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VIRTUAL COACHING CLASSES
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FINAL LEVEL
PAPER : FINANCIAL REPORTING

Faculty: CA ACHAL JAIN

Identification of a Business Combination

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SCOPE

- Ind-AS 103 applies to a **transaction** or other event that meets the definition of a **business combination (BC).**
- Combination of entities or businesses under common control

(Dealt with in Appendix C of Ind-AS 103)

Scoped – Out
Formation of joint ventures
Asset acquisition (that do not constitute a business)

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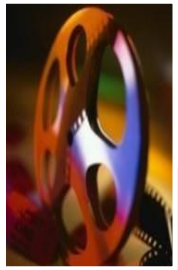
IDENTIFYING A BUSINESS COMBINATION



BUSINESS COMBINATION

- Transaction or event in which <u>acquirer obtains CONTROL over one or more BUSINESSes</u>



CONTROL

- Power over the investee
- Exposure, or rights to variable returns
- Ability to use its power over the investee to affect the amount of investor returns



BUSINESS

- <u>Integrated set of activities and assets</u>
- <u>Capable of being conducted and managed to provide return</u>
- Returns include dividends and cost savings.

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BUSINESS

Business generally consists of

inputs
(economic resource that creates, or has the ability to create, outputs)



Process
(Any system, standard, protocol, convention or rule that when applied to an input or inputs, creates or has the ability to create outputs.)



Output
(The result of inputs and processes applied to those inputs that provide or have the ability to provide a return in the form of dividends, directly to investors or other owners)

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BUSINESS

- 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

GOODWILL

Presumption is that if goodwill exists, the acquisition is a business.

BUT

A business need not necessarily have goodwill

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DEFINITION OF A BUSINESS: MEANING OF 'CAPABLE OF'

- A business need not include all the inputs or processes that the seller used in operating that business.
  - If a market participant is capable of utilising the acquired set of activities and assets to produce outputs by integrating the acquired set with its own inputs and processes, the acquired set might constitute a business.
  - If the elements that are missing from an acquired set are not present with a market participant but easily replaced/replicated, the acquired set might still be a business.
  - **However,** in most cases, the acquired set of activities and assets must have **at least some inputs and processes in order to be considered a business.**

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DEFINITION OF A BUSINESS: DEVELOPMENT STAGE OF A SET OF ACTIVITIES AND ASSETS

- Is the transferred set of activities and assets a business?
- Factors include but are not limited to whether the set:
  - Has begun its planned principal activities
  - Has employees, intellectual property and other inputs and processes that could be applied to those inputs
  - Is pursuing a plan to produce outputs
  - Will be able to obtain access to customers that will purchase the outputs
- Determination should be based on whether the integrated set is capable of being conducted and managed as a business by a market participant.

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ACTIVITY 1- DEVELOPMENT STAGE ENTERPRISE

Scenario 1

- Biotech A acquires outstanding shares in Biotech B, a start-up with a license for a product candidate.
- Due to loss of funding, Biotech B has no employees, no other assets.
- Neither clinical trials nor development are currently performed. However Biotech A will commence Phase 1 clinical tests .

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

Not a business, since there is no process.

- ✓ **Inputs – license**
- ✓ **Processes – none**
- ✓ **Outputs – none**

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ACTIVITY 1- DEVELOPMENT STAGE ENTERPRISE

Scenario 2

- 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 acquisition 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**

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ACTIVITY 2- APPLICATION IN REAL ESTATE INDUSTRY

Scenario 1

- Company A acquires land and a vacant building from Company B.
- No processes, other assets or employees (for example, leases and other contracts, maintenance or security personnel or a leasing office) are acquired in the transaction.
- **Should the acquisition be accounted as a business combination or an asset acquisition?**

Not a business, since there is no process.

- ✓ **Inputs – land and vacant building**
- ✓ **Processes – none**
- ✓ **Outputs – none**

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ACTIVITY 2- APPLICATION IN REAL ESTATE INDUSTRY

Scenario 2

- Company A acquires an operating hotel, the hotel's employees, the franchise agreement, inventory, reservations system and all 'back office' operations.

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

It is a Business.

- ✓ Inputs – non-current assets, franchise agreement and Employees
- ✓ Processes – operational and resource management processes associated with operating the hotel
- ✓ Outputs – revenues from operating the hotel

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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

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EXAMPLE : ACCOUNTING FOR A BUSINESS COMBINATION 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 tax 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

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Business Combination – Acquisition Method of Accounting

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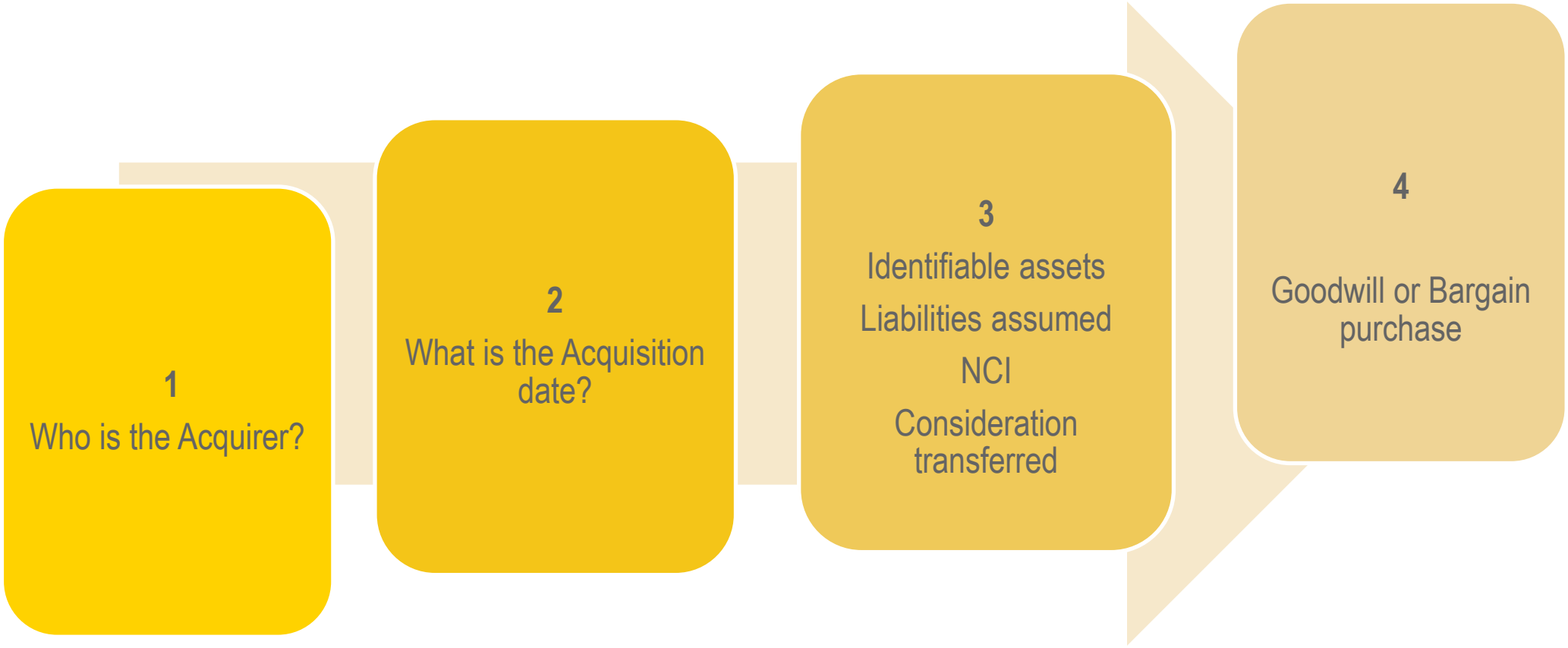
APPLICATION OF THE ACQUISITION METHOD-4 STEP PROCESS–4 STEP PROCESS



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WHO IS THE ACQUIRER?

- For each business combination, one of the combining entities shall be identified as the acquirer.
- The entity that obtains control of the acquiree is identified as acquirer in all business combinations.
- Refer Ind-AS 110 guidance on control for identification of the acquirer.



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If applying the guidance in Ind-AS 110 does not clearly indicate the acquirer, the following factors are considered in making that determination :

- Acquirer is usually the entity that transfers the cash or other assets or incurs the liabilities
- Acquirer is usually the entity that issues its equity interests
- Acquirer normally has the largest portion of the voting rights in the combined entity
- Acquirer will have ability to elect or appoint or to remove a majority of the members of the governing body of the combined entity

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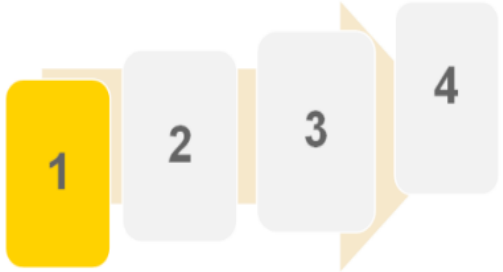
SPECIFIC CASE OF FORMATION OF NEW ENTITY

- Where a new entity (NewCo) is formed to effect business combination between two or more entities, say B and C, Ind-AS 103 identifies two distinct scenarios





  - **NewCo issues its equity instruments** in exchange for equity instruments in B and C - **Either B or C should be identified as the acquirer**
  - **NewCo transfers cash (or other assets)** in exchange for equity instruments in B and C (e.g. from the proceeds of a debt/ equity issue to new investors) **NewCo may be identified as the acquirer**.

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Acquisition date

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DATE OF ACQUISITION

- Generally the date on which the acquirer: legally transfers the consideration, acquires the assets; and assumes the liabilities of the acquire will normally be the closing date.
- However, the acquirer might obtain control on a date that is either earlier or later than the closing date.
  - the acquisition date precedes the closing date if a written agreement provides that the acquirer obtains control of the acquiree on a date before 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)



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EXAMPLE 4

- 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 trustee'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 20X1.

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

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EXAMPLE

Question:

X Ltd. makes an offer (subject to the satisfactory completion of due diligence) to buy all of the shares in Y Ltd. which is wholly owned by Z Ltd. Pending transfer of shares to X, the parties agree that X Ltd. should be consulted on any major business decisions. Whether offer date can be considered to be the date of acquisition?

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EXAMPLE

Response:

As per paragraph 8 of Ind AS 103, the acquisition date is the date on which the acquirer obtains control of the acquiree. Further, paragraph 9 of Ind AS 103 clarifies that the date on which the acquirer obtains control of the acquiree is generally the date on which the acquirer legally transfers the consideration, acquires the assets and assumes the liabilities of the acquiree—the closing date. However, the acquirer might obtain control on a date that is either earlier or later than the closing date. For example, the acquisition date precedes the closing date if a written agreement provides that the acquirer obtains control of the acquiree on a date before the closing date. An acquirer shall consider all pertinent facts and circumstances in identifying the acquisition date.

Hence, in the given case, X Ltd. cannot be considered to have the power to direct the relevant activities of Y Ltd. only due to the fact that it will be consulted on major decisions. X Ltd. does not have the power to impose its decisions on Y Ltd. Accordingly, based on the above, the offer date cannot be considered to be the date of acquisition.

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EXAMPLE

Question:

Company ABC Ltd. acquired all the shares of Company XYZ Ltd. The negotiations had commenced on 1 January 2016 and the agreement was finalised on 1 March 2016. While ABC Ltd. obtains the power to control XYZ's operations on 1 March 2016, the agreement states that the acquisition is effective from 1 January 2016 and that ABC Ltd. is entitled to all profits after that date. In addition, the purchase price is based on XYZ's net asset position as at 1 January 2016. What is the date of acquisition?

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Response:

Paragraph 8 of Ind AS 103 provides that acquisition date is the date on which the acquirer obtains control of the acquiree. Further paragraphs 6 and 7 of Ind AS 110, Consolidated Financial Statements, inter alia, state as follows:

"6 An investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.

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EXAMPLE(CONTD.)

Response:

7 Thus, an investor controls an investee if and only if the investor has all the following:

(a) power over the investee;

(b) exposure, or rights, to variable returns from its involvement with the investee; and

(c) the ability to use its power over the investee to affect the amount of the investor's returns."

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EXAMPLE(CONTD.)

Further, paragraph 9 of Ind AS 103 clarifies that the date on which the acquirer obtains control of the acquiree is generally the date on which the acquirer legally transfers the consideration, acquires the assets and assumes the liabilities of the acquiree—the closing date. However, the acquirer might obtain control on a date that is either earlier or later than the closing date. For example, the acquisition date precedes the closing date if a written agreement provides that the acquirer obtains control of the acquiree on a date before the closing date. An acquirer shall consider all pertinent facts and circumstances in identifying the acquisition date.

Therefore, in this case, notwithstanding that the price is based on the net assets at 1 January 2016 and that XYZ's shareholders do not receive any dividends after that date, ***the date of acquisition for accounting purposes will be 1 March 2016****. It is only on 1 March 2016 and not 1 January 2016, that ABC has the power to direct the relevant activities of XYZ Ltd. so as to affect its returns from its involvement with XYZ Ltd. Accordingly, the date of acquisition is 1 March 2016.*

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EXAMPLE

Question:

Company ABC Ltd. and Company XYZ Ltd. are manufacturers of rubber components for a particular type of equipment. ABC Ltd. makes a bid for XYZ Ltd.'s business and the Competition Commission of India (CCI) announces that the proposed transaction is to be scrutinised to ensure that competition laws are not breached. Even though the contracts are made subject to the approval of the CCI, ABC Ltd. and XYZ Ltd. mutually agree the terms of the acquisition and the purchase price before competition authority clearance is obtained. Can the acquisition date in this situation be the date on which ABC Ltd. and XYZ Ltd. agree the terms even though the approval of CCI is awaited (Assume that the approval of CCI is substantive)?

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EXAMPLE

Response:

Paragraph 8 of Ind AS 103 provides that acquisition date is the date on which the acquirer obtains control of the acquiree.
Further, paragraph 9 of Ind AS 103 clarifies that the date on which the acquirer obtains control of the acquiree is generally the date on which the acquirer legally transfers the consideration, acquires the assets and assumes the liabilities of the acquiree—the closing date. However, the acquirer might obtain control on a date that is either earlier or later than the closing date. For example, the acquisition date precedes the closing date if a written agreement provides that the acquirer obtains control of the acquiree on a date before the closing date. An acquirer shall consider all pertinent facts and circumstances in identifying the acquisition date.

***Since CCI approval is** a **substantive** approval for ABC Ltd. to acquire control of XYZ Ltd.'s operations, the **date of acquisition cannot be earlier than the date on which approval is obtained** from CCI. This is pertinent given that the approval from CCI is considered to be a substantive process and accordingly, the acquisition is considered to be completed only on receipt of such approval.*

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CONSIDERATION TRANSFERRED

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CONSIDERATION TRANSFERRED

➢The consideration transferred in a business combination shall be measured at acquisition date fair value, which shall be calculated as the sum of the following:

- ➢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.



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➢**Examples** of potential forms of consideration **include** cash, other assets, a business or a subsidiary of the acquirer, contingent consideration, deferred consideration ordinary or preference equity instruments, options, warrants and member interests of mutual entities.

➢However, any portion of the acquirer's share-based payment awards exchanged for awards held by the acquiree's employees that is included in consideration transferred in the business combination shall be measured in accordance with Ind-AS 102 rather than at fair value.

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EXAMPLE

Question:

ABC Ltd. acquired the entire equity share capital of PQR Ltd. for INR 8 crores. ABC Ltd. paid INR 2 crores in cash and the balance INR 6 crores has been agreed to be paid to the seller in 5 years as a deferred consideration.
How should the deferred consideration be valued for determining the consideration transferred in relation to computation of goodwill?

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EXAMPLE

Response:

Paragraph 37 of Ind AS 103 provides that the consideration transferred in a business combination should be measured at fair value, which should be calculated as the sum of (a) the acquisition-date fair values of the assets transferred by the acquirer, (b) the liabilities incurred by the acquirer to former owners of the acquiree and (c) the equity interests issued by the acquirer.

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Cont..

Based on above, the deferred consideration issued is required to be measured at its fair value. The deferred consideration will be valued at its net present value determined with reference to an appropriate discount rate (e.g. the rate at which entity ABC Ltd. could issue the same amount of debt in a separate market transaction with the appropriate adjustment for credit rating) for the purpose of computation of the consideration transferred.

Subsequent unwinding of the discounting discussed above is required to be recognised as finance cost in the respective years' statement of profit and loss.

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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



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Cont…

No adjustment made to goodwill , <u>except in case of provisional accounting during the measurement period</u> when :

- Additional/ new information becomes available during the measurement period on facts and circumstances that existed at the acquisition date.
- Measurement period not to exceed one year from acquisition date

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EXAMPLE 6 – CONTINGENT CONSIDERATION



- On January 1, 2007, entity A acquires 100% interest in entity B.
- The consideration for acquisition is payable in the following 2 tranches:
  - an immediate issuance of 1 million shares of entity A having face value of CU10 per share,
  - a further issuance of 0.2 million shares after one year if the profit before interest and tax for the first year following acquisition exceeds CU500,000
- At the date of acquisition, the fair value of shares of entity A is CU20 per share.
- The management has estimated that at the date of acquisition, the fair value of contingent consideration is CU2.5 million.
- At the end of year 1, it is noted that entity A has actually met the condition for issuance of further shares.
- At that date, the fair value of shares of entity A is CU25 per share.
- **How should the contingent consideration be treated at initial recognition and subsequently?**

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RESPONSE



- At the date of acquisition, consideration payable for acquisition is calculated as below:

Fair value of shares issued (1,000,000 x CU20)	CU20,000,000
Fair value of contingent consideration	CU 2,500,000
Total	CU22,500,000

- Regarding contingent consideration:
  - Number of shares to be issued is stated to be fixed
  - No obligation to pay cash
  - Thus, it meets definition of equity as per Ind-AS 32.
- Accordingly, CU2,500,000 would be classified as part of equity.
- Not to be remeasured subsequently or on issuance of shares.
- Amount recognized initially would be split into share capital and share premium upon issuance of shares.

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EXAMPLE 7- CONTINGENT CONSIDERATION

- The facts pattern given in this case is the same as that in Example 6 except the following
  - The number of shares to be issued after one year is not fixed.
  - Rather, entity A agreed to issue as many shares as have the fair value equal to CU4 million after one year, if the profit before interest and tax for the first year following acquisition exceeds CU500,000
- The management has estimated that at the date of acquisition, the fair value of contingent consideration is CU2.5 million.
- At the end of year 1, it is noted that entity A has actually met the condition for issuance of further shares.
- At that date, the fair value of shares of entity A is CU25 per share.



How should be treated the contingent consideration at initial recognition and subsequently?

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RESPONSE

- At the date of acquisition, consideration payable for acquisition is CU22,500,000 (i.e., CU20,000,000 plus CU2,500,000).
- Regarding contingent consideration:
  - Number of shares to be issued varies (depending on profit) in a manner that the fair value of the shares would always be equal the fair value of the obligation
  - Thus, it meets definition of liability as per Ind-AS 32.
- Liability would be fair valued at the end of year one and resulting loss of CU1,500,000 (CU4,000,000 – CU2,500,000) to be recognised in the profit or loss for the period.
- Subsequent to restatement of liability, Entity A would recognise issuance of 160,000 (CU4,000,000/ 25) shares at the fair value of liability on that date, i.e., CU4 million.



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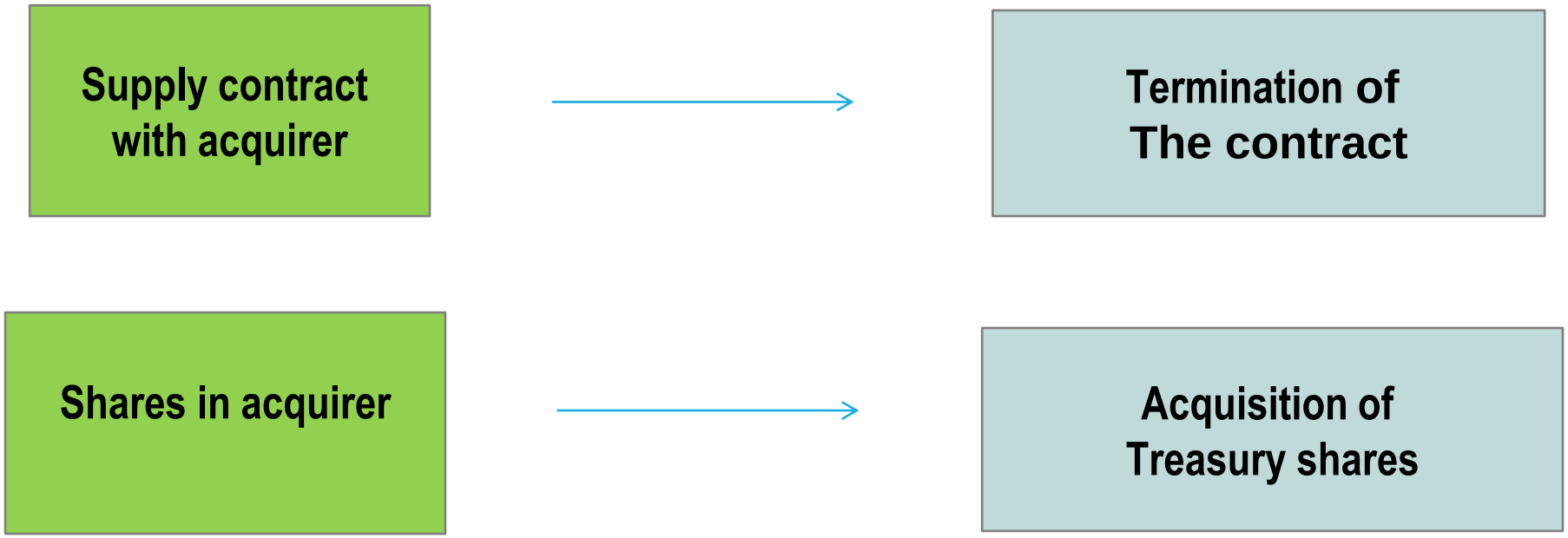
PRE - EXISTING RELATIONSHIPS

- Business combination in effect settles pre-existing relationship,



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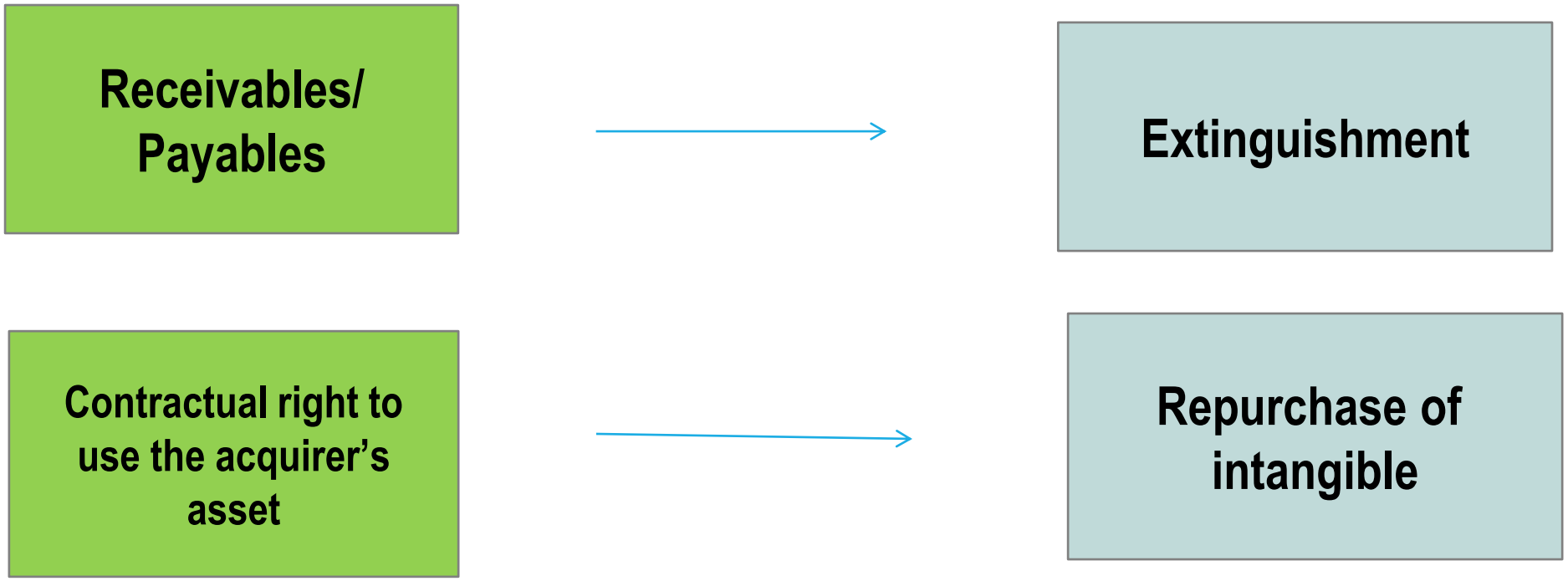

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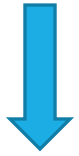
PRE – EXISTING RELATIONSHIPS

A *pre-existing relationship* is any relationship that existed between acquiree and acquirer before business combination was contemplated

Settlement favourable to acquirer



Gain on settlement

Settlement unfavourable to acquirer



Loss on settlement

Subject to adjustment in respect of any existing carrying amount in the financial statements of the acquirer

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EXAMPLE

Question:

Entity ABC acquires entity PQR for a consideration of INR 1 crore. Four years ago, Entity ABC had granted a ten-year license allowing entity PQR to operate in Europe. The cost of the license was INR 2,50,000. The contract allows either party to terminate the franchise at a cost of the unexpired initial fee plus 20%. At the date of acquisition, the settlement amount is INR 1,80,000 ((INR 2,50,000 X 6/10) + 20%).

Entity ABC has acquired entity PQR, because it sees high potential in the European market and wishes to exploit it. Entity ABC calculates that under current economic conditions and at current prices it could grant a six-year franchise for a price of INR 4,50,000.

How is the license accounted for as part of the business combination?

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EXAMPLE

Response:

Paragraph B51 of Ind AS 103 provides that "the acquirer and acquiree may have a relationship that existed before they contemplated the business combination, referred to here as a 'pre-existing relationship'. A pre-existing relationship between the acquirer and acquiree may be contractual (for example, vendor and customer or licensor and licensee) or non-contractual (for example, plaintiff and defendant)."

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Cont…

Further, paragraph B52 of Ind AS 103 provides that "if the business combination in effect settles a pre-existing relationship, the acquirer recognises a gain or loss, measured as follows:
(a) for a pre-existing non-contractual relationship (such as a lawsuit), fair value.
(b) for a pre-existing contractual relationship, the lesser of (i) and (ii):
(i) the amount by which the contract is favourable or unfavourable from the perspective of the acquirer when compared with terms for current market transactions for the same or similar items. (An unfavourable contract is a contract that is unfavourable in terms of current market terms. It is not necessarily an onerous contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.)
(ii) the amount of any stated settlement provisions in the contract available to the counterparty to whom the contract is unfavourable.

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EXAMPLE (CONTD.)

Response:

If (ii) is less than (i), the difference is included as part of the business combination accounting.

The amount of gain or loss recognised may depend in part on whether the acquirer had previously recognised a related asset or liability, and the reported gain or loss therefore may differ from the amount calculated by applying the above requirements."

Based on the above in the instant case, the license is recognised at INR 4,50,000, the fair value at market rates of a license based on the remaining contractual life.

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EXAMPLE (CONTD.)

The gain or loss on settlement of the contract is the lower of:

- *INR 3,00,000, which is the amount by which the right is unfavorable to entity ABC compared to market terms. This is the difference between the amount that entity ABC could receive for granting a similar right, INR 4,50,000, compared to the carrying value (or the unamortised value) that it was granted for, INR 1,50,000 (2,50,000 X 6/10).*
- *INR 1,80,000, which is the amount that entity ABC would have to pay to terminate the right at the date of acquisition.*

The loss on settlement of the contract is INR 1,80,000. Therefore, out of the INR 1 crore paid, INR 98.2 lakhs is accounted for as consideration for the business combination and INR 1,80,000 is accounted for separately as a settlement loss on the re-acquired right.

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Recognition of Assets Acquired, liabilities assumed and NCI

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RECOGNITION AND MEASUREMENT PRINCIPLE

- At the acquisition date, the acquirer shall recognize, separately from goodwill:
  - the identifiable assets acquired,
  - the liabilities assumed; and
  - any non-controlling interest in the acquiree*
- Measurement at the fair value at acquisition date**
- For recognition of identifiable assets acquired/ liabilities assumed as part of the acquisition method, these assets/ liabilities
  - must meet the definitions of assets and liabilities in the Framework at the acquisition date
  - must be part of what the acquirer and the acquiree (or its former owners) exchanged in the business combination transaction



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***Exceptions to recognition principle:** contingent liability, deferred taxes, employee benefits, assets indemnifications, leases in which acquiree is the lessee

****Exceptions to measurement principle:** deferred taxes, employee benefits, assets indemnifications, leases in which acquiree is the lessee, reacquired rights, share-based payments, assets held for sale

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EXAMPLE

Question:

On 1 April 2017, the PQR Ltd. merges with ABC Ltd. The net assets of PQR Ltd. includes investment in two wholly owned subsidiaries- P Ltd. and Q Ltd. On merger, how will these investments be accounted for in the separate financial statements of ABC Ltd.?

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Response:

Paragraph 18 of Ind AS 103 states as follows:

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

Based on the above referred general principle, the identifiable assets acquired and liabilities assumed of the acquiree are measured at the acquisition date fair values, with certain limited exceptions. In the absence of any exception for valuation of investment in subsidiaries getting acquired as a part of identified assets, the general measurement principles as stated above will be applied, i.e. the acquired investment in subsidiaries will be measured at acquisition date fair value. Accordingly, fair value of the subsidiary will now be the new cost.

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INTANGIBLE ASSETS

Marketing related

In-process research and development



Customer-related

Technology-based

Artistic-related

Contract-based

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CASE STUDY: INTANGIBLE ASSETS

Please comment on recognition of intangible asset other than Goodwill in the following situation:

1) Company P acquires Company S, a medical testing company, in a business combination on 31 December 20X1. S provides testing services to patients, such as blood screening, based on referrals from their general practitioners (medical practitioners who provide primary care to patients). S maintains a database with each patient's information, such as name, address, telephone number, doctor's name, insurer's name and policy number. However, this patient information is protected by privacy laws and S cannot sell, licence, transfer or otherwise exchange it.

Solution:

The customer list does not meet the separability criterion because privacy laws and regulations over patient information prevent selling, transferring, licensing or exchanging patient information separately from the acquiree. Whether or not P could recognise a separate intangible asset for the relationship with the patients and the general practitioner would depend on the specific facts and circumstances of each case.

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CASE STUDY: INTANGIBLE ASSETS

Please comment on recognition of intangible asset other than Goodwill in the following situation:

2) Company P acquires Company S, a bottling company, in a business combination on 31 December 20X1. S has a five-year agreement to supply bottles to Customer.

Solution:

The agreement, whether cancellable or not, meets the contractual-legal criterion. Additionally, because S establishes its relationship with Customer through a contract, not only the agreement itself but also S's customer relationship with Customer meet the contractual-legal criterion. Therefore **both** the **bottling agreement** and the **related customer relationships** are **recognised separately from goodwill** at their acquisition-date fair values.

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CASE STUDY: INTANGIBLE ASSETS

Please comment on recognition of intangible asset other than Goodwill in the following situation:

3) Company P acquires Company S, a ski-holiday company, in a business combination on 30 June 20XX, which is during S's off-season. S has a practice of establishing customer relationships through contracts but it does not have any contracts in place with customers at the acquisition date.

Solution:

S does not have any contracts in place with customers at the acquisition date, P does not recognise any customer contracts as part of its acquisition accounting. However, S's customer relationships are considered to meet the contractual-legal criterion because S has a practice of establishing customer relationships through contracts. These customer relationships are recognised separately from goodwill at their acquisition-date fair values.

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EXAMPLE

Question:

Do the following acquired items qualify as assets which can be recognised in a business combination:

a) Assembled workforce

b) Contingent assets

c) Potential contracts with new customers

d) Future contract renewals

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EXAMPLE

Response:

- ***Assembled workforce*** *is an existing collection of employees that permits the acquirer to continue to operate an acquired business from the date of acquisition. Although individual employees might have employment contracts with the employer, the collection of employees, as a whole, does not have such a contract. In addition, an assembled workforce is not separable; it cannot be sold, transferred, licensed, rented or otherwise exchanged without causing disruption to the acquirer's business. Therefore, it is not an identifiable intangible asset to be recognised separately from goodwill. Nor does the assembled workforce represent the intellectual capital of the skilled workforce, which is the (often specialised) knowledge and experience that employees of an acquiree bring to their jobs.*

- ***Contingent assets****: If the acquiree has a contingent asset, it should not be recognised unless it meets the definition of an asset.*

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Cont..

- ***Potential contracts with new customers****: The acquirer does not recognise them separately from goodwill because those potential contracts are not themselves assets at the acquisition date. Nor should the acquirer subsequently reclassify the value of those contracts from goodwill for events that occur after the acquisition date.*

- ***Future contract renewals****: Future contract renewals by themselves may not meet the identifiability criteria as prescribed under paragraph B40 of Ind AS 103. However, any value attributable to the expected future renewal of the contract is reflected in the value of, for example, the customer relationship, rather than being subsumed within goodwill.*

In measuring the fair value of an intangible asset, the acquirer would take into account assumptions that market participants would use when pricing the intangible asset, such as expectations of future contract renewals (except in the case of reacquired rights)..

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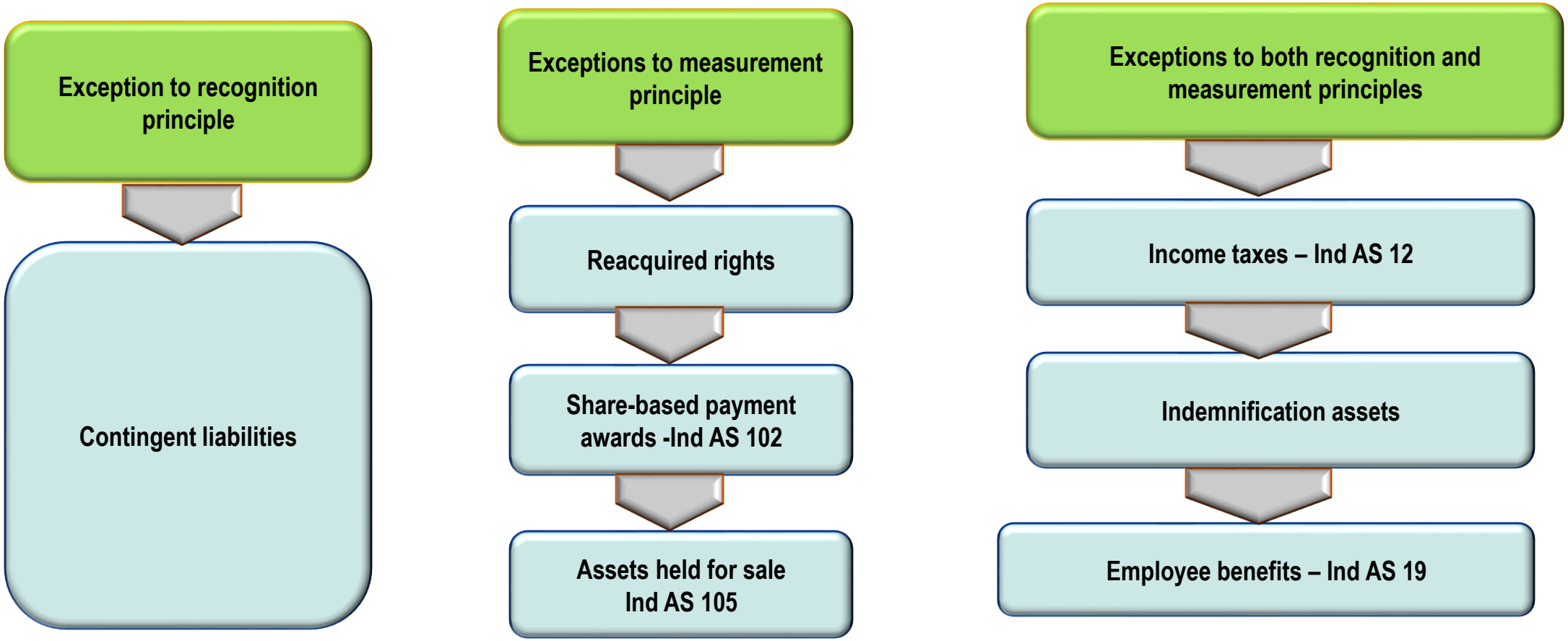
EXCEPTIONS TO THE RECOGNITION AND MEASUREMENT PRINCIPLES



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CONTINGENT LIABILITY - MEASUREMENT

Initial recognition

FV

(In case of Present Obligation)

Subsequent recognition

Higher of

Amount that would be recognized under Ind-AS 37;

AND

Amount initially recognized less, if applicable, cumulative amortization recognized.



This requirement does not apply to Financial contracts that are accounted for in accordance with Ind-AS 109 (for e.g. financial guarantee)

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EXAMPLE

Question:

ABC Ltd. is in the process of acquiring PQR Ltd., an entity engaged in the business of software related products and services. PQR Ltd. has been sued for one of the software licenses it uses in its business. The entity's lawyer has advised that, in his opinion, it is probable that the case could be successfully defended. Accordingly, no provision has been included in the PQR Ltd.'s financial statements immediately prior to the acquisition. However, post-acquisition, ABC Ltd.'s management has decided that the case should be settled out of court in order to avoid a protracted court case.

Should the acquirer recognise the contingent liability?

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EXAMPLE

Response:

Paragraph 23 of Ind AS 103 states that the requirements in Ind AS 37 do not apply in determining which contingent liabilities to recognise as of the acquisition date. Instead, the acquirer shall recognise as of the acquisition date a contingent liability assumed in a business combination if it is a present obligation that arises from past events and its fair value can be measured reliably. Therefore, contrary to Ind AS 37, the acquirer recognises a contingent liability assumed in a business combination at the acquisition date even if it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation. Paragraph 56 provides guidance on the subsequent accounting for contingent liabilities.

In accordance with the above, in the given case, although the case is probable to be successfully defended, the contingent liability will have a fair value on the assumption that there is some risk that the case may not be successfully defended. To the extent that the fair value can be reliably measured, the contingent liability would be recognised as part of the business combination accounting. The financial effect of the acquirer's decision not to defend the case would be reflected as a current –that is, post combination event.

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EXAMPLE 8 – CONTINGENT LIABILITY

Burger King sells burgers. Experience suggests that one in a million burger sold is contaminated. Burger King was acquired by Pizza King, on which date Burger King had sold one million burgers (in the past week or so).

Should Pizza King provide for the liability in the acquisition accounting that may arise on the contaminated burger.

Response:

No, since on acquisition date this is a possible obligation and not a present obligation.

Pizza King should account for this liability in the post combination financial statements only if the contaminated case is reported.

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INDEMNIFICATION ASSET

- 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. As a result, the acquirer obtains an indemnification asset.
- Examples of indemnification assets:
  - The seller agrees to pay the settlement costs of an outstanding court case against the acquiree.
  - The acquiree is the subject of an uncertain tax position and the seller agrees to refund the acquiree if any costs are incurred as a result of tax proceeding.

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INDEMNIFICATION ASSET (CONT.)

- **Recognition and measurement**

Indemnified item	Indemnification asset
Fair value	Fair value
Exception to recognition and measurement rule	Exception to recognition and measurement rule subject to the need for a valuation allowance for uncollectible amounts

  - Derecognition
    - Collected
    - Sold
    - Lost otherwise

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EXAMPLE

In January 2010, Entity P acquires a 100% interest in Entity S, a manufacturer of cosmetics, from Entity V.

At the time of acquisition there are two open litigations against S:

- **Litigation 1**: Customers of S have alleged that products of S contain harmful levels of parabens that cause cancer. The claimants are suing S for damages amounting to CU 50 million.
- **Litigation 2**: S is in a dispute with tax authorities over its tax return for 2008.

V will indemnify P for the losses up to CU 25 million in the case of Litigation 1. P has also received an indemnification from V to cover the outcome of Litigation 2.

How should P account for the contingent liability/liability and the indemnification assets assuming that:

- The fair value of the contingent liability resulting from Litigation 1 is CU 15 million.
- An outflow in relation to Litigation 2 is probable. The estimated amount expected to be paid is CU 13 million (amount claimed by tax authorities). The fair value of the liability is CU 11 million.

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RESPONSE

- **Litigation 1**
  - In the purchase price allocation, identifiable liability of CU 15 million is recognised.
  - The liability is measured at fair value, and the indemnification asset should be measured at fair value.
  - Asset is recognised amounting to CU 15 million assuming that none of the possible outcomes taken into calculation of the fair value of liability exceeds the indemnification cap and there is no risk of uncollectibility.
- **Litigation 2**
  - In the purchase price allocation, liability related to Litigation 2 — tax litigation — is recognised at CU 13 million, i.e., at the amount expected to be paid, not at fair value
  - The indemnification asset has to be recognised and measured using assumptions consistent with those used to measure the indemnified item.
  - An asset amounting to CU 13 million is recognised assuming there is no risk of uncollectibility.

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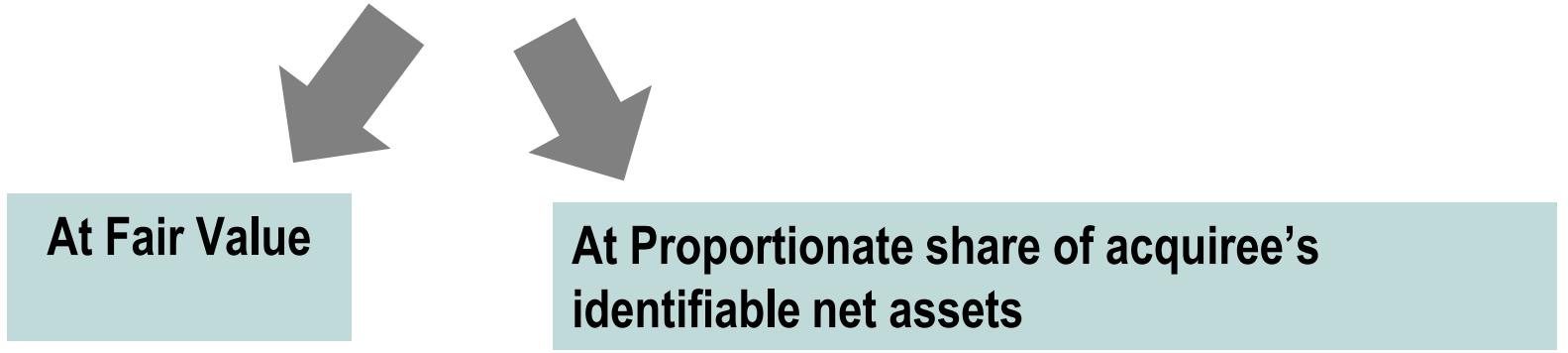
NON – CONTROLLING INTEREST

- NCI is equity in a subsidiary not attributable, directly or indirectly to a parent
- Measurement option for NCI at acquisition date:



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

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MEASUREMENT PERIOD - PROVISIONAL ALLOCATIONS

- If the initial accounting is incomplete by end of the reporting period in which combination occurs, the acquirer shall report provisional amounts

- Measurement period
  - is the period after the acquisition date during which the acquirer may adjust the provisional amounts recognized for a business combination
  - ends as soon as the acquirer receives the information it was seeking about facts and circumstances that existed as of the acquisition date or learns that more information is not obtainable.
  - **shall not exceed one year** from the acquisition date.

- Results in retrospective restatement to **reflect additional information within the measurement period** of goodwill and comparatives.
- After the measurement period ends, the accounting for a business combination can be amended only as to correct an error in accordance with Ind-AS 8

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EXAMPLE

Question:

ABC Ltd. acquired XYZ Ltd. on 28 February 2017. As part of the acquisition accounting, ABC Ltd. recognised a provisional amount of INR 1 crore in respect of a patent developed by XYZ Ltd. However, the technology covered by the patent was new and ABC Ltd. expected the cash flows to be generated by the patent to increase beyond those being generated at the time. Accordingly, ABC Ltd. sought an independent valuation report from a third party consultant, which was not expected to be finalised for several months. ABC Ltd. assessed the useful life of the patent to be 10 years. Goodwill of INR 1.2 crores was recognised in the provisional accounting.

The consolidated financial statements of ABC Ltd. as at 31 March 2017 included appropriate disclosures about the provisional accounting. The valuation report is finalised subsequent to the issuance of the financial statements of the year 2016-17 but before the end of the measurement period. Based on the valuation, ABC Ltd. concludes that the fair value of the patent was INR 1.5 crores. Management does not revise the estimated useful life of the patent, which remains at 10 years.

Whether ABC Ltd. is required to restate the comparative information for the year 2016-17 presented in the financial statements of the year 2017-18?

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EXAMPLE

Response:

Paragraph 45 of Ind AS 103 provides that if the initial accounting for a business combination is incomplete by the end of the reporting period in which the combination occurs, the acquirer should report in its financial statements provisional amounts for the items for which the accounting is incomplete. During the measurement period, the acquirer should retrospectively adjust the provisional amounts recognised at the acquisition date to reflect new information obtained about facts and circumstances that existed as of the acquisition date and, if known, would have affected the measurement of the amounts recognised as of that date.

In accordance with above, the acquirer should revise comparative information for prior periods presented in financial statements as required, including making any change in depreciation, amortisation or other income effects recognised in completing the initial accounting.

Based on above, the comparative information presented in the financial statements for the year 2017-18 needs to be restated for the measurement period adjustment as follows:

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EXAMPLE (CONTD.)

	As stated originally	Revised
Profit or loss (patent amortisation)	83,333(1)	125,000 (2)
Goodwill	1,20,00,000	70,00,000 (3)
Patent	99,16,667 (4)	1,48,75,000 (5)

Notes:

1. 1,00,00,000 x 1 /10 x 1 / 12

2. 1,50,00,000 x 1 / 10 x 1 / 12

3. 1,20,00,000 – 50,00,000

4. 1,00,00,000 – 83,333

5. 1,50,00,000 – 125,000

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Recognition and Measurement of Goodwill and Bargain Purchase

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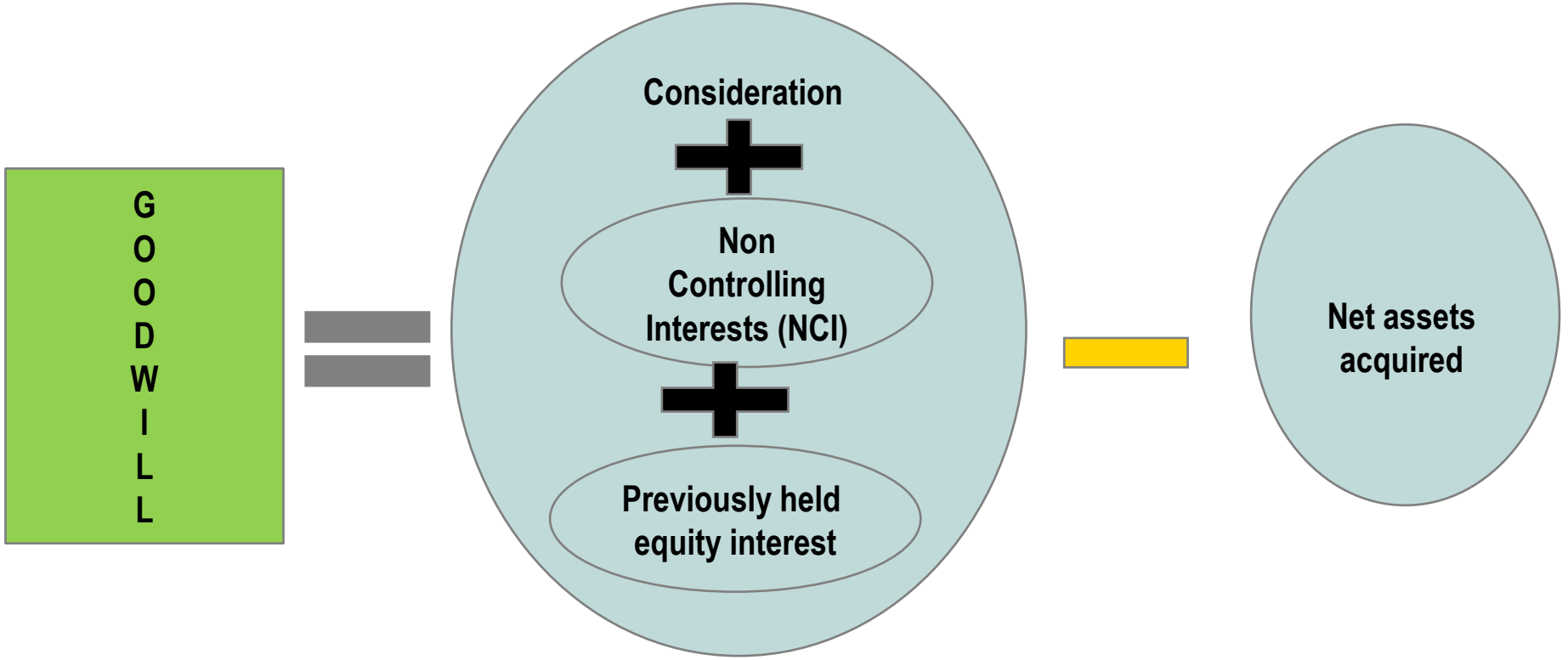
MEASUREMENT OF GOODWILL



Acquisition related costs charged to P&L Except, Debt securities issue cost–incorporated in effective interest rate (Ind-AS 109) and Equity issues cost recognized in equity (Ind-AS 32).

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BARGAIN PURCHASE

- A bargain purchase is one where the goodwill is negative

  A bargain purchase might happen, for example, in a business combination that is a forced sale in which the seller is acting under compulsion.

- In such cases, **the acquirer should reassess whether it has correctly identified all of the assets acquired and all of the liabilities assumed**

- **If reassessment confirms bargain purchase, any gain is recognized in equity as capital reserve (routed through OCI) on the acquisition date. However, If there does not exist clear evidence** of the underlying reasons for classifying the business combination as a bargain purchase, **the gain (bargain purchase) should be recognised directly in equity as capital reserve.**

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Business Combination – Achieved in stages

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COMBINATION ACHIEVED IN STAGES

- An acquirer may obtain the control of an acquiree in stages, by successive purchases of shares (commonly referred to as a '**step acquisition**')

- If the acquirer holds a non-controlling equity investment in the acquiree immediately before obtaining control:
  - Remeasure investment to fair value as at the date of gaining control
  - Recognise any gain or loss on remeasurement in profit or loss or OCI as appropriate.
  - If the investment was previously classified as FVOCI, any gain or loss accumulated in equity shall be recognised on the same basis as would be required if the acquirer had disposed off directly the previously held equity interest.
  - Goodwill calculation to follow such valuation.

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EXAMPLE 9- ACQUISITION IN STAGES

- Investor acquires a 20 per cent ownership interest in Investee (a service company) on 1 January 200X for CU3,500,000 cash. At that date, the fair value of Investee's net identifiable assets is CU10,000,000, and the carrying amount of those assets is CU8,000,000.

- Investor does not have significant influence over investee. Thus, it treated investments as FVOCI investments. Fair value of investment as at December 31, 200X was CU6,000,000. Accordingly, investor recognized unrealized gain of CU2,500,000 in equity.

- On 1 January 20X1, Investor acquires a further 60 per cent ownership interest in Investee for CU19,000,000 cash, thereby obtaining control. This includes control premium of CU1,000,000. At that date, the fair value of Investee's net identifiable assets is CU12,000,000 and the carrying amount of those assets is CU10,000,000.

- Investee's profit for the year 200X is CU2,000,000. Fair value of Non-controlling interest (20%) and Fair value of original investment (20%) on the date of acquisition is CU6,000,000.

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RESPONSE

- Under Ind-AS 103, the following approach would be followed for computation of goodwill
  - **Remeasure investment to fair value as at the date of gaining control and Recognise any gain or loss on remeasurement in profit or loss.**

    20% investment which is previously held and classified as FVOCI (3.5) would be fair valued on date of acquisition.

    CU6,000,000 and CU2,500,000 gain accumulated in equity would be recognized in profit or loss.
  - **Fair value of net identifiable assets of the acquiree at the acquisition date** is CU12,000,000.
  - **Total cost of acquisition would be measured at acquisition date** as CU25,000,000, i.e., CU19,000,000 plus CU6,000,000.
  - Goodwill shall be calculated using one of the two approaches discussed above for measurement of non-controlling interest.
  - If the entity follows option I to measure non-controlling interest at fair value, amount on non-controlling interest may be significantly different.

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RESPONSE

	Option 1 NCI at fair value	Option 2 NCI at proportion of net assets
Cost of acquisition	25,000,000	25,000,000
Non-controlling interest at fair value	6,000,000	NA
Non-controlling interest as proportion of net assets	NA	2,400,000
Total	31,000,000	27,400,000
Less: Fair value of net identifiable assets	12,000,000	12,000,000
Goodwill	**19,000,000**	**15,400,000**

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EXAMPLE

Question:

ABC Ltd. acquires PQR Ltd. on 30 June 2017. The assets acquired from PQR Ltd. include an intangible asset that comprises wireless spectrum license. For this intangible asset, ABC Ltd. is required to make an additional one-time payment to the regulator in PQR's jurisdiction in order for the rights to be transferred for its use. Whether such additional payment to the regulator is an acquisition-related cost?

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EXAMPLE

Response:

As per Ind AS 103, the acquisition-related costs incurred by an acquirer to effect a business combination are not part of the consideration transferred.

Paragraph 53 of Ind AS 103 states that, acquisition-related costs are costs the acquirer incurs to effect a business combination. Those costs include 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; and 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 109.

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RESPONSE (CONTD.)

The payment to the regulator represents a transaction cost and hence will be regarded as acquisition related cost incurred to effect the business combination. Applying the requirements of paragraph 53 of Ind AS 103, it should be expensed as it is incurred. Transfer of rights in the instant case cannot be construed to be separate from the business combination because the transfer of the rights to ABC Ltd. is an integral part of the business combination itself.

Note: *Had the right been acquired separately (i.e. not as part of business combination), the transaction cost would have been capitalised as part of the intangible asset as per the requirements of Ind AS 38, Intangible Assets.*

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Business Combination – Common control transactions

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COMMON CONTROL TRANSACTIONS

- Combination of entities or businesses in which ALL of the combining entities/businesses are ultimately **CONTROLLED** by the **SAME** party (ies) both **BEFORE** and **AFTER** the transaction and that control is not transitory

  - It will include transactions such as transfer of subsidiaries or businesses, between entities within a group
  - The extent of minority interest in each of the combining entities before and after the BC not relevant to determine whether a combination involves entities under common control
  - It is not necessary that combining entities are included as part of the same CFS
  - A group of individuals can be a controlling party

- BC involving entities or businesses under common control shall be accounted for using the pooling of interests method

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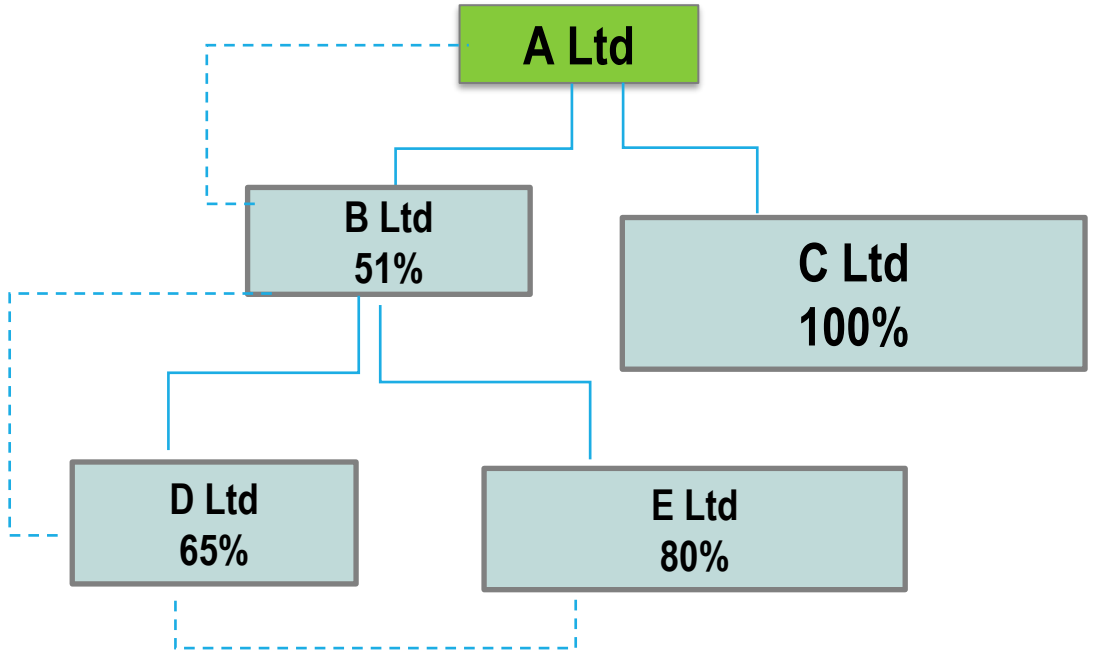
COMMON CONTROL TRANSACTION



E Ltd amalgamated with D Ltd

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APPLICATION OF POOLING OF INTEREST METHOD – KEY PRINCIPLES

Assets and liabilities of the combining entities are reflected at their carrying amounts (only adjustments that are made are to harmonise accounting policies);

No 'new' goodwill is recognized as a result of the combination;

Financial information in financial statements in respect of prior periods should be restated as if business combination had occurred from beginning of preceding period in financial statements, irrespective of actual date of combination

However, if business combination had occurred after that date, prior period information shall be restated only from that date

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APPLICATION OF POOLING OF INTEREST METHOD – KEY PRINCIPLES

Consideration for business combination may consist of securities, cash or other assets. Securities shall be recorded at nominal value. In determining the value of consideration, assets other than cash shall be considered at their fair values

Identity of reserves shall be preserved and shall appear in financial statements of transferee in same form in which they appeared in financial statements of transferor

Difference, if any, between amount recorded as share capital issued plus any additional consideration in form of cash or other assets and amount of share capital of transferor shall be transferred to capital reserve and should be presented separately from other capital reserves

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Business Combination – Disclosure requirements

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DISCLOSURES

General Information on the business combination

Consideration Transferred

Assets acquired and liabilities assumed

Goodwill or a gain on bargain purchase

Transactions that are not part of the business combination;

In which the acquirer holds less than 100 percent of the acquiree;

In which the acquirer holds less than 100 percent of the acquiree;

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DISCLOSURES (CONTD.)

Business combinations achieved in stages, i.e., step acquisitions;

Pro forma information about revenue and profit or loss; and

Measurement period adjustments and contingent consideration adjustments.

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DISCLOSURES (CONTD.)

- Revenue and profit or loss of combined entity for current reporting period as though acquisition date for all business combinations that occurred during the year had been as of beginning of annual reporting period.

- Reconciliation of movements in goodwill:
  - Opening amounts for gross goodwill and impairment losses
  - Additional goodwill recognised in the period
  - Adjustments from recognition of deferred tax assets
  - Movements in goodwill of a 'disposal group' under Ind-AS 105
  - Impairment losses recognised in the period
  - Net exchange differences arising in the period
  - Any other changes arising in the period
  - Closing amounts for gross goodwill and impairment losses

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Business Combination –Differences between GAAPs

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KEY DIFFERENCES
INDIAN GAAP VS IND-AS 103 VS IFRS 3

Area	Indian GAAP	Ind-AS / IFRS
Scope	No comprehensive standard covering all business combinations. AS 14 deals only with amalgamation	Ind-AS 103 / IFRS 3 deals with both amalgamations and acquisitions except formation of joint venture and acquisition of assets which do not constitute business
Accounting for common control transactions	No standard differentiates between common control and other business combinations but AS 14 allows use of pooling of interest method for accounting of amalgamation in the nature of merger	**Appendix C of Ind-AS 103** deals with accounting for BCs involving entities under common control. It requires the same to be accounted for using the pooling of interest method. **IFRS** excludes common control transactions from the scope of **IFRS 3**
Acquisition Date	The date of amalgamation / acquisition mentioned in the court scheme is the acquisition date	The date on which the acquirer effectively obtains control of the acquiree is the acquisition date

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KEY DIFFERENCES
INDIAN GAAP VS IND-AS 103 VS IFRS 3

Area	Indian GAAP	Ind-AS / IFRS
Accounting for assets and liabilities taken over	Under purchase method, acquired assets and liabilities are recognised at their existing book values or consideration is allocated to individual assets and liabilities based on their acquisition date fair values. Identifiable assets and liabilities may include assets and liabilities not recorded in financial statements of transferor company.	Under purchase method, acquired identifiable assets, liabilities and contingent liabilities are recognised at fair value.
Consideration	Consideration for amalgamation means aggregate of shares and other securities issued and payment made in form of cash or other assets by acquirer to shareholders of acquiree. While it is required that non-cash elements of consideration should be included at fair value, it is also stated that the value of any securities (forming part of consideration) fixed by statutory authorities may be taken to be their fair value.	The cost of acquisition is amount of cash or cash equivalents paid, plus fair value of other purchase consideration given. The fair value of securities issued by acquirer is determined at the date of exchange.

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KEY DIFFERENCES
INDIAN GAAP VS IND-AS 103 VS IFRS 3

Area	Indian GAAP	Ind-AS / IFRS
Non-controlling interest	Minority interest is valued at its proportionate share of historical book value of net assets and presented outside shareholders' equity	Non-controlling interest is stated either at acquisition-date fair value or at non-controlling interest's proportionate share of fair value of acquiree's identifiable net assets and included within shareholders' equity
Accounting for goodwill / bargain purchase	Under AS 14, excess of consideration paid over the net assets acquired is recorded as goodwill and is amortised to profit or loss over a period not exceeding 5 years. In case of bargain purchase, the difference is recorded as capital reserve.	As per **Ind-AS 103**, on acquisition date, acquirer will recognise excess as goodwill and subsequently it would be recorded as cost less impairment losses. Amortisation of goodwill is prohibited. Bargain purchase is recognised in OCI or directly in equity as capital reserve on acquisition date **IFRS 3** prescribes treatment similar to Ind-AS for accounting of goodwill. However, in case of bargain purchase, the gain is recognised in profit or loss

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THANK YOU

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