Insights into Business Combinations

At present, there is no single standard in Indian GAAP which comprehensively deals with various forms of business combinations. Current principles on accounting for 'amalgamations' address the accounting for merger of two companies to form a new company, or the merger of one company into another. Separate principles govern the accounting for acquisition of a group of assets that constitute a 'business', and for acquisition of shares in a subsidiary, jointly controlled entity or an associate. In this regard, Ind AS 103 provides consistent guidance for all 'business combination' transactions and represents significant changes to existing practices.

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Scope

Ind AS 103 does not apply to (i) the accounting for formation of joint arrangement in the financial statements of the joint arrangement, (ii) acquisition by an investment entity of an investment in a subsidiary that is required to be measured at fair value through profit or loss and (iii) an acquisition of an asset or a group of assets which does not constitute a business.

In Ind AS 103, goodwill is recognised only when there is a business combination. Accordingly, a purchase of assets not constituting a business does not lead to recognition of goodwill. Thus, in case goodwill is present, there is a rebuttable presumption

that the transaction is a business combination. For example, Alpha Ltd. acquires Beta Ltd. which holds land at two locations. Apart from ownership of the land, Beta Ltd. does not have any other assets nor does it carry out any operations. Although Alpha Ltd, has through share acquisition, purchased a legal company, this purchase does not meet the definition of a business combination and would be considered an asset acquisition based on the substance of the transaction. The purchase consideration would be allocated to the underlying land and no goodwill will be recorded. Under current principles, such goodwill may be recorded in the consolidated financial statements of Alpha.

What is a Business/Business Combination

While the term 'business' has not been defined in the existing standards, the distinguishing feature of an amalgamation in AS 14 is that the acquired company is dissolved and its separate entity ceases to exist. The term 'business combination' in Ind AS 103 is a broader term than 'amalgamation'. It is defined as a transaction in which an acquirer obtains control of one or more businesses.

An acquirer may obtain control in a number of ways including, for example, by transferring cash or other assets, incurring liabilities, issuing equity instruments or without transferring consideration. Whether an acquirer obtains control of one or more businesses is the determining factor; the structure of a transaction or event does not affect the determination of whether it is a business combination.

For this purpose, Ind AS 103 defines a business as an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants. A business generally consists of inputs, processes applied to those inputs and the ability to create outputs.

X Ltd. acquires a group of assets of Y Ltd. including the procurement system, X Ltd. also offers employment to Y Ltd.'s employees and X Ltd. plans to integrate the acquired plant into its existing accounting and human resources; the acquisition by X Ltd. will constitute to be a business because it contains all of the inputs and processes necessary for it to be capable of creating output to provide return in future. Although the administrative systems (accounting and human resources) of Y Ltd. are not acquired by X Ltd., the acquired plant will be integrated into existing system of X Ltd. Since all the acquired group of assets is a business, the acquisition is accounted for as a business combination.

The determination of whether the activities and assets acquired constitute a business at the acquisition date is made from the view of a market participant, rather than based on how they were used by the seller or how they might be used by the specific acquirer. Therefore, it is not relevant whether the seller operated the set as a business or whether the acquirer intends to operate it as a business.

In most cases, it will be straightforward to determine whether the acquired set of activities and assets constitutes a business. However, in some cases careful analysis of the specific facts and circumstances and the application of judgement will be required.

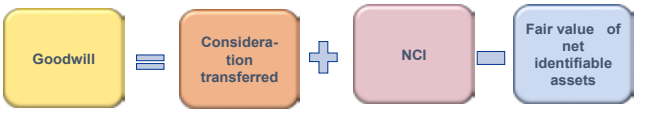
Acquisition accounting:

Under current principles:

- amalgamations are accounted for using either the pooling of interests method or the purchase method
- accounting for acquisition of stake in a subsidiary, jointly controlled entity or an associate is done on the basis of existing carrying values
- where several assets are purchased for a consolidated price, the consideration is apportioned to the various assets on a fair basis as determined by competent valuers.

As against the above, Ind AS 103 requires all business combinations to be accounted as per the acquisition method, irrespective of their legal form. The application of the acquisition method requires recognition of identifiable net assets of the acquiree at fair value. Consideration transferred for the business combination is also measured at fair value and any excess of the aggregate of (a) fair value of consideration transferred, (b) the amount of any non-controlling interest in the acquiree and (c) the acquisition date fair value of acquirers previously held equity interests in acquiree, if any over the fair value of the identifiable net assets of the acquiree is recorded as goodwill/capital reserve as the case may be.

Acquisition accounting



The acquisition method can be understood through the following steps:

- Step 1 • Identifying the acquirer
- Step 2 • Determining the acquisition date
- Step 3 • Determining the consideration transferred
- Step 4 • Recognising and measuring the identifiable assets acquired, liability assumed and non-controlling interest in the acquiree
- Step 5 • Recognising and measuring goodwill or a gain from a bargain purchase.
- Step 6 • Subsequent measurement and accounting

Step 1: Identifying the acquirer: The acquirer is the entity that obtains control of the other combining business. It is usually the entity that transfers the cash or other assets, or incurs the liabilities, or issues the new equity instruments. The guidance laid down in Ind AS 110 *Consolidated Financial Statements* should be used to identify the acquirer. Additional specified factors in Ind AS 110 should also be considered especially when the Ind AS 110 guidance does not clearly indicate which of the combining entities is the acquirer. Generally, identifying the acquirer is straightforward. However, this assessment can be difficult in cases where the consideration is through exchange of equity interests. For example, A merges with B, with B as the surviving company. The terms of the swap ratio are such that the former shareholders of A would hold a majority of the voting interest in B subsequent to the transaction and post merger, the management of A would take over the management of B ('reverse merger'). Under Ind AS, A will be considered as the accounting acquirer and the net assets of B will be fair valued.

Step 2: Determining the acquisition date: Under Ind AS, the acquisition date is defined as the date when control over the company or business is obtained. This date cannot be designated. The date of acquisition will usually be the closing date, i.e. the date on which the acquirer legally transfers the consideration, acquires the assets and assumes the liabilities of the acquiree. However, acquirer might obtain control on a date that is either earlier or later than the closing date. Hence, a careful analysis of the facts and circumstances and judgment will be required. In case an acquisition is subject to receiving regulatory approval, the acquisition date cannot be earlier than the date the approval is obtained from the concerned authority as it is a substantive hurdle to be overcome before control is transferred (unless the approval is procedural). For example, Sugar Ltd. and Cookie Ltd. are dominant traders in a particular region, and Cookie Ltd. makes a bid for Sugar Ltd. and transfers the purchase price Immediately thereafter, the competition authority announces that the proposed transaction is to be scrutinised as it may violate the competition law. In this case, the date of acquisition cannot be earlier than the date from which approval is obtained from the competition authority.

Determination of acquisition date is important since it is the date from which the results of the acquired company are included in the financial statements of the acquirer and the date on which the fair value is determined.

It appears that the acquisition date under Ind AS would generally be later than the 'appointed date' that may be prescribed in acquisition agreements or court schemes.

Step 3: Determining consideration transferred: The consideration transferred in a business combination is measured at fair value, which is calculated as the sum of the acquisition-date fair values of the assets transferred by the acquirer, the liabilities incurred by the acquirer to former owners

of the acquiree and the equity interests issued by the acquirer.

Consideration also includes deferred consideration (i.e. obligations to pay specified amounts at future dates), contingent consideration:

- Under current practice, contingent consideration is included only if probable and any subsequent adjustments to contingent consideration are generally adjusted to goodwill when the contingency is resolved. Ind AS requires the 'fair value' of the contingent consideration to be recorded upfront as a component of the total consideration. Any subsequent changes to the value of cash-settled contingent consideration are recorded in the profit and loss account.
- Currently, any deferred consideration is recorded at the amount contractually payable. Under Ind AS, deferred consideration is recorded at its present value. Accrual of imputed interest expense for such deferred payments is recorded in the profit and loss account.

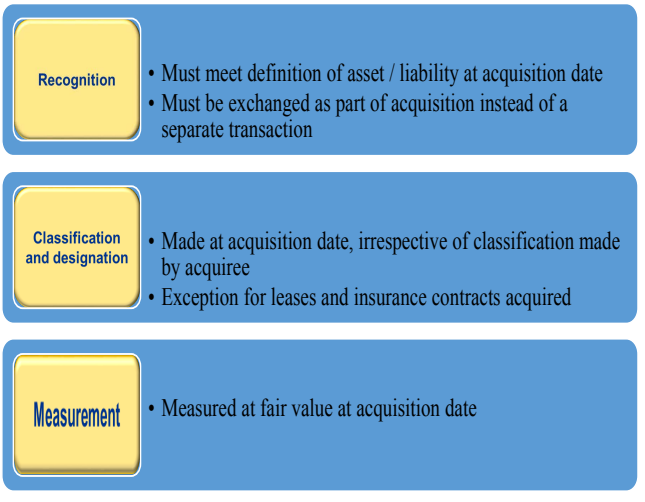
Acquisition-related costs are specifically excluded from consideration transferred, and expensed as incurred. Such costs include auditor/legal fees, underwriting fees and due diligence costs.

Ind AS 103 requires that any amounts which are not part of the business combination are accounted for separately from the business combination. This would be particularly relevant for pre-existing relationships, payments to employees who are former owners of the acquiree, and acquirer share-based payment awards exchanged for awards held by employees of the acquiree. For example,

- pre-existing relationships including non-contractual arrangements (i.e. plaintiff/defendant) and contractual arrangements (i.e. customer/vendor, licensor/licensee, lender/borrower and lessee/lessor relationships) are considered to be settled by the business combination, and are accounted for separately from the business combination. Generally, a gain or loss on settlement depends on whether the settlement is favourable or unfavourable to the acquirer.
- accounting for payments to employees who are former owners of the acquiree is dependent on whether such payments represent contingent consideration or remuneration for future services. Generally, payments that are linked to continuing employment should be treated as an expense, even if they are determined based on the performance of the acquired business.

Step 4: Recognising and measuring the identifiable assets acquired, liability assumed and non-controlling interest in the acquiree:

The general recognition and measurement principles for acquisition accounting are summarised below:



Classification and designation

As mentioned above, the classifications or designations are made by the acquirer on the basis of the contractual terms, economic conditions, its operating or accounting policies and other pertinent conditions as they exist at the acquisition date. This is subject to two exceptions, i.e lease and insurance contracts, in which the acquirer shall classify these contracts on the basis of contractual terms and other factors at the inception of the contract in accordance with applicable standards

Recognition and Measurement : There are a number of exceptions to the recognition and measurement principles of the standard:

<u>* These exceptions are primarily due to guidance included in other Ind ASs</u>

Exception to recognition principle	Exception to recognition and measurement principle*	Exception to measurement principle
•Contingent liabilities	•Deferred taxes and tax uncertainties •Indemnification assets •Employee benefits	•Reacquired rights •Share-based payment awards* •Assets held for sale or distribution*

Currently, 'minority interest' arising on consolidation is measured at proportionate share in the book values of the net assets of the subsidiary. Under Ind AS, the 'non-controlling interest' needs to be measured on the acquisition date at either their fair value or based on the proportionate share of the fair value of the acquired company's identifiable net

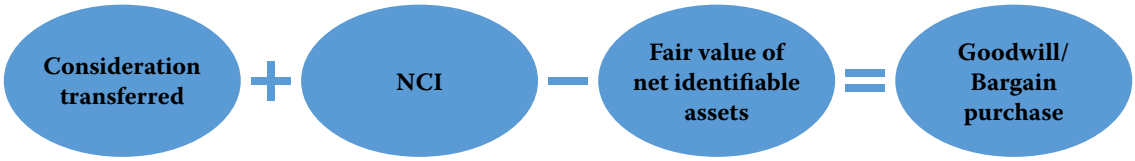
assets. This choice can be applied on a case by case basis. In either case, the values assigned to the non-controlling interest would be different from current principles.

Measurement

Ind AS 103 requires measurement at fair value at acquisition date. Ind AS 113 provides extensive guidance on fair valuation based on a market participant approach (rather than entity specific value).

Ind AS 103 specifically also requires identification and valuation of intangible assets of the acquired company including those relating to non-contractual customer relationships.

Step 5: Recognising and measuring goodwill or a gain from a bargain purchase.



Under the current practice, goodwill arising on amalgamation needs to be amortised over a period not exceeding five years, unless a somewhat longer period can be justified. Goodwill arising on consolidation or on acquisition of a group of assets is either tested for impairment or amortised over a determined period. Under Ind AS, goodwill is not amortised but tested for impairment, at least annually, in accordance with Ind AS 36 *Impairment of Assets.*

In some case, acquisition may result in a gain rather than goodwill. This may be due to a number of reasons e.g. distress sale. Before recognising a gain on a bargain purchase, the standard requires the acquirer to reassess whether it has correctly identified all of the assets acquired and the liabilities assumed. If there is gain even after such reassessment, Ind AS requires such gains to be recognised either through other comprehensive income and then accumulation in equity as capital reserve or directly in the capital reserves, depending upon whether there exists clear evidence of the underlying reasons for classifying the business combination as a bargain purchase. However, IFRS requires that the excess of the fair value of the identifiable net assets over the consideration paid should be recognised in the profit and loss account and to this extent there is a carve out in Ind AS 103 with regard to accounting for bargain purchase.

Step 6: Subsequent measurement and accounting

In general, an acquirer is required to subsequently measure and account for assets acquired, liabilities assumed or incurred and equity instruments issued in a business combination in accordance with other applicable Ind ASs for those items, depending on their nature. However, specific guidance on subsequently measuring and accounting for reacquired rights, contingent liabilities as at acquisition date, indemnification assets and contingent considerations has been provided in the standard.

Goodwill cannot be changed unless additional **information about facts and circumstances that existed at the acquisition date** has been received during the 'measurement period'. Such measurement period cannot exceed 12 months. This provides useful relaxation if acquisitions is made near the year end and accounting is not completed before issuance of the financial statements. Additional information representative of an error is accounted for as per Ind AS 8.

Accounting for acquisitions achieved in stages

- Currently, in step-acquisitions, goodwill/ capital reserve is computed by considering the share acquired in equity as at the date of each acquisition. Under Ind AS, goodwill is measured at the stage when controlling interest

is acquired. Any ownership interests that were previously acquired are fair valued on the date of acquisition of the controlling interest. The difference between the cost and fair value of the previous investment is recognised in the profit and loss account.

- Currently, additional goodwill is recorded for acquisition of minority interest (e.g. increase in ownership interest from 80% to 100%). Under Ind AS, any acquisition of NCI is recorded as a capital transaction.

Significant disclosure requirements

Ind AS disclosure requirements for business combinations are extensive. These include disclosures relating to major classes of consideration given, amounts recognised for each major class of assets acquired and liabilities assumed, qualitative description of factors that constitute goodwill and, pro-forma revenues and profit and loss of the combined company as though the acquisition was done at the beginning of the reporting period.

Accounting as per court approved schemes

Currently, court approved schemes often determine the accounting for amalgamations and mergers. These schemes may provide the appointed date for the acquisition, valuation for the assets and liabilities and treatment of goodwill or reserves. Ind AS has explicit guidance on each of the elements of accounting for a business combination. While the Companies Act, 2013 provides that no compromise or arrangement can be sanctioned by the Tribunal unless a certificate by the company's auditor has been filed with the Tribunal to the effect that the accounting treatment, if any, proposed in such scheme is in conformity with the accounting standards, the relevant sections have still not been notified. Thus, subject to the requirements of the listing agreement, if any, for listed entities, the interaction of accounting requirements prescribed in court approved schemes (including those approved prior to transition) with Ind AS would be relevant. Subject to any clarification from MCA/ICAI, it appears that in the interim, a court approved scheme will have an over-riding effect over Ind AS. Nevertheless, appropriate disclosures in the financial statements and audit report would be required in view of the requirements of Section 129 of the Companies Act, 2013 and pronouncements of ICAI.

Common control business combination

A 'common control' business combination transaction involves companies or businesses in which all the combining companies or businesses are ultimately controlled by the same party or parties both before and after the business combination and such control is not transitory. For example, a merger of two companies controlled by the same parent company would be considered as a common control transaction in the separate financial statements of the subsidiary making the acquisition. While IFRS 3 scopes out common control business combination, Ind AS requires application of the 'pooling of interests method' to account for the common control business combination. Assets, liabilities and reserves of the acquired company are recognised at their carrying values (subject to adjustment for harmonisation of policies). The differences 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 of the transferor is to be transferred to Capital Reserve and presented separately from other Capital Reserves in the financial statements of the transferee entity, with disclosure of its nature and purpose in the notes. The identity of reserves is preserved.

Currently, there is no requirement to restate comparative information of the previous year. In the case of common control transactions, Ind AS requires that the comparative information should be restated as if the common control transaction had occurred at the beginning of the earliest period presented (or the date when common control relationship was established, if later) regardless of the actual acquisition date. ■