Mergers & Acquisition

Accounting Implications under IND AS

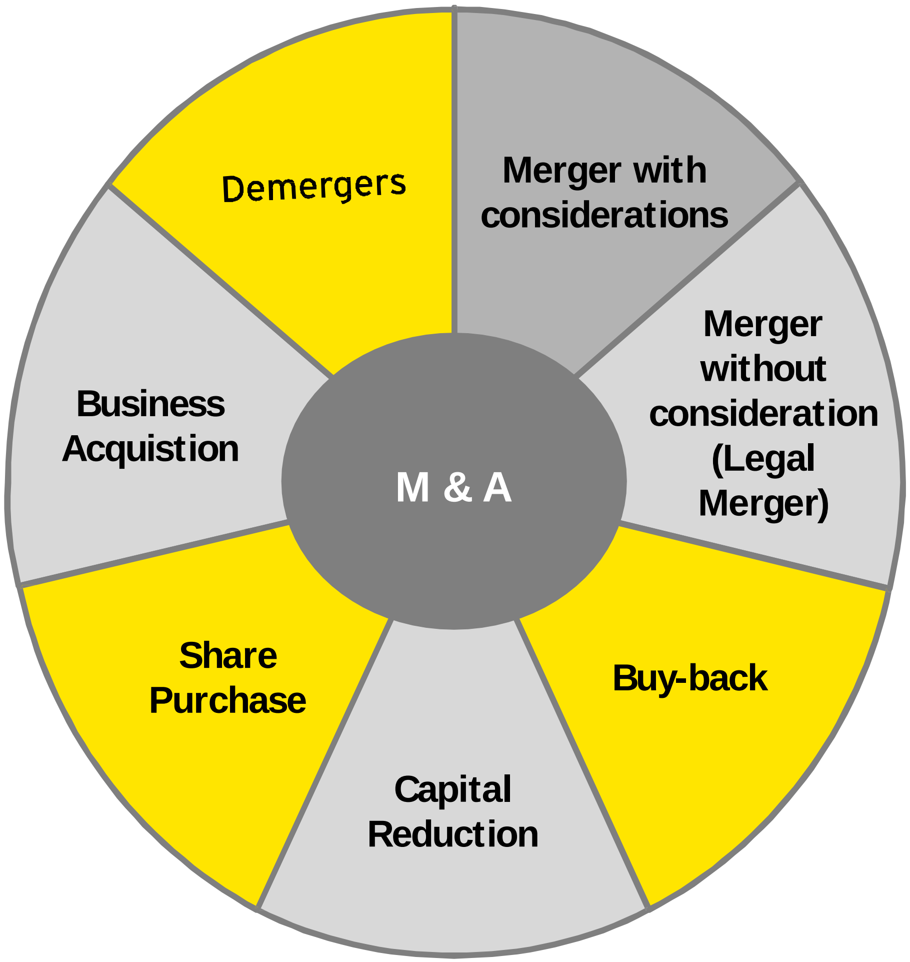
1 April 2017

Contents

1

M&A Deals : Changing Landscape

Business Restructuring – Current State



- Most of these forms of mergers and business restructuring are effected through court schemes.
- AS-14 deals with accounting for amalgamations, but very limited guidance with respect to complex restructuring arrangements. Diverse practices prevails.
- Continuing debate if law overrides accounting standard?
- SEBI has mandated compliance with accounting standards for any amalgamation / mergers/ reorganisation scheme filed by listed companies
- Companies Act, 2013 proposes compliance with accounting standards by all companies (section 230 notified on 15 Dec 2016)

Business Restructuring – Changing landscape

Business acquisition + share purchase + Demergers + Mergers (with Consideration)

- Ind-AS 103 applies to business combinations, provided transaction meets definition of business.
- The same shall be accounted by applying acquisition method meaning assets and liabilities acquired to be recorded at fair value
- Resulting recognition of goodwill/bargain purchase
- Excludes common control transactions.

Definition of "Control"

- Control definition as per IND AS 110 – very different
- "Control" established on substance and not mere shareholding or composition of Board
- "Potential Voting Rights" are considered in this assessment
- Participative V Protective rights

Reverse Acquisitions

- Legal v/s accounting acquirer

Buy Back/ Capital Reduction

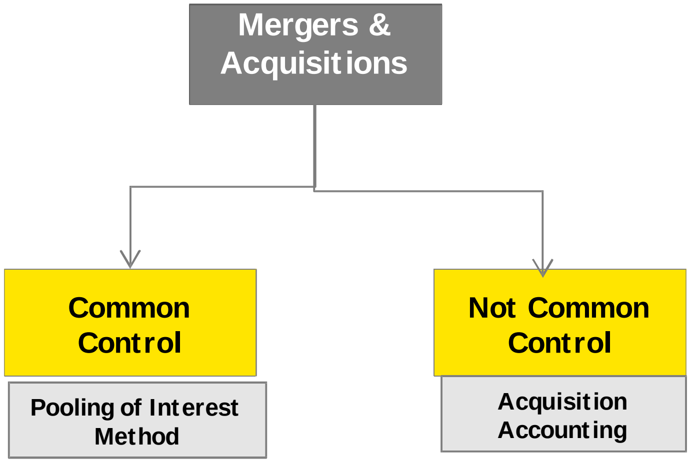
- Gain or loss on transaction with owners - SOCIE
- Continue to be driven by court schemes/Companies Act, 2013

2

Mergers/Acquisitions

Mergers & Acquisitions

- Under AS-14, Mergers fall into two broad categories :
  - Amalgamation in nature of merger
  - Amalgamation in nature of purchase
- Ind-AS 103 , acquisition accounting applies to mergers and acquisitions which are not common control.
- For common control transactions, Ind AS 103 provides for pooling of interest method



Example of Acquisition Accounting

Potential Areas of significant impact	Indian GAAP	Ind AS 103
Inventories	31	29
Prepaid expenses and other current assets	21	45
Land	2	8
Buildings and installations	19	23
Machines	186	297
Intangible assets	-	62
Total assets	259	464
Current liabilities	(138)	(150)
Deferred income taxes	(21)	(77)
Contingent liabilities		(6)
Total liabilities	(159)	(233)
Net assets	100	231
Consideration	374	374
Goodwill	**274**	**143**

Under Ind AS, Goodwill is only tested for Impairment and should not be amortised

Key Challenges

- **Assessment of Business Vs. Asset Acquisition**
- **Determining Acquisition Date for accounting – Retrospective dates ??**
- **Accounting of Transaction Costs – Stamp duty, due diligence cost, legal fees etc.**
- **Accounting of Contingent Considerations**
- **Earn out arrangements**

Business

- Business generally consists of **inputs + processes+ outputs**
- BUT only **inputs and processes are mandatorily required**:
  - Inputs(e.g. employees, non current assets…)
  - Processes (e.g. Strategic/operation management ..)
- Outputs are not mandatorily required for a set of activities and assets to qualify as a business.
  - Development stage activities without outputs may still be businesses

Example – Share acquisition

- Company X acquires 100% equity shares of Company Y . The assets of company Y at the time of acquisition comprised of a telecom license and bank balances. As it was a start up, there were no other assets / liabilities or employees.

- Should the acquisitions be accounted as business combination or an asset acquisition?

It is not a business

✓ Inputs – license

Processes – None

Outputs – none

Example - Development stage enterprise

- Biotech A acquires outstanding shares in Biotech B, a start-up with a license for a product candidate.
- Phase 1 clinical tests are currently performed by the 3 Biotech B's employees (one of whom founded Biotech B and discover the product candidate)

- **Should the acquisitions be accounted as a business combination or an asset acquisition?**

It is a Business.

- ✓ Inputs – license & employees
- ✓ Processes – operational & management processes associated with the performance and supervision of the technical tests.
- ✓ Outputs – none

Differences in accounting for business combination vs. asset acquisition

Impact on:	Business combination	Asset acquisition
Goodwill	Goodwill (or a gain on a bargain purchase) may arise	No goodwill is recognised
Initial measurement of assets acquired and liabilities assumed	Fair value	Allocated cost (on a relative fair value basis)
Directly attributable transaction costs	Expensed	Capitalised
Deferred tax on initial recognition	Recognised	Not recognised*****
Disclosures	More extensive	Less disclosures required
Consideration in the form of shares	Ind-AS 102 *Share-based Payment* does not apply	Ind-AS 102 *Share-based Payment* applies

Example : Differences for accounting for a BC vs. Asset Acquisition

- Entity P acquires 100% of entity V's shares for 1000, incurring transaction costs of 200.
- V has no liabilities. The only assets are 2 buildings (A,B) their book value is 700. The fair value of A and B is 300 and 600 respectively.
- Tax base of buildings is 700 and income rate is 20%.

	BC	Asset acquisition
Price paid	1,000	1,000
Transaction costs	P&L- expensed	200 - capitalized
Total consideration	**1,000**	**1,200**
Fair values (BC) /	Relatives FV of	Assets acquired
Asset A	300	400=(1200*300/900)
Asset B	600	800=(1200*600/900)
total	**900**	**1,200**
DTL	40=(900-700)*20%	N/A
Goodwill	140=(1000-900+40)	N/A

Date of acquisition

- Generally the date on which the acquirer: legally transfers the consideration, acquires the assets; and assumes the liabilities of the acquiree
  - will normally be the closing date.

- Date on which control is acquired by the acquirer
  - Is the agreement subject to substantive pre-condition, the acquisition date will be the date the last of those pre-condition is satisfied
  - Date when acquirer commences direction of operation and financial policies
  - Date when majority of board members are appointed
  - Date from which the flow of economic benefit changes
  - Date of clearance by competition authority (if any)

Example - Acquisition Date

- Company A has signed a purchase agreement (PA)with Company B on July 1, 20X0.

- PA was filed with the high court for approval on Jan 1, 20X1

- PA provides that subject to the High Court approval of the agreement, any profits or losses arising out of operations of B from July 1, 20X0 will belong to A.

- PA provides that the management of B will run B from the July 1 20X0 as t rustee's of A.
- PA also provides that the purchase consideration payable by A to B will be based on B net assets value as at July 1 20X0 and as determined by the independent valuer.

- The High Court approves the transaction on 25 March 20X1 and is filed with the ROC immediately. A is preparing CFS for the year ended 31 March 20 X1.

Should CFS include Company B from 1 July 20X0,1 January 20X1 or from 25 March 20X1?

Response

- The date control is obtained will be dependent on a number of factors, including whether the acquisition arises from a public offer or a private deal, is subject to approval by other parties, or is effected by the issue of shares.

- One of the key factors is that the offer is 'unconditional'.
  - Where the offer is conditional upon receiving some form of regulatory approval, then it will depend on the nature of that approval.
  - Where it is substantive hurdle, it is unlikely that control could have been obtained prior to that approval.
  - However, where the approval is merely a formality, then this would not preclude control having been obtained at an earlier date.

- In the given case, A's CFS should include Company B from 25 March 20X1.

Measurement of Assets and Liabilities

All assets and liabilities to be fairvalued

Contingent liablities recognised if
Present obligation + Fair Valuation reliable

Contingent consideration to be paid by the acquirer

Initial treatment	Ind-AS 103
Recognition	Always recognise
Measurement	Fair value at acquisition date
Classification	As Financial Instrument in most cases - liability /equity as per Ind-AS 32

Subsequent treatment	Ind-AS 103
Equity	Not re-measured
Liability	Re-measured at fair value through P&L in accordance with Ind-AS 109

Remuneration vs. contingent consideration

Remuneration	← Indicator →	Contingent consideration
Payment forfeited on termination	**Continuing employment (conclusive indicator)**	Payments are not affected by termination
Coincides with or exceeds payment period	Duration of required employment	Shorter than payment period
Not reasonable compared to other employees	Level of other elements of remunerations	Reasonable compared to other employees
Other non-employee selling shareholders receive lower additional payments (per share)	Incremental payments to other non-employee selling shareholders	Other non-employee selling shareholders receive similar additional payments (per share)
Owned substantially all shares	Number of shares owned	Owned small portion of shares
Formula for payment is not linked to the valuation approach	Linkage of payments to valuation of business	Formula for payment is linked to the valuation approach
Based on performance	Formula for additional payment	Based on valuation formula

Non-controlling interest

- NCI is equity in a subsidiary not attributable, directly or indirectly to a parent

- Measurement option for NCI at acquisition date:

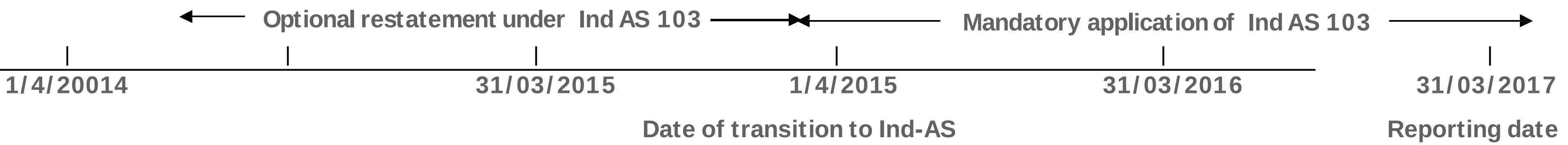
At Fair Value

At Proportionate share of acquiree's identifiable net assets

Choice is made for <u>each business combination</u> (not a policy choice)

Business Combination – Transition Impacts

- Business combination – Ind AS 3
  - first-time adopter can choose not to restate business combinations (in accordance with Ind AS 103) that have occurred before transition date



  - however, if an entity chooses to restate one business combination under Ind AS 103 prior to transition date, it will need to restate all the business combinations which occur after such restatement, for its opening IFRS balance sheet

3

Common Control Transactions

Common Control Restructuring

- Common control exemption applies between entities when it can be demonstrated that they are **ultimately controlled before and after by** :

The **same** parent entity

The **same** individual

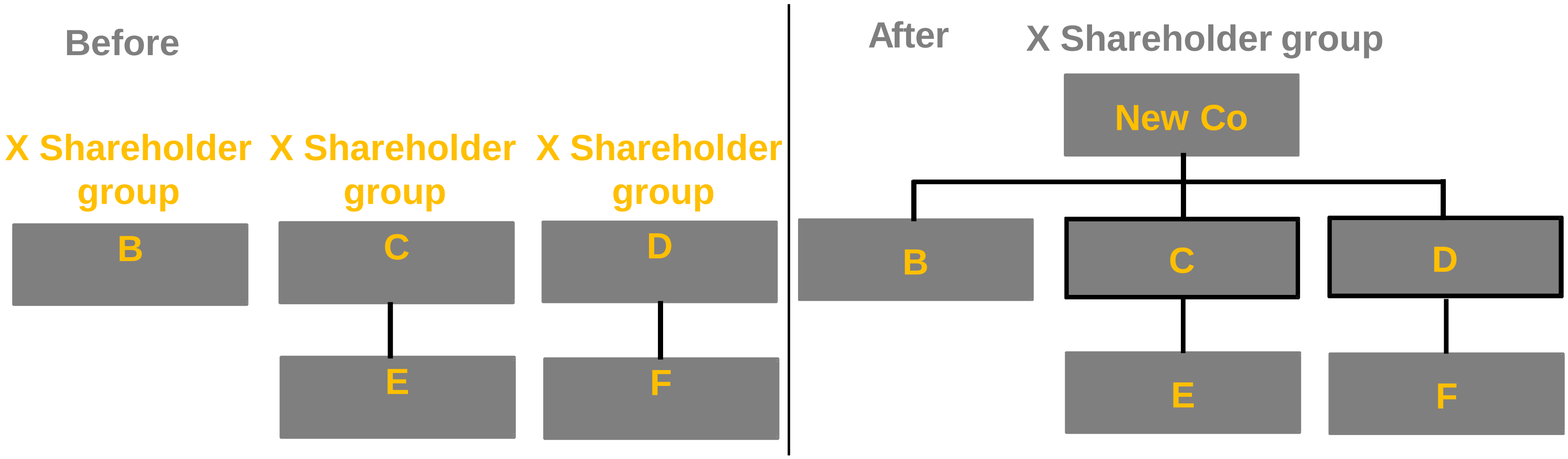
The **same** group of individuals /entities (acting in concert)

- Control should **not be transitory**

Common Control Accounting

- Common control business combinations will include transactions, such as transfer of subsidiaries or businesses, between entities within the group.
- Business combinations involving entities or businesses under common control shall be accounted for **using the pooling of interests method**.
- **Pooling of Interest method involve:**
  - The assets and liabilities of the combining entities are reflected at their carrying amounts
  - No adjustments are made to reflect fair values, or recognise any new assets or liabilities
  - Financials of prior periods should be restated as if the business combination had occurred from the beginning of the preceding period in the financial statements, irrespective of the actual date of the combination
  - If business combination had occurred after that date, the prior period information shall be restated only from that date
  - Consideration may consist of securities, cash or other assets. Securities issued should be recorded at nominal value. Assets other than cash should be measured at fair value.

New Co Formation - 'ultimately controlled by the same parties'



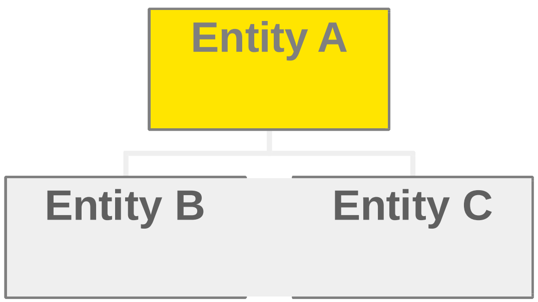
A Newco is incorporated and inserted at the top of a number of entities owned by the same shareholders. Newco issues shares to the existing shareholders of entities B, C and D in exchange for the shares already held in those entities.

This transaction may qualify for common control exemption depending on :

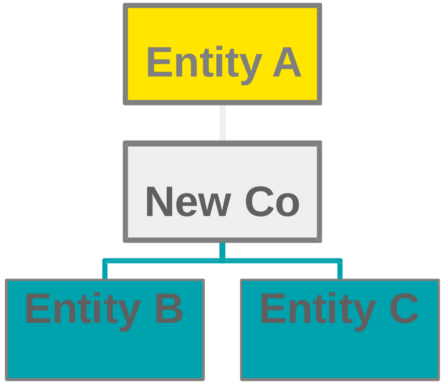
- how does the group of shareholders act (is there any contractual agreement between the shareholders?)
- Is the common control transitory?

Example : New Co Formation

Existing group structure



Proposed structure



- Entity A has been operating as per the existing structure for the past ten years.
- During the last year, it envisaged a plan to transfer these two entities by establishing New Co.
- Shortly after transaction, New Co would be going for an initial public offering (IPO).
- After the IPO, New Co will not be under control of entity A.

In the preparation of its CFS, whether New Co is entitled to the 'common control' accounting?

4

Demergers/ Buy Back/ Capital Reduction

Demergers

(In the books of acquirer)

Present Indian GAAP provides no direct authoritative guidance on accounting on demergers . Analogies can be drawn to guidance available under other accounting standards. Considering the same, following accounting treatments are being adopted

1. **Accounting under AS-10 for purchase of business (only possibility for slump sale)**

2. **Accounting using guidance under AS-14 for amalgamation in nature of merger**
   - Though demerger in legal form, in substance, it envisages merger of significant business.
   - Though AS-14 is strictly not applicable, the pooling of interest method are being used by analogy, provided all the given conditions such as transfer of all business and liabilities shall be transferred and no adjustment to book values thereof are intended.
   - Under pooling of interest method, Net Assets acquired to be recorded at carrying value
   - Excess of consideration paid over net assets taken over is to be recorded as "Negative Capital Reserve"

Under Ind AS, demerger may be accounted through acquisition method provided the transaction meets definition of "business".

Buy-Back/Capital Reductions

- ICAI has not issued any accounting standard on buy-back or capital reduction. Under IND AS, there is specific guidance on accounting for transaction with owners.
- Legal provisions permit buy-back of securities out of free reserves or securities premium account or fresh proceeds of any shares or other specified securities.
- The regulatory framework provides for certain modes in which capital reduction can be done.
- Any transaction with/amongst shareholders is equity transaction unless control is acquired or lost

5

Key Implications

Implications

- Greater transparency
- Purchase method of accounting not allowed for common control transaction
- Formation of new co may create form but not substance
- Increase charge in P&L for amortisation of intangibles recorded due to PPA
- Transaction Costs Accounting
- ROCE will change
- More volatile P&L as amortisation is replaced by goodwill impairment
- Dual set of accounts may need to be maintained
- Experts may be required for valuation of :
  - Property, plant and equipment
  - Intangibles
  - Contingent Liabilities

Considerations for various stage of Transaction life cycle

Pre-transaction considerations

- High level accounting implications before the deal
- Ind AS readiness of the target
- Identification of accounting policy differences
- Assess nature of acquisition (business Vs asset acquisition)
- Planning for deal finance – debt or equity?

During the deal considerations

- Balance sheet implications of debt vs equity funding
- Identification of contingent liabilities
- Assess accounting for employee compensation arrangements
- Accounting for transaction costs

Cycle

Finalising the deal

- Finalisation of the sale & purchase agreement
- Process for preparation of completion accounts – Ind AS issues
- Impact of Ind AS on net debt calculation

Post transaction

Purchase Price Accounting

- Identification/valuation of assets/liabilities (particularly intangibles, contingent liabilities)
- Allocation of goodwill to CGUs + impairment testing process
- Future impact on EBT of amortisation of intangible assets
- Harmonisation of target accounting policies and systems

Thank you