IFRS 3 – Business Combinations

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Agenda

- Overview of IFRS
- Principles of IFRS
- Conceptual Understanding
- Need for IFRS 3
- Business and its Combinations
- Identification
- Recognition
- Measurement
- Other Issues

Major principles of IFRS

Type of asset / liability	Initial Measurement	Subsequent measurement
Inventories IAS 2	Cost	Lower of cost and net realizable value
Property, Plant and Equipment IAS 16	Cost	Cost model or revaluation model
Investment property IAS 40	Cost	Fair value model or cost model
Intangible assets IAS 38	Cost	Cost model or revaluation model
Exploration and Evaluation of mineral assets IFRS 6	Cost	Cost model or revaluation model
Non Monetary Government grants IAS 20	Fair Value or Nominal Value	Fair Value or Nominal Value
Non-current assets held for sale & Disposal groups IFRS 5	lower of carrying value and fair value less costs to sell	lower of carrying value and fair value less costs to sell
Biological Assets IAS 41	Fair value	Fair value less costs to sell

Understanding Few Concepts….

- Amalgamation
- Absorption
- Merger
- Demerger
- Takeover
- Internal Reconstruction
- External Reconstruction
- Reverse Purchase or Reverse Merger

Don’t get Confused!!

IFRS 3 should not be mixed or confused with Consolidation Process

It about passing journal entries and recording a Business Combination than consolidation of entities.

Grouping of the Standard

- **IFRS 3** on Business Combinations can be grouped under Standards relating to Group Statements.
- The standard is grouped along side
  - IAS 27 – Separate Financial Statements (given that the standard has been revised after the introduction of IFRS 10 on Consolidation Financial Statements in May 2011),
  - IAS 28 Investment in Associates and Joint Ventures (Revised in May 2011 to include “and Joint Ventures” in the name of the Standard),
  - IFRS 11 on Joint Arrangements (which replaces IAS 31 Interest in Joint Ventures)

What is Business ?

A **business** is defined as

- an integrated set of activities and assets
- that is capable of being conducted and managed
- for the purpose of providing a return directly to investors or other owners, members or participants

Identification of Business - Example

An entity may decide to outsource its information technology or call centre operations to a third party. Before the outsourcing, these functions generally will have been operated as a cost centre for the business as a whole, rather than as a business per se.

Generally, the staff, plant and equipment and other working capital of the outsourced department are transferred to the third party, and a contractual arrangement entered into with the third party for the provision of the service to the outsourcing entity on an ongoing basis.

Identification of Business - Example

While they were part of the outsourcing entity, the operations generally would not have been considered a business and would not have been operated as such. However, the third party that acquires the assets and liabilities and takes on the staff could be seen to have acquired a business, as the transferred set of assets and activities is *capable* of being operated as a business. The conclusion is even clearer where the transferred assets and employees are used as the ‘seed capital’ to offer similar services to other parties.

What is Combination?

In mathematics a **combination** is a way of selecting several things out of a larger group, where (unlike permutations) order does not matter.

In smaller cases it is possible to count the number of combinations. For example given three fruit, an apple, orange and pear say, there are three combinations of two that can be drawn from this set: an apple and a pear; an apple and an orange; or a pear and an orange

Business Combinations

What is a Business Combination?

A **business combination** is

- a transaction or event
- in which an acquirer obtains **control** of one or more businesses.

Transactions sometimes referred to as 'true mergers' or 'mergers of equals' are also **business combinations** as that term is used in this IFRS.

Purchase of Business

Purchase of a business by an entity with or without controlling interest.

Controlling of Business

Generally, an entity becomes a subsidiary of another entity when it ***purchases controlling interest*** in the equity of first mentioned entity. For purchasing such interest, the consideration may be paid in cash or by issuing equity interests or by assuming liabilities.

Sometimes it is also possible that an entity becomes subsidiary of another without transfer of any consideration.

Where a Transaction is not a BC

Where the definition of business is not met, the transaction is termed as “**Asset Acquisition**”.

The acquirer

1. Identifies and recognizes individual identifiable assets acquired (inlcuding those falling within IAS 38 Intangible Assets)
2. Allocates cost to individual assets or liabilities on the basis of FVs
3. There is no question of Goodwill here.

Examples

- Incorporation of a New Subsidiary - the acquisition of a ‘shell’ or ‘shelf’ company is not a business combination as defined in IFRS 3 because no business is being acquired.
- Exploration and evaluation assets held in corporate shells - 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. Accounted for under IFRS 6 – Exploration for and evaluation of Minerals

The need for IFRS 3

“The objective of this IFRS is to specify the financial reporting by an entity when it undertakes a business combination.”

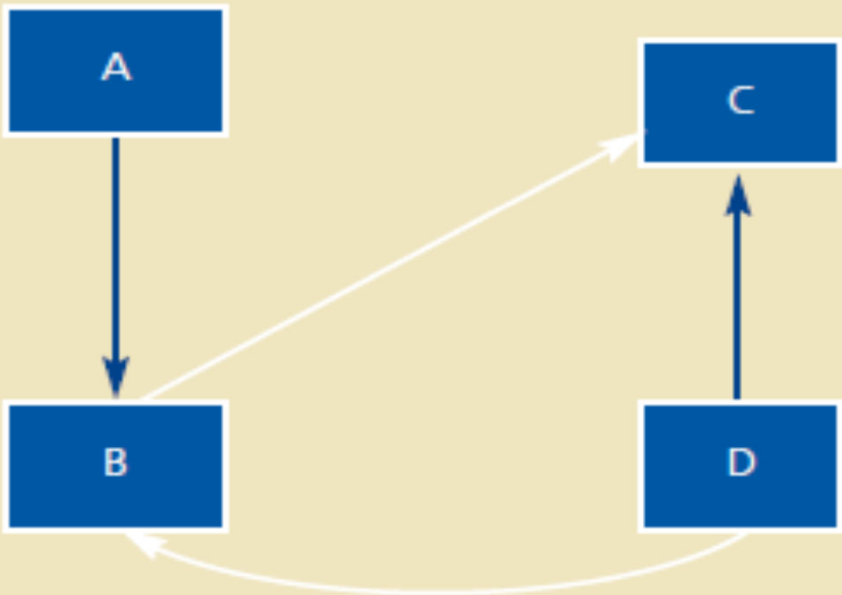
What is not covered under IFRS 3?

IFRS 3 does not apply to the formation of

1. a joint venture,
2. the acquisition of an asset or a group of assets that do not constitute a business
3. combinations of entities or businesses under common control

Formation of Joint Venture

Formation of a joint venture that is outside the scope of IFRS 3 but within the scope of IAS 27



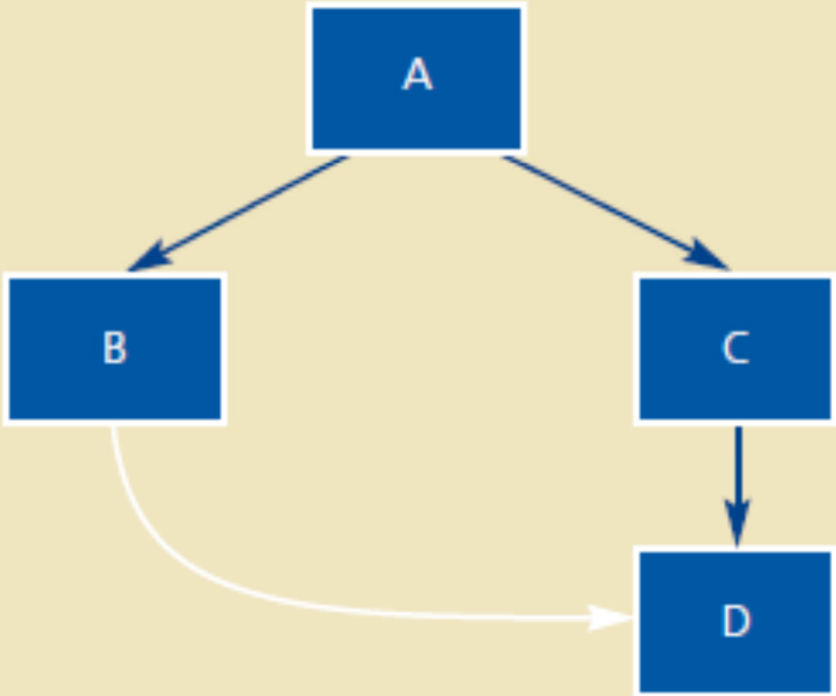
B and D are respectively wholly-owned subsidiaries of A and C.

A and C form a new joint venture whereby B issues equity interests representing 50% of B's equity to C in return for the transfer of C's equity interest in D.

In A's consolidated financial statements, A has disposed of its controlling interest in B. Accordingly, A's residual interest in B should be fair valued – see section 12.4.

Common Control Transaction

A common control transaction



B and C are wholly-owned subsidiaries of A.

A transfers its equity interest in B to C. In exchange, C issues further equity shares to A.

The transaction is a common control transaction since both B and C are under the common control of A.

Currently, there is no specific guidance on accounting for common control transactions under IFRSs

Concepts under IFRS 3

- Acquirer
- Business
- Business Combination
- Acquisition Method
- Cost of Acquisition
- Acquisition Date
- Good will
- Recognition
- Measurement

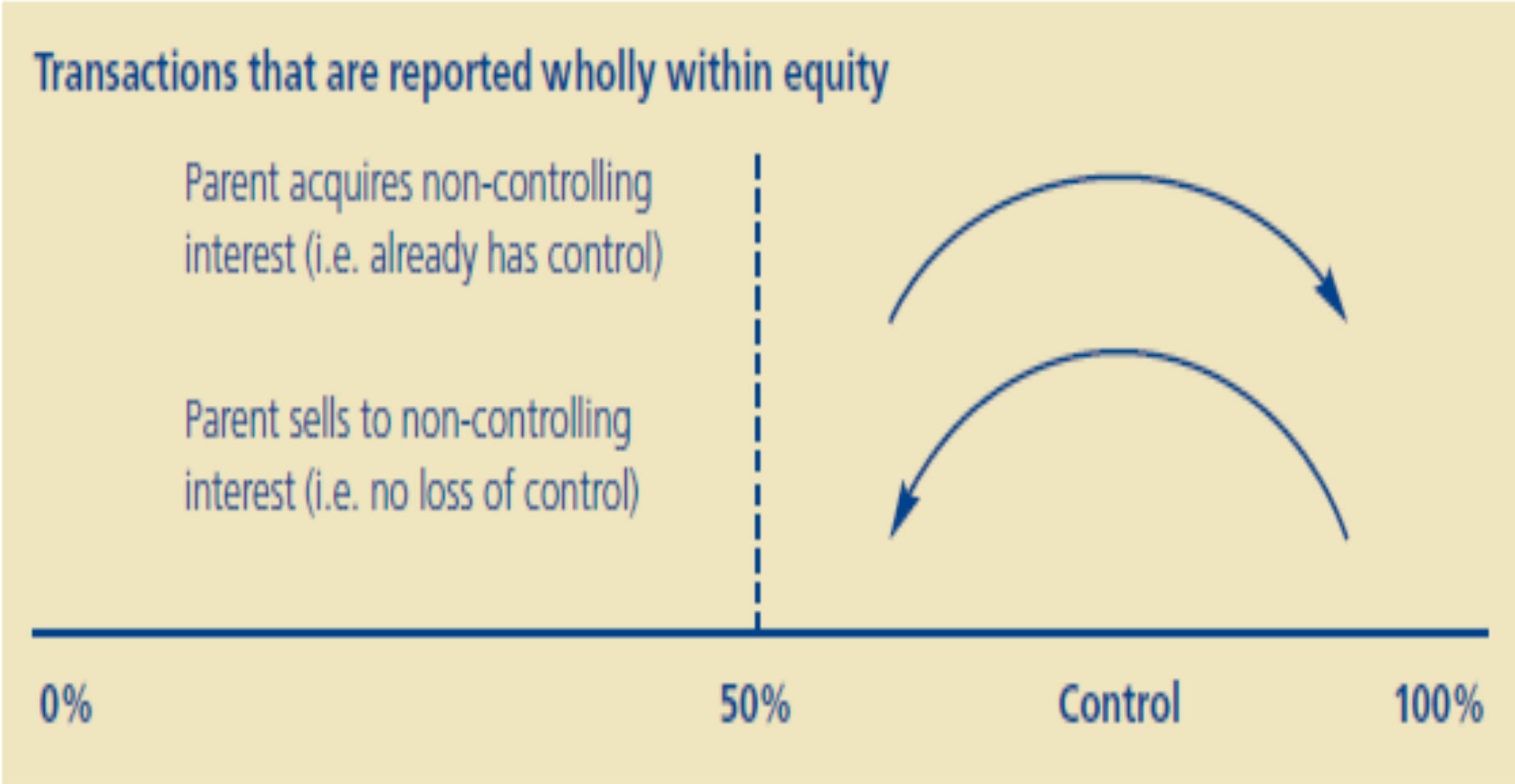
Accounting Boundary

- Making an Investment
- Acquiring Significant Control or Influence
- Obtaining Controlling Interest

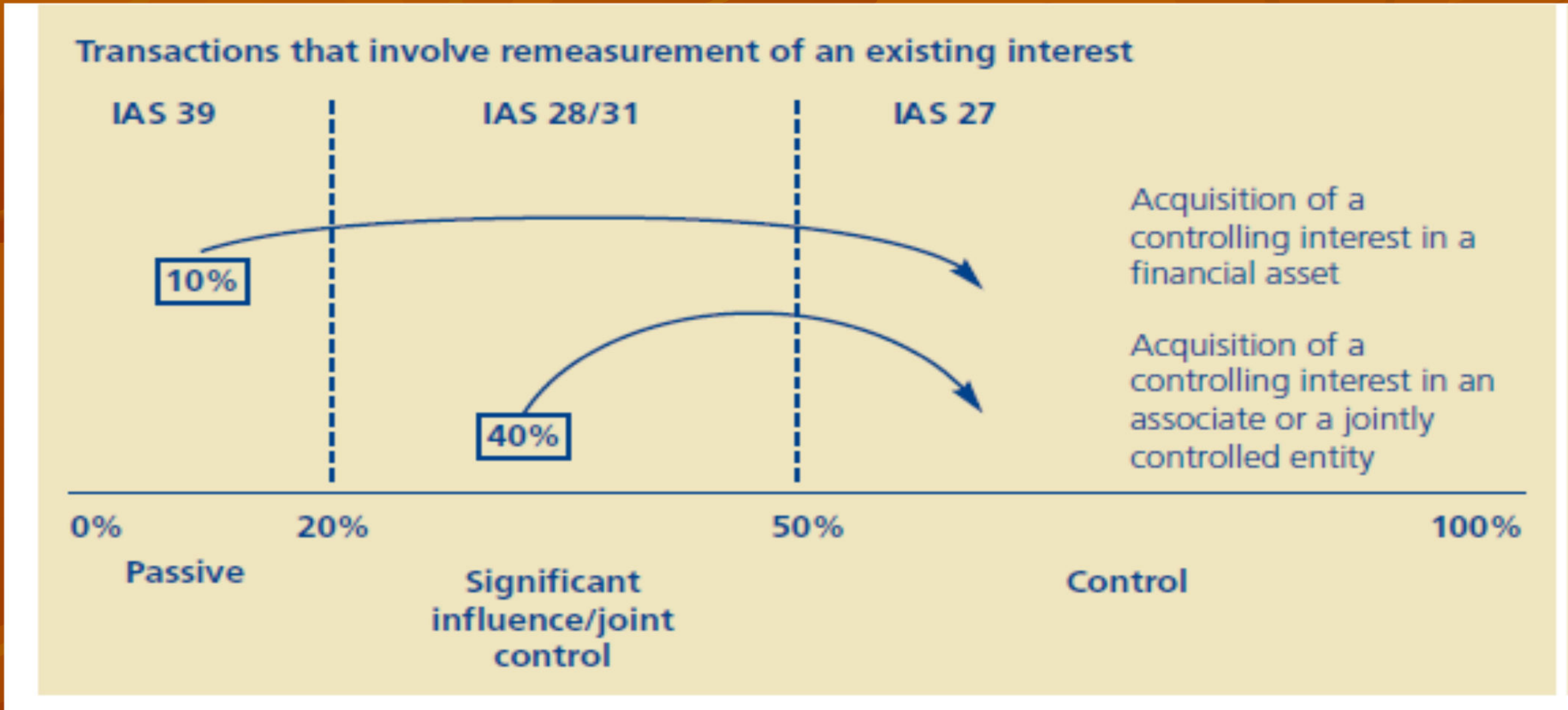
Crossing the Accounting Boundary

- ‘Crossing an accounting boundary’ describes a change in the method of accounting
- A business combination accounted for under IFRS 3 occurs only at the time that one entity obtains control over another, and does not apply to previous or subsequent transactions not involving a change in control.

No Change in the Controlling Interest



Obtaining Controlling Interest



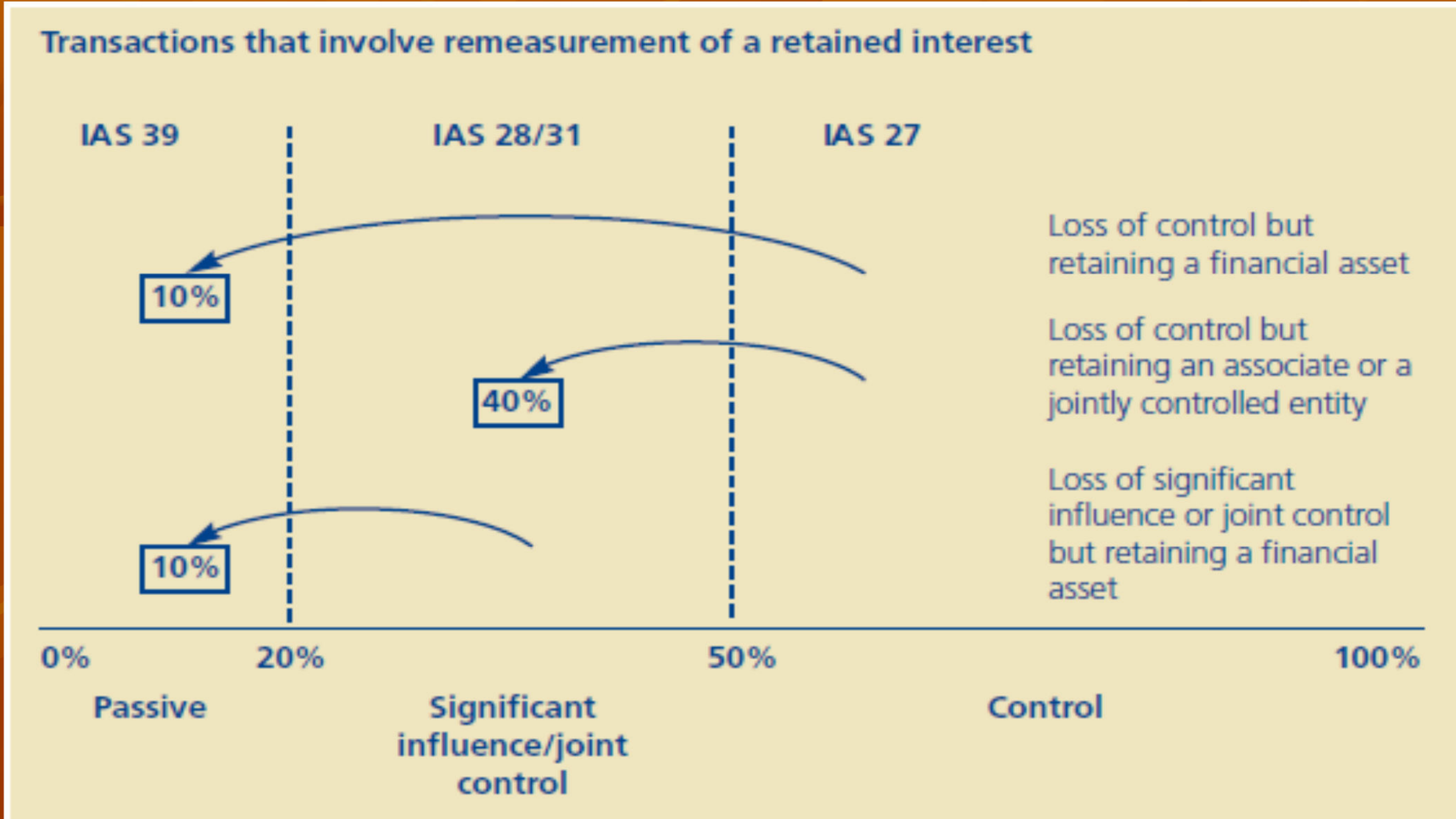
IAS 31 – Interest in Joint Venture replace with IFRS 11 – Joint Arrangements

IAS 39 – Financial Instrument: Recognition and Measurement

IAS 28 – Investment in Associates and Joint Ventures (May 2011)

IAS 27 – Separate Financial Statements (May 2011)

Losing Controlling Interest



Method of Accounting a Business Combination

- An entity shall account for each business combination by applying the acquisition method.
- The acquisition method is used for all business combinations

Possible Forms of Business Combinations

1. One business becomes a subsidiary of another;
2. Two entities are legally merged into one entity;
3. One entity transfers its net assets to another entity;
4. An entity’s owners transfer their equity interests to the owners of another entity;

Possible Forms of Business Combinations

5. Two or more entities transfer their net assets, or the owners transfer their equity interests, to a newly-formed entity (sometimes termed a 'roll-up' or 'put-together' transaction); and
6. A group of former owners of one entity obtains control of a combined entity.
7. Transactions that involve dual listing and equalisation arrangements between two entities
8. A contractual arrangement between two entities that has the effect of creating one entity in substance (i.e. a 'stapling' arrangement);

Possible Forms of Business Combinations

9. A contractual arrangement that provides a third party with all economic returns, and responsibility for risks, in relation to an investee, even though the legal ownership of ordinary capital is with another entity (e.g. a 'pass-through' arrangement); and
10. Arrangements whereby an entity is the beneficial owner of an interest held in trust but the trustee is the legal owner of that interest.

Requirements of Acquisition Method

(a) identifying the acquirer;

(b) determining the *acquisition date*;

(c) recognising and measuring the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree; and

(d) recognising and measuring goodwill or a gain from a bargain purchase.

Acquisition Method

1. In applying acquisition method of accounting (previously known as the “purchase method”) all contingent liabilities assumed should be recognized if their fair value can be measured reliably.
2. Any contingent liability recognized under IFRS 3 continues to be recognized subsequently, even though it may not quality for recognition under IAS 37

Three steps in IFRS 3 appln

- **I**dentification - Identify the Acquirer
- **M**easurement - Measure the cost of Purchase (Business Combinations)
- **A**llocation - Allocation of cost to Assets and Liabilities on the Date of Acquisition

Identify the Acquirer

- For each business combination, one of the combining entities shall be identified as the acquirer.
- Acquirer in a business combination – The entity that issued the equity shares in exchange for the net assets of the other entity normally can be designated the acquirer.
- In BCs called reverse acquisitions, the acquirer could be entity whose equity interests are acquired. This is determined taking into account the controlling interest of the two entities.

Example - Partnership

A limited partnership is formed with 3 partners: A is the general partner with responsibility for management for which it receives a fee that is comparable with similar arrangements between third parties; B and C are limited partners with no responsibility for management and 50% share of profits each. A cannot be removed by B and C.

As general partner, A will govern the financial and operating policies of the partnership. However, because A does not participate in the benefits of the partnership's activities, it would be concluded that A does not control the partnership within the meaning of IFRS 10 Joint Arrangements.

Example - Trust

A trust usually involves the appointment of a trustee The trustee has legal ownership of the property of the trust, whereas the beneficiaries have ‘beneficial’ or ‘equitable’ ownership in the trust property. Although a trustee can control the financial and operating policies of a trust, it does not control the trust. Hence a trustee’s relationship with the trust can be viewed as a fiduciary relationship rather than one of control.

Potential Voting Rights

Where an entity, by using the threat of exercise or conversion of potential voting rights, is able to ensure that its wishes are followed, then it has the power to direct the actions of others who are affected by a change in voting power

Example – Options are out of money

Entities A and B own 80 per cent and 20 per cent respectively of the ordinary shares that carry voting rights at a general meeting of shareholders of Entity C.

Entity A sells one-half of its interest to Entity D and buys call options from Entity D that are exercisable at any time at a premium to the market price when issued, and if exercised would give Entity A its original 80 per cent ownership interest and voting rights.

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Example – Options are out of money

Though the options are out of the money, they are currently exercisable and give Entity A the power to continue to set the operating and financial policies of Entity C, because Entity A could exercise its options now.

The existence of the potential voting rights, as well as the other factors described in paragraph Para B35 of IFRS 10 Consolidated Financial Statements, are considered and it is determined that Entity A controls Entity C

Example – Intention of the Mgmt

Entities A, B and C each own 33 per cent of the ordinary shares that carry voting rights at a general meeting of shareholders of Entity D. Entities A, B and C each have the right to appoint two directors to the board of Entity D.

Entity A also owns call options that are exercisable at a fixed price at any time and if exercised would give it all the voting rights in Entity D. The management of Entity A does not intend to exercise the call options, even if Entities B and C do not vote in the same manner as Entity A.

Example – Intention of the Mgmt

The existence of the potential voting rights, as well as the other factors described in paragraph B35 of and paragraphs 6 and 7 of IAS 28 Investments in Associates and Joint Ventures, are considered and it is determined that Entity A controls Entity D. The intention of Entity A's management does not influence the assessment.

Acquisition Date

The acquirer shall identify the acquisition date, which is the date on which it obtains control of the acquiree.

Recognizing and Measuring Assets and Liabilities

*The **acquirer** shall recognise*

- *the identifiable assets acquired,*
- *the liabilities assumed and*
- *any non-controlling interest in the acquiree*

*as of the **acquisition date***

Assets and Liabilities

To qualify for recognition as part of applying the acquisition method, the identifiable assets acquired and liabilities assumed

- Must meet the definitions of assets and liabilities in the *Framework for the Preparation and Presentation of Financial Statements* at the acquisition date.
- Must be part of what the acquirer and the acquiree (or its former *owners*) exchanged in the business combination transaction

Measurement Principle

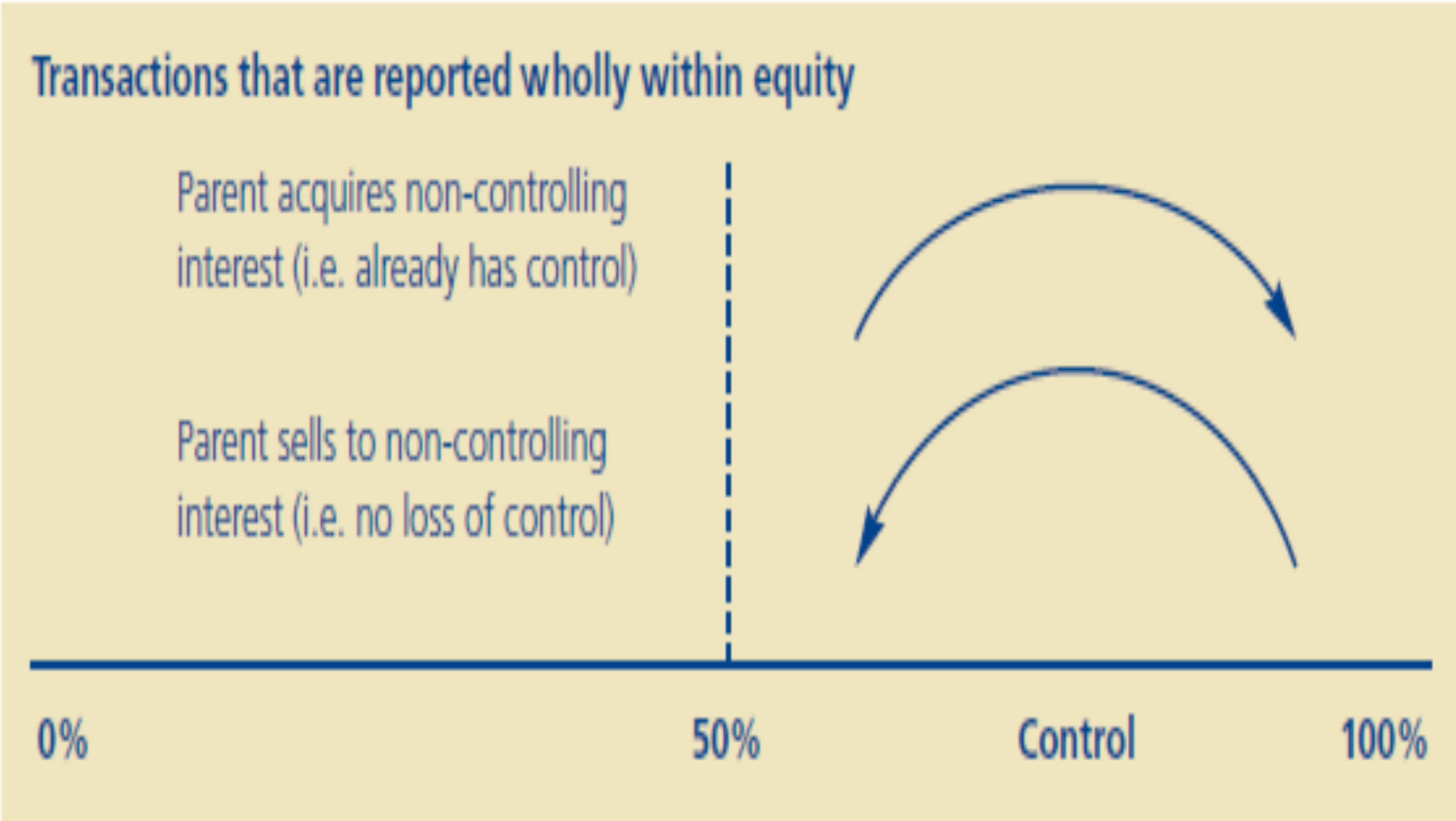
The acquirer shall measure the identifiable assets acquired and the liabilities assumed at their acquisition-date fair values.

NCI – Non Controlling Interest

IFRS 3 allows an accounting policy choice, available on a transaction by transaction basis, to measure NCI either at:

- fair value (sometimes called the full goodwill method), or
- the NCI's proportionate share of net assets of the acquiree (option is available on a transaction by transaction basis).

NCI – Entity View



Goodwill

Goodwill is measured as the difference between:

- the aggregate of

  (i) the acquisition-date fair value of the consideration transferred,

  (ii) the amount of any NCI, and

  (iii) in a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously-held equity interest in the acquiree; and
- the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed (measured in accordance with IFRS 3).

If the difference above is negative, the resulting gain is recognised as a bargain purchase in profit or loss.

Goodwill

1. Restructuring Provision is not allowed under IFRS (while determining the cost of the goodwill)
2. Goodwill determined should not amortized but tested atleast annually for impairment in accordance with IAS 36.
3. The term " negative goodwill" has been dropped from the standard, instead it is described as the " excess of the acquirer's interest in the net fair value of the aqcuiree's identifiable assets, liabilities and contingent liabilities over the cost"
4. The IFRS assumes negative goodwill would arise only in exceptional circumstances.

Bargain Purchase

- The Standard requires that prima facie if a business is acquired with bargain purchase, then acquirer shall further ascertain that it has recognised all the identifiable assets and liabilities. The Standard requires such reassessment so as to ensure that all available informations have been considered while assessing the asset and liabilities.

Ind AS 103 – Business Combinations

- Para 36:Before recognising a gain on a bargain purchase, the acquirer shall determine whether there exists clear evidence of the underlying reasons for classifying the business combination as a bargain purchase. If such evidence exists, the acquirer shall reassess whether it has correctly identified all of the asset s acquired and all of the liabilities assumed and shall recognise any additional assets or liabilities that are identified in that review. The acquirer shall then review the procedures used to measure the amounts this Indian Accounting Standard requires to be recognised at the acquisition date for all of the following:

Ind AS 103 – Business Combinations

(a) the identifiable assets acquired and liabilities assumed;

(b) the non-controlling interest in the acquiree, if any;

(c) for a business combination achieved in stages, the acquirer's previously held equity interest in the acquiree; and

(d) the consideration transferred.

The objective of the review is to ensure that the measurements appropriately reflect consideration of all available information as of the acquisition date.

Ind AS 103 – Business Combinations

Para 36A: If there does not exist clear evidence of the underlying reason s for classifying the business combination as a bargain purchase, the acquirer shall apply the requirements of reassessment and review described in paragraph 36.

The excess, if any, as determined after applying the said requirements of paragraph 36, shall be recognized directly in equity as capital reserve.

Goodwill Calculation – Ex 1

Facts

- A acquires 60 % of B for Rs.1000
- Fair value of B's identifiable assets Rs.1500
- Carrying amount of B's net assets Rs.1200
- Fair value of non-controlling interest (NCI) 650

Goodwill Calculation – Ex 1

	NCI	Good will
Current IFRS 3	600	100

NCI = Rs.1500 * 40% = Rs. 600

Consideration paid less fair value of proportion of identifiable net assets acquired: Rs.1000 – (Rs.1,500 * 60%) = Rs. 100.

GW on Date of Acquisition– Ex 2

- On 1st July 2010 Entity A obtained 100% control in Entity B. Net Fair Values of Asset is Rs. 12 Crores. Consideration paid Rs. 18 Crores in cash. What is the JE?

	Rs. Crores	
Dr Goodwill A/c	6	
Dr Investment in Subsidiary	12	
To Bank		18

GW on Date of Aquisition – Ex 2

Consideration paid in Share at a premium of 8%

		Rs. In Crores
Dr Goodwill A/c	6	
Dr Investment in Subsidiary	12	
To Share Capital		10
To Share Premium		8

Consolidation Entry

Intangible Assets

1. Intangible assets should be recognized as assets separately from goodwill.
2. Any asset or liability, that is not recognised in the financial statements of the acquiree but the same is separately identifiable, is required to be included in a business combination, e.g. intangible assets, viz. patents, copyrights, etc., which were earlier not recognised by the acquiree as it was self generated during the course of business, must be recognised by the acquirer in a business combination.

Cost of Business Combinations

- The cost of the business combination could be subject to adjustment because it may be contingent on certain future events
- Cost of issuing equity instruments shall not be included in the cost of business combination. Such cost should reduce the proceeds from the equity issued (IAS 32)

Initial Accounting

- There are times when the initial accounting can be determined only provisionally by the time the first accounts are drawn up after the acquisition.
- In such cases the acquiring entity should use those provisional values.
- Any adjustment to the provisional values should be made within 12 months of the acquisition and from the date of acquisition.
- Any further adjustments to be made after the initial accounting is completed can be done only to correct an error, as set out in IAS 8.

Other Issues in Business Combinations

- A Business Combination achieved in Stages
- A Business Combination achieved without the transfer of consideration
- Reverse Acquisitions
- Identifying intangible assets acquired
- The reassessment of the acquiree's contractual arrangements at the acquisition date

Business Combination Achieved in Stages

In a piecemeal acquisition (or acquisition in stages) successive share purchases may result in the control being gained by the acquirer. In such cases each share exchange transaction and fair value if the net assets, liabilities and contingent liabilities at the date of each transaction to determine the amount of any goodwill.

Business Combination Achieved in Stages

- Prior to control being obtained, the investment is accounted for under IAS 28 (revised to include Investments in Joint Ventures), IFRS 11 (IAS 31 has been superceded by IFRS 11), or IAS 39, as appropriate.
- On the date that control is obtained, the fair values of the acquired entity's assets and liabilities, including goodwill, are measured (with the option to measure full goodwill or only the acquirer's percentage of goodwill).
- Any resulting adjustments to previously recognised assets and liabilities are recognised in profit or loss.

Consolidation of Statements

- IFRS 10 *Consolidated Financial Statements* establishes principles for the presentation and preparation of consolidated financial statements when an entity controls one or more other entities. (IAS 27 – Separate Financial Statements (Revised) in May 2011)
- IAS 1 Para 4 will apply to Consolidated Financial Statements

Consolidation of Statements

- The IFRS supersedes IAS 27 *Consolidated and Separate Financial Statements* and SIC-12 *Consolidation—Special Purpose Entities* and is effective for annual periods beginning on or after 1 January 2013.

Disclosure Requirements

- The acquirer shall disclose information that enables users of its financial statements to evaluate the nature and financial effect of a business combination that occurs either during the current reporting period or after the end of the period but before the financial statements are authorised for issue

List of Disclosures Required 1

- name and a description of the acquiree
- acquisition date
- percentage of voting equity interests acquired
- primary reasons for the business combination and a description of how the acquirer obtained control of the acquiree. description of the factors that make up the goodwill recognised

List of Disclosures Required 2

- qualitative description of the factors that make up the goodwill recognised, such as expected synergies from combining operations, intangible assets that do not qualify for separate recognition
- acquisition-date fair value of the total consideration transferred and the acquisition-date fair value of each major class of consideration
- details of contingent consideration arrangements and indemnification assets
- details of acquired receivables

List of Disclosures Required 3

- the amounts recognised as of the acquisition date for each major class of assets acquired and liabilities assumed
- details of contingent liabilities recognised
- total amount of goodwill that is expected to be deductible for tax purposes
- details of any transactions that are recognised separately from the acquisition of assets and assumption of liabilities in the business combination

List of Disclosures Required 4

- information about a bargain purchase ('negative goodwill')
- for each business combination in which the acquirer holds less than 100 per cent of the equity interests in the acquiree at the acquisition date, various disclosures are required
- details about a business combination achieved in stages
- information about the acquiree's revenue and profit or loss

List of Disclosures Required 5

- information about a business combination whose acquisition date is after the end of the reporting period but before the financial statements are authorised for issue

About the Author

- *CA. Rajkumar S Adukia is an eminent business consultant, academician, writer, and speaker. He is the senior partner of Adukia & Associates.*

- *In addition to being a Chartered Accountant, Company Secretary, Cost Accountant, MBA, Dip IFR (UK), Mr. Adukia also holds a Degree in Law and Diploma in Labor Laws and IPR.*

- *Mr. Adukia, a rank holder from Bombay University completed the Chartered Accountancy examination with 1st Rank in Inter CA & 6th Rank in Final CA, and 3rd Rank in Final Cost Accountancy Course in 1983.*

- *He started his practice as a Chartered Accountant on 1st July 1983, in the three decades following which he left no stone unturned, be it academic expertise or professional development.*

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About the Author

- *He has been coordinating with various Professional Institutions, Associations, Universities, University Grants Commission and other Educational Institutions.*

- *Authored more than 50 books on a vast range of topics including Internal Audit, Bank Audit, SEZ, CARO, PMLA, Anti-dumping, Income Tax Search, Survey and Seizure, IFRS, LLP, Labour Laws, Real estate, ERM, Inbound and Outbound Investments, Green Audit etc.*

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