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Accounting Principles of Business Combination Transactions for Tax Practitioners

YOUR KEY TO THE TAX COMMUNITY

What is a “business combination transaction”?

What is a 'business combination'?

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- 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)
- How can a business combination be structured?
  - 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 (%)

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- SME ABC (Pty) Ltd acquires **80% of the issued equity** of DEF (Pty) Ltd on 1/1/2023 for R1 million 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 individual AFS of ABC (Pty) Ltd is as follows on the acquisition date (1/1/2023):
  - Dr Investment in DEF (Pty) Ltd R1 000 000
  - Cr Bank R1 000 000
  - *(recognition of investment in subsidiary)*

Goodwill??

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Example 2 – information

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- On 1/1/2023, 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 1/1/2023**:

	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)
• Net value	R1 700 000	R3 350 000

- The SARS accepts the *transfer values* of the assets and liabilities.

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Example 2 – suggested solution

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- On **1/1/2023**, 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**	

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How is a business combination transaction accounted for?

The accounting for a b/combo

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- The **purchase method** must be used – no other method is acceptable

- Main 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)

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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
- *Control is the power to GOVERN the operating and financial policy decisions of an entity so as to obtain benefits from its activities*
  - *Remember that IFRS 10 applies a new definition to determine "control"*
- 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

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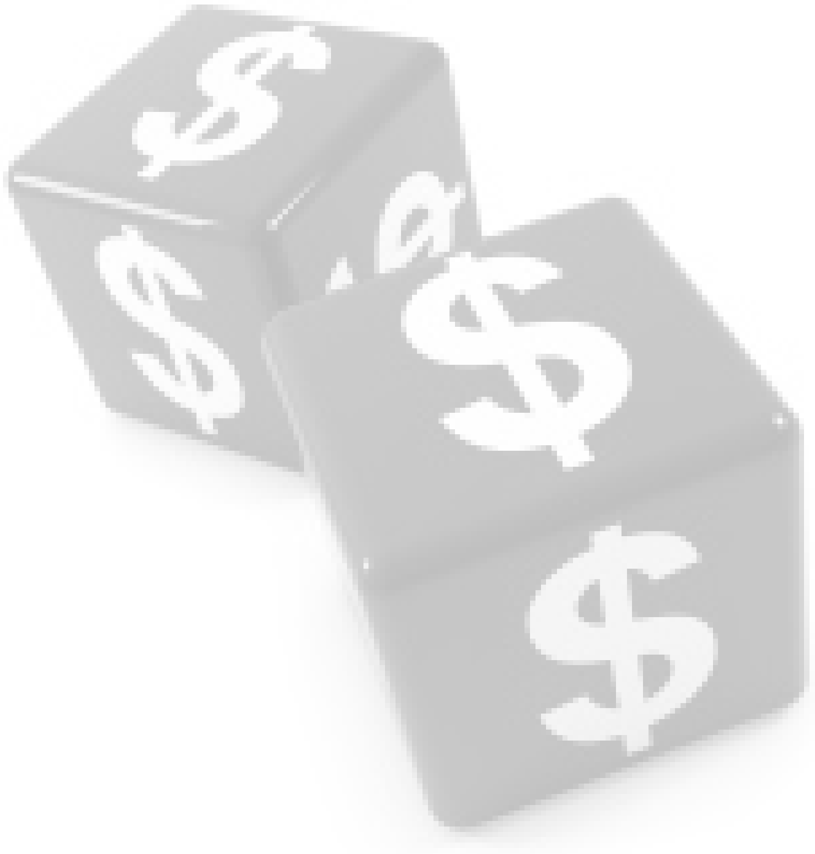
- Cost price =
  - The **fair values** (at date of exchange) of assets given, liabilities incurred and equity instruments issued by the acquirer (in exchange for control of acquiree)
  - PLUS
  - Any costs directly attributable to the B/C



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Example 3 – 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 1/1/2023. The transaction satisfies the definition of a "business combination". The cost price of the 80% equity stake is settled as follows by the acquirer:
  - Cash of R10 million is paid to the previous owner of the interest on 1/1/2023.
  - Another R2 million cash will be paid to the previous owner of the interest on 31/12/2023.
  - 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 1/1/2023.
  - 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 1/1/2023.

- **What is the cost price of the B/C and provide the journal entry on 1/1/2023 in the accounting records of JKL (Pty) Ltd (the acquirer)?**

Example 3 – suggested solution

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- Calculate cost price of business combination:

	R
Cash	10 000 000
PV of future cash flow (31/12/2023) *(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 at fair value	**15 318 181**

@FV!!

R15 318 181

- Journal entry (1/1/2023)

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

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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**

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Additional points

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- **Contingent liabilities** must be recognised as liabilities (IFRS for SMEs calls them "provisions") if their fair values can be reliably measured
- It will probably be seen that **internally-generated intangible assets** 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)

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What is a contingent liability?

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- **Two types of contingent liabilities:**

  - TYPE 1: There is no **present obligation** (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

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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 **at the acquisition date**
- **Goodwill is subsequently measured at cost lest accumulated amortisation and accumulated impairment losses**
- Goodwill shall be AMORTISED to profit per the IFRS for SMEs
  - Useful life cannot be reliably determined? Use 10 years for amortisation
  - *Full IFRS: goodwill is not amortised, but only annually tested for impairment*
- Impairment of goodwill to be done i.t.o. S27 (Impairment of Assets) of IFRS for SMEs

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'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*
  - *Commonly referred to:* ***Gain from a bargain purchase***

- 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 1/1/2023 for R5.5 million cash. The equity of DEF (Pty) Ltd, consists of the following at the acquisition date (1/1/2023):
  - Share capital and share premium R100 000
  - Retained earnings R7 400 000

- <u>The following fair value information is NOT reflected in the above information:</u>
  - DEF (Pty) Ltd owns land (with a cost price <u>and</u> 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 for these.

Solution: individual AFS

- In ABC (Pty) Ltd's **individual** AFS, the following journal entry is done on 1/1/2023:

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

- As only cash is paid, the fair value of the consideration given (i.e., the cost price of the business combination transaction) is R5.5 million

- What is the **fairly stated NAV** at acquisition date? Goodwill?

• Share capital	R100 000	
• Retained earnings	R7 400 000	
• Revalued land	R1 500 000	
• Deferred tax on land	(R336 000)	
• CL (court case)	(R250 000)	
• IA (int.-generated)	R500 000	
• Fairly stated NAV	R8 914 000 @60%	R5 348 400
Goodwill		**R151 600**

Solution: consolidated AFS

- In ABC Group (Pty) Ltd's **consolidated** AFS, the following **PRO FORMA journal entries** are done on 31/12/2023 (the first reporting date after the acquisition):

• Dr Land (R2m – R500k)	R1 500 000		
• Cr Revaluation surplus (OCI)		R1 164 000	*Valuing land @ FV*
• 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	*Recognising CL*
• Dr Internally-generated intangible asset (F/P)	R500 000		
• Cr Retained earnings (AT)		R500 000	*Recognising IA*
• Dr Share capital and share premium (@Acq)	R100 000		
• Dr Retained earnings (R7.4m – R250k + R500k)	R7 650 000		*Eliminate R8 914 000 NAV*
• Dr Revaluation surplus (OCI) (@Acq)	R1 164 000		
• **Dr Goodwill (F/P)**	**R151 600**		
• Cr Investment in DEF (Pty) Ltd – @ cost		R5 500 000	
• Cr Non-controlling interest (F/P) (R8 914 000 x 40%)		R3 565 600	

The tax consequences of business combination transactions

- Direct acquisitions of assets & liabilities

vs

- Acquisitions of equity stakes in entities

Thank you for your participation