

Business Combinations – IND AS 103



For many men, the acquisition of wealth does not end their troubles, it only changes them.

- [Lucius Annaeus Seneca](#)

Scope of Business Combination

- Identification of Business Combination
- Acquirer and Acquisition Date
- Consideration transferred as part of BC
- Identification of Assets and Liabilities Assumed
- Goodwill / Bargain Purchase
- Measurement after Initial Recognition
- Disclosures



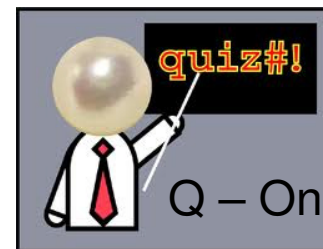
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- You have been working in the Accounts Department of Cook India Ltd (CIL).
 - Your boss calls you up and says we are in the process of finalising an acquisition of Linda Foods (LF).



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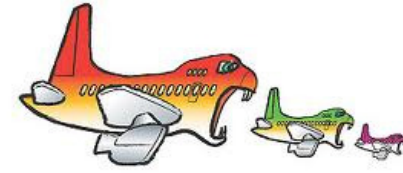
Here are some of the options considered for acquisition. You need to advise which one leads to BC

- CIL purchases 100% equity of LF
- CIL directly purchases Net Assets of LF
- CIL purchases one of the three units of LF
- CIL forms new company Singapore Inc. and transfers the business of LF to this new company. CIL does not have shares but all decision making powers for Singapore Inc.
- CIL enters into a Joint Venture with LF to combine their businesses



Q – On the Screen

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Key Definitions:-

- **Business Combination** - A transaction or other event in which an acquirer obtains **control** of one or more **businesses**.
- **Business** - “ *an integrated set of activities and assets conducted and managed for providing....return to investor or economic benefit to stakeholders....generally consists of inputs and processes applied to those inputs , and resulting in 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.



**Set of
Activities
and Assets**

What constitutes Business ?

Input



Process

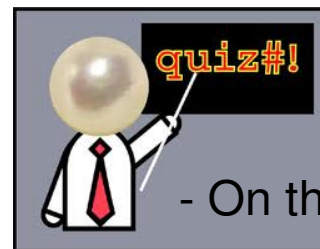


**Resulting
Out
Generate
Revenue**



Which of these is a BC?

- Q – Company P acquires operations of Company S.
- Q - Company P acquires operations of Company S, except for a vital Patent which is very important part of S's business
- Q - Company P acquires operations of Company S, except for a vital Patent which is very important part of S's business, but it enters into an agreement with S use its Patents on a long term basis



- On the Screen

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Business – Combination ?



Acquisition



Merger

Need for consolidated information



New formation



Joint Venture

Hostile take-over



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Issues that arise are?

- What constitutes control?
- What is control?
- Factors influencing control!
- Control or no control? That is the question!
- Control is defined as:-
 - “ Power to govern the operating and financial policies of an entity so as to gain benefits from its activities.”



When is control said to be established:-

- Equity Shareholding
- Ability to appoint directors to the board
- Potential Voting Rights
- Special Purpose Entities
- Control Agreement
- Defacto Control

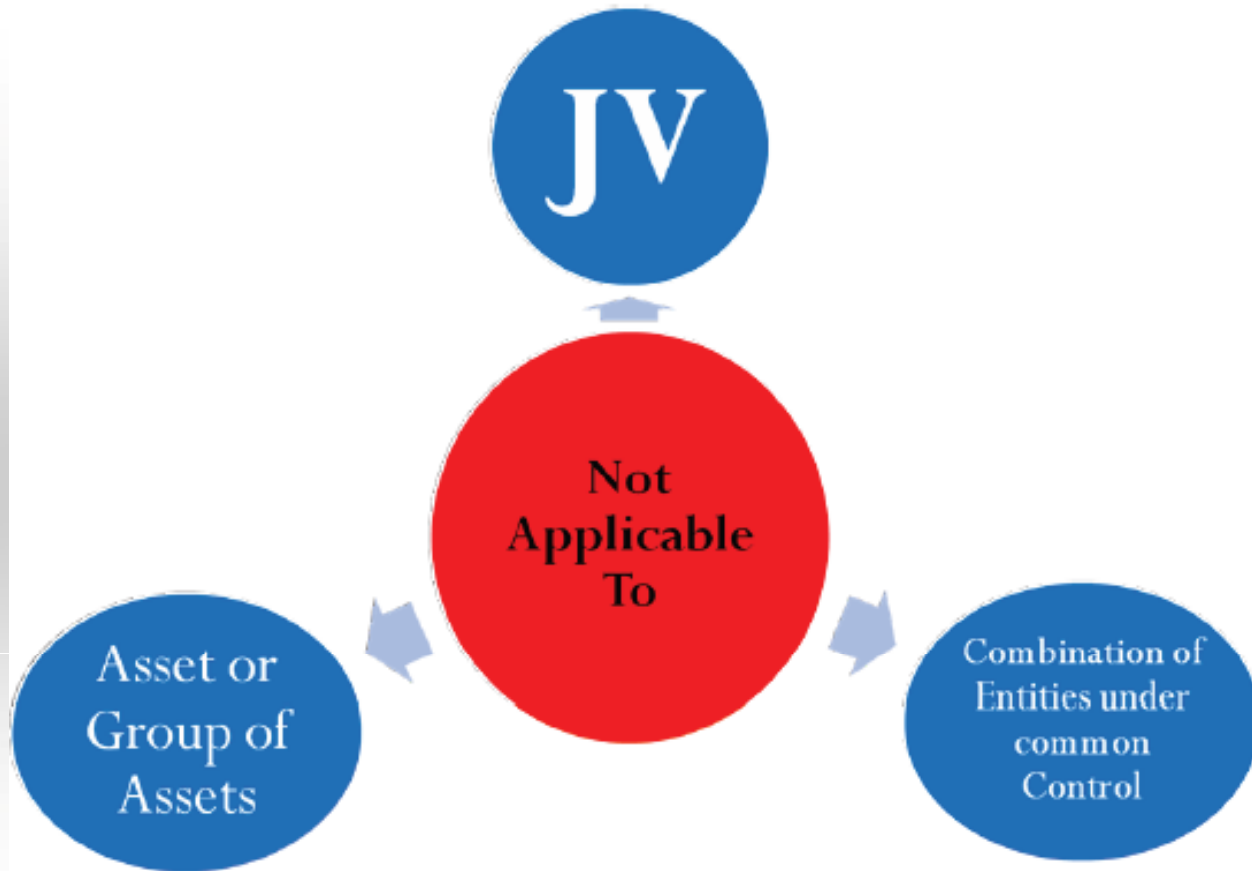




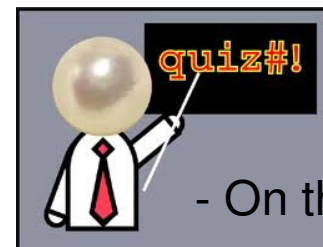
De facto Control

- Under this model, the power to govern through majority of voting rights, or other legal means does not exist,
- But ability in practise to control i.e. by majority of votes actually cast
- Thus it can lead to consolidation by minority shareholder





How does business combination differ in case of entities Under common Control?

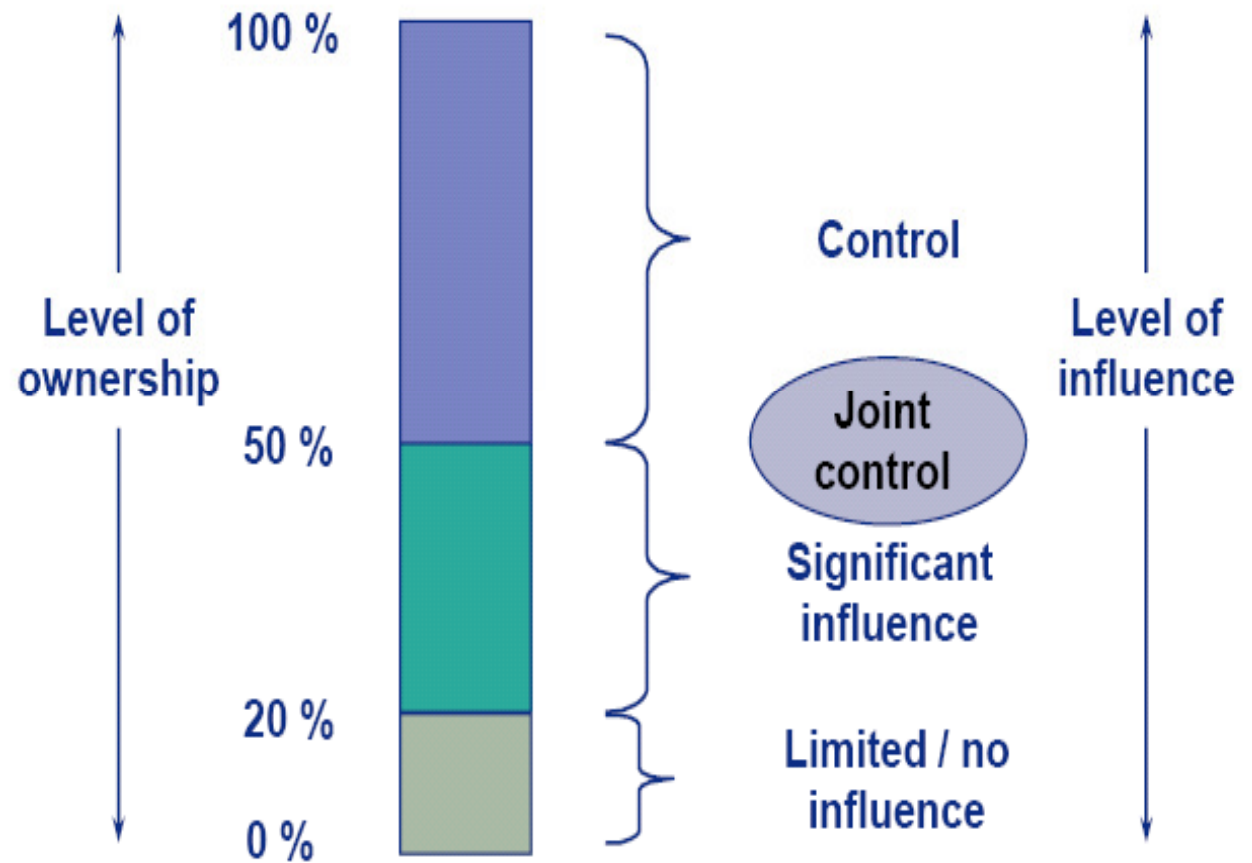


- On the Screen

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Levels of influence over an investment

Looking to this Chart, Can I have A subsidiary with 0% stake?



Minutes of Board Meeting....

- We're interested in diversifying our business and we've decided to enter the drinking chocolate market. Negotiations have been entered into to buy a company in France called LF. LF manufactures hot chocolate and supplies its products throughout Europe.
- We have narrowed down our options to two, but no decision has been made as to how we will acquire control over the company.
- The options are:
 - 1. Purchasing a percentage of the company and having the power to govern the financial and operating policies of the business.
 - 2. Purchasing one of the trademarks of LF Inc - the brand name for its 'Famous Hot Chocolate' drink.



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- Under each of the proposed plans for LF, would the acquisition constitute a business?



- Q 1 / Q2 of Paperbook

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Who is the acquirer?

- IND AS says that all Business Combinations should be accounted for by applying the acquisition method. Thus acquirer should recognise acquiree's:-
 - Identifiable assets and
 - LiabilitiesAt the fair value at the acquisition date.



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-
- Although there was a merger between
 - Arcelor and Mittal
 - Sahara & Jet
 - Kingfisher and Air Deccan

 - but ultimately who controlled the company

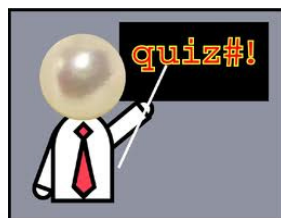


Do you still believe in mergers



Acquisition Date – Some issues

- Agreement entered into on 23rd May but it may provide that date of control effective from 1st April
- Agreement provides that effective date of transfer is 1st April but it is subject to shareholder approval on 1st May
- Shares are acquired on April 1 but the same need to be registered with regulators. They are registered on June 1
- Public offer for purchase of 75% shares made, 51% shares received on 23rd May and offer closes on 31st May



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Date of Exchange V/S Acquisition Date

- Date of exchange is date of each exchange transaction whereas acquisition date is date of obtaining control of acquiree.
- Valuation is based on date of exchange but all the components that existed at the date of acquisition are recognised.



What is the cost of a business combination?

- Fair values, at the date of exchange, of assets given (including Fair Value of Contingent Consideration),
- liabilities incurred or assumed, and equity instruments issued in exchange for gaining control;



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Costs you can't include!

Consideration

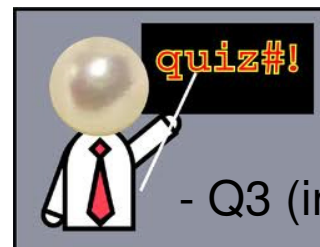
- a) Cost of maintaining an acquisitions department
- b) Cost of internal staff who work on the deal
- c) Cost of investigation
- d) Incentives to of potential targets employees to remain with company post acquisition
- e) Issue costs for debt or equity
- f) Direct costs related to acquisition like consultant fees, rating fee



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- Please find attached the document that explains how we intend to pay for the 80% purchase of LF. I'm not sure which forms of consideration are to be included and excluded.

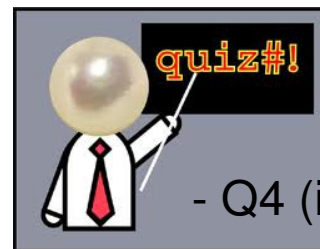
- Can you identify which payments are included/excluded in calculation of consideration transferred in the business combination? – Please read Page 1 of the Questions Sheet



- Q3 (in Paper Book)

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-
- Can you now identify the value to be put up against various cost heads which have to be included in the calculation of Purchase Consideration ?

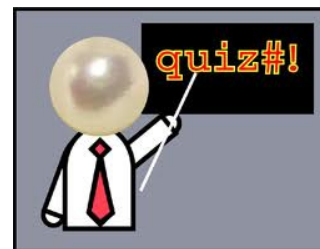


- Q4 (in Paper Book)

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Payment to Employees of Acquiree

- Whether the amounts paid to former employees part of Purchase Consideration
- What do I mean, when I pose this question?
- ESOP Accounting



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Theory on Recognition and Measurement



We need to refer to IFRS-3, the basic objectives of which are:-

Recognition and measurement:-

- a) Of the *identifiable assets* acquired, the liabilities assumed and any *non-controlling interest in the acquiree* in the financial statements;
- b) Of the *goodwill acquired in the business* combination or a gain from a bargain purchase; and
- c) determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination.



Fair value everything!

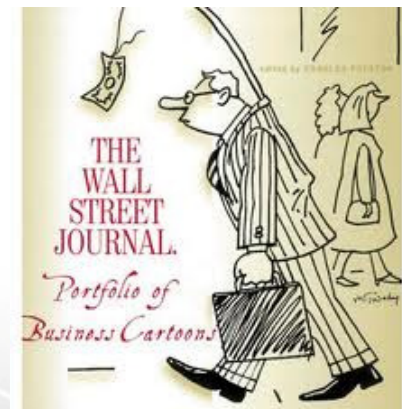
- Identifiable assets, liabilities and contingent liabilities recognised at fair value (FV).

FV is “amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction”.

- Acquirer’s intentions are not relevant!
- Difference between cost and net FV of identifiable assets, liabilities and contingent liabilities is goodwill.
- Goodwill represents future economic benefits not capable of being individually identified / separately recognised.

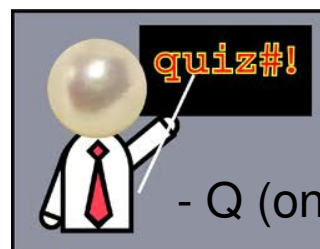


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Exercise – Fair Valuation

- Entity C has acquired its principal competitor, entity D. Entity C's management has explained that its motivation for the acquisition was to acquire market share by taking its rival's brand out of the market. Management has, therefore, proposed that the brand be allocated at minimal value since it will be removed from the market shortly after the acquisition.
- How will the Brand be valued ?



- Q (on the screen)

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Solution....

- Fair value is what a third party would pay for the assets (or charge to assume liabilities).
- The value of the brand name should be based on the assumption of cash flows from continuing use or sale to a third party.

Taking the brand out of the market may result in a post acquisition impairment charge.



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-
- Acquirer's intentions are not relevant

Eg. When Aditya Birla Group acquired



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Fair Values Guidelines

- - Equity Instruments > Published Price at the date of exchange except under rare circumstances
- - Financial instruments > Market values
- - Receivables > Present values net of allowances
- - Inventories FG > NRV less reasonable profits
- - Inventories RM > Replacement Cost
- - Land and Building > Market Value
- - Plant and Machinery > Market Value
- - Taxes > From acquirers perspective
- - Liabilities > Present Values
- - Contingent Liabilities > Third party ...expectation of possible cash flows



Recognition criteria for intangible assets acquired in a business combination

- Is it identifiable as it arises from contractual or other legal rights or separable from the entity (can be sold, transferred ,licensed or exchanged)
- Can the cost of the asset be measured reliably (Highly probable, except in rare circumstances)
- Is it a resource (future benefits) without physical substance controlled by the entity?

Some Examples are :-

- Customer Lists – Non-Contractual,
- Orders – Contractual,
- Internet Domain - Contractual



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Allocation of cost

- Identify which items would be recognised separately from goodwill under IFRS 3, and why (i.e., due to satisfying the specified recognition criteria in IFRS 3 and IAS 38).
- Satisfies the definition of an intangible asset and fair value can be reliably measured. Therefore recognised separately from goodwill.
 - (a) Customer contracts
 - (b) Internet domain names
 - (c) Customer database
 - (d) Brand name
 - (e) In-process R&D
 - (f) Lease agreement
 - (g) Trademarks, trade names, service
 - (h) Order backlog
 - (l) Licenses, royalties, agreements, rights, contracts



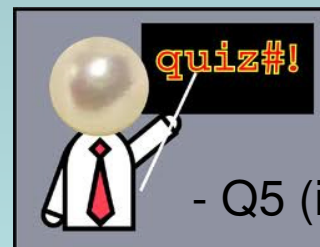
Allocation of cost (cont'd)

- IND AS 103 requires all contingent liabilities of the acquiree to be recognised at their fair values (provided that fair value can be reliably measured).
- Recognition even if the amount is not payable as per the relevant standard on Contingent Liability



Open Question for all the Teams

- Could you please help me to determine the appropriate recognition and measurement of the identifiable assets acquired, the liabilities assumed and any non-controlling interest in LF?



- Q5 (in Paper Book)

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- So now you have successfully :-
 - Identified a Business Combination
 - Determined what constitutes a business
 - Determined what is included in consideration
 - Also calculated the consideration transferred



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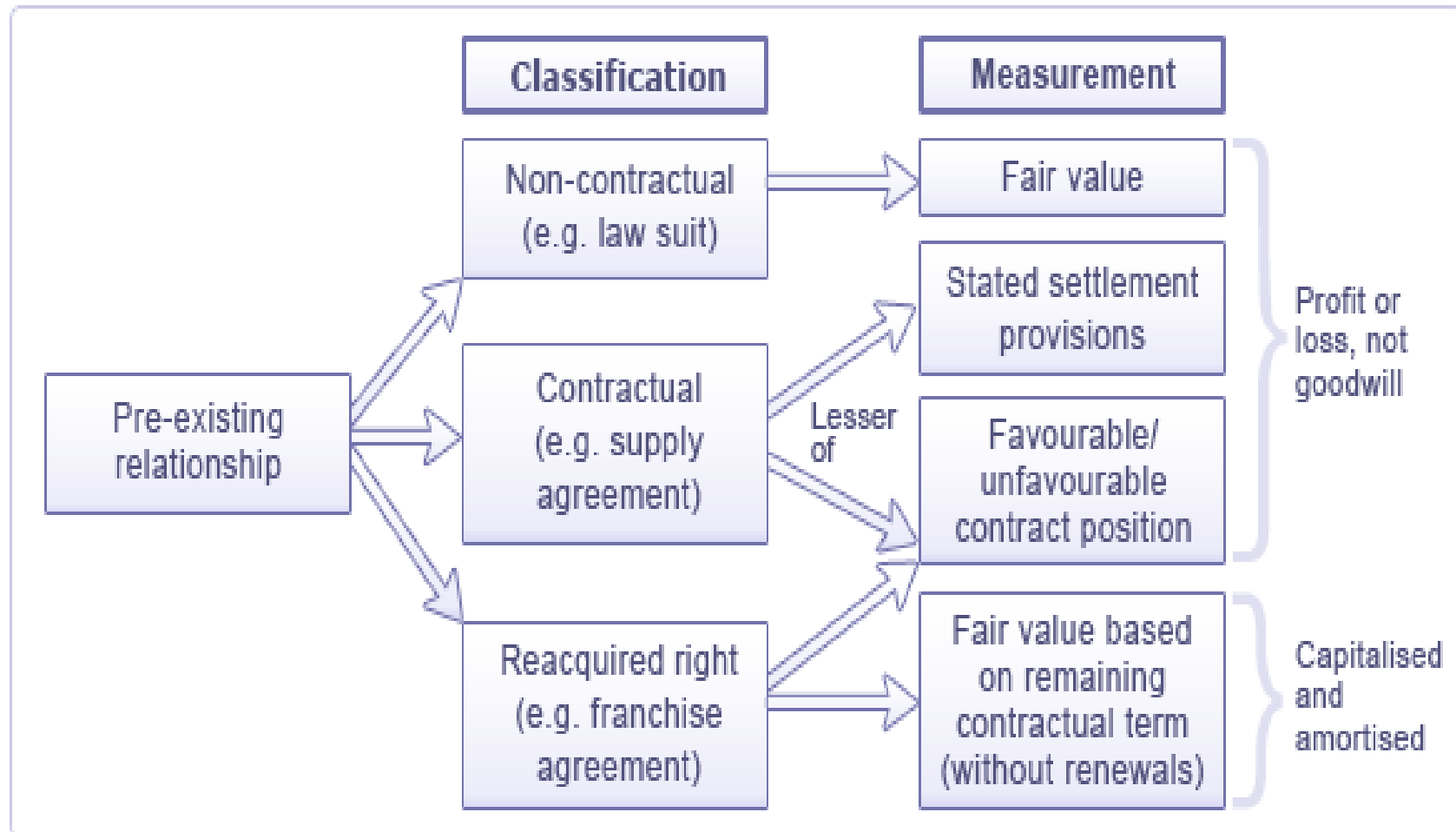
Additional Matters

- Treatment of Cost Contingent on Future Events
 - Included in cost at acquisition date if the adjustment is probable and can be measured reliably
 - Where criteria are met later, the additional consideration is treated as an adjustment to the cost of combination
- May include assets/liabilities not previously in books of acquiree, e.g.: - Deferred tax - Intangible assets



Pre-existing Relationships

Summary of accounting for a pre-existing relationship



Preexisting Law suit with a liability recognition of Rs. 8 Lacs

Fair Value of Law suit on date of Acq – 5 Lacs

Liability for Litigation Dr – 8 Lacs

Gain on Settlement Cr – 3 Lacs

Purchase Consideration Cr – 5 Lacs

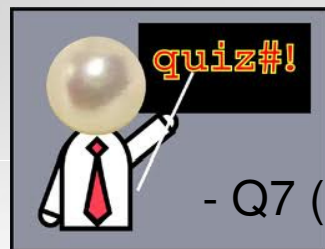


-
- Pre-existing Supply Contract
 - Current terms less favourable by Rs. 100 Lacs
 - Loss on Settlement of pre-existing Relationship Dr
100 Lacs

Purchase Consideration cr – 100 Lacs



Subsequent Adjustments to Acquisition Date Values...



- Q7 (in Paper Book)



Adjustments to provisional values within one year relating to facts and circumstances that existed at the acquisition date. [IFRS 3.45] No adjustments after one year except to correct an error in accordance with IAS 8.

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Lets take a look at the GAAP Differences

- Under IFRS, business combination has a wider scope.
- IFRS requires that for each business combinaton, the acquirer shall measure any non-controlling interest in the acquiree either at fair value or at the non-controlling interest's proportionate share of the acquiree's identifiable net assets.



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Under the existing AS 14, the acquired assets and liabilities are recognised at their existing book values or at fair values under the purchase method (Accounting on basis of Court Order).



GAAP differences continued.....

- AS 14 requires that the goodwill arising on amalgamation in the nature of purchase is amortised over a period not exceeding five years.
- IFRS deals with reverse acquisitions whereas the existing AS 14 does not deal with the same.
- As per IFRS, the consideration includes any asset or liability resulting from a contingent consideration arrangement. No guidance in AS 14.

IFRS gives guidance on Preexisting relationships on which AS-14 is silent.





Goodwill vs Negative Goodwill



Under Indian GAAP

- Negative Goodwill to be capital reserve

Under IFRS

- Negative Goodwill to be credited to profit & loss account (Bargain Purchase)

Under IND-AS

First Carve OUT



- IFRS 3 requires a bargain purchase gain on business combination to be recognized in profit or loss for the period. However, Ind-AS 103 requires the same to be recognized in OCI and accumulated in equity as capital reserve. However, if there is no clear evidence of bargain purchase, companies will recognize the gain directly in equity as capital reserve, without routing the same through OCI.



Second Carve Out

- IFRS 3 *Business Combinations* excludes common control business combinations from its scope. However, Ind-AS requires such combinations to be accounted using the pooling of interest method.



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Significant changes - goodwill

- Acquired business measured at fair value as a whole
- 100% goodwill recognised
 - Consistent with treatment of other assets
- Goodwill allocated between acquirer and non-controlling interest (was minority interest)
- Allocation of goodwill to acquirer based on:
 - Fair value of acquirer's equity interest LESS
 - Fair value of share of net assets acquired
 - Balance to NCI



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Goodwill example

- P acquires 75% (750 000 shares) of S for Rs 7.5cr
- Value of S = Rs 9.7cr
- Fair value of net assets acquired = Rs 8cr

Current requirements AS	
Consideration	7,5
Share of identifiable A (75% 8m)	<u>(6,0)</u>
Goodwill as per IND AS 103	1,5

Current requirements	
Goodwill	1,5
Net assets	8,0
Minority interest	2,0



IFRS : Goodwill example

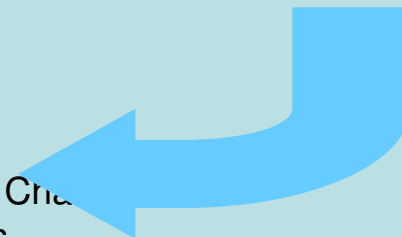
Current requirements AS 21	
Goodwill	1,5
Net assets	8,0
Minority interest (MI)	2,0

IND AS 103	
Fair value of S	9,7
Fair value of net assets	<u>(8,0)</u>
Goodwill	1,7



IND AS 103 - Allocate to P	
Consideration	7,5
Share of identifiable A+L (75% 8m)	<u>(6,0)</u>
GW allocated to P	1,5
=> Balance to NCI	0,2

IND AS 103	
Goodwill	1,7
Net assets	8,0
Non-controlling interest (NCI)	2,2



Goodwill – allocation

- Goodwill – allocated to all CGU's, expected to benefit from synergies from the combination
- Goodwill allocation must be completed before the end of the first reporting period beginning after the business combination
- Cash generating unit or group of units to which goodwill is allocated should be tested for impairment during the year in which goodwill was allocated



Reverse Acquisition

- A reverse acquisition occurs when the entity that issues securities (the legal acquirer) is identified as the acquiree for accounting purposes .
- The entity whose equity interests are acquired (the legal acquiree) must be the acquirer for accounting purposes for the transaction to be considered a reverse acquisition.



Key points to take away

- Understand the economics of the transaction before looking at the accounting.
- Consider whether you have an asset acquisition or a business combination.
- Control is a much broader concept than % equity ownership.
- Cost: determine what is a cost of the business combination and what is a post-acquisition cost.



Disclosures



- Information that enable users of its financial statements to evaluate the nature and financial effect of the business Combination
- For each business combination
 - Names and description
 - Acquisition Date
 - Percentage of Voting Instruments Acquired
 - Cost of Business Combinations and its components, including Equity – Number, Basis of FV; published or why not published price used.
 - Operations intended to be disposed off
 - At acquisition date, amounts for each class of assets & liabilities
 - Gain, if any and the line item
 - Factors contributing to recognition of Goodwill and description of each intangible asset that was not recognised and explanation why not recognised.
 - Profit or Loss since the acquisition date



Disclosures (Continued)

- For immaterial combinations disclosure may be aggregated:-
- Fact of provisional determination of values
- Revenue & Profit or loss of combined entity as though business combinations were effected at the beginning of the period.
- Information that enables users of its financial statements to evaluate financial effects of gains and losses, error corrections and other adjustments recognised in current period that relate to business combinations that were effected in current or previous periods.
- Changes in Carrying amount of Goodwill during the period



Lets now start preparing CFS.....



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