Converged IND AS 103-*Business Combination* and Treatment of Goodwill and Bargain Purchase

The necessity of a standard on Business Combinations in India assumes importance considering the fact that Indian companies are increasingly stretching their business in foreign countries for best-fit business combinations. At present in India, though the AS 14 lays out specific treatment for Amalgamation, it is not matching the global reporting standards requirements. So ICAI has converged the present standard AS 14 to Ind AS 103 *Business combination* which is in line with IFRS 3. The transition to Ind AS, as and when it happens, is likely to have impact on the accounts of companies involved in such acquisitions and mergers. With reference to this convergence, this article provides an insight on the treatment of goodwill and its impairment, bargain purchase, non-controlling interests, reverse acquisitions and identifiable net assets & liabilities at fair value through various examples. Also, Ind AS 103 is more stringent about the accounting method to be used. This article also shows the major difference between IND AS 103 and As 14 *Amalgamation* with the help of different case studies as well as carves outs of Ind AS 103 from IFRS 3 and its reasons.

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With the integrated global economies and cross border mergers and acquisitions, it would be imperative for the Indian corporate to bridge the gap between Indian GAAP and IFRS. In order to harmonise with the Financial Reporting worldwide the ICAI (Institute of Chartered Accountants of India) has issued 35 Ind AS –the converged accounting standards which are in line with IFRS subject to certain carve outs (differences) due to tax related issues, as notified by the Ministry of Corporate Affairs (MCA). The Ind AS will be applicable to the entities in a phased manner at a future date as notified by the MCA. With the implementation of Revised Schedule VI in India, the ICAI has definitely taken a positive step towards IFRS implementation in India.

Need of converged IND AS 103 Business Combination

The necessity of a standard on Business Combinations in India assumes importance considering the fact that Indian companies are increasingly stretching their business in foreign countries for best-fit business combinations. When Vodafone took over Hutchison Essar, there were a number of tax related issues in India. Despite that, it triggered the interest of small and medium sized companies for such acquisitions. With the cross border mergers and acquisitions, the compatibility of Indian accounting standards with the IFRS is challenging but necessary for a true and fair view of the financial statements worldwide.

The following difference between As 14 *Amalgamation* and Ind AS 103 *Business Combination* justifies the convergence and the need to match the global reporting standards.

Particulars	AS 14	Ind AS 103
Scope	The scope of the existing AS 14 is confined only to amalgamation. It stays silent for the issues of common control transactions.	Ind AS 103 has a wider scope ie it also includes common control transactions and additional guidance (APPENDIX C) provides that business combination transactions for such entities should be accounted for using the "pooling of interest" method.
Method of Accounting	Under the existing AS 14 there are two methods of accounting for amalgamation. The pooling of interest method and the purchase method.	Ind AS 103 prescribes only the Acquisition method (purchase method) for each business combination
Valuation of Assets and liabilities	AS–14 requires valuation at carrying value in the case of pooling method. In the case of purchase method either carrying value or fair value may be used. Contingent liabilities are not fair valued. Under AS–21, AS–23, and AS–28, goodwill is determined based on book values rather than fair values.	Ind AS 103 requires the acquired identifiable assets, liabilities and non-controlling interest to be recognised at fair value under acquisition method. (See Case study 2-Table 2) Even contingent liabilities are fair valued. (See Case study 1)
Non-controlling interest	The existing AS 14 states that the minority interest is the amount of equity attributable to minorities at the date on which investment in a subsidiary is made and it is shown as outside shareholders' equity.	Ind AS 103 requires that for each business combination, the acquirer shall measure any non-controlling interest in the acquiree company either at fair value or at the non-controlling interest's proportionate share of the acquiree's identifiable net assets (See Case study 2-Table 2)
Goodwill	Any excess of the amount of the consideration over the value of the net assets of the transferor company acquired by the transferee company is recognised in the financial statements as goodwill arising on amalgamation.	Measured as the difference between the aggregate of (a) the acquisition date fair value of the consideration transferred (b) the amount of any non-controlling interest and (c) in a business combination achieved in stages, the acquisition date fair value of the acquirers previously held equity interest in the acquirer and • The net of the acquisition-date fair values of the identifiable assets acquired and the liabilities assumed.
Measuring the goodwill	The existing AS 14 requires that the goodwill arising on amalgamation in the nature of purchase is amortised to the statement of profit or loss over a period not exceeding five years and in case of amalgamation in the nature of merger excess consideration over net assets taken over, is adjusted against the revenue reserves.	Under Ind AS 103, the goodwill is not amortised but tested for impairment on annual basis in accordance with Ind AS 36.

Particulars	AS 14	Ind AS 103
Gain on bargain Purchase	Under existing AS 14 the excess amount of net assets over consideration is treated as capital reserve (paragraph 34 of Ind AS 103 and paragraph 17 of the existing AS 14).	Gain on bargain purchase is recognised in Other comprehensive Income (OCI) and accumulated in equity as capital reserve.(See Case study 3-Table 3)
Acquisition related costs	Acquisition related costs are accounted for as expenses in the period in which costs are incurred and services are received	No specific guidance is provided.
Reverse Transactions	The existing AS 14 does not deal with the same.	Ind AS 103 deals with reverse acquisitions

IND AS 103 *Business Combination*

1. *Objective:*

The objective of the Indian Accounting Standard 103 is to improve the relevance, reliability and comparability of the information that a reporting entity provides in its financial statements about a business combination and its effects. To accomplish that, this Indian Accounting Standard establishes principles and requirements for how the acquirer:

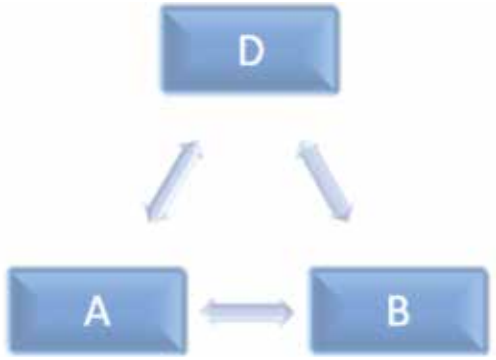
- ✓ recognises and measures in its financial statements the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree
- ✓ recognises and measures the goodwill acquired in the business combination or a gain from a bargain purchase
- ✓ determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination.

2. *Scope:*

Ind AS 103 defines business combination which has a wider scope. It includes both amalgamation and acquisition including common control transactions

2.1 *Inclusion of Common Control transactions*

- Assume A and B are subsidiary companies that are owned by the same parent entity D. ***Does the transaction constitute a business combination within the scope of IFRS 3 and Ind AS 103?***



- Here A and B are under common control of D. Business combinations involving entities under common control are excluded from the scope of IFRS 3 but in Ind AS 103, Common control transactions are included in the scope

2.2 *Reverse Acquisition*

- Reverse acquisition takes place when a private entity wants to become a public entity but does not want to register its equity shares. In such case, private entity approaches a public entity, i.e. the one which is listed, to acquire its (private entity's) equity interests in exchange for the equity interests of the public entity.
- In a reverse acquisition, the entity issuing equity interests is legally the acquirer, but for accounting purposes is considered the acquiree. Accounting for business combination is done from the perspective of accounting acquirer and not legal acquirer.
- Accounting for reverse acquisition are a bit complex, but Ind AS 103 deals with reverse acquisitions unlike AS 14 which is silent on treatment of reverse acquisitions.

2.3 *Exclusions*

However, IND AS 103 excludes:

1. Formation of a joint venture
2. Acquisition of an asset or group of assets not constituting a business combination of entities.

3. *Business combination*

A business combination is a transaction or other event in which an acquirer obtains control of one or more businesses

Identifying a Business Combination: If the assets acquired are not a business, the reporting entity shall account for the transaction or other event as an asset acquisition. For example, acquisition of a "shell" or "shelf" company is not a business combination because no business is being acquired.

4. *Business:*

The Standard defines the business as an integrated set of activities and assets from which economic benefits

are gained by the investor or other owners. It also explains that, for determining whether a group of assets and liabilities is a business, one must examine the three ingredients, viz. Inputs, Process and Outputs. In other words a business consists of inputs and processes applied to those inputs that have the ability to create outputs.

5. *Acquirer*

An acquirer is the entity that obtains control of the entity–*the acquiree*.

6. *Control*

In the above definition control means the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities

7. *Acquiree*

The business or businesses that the acquirer obtains control of in a business combination

8. *Method of Accounting*

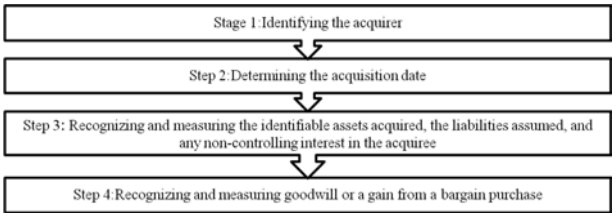
Under Ind AS 103 only acquisition method is used for business combination. The Standard eliminates the now-optional pooling-of-interests method and mandates the Purchase Method in accounting for a Business Combination.

Purchase method requires the Acquiring Company to fair value all the identified Assets and Liabilities and also recognise additional liabilities if any, at fair values on balance sheet. It requires allocating the Purchase Price to all the items on the balance sheet and also off the balance sheet i.e. contingent liabilities. Under this method, the Acquirer has to recognise various components of business combination like non-controlling interest, consideration and the goodwill or bargain purchase on the date of acquisition.

9. *Fair value*

The International Accounting Standards Board (IASB) defines fair value as "... an amount at which an asset could be exchanged between knowledgeable and willing parties in an arms length transaction".

Steps in Acquisition Method



Step 1: Identifying the acquirer:

For each business combination, one of the combining entities shall be identified as the acquirer.The entity that issues equity shares in exchange for the net assets of other entity is usually identified as acquirer

Step 2: Determining the acquisition date

Measurement of assets, liabilities, intangible assets, non-controlling interest, recognition of goodwill etc. in case of business combination is acquisition-date sensitive. Hence, it is very critical to determine the acquisition date.

Acquisition date is the date on which the acquirer obtains effective control of the acquiree. Usually, the date on which the acquirer legally transfers the consideration, acquires the assets, and assumes the liabilities of the acquiree - the "closing date". (See CASE STUDY 2)

Step 3 : Identifying and measuring consideration (See CASE STUDY 1)

- Consideration is the sum of the acquisition-date fair values of:
  – the assets transferred
  – the liabilities incurred by the acquirer
  – the equity interests issued
- Acquisition-related costs

Consideration should be measured at fair value.

Acquisition-related costs are costs the acquirer incurs to effect a business combination. They are as under:

✓ Finder's fees
✓ Advisory, legal, accounting, valuation and other professional or consulting fees
✓ General administrative costs, including the costs of maintaining an internal acquisitions department
✓ Costs of registering and issuing debt and equity securities.

The acquirer shall account for acquisition-related costs as expenses in the periods in which the costs are incurred and the services are received, with one exception. The costs to issue debt or equity securities shall be recognised in accordance with Ind AS 32 and Ind AS 39.

Case Study 1

Treatment of consideration at fair value, contingent consideration and acquisition related costs

Entity A acquired controlling interest in Entity B and issued 1,00,000 shares to its owners as a consideration for the acquisition. The fair value of the shares issued by Entity A was as follows:

✓ ₹4,00,000 as at the date of the acquisition agreement

- ✓ ₹4,75,000 as at the date of the acquisition as identified by the agreement

Entity A incurred the following expenses in relation with the acquisition:

- o Legal and consulting fees of ₹30,000
- o General administrative costs of ₹20,000
- o Costs related to issuance of equity ₹25,000

- ✓ Entity A also agrees with Entity B that if it meets certain performance based targets within next two years, an additional consideration (in cash) of ₹80,000 will be paid to it.
- ✓ Entity A determines the fair value of this additional consideration as **₹50,000**.

Computation of the amount of consideration paid in the above transaction

Particulars	Amt (in ₹)
Fair value of equity issued as at the date of Acquisition	4,75,000
Fair value of the contingent consideration	50,000
Total consideration paid	**5,25,000**

Treatment of acquisition related costs

Other expenses	Accounting treatment
Legal and consulting fees ₹30,000	To be charged to expenses as incurred
General costs of ₹20,000	To be charged to expenses as incurred
Costs related to issuance of equity ₹25,000	To be recognised in accordance with Ind AS32 and 39.

Exceptions:

"The acquirer shall, at the acquisition date, allocate the cost of a business combination by recognising the acquiree's identifiable assets, liabilities and contingent liabilities that satisfy the recognition criteria, at their fair values at that date, except for noncurrent assets (or disposal groups) that are classified as held for sale in accordance with IND AS105, Non-current Assets Held for Sale and Discontinued Operations, which shall be recognised at fair value less costs to sell."

Step 4: Recognising and measuring goodwill (Case Study 2-Table 2)

Goodwill: An asset representing the future economic benefits arising from the **other assets** acquired in a business combination *that are not individually identified and separately recognised*.

The goodwill can be measured as under:

Goodwill=
Aggregate Consideration
(+)
Non-controlling interest
(at fair value or proportionate share in net assets)
(+)
Previously held equity interest (acquisition date fair value)
(-)
Net Identifiable assets acquired and liabilities assumed

Case Study 2

Acquisition in two stages (step acquisition) and resulting in goodwill

X Ltd acquires Y Ltd in the following two stages:

- On 1st Jan 2008 it purchased 30% of the equity shares of Y Ltd for ₹20 crore
- On 1st Jan 2012 X Ltd purchased 50% of shares for ₹150 crore

As on the acquisition date :

The carrying amount of net assets is ₹180 crore and the fair value of identifiable net assets is ₹200 crore.

The fair value of the original investment of 30% equity shares is ₹50 crore and the fair value of remaining 20% non-controlling interest is ₹80 crore.

Table1: Acquisition break up

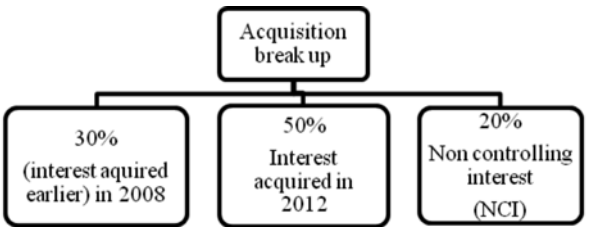
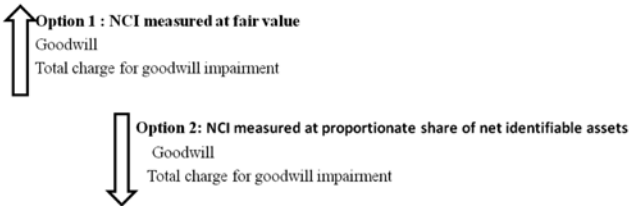


Table 2:Recognition and measurement of goodwill under IndAs 103

Particulars	**Option 1**	**Option 2**
	NCI at Fair value (Amt. in ₹crore)	**If NCI is in Proportion of net assets (Amt. in ₹crore)**
Fair value of the consideration	150	150
Non-controlling interest	80	40 (20% of 200)
Interest acquired **earlier**	20	20
Total	**250**	**210**
Fair value of net assets	200	200
Goodwill	**50**	**10**

The above table gives some important findings

- ✓ The acquisition date is in the year 2012 and not in 2008
- ✓ Goodwill is identified and measured in a different way under IndAS 103 compared to AS 14. Under Ind AS 103, the goodwill of ₹50 crore as per first option and ₹10 crore as per 2nd option is not amortised but tested for impairment on annual basis in accordance with Ind AS 36
- ✓ If less than 100% of the equity interests of another entity are acquired in a business combination, non-controlling interest is recognised. (In the above example it is 20%)
- ✓ Also there is a choice in each business combination to measure non-controlling interest. ***The following figure shows the effect of using two different options for measuring NCI***.



- ✓ It is clear from the above figure that if NCIs measured at fair value, goodwill and its impairment will be valued higher and if NCI is measured by proportionate share method it shows a downward trend
- ✓ The general measurement principle in the acquisition accounting is fair value
- ✓ Also, previously held interests are measured at fair value.

Bargain purchase (paragraph 36 of IND AS 103)

Bargain purchase occurs if the fair value of the identifiable net assets of the acquiree exceeds the aggregate

- ✓ of the consideration transferred
- ✓ the non-controlling interests and
- ✓ the fair value of any previously held equity interest.

Gain on bargain purchase or simply bargain purchase may arise because of:

- Forced sale
- Recognition or measurement exceptions for particular items discussed under IFRS 3
- Error in the valuation of identifiable assets, non-controlling interest and/or equity interest.

Conditions to be fulfilled

In case the bargain purchase arises, then before this gain is recognised, the acquirer must review the calculations to make sure that everything is arithmetically correct and no mistakes are made in measurement of different elements as bargain purchase does not arise normally and IND AS103 requires that the reassessment is done to make sure that no mistakes are made.

The following explanation with case study will clear the treatment of bargain purchase.

Case Study 3

(Based on acquisition at one go and resulting in bargain purchase)

- A pays ₹3,500 crore to purchase 80% of the shares of B.
- Fair value of 100% of B's identifiable net assets is ₹4,500 crore.
- Fair value of the non-controlling interest is ₹1,000 crore

Table 3: Treatment of Bargain Purchase

Particulars	Option 1	Option 2
	NCI at Fair value (Amt. in ₹crore)	**If NCI is in Proportion of net assets (Amt. in ₹crore)**
Fair value of the consideration transferred	3,500	3,500
Fair value of the non-controlling interest	1,000	900 **(4,500*20%)**
Sub total	**4,000**	**4,400**
Less: Fair value of B's identifiable net assets	4,500	4,500
Bargain purchase	500	100

As per IndAs 103, Gain on bargain purchase of ₹500 crore in option 1 and ₹100 crore in option 2 is recognised in Other comprehensive income (OCI) and accumulated in equity as capital reserve.

Major carve out of Ind AS 103 Business Combinations from IFRS 3

Carve out: Treatment of bargain purchase

- ✓ As per IFRS 3, it is recognised in the profit and loss at the acquisition date in the books of acquirer.

It is pertinent to note that the Ministry of Corporate Affairs has carved out the treatment of bargain purchase, while converging Indian Standards towards IFRS 3. It will create a GAAP difference in which Converged Indian AS 103 will recognise the bargain purchase in **other comprehensive income (OCI)** and accumulated in **equity as capital reserve if** there is a clear evidence of the underlying reason for classification of the business combination as a bargain purchase; otherwise, the resulting gain is recognised directly in equity as capital reserve.

Reasons for such treatment of bargain purchase in IND AS 103

IND AS 103 recognises it in OCI or as capital reserve because recognition of such gains in profit or loss would result into recognition of unrealised gains as the value of net assets is determined on the basis of fair value of net assets acquired.

Conclusion

Over and above the findings in Table 2, the following apparent conclusions can be made from the above converged standard Ind AS 103:

- ✓ Ind AS 103 will require disclosure of information to assist the users of the financial statements with the understanding of the nature and financial effect of a business combination.
- ✓ Even though IND AS 101 provides exemptions regarding retrospective application of IND AS 103 for the first time adopter, the standard will pose many challenges for the Chartered Accountants.
- ✓ Also IND AS 103 is associated to **the measurement of many other standards like Ind AS 37, 39, 19 individually** so, the understanding and applicability in India will require lots of deliberation which need to be weighed in view of facts and circumstances.
- ✓ It adopts a "business fair value" measurement approach as opposed to the traditional "cost-based" approach.The concept of fair value is debatable and its implementation will question the financial statements results.

Lastly, Indian companies are listed on overseas stock exchanges and have to recast their accounts to be compliant with GAAP requirements of those countries. Foreign companies having subsidiaries in India, are having to recast their accounts to meet Indian & overseas reporting requirements which are different. Also, Foreign Investors will be attracted to economies where IFRS compliant financial statements are the norms. So, the robust change of converged IND AS which are in line with IFRS is probably the most complicated issue for the current Indian accounting scenario, but necessary for authentic financial reporting worldwide.

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