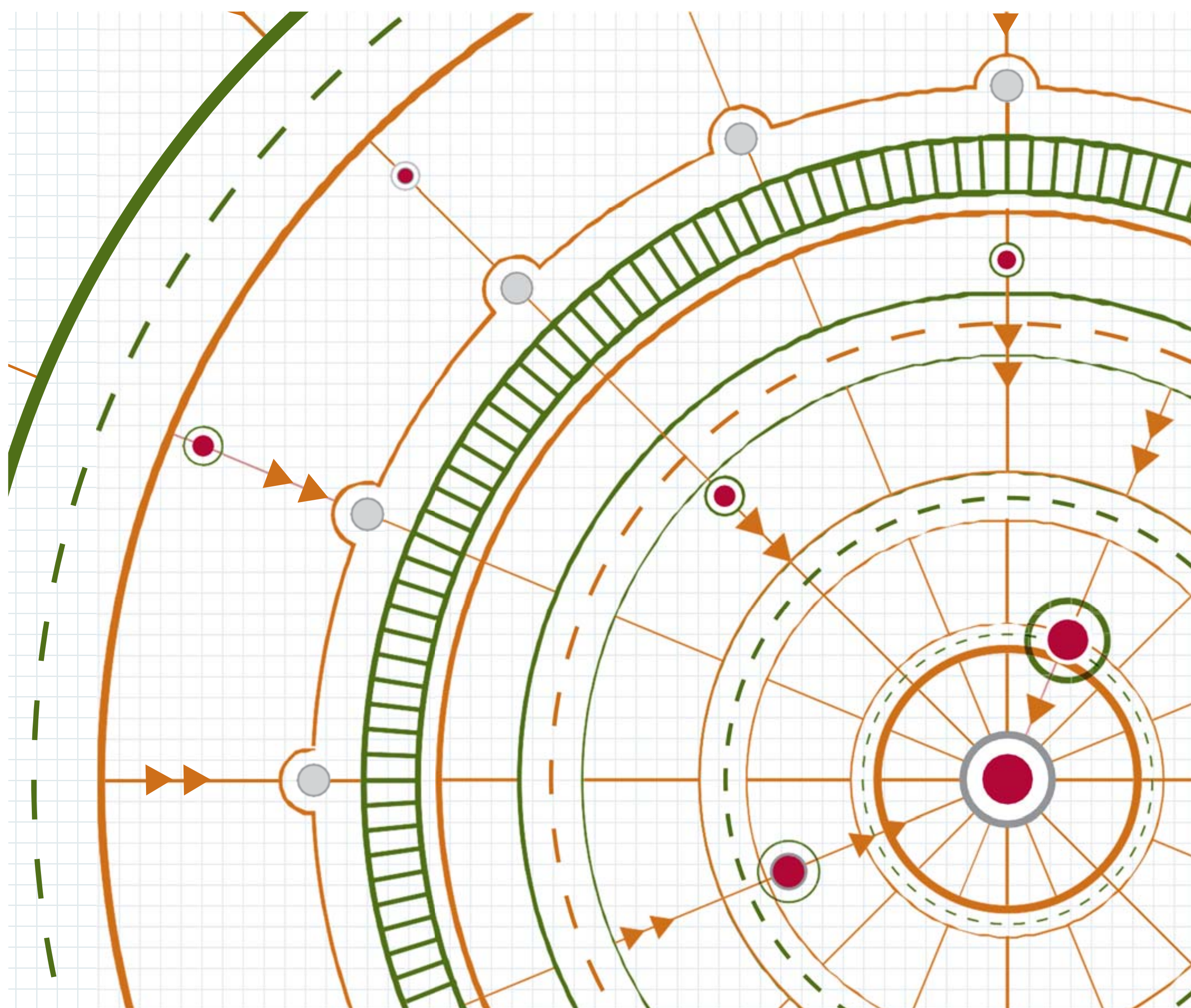
IFRS® Foundation—Supporting Material for the *IFRS for SMEs* Standard

Module 19—Business Combinations and Goodwill



IFRS®

IFRS® Foundation Supporting Material for the *IFRS for SMEs®* Standard

including the full text of
Section 19 *Business Combinations and Goodwill*
of the *IFRS for SMEs* Standard
issued by the International Accounting Standards Board in October 2015

with extensive explanations, self-assessment questions and case studies

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Module 19–Business Combinations and Goodwill

The accounting requirements applicable to small and medium-sized entities (SMEs) discussed in this module are set out in the *IFRS for SMEs* Standard, issued by the International Accounting Standards Board (Board) in October 2015.
This module has been prepared by IFRS Foundation education staff.
The contents of Section 19 *Business Combinations and Goodwill* of the I*FRS for SMEs* Standard are set out in this module and shaded grey. The Glossary of terms of the *IFRS for SMEs* Standard (Glossary) is also part of the requirements. Terms defined in the Glossary are reproduced in **bold type** the first time they appear in the text of Section 19. The notes and examples inserted by the education staff are not shaded. These notes and examples do not form part of the *IFRS for SMEs* Standard and have not been approved by the Board.

INTRODUCTION

Which version of the *IFRS for SMEs*® Standard?

When the *IFRS for SMEs* Standard was first issued in July 2009, the Board said it would undertake an initial comprehensive review of the Standard to assess entities' experience of the first two years of its application and to consider the need for any amendments. To this end, in June 2012, the Board issued a Request for Information: *Comprehensive Review of the IFRS for SMEs*. An Exposure Draft proposing amendments to the *IFRS for SMEs* Standard was subsequently published in 2013, and in May 2015 the Board issued *2015 Amendments to the IFRS for SMEs* Standard.

The document published in May 2015 only included amended text, but in October 2015, the Board issued a fully revised edition of the Standard, which incorporated additional minor editorial amendments as well as the substantive May 2015 revisions. This module is based on that version.

The *IFRS for SMEs* Standard issued in October 2015 is effective for annual periods beginning on or after 1 January 2017. Earlier application was permitted, but an entity that did so was required to disclose the fact.

Any reference in this module to the *IFRS for SMEs* Standard refers to the version issued in October 2015.

This module

This module focuses on the general requirements for the accounting for and the reporting of business combinations and goodwill applying Section 19 *Business Combinations and Goodwill* of the *IFRS for SMEs* Standard. It introduces the subject and reproduces the official text along with explanatory notes and examples designed to enhance understanding of the requirements. The module identifies the significant judgements required in the accounting for and the reporting of business combinations and goodwill. In addition, the module includes questions designed to test your understanding of the requirements and case studies that provide a practical opportunity to apply the requirements to account for and report business combinations and goodwill applying the *IFRS for SMEs* Standard.
Upon successful completion of this module, you should, within the context of the *IFRS for SMEs* Standard, be able to:

- identify a business combination;

- understand and apply the purchase method of accounting for business combinations;
- identify the acquirer in a business combination;
- 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 negative goodwill;
- account for goodwill after its initial recognition;
- determine what information should be disclosed about a business combination; and
- demonstrate an understanding of the significant judgements that are required in accounting for business combinations and goodwill.

Throughout this module, references are made to IFRS 3 *Business Combinations*[1] for those SMEs that may have more complex transactions and/or would like further guidance that they can consider when applying the requirements of this section of the *IFRS for SMEs* Standard. However, these references to IFRS 3 are not required to be used and most SMEs will be able to apply the requirements in Section 19 without such further guidance.

IFRS for SMEs Standard

The *IFRS for SMEs* Standard is intended to apply 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* Standard is comprised of mandatory requirements and other non-mandatory material.

The non-mandatory material includes:

- a preface, which provides a general introduction to the *IFRS for SMEs* Standard and explains its purpose, structure and authority;
- implementation guidance, which includes illustrative financial statements and a table of presentation and disclosure requirements;
- the Basis for Conclusions, which summarises the Board's main considerations in reaching its conclusions in the *IFRS for SMEs* Standard issued in 2009 and, separately, in the 2015 Amendments; and
- the dissenting opinion of a Board member who did not agree with the issue of the *IFRS for SMEs* Standard in 2009 and the dissenting opinion of a Board member who did not agree with the 2015 Amendments.

In the *IFRS for SMEs* Standard, Appendix A: Effective date and transition, and Appendix B: Glossary of terms, are part of the mandatory requirements.

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

[1] Both the 2004 version (the version on which Section 19 is generally based) and the 2008 version (the latest version in full IFRS Standards) are referred to in this module.

Module 19–Business Combinations and Goodwill

The *IFRS for SMEs* Standard has been issued in two parts: Part A contains the preface, all the mandatory material and the appendices to Section 21, Section 22 and Section 23; and Part B contains the remainder of the material mentioned above.

Further, the SME Implementation Group (SMEIG), which assists the Board with supporting implementation of the *IFRS for SMEs* Standard, publishes implementation guidance as 'questions and answers' (Q&As). These Q&As provide non-mandatory, timely guidance on specific accounting questions raised with the SMEIG by entities implementing the *IFRS for SMEs* Standard and other interested parties. At the time of issue of this module (January 2019) the SMEIG has not issued any Q&As relevant to this module.

Introduction to the requirements

The objective of general purpose financial statements of a small or medium-sized entity is to provide information about the entity's financial position, performance and cash flows that is useful for economic decision-making by a broad range of users who are not in a position to demand reports tailored to meet their particular information needs. Such users include, for example, owners who are not involved in managing the business, existing and potential creditors and credit rating agencies.

The objective of Section 19 is to prescribe 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.

Business combinations are accounted for by applying the purchase method, which involves the following three steps:

- 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 amortisation and accumulated impairment losses. Goodwill is considered to have a finite useful life and is amortised over that finite period.

Section 19 also specifies disclosure requirements for business combinations that were effected in the reporting period and for goodwill that is recognised in the statement of financial position.

Module 19–Business Combinations and Goodwill

What has changed since the 2009 IFRS for SMEs Standard

The 2015 Amendments changed Section 19 by:

- replacing the undefined term 'date of exchange' with the defined term 'date of acquisition' (see paragraph 19.11(a));
- adding clarifying guidance on the measurement requirements for employee benefit arrangements, deferred tax and non-controlling interests when allocating the cost of a business combination (see paragraph 19.14); and
- adding an undue cost or effort exemption to the requirement to recognise intangible assets separately in a business combination and adding a disclosure requirement for all entities to provide a qualitative description of the factors that make up any recognised goodwill (see paragraphs 19.15(c)–(d) and 19.25(g)).

The 2015 amendments also made consequential changes to paragraph 19.2(a) relating to changes to the definition of 'combined financial statements' in Section 9 *Consolidated and Separate Financial Statements* to refer to entities under common control, instead of only those under common control by a single investor. There are also consequential changes to paragraphs 19.23(a) and 19.26 relating to changes to Section 18 *Intangible Assets other than Goodwill* requiring that if the useful life of goodwill or another intangible asset cannot be established reliably, the useful life shall be determined based on management's best estimate but shall not exceed 10 years.

All the changes are covered in this module. In addition, this module reproduces other editorial changes.

Module 19–Business Combinations and Goodwill

REQUIREMENTS AND EXAMPLES

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 (or entity) acquired constitutes a business.

A business is 'an integrated set of activities and assets 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* Standard, they can be given the meanings set out below, which are taken from paragraphs B7–B8 of IFRS 3 *Business Combinations* (2008).[2]

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, and 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 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.

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

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.

Examples—a business[3]

Ex 1 **SME A is an IT company that applies a computer programming process to develop accounting software and sells that software directly to customers. It has the intellectual property, staff and non-current assets (for example, computer equipment) 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 programming processes to develop accounting software for sale to customers) is being managed by SME A to provide returns to its owners. The business consists of inputs (for example, intellectual property, staff and non-current assets) and processes applied to the inputs (managed computer programming processes to develop accounting software) that result in outputs (accounting software) generating revenue.

Ex 2 **SME A develops and sells 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 for developing and selling software. However, since its inception, SME A has produced no revenue 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 programming process to develop accounting software for sale.

The operation includes all the inputs and processes necessary for managing and producing outputs. It is an integrated set of activities and assets that are conducted and managed for the purpose of providing a return to investors.

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 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. At the time of acquisition, the integrated set of

[3] Throughout the examples in this module (unless otherwise stated), income tax has been ignored.

activities and assets that SME B acquired (SME A's operation) was being conducted and managed to provide returns or other forms of economic benefits to its owners. 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, a wholly-owned subsidiary of a listed entity, is a market expansion service provider. Its operation is divided into five core business units—sourcing, market analysis and research, marketing and sales, distribution and logistics, and after-sales services. Each business unit uses dedicated property, plant and equipment and has separate contracts with third parties, management, employees and sales departments. However, all services are carried out under a common brand name.**

Each of the business units that together comprise SME A is a separate business—each operation has distinct inputs (equipment, management, employees), processes (strategic management processes, operational processes and resource management processes) and outputs (services).

The fact that the services are carried out under a common brand name is irrelevant for determining whether each operation is a business. SME A being a wholly-owned subsidiary of a listed entity is also irrelevant in determining whether the entity satisfies the definition of a business under the *IFRS for SMEs* Standard.

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

The business SME A acquired has all three components of a business: inputs (assets, for example, buildings, furniture and fixtures and inventory; management; employees), processes (reservations system and 'back office' operations) and outputs (hotel services) and is capable of providing returns or other forms of economic benefits 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. They have no integrated set of activities or processes to apply to the building to create outputs. In the absence of other relevant facts, the building on its own is not being managed to provide returns or other forms of economic benefits to its owners.

Example—not all 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. SME A is acquiring SME B's telescope business, which is not a separate entity (subsidiary). Consequently, SME A would not be required to prepare consolidated financial statements (unless SME A already has subsidiaries).

A business can be an integrated set of activities and assets without the existence of an entity and therefore not all business combinations will result in a parent-subsidiary relationship.

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 or parties 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* Standard does not specify how to account for such combinations, the management of an entity must, applying paragraph 10.4, use its judgement in developing and applying an accounting policy that results in information that is reliable and relevant to the economic decision-making needs of users. That is, using the accounting policy must result in financial statements that:

- represent faithfully the financial position, financial performance and cash flows of the entity;
- reflect the economic substance of transactions, other events and conditions, and not merely the legal form;
- are neutral, free from bias;

- are prudent; and
- are complete in all material respects.

Paragraph 10.5 of Section 10 *Accounting Policies, Estimates and Errors* specifies that in developing and applying such accounting policies, management must refer to and consider, in descending order, the applicability of:

- the requirements and guidance in the *IFRS for SMEs* Standard dealing with similar and related issues; and
- the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses and the pervasive principles in Section 2 *Concepts and Pervasive Principles*.

The *IFRS for SMEs* Standard also permits management to consider the requirements and guidance in full IFRS Standards (see paragraph 10.6). Doing so, however, does not provide any additional guidance in this case because full Standards contain the same exclusion for combinations of entities under common control (see IFRS 3).

The scope exception in paragraph 19.2(a) does not preclude an entity from applying Section 19 to a business combination under common control. However, the exception means 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 consider pronouncements from other standard-setting bodies, other accounting literature and accepted industry practice, to the extent that these do not conflict with the hierarchy in paragraph 10.5. Taking this alternative approach may lead to the use of other methods, such as the pooling of interests method.

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 applying Section 15 *Investments in Joint Ventures*.

A group of assets

The acquisition of a group of assets that does not constitute a business is accounted for applying other sections of the *IFRS for SMEs* Standard. Each asset will be accounted for applying the relevant section, for example, if an acquired asset qualifies as property, plant or equipment, Section 17 *Property, Plant and Equipment* would apply.

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, nor did it acquire any processes to run the station from SME B. SME A did not ‘take on’ any of SME B’s employees (it purchased only the property, plant and equipment).**

This transaction is not a business combination. SME A merely acquired a group of assets. In other words, in the absence of accompanying processes and outputs, the inputs on their own cannot constitute a business. Consequently, SME A accounts for the acquisition of the petrol station assets applying Section 17 rather than Section 19.

Ex 9 **SME A and SME B each acquired 50% of SME C's ordinary shares that carry voting rights at general meetings of shareholders. SME C manufactures plastic containers for storing edible oils and sells those containers to several third party entities. The terms of the contractual arrangement between SME A and SME B specify that strategic decisions relating to SME C require the approval of both SME A and SME B.**

This transaction is not a business combination. Instead, it represents the formation of a joint venture—SME A and SME B have contractually agreed to share control of SME C. 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 applying Section 15 rather than Section 19.

Ex 10 **SME A operates a painting and decorating business and is owned entirely by Mr X. Mr X also owns SME B, which operates a garden maintenance business. Both businesses had been operating successfully for 10 years when Mr X decided to transfer his shares in SME B to SME A due to significant tax savings Mr X will potentially realise.**

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 accounting for this 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, applying paragraph 10.4, use its judgement in developing and applying an appropriate accounting policy. SME A might consider using the purchase method of accounting (applying the method set out in Section 19). Alternatively, SME A could consider the pronouncements of other standard-setting bodies, other accounting literature and accepted industry practice, to the extent that these do not conflict with the hierarchy in paragraph 10.5.

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 Standards or the *IFRS for SMEs* Standard, 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. Accounting for such combinations is not specified in Section 19 (see paragraph 19.2(a)). Accordingly, SME B must, applying paragraph 10.4, use its judgement in developing and applying an appropriate accounting policy.

SME B might consider using the purchase method of accounting (applying the method set out in Section 19). Alternatively, SME B could consider the pronouncements of other standard-setting bodies, other accounting literature and accepted industry practices, to the extent that these do not conflict with the hierarchy in paragraph 10.5.

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 obtains control of the acquiree.

Notes

For all business combinations, the acquirer must identify the acquisition date—the date on which the acquirer obtains control of the acquiree or of the business acquired. The acquisition date is often the date on which the acquirer legally transfers the consideration, becomes the legal owner of the acquiree, 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 the date written in relevant documents; it is the date on which the acquirer obtains control of the acquiree.

The following might be relevant in determining the acquisition date:

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

Examples—date of acquisition

Ex 12 **The shares in SME B are owned equally 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 acquired the shares in SME B that were owned by Y in exchange for cash of CU11,200.**

The date of acquisition (being the date the acquirer obtains control of the acquiree) is 1 March 20X2.

Ex 13 **On 15 January 20X1, SME A signed an agreement for the purchase of 100% 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 B and appointed directors of its choice. On 1 April 20X1, ownership of all of the shares in SME B transferred to SME A and the consideration was 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 14 **On 1 January 20X1, the owners of SME A and SME B commenced negotiations relating to the acquisition of 100% 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.

The price is based on the net assets at 1 January 20X1 and the former owners of SME B are not entitled to any dividends after that date. However, 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. 1 January 20X1 is not the acquisition date as it is only a practical expedient for working out the price (being the basis of the consideration) and that SME B's management were still controlling the business at that date up until 1 April 20X1.

Ex 15 **On 1 January 20X1, SME A makes an offer to acquire 100% 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 concerning SME B is made. SME A will be entitled to all profits from SME B after 1 January 20X1 if the acquisition is successfully completed. On 2 February 20X1, the due diligence is successfully completed, and the consideration and shares are transferred on the same day.**

In the absence of evidence to the contrary, the acquisition date is 2 February 20X1—the date on which SME A obtains control of SME B. Although SME A has to be consulted regarding any major decision made in relation to SME B after 1 January 20X1, this does not in itself mean 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 16 **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 (that is, a significant influence), but not to control SME B.**

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 (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 17 **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 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* Standard applies to business combinations regardless of the form of the transaction. Possible structures include:

- an acquirer obtaining the equity of another business such that the business becomes a subsidiary of the acquirer;
- one or more unincorporated businesses being purchased by an acquirer and forming part of the acquirer, without becoming its subsidiary or subsidiaries; and
- two or more entities combining by transferring their equity interests or net assets to a newly formed entity.

The consideration can take various forms (for example, equity instruments, cash, cash equivalents, other assets, or a combination of any of these). Transactions involving 'other assets' may involve the transfer of tangible assets, such as property, or intangible assets, such as patents.

Examples—ways of effecting a business combination

Ex 18 **SME A delivers CU375,000[4] cash in exchange for receiving all of the equity interests in SME B, a company operating a car hire business.**

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

Ex 19 **SME A delivers CU300,000 cash in exchange for receiving 80% of the equity interests in SME B, a company operating an IT business.**

This transaction is a business combination effected by the transfer of cash to the previous owners of 80% of the shares in SME B.

Ex 20 **SME A issues 10,000 new shares in itself in exchange for receiving 80% 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 effected by the transfer of SME A's equity instruments to the previous owners of 80% of the shares in SME B.

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

Ex 21 **SME A acquires 100% 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% of the equity instruments of SME A; and**
- **1,000 shares in Entity C.**

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

Ex 22 **SME A has two divisions: a shoe manufacturing division, and a division that manufactures 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 effected by the transfer of cash to the previous owners of the business.

Ex 23 **SME A and SME B enter into an agreement to merge their businesses. SME A and SME B achieve this 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 effected by the transfer of SME A's equity instruments to the previous owners of the equity instruments in SME B.

Ex 24 **SME A and SME B enter into an agreement to merge their businesses. SME A and SME B achieve this 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 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. However, SME C may not be the identified as the acquirer (see examples 27–29.)

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; and

(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. If the business combinations involved entities that separately retained their legal form, the acquirer will have to prepare consolidated financial statements subject to certain exemptions in Section 9 *Consolidated and Separate Financial Statements*. The acquirer's consolidated financial statements enable users to assess and compare the performance of a group of entities with that of other entities (for example, with the performance of an individual, stand-alone entity).

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 yields financial statements that include 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.

The *IFRS for SMEs* Standard does not permit the use of the pooling of interests method when accounting for a business combination within the scope of Section 19. The pooling of interests method is commonly used for business combinations of entities under common control that combine the pre-business combination carrying amounts of assets, liabilities and 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* Standard:

- 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.

Examples—applying the purchase method

Ex 25 **SME A purchased a competitor's (SME B's) taxi business for CU42,000, which was paid in cash on the date of acquisition. The business combination was effected when the assets, obligations and operations of the taxi business were 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

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

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

	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
Retained earnings	100,000
Total equity	**105,000**

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, a contingent liability for which a fair value can be measured reliably), at their respective fair values at the date of acquisition with the following journal entry:

		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] Excess of the cost of the business combination over the identifiable assets acquired and liabilities and contingent liabilities assumed (see paragraph 19.14).

Immediately after the acquisition, SME A's statement of financial position would be as follows:

	Before acquisition CU	*Effect of acquisition* CU	*After acquisition* 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
Retained earnings	100,000	–	100,000
Total equity	**105,000**	**–**	**105,000**

Ex 26 **The facts are the same as in Example 25. However, in this example, the business combination was effected when SME A, the acquirer, bought (for CU42,000 cash) 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. Consequently, the investment would be recognised at CU42,000.

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

In preparing SME A's consolidated statement of financial position at the acquisition date, management would make 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 immediately after the acquisition would be calculated as follows (assuming SME B had share capital of CU1,000 and retained earnings of CU19,000):

	SME A	**SME B**	**Consolidation adjustments**	**Consolidated**
	Carrying amount	*Carrying amount*		
	CU	CU	CU	CU
Assets				
Non-current assets				
Investment in subsidiary	42,000	–	(42,000)	–
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
	87,000	20,000	(19,000)	88,000
Current assets				
Cash	18,000	–	–	18,000
	18,000	–	–	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
Retained earnings	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. Accounting for a business combination applying the *IFRS for SMEs* Standard requires the identification of the acquirer. Making such an identification is usually straightforward, but in some cases, especially those involving combinations sometimes referred to as 'mergers of equals', identifying the acquirer may pose more difficulty.

The key to identifying the acquirer is first to establish which entity has control over the other. 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 *Consolidated and Separate Financial Statements* (paragraphs 9.4–9.6).

In assessing whether one entity controls another, all the facts and circumstances are considered. The main judgements in determining control are set out in Section 9.

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; and

(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 to assist with identifying the acquirer.

In most business combinations involving SMEs it will be clear which entity is the acquirer. In more complex cases an entity may, but is not required to, refer to IFRS 3 which provides more detailed application guidance for identifying the acquirer in a business combination (see paragraph 10.6). The following is based on the guidance in IFRS 3 (2008).
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 should also be considered when identifying the acquirer in a business combination effected by exchanging equity interests, including:

- the relative voting rights in the combined entity after the business combination. The acquirer is usually the combining entity whose owners as a group retain or receive 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.
- 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 body of the combined entity.
- 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 involves considering, 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 difficult 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.

Examples—identifying the acquirer

Ex 27 **SME A delivers CU375,000 cash and issued 1,000 of its own equity instruments (approximately 5% of its total share capital) in exchange for receiving all of the equity interests in SME B, a company operating a car hire business.**

The business combination results in SME A controlling SME B. SME A is the acquirer.

Ex 28 **The facts are the same as in Example 23. Further, SME A issued shares such that after the business combination the shareholding structure of SME A is that 60% are held by its original owners while 40% are held by the previous owners of SME B.**

The business combination results in SME A controlling SME B. In the absence of other information, the acquirer is usually the combining entity whose owners as a group retain or receive the largest portion of the voting rights in the combined entity. SME A is the acquirer.

Ex 29 **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 structures 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 30 **The facts are the same as in Example 29. 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 31 **The facts are the same as in Example 29. 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 board of directors, the latter's governing body.**

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

Ex 32 **On 31 December 20X0 SME A had 100 shares in issue. On 1 January 20X1 SME A acquired 100% 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 and SME A will be required to prepare consolidated financial statements (unless exempt by Section 9). 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* Standard, 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% shareholding in SME A (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 acquisition, 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 acquisition

Paragraph 19.11 of the *IFRS for SMEs* Standard refers to the fair value of the consideration 'at the date of acquisition'. The date of acquisition is the date on which the acquirer obtains control of the acquiree (see paragraph 19.3).

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 that is not in the form of cash requires a value to be placed on it for the acquirer to calculate exactly how much it paid for the acquired business. The fair value of the consideration is used for this purpose. Even consideration in the form of cash may need to be adjusted. For example, if an entity paid CU100,000 to acquire all of the equity in another entity, the cost of the business combination is the fair value of the cash transferred. If the CU100,000 is paid to the former owners immediately, the fair value will be the nominal value of CU100,000. If instead the cash of CU100,000 is paid, say, one year after the acquisition date and the applicable interest rates are 5% a year, the present value of the cash at the acquisition date, CU95,238 (CU100,000 discounted at 5%), 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 acquisition date fair value of those forms of payment may require significant estimates and judgements.

Section 19 does not provide guidance on how to measure fair value. Paragraphs 11.27–11.32 provide guidance on fair value measurement. That guidance includes a hierarchy for estimating fair value (see paragraph 11.27).

Example—non-monetary assets and equity instruments

Ex 33 **SME A acquires 100% 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 in the jurisdiction = CU1,000 per gold bar).**

- **10% of the equity instruments of SME A (share capital of SME A consists of 10,000 ordinary, fully paid shares; the fair value of each share at the acquisition date was CU10—the fair value was measured using an income approach (discounted cash flows) based on market participant assumptions).**
- **1,000 shares of a third party (Entity C). Entity C's shares are actively traded on the stock exchange (acquisition-date fair value = CU6 per share).**

The cost of the business combination is CU78,000.

Calculation:

	CU
Cash paid immediately	10,000
Fair value of the office building	50,000
Fair value of two gold bars	2,000
Equity instruments of SME A	10,000
Equity instruments of Entity C	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 34 **On 1 January 20X1 SME A acquired 100% 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 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% each year 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 the acquirer incurs directly to effect the 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 profit or loss in the year of acquisition). The costs include finders' fees and advisory, legal, accounting, valuation and other professional or consulting fees. These costs are incremental in the acquisition of the acquiree. 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.

The 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 applying

paragraphs 11.13 and 22.8, respectively, of the *IFRS for SMEs* Standard; they are not treated as part of the costs that are directly attributable to the business combination.

Examples—directly attributable costs

Ex 35 **SME A acquires 100% 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 36 **The facts are the same as in Example 35. However, in this example, SME A acquires 100% 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) being above an agreed target over an agreed period;
- a licence or patent being approved within an agreed period;
- completion of specified contract negotiations in an agreed period; and
- cash flow arising from specified assets being 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) 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).

The assessment as to whether the payment of contingent consideration is probable must be based on all facts and circumstances at the acquisition date.

Once it has been determined that a payment is probable and can be measured reliably, it is included in the cost of the business combination. For example, if it is probable that cash of CU200,000 will be paid 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 37 **On 1 January 20X3 SME A acquired 100% 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%, CU7,000 if the weighted average ROA was higher than 14%, CU1,000 if the weighted average ROA was positive but lower than 6% 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% and, therefore, at the acquisition date, it was probable that a payment of CU4,000 would be made on 1 January 20X7. Assuming the applicable discount rate for four years at the acquisition date is 5%, SME A will measure 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 (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%, SME A would pay the additional consideration of CU4,000 on 1 January 20X7. The difference of CU709 between the nominal amount paid (CU4,000) and its present value (CU3,291) 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. The accounting for the provision (the liability) is covered by Section 21 *Provisions and Contingencies.*

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.

Notes

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 38 **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 (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 date when the contingent consideration becomes probable would be CU454, assuming a discount rate of 5% (discounted over a period of two years). The adjustment is made at the end of year 2. Adjusting by CU454 would be consistent with the prospective adjustment to accounting estimates required by paragraphs 10.16 and 10.17 of the *IFRS for SMEs* Standard.

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 19.15 at their fair values at that date except as follows:

(a) a **deferred tax asset** or **deferred tax liability** arising from the assets acquired and liabilities assumed in a business combination shall be recognised and measured in accordance with Section 29 *Income Tax*; and

(b) a liability (or asset, if any) related to the acquiree's **employee benefit** arrangements shall be recognised and measured in accordance with Section 28 *Employee Benefits*.

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'). Any **non-controlling interest** in the acquiree is measured at the non-controlling interest's proportionate share of the recognised amounts of the acquiree's identifiable net assets.

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.

In most cases it will be clear when assets and liabilities are identifiable. However, paragraph 18.2 provides an explanation of 'identifiable' in the context of intangible assets and explains that such an asset is identifiable when it:

- is separable, that is, capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, asset or liability; 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.

With limited exceptions (described in paragraph 19.14(a) and (b)), 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 or assumes them. Paragraphs 11.27–11.32 provide guidance on fair value measurement.

Section 19 is generally based on the 2004 version of IFRS 3. The 2004 version of IFRS 3 contains application guidance for determining the fair value of particular identifiable assets and liabilities that an SME might wish to consider (but is not required to consider, see paragraph 10.6 of Section 10). The guidance in the tables below is taken from this source.

Identifiable tangible assets

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

Inventories	Finished goods. The acquirer shall use selling prices less the sum of (1) the costs of disposal and (2) a reasonable profit allowance for the selling effort of the acquirer based on profit for similar finished goods and merchandise. Work in progress. The acquirer shall use selling prices of finished goods less the sum of (1) costs to complete, (2) costs of disposal and (3) a reasonable profit allowance for the completing and selling effort based on profit for similar finished goods. Raw materials. The acquirer shall use current replacement costs.
Land and buildings	The acquirer uses market values.
Plant and equipment	The acquirer uses market values. When there is no evidence of 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 when determining which intangible assets to recognise. As stated previously, 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 acquiree's assembled workforce (an existing collection of employees that permits the acquirer to continue to operate an acquired business from the acquisition date);
- synergies from combining the acquiree's net assets with those of the acquirer; and
- greater or enhanced market share.

The tables below are based on the application supplement in the 2004 version of IFRS 3 that an SME might wish to consider (but is not required to consider, see paragraph 10.6 of Section 10). These tables show the intangible assets that typically meet the recognition criteria, and applying paragraphs 18.8 and 19.15, are recognised separately from goodwill in a business combination if their fair value can be measured reliably without undue cost or effort.

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

Financial assets

The table below is based on the application guidance from the 2004 version of IFRS 3 that an SME might wish to consider (but is not required to consider, see paragraph 10.6 of Section 10). The table shows examples of the measurement of financial assets at their fair value at the acquisition date:

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 instruments.
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.

Liabilities

The following table is based on the application guidance of the 2004 version of IFRS 3 that an SME might wish to consider (but is not required to consider, see paragraph 10.6 of Section 10). The table provides some guidance for the measurement of liabilities at the date of acquisition:

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 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 reliably (see paragraph 21.12). Consequently, an entity must not recognise a contingent liability in its statement of financial position. The exception to this is if an acquirer recognises contingent liabilities of an acquiree when it is allocating the cost of a 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. The contingent liability has been acquired as part of acquiring the business and, therefore, should be recognised as if it had been acquired directly. Applying 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 applying paragraph 19.14—see Example 53.

Measuring non-controlling interest

At the acquisition date, any non-controlling interest in the acquiree is measured at that non-controlling interest's proportionate share of the recognised amounts of the acquiree's identifiable net assets. Subsequently, the value of the non-controlling interest is increased or decreased by its share in net profit or loss and dividends declared by the acquiree (see paragraph 9.22).

Example—non-controlling interest

Ex 39 **The facts are the same as in Example 25. However, in this example, SME A only purchased 80% of SME B's equity.**

In SME A's consolidated financial statements (if prepared), the remaining 20% held by the original shareholders of SME B is accounted for as non-controlling interest. The non-controlling interest is measured as follows:

	CU
Fair value of assets acquired from SME B	41,000
Fair value of liabilities assumed from SME B	(1,000)
Fair value of net assets acquired from SME B	40,000
Equity interest held by non-controlling interest	20%
Total	**8,000**

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, its fair value can be measured reliably without undue cost or effort; and

(d) in the case of a contingent liability, its fair value can be measured reliably.

Notes

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

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

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

Paragraph 18.8 of the *IFRS for SMEs* Standard requires intangible assets acquired in a business combination to be recognised separately unless their fair value cannot be measured reliably without undue cost or effort at the acquisition date. Considering whether determining the fair value would involve undue cost or effort depends on the entity's specific circumstances and on management's judgement in assessing the costs and benefits. This judgement requires consideration of how the economic decisions of expected users of the financial statements could be affected by not having that information. Applying a requirement would involve undue cost or effort by an SME if the incremental cost (for example, valuers' fees) or additional effort (for example, endeavours by employees) substantially exceeds the benefits that expected users of the SME's financial statements would receive from having the information (see paragraph 2.14B). If an SME already has, or could easily and inexpensively acquire, the information necessary to comply with a requirement, any related undue cost or effort exemption would not be applicable. In that case, the benefits to the users of the financial statements of having the information would be expected to exceed any further cost or effort by the SME. Assessing whether a requirement would involve undue cost or effort on initial recognition in the financial statements, for example at the date of acquisition, should be based on information about the costs and benefits of the requirement at the time of initial recognition.

Where an entity uses the undue cost or effort exemption, intangible assets are not recognised separately at the acquisition date in a business combination.

Examples—recognition of acquiree's identifiable assets, liabilities and contingent liabilities

Ex 40 **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 (former participants) that includes names, contact information, history of prior training sessions attended and feedback regarding subjects of interest. Applying paragraph 18.4 of the *IFRS for SMEs* Standard, 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 provided the terms of confidentiality or other agreements do not prohibit SME B from selling, leasing or otherwise exchanging information about its customers.

Had SME A acquired the trade and assets of SME B (rather than buying the shares in SME B), SME A would recognise the database in its individual entity statement of financial position because it would still be acquired in a business combination.

Ex 41 **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 recognised the**

patent, but not recognised the related development expenditure as an intangible asset, because all research and development costs must be expensed applying Section 18 of the *IFRS for SMEs* Standard (see paragraphs 18.14–18.15).

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 related development expenditure as intangible assets (for the same reason).

In its consolidated statement of financial position, the group must recognise the patents and the related development expenditure 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. SME A may recognise the related development expenditure of SME B at the acquisition date as a separate intangible asset if, based on SME A's assessment, it satisfies the recognition criteria in paragraph 19.15. Any subsequent expenditure on research and development by SME B after the date of acquisition cannot be recognised in SME A's consolidated statement of financial position; these would be considered as internally developed (by the group) and thus would not qualify for recognition.

The acquisition of SME B does not change the previous accounting by SME A for its own research and development and related intangibles in either the consolidated financial statements or 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 and related development expenditure acquired 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.

Ex 42 **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 fair value cannot be measured reliably without undue cost or effort.

Ex 43 **SME A acquired SME B. In a lawsuit brought against SME B before the acquisition, members of the local community are seeking compensation for damage 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% chance of being ordered to pay the compensation. Consequently, SME B did not recognise a provision in its 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 SME B only has a possible obligation and/or 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 notes and examples supporting paragraphs 19.6–19.15 analyse 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 44 **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 adviser's 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:**

	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 and share premium	5,000		2,000	
Retained earnings(b)	10,200		2,300	
	15,200		4,300	
Current liabilities				
Trade payables	300		150	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, legal and other advisers fees).

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

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 *(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 and share premium	5,000	2,000	(2,000)	5,000
Retained earnings	10,200	2,300	(2,300)	10,200
	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 applying paragraph 9.13(a).
2. Applying 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 that arose on acquisition of the subsidiary. See the following consolidation adjustment/journal entry required for preparing the consolidated financial statements at 31 December 20X1 set out in column D above:

Consolidation adjustments		
Dr. Asset—goodwill	800[(c)]	
Dr. Asset—buildings & other PPE	300	
Dr. Asset—intangible asset (customer list)	400	
Dr. Asset—inventories	100	
Dr. Equity—share capital (SME B)	2,000	
Dr. Equity—retained earnings (SME B)	2,300	
Cr. 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 building 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 in the examples supporting paragraph 19.15, 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 and liabilities at an amount that may differ (higher or lower) from the amount in the individual statement of financial position of the acquiree. Contingent liabilities that are not recognised in the acquiree's individual statement of financial position are recognised in the consolidated statement of financial position if their fair value can be measured reliably.

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 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 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 (its cost to the group). Consequently, the consolidated statement of comprehensive income for the year ended 31 December 20X1 includes a gain of CU30 (CU180 selling price minus 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 (CU180 selling price minus CU100 carrying value in SME B's statement of financial position). On consolidation an adjusting entry would be made to reduce this gain to CU30 (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 46 **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 loss of CU20 (the fair value at the date of acquisition (CU150) minus the recoverable amount (CU130)).

There would be no impairment loss recognised in the individual 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 47 **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 parent'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 (their cost to the group). Consequently, depreciation of CU15 (CU300 depreciable amount (fair value at the date of the acquisition) ÷ 20 years) is recognised in SME A's consolidated statement of comprehensive income for the year ended 31 December 20X1.

The depreciation expense recognised in SME B's individual 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 20X1	(15)	–	(10)	(5)
31 December 20X1—carrying value	**285**	**–**	**190**	**95**

Ex 48 **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 a cost of CU50. The fair value of the inventory at the date of the acquisition was CU79. 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—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 CU1 (CU80 revenue minus CU79 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 minus CU50 cost of goods sold). On consolidation an adjusting entry would be made to reduce this profit to CU1 (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	79	–	50	29
February 20X1—sales proceeds	(80)	–	(80)	–
Profit on sale	**(1)**	**–**	**(30)**	**29**

Ex 49 **The facts are the same as in Example 41. In this example, the business combination occurs on 31 December 20X1 and the fair value of the patent and development intangible asset on acquisition are as follows:**

	CU
Patent (CU8,000 in the individual financial statements of SME B with a useful life of four years amortised on a straight-line basis)	**10,000**
Development intangible asset	**40,000**

Applying paragraphs 18.19–18.20, SME A estimates the useful life of the patent and development intangible asset to be five years and adopts a straight-line method of amortisation.

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 (its cost to the group). Consequently, the cost of drugs produced after the date of acquisition (starting from 20X2 in the example) must include amortisation of SME B's patent at CU2,000 (CU10,000 ÷ 5 years) and of the capitalised expenditures incurred in developing the internally patented drugs at CU8,000 (CU40,000 ÷ 5 years).

The carrying amount of intangible assets acquired by SME A from SME B in the consolidated financial statements of SME A and individual financial statements of SME B are summarised as follows:

Patent:	*SME A's consolidated financial statements*	*Individual financial statements of SME B (if prepared)*
	CU	CU
1 January 20X2—carrying amount	50,000	8,000
Amortisation for 20X2	(10,000)	(2,000)
31 December 20X2—carrying amount	**40,000**	**6,000**

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 that satisfy the recognition criteria in paragraph 19.15. Consequently:

(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 of restructuring or exiting an acquiree's activities that are not liabilities at the date of acquisition are recognised as post-combination expenses.

Allocating the cost of a business combination to the acquiree's identifiable assets, liabilities and contingent liabilities determines 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, as 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 recognised as a liability. 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 (the one already recognised) can be recognised in the acquirer's consolidated financial statements.

Examples—liabilities for reducing the activities of the acquiree or for future losses and other costs

Ex 50 **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 pay 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 considering these restructuring costs.**

When recognising the assets acquired and liabilities and contingent liabilities assumed from 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 at CU1,000.

Ex 51 **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 a provision for these restructuring costs is not included in the identifiable net assets acquired 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 identifiable net 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 52 **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.**

When recognising SME B's identifiable assets, liabilities and provisions for contingent liabilities, 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 determining the fair value of the consideration for the business combination and 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 'negative goodwill' (also known as a bargain purchase gain) recognised. Any adjustments that arise after the measurement period has elapsed are to be accounted for in accordance with Section 10.

Example—adjustments to initial accounting

Ex 53 **At 30 September 20X5 SME A acquired 100% 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 minus the additional depreciation (CU150) 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 (of the property, plant and equipment) at the acquisition date of CU3,000 minus the decrease in goodwill amortisation of CU75 (CU3,000 ÷ 10 years ÷ 12 months × 3 for three months' amortisation).
- amortisation expense for goodwill is decreased by CU75.

Contingent liabilities

19.20 Paragraph 19.15 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—contingent liability assumed

Ex 54 **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 fair value of the claim.**

As the fair value of the contingent liability cannot be measured reliably, no liability is recognised in accounting for the business combination. The effect of this is that the amount recognised as goodwill will be smaller (or negative goodwill will be bigger). Since the amount could not be measured reliably, the disclosures required by paragraph 21.15 must be given.

19.21 After their initial recognition, the acquirer shall measure contingent liabilities that are recognised separately in accordance with paragraph 19.15 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—measurement of contingent liability assumed after initial recognition

Ex 55 **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 as the recognition criteria in Section 21 are met. The amount required to settle the claim is estimated to be CU180.**

Applying paragraph 19.15, a provision for the contingent liability was recognised at its acquisition date fair value of CU100 as a result of the business combination, even though not all of the criteria in paragraph 21.4 were met.

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 the 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.

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*). According to paragraph 19.22(b) 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. If less than 100% of the business was acquired, the acquirer's interest excludes that of the non-controlling interest. 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) (see paragraph 19.11) and to determine the fair value of the identifiable assets, liabilities and contingent liabilities acquired. Goodwill is then the residual amount, after deducting the acquirer's interest in the identifiable assets, liabilities and contingent liabilities of the acquiree.

Examples—recognition and measurement of goodwill

Ex 56 **At 1 January 20X5 SME A acquired 100% 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 [CU30,000 (cost of the business combination) minus CU27,000 (identifiable net assets at fair value at the date of acquisition)].

Ex 57 **The facts are the same as in Example 56. However, in this case SME A acquired only 80% of the equity interests in SME B for cash of CU24,000.**

SME A must recognise goodwill of CU2,400 [CU24,000 (cost of the business combination) minus CU21,600 (SME A's interest in the net assets at fair value at the date of acquisition—80% × CU27,000)].

Note: SME B's identifiable net assets are recognised in the consolidated statement of financial position at their fair value of CU27,000 (and not just SME A's 80% share of CU21,600). Equity is accordingly higher by the non-controlling interest's share of those net assets, CU5,400 (20% 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 more discussion of non-controlling interest.

Ex 58 **At 1 January 20X5 SME A acquired 100% 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 CU	*Fair value* CU
Assets		
Non-current assets		
Land	300	500
Equipment	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:

Consideration transferred		1,500
Net recognised values of SME B's identifiable assets and liabilities:		
Current assets	350	
Non-current assets	1,050	
Current liabilities	(290)	
Non-current liabilities	(170)	(940)
Goodwill		560

Notes—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 amounts attributed to those assets and liabilities by the tax authorities (such differences are called 'temporary differences') (see paragraph 29.8).

In some cases, upon acquisition, adjustments are made to the carrying amounts of the acquiree's assets, liabilities and contingent liabilities for inclusion in the group's consolidated statement of financial position; this is to recognise them at their fair values. Consequently, the group carrying amount differs from the carrying amount in the subsidiary's individual financial statements. In cases such as these, where no similar adjustments are made for tax purposes, a deferred tax asset or liability must be recognised in the consolidated financial statements and is reflected in calculating goodwill.

Example—deferred tax on fair value adjustments

Ex 59 **The facts are the same as in Example 58. In addition, at the date of acquisition, SME B had the following unrecognised items in its statement of financial position:**

Intangible asset—customer list, with fair value of	CU700
Contingent liability, with fair value of	CU300

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

SME A must recognise goodwill of CU296.

Calculation of goodwill: CU296 = CU1,500 (cost of the business combination) minus 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) minus CU896 (fair value of liabilities and contingent liabilities, including the net deferred tax liability, CU760 plus CU136[(a)]).

[(a)] The net deferred tax liability is CU200 (total deferred tax liabilities on fair value adjustments of assets, see below) minus CU64 (total deferred tax assets on fair value adjustments of liabilities, see below) = CU136. This calculation assumes that the tax base of the acquiree's assets and liabilities are equal to their carrying amounts. Although the group's carrying amount of goodwill (CU296) exceeds its tax base (nil), no deferred tax arises from this temporary difference because it is exempt from deferred tax (see paragraph 29.14(a)).

	Carrying amount CU	*Fair value* CU	*Difference* CU	*Tax (20%) on difference* CU
Customer list	–	700	700	140
Land	300	500	200	40
Equipment	500	550	50	10
Inventory	200	250	50	10
Cash	100	100	–	–
	1,100	**2,100**	**1,000**	
Total deferred tax liabilities on fair value adjustments of assets				**200**
Provisions (long-term)	150	170	20	4
Provision for contingent liability	–	300	300	60
Payables	250	250	–	–
Current tax liability	40	40	–	–
	440	**760**	**320**	
Total deferred tax assets on fair value adjustments of liabilities				**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 the **useful life** of goodwill cannot be established reliably, the life shall be determined based on management's best estimate but shall not exceed ten years.

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

Notes

Amortisation

In accordance with the *IFRS for SMEs* Standard, all intangible assets, including goodwill, are considered to have a finite useful life. Goodwill must be amortised systematically 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 the useful life of goodwill cannot be estimated reliably, the *IFRS for SMEs* Standard requires the life to be determined based on management's best estimate but not to exceed ten years.

Whenever the expected useful life of goodwill has 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 (see paragraph 18.24).

Examples—amortisation of goodwill

Ex 60 **The facts are the same as in Example 56. Further, management estimates the useful life of the goodwill to be 15 years. The estimate was made based on management's long-term business plan and review of the condition and average useful lives of the assets that make up its cash generating units.**

The amortisation of goodwill for the year ended 20X5 is CU200 (CU3,000 ÷ 15 years). Provided the principles of paragraph 18.19—18.24 were complied with and the estimate was established reliably, the useful life of the goodwill may exceed 10 years.

Ex 61 **The facts are the same as in Example 60. However, management cannot establish reliably the goodwill's useful life. Management's best estimate is 15 years.**

Amortisation of goodwill for the year ended 20X5 is CU300 (CU3,000 ÷ 10 years). If the estimate of the useful life cannot be established reliably, the life of the goodwill shall be determined based on management's best estimate but shall not exceed 10 years. If the management's best estimate is less than 10 years, say five years, the amortisation of the goodwill should be based on five years (that is, CU600 = CU3,000 ÷ 5 years).

Notes

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 *Impairment of Assets* requires that, for the purpose of impairment testing, goodwill acquired in a business combination is, from the date of acquisition, 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.

For examples on impairment of goodwill, please refer to Module 27.

Excess over cost of acquirer's interest in the net fair value of acquiree'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 (sometimes referred to as 'negative goodwill').

The existence of negative goodwill might be due to one or more of the following factors:

- errors in measuring the cost of the business combination or the fair value of either the assets acquired or the liabilities and contingent liabilities assumed (the aim of requiring the reassessment in paragraph 19.24(a) is to mitigate, or eliminate, such errors);
- despite the *IFRS for SMEs* Standard 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 acquired business 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; for example, is there an asset that was not identified initially or was the fair value of an asset or liability incorrectly calculated? If after this reassessment an 'excess' still exists (either the original excess or a reduced one) then the combination gives rise to 'negative goodwill'. Consequently, the acquirer recognises the excess as income in profit or loss immediately.

Example—negative goodwill

Ex 62 **At 1 January 20X5 SME A acquired 100% 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**

Application of the purchase method gives rise to negative goodwill of CU2,000. The goodwill is calculated as CU25,000 cost of the business combination minus the CU27,000 identifiable net assets at fair value at the date of acquisition.

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

The revised assessment gives rise to negative goodwill of CU1,800. This is calculated as CU25,000 cost of the business combination minus CU26,800 identifiable net assets at fair value at the date of acquisition.

SME A recognises immediately the negative goodwill 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 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; and

(g) a qualitative description of the factors that make up the goodwill recognised, such as expected synergies from combining operations of the acquiree and the acquirer, or intangible assets or other items not recognised in accordance with paragraph 19.15.

Example—disclosures on business combinations effected during the period

Ex 63 **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.**

Notes to the consolidated financial statements (extract)

…

Note X. Acquisition of business

Paragraph reference	
19.25(a), (b), (c), (d)	On 1 November 20X0, SME A acquired 100% 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 cost of the business combination was CU10,500 comprising cash consideration of CU10,000 and directly attributable expenses of CU500.
19.25(g)	The goodwill of CU2,000 arising from the acquisition consists of the synergies and economies of scale expected from combining the operations of SME B and SME C and intangible assets arising from the assembled workforce and customer relationships of SME C that are not recognised because their fair value cannot be measured reliably without undue cost or effort.
19.25(a)	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.

19.25(e) 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 are 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 identifiable net assets acquired	8,500
Goodwill	2,000
Cost of the business combination	10,500

For all business combinations

19.26 An acquirer shall disclose the useful lives used for goodwill and 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; and

(d) other changes.

This reconciliation need not be presented for prior periods.

Example—disclosures for all business combinations

Ex 64 The following example illustrates the disclosure requirements above.

Notes to the consolidated financial statements (extract)

...

Note Y.. Goodwill

	Cost	*Accumulated amortisation and impairment*	*Carrying amount*
	CU	CU	CU
1 January 20X0	**X**	**(X)**	**X**
Acquired in a business combination	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**

Amortisation is calculated by applying the straight-line method over the estimated useful lives of goodwill of 5–10 years.[5]

[5] This information could also be disclosed in the accounting policy for intangible assets.

SIGNIFICANT ESTIMATES AND OTHER JUDGEMENTS

Applying the requirements of the *IFRS for SMEs* Standard to transactions and events often requires the exercise of judgement, including making estimates. Information about significant judgements made by an entity's management and key sources of estimation uncertainty are useful when assessing an entity's financial position, performance and cash flows. Consequently, in accordance with paragraph 8.6, an entity must disclose the judgements—apart from those involving estimates—that its management has made when applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements.

Furthermore, applying 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* Standard require disclosure of information about particular judgements and estimation uncertainties.

Some of the areas where significant estimates and other judgements applying Section 19 are set out under separate headings 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. Factors to be considered in making the determination include 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 consideration, in its various forms, plus any 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, and liabilities incurred, among others. Furthermore, payment, or part of the payment, is sometimes 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 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 must be analysed to determine whether these payments constitute performance-related

remuneration (which would be included in calculations of profit or loss) or contingent consideration (which 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 costs 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 and liabilities and contingent liabilities assumed as a result of the business combination. All of these items are measured at their respective fair values. Significant judgements may be required in determining the fair value of the items to be measured, for example, contingent liabilities and unique intangible assets.

Goodwill

Significant judgment is often required in determining the amortisation method and estimating the useful life of goodwill. Significant judgements and estimates may also be required in applying the impairment requirements in Section 27.

COMPARISON WITH FULL IFRS STANDARDS

When accounting for and reporting business combinations and goodwill for periods beginning on 1 January 2017, the main differences between the requirements of full IFRS Standards (see primarily IFRS 3 (2008) *Business Combinations*) and the *IFRS for SMEs* Standard (see Section 19 *Business Combinations and Goodwill*) are:

- the definition of 'business combination' and 'business' differ between the *IFRS for SMEs* Standard and IFRS 3 and so may result in differences in application.
- applying paragraph 19.11(b) of the *IFRS for SMEs* Standard, 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 (2008) explicitly excludes such costs from the cost of a business combination (see paragraph 53 of IFRS 3). Consequently, such costs generally form part of goodwill under the *IFRS for SMEs* Standard, whereas under IFRS 3 they are recognised as expenses in the period in which the costs are incurred and the services are received.
- applying IFRS 3, if a business combination is acquired in stages, the acquirer remeasures any previously held equity interest in the acquiree at its acquisition-date fair value and takes this amount into account in the determination of goodwill (see paragraphs 41–42 of IFRS 3 (2008)). Section 19 of the *IFRS for SMEs* Standard does not provide explicit guidance on the accounting for a step acquisition.
- contingent consideration is included in the cost of a business combination, applying the *IFRS for SMEs* Standard, 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 possible outcomes and estimating the probability of each (see paragraph 39 of IFRS 3(2008)).
- applying the *IFRS for SMEs* Standard if subsequently, the contingent consideration becomes both probable and can be measured reliably, the fair value amount is treated as an adjustment to the cost of the business combination (see paragraph 19.13) and so will affect the amount recognised for goodwill. Under IFRS 3, changes in the fair value of contingent consideration only affect the cost of the business combination if they are measurement period adjustments (adjustments made during the period after the acquisition date during which the acquirer may adjust the provisional amounts recognised for a business combination), otherwise they are accounted for separately (see paragraph 58 of IFRS 3 (2008)).
- after initial recognition, applying the *IFRS for SMEs* Standard, goodwill is measured at cost less accumulated amortisation and any accumulated impairment losses. Goodwill is amortised over its useful life and cash-generating units to which goodwill has been allocated are subject to an impairment test if there is an indication of impairment. If an entity cannot establish reliably the useful life of goodwill, the life shall be determined based on management's best estimate but shall not exceed 10 years (see paragraph 19.23). Applying full IFRS Standards goodwill is not amortised. However, cash-generating units to which goodwill has been allocated are 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 *Impairment of Assets*).

- applying Section 18, an intangible asset acquired in a business combination shall be recognised unless its fair value cannot be measured reliably without undue cost or effort at the acquisition date (see paragraph 18.8). IFRS 3 (2008) and IAS 38 *Intangible Assets* assume that if an intangible asset is separable or arises from contractual or other legal rights the reliable measurement criterion is always satisfied (see paragraph 33 of IAS 38) and do not provide undue cost or effort exemptions.
- applying the *IFRS for SMEs* Standard, contingent liabilities assumed in a business combination are recognised only when their fair value can be measured reliably (see paragraph 19.15(d)). Entities are required, under IFRS 3 (2008) to recognise contingent liabilities only if they are present obligations (and exclude those that are *possible* obligations) arising from past events whose fair value can be measured reliably.
- applying the *IFRS for SMEs* Standard, non-controlling interest is measured at the non-controlling interest's proportionate share of the recognised amounts of the acquiree's identifiable net assets (sometimes called the proportionate share method—see paragraph 19.14). Using this method, goodwill that is attributable to the non-controlling interest is not recognised. Applying IFRS 3 (see paragraph 19), non-controlling interest is measured using either the full goodwill method or the proportionate share method. The difference between the two is that with the full goodwill method, the non-controlling interest's stake in the entity is valued at fair value and this is used, along with consideration paid by the parent for its stake in the subsidiary, to calculate the goodwill arising on 100% of the subsidiary. The full goodwill is recognised in the consolidated financial statements (that is, it includes goodwill attributable to the non-controlling interest). If the full goodwill method is used, at the acquisition date of a partly owned subsidiary, both goodwill and non-controlling interest are different from those calculated applying the *IFRS for SMEs* Standard.

IFRS 3 and the *IFRS for SMEs* Standard have other differences, including:

- under the *IFRS for SMEs* Standard the method used to account for business combinations is called the purchase method. Under IFRS 3 it is called the acquisition method.
- IFRS 3 contains additional exceptions from the recognition and/or fair value measurement requirements for the acquiree's identifiable assets and liabilities, for example it includes exemptions and specific requirements for indemnification assets, leases, reacquired rights and share-based payments.
- IFRS 3 contains additional guidance in some specific areas that are not covered by the *IFRS for SMEs* Standard, for example reverse acquisitions, business combinations achieved without the transfer of consideration and the identification of intangible assets.
- the *IFRS for SMEs* Standard is drafted in simpler language than that used in full IFRS Standards.

TEST YOUR KNOWLEDGE

Test your knowledge of the requirements for accounting and reporting business combinations and goodwill applying the *IFRS for SMEs* Standard by answering the questions provided.

You should assume that all amounts mentioned are material.

Once you have completed the test, check your answers against those set out beneath it.

Mark the box next to the most correct statement.

Question 1

SME A acquires 100% 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', 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 obtains control of the acquiree.

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

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

Question 3

In accordance with the *IFRS for SMEs* Standard, 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% 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 10 years.

☐ (c) over its estimated useful life. If an entity cannot establish reliably the useful life of goodwill, the life shall be determined based on management’s best estimate but shall not exceed 10 years.

☐ (d) over its estimated useful life. If an entity cannot establish reliably 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 it is more likely than not that CU5,000 would be payable. 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 it is more likely than not that it would win 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 (it is more likely than not that an additional 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 applying the *IFRS for SMEs* Standard by completing the case studies below.

Once you have completed a case study check your answers against those set out beneath it.

Case study 1

SME A's major business is in the children's food industry. It makes baby food and drinks. On 20 February 20X1 SME A began negotiations with the owners of SME B (which makes sweets) to acquire 100% 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 (who are in-charge of governance) of SME B. It is determined that this is also the date that SME A has the power to govern the financial and operating policies of SME B. All profits earned (or losses incurred) by SME B accrue to SME A from 1 September 20X1 too. 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 is estimated to be 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 is 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 as follows:

- 100 shares in SME A—the fair value at the date of acquisition is estimated to be 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 EBIT for the first year following the acquisition exceeds CU4,000. At the date of the acquisition, SME A estimated that it was probable that EBIT will be higher than CU2,500 but lower than CU4,000.
- 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%.

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 identifiable net 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%;
- the tax base of each 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 obtains 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, in the absence of further facts or circumstances that might indicate otherwise, the date of acquisition is 1 September 20X1. SME A obtains control from 1 September 20X1, as from that date it has the power to appoint all the directors of SME B and it has the power to govern SME B's financial and operating policies. Furthermore, from that date, the operating results of SME B—whether profit or loss—accrue to SME A.

Part B

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

Calculation of identifiable net 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
Identifiable net assets acquired	**2,610**

Part C

The cost of the business combination is CU3,308.

Working:

		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—see Part C) minus CU2,610 (net assets acquired—see 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) minus CU2,288 (fair value of identifiable net assets acquired—see calculation below) = CU1,020 goodwill.

The fair value of the identifiable net 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 (fair value)*	*Difference*	*Deferred tax asset (liability)*
	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.

Although the group carrying amount of goodwill (CU1,020) exceeds its tax base (nil), no deferred taxation arises from this temporary difference because it is exempt from deferred tax (see paragraph 29.14(a)).

Case study 2

On 1 June 20X1 SME A, a retail company supplying women's clothing, acquired 75% of the issued share capital, and control, of SME B, another retail company specialising in casual clothes for children and teenagers. 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	800	200	210
	800	200	
Current liabilities			
Payables	600	180	180
Provisions	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 customer relationship intangible asset with a fair value of CU2,000.

Tax effects are to be reflected using the following assumptions:

- the applicable income tax rate is 20%;
- the tax bases of the assets and liabilities recognised by SME B in its individual accounting records are 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 SME A's consolidated statement of financial position at the date of acquisition (1 June 20X1).

Part C

Prepare the necessary disclosures relating to the business combination that would be included in SME A's consolidated financial statements for the year ended 31 December 20X1 as required by Section 19 of the *IFRS for SMEs* Standard. Assume that SME A uses the straight-line method to amortise goodwill over an estimated useful life of 10 years.

Answer to Case study 2

Part A

SME A recognises goodwill of CU516 [CU3,795 (cost of the business combination: CU3,765 + CU30) minus CU3,279 (75% of identifiable net assets acquired: 0.75 × CU4,372)].

Fair value of identifiable net assets acquired:

	Fair value
	CU
Intangible assets (customer relationships)	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**
Identifiable net assets acquired	**4,372**

Calculation for the deferred tax liability:

	Carrying amount SME B	*Carrying amount Group fair value*	*Difference*	*Deferred tax asset (liability)*
	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:

Although the carrying amount of goodwill (CU516) exceeds its tax base (nil), no deferred taxation arises from this temporary difference because it is exempt from deferred tax (see paragraph 29.14(a)).

Part B

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

	CU	CU
Assets		
Non-current assets		
Goodwill	516	
Intangible assets (customer relationships)	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% of the CU4,372 acquisition date fair value of the identifiable net assets of SME B (see Part A).

Workings:

	SME A	*SME B*	*Adjustments*	*Consolidation*
	CU	CU	CU	CU
Assets				
Goodwill	–	–	516	516
Intangible assets (customer relationships)	–	–	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
Acquired in the business combination	Z	516	–	516
Annual amortisation		–	(30)	(30)
31 December 20X0		**516**	**(30)**	**486**

SME A estimated that the goodwill has a 10-year useful life.

Working for goodwill amortisation:

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

Z. Acquisitions during the year ended 31 December 20X1

On 1 June 20X1, SME A acquired 75% 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, 1 June 20X1.

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 goodwill of CU516 arising from the acquisition consists largely of the synergies and economies of scale expected from combining the operations of SME A and SME B.

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

		CU	CU
Identifiable net assets acquired:			
Intangible assets (customer relationships)		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