessed a well-known brand which had a fair value of Rs.3, 000. The company had not recognized a bad debt amounting to Rs.1, 000. An employee had filed a case against the company claiming compensation of Rs.5, 000. No provision has been made in this regard. The fair value adjustments give rise to temporary differences which create a deferred tax liability of Rs.4, 000.

Required

- **Calculate the Goodwill on the acquisition**

3. King acquired 80% of the shares of Queen on 1 Jan 2017 at a value of Rs.1, 000. The Statement of Financial Position of Queen on the date of acquisition was as shown below.

	Queen
Non-current assets	1,200
Current assets	600
Total assets	1,800
Stated capital	600
Retained earnings	500
Liabilities	700
Total equity and liabilities	1,800

The shares of Queen were being traded at a price of Rs.12.5 each and had a total of 100 shares in issue.

Required

- **Calculate the Goodwill if Non-Controlling interest was measured at proportion of net assets**

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- **Calculate the Goodwill if Non-Controlling interest was measured at Fair value and for this purpose the market value of the shares were to be used.**

4. P acquired 70% of the capital of S on 1st April 2017 by paying Rs.100, 000 in cash. The Statement of Financial Position as at 1st April 2017 of S Ltd was as follows.

S Ltd

	Rs.'000
PPE	80
Trade receivables	15
Cash	5
Total assets	100
Stated capital	50
Retained earnings	20
Liabilities	30
Total equity and liabilities	100

On this date the PPE of S Ltd included a land carried at a value of Rs.30, 000 which had a fair value of Rs.35, 000. S was catering to a very specific customer segment and had a very well recognized trade mark and it was valued atRs.4, 000. An employee had filed a case against the company at claiming compensation of Rs.6, 000. No provision has been made in this regard.

S Ltd had 1,000 shares in issue and the market price per share was Rs.120 each.

Required

- **Calculate the Goodwill if Non-Controlling interest was measured at proportion of net assets**
- **Calculate the Goodwill if Non-Controlling interest was measured at Fair value and for this purpose the market value of the shares were to be used.**

Practice questions

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Question 1

Kayte operates in the shipping industry and owns vessels for transportation. In June 2014, Kayte acquired Ceemone whose assets were entirely investments in small companies. The small companies each owned and operated one or two shipping vessels. There were no employees in Ceemone or the small companies. At the acquisition date, there were only limited activities related to managing the small companies as most activities were outsourced. All the personnel in Ceemone were employed by a separate management company. The companies owning the vessels had an agreement with the management company concerning assistance with chartering, purchase and sale of vessels and any technical management. The management company used a shipbroker to assist with some of these tasks.

Kayte accounted for the investment in Ceemone as an asset acquisition. The consideration paid and related transaction costs were recognized as the acquisition price of the vessels. Kayte argued that the vessels were only passive investments and that Ceemone did not own a business consisting of processes, since all activities regarding commercial and technical management were outsourced to the management company. As a result, the acquisition was accounted for as if the vessels were acquired on a stand-alone basis.

Required:

Discuss the accounting treatment of the above transactions in the financial statements of Kayte.

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ANSWER

The accounting for the transaction as an asset acquisition does not comply with the requirements of SLFRS 3 Business Combinations and should have been accounted as a business combination. This would mean that transaction costs would be expensed, the vessels recognized at fair value, any deferred tax recognized at nominal value and the difference between these amounts and the consideration paid to be recognized as goodwill.

In accordance with SLFRS 3, an entity should determine whether a transaction is a business combination by applying the definition of a business in SLFRS 3. A business is an integrated set of activities and assets which is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants. A business consists of inputs and processes applied to those inputs which have the ability to create outputs. Although businesses usually have outputs, outputs are not required to qualify as a business.

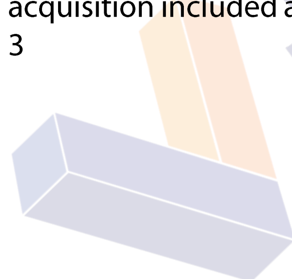
When analyzing the transaction, the following elements are relevant:

(i) Inputs: Shares in vessel owning companies, charter arrangements, outsourcing arrangements with a management company, and relationships with a shipping broker.

(ii) Processes: Activities regarding chartering and operating the vessels, financing the business, purchase and sales of vessels.

(iii) Outputs: Ceemone would generate revenue from charter agreements and has the ability to gain economic benefit from the vessels.

SLFRS 3 states that whether a seller operated a set of assets and activities as a business or intends to operate it as a business is not relevant in evaluating whether it is a business. It is not relevant therefore that some activities were outsourced as Ceemone could chose to conduct and manage the integrated set of assets and activities as a business. As a result, the acquisition included all the elements which constitute a business, in accordance with SLFRS 3



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Question 2

On 28 February 2017, Canto acquired all of the share capital of Binlory, a company which manufactures and supplies industrial vehicles. At the acquisition date, Binlory has an order backlog, which relates to a contract between itself and a customer for 10 industrial vehicles to be delivered in the next two years.

In addition, Binlory requires the extensive use of water in the manufacturing process and can take a pre-determined quantity of water from a water source for industrial use. Binlory cannot manufacture vehicles without the use of the water rights. Binlory was the first entity to use water from this source and acquired this legal right at no cost several years ago. Binlory has the right to continue to use the quantity of water for manufacturing purposes but any unused water cannot be sold separately. These rights can be lost over time if non-use of the water source is demonstrated or if the water has not been used for a certain number of years. Binlory feels that the valuation of these rights is quite subjective and difficult to achieve.

The directors of Canto wish to know how to account for the above intangible assets on the acquisition of Binlory. (7 marks)

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ANSWER

SLFRS 3 Business Combinations states that an acquirer should recognize, separately from goodwill, the identifiable intangible assets acquired in a business combination. An asset is identifiable if it meets either the reparability or contractual-legal criteria in LKAS 38 Intangible Assets. Customer relationship intangible assets may be either contractual or non-contractual. Contractual customer relationships are normally recognized separately from goodwill as they meet the contractual-legal criterion. However, non-contractual customer relationships are recognized separately from goodwill only if they meet the separable criterion.

Consequently, determining whether a relationship is contractual is critical to identifying and measuring both separately recognized customer relationship intangible assets and goodwill, and different conclusions could lead to substantially different accounting outcomes.

In the case of accounting for the acquisition of Binlory, the order backlog should be treated as an intangible asset on the acquisition. The fair value of the order backlog is estimated based on the expected revenue to be received, less the costs to deliver the product or service.

Canto has acquired water acquisition rights as part of a business combination.

The rights are valuable, as Binlory cannot manufacture vehicles without them. The rights were acquired at no cost and renewal is certain at little or no cost. The rights cannot be sold other than as part of the sale of a business as a whole, so there exists no secondary market in the rights. If Binlory does not use the water, then it will lose the rights. In this case, the legal rights cannot be measured separately from the business as a whole and therefore from goodwill. Binlory would not be able to manufacture without the rights. Therefore, the legal rights should not be accounted for as a separate intangible asset acquired in the business combination because the fair value cannot be measured reliably as the legal rights cannot be separated from goodwill.

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