Ind AS 103 Business Combinations

Seminar on Merger & Acquisitions

26th December 2015

J.S. Lodha Auditorium , ICAI Bhawan, Cuffe Parade, Mumbai

Agenda

- Scope of Ind AS 103
- Steps in a business combination
- Identifying business combination
- Assets and liabilities acquired in a business combination
- Consideration transferred in a business combination
- Measurement of goodwill and non-controlling interests
- Common control transactions
- Reverse acquisitions
- Other application issues and practicalities
- GAAP differences

Scope of Ind AS 103

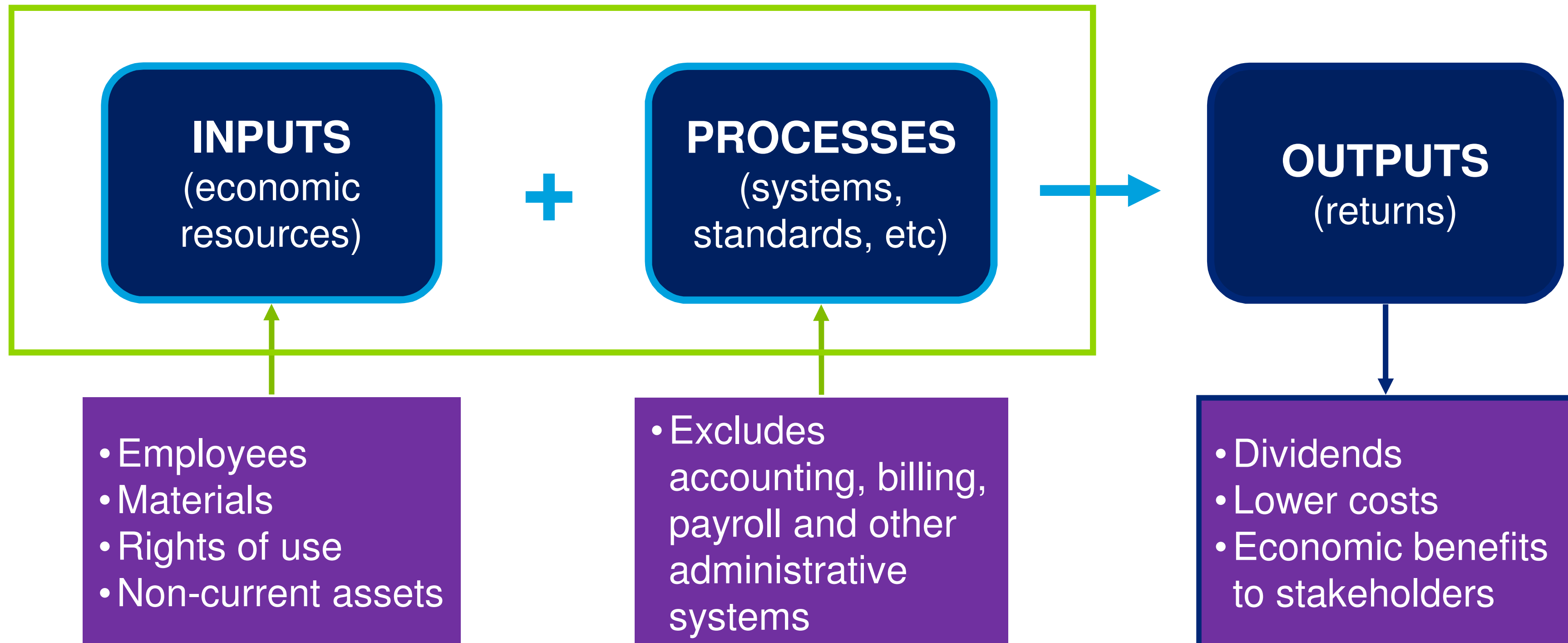
Transaction type	In scope?
one or more businesses become subsidiaries of an acquirer – **no liquidation of any company**	☑
net assets of one or more businesses are legally merged into the acquirer – **acquiree doesn't get liquidated**	☑
An entity along with its net assets are merged into the acquirer – **acquiree gets liquidated**	☑
a group of former owners of one of the acquiree entities obtains control of the combined entity – **reverse acquisition**	☑
Common control transactions* - **acquisition of net assets of one or more businesses or entities within a group**	☑
Formation of a joint venture	☒
Acquisition of an asset or a group of assets that does not constitute a business – **asset acquisition and not business**	☒

* Ind AS 103 contains detailed guidance on business combinations under common control in Appendix C which is not the case with IFRS 3.

Steps in a business combination

Steps	Further explanation	Coverage
1. Identifying a **business combination**	Business v/s asset acquisition	**Detailed**
2. Identifying the **acquirer**	Whether the legal owner is the acquirer in substance (Eg. Reverse acquisitions)	**Detailed**
3. Determining the **acquisition date**	Date on which control of the acquiree is obtained i.e. the closing date	**Limited**
4. Recognising and measuring **identifiable assets acquired and liabilities** assumed	Recognise the assets and liabilities acquired at fair value and also recognise some intangible assets that may not have been recognised in the acquiree's financial statements	**Detailed**
5. Recognising and measuring any **non-controlling interest** (minority interest)	2 different methods of measuring non-controlling interest	**Detailed**
6. Determine the **consideration transferred**	Accounting of assets transferred, liabilities assumed, contingent consideration, settlement of pre-existing relationship and acquisition costs	**Limited**
7. Recgonising and measuring a **goodwill or gain on bargain purchase**	Formula for computation of goodwill/ gain on bargain purchase	**Covered with 5**

Identifying business combination- Definition of a business



Must be present for a business to exist

Doesn’t need to be all the inputs and processes required

Must be capable of being managed as a business

If goodwill present, presumed to be a business

Outputs are not necessary

Development stage entities can be a business

Example: Identification of whether transaction is a business

Exploration and evaluation assets held in corporate shells:

In some jurisdictions, it is common for rights to tenure over exploration and evaluation interests to be held in separate companies for each tenement, area of interest, field, etc.

In many cases, transactions involving the transfer of a particular exploration and evaluation interest involves the legal transfer of the company, rather than the underlying right or title over the interest.

Question: Does the transferred company constitute a business?

Example : Suggested solution

Does the transferred company constitute a business?

Where an entity acquires a company in these circumstances, it is likely that the acquisition will not meet the definition of a business combination, because the acquisition is in substance the acquisition of the exploration and evaluation interest, rather than the acquisition of a business.

Accordingly, in the consolidated financial statements, such a transaction would be accounted for in accordance with the entity's accounting policy for exploration and evaluation under Ind AS 106.

Accounting of transactions that do not constitute a business combination

- Where a transaction or other event does not meet the definition of a business combination due to the acquiree not meeting the definition of a business, it is termed an ‘asset acquisition’. In such circumstances, the acquirer:
  - Identifies and recognises the individual identifiable assets acquired and liabilities assumed; and
  - Allocates the cost of the group of assets and liabilities to the individual identifiable assets and liabilities on the basis of their relative fair values at the date of purchase
- Such a transaction **does not give rise to goodwill.**

Accounting of business combination and asset acquisition - How is it different ?

Accounting topic	Business combination	Asset acquisition
Recognition of identifiable assets and liabilities	Measured at fair value	total cost is allocated to individual items based on relative fair values
Goodwill or gain on bargain purchase	Recognised as an asset (goodwill) or as income (gain on bargain purchase)	Not recognised
Transaction costs	Expensed when incurred	Typically capitalized
Deferred tax on initial temporary differences	Recognised as assets and liabilities	Not recognised unless specific circumstances apply

Assets and liabilities acquired in a business combination

Recognition and measurement of assets and liabilities in business combinations

	Recognition	Measurement
Principle	Meet the definition of assets and liabilities in the Framework for the Preparation and Presentation of Financial Statements issued by ICAI	Measure assets and liabilities at acquisition date fair values
Exceptions	Contingent liabilities (measure at fair value)	Share-based payment transactions Assets held for sale
	Deferred taxes Employee benefits Indemnification assets	

Contingencies in business combinations

Contingent liabilities	At acquisition date
Possible obligations	Not recognised
Present obligations that are not probable	Recognised if reliably measurable

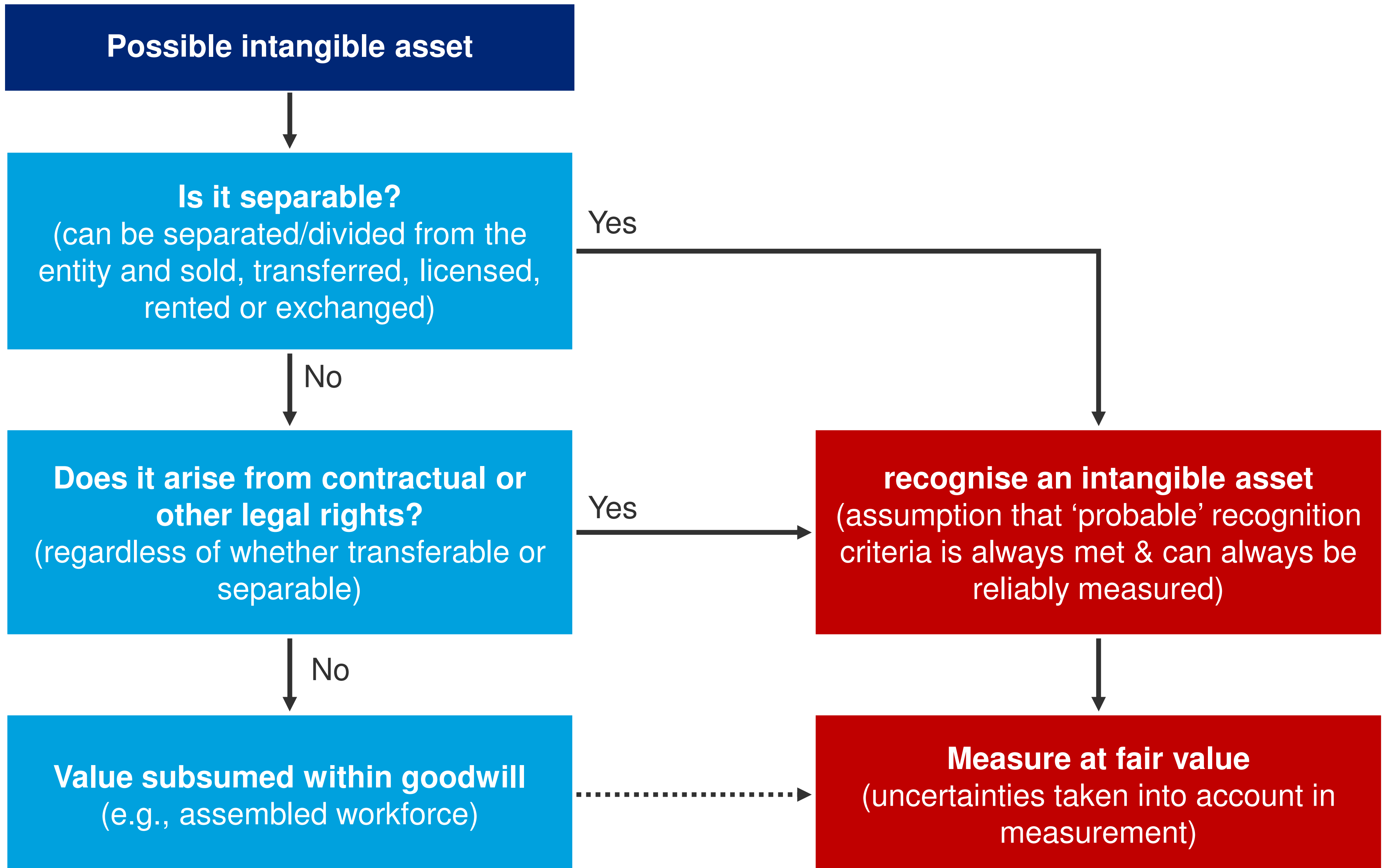
Example – Recognition and measurement of contingent liability

Company A purchased 100% interest of Company B. Company B is being sued over a personal injury allegedly caused by a faulty product. The claimant is suing for CU1 million in damages. The acquiree's management acknowledge that the product was faulty and may have caused injury. However, they strongly dispute the level of damages being claimed. The acquiree's legal advisers estimate such claims are usually settled for between 100,000 and 250,000.

Analysis

Based on the available evidence, this is an example of a present obligation, which is consequently recognised as a contingent liability and measured at fair value. **Company A will need to estimate the fair value of the liability which may involve weighting possible outcomes within the expected range using their associated probabilities.**

Intangible assets in business combinations



Example – Data base used in a supporting activity

Company Q acquired Company R, a retailer. Company R owns a database, used in managing its loyalty scheme, which captures information on customer demographics, preferences, relationship history and past buying patterns. The database can either be sold or licensed. However, Company R has no intention to do so because it will negatively impact its operations.

Analysis

In this situation, the database does not arise from a contractual or legal right. Thus, an assessment of its separability is required. The database and content were generated from one of Company R's supporting activities (ie management of the loyalty scheme) and could be transferred independently of the rest of the business. **The actual intention not to transfer the database does not affect the assessment.The separability criterion is met and the database is recognised as an intangible asset in the business combination**.

Example – Complimentary intangible assets

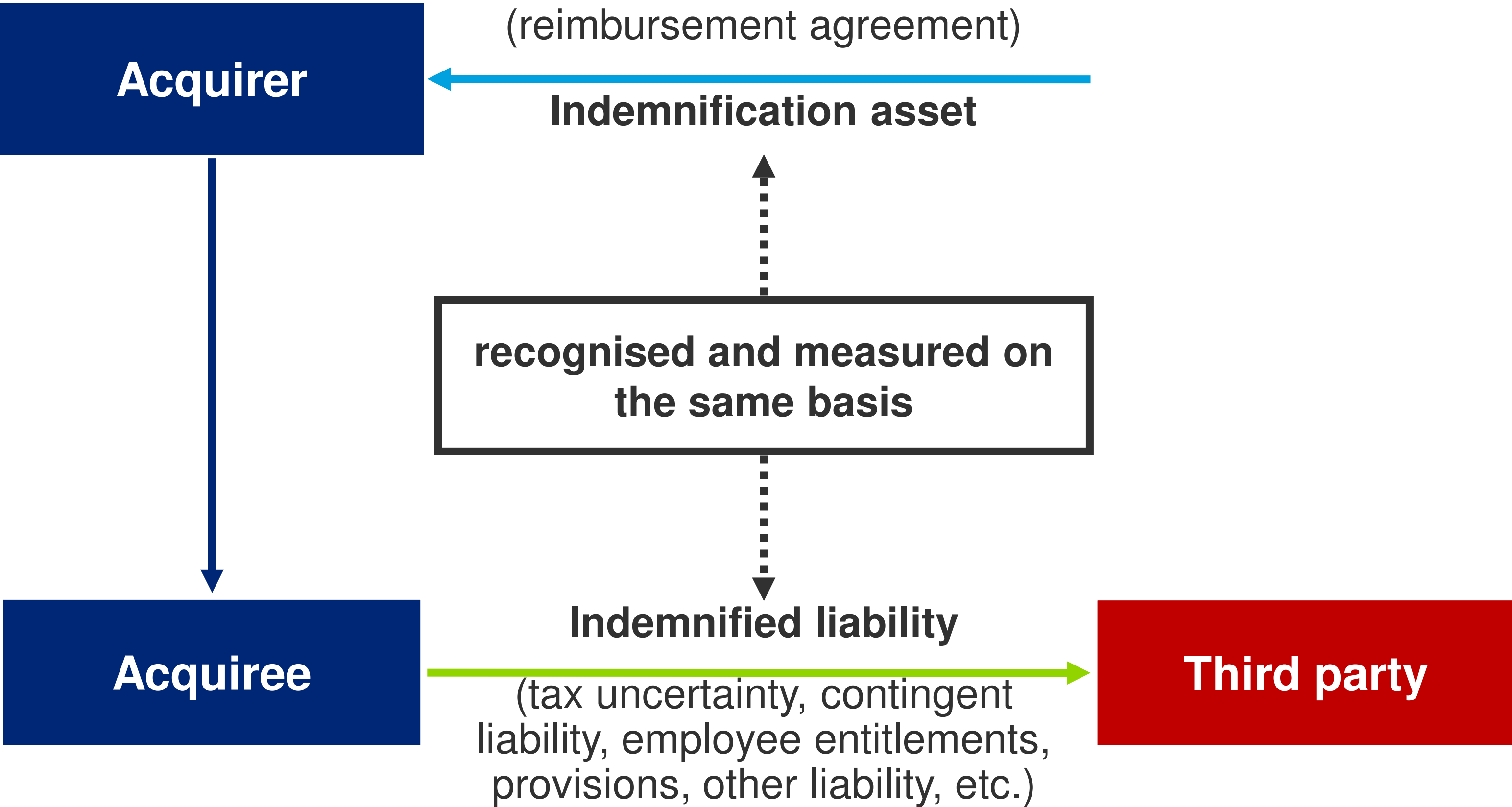
Company X acquired the food manufacturing division of Company Y, which includes a registered trademark for a certain product and an associated secret recipe for the product. Access to the secret recipe is required to enable the product to be manufactured and reasonable steps are taken to maintain its secrecy. The recipe is not protected by legal rights.

Analysis

The trademark is recognised as a separate intangible asset – as this is based on a legal right. The secret recipe is not covered by the trademark registration and is not otherwise protected by legal rights. Its separability is therefore assessed. It is probably not feasible to transfer the recipe without the trademark, or vice versa. It is however likely to be feasible to transfer the recipe and trademark together without transferring the entire business. **If so, the secret recipe meets the separability criterion and is recognised as a separate intangible asset. However, the recipe may be grouped with the trademark for presentation and measurement purposes if their useful lives are similar.**

Other items which may get subsumed in goodwill

Indemnification assets



Illustrative example: Third-party indemnification arrangements

Background

S Limited is acquiring a subsidiary from E Limited. As part of the business combination, E Limited agrees to indemnify S Limited for uncertainty related to a number of the subsidiary's existing liabilities. Instead of a direct indemnification by E Limited, the indemnification will be provided by means of an insurance contract written by a third-party insurance company. As agreed in the sale and purchase agreement, E Limited negotiates the insurance policy with the insurance company on behalf of S Limited.

Question:

Does the arrangement under the insurance policy represent an indemnification asset of S Limited as defined in Ind AS 103?

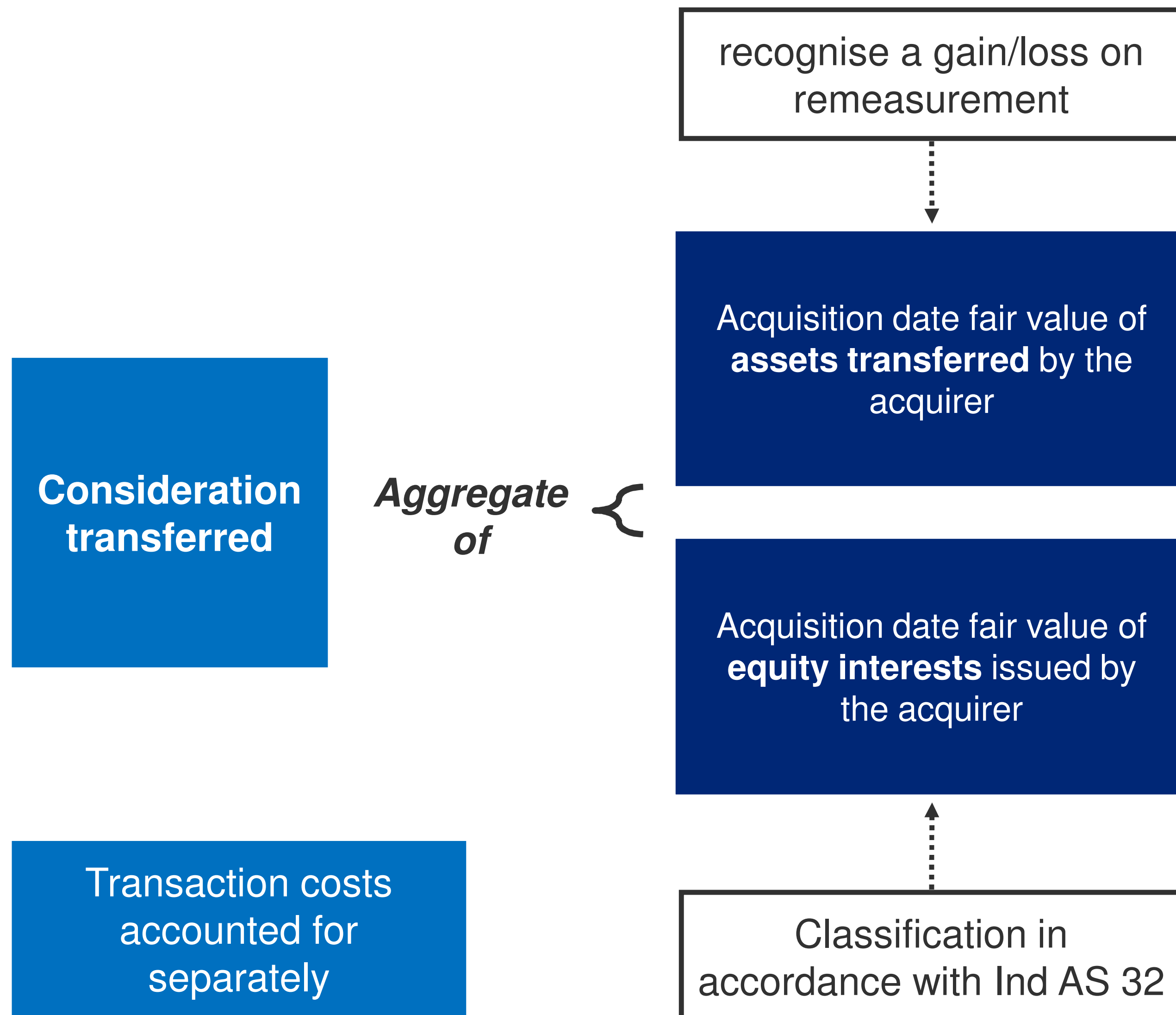
Illustrative example: Third-party indemnification arrangements

Suggested solution

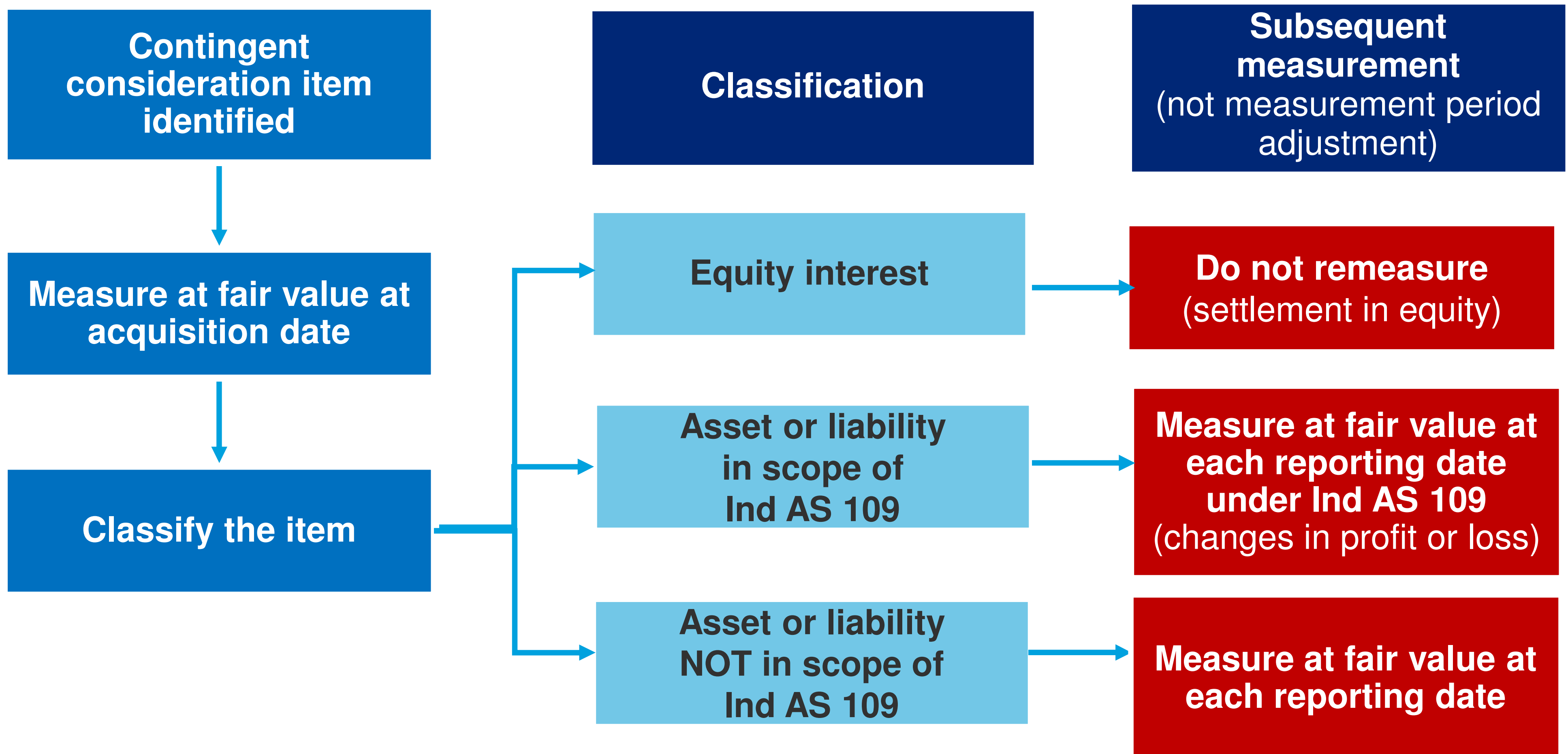
Yes. Ind AS 103.27 applies when the seller indemnifies the buyer for the outcome of a contingency or uncertainty related to all or part of a specific asset or liability. It does not prescribe the form of the indemnification arrangement. Therefore, E Limited's arranging for an insurance contract on behalf of and for the benefit of S Limited, as part of the business combination transaction, falls within the scope of Ind AS 103's requirements regarding indemnification assets.

Consideration transferred in a business combination

Components of consideration transferred



Contingent consideration



Illustrative example: Contingent consideration

An acquirer purchased a business in the pharmaceutical industry. The sale and purchase agreement specifies the amount payable as:

- cash of CU100 million to be paid on the acquisition date and
- an additional 1,000,000 shares of the acquirer to be paid after 2 years if a specified drug receives regulatory approval.

Analysis

The consideration transferred comprises the cash paid plus the fair value of the contingent obligation to pay 1,000,000 shares in 2 years' time.

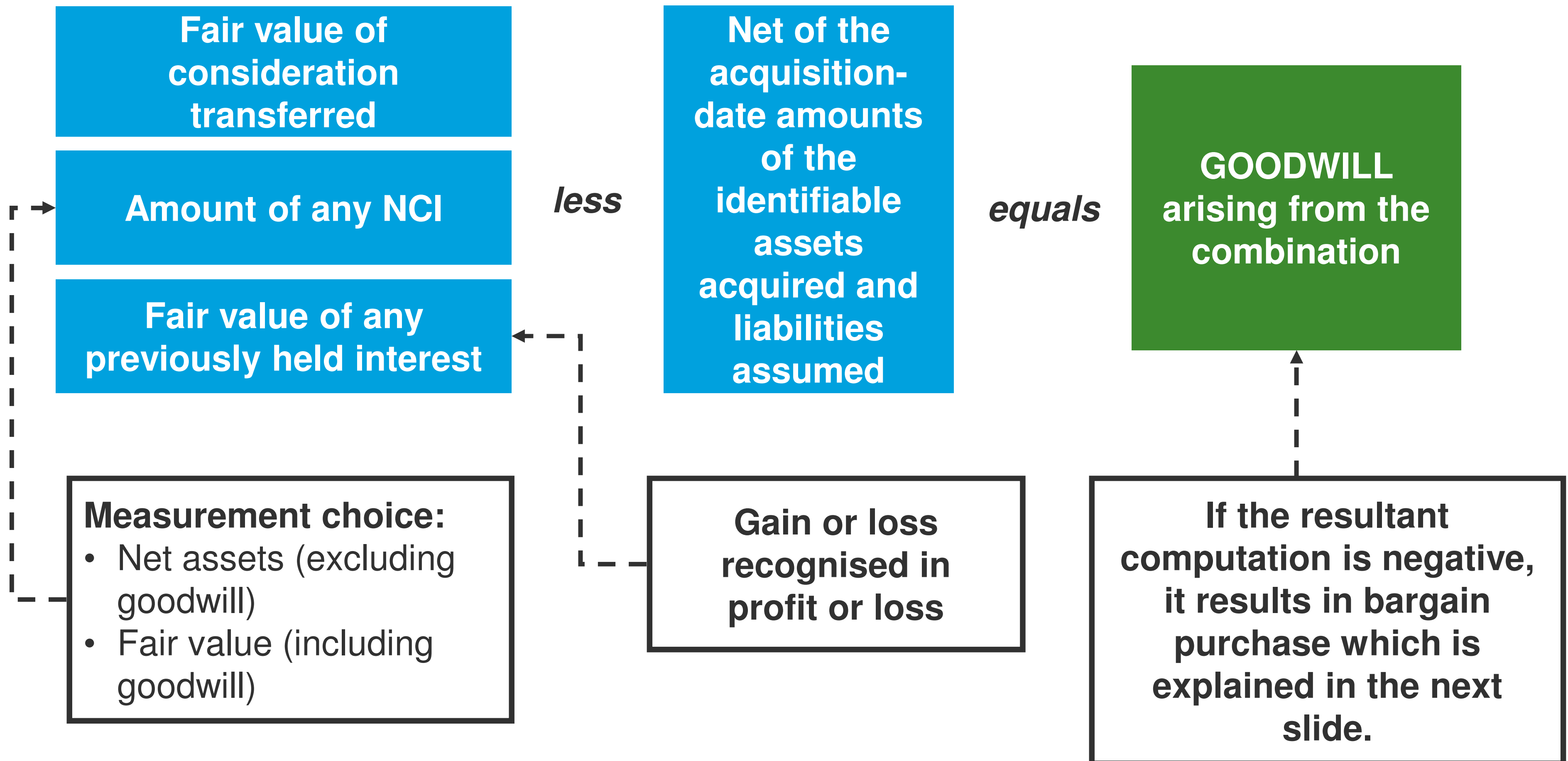
The fair value of the contingent element would be **based on a 2-year forward price and would be reduced by the effect of the performance conditions**.

The classification of the contingent consideration is based on the definitions in IAS 32. Because this obligation can be settled only by issuing a fixed number of shares, it is classified as an equity instrument.

Accordingly, the initial fair value of the contingent consideration is credited to equity. There is no subsequent adjustment (although the credit might be reclassified within equity on settlement in shares or on expiry of the obligation).

Measurement of goodwill and non-controlling interests

Determining goodwill



Bargain Purchase

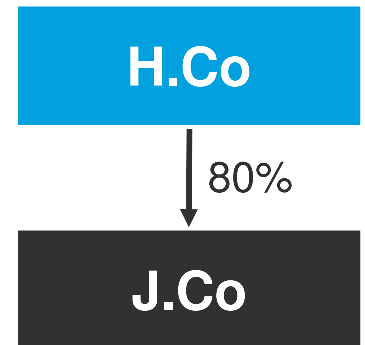
- Before recognising a bargain purchase gain, the acquirer shall determine whether there exists clear evidence of the underlying reasons for bargain purchase.
- If such evidence exists, the acquirer shall reassess whether it has correctly identified all of the assets acquired and all of the liabilities assumed.
- If there does not exist clear evidence of the underlying reasons for bargain purchase, the gain after carrying out reassessment and review shall be recognised directly in equity as capital reserve.
- On the other hand, if there exists clear evidence and even after the reassessment and review there is a gain, it shall be recognised in other comprehensive income on the acquisition date and accumulated in equity as capital reserve. The gain shall be attributed to the acquirer.

Question 3

Fact pattern

- H.Co acquires J.Co in a step acquisition
- Step 1 (25%) gives H.Co significant influence over J.Co
  (equity accounting is adopted)
- Step 2 (55%) results in H.Co controlling J.Co

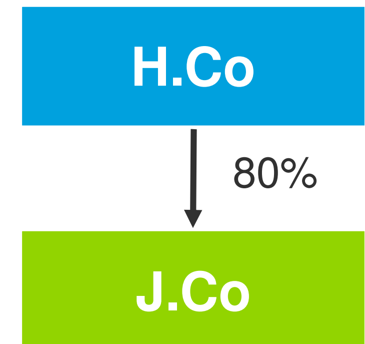
What is the goodwill based on the following information under both measurement alternatives for NCI?



Item	Step 1	Step 2
Interest acquired	25%	55%
Total consideration transferred	500	2,250
Fair value of net identifiable assets	1,750	3,500
Fair value of original 25% holding	-	1,000
Fair value of NCI	-	750

Question 3: Suggested solution

Analysis	NCI based on net assets	NCI based on fair value
Fair value of consideration	2,250	2,250
NCI	700 (3,500*20%)	750
Fair value of previously held interest	1,000	1,000
Subtotal	**3,950**	**4,000**
Less: net identifiable assets acquired	(3,500)	(3,500)
Goodwill	**450**	**500**
Consolidated net assets	**3,950**	**4,000**
Non-controlling interest	**700**	**750**



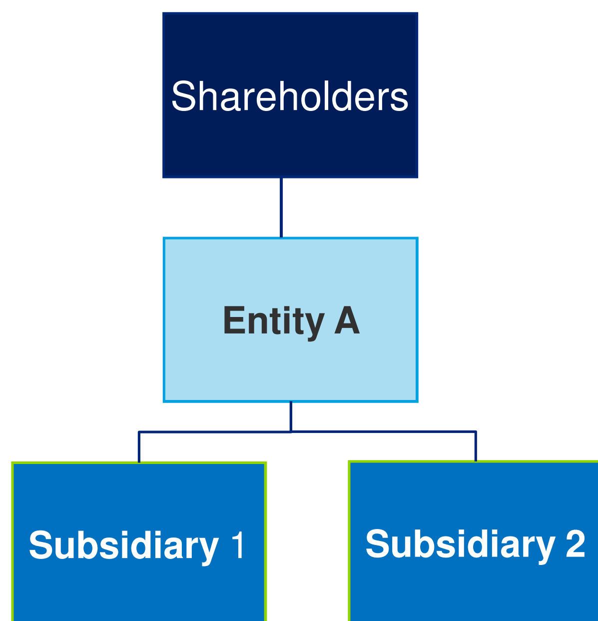
Common control transactions

Common control transactions

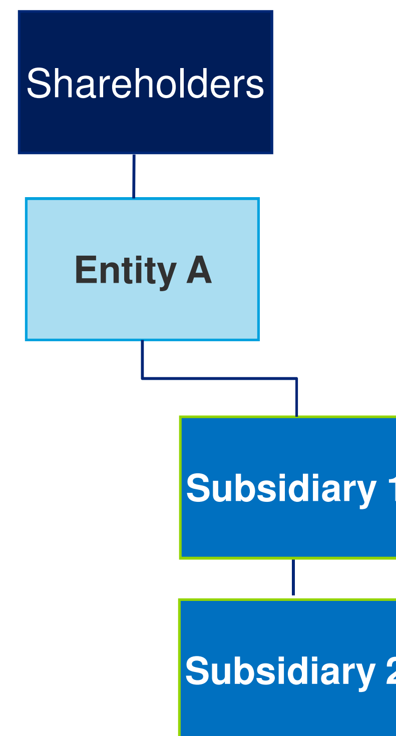
- A business combination involving common control transactions is a transaction in which
  - The combining entities or businesses are ultimately controlled by the same party (or parties) both before and after the transaction, and
  - Control is not transitory
- The extent of **non-controlling interests** in each of the combining entities before and after the business combination is not relevant
- Make sure to consider **contractual arrangements** when evaluating whether the same group of individuals has control before and after the transaction

Illustrative example: Common control transactions—In-group (1/3)

Before the transaction:



After the transaction:



Assume that the subsidiaries are wholly owned and each represents a separate business. Assume Entity A is simply a parent with no separate business activity.

Question: How should this transaction be accounted for in the consolidated financial statements of Subsidiary 1?

Illustrative example: Common control transactions—In-group (2/3)

- The acquisition will be accounted for using the **pooling of interests method**.
- The assets and liabilities Subsidiary 2 will be reflected at their carrying amounts in consolidated financial statements of Subsidiary 1. No adjustments are made to reflect fair values, or recognise any new assets or liabilities.
- The only adjustments that are made are to **harmonise accounting policies.**
- The balance of the retained earnings appearing in Subsidiary 2 is aggregated with that of Subsidiary 1. Alternatively, it is transferred to General Reserve, if any.
- The excess, if any, between the amount recorded as share capital issued plus any additional consideration in the form of cash or other assets and the amount of share capital Subsidiary 2 is transferred to Capital Reserve and this Capital Reserve is presented separately from other capital reserves with disclosure of its nature and purposes in the notes.

Example – Common control

Company A and Company B are under common control. Company A acquired entire share capital of Company B and issued 10 shares with face value of Re.1 and fair value of shares being Re. 2. (All numbers in Rupees)

Particulars	Company A	Company B	Company A+B
Assets	500	200	700
Total assets	***500***	***200***	***700***
Liabilities	100	50	150
Reserves	200	70	270
Securities premium (10X 1)	-	-	10
Capital reserve *	-	-	60
Equity Share capital (200 + 10 X 1)	200	80	210
Total Share capital, reserves and liabilities	***500***	***200***	***700***

*Capital reserve – 60 (80- 20)

Reverse acquisitions

Reverse acquisitions

Key concepts:

- A reverse acquisition occurs when:
  - The entity that issues securities (the 'legal acquirer') is the acquiree for accounting purposes
  - The entity whose equity interests are acquired (the 'legal acquiree') is the acquirer for accounting purposes
- The accounting acquiree must meet the definition of a business in order for the transaction to be treated as a reverse acquisition under Ind AS 103.

Primary indicators of reverse acquisition:

- The former shareholders of the entity whose shares are acquired own the majority of shares, and control the majority of votes, in the combined entity
- The management of the combined entity is drawn predominantly from the entity whose shares are acquired

[Based on Ind AS 103.B13-B18]

Illustrative example

Background:

A private entity wants to become a public entity but does not want to register its equity shares. To accomplish that, the private entity will arrange for a public entity to acquire its equity interests in exchange for equity interests of the public entity. After the transaction, the shareholders of the private entity will own the majority of the shares of the public entity and will control the public entity.

Is this a reverse acquisition? Who is the legal acquirer and who is the accounting acquirer?

In this example, the public entity is the legal acquirer because it issued its equity interests, and the private entity is the legal acquiree because its equity interests were acquired.

However, because control of the public entity falls into the hand of the former shareholders of the private entity, the listed entity is the acquiree for accounting purposes (the accounting acquiree) and the private entity is the acquirer for accounting purposes (the accounting acquirer).

This is a reverse acquisition.

Illustrative example: Presentation of equity for an entity with share capital

Background:

The Balance Sheet of Entity A and Entity B immediately before the transaction include the following:

Particulars	Entity A Legal parent/ Accounting acquiree	Entity B Legal subsidiary, accounting acquirer	Consolidated FS post combination
Current Assets	500	700	1,200
Non-current Assets	1,300	3,000	4,500
Goodwill	-	-	300
Total Assets	**1,800**	**3,700**	**6,000**
Current liabilities	300	600	900
Non-current liabilities	400	1,100	1,500
Total liabilities	**700**	**1,700**	**2,400**
Retained earnings	800	1,400	1,400
Equity share capital – 100 shares	300	-	-
Equity share capital – 60 shares	-	600	2,200
Share holders funds	**1,100**	**2,000**	**3,600**
Total liabilities and share holders funds	**1,800**	**3,700**	**6,000**

Entity A issued 2.5 new shares in exchange for each share of Entity B. Therefor, Entity A issued 150 shares in total. Fair value of each share of entity A is 16 and of B is 40. Entity A's non-current assets have fair value of 1,500, rest assets have the same fair value as carrying amounts.

Calculating the fair value of consideration transferred

- As a result of Entity A (legal parent, accounting acquiree) issuing 150 ordinary shares, Entity B's shareholders own 60 per cent of the issued shares of the combined entity (i.e 150 of 250 issued shares).
- The remaining 40 per cent are owned by Entity A's shareholders.
- If the business combination had taken the form of Entity B issuing additional ordinary shares to Entity A's shareholders in exchange for their ordinary shares in Entity A, **Entity B would have had to issue 40 shares** for the ratio of ownership interest in the combined entity to be the same.
- Entity B's shareholders **would then own 60 of the 100 issued shares** of Entity B—60 per cent of the combined entity. As a result, the fair value of the consideration effectively transferred by Entity B and the group's interest in **Entity A is 1,600 (40 shares with a fair value per share of 40).**

Calculation of goodwill

Particulars	Amounts	Amounts
Consideration effectively transferred (A)		1,600
Net recognised values of entity A's identifiable assets and liabilities (B)		
Current Assets	500	
Non-current Assets	1,500	
Current liabilities	(300)	
Non-current liabilities	(400)	(1,300)
Goodwill (A – B)		**300**

Other application issues and practicalities

Effect of deal terms on the accounting for business combinations

Deal terms	Effect on accounting for business combination
1. Structure of Purchase price - The purchase price may include the following	
contingent consideration arrangements, such as variations to the ultimate price depending on the future performance of the acquired business	recognition on the acquisition date at fair value has an immediate effect on the balance sheet (ie directly impacts goodwill and reported amounts of liability or equity) subsequent changes in the fair value of any contingent consideration liability will usually affect post-combination earnings
contingent payment arrangements with selling employee shareholders who remain employees of the acquired business (eg earn-out agreements)	accounted for based on their substance and may need to be treated (wholly or partly) as compensation for future services rather than payment for the business acquired compensation payments are recognised as remuneration expense in the period when services are rendered
transfer of acquirer's assets	the assets are remeasured at fair value on the acquisition date and form part of consideration transferred any remeasurement gain or loss is recognised immediately in earnings

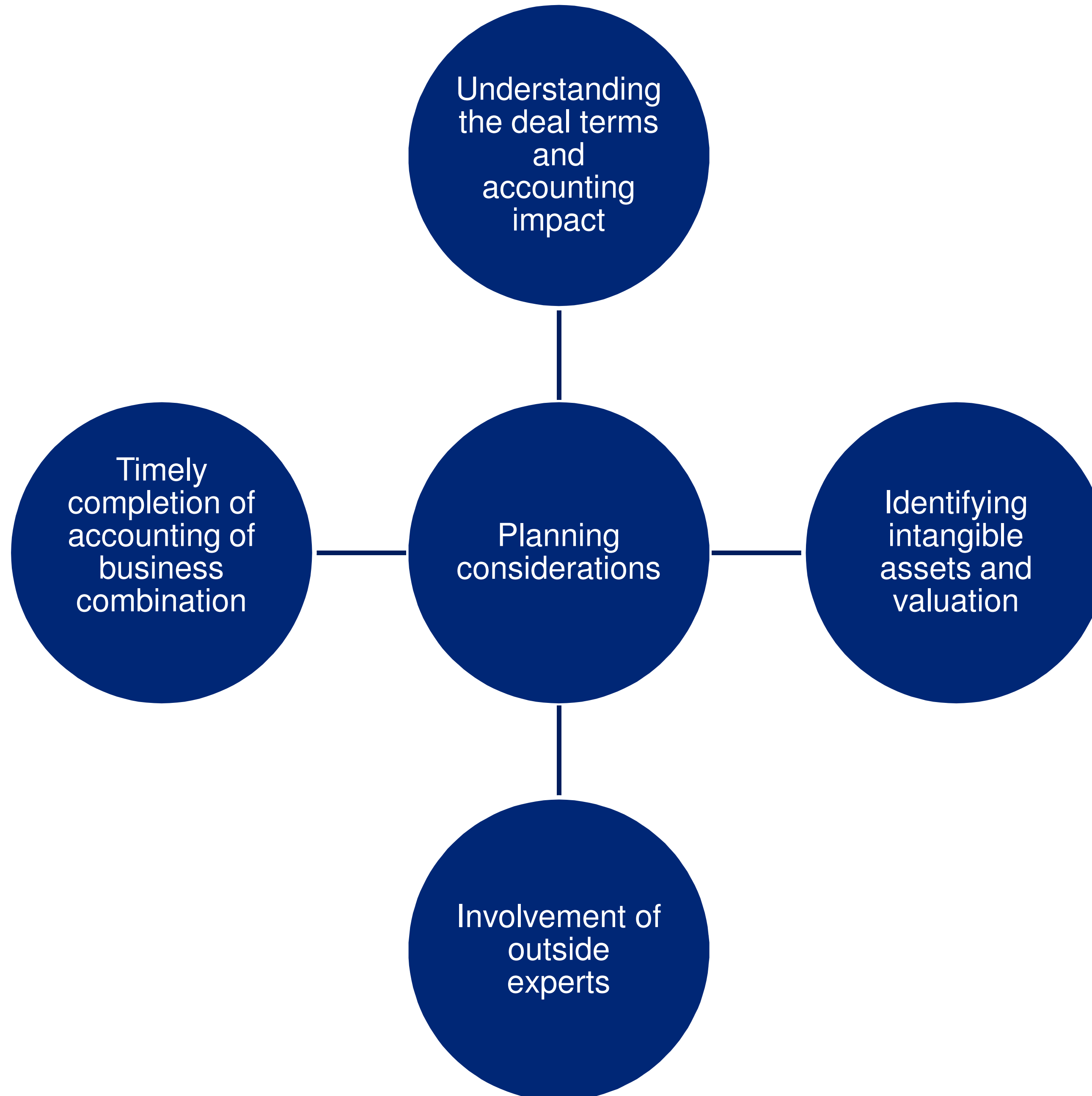
Effect of deal terms on the accounting for business combinations

Deal terms	Effect on accounting for business combination
2. Arrangement for payment of acquisition costs	
the parties may arrange that transaction costs are paid by the vendor which may or may not be reimbursed by the acquirer	reimbursement of acquisition costs is recognised as an immediate expense if costs paid by the vendor are not reimbursed directly by the acquirer, a portion of the contractual price is treated as in-substance reimbursement and excluded from consideration transferred
3. Pre-existing relationship between the acquirer and the acquiree	
The parties may have an existing: • contractual arrangement (eg supplier and customer relationship) • non-contractual relationship (eg litigation)	the business combination is treated as an effective settlement of the pre-existing relationship, which is in turn accounted for as a separate transaction any gain or loss arising from such settlement is recognised immediately in earnings the amount deemed to relate to the settlement is excluded from consideration transferred

Effect of deal terms on the accounting for business combinations

Deal terms	Effect on accounting for business combination
4. Contracts to acquire shares from non-selling shareholders at a later date	
these contracts may be negotiated at or around the same time as the business combination	a contract that in substance represents the purchase of the underlying acquiree shares is accounted for as part of the business combination, as a deferred or contingent consideration arrangement. Contracts that are in substance arrangements to purchase NCI shares at a future date are accounted for separately.
5. Third party indemnification arrangements	
The seller in a business combination may contractually indemnify the acquirer for the outcome of a contingency or uncertainty related to all or part of a specific asset or liability.	The acquirer shall recognise an indemnification asset and the indemnified item at the same time, the asset should be recorded at the same accounting bases as the indemnified item. (i.e., fair value at acquisition), subject to the need for a valuation allowance for uncollectible amounts.

Planning considerations



GAAP differences

GAAP differences

Topic	AS – 14 – Accounting for amalgamation	Ind AS 103- Business Combinations
Scope	Guidance for business combinations is scattered in AS 14, AS 21 and AS 10.	Comprehensive standard for all business combinations
Acquisition date	Acquisition date is driven by Court order.	Acquisition date is has been clearly defined in the standard.
Accounting method	It allows both pooling of interest method and acquisition method. Pooling of interest method is satisfied only when all the pre-requisites mentioned in AS 14 get satisfied	Pooling of interest is only allowed in accounting of common control transactions.
Non controlling interest / Minority interest	There are no alternatives in determining the Minority interests.	It allows two alternatives : i) Fair value approach ii) Net assets approach
Capital reserve	Capital reserve is accounting directly as a part of reserve	Capital reserve is routed through Other comprehensive income if reasons are justified.
Goodwill	Goodwill is amortized within a period not exceeding 5 years.	No amortization of goodwill but is tested for impairment from time to time.
	No specific guidance on provisional accounts.	Accounting of business combination can be determined provisionally at the end of the first reporting period using the provisional values. A window of 1 year is available for amendments in the provisional values.

THANK YOU

Q & A