CA FINAL

40th Edition

FINANCIAL REPORTING

ALDINE CA

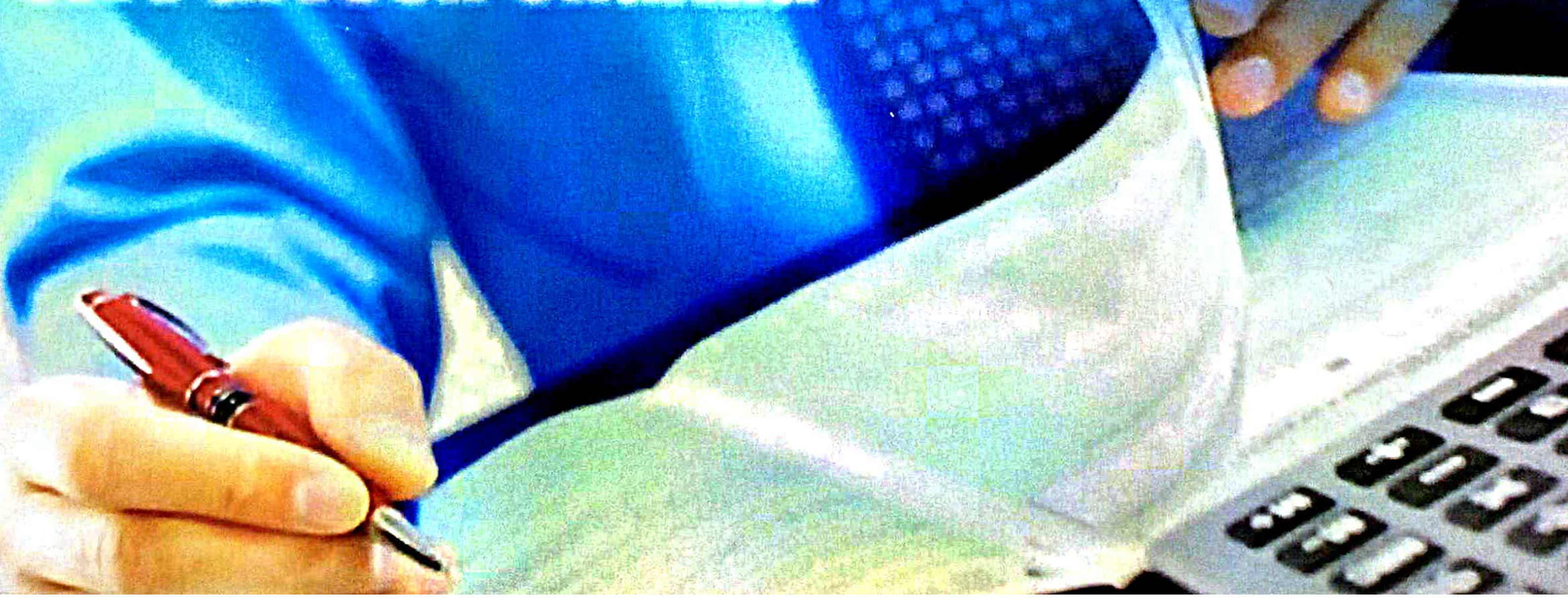
Always A Step Ahead

Module 4

BOOK NO.

2301A

CA Parveen Sharma



CHAPTER

13

IND AS 103: BUSINESS COMBINATIONS

Question 1

An entity acquires an equipment and a patent in exchange for ₹ 1,000 crore cash and land. The fair value of the land is ₹ 400 crore and its carrying value is ₹ 100 crore. Fair values of the equipment and patent are estimated to be ₹ 500 crore and ₹ 1,000 crore, respectively. The equipment and patent relate to a product that has just recently been commercialised. The market for this product is still developing.

Assume the entity incurred no transaction costs. For ease of convenience, the tax consequences on the gain have been ignored. How should the transaction be accounted for?

(*Study Material*)

Answer

As per paragraph 2(b) of Ind AS 103, the standard does not apply to "the acquisition of an asset or a group of assets that does not constitute a business. In such cases the acquirer shall identify and recognise the individual identifiable assets acquired (including those assets that meet the definition of, and recognition criteria for, intangible assets in Ind AS 38, Intangible Assets) and liabilities assumed. The cost of the group shall be allocated to the individual identifiable assets and liabilities on the basis of their relative fair values at the date of purchase. Such a transaction or event does not give rise to goodwill". In the given case, the acquisition of equipment and patent does not represent acquisition of a business as equipment and patent relate to a product that has just recently been commercialised.

The cost of the asset acquisition is determined based on the fair value of the assets given, unless the fair value of the assets received is more reliably determinable. In the given case, the fair value measurement of the land appears more reliable than the fair value estimate of the equipment and patent. Thus, the entity should record the acquisition of the equipment and patent as ₹ 1,400 crore (the total fair value of the consideration transferred).

Thus, the fair value of the consideration given, i.e., ₹ 1,400 crore is allocated to the individual assets acquired based on their relative estimated fair values. The entity should record a gain of ₹ 300 crore for the difference between the fair value and carrying value of the land.

The equipment is recorded at its relative fair value ((₹ 500/₹ 1,500) × ₹ 1,400 = ₹ 467 crore). The patent is recorded at its relative fair value ((₹ 1,000 / ₹ 1,500) × ₹ 1,400 = ₹ 933 Crore).

Question 2

Entity A holds 20% interest in Entity B. Subsequently Entity A, further acquires 50% share in Entity B by paying ₹ 300 Crores.

The fair value of assets acquired and Liabilities assumed are as follows:

Building	- ₹ 1000 Crores
Cash and Cash Equivalent	- ₹ 200 Crores
Financial Liabilities	- ₹ 800 Crores
DTL	- ₹ 150 crores

Fair value of Entity B is ₹ 400 Crores and Fair value of NCI is ₹ 120 Crores (400 x 30%)

Fair value of Entity A's previously held interest is ₹ 80 Crores (400 x 20%)

Entity A needs to determine whether acquisition is an asset acquisition as per concentration test.

(*Study Material*)

Answer

(i) Fair value of consideration transferred (including fair value of non-controlling interest and fair value of previously interest held) = 300 + 120 + 80 = ₹ 500 Crores

(ii) Fair value of liability assumed (excluding deferred tax) – ₹ 800 crores

(iii) Cash and cash equivalent – ₹ 200 crores.

Fair value of gross assets acquired - ₹ 1,100 Crores

In the above scenario, substantially all fair value of gross assets acquired is concentrated in a single identifiable asset i.e. building. Hence it should be asset acquisition. (1,000/1,100 = 91% of value of gross assets is concentrated into single identifiable asset i.e. building). A Judgement is required to conclude on the word substantially as the same is not defined in the standard.

Question 3

Company X is a liquor manufacturer and has traded for a number of years. The company produces a wide variety of liquor and employs a workforce of machine operators, testers, and other operational, marketing and administrative staff. It owns and operates a factory, warehouse, machinery and holds raw material inventory and finished products.

On 1st January, 20X1, Company Y pays USD 80 million to acquire 100% of the ordinary voting shares of Company X. No other type of shares has been issued by the Company X. On the same day, the four main executive directors of the Company Y take on the same roles in the Company X. Is it business?

(*Study Material*)

Answer

In this case, it is clear that the Company X is a business. It operates a trade with a variety of assets that are used by its employees in a number of related activities. These assets and activities are necessarily integrated in order to create and sell the company's products. As per definition the above acquisition includes an inputs (including four main executive directors of Company X) and thus it can be concluded as the significant process acquired along with the other inputs.

Thus, Company Y obtains control on 1st January, 20X1 by acquiring 100% of the voting rights.

Question 4

Company D is a development stage entity that has not started revenue-generating operations. The workforce consists mainly of research engineers who are developing a new technology that has a pending patent application. Negotiations to license this technology to a number of customers are at an advanced stage. Company D requires additional funding to complete development work and commence planned commercial production.

The value of the identifiable net assets in Company D is ₹ 750 million. Company A pays ₹ 600 million in exchange for 60% of the equity of Company D (a controlling interest). Is it business?

(*Study Material*)

Answer

Although Company D is not yet earning revenues (an example of 'outputs') there are a number of indicators that it has a sufficiently integrated set of activities and assets that are capable of being managed to produce a return for investors. In particular, Company D:

- employs specialist engineers developing the know-how and design specifications of the technology.
- is pursuing a viable plan to complete the development work and commence production.
- has identified and will be able to access customers willing to buy the outputs.

In addition, Company A has paid a premium (or goodwill) for its 60% interest. In the absence of evidence to the contrary, Company D is presumed to be a business.

Question 5

Company A acquires 100% of the equity and voting rights of Company P, a subsidiary of a property investment group. Company P owns three investment properties. The properties are single-tenant industrial warehouses subject to long-term leases. The leases oblige Company P to provide basic maintenance and security services, which have been outsourced to third party contractors. The administration of Company P's leases was carried out by an employee of its former parent company on a part-time basis but this individual does not transfer to the new owner. Is it business?

(*Study Material*)

Answer

In most cases, an asset or group of assets and liabilities that are being capable of generating revenues, combined with all or many of the activities necessary to earn those revenues, would constitute a business. However, investment property is a specific case in which earning a return for investors is a defining characteristic of the asset. Accordingly, revenue generation and activities that are specific and ancillary to an investment property and its tenancy agreements should therefore be given a lower 'weighting' in assessing whether the acquiree is a business.

Further process (i.e. Basic maintenance, security services and administration) is not critical to the ability to continue producing outputs. Also process (i.e. Basic maintenance, security services and administration) is not unique and it can be replaced easily without significant cost.

In our view the purchase of investment property with tenants and services that are purely ancillary to the property and its tenancy agreements should generally be accounted for as an asset purchase.

Question 6

Company A acquires 100% of the equity and voting rights of Company Q, which owns three investment properties. The properties are multi-tenant residential condominiums subject to short- term rental agreements that oblige Company Q to provide substantial maintenance and security services, which are outsourced with specialist providers. Company Q has five employees who deal directly with the tenants and with the outsourced contractors to resolve any non-routine security or maintenance requirements. These employees are involved in a variety of lease management tasks (e.g. identification and selection of tenants; lease negotiation and rent reviews) and marketing activities to maximise the quality of tenants and the rental income. Is it business?

(*Study Material*)

Answer

In this case, Company Q consists of a group of revenue-generating assets, together with employees and activities that clearly go beyond activities ancillary to the properties and their tenancy agreements.

Further process (i.e. identification and selection of tenants; lease negotiation and rent reviews) is critical to the ability to continue producing outputs (i.e. in terms to maximise quality of tenants and the rental income).

The assets and activities are clearly integrated so Company Q is considered a business.

Question 7

Company S is a manufacturer of a wide range of products. The company's payroll and accounting system is managed as a separate cost centre, supporting all the operating segments and the head office functions.

Company A agrees to acquire the trade, assets, liabilities and workforce of the operating segments of Company S but does not acquire the payroll and accounting cost centre or any head office functions. Company A is a competitor of Company S. Is it business?

(*Study Material*)

Answer

In this case, the activities and assets within the operating segments are capable of being managed as a business and so Company A accounts for the acquisition as a business combination. The payroll, accounting cost centre and administrative head office functions are typically not used to create outputs and so are generally not considered an essential element in assessing whether an integrated set of activities and assets is a business or not.

Question 8

Company A is a property development company with a number of subsidiary companies, each of which holds a single development. After completion of the development, Company A sells its equity investment because the applicable tax rate is lower than that applicable to the sale of the underlying property.

Company A is planning to start the development of a large new retail complex. Rather than incorporating a new company, Company A acquires the entire share capital of a 'shell' company. Is it business?

(*Study Material*)

Answer

The shell company does not contain an integrated set of activities and assets and so does not constitute a business. Consequently, Company A should account for the purchase of the shell company in the same way as the incorporation of a new subsidiary. In the consolidated financial statements, any costs incurred will be accounted for in accordance with their nature and applicable Ind AS. No goodwill is recognised.

Question 9

Company A is a pharmaceutical company. Since inception, the Company had been conducting in- house research and development activities through its skilled workforce and recently obtained an intellectual property right (IPR) in the form of patents over certain drugs. The Company's has a production plant that has recently obtained regulatory approvals. However, the Company has not earned any revenue so far and does not have any customer contracts for sale of goods. Company B acquires Company A.

Does Company A constitute a business in accordance with Ind AS 103?

(Study Material)

Answer

The definition of business requires existence of inputs and processes. In this case, the skilled workforce, manufacturing plant and IPR, along with strategic and operational processes constitutes the inputs and processes in line with the requirements of Ind AS 103.

When the said inputs and processes are applied as an integrated set, the Company A will be capable of producing outputs; the fact that the Company A currently does not have revenue is not relevant to the analysis of the definition of business under Ind AS 103. Basis this and presuming that Company A would have been able to obtain access to customers that will purchase the outputs, the present case can be said to constitute a business as per Ind AS 103.

Question 10

Modifying the above Question, if Company A had revenue contracts and a sales force, such that Company B acquires all the inputs and processes other than the sales force, then whether the definition of the business is met in accordance with Ind AS 103?

(Study Material)

Answer

Though the sales force has not been taken over, however, if the missing inputs (i.e., sales force) can be easily replicated or obtained by the market participant to generate output, it may be concluded that Company A has acquired business. Further, if Company B is also into similar line of business, then the existing sales force of the Company B may also be relevant to mitigate the missing input. As such, the definition of business is met in accordance with Ind AS 103.

Question 11

Company P Ltd., a manufacturer of textile products, acquires 40,000 equity shares of Company X (a manufacturer of complementary products) out of 1,00,000 shares in issue. As part of the same agreement, the Company P purchases an option to acquire an additional 25,000 shares. The option is exercisable at any time in the next 12 months. The exercise price includes a small premium to the market price at the transaction date.

After the above transaction, the shareholdings of Company P's two other original shareholders are 35,000 and 25,000. Each of these shareholders also has currently exercisable options to acquire 2,000 additional shares. Assess whether control is acquired by Company P.

(Study Material)

Answer

In assessing whether it has obtained control over Company X, Company P should consider not only the 40,000 shares it owns but also its option to acquire another 25,000 shares (a so-called potential voting right). In this assessment, the specific terms and conditions of the option agreement and other factors are considered as follows:

- the options are currently exercisable and there are no other required conditions before such options can be exercised
- if exercised, these options would increase Company P's ownership to a controlling interest of over 50% before considering other shareholders' potential voting rights (65,000 shares out of a total of 1,25,000 shares)
- although other shareholders also have potential voting rights, if all options are exercised Company P will still own a majority (65,000 shares out of 1,29,000 shares)
- the premium included in the exercise price makes the options out-of-the-money. However, the fact that the premium is small and the options could confer majority ownership indicates that the potential voting rights have economic substance.

By considering all the above factors, Company P concludes that with the acquisition of the 40,000 shares together with the potential voting rights, it has obtained control of Company X.

Question 12

Veera Limited and Zeera Limited are both in the business of manufacturing and selling of Lubricant. Shareholders of Veera Limited and Zeera Limited agreed to join forces to benefit from lower delivery and distribution costs. The business combination is carried out by setting up a new entity called Meera Limited that issues 100 shares to Veera Limited shareholders

and 50 shares to Zeera Limited shareholders in exchange for the transfer of the shares in those entities. The number of shares reflects the relative fair values of the entities before the combination. Also respective company's shareholders get the voting rights in Meera Limited based on their respective shareholdings.

Determine the acquirer by applying the principles of Ind AS 103 'Business Combinations'

(*Study Material*)

Answer

As per para B15 of Ind AS 103, in a business combination effected primarily by exchanging equity interests, the acquirer is usually the entity that issues its equity interests. However, in some business combinations, commonly called 'reverse acquisitions', the issuing entity is the acquiree. Other pertinent facts and circumstances shall also be considered in identifying the acquirer in a business combination effected by exchanging equity interests, including:

The relative voting rights in the combined entity after the business combination - The acquirer is usually the combining entity whose owners as a group retain or receive the largest portion of the voting rights in the combined entity.

Based on above mentioned para, acquirer shall be the either of the combining entities (i.e. Veera Limited or Zeera Limited) whose owners as a Group retain or receive the largest portion of the voting rights in the combined entity.

Hence in the above scenario Veera Limited shareholder gets 67% Share [(100/150) x100] and Zeera Limited shareholder gets 33.33% share in Meera Limited. Hence Veera Limited is acquirer as per the principles of Ind AS 103.

Question 13

ABC Ltd. incorporated a company Super Ltd. to acquire 100% shares of another entity Focus Ltd. (and therefore to obtain control of the Focus Ltd.). To fund the purchase, Super Ltd. acquired a loan from XYZ Bank at commercial interest rates. The loan funds are used by Super Ltd. to acquire entire voting shares of Focus Ltd. at fair value in an orderly transaction. Post the acquisition, Super Ltd. has the ability to elect or appoint or to remove a majority of the members of the governing body of the Focus Ltd. and also Super Ltd.'s management is in a power where it will be able to dominate the management of the Focus Ltd. Can Super Ltd. be identified as the acquirer in this business combination?

(*Study Material*)

Answer

Paragraph 6 of Ind AS 103 states that for each business combination, one of the combining entities shall be identified as the acquirer.

While paragraph 7 states that the guidance in Ind AS 110 shall be used to identify the acquirer that is the entity that obtains control of another entity called the acquiree. If a business combination has occurred but applying the guidance in Ind AS 110 does not clearly indicate which of the combining entities is the acquirer, the factors in paragraphs B14–B18 of Ind AS 103 shall be considered in making that determination.

Further, paragraph B15 provides that, in a business combination effected primarily by exchanging equity interests, the acquirer is usually the entity that issues its equity interests. However, in some business combinations, commonly called 'reverse acquisitions', the issuing entity is the acquiree. Other pertinent facts and circumstances shall also be considered in identifying the acquirer in a business combination effected by exchanging equity interests, including:

(a) **The relative voting rights in the combined entity after the business combination:** The acquirer is usually the combining entity whose owners as a group retain or receive the largest portion of the voting rights in the combined entity. In determining which group of owners retains or receives the largest portion of the voting rights, an entity shall consider the existence of any unusual or special voting arrangements and options, warrants or convertible securities.

(b) **The existence of a large minority voting interest in the combined entity if no other owner or organised group of owners has a significant voting interest:** The acquirer is usually the combining entity whose single owner or organised group of owners holds the largest minority voting interest in the combined entity.

On 1st April, 20X2, PQR Ltd. acquired the remaining 70% of XYZ Ltd. for cash ₹ 25,000 crore. The following additional information is relevant at that date:

	(₹ in crore)
Fair value of the 30% interest already owned	*9,000*
Fair value of XYZ's identifiable net assets	*30,000*

How should such business combination be accounted for?

(Study Material)

Answer

Paragraph 42 of Ind AS 103 provides that in a business combination achieved in stages, the acquirer shall remeasure its previously held equity interest in the acquiree at its acquisition-date fair value and recognise the resulting gain or loss, if any, in statement of profit and loss or other comprehensive income, as appropriate. In prior reporting periods, the acquirer may have recognized changes in the value of its equity interest in the acquiree in other comprehensive income. If so, the amount that was recognised in other comprehensive income shall be recognised on the same basis as would be required if the acquirer had disposed directly of the previously held equity interest.

Applying the above, PQR Ltd. records the following entry in its consolidated financial statements:

		(₹ in crore)	
		Debit	**Credit**
Identifiable net assets of XYZ Ltd.	Dr.	30,000	
Goodwill (W.N.1)	Dr.	4,000	
Foreign currency translation reserve	Dr.	100	
PPE revaluation reserve	Dr.	50	
To Cash			25,000
To Investment in associate -XYZ Ltd.			8,850
To Retained earnings (W.N.2)			50
To Gain on previously held interest in XYZ recognised in Profit or loss (W.N.3)			250
(To recognise acquisition of XYZ Ltd.)			

Working Notes:

1. Calculation of Goodwill

	₹ in crore
Cash consideration	25,000
Add: Fair value of previously held equity interest in XYZ Ltd.	9,000
Total consideration	34,000
Less: Fair value of identifiable net assets acquired	(30,000)
Goodwill	4,000

2. The credit to retained earnings represents the reversal of the unrealized gain of ₹ 50 crore in Other Comprehensive Income related to the revaluation of property, plant and equipment. In accordance with Ind AS 16, this amount is not reclassified to profit or loss.

3. The gain on the previously held equity interest in XYZ Ltd. is calculated as follows:₹

	₹ in crore
Fair Value of 30% interest in XYZ Ltd. at 1st April, 20X2	9,000
Carrying amount of interest in XYZ Ltd. at 1st April, 20X2	(8,850)
	150
Unrealised gain previously recognised in OCI	100
Gain on previously held interest in XYZ Ltd. recognised in profit or loss	250