ACCOUNTING FOR AMALGAMATION

WIRC SEMINAR

PRESENTED BY

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Introduction

- AS - 14, last revised in 1995
- Has become outdated and requires substantial modification. ICAI has formed a group for revision of the standard. Yet to be considered by Accounting Standard Board (ASB).
- IFRS 3 and IAS-27 revised in January, 2008.
- The revision has achieved substantial conversion between IFRS and US GAAP.

AS - 14 - Accounting for Amalgamation

- Has come into effect from 1st April, 1995.
- Deals with accounting for amalgamation of two companies.
- Does not deal with acquisition of one company by another - major drawback.
- In amalgamation one company loses its identity, in acquisition identities of companies are maintained.

AS - 14

Amalgamation

(pursuant to the provisions of the companies act)

In the nature of merger | In the nature of purchase

- Conditions for amalgamation in the nature of merger:
  - All assets & liabilities are transferred.
  - At least 90% shareholders of transferee company become shareholders of transferor company.
  - Consideration of amalgamation is equity shares of transferee company.

Pooling of Interest

- Business of the transferee company is intended to be carried on.
- No adjustments are intended to be made to the carrying value of assets and liabilities of transferor company.

- All the above conditions should be satisfied.
- If any of the above conditions are not fulfilled it would be termed as amalgamation in the nature of purchase.
- Intention of the management is sufficient to classify the type of merger, unlike IFRS and US GAAP. Hence Indian GAAP is subjective.

AS - 14

Accounting of Amalgamation

Pooling of interest method for amalgamation in the nature of merger	Purchase method for amalgamation in the nature of purchase

- Pooling of interest method :
  - All assets liabilities of transferor company are taken over at their carrying values.
  - Identity of reserves is preserved.
  - Uniform accounting policy to be adopted – to be accounted as per AS 5, which means that the impact should be taken to P&L account.

AS - 14

  - Difference between the consideration and share capital of transferor company is adjusted in reserves of the merged company.
- If no reserves ? - to be shown as negative amalgamation reserve or goodwill !!
- Amalgamation expenses need to be charged off to profit and loss account.
- Important to prescribe required accounting treatment in the scheme if above treatment is not to be followed.
- For listed company, certification of accounting treatment prescribed in the scheme in line with AS 14 and other accounting standards is now mandated in listing agreement.
- New Companies bill provides compliance with accounting standards for all companies including unlisted companies.

Purchase Method

- Assets taken either at carrying value or fair value. Value can also be assigned to non existent assets / liabilities, provided it is as per other AS.
- Identity of reserves is lost except for statutory reserves. In case of latter “Amalgamation adjustment account” needs to be created for corresponding amount, which will be reversed when separate identity of the reserve is no more required.
- the difference between the fair value and value of consideration is treated as goodwill or capital reserve.

Purchase Method ….

Treatment of Goodwill

- Goodwill shall be amortised over its useful Life, normally over a five years period.
- Factors to be considered for estimated life :
  - foreseeable life of business / industry
  - product obsolescence, change in demand, economic factors
  - legal, regulatory or contractual provisions
  - service life of key individuals or group
  - expected actions by competitors or potential competitors.

Treatment of Reserves

- Para 23 & 42 of the standard provides that reserves should be treated as prescribed by the scheme sanctioned under the statute (overriding the earlier provisions of treatment to reserves).
- The above provision is being misused. As a result, limited revision has been made in AS 14.
- Where treatment of reserves is different under a scheme from the treatment prescribed by the AS disclosures required are :
  - Description of the treatment given and reasons for giving a different treatment.
  - Deviation in the accounting treatment.
  - Financial effect, if any, due to such deviation.

Amalgamation after the balance sheet date

- In case an amalgamation is effected after the balance sheet date disclosure is required as per AS 4 but the amalgamation should not be incorporated in the financial statement.
- If amalgamation is with effect from the date earlier to balance sheet, it is advisable to give effect in the same year. For e.g. amalgamation announced in April, 2012 and got approved in August, 2012. If the appointed date is 1 January, 2012, in the accounting year 2011-12 effect of the same may be given.

Amalgamation with Retrospective Effect

- Permitted under Indian Laws. A procedure of approval of court scheme takes lot of time – usually 6 months to 1 year.
- Let us look at the following situations :
  - Company A Ltd. announced the merger with Company B Ltd. in February, 2012, and if approved it will be effective from 1st April, 2011.
  - At the time of finalisation of 2011-12 accounts in July, 2012 approval for the merger was not received.
  - Finally the merger got approved in November, 2012.

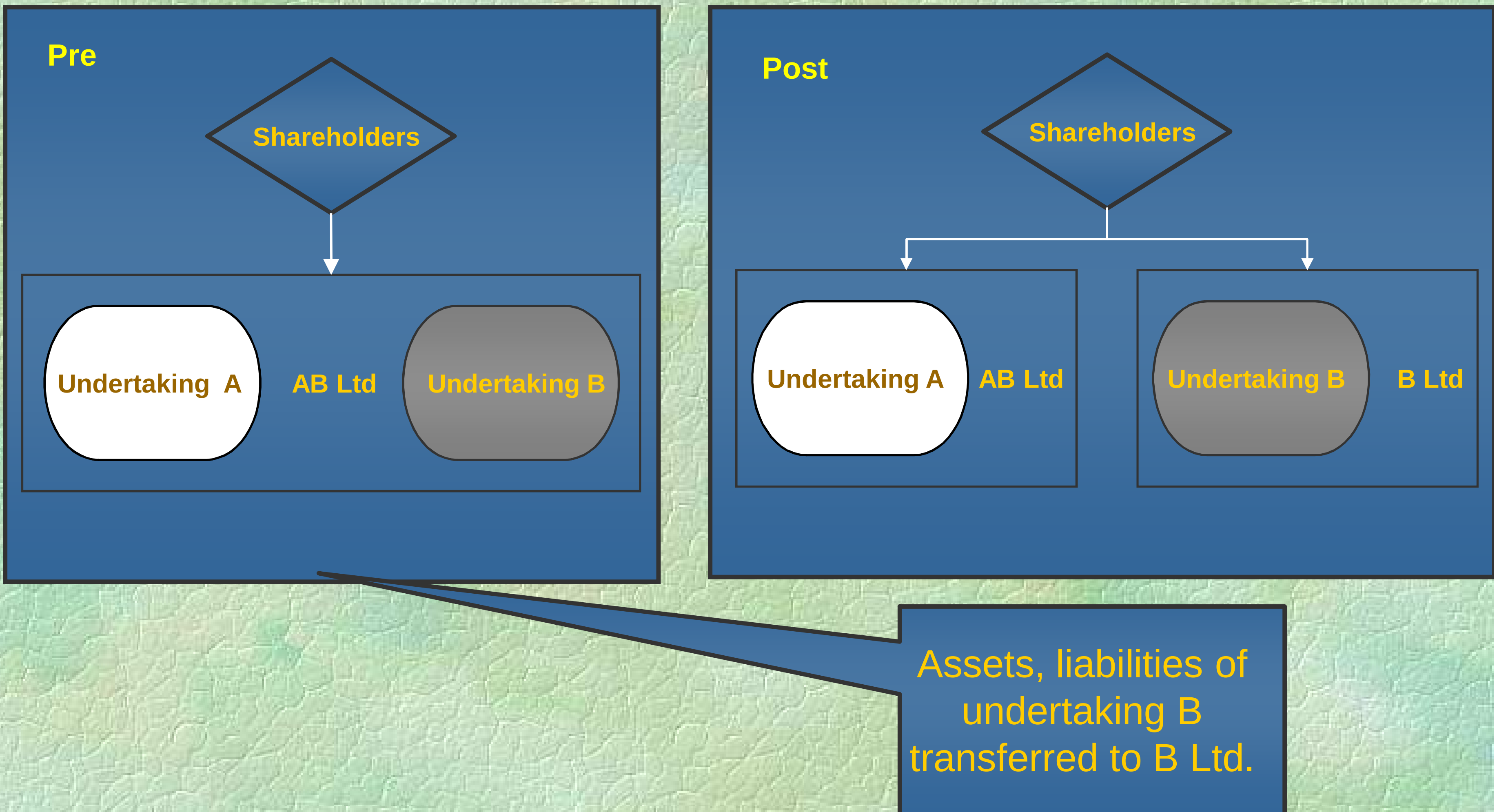
Amalgamation with Retrospective Effect (contd.)

- Accounting in the year 2011-12
  - Merger accounting is not possible. Only disclosure is required.
  - Tax Return to be filed and Income-tax to be paid separately by both the companies.
- Accounting in the year 2012-13
  - Profit earned by the transferor company for the year 2011-12 will have to be accounted as one line adjustment in the transferee books.
  - Profit of the transferor company for the year 2012-13 will be accounted in normal course in the transferee company.
  - Comparative figures can not be changed as restatement is not allowed in India.

Amalgamation with Retrospective Effect (contd.)

- Dividend paid, if any for the year 2011-12 needs to be adjusted in profit and loss appropriation.
- If A Ltd. has carry forward losses, combined tax liability may get changed and therefore, it requires revision of income tax returns for the year 2011-12.
- To the extent carry forward loss could not absorbed, it may not be possible to create DTA.

Demerger



Pre
Shareholders
Undertaking A
AB Ltd
Undertaking B
Post
Shareholders
Undertaking A
AB Ltd
Undertaking B
B Ltd
Assets, liabilities of undertaking B transferred to B Ltd.

Demerger – Case Study

Particulars	Demerged Company Before	Demerged Company After	Resulting Company
Share Capital	100	100	40
Reserves	600	350	210
Loans	300	200	100
Total Liabilities	**1,000**	**650**	**350**
Fixed Assets	600	400	200
Net Current Assets	400	250	150
Total Assets	**1,000**	**650**	**350**

Accounting Case Study

An illustrative Merged Balance Sheet under Pooling of Interest Method and Purchase Method is as under

MERGER OF A LTD. INTO B LTD.					
Liabilities	**A Ltd**	**B Ltd**	**Assets**	**A Ltd**	**B Ltd**
	Rs.	**Rs.**		**Rs.**	**Rs.**
Equity Share Capital	40	75	Fixed Assets	23	112
General Reserve	7	65	Investments	22	40
Profit and Loss Balance	-5	15			
Debenture Redemption Reserve	5	-	Current Assets,Loans& Adv	34	80
Loans	20	25			-
Current Liabilities & Provisions	12	52			
Total	**79**	**232**	**Total**	**79**	**232**

Accounting Case Study

Assumptions		
i) The share exchange ratio for the merger of A Ltd. into B Ltd. is: "For every 2 equity shares of Rs. 10 each fully paid up of A Ltd., 1 equity share of Rs. 10 each fully paid up of B Ltd."; which means that B Ltd. will issue equity share capital of Rs. 20 to the shareholders of A Ltd.		
ii) Mkt Value of Fixed Assets of A Ltd is Rs.	20	
iii) Mkt Value of Investments of A Ltd is Rs.	25	

Balance Sheet of B Ltd.

a) POOLING OF INTEREST METHOD (AT BOOK VALUE)			
Liabilities	**B Ltd**	**Assets**	**B Ltd**
	Rs.		**Rs.**
Equity Share Capital [See Assumption i)]	95	Fixed Assets (23+112)	135
General Reserve (7+65)	72	Investments (22+40)	62
Profit and Loss A/c (-5+15)	10		
Debenture Redemption Reserve (5+0)	5	Current Assets, Loans & Advances (34+80)	114
Amalgamation Reserve	20		
Loans (20+25)	45		
Current Liabilities and Provisions (12+52)	64		
Total	**311**	**Total**	**311**

Balance Sheet of B Ltd.

b) PURCHASE METHOD (AT MARKET VALUES)			
Liabilities	**B Ltd**	**Assets**	**B Ltd**
	Rs.		**Rs.**
Equity Share Capital [See Assumption i)]	95	Fixed Assets (20+112)	132
General Reserve	65	Investments (25+40)	65
Profit and Loss Balance	15		
Debenture Redemption Reserve (DRR) (5+0)	5	Current Assets, Loans & Advances (34+80)	114
Capital Reserve	27	Amalgamation Adjustment a/c	5
Loans (20+25)	45	(Created against DRR)	
Current Liabilities and Provisions (12+52)	64		
Total	**316**	**Total**	**316**

Disclosures under AS - 14

- For all amalgamations
  - Name and general nature of the companies
  - Effective date of amalgamation
  - Method of accounting used
  - Particulars of the scheme sanctioned under a statute.
- For amalgamation under pooling of interest method
  - Exchange ratio, description and number of shares.
  - Difference between consideration and net identifiable assets acquired and treatment of the same.
- For amalgamation under purchase method
  - Consideration for amalgamation
  - Treatment of goodwill / capital reserve if any.

IFRS 3 (IndAS 103) - Business Combinations

- Steps for accounting
  - Determining whether the transaction or event is a business combination
  - Identify an Acquirer
  - Determine the acquisition date
  - Determine the cost of the business combination - consideration paid
  - Allocate the cost of the business combination to various assets and liabilities and determine non-controlling interest
  - Deal with residual goodwill or gain from bargain purchase
  - Subsequent measurement and accounting

IFRS 3 - Identify an acquirer

- Consider
  - Respective sizes of entities prior to the combination
  - power to govern financial and operating policies of combines entity
  - voting rights in combined entity.
- Acquirer for accounting purposes may be different from ‘legal’ acquirer (a ‘reverse acquisition’)
- Where a new entity is formed one of the pre-existing entities must be identified as the acquirer.

IFRS 3 - Determine cost of combination

- Include
  - Cash consideration
  - Equity instruments issued to effect transaction
  - Liabilities incurred as a result of the transaction
  - Contingent payments to the extent they are probable / can be reliably measured
- Equity instruments issued as purchase consideration measured at market price / fair value.
- Costs of arranging finance for the acquisition and costs of issuing equity instruments are not recognised as an asset - they are accounted for in accordance with IAS 39.

Allocate cost of combination

- Allocate acquisition costs across fair values of assets, liabilities and contingent liabilities assumed
- Identify all intangibles that may require separate recognition
- Only allocate to those assets, liabilities and contingent liabilities of the acquiree that exist at the date of acquisition
- Measure contingent liabilities if reliably measurable - based on the amount a third party would charge to assume the liability.

Intangible Assets Recognised

Illustrative Examples

- Marketing - related
  - Trademarks, trade names, interest domain names, trade dress, newspaper masthead, non-competition agreement.
- Customer - related
  - Customer lists, order / production backlog, customer contracts, non-contractual customer relationships
- Artistic - related
  - Copyrights

Intangible Assets Recognised ….

- Contract - related
  - Licenses, royalties, supply and service contacts, leases, franchises, broadcasting rights, access rights, beneficial employment contracts

- Technology - based
  - Patents, software, databases, trade secrets

Allocate cost of combination

- Positive goodwill
  - Recognise as an asset
  - do not amortise
  - apply IAS 36 impairment test

- Negative goodwill
  - re-check fair values
  - recognise balance as profit

Business Combinations without consideration

- This can be achieved by
  - the acquirer repurchases a sufficient number of its own shares to obtain control.
  - Minority veto rights lapse that previously kept the acquirer from controlling an acquiree with majority voting rights
  - a combination by contract - two entities enter into a contractual arrangement which covers, operation under a single management and equalisation of voting power.
- IFRS 3 requires one of the combining entities to be identified as an acquirer. There may be difficulty in identifying the acquirer but that can not be a reason to justify different accounting treatment.

Business Combinations without consideration ….

- Deemed consideration
  - the acquirer substitutes fair value of its interest in the acquiree for the fair value of consideration transferred to measure goodwill or gain on bargain purchase
  - fair value is arrived at using appropriate valuation techniques. If more than one techniques is used the result of the techniques should be evaluated considering the relevance and reliability of the input data used.

Reverse Acquisition

- It occurs when the entity that issues securities (legal acquirer) is identified as the acquiree for accounting purpose.
- Reverse acquisition some times occur when private operating entity wants to become a public entity but does not want to list its equity shares. In such situation, the private entity will arrange for a public entity to acquire its equity interest in exchange for equity interest of the public entity.
- IFRS 3 limits business combination to circumstances where the acquiree has a business and therefore for reverse acquisition, the accounting acquiree must have business operations.

Reverse Acquisition ….

- In case where a private entity is merged in to a publicly listed shell company (without any business activity), reverse acquisition can not be applied as per IFRS 3.
- Two primary factors to be considered
  - whether the formal shareholders of the entity whose shares are acquired own the majority of shares and control the majority of votes, in the combined entity and
  - the management of the combined entity is made up of employees pre-dominantly from the entity whose shares are acquired.

Reverse Acquisition ….

- Accounting
  - IFRS 3 to achieve an accounting outcome that reflects the CFS as if the accounting acquirer had legally acquired the accounting acquiree.
  - The legal form of business combination should not impact substance.
  - CFS prepared following reverse acquisition are issued under the name of the legal parent but prescribed in the notes as a continuation of the financial statement of the legal subsidiary, with one adjustment i.e. to adjust retrospectively capital of the legal subsidiary to reflect capital of the legal parent.

Major Issues in IFRS - 3

- Acquisition cost
- Contingent consideration
- Partial acquisitions
- Step-by-step acquisitions
- Transactions with non controlling interest (minority)

IFRS 3 - Acquisition Cost

- Previously, acquisition related cost were considered for working out goodwill.
- As per revised standard it needs to be recognised in the P&L account of the period.
- Cost incurred to issue debt or equity securities will be recognised in accordance with financial instrument standards.
- Emphasis is on consideration received by the vendor rather than on the amount spent for acquisition.
- If acquisition related cost is borne by the acquiree, to check whether it is reimbursed in the consideration paid by the acquirer.

IFRS 3 - Acquisition Cost ….

- If such acquisition related cost is part of the consideration paid, it should be separated and expensed out by the acquirer and balance amount to be considered for goodwill calculation.

IFRS 3 - Contingent Consideration

- Contingent Consideration is generally linked to achievement of certain revenue or reaching specific share price or meeting targeted EPS or meeting a milestone of capacity utilisation, research and development project.
- It also includes situation which gives the acquirer right to the return of previously transferred consideration, if certain specified conditions are met.
- Contingent Consideration is recognised and measured at fair value on the acquisition date.
- Subsequent changes in fair value can be considered in goodwill only if :

IFRS 3 - Contingent Consideration ….

  - it has occurred during measurement period (maximum 1 year)
  - it is as a result of additional information about facts and circumstances existed on the acquisition date
  - all other changes are recognised in profit and loss account
- Changes in the fair value after the measurement period are accounted as follows :
  - portion classified as an equity is not remeasured and its subsequent settlement is accounted for within equity
  - portion classified as an asset or liability, if financial instruments as per IAS - 39 is measured at fair value with the resulting gain or loss in the profit and loss account or in other comprehensive income. If not within scope of IAS - 39 it is done in accordance with IAS - 37 (AS-29) or other IAS.

IFRS 3 - Contingent Consideration ….

Example

X Ltd. acquires Z Ltd. The consideration is payable as under :

- an immediate payment of Rs. 50 mln
- a further payment of Rs. 10 mln after 1 year if EBDITA for the first year exceeds Rs. 30 mln
- a further payment of Rs. 10 mln after 2 years if EBDITA for the second year exceeds Rs. 35 mln

- The last two payments are conditional upon achievement of certain earnings and hence it is contingent consideration.

IFRS 3 - Contingent Consideration ….

- To arrive at the fair value on the date of acquisition, probability of reaching required earnings need to be considered.
- Let us assume probability is 40% in both the cases, which works out to Rs. 8 mln.
- After considering time value of money, the amount of contingent consideration comes to Rs. 7 mln. and the same amount is recognised as consideration.
- Contingent consideration is recognised when it meets 'probable' test and a 'reliably measurable' test.
- Provisional values may be used at the year end if accounting for business combination is incomplete.

IFRS 3 - Deferred Tax Relating to BC

- Deferred Tax benefit is recognised as an asset. Any additional deferred tax benefit during the measurement period reduces the carrying amount of goodwill.
- If the carrying amount of goodwill is zero, the additional deferred tax benefit is recognised in the profit and loss account.
- All other deferred tax benefits realised subsequently are recognised in the profit and loss account.

IFRS 3 - Partial Acquisitions

- Partial Acquisitions means the acquisition of controlling interest, with the proportion of acquiree equity held by other investors.
- IFRS 3 provides the choice to measure non-controlling interest
  - at proportionate interest in the net identifiable assets of the acquiree (previous IFRS 3)
  - at fair value (new option) in line with US GAAP
  - a choice is available for each acquisition i.e. for one acquisition fair value can be used and for other acquisition proportionate interest can be used for non-controlling interest accounting.

IFRS 3 - Partial Acquisitions ….

- The choice of method has consequential effect on goodwill.
- The choice effects only initial measurement. The fair value option is not available for subsequent changes in non-controlling interest.
- Amount of goodwill is subject to impairment testing by applying IAS 36 (AS - 28). For impairment testing, the carrying amount of goodwill allocated to CGU is grossed up to include the goodwill attributable to the non-controlling interest in case of proportionate interest accounting. The gross amount is compared with the recoverable amount to determine impairment.

IFRS 3 - Partial Acquisitions ….

Example

- A acquires B in two stages
  - 1/3rd equity interest is acquired at Rs. 100 per share, which resulted in A having a significant influence over B
  - a further 1/3rd equity interest is acquired at Rs. 150 per share, which resulted in controlling interest
  - market price of shares on the date of acquisition was Rs. 90 per share.
- Each fair value reflect a different fact pattern and therefore a different market :
  - Rs. 100 represent fair value of an equity interest carrying significant influence with the potential to have controlling interest.

IFRS 3 - Partial Acquisitions ….

- Rs. 150 represent fair value of controlling interest, including controlling premium.
- Rs. 90 represent fair value of minority interest, which is controlled by another party.

IFRS 3 - Step Acquisitions

- A step acquisition refers to controlling interest through two or more separate transactions.
- IFRS 3 and IAS 27 requires acquisition accounting only on the date when control is achieved.
- Goodwill is identified and net asset is remeasured to fair value only on the date when the control is achieve.
- In measuring goodwill any earlier holding are first measured to fair value, with any gain or loss recognised in the profit and loss account.
- Similarly, on disposal of controlling interest, any residual interest is remeasured at fair value and reflected in any profit / loss on disposal.

IFRS 3 - Step Acquisitions ….

Example

- A acquired a 75% controlling interest in B in two stages.
  - In 2009, A acquired a 15% equity interest for cash consideration of Rs. 10,000. A classified the interest as available for sale under IAS 39. From 2009 to the end of 2012, A reported fair value increases of Rs. 2,000 in other comprehensive income (OCI).
  - In 2013, A acquired a further 60% equity interest for cash consideration of Rs. 60,000. A identified net assets of B with a fair value of Rs. 80,000. A elected to measure non-controlling interests at their share of net assets. On the date of acquisition, the previously-held 15% interest had a fair value of Rs. 12,500.

IFRS 3 - Step Acquisitions ….

- In 2013, A will book profit of Rs. 2500 in profit and loss account for 15% investment acquired in 2009. Out of this, Rs. 2000 will be transferred from OCI (Reserves).
- Goodwill will be measured as follows :
  - fair value of consideration for controlling interest and previously held interest is Rs.72,500
  - non-controlling interest at 25% of Rs. 80,000 is Rs. 20,000
  - fair value of net assets of the acquiree on the acquisition date is Rs. 80,000
  - this is compared with fair value of investments and non-controlling interest and difference of Rs. 12,500 is considered as Goodwill.

Transactions with non-controlling Interest

- Further transactions of parents acquiring further stake from non-controlling interest or disposes of equity interest without losing control are accounted for as equity transactions.
- Consequently
  - the carrying amounts of the controlling and non-controlling interests are adjusted to reflect the changes in their relative interests in the subsidiary
  - any difference between the amount adjusted and the fair value of consideration paid / received is recognised directly in equity
  - there is no consequential adjustment to the carrying amount of goodwill and no gain or loss.

Transactions with non-controlling Interest ….

- IAS 27 does not give detailed guidance as how to measure the amount to be allocated to the parent and non-controlling interest to reflect a change in their relative interests in the subsidiary.
- One of the option is to recognised any difference between the fair value of the consideration paid and the non-controlling interest, in terms of existing carrying amount, directly in equity attributable to the parent.
- IAS 32 requires that the transaction cost of any equity transaction be recognised in equity. Therefore, such costs are recognised to equity.

THANK YOU

QUESTIONS ??

QUESTIONS ??

QUESTIONS ??