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# IFRS for SMEs
## Section 19 *Business Combinations and Goodwill*

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# Presenter

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Anton van Wyk is a **chartered accountant** and independent consultant in International Financial Reporting Standards (IFRS and IFRS for SMEs). As former subject head of Financial Accounting at various higher education providers (including the University of Johannesburg and Monash University South Africa), he has gained valuable insights into and understanding of the important principles underlying the International Financial Reporting Standards (IFRS).  Anton is a well-known and popular presenter who has presented numerous IFRS updates for several accounting bodies across South Africa. He is known for his ability to simplify and highlight the most important principles contained in IFRS, whilst keeping the learning process enjoyable for attendees.

# Welcome to the Webinar

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Welcome to this webinar dealing with **Section 19 *Business Combinations and Goodwill*** in the **IFRS for SMEs**

## AGENDA POINTS TO COVER:

1. Introduction to and scope of of **S19**
2. What is a “business combination”?
3. How is a business combination **accounted** for?
4. Disclosures required
5. IFRS for SMEs vs full IFRS (a quick comparison)

# IFRS for SMEs
# Section 19 *Business Combinations and Goodwill*

## Introduction to and scope of Section 29

# Section 19 overview

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- Deals with **business combinations and goodwill**

- **Overview:**
  - Scope of s19 (exclusions)
  - What is a 'business combination'?
  - How is a business combination accounted for?
    - The 'purchase method':
      - Step 1: Identifying the acquirer – how?
      - Step 2: Cost of a business combination – how measured?
      - Step 3: Allocation of the cost to the assets, liabilities and contingent liabilities
      - Step 4: Recognising contingent liabilities
      - Step 5: Goodwill/Gain on bargain purchase ('negative goodwill')
  - Disclosures required

# Scope of section 19

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- Applies to **all** business combination transactions, <u>except</u>:
  - Combinations of entities/businesses under "common control"
  - Formation of a joint venture (joint control is not control)
  - Acquisition of a group of assets that does not constitute "a business"

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# IFRS for SMEs
# Section 19 *Business Combinations and Goodwill*

## What is a “business combination”?

# What is a ‘business combination’?

- **The bringing together of separate entities OR businesses into one reporting entity**
  - In almost all business combinations, one entity (the acquirer) **obtains control** over one or more other businesses (the acquiree)
- <u>How can a business combination be structured?</u>
  - Purchase of controlling interest in equity of another entity
  - Purchase of all the net assets of another entity
  - The assumption of the liabilities of another entity
  - The purchase of SOME of the net assets of another entity that form one or more businesses

# Example 1: equity stake (%)

- SME ABC (Pty) Ltd acquires 80% of the **issued equity** of DEF (Pty) Ltd on 1 January 2020 for R1 million in cash. The equity of DEF (Pty) Ltd was as follows at that date:
  - Share capital 100 000
  - Retained earnings 900 000
  - Total equity (**fairly stated**) **1 000 000**

**Value obtained is R800 000**

- The journal entry, in the separate or individual AFS of ABC (Pty) Ltd is as follows on the acquisition date (1 Jan 2020):
  - Dr Investment in DEF (Pty) Ltd R1 000 000
  - Cr Bank R1 000 000
  - *(recognition of investment in subsidiary)*

**Goodwill??**

# Example 2 – information

- On 1 January 2020, SME ABC (Pty) Ltd acquires certain assets and liabilities of DEF (Pty) Ltd for R3.5 million cash, but does NOT obtain an equity stake in the acquiree. The assets and liabilities acquired, together form "a business". The information relating to the assets and liabilities are as follows **on 1 January 2020**:

| | **CA in DEF (Pty) Ltd** | **Fair value** |
|---|---|---|
| • Land | R300 000 | R400 000 |
| • Building | R600 000 | R900 000 |
| • Plant | R900 000 | R1 500 000 |
| • Machinery | R200 000 | R800 000 |
| • Finance lease liability | (R300 000) | (R250 000) |

- The SA Revenue Service (SARS) accepts the *transfer values* of the assets and liabilities in terms of S19 of the IFRS for SMEs.

# Example 2 – suggested solution

- On **1 January 2020**, the acquisition journal entry in the individual accounting records of ABC (Pty) Ltd, is as follows:

| | | Dr | Cr |
|---|---|---|---|
| • Dr Land | | R400 000 | |
| • Dr Building | | R900 000 | |
| • Dr Plant | **@FV!!!** | R1 500 000 | |
| • Dr Machinery | | R800 000 | |
| • Cr Finance lease liability | | | R250 000 |
| • Cr Bank (cost price) | | | R3 500 000 |
| • **Dr Goodwill (SOFP) (bal. figure)** | | **R150 000** | |

# What is the 'acquisition date'?

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- The date on which the acquirer **effectively** obtains control of the acquiree

- Consider when the risks and rewards associated with ownership of the control (e.g. over the assets/liabilities, or the equity stake) effectively pass to the acquirer in substance
    - Economic substance over legal form to be considered…

- **Suspensive** legal conditions must be satisfied before acquisition date can occur
  - Successful completion of due diligence review…
  - Approval of SA Competition Commission i.r.o. mergers and acquisitions…

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# IFRS for SMEs
# Section 19 *Business Combinations and Goodwill*

## How is a business combination accounted for?

# The accounting for a b/combo

- The **purchase method** to be used…
  - Pooling of funds etc. no longer allowed

- STEPS of purchase method:

  - 1. Identify the acquirer
  - 2. Calculate the correct cost price for the business combination
  - 3. Allocate the cost price to the A&L acquired, remainder is goodwill (or GBP)

# Identifying the acquirer

- An **acquirer** MUST be identified for all business combinations
- The acquirer is the combining entity that obtains control of the other combining entities or businesses
- *Section 9: Control is the power to GOVERN the operating and financial policy decisions of an entity so as to obtain benefits from its activities*
  - *Assessed i.t.o. section 9*
- Indicators of the possible acquirer:
  - The entity with the significantly greater FAIR VALUE than the other entity
  - If B/C is effected through an exchange of voting ordinary shares for cash or other assets, the party giving up the cash or other assets
  - The B/C 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 dominating entity is the likely acquirer

# Identifying the cost of the B/C

- Cost price =
  - The **fair values** (at date of exchange) of assets given, liabilities incurred and equity instruments issued by the acquirer (in exchange for control of acquiree)
  - PLUS
  - Any costs directly attributable to the B/C

**Date of exchange is different to full IFRS!**

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# Example – cost of B/C

- Assume a market-related applicable interest rate of 10% per annum, nominal and pre-tax. Ignore tax in this example.
- SME JKL (Pty) Ltd obtains a controlling equity interest of **80%** in MNO (Pty) Ltd on 1 January 2020. The transaction satisfies the definition of a "business combination" per S19 of the IFRS for SMEs. The cost price of the 80% stake is settled as follows by the acquirer:
  - Cash of R10 million is paid to the previous owner of the interest on 1/1/2020.
  - Another R2 million cash will be paid to the previous owner of the interest on 31/12/2020.
  - JKL (Pty) Ltd also issues 100 000 of its own ordinary shares (with a par value of R2 per share and a fair value of R10 per share) to the previous owner of the interest on 1/1/2020.
  - JKL (Pty) Ltd also transfers land, with a carrying amount of R500 000 and a fair value of R2.5 million, to the previous owner of the interest on 1/1/2020.

- **What is the cost price of the B/C <u>and</u> provide the journal entry on 1/1/2020 in the accounting records of JKL (Pty) Ltd (the acquirer)?**

# Example (continued)

- <u>Calculate cost price of business combination:</u>

| | R |
|---|---|
| • Cash | 10 000 000 |
| • PV of future cash flow (31/12/2020) *(FV: R2m; N:1; P/Yr:1; Pmt:0; I/Yr:10%)* | 1 818 181 |
| • Ordinary shares issued (100 000 x R10 p.s.) | 1 000 000 |
| • Land transferred | 2 500 000 |
| • **Cost price i.t.o. S19** | **15 318 181** |

**@FV!!**

- <u>Journal entry (1/1/2020)</u>

| | Dr | Cr |
|---|---|---|
| • Dr Investment in MNO (Pty) Ltd | **R15 318 181** | |
| • Cr Bank | | R10 000 000 |
| • Cr Short-term liability | | R1 818 181 |
| • Cr Share capital – at par value (100 000 x R2 p.s.) | | R200 000 |
| • Cr Share premium (R1m – R200 000) | | R800 000 |
| • Cr Land (at CA) | | R500 000 |
| • Cr Gain on disposal of land (P/L) | | R2 000 000 |

# Adjustments to cost of B/C??

- When a B/C agreement provides for an adjustment to the cost of the B/C **contingent on future events**, the acquirer shall include the estimated amount of that adjustment in the cost of the B/C at the acquisition date, if:
  - The adjustment is probable; **and**
  - The adjustment can be reliably measured

- If the additional adjustment is not probable or not reliably measured (i.e. not recognised), but **becomes** probable and reliably measurable, the additional consideration shall be **treated as an adjustment to the cost of the B/C**

**Different to full IFRSs…**

# Example: adjustments to cost

- SME ABC (Pty) Ltd acquires an **80%** controlling equity stake in DEF (Pty) Ltd on 1 January 2020 in terms of a qualifying business combination transaction. The consideration for the B/C is as follows:
  - R10 million cash paid at acquisition date (1/1/2020)
  - R2 million cash paid on 31 December 2020 (applicable interest rate = 10% p.a.)
  - The B/C agreement determines that, if the combined entity achieves a profit after tax of R500 000 for the first year of trading after the B/C transaction, a further R1 million will be payable in cash on 31 December 2020.

- Option 1: On 1/1/2020, ABC (Pty) Ltd deems it **probable** that the combined entity will achieve a profit of R500 000 by 31/12/2020.

- Option 2: On 1/1/2020, ABC (Pty) Ltd deems it **improbable** that the combined entity will achieve a profit of R500 000 by 31/12/2020, but on 31 December 2020, an actual profit after tax of R520 000 is achieved by the combined entity.

# Example: suggested solution (1)

- **R500 000 PAT deemed probable at 1/1/2020**
  - Cost price calculation:

| | R |
|---|---|
| Cash price | 10 000 000 |
| Short-term liability | 1 818 181 |
| Short-term liability (contingency) | 909 090 |
| *(FV:R1m; N:1; I/Yr:10%; P/Yr:1; Pmt:0)* | |
| **Total cost price** | **12 727 271** |

- **R500 000 PAT deemed improbable at 1/1/2020**
  - Cost price calculation:

| | R |
|---|---|
| Cash price | 10 000 000 |
| Short-term liability | 1 818 181 |
| Short-term liability (contingency) | - |
| **Total cost price** | **11 818 181** |

**All or nothing!!**

# Example: suggested solution (2)

- **R500 000 PAT deemed probable at 1/1/2020**
- Journal entry 1/1/2020

| | Dr | Cr |
|---|---|---|
| Dr Investment in DEF (Pty) Ltd | R12 727 271 | |
| Cr Bank | | R10 000 000 |
| Cr Current liability | | R1 818 181 |
| Cr Current liability (contingency) | | R909 090 |

- Journal entry 31/12/2020

| | Dr | Cr |
|---|---|---|
| Dr Interest expense (P/L) | R272 729 | |
| Cr Current liability | | R181 819 |
| Cr Current liability (contingency) | | R90 910 |
| | | |
| Dr Current liability | R2 000 000 | |
| Dr Current liability (contingency) | R1 000 000 | |
| Cr Bank | | R3 000 000 |

# Example: suggested solution (3)

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- **R500 000 PAT deemed improbable at 1/1/2020**
- Journal entry 1/1/2020
  - Dr Investment in DEF (Pty) Ltd R11 818 181
  - Cr Bank R10 000 000
  - Cr Short-term liability R1 818 181
- Journal entry 31/12/2020
  - **Dr Investment in DEF (Pty) Ltd R1 000 000**
  - **Cr Bank R1 000 000**
  - Dr Interest expense (P/L) R181 819
  - Cr Current liability R181 819
  - Dr Current liability R2 000 000
  - Cr Bank R2 000 000

**Subsequent adjustment corrected @ investment (i.e. goodwill)**

# Allocating the cost to A & L's

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- Done at the acquisition date
- Identifiable assets, liabilities and contingent liabilities (that meet certain requirements) to be recognised and measured at their FAIR VALUES
- Difference between cost of B/C and fairly stated identifiable NAV at acquisition to be recognised as goodwill or 'negative goodwill' (gain from bargain purchase)

- **Recognition criteria at acquisition date in a B/C:**
  - **Assets (excluding intangible assets): Probable that FEB will flow to entity AND its fair value can be measured reliably**
  - **Liabilities (excluding contingent liabilities): Probable that FEB will flow from entity AND its fair value can be measured reliably**
  - **Intangible assets/contingent liabilities: Its fair value can be measured reliably**

# Additional points

- **Contingent liabilities** so recognised must be recognised as PROVISIONS at the acquisition date, and not contingent liabilities (also see later slides)
- It will probably be seen that **internally-generated intangible assets** (i.t.o. s18) that are NOT recognised as assets, are now recognised as intangible assets at the acquisition date
- Due to A&L measured at FAIR VALUE at acquisition date, certain **pro forma adjustments** may be required post-acquisition (e.g. increased/decreased depreciation based on fair value i.s.o. carrying amount in acquiree)
- Cost of the B/C may only be allocated to assets, liabilities and contingent liabilities of the acquiree that EXISTED AT the acquisition date (e.g. termination payments agreed upon per contract BEFORE acquisition date) and **not any items arising AFTER/AS A RESULT OF the business combination** (also no provisions for future losses/costs)

# Initial accounting in a B/C

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- The acquirer is granted an initial accounting period ('grace period') of 12 months after the acquisition date in the B/C to complete the **initial accounting** of the B/C (fair values take a while to finalise etc.)

- If a reporting date falls within such initial accounting period, **provisional amounts** will be used for items that are incomplete

- Within 12 months of the acquisition date, the acquirer shall retrospectively adjust these provisional amounts recognised as assets and liabilities at the acquisition date **as if they were made at the acquisition date**
  - This implies that goodwill is adjusted for these changes to provisional amounts

- Beyond twelve months? Adjustments to provisional amounts only made i.r.o. errors that were made (accounted for i.t.o. s10 of the IFRS for SMEs)

# Contingent liabilities

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- If their **fair value** can be **reliably measured** at acquisition date in a B/C, the acquirer shall recognise a **provision** for <u>all</u> contingent liabilities at the acquisition date

- If not, the acquirer **discloses** in the notes to the AFS information about the contingent liability i.t.o. s21 of the IFRS for SMEs

- Subsequent measurement of CL's
  - The **HIGHER** of:
    - The amount initially recognised; and
    - The amount recognised i.t.o. S21 of the IFRS for SMEs

# What is a contingent liability? (S21)

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- **Two types of contingent liabilities:**

  - TYPE 1: The **present obligation** is not probable (and not even deemed probable i.t.o. s21), but only possible (i.e. definition of liability not satisfied)

  - TYPE 2: One (or both) of the **recognition criteria** is/are not met:
    - Improbable that FEB will flow out of the entity, and/or
    - The amount cannot be reliably measured

# Goodwill

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- Goodwill is recognised (at the acquisition date) as an asset
- Goodwill arises when the cost of the business combination EXCEEDS the fair value of the identifiable net assets recognised (i.t.o. s19) at the acquisition date
- **Goodwill is subsequently measured at cost lest accumulated amortisation and accumulated impairment losses**
- Goodwill shall be AMORTISED in terms of the guidance provided in s18 (Intangible Assets) of the IFRS for SMEs
  - Useful life cannot be reliably determined? Use 10 years for amortisation
- Impairment of goodwill to be done i.t.o. S27 (Impairment of Assets) of IFRS for SMEs

# ‘Negative goodwill’

- Different terminology
  - *Actual terminology: Excess over the cost of the acquirer’s interest in the net fair value of the acquiree’s identifiable assets, liabilities and contingent liabilities*

- Before recognising this item, the acquirer shall:

  - Reassess the identification and measurement of the acquiree’s assets, liabilities and provisions for contingent liabilities AND the measurement of the cost of the B/C
  - Recognise immediately in P/L any excess remaining after such reassessment

# Example: the purchase method

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- SME ABC (Pty) Ltd acquires **60%** of the equity of DEF (Pty) Ltd in a single acquisition on 1 January 2020 for R5.5 million cash. The equity of DEF (Pty) Ltd, consists of the following at the acquisition date (1/1/2020):
  - Share capital and share premium R100 000
  - Retained earnings R7 400 000

- The following fair value information is NOT reflected in the above information:
  - DEF (Pty) Ltd owns land (with a cost price and carrying amount of R500 000) with a fair value of R2 million. The base cost of the land for CGT purposes, is R500 000.
  - DEF (Pty) Ltd is currently involved in a court case i.t.o. which DEF (Pty) Ltd is being sued for R1 million i.t.o. alleged breach of contract. The legal advisers of DEF (Pty) Ltd have indicated that it is less than 50% probable that DEF (Pty) Ltd will be found guilty in the court case and that the fair value of the court case (based on probability and all other factors) is R250 000 at acquisition date. DEF (Pty) Ltd did not recognise this in their individual AFS. There are no tax consequences.
  - DEF (Pty) Ltd also expensed R600 000 on internally-generated intangible assets in profit or loss. The fair value of the internally-generated intangible assets is R500 000 at the acquisition date. There are no tax consequences.

# Solution: individual AFS

- In ABC (Pty) Ltd's **individual** AFS, the following journal entry is done on 1/1/2020:

  - Dr Investment in DEF (Pty) Ltd R5 500 000
  - Cr Bank R5 500 000

# Solution: consolidated AFS

- In ABC Group (Pty) Ltd's **consolidated** AFS, the following **PRO FORMA journal entries** are done on 31/12/2020 (the first reporting date after the acquisition):

| | Dr | Cr | |
|---|---|---|---|
| Dr Land (R2m – R500k) | R1 500 000 | | |
| Cr Revaluation surplus (OCI) | | R1 164 000 | |
| Cr Deferred tax (F/P) (R1.5m x 80% x 28%) | | R336 000 | |
| | | | |
| Dr Retained earnings (AT) | R250 000 | | |
| Cr Provision for contingent liability (F/P) | | R250 000 | |
| | | | |
| Dr Internally-generated intangible asset (F/P) | R500 000 | | |
| Cr Retained earnings (AT) | | R500 000 | |
| | | | |
| Dr Share capital and share premium (AT) | R100 000 | | |
| Dr Retained earnings (R7.4m – R250k + R500k) | R7 650 000 | | *R8 914 000 NAV* |
| Dr Revaluation surplus (OCI) (AT) | R1 164 000 | | |
| **Dr Goodwill (F/P)** | **R151 600** | | |
| Cr Investment in DEF (Pty) Ltd – at cost | | R5 500 000 | |
| Cr Non-controlling interest (F/P) (R8 914 000 x 40%) | | R3 565 600 | |

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## Disclosures

# Disclosures (notes to AFS)

- **For B/C's that occurred DURING the reporting period:**
  - Names and descriptions of combining entities or businesses
  - Acquisition dates
  - % of voting equity instruments acquired
  - Cost of the combination and description of the components of that cost
  - Amounts recognised at acquisition date for each class of acquiree's assets, liabilities and contingent liabilities, including goodwill
  - Amount of any excess recognised in P/L i.r.o. 'negative goodwill' and the line-item in which such excess was included

- **For all B/C's (disclosure requirements only for current year):**
  - Changes arising from new B/C's
  - Impairment losses
  - Disposals of previously acquired businesses
  - Other changes

# IFRS for SMEs

# Section 19 *Business Combinations and Goodwill*

## IFRS for SMEs vs full IFRS
## (a quick comparison)

# Full IFRSs versus IFRS for SMEs

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- Full IFRSs: Transaction costs not part of the cost of the B/C (i.e. does not affect goodwill)
- IFRS for SMEs: Transaction costs form part of the cost of the B/C

- Full IFRSs: Consideration transferred is all measured at the date of acquisition (i.e. when control is obtained) – even in acquisition in stages ('step acquisition')
- IFRS for SMEs: Consideration transferred is measured at date of exchange (i.e. when consideration is exchanged by parties) – even in acquisition in stages (e.g. 20% + 20% + 20%) – goodwill is therefore measured differently in IFRS for SMEs when step-acquisitions occur

- Full IFRSs: Contingent consideration is measured at FAIR VALUE (i.e. probability of payment reflected in the fair value, e.g. even 23% probability…)
- IFRS for SMEs: Contingent consideration is included in cost of B/C when it is PROBABLE (i.e. >50%) and the amount can be reliably measured

# Full IFRSs versus IFRS for SMEs

- Full IFRSs: Goodwill is not amortised, but tested annually for impairment with or without indicators of possible impairment
- IFRS for SMEs: Goodwill is amortised over its useful life (if no useful life can be determined: use 10 years). Goodwill is only tested for impairment if indicators exist of possible impairment (done i.t.o. S27)

- Full IFRSs: NCI can be measured at either their proportionate share of the fair value of the identifiable net assets of the acquiree at the acquisition date OR at the FAIR VALUE of the NCI at the acquisition date (the latter results in goodwill being calculated for the NCI as well)
- IFRS for SMEs: NCI can only be measured at their proportionate share of the fair value of the identifiable net assets of the acquiree at the acquisition date (this results in goodwill only being calculated for the parent/acquirer at the acquisition date)

# Full IFRSs versus IFRS for SMEs

- Full IFRSs: Only contingent liabilities where the recognition criteria are not met (i.e. type 2), may be overridden at acquisition and recognised as a liability
- IFRS for SMEs: All contingent liabilities (type1 and type 2 per slide) may be recognised at the acquisition date in a B/C

- Full IFRSs: Contingent liabilities are recognised as "contingent liabilities" at acquisition date
- IFRS for SMEs: Contingent liabilities are recognised as "provision for contingent liabilities"- clearly treated as provision…

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# Thank you for your participation

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