Inaccurate Goodwill Computation

K.D.W.S.Kalubovila & R.M. Saman Bandara
wasanasajeewikalubowila@gmail.com & samanb@kln.ac.lk

Introduction

XYZ is a quoted public company registered under the companies act no. 07 of 2007 in Sri Lanka. The company operates its business activities through 92 branches covering all eight provinces. The principal business activities of the company are lease financing, hire purchasing, real estate projects, granting term loans, vehicle hiring & deposit mobilization.

- Central Bank of Sri Lanka introduced a new financial sector consolidation programme in 2014. Several finance companies needed to be merged under this programme.
- XYZ PLC had also acquired a medium size finance company called ABC co. Ltd to comply with the provisions given by CBSL. The main business activities of ABC is hire purchase financing, granting of term loans and real estate development

Acquisition of all the shares of ABC was taken placed under two different days.

a) XYZ PLC acquired 90.1% of issued ordinary share capital of ABC co. Ltd (ABC) on 12/11/2014 at a purchase consideration of Rs. 301.415 Million.
b) On 24th June 2015, the company completed the acquisition of 100% of the issued ordinary shares of ABC at a total purchase consideration of Rs.334.507 Million and ABC became a fully owned subsidiary of the Company.

The issue was aroused regarding the goodwill computation as at the date of acquisition. ABC had recognized its investment property on cost basis in its individual financial statements. However, the group policy is to measure investment properties on fair value basis. This had not been considered in calculating the goodwill on business combination.

Also According to the purchase agreement, Rs.3,000,000.00 needs to be paid as the contingent consideration if the profits for next 3 years exceed over 1,250 Million. This had not been incorporated in goodwill calculation. With reference to the accounting standards the recommendations were given to the management to adjust the goodwill computation by including these changes.

Discussion of the Issue

We examined the accuracy of calculated goodwill on the acquisition date and noted the following observations.

This acquisition was carried out based on the un-audited financial statements of ABC as at 31.10.2014 and the investment has been accounted for using the full goodwill method. The examined goodwill calculation was as follows.

Goodwill on Acquisition as at 31/10/2014

Total identifiable net assets	316,835
Non-controlling interest	(31,345)
	285,490
Purchase consideration transferred	301,415
Goodwill arising on acquisition	**15,925**

When we examine the accuracy of goodwill calculation, the following two deviations which are not compatible with LKAS were observed.

1. ABC had recognized its investment property on cost basis in its individual financial statements. However, the group policy is to measure investment properties on fair value basis. This had not been considered in calculating the goodwill figure above. The investment property value as difference between cost and fair value models on the acquisition date was Rs. 4.586 Million.
2. According to the purchase agreement, Rs.300,000 needs to be paid as the contingent consideration if the profits for next 3 years exceed over 1,250 Million. This had not been considered in goodwill calculation.

Implication of the issue

Because of these issues the accuracy of goodwill calculation will be affected in followings ways,

- ✓ Net assets value on acquisition date was under recognized and the reported goodwill was inaccurate.
- ✓ Since an additional liability must be recorded, calculated goodwill figure is incorrect.

Conclusion & Recommendation

We reported errors in goodwill calculation immediately to AGM/IA (internal auditor) and examined the guidelines given by relevant LKAS. The following points were noted with regard to the each observations expressed above.

- ➢ Requirement of SLFRS 3 - Business Combination Standard is as follows.
  Paragraph No. 18
  An acquirer of a business recognizes the assets acquired and liabilities assumed at their acquisition date fair values
- ➢ Based on LKAS 40 & LKAS 32, we highlighted the following points and suggestions were given to the management who is responsible for financial reporting.

1. **<u>Reference to LKAS 40 - Investment Property</u>**

   Paragraph No. 33- "After initial recognition, an entity that chooses the fair value (FV) model shall measure all of its investment property at fair value."

   Paragraph No. 35 -"A gain or loss arising from a change in the fair value of investment property shall be recognized in profit or loss for the period in which it arises."
   With regard to ABC, FV should be calculated based on discounted cash flow method.

   Suggestions made

   The property should be recognized under FV model to be compatible with parent company's accounting policies.

   Rs.4.586 Million fair value gain should be taken in to consideration in the consolidation process by increasing the value of the investment property and recognizing the gain to income statement.

2. **<u>Reference to SLFRS 03 - Business Combinations</u>**

   Paragraph No. 39 - "An entity should recognize the acquisition date fair value of contingent consideration as part of the consideration transferred in exchange for the subsidiary.

   Paragraph No.40 - "The acquirer shall classify an obligation to pay contingent consideration as a liability or as equity on the basis of the definitions of an equity instrument and a financial liability in paragraph 11 of LKAS 32 Financial Instruments: Presentation, or other applicable SLFRSs.

   Suggestions & Recommendations

   The FV of contingent consideration on the acquisition should be recognized as part of the acquiree. The amount should be recognized in goodwill calculation by considering the probability of achieving the earning target and time value of money concept. Based on the definition in the LKAS 32, we recommended to recognize the obligation as a liability based on paragraph no 11 of LKAS 32in consolidated financial statements.
   Further we recommended to recognize the changes in FV of contingent consideration after acquisition date based on additional information received.
   The contingent liability should be measured at FV at each reporting date and changes should be recognized in income statement.