CA
THE INSTITUTE OF
CHARTERED ACCOUNTANTS OF SRI LANKA

1

SLFRS 3 - Business Combinations

Anoji De Silva
Partner, Ernst & Young

26th July 2012

SLFRS 3- Topics covered

1. Introduction and overview
2. Identifying a business combination
3. Definition of a business
4. The Acquisition Method
5. Accounting for Non Controlling Interest.
6. Business Combination achieved in Stages
7. Disclosure

1. Introduction & Overview

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

SLFRS- 3 Business Combinations
26th July 2012

1. Introduction & Overview

Objective of the Standard

To improve the relevance, reliability and comparability of the information that a reporting entity provides in its financial statement about a *business combination* and its effects. To accomplish that, this SLFRS establishes principles and requirements for how the ***acquirer***:

a) recognizes and measures in its financial statements **the *identifiable* assets acquired**, the **liabilities assumed** and any ***non-controlling interest*** in the ***acquiree***;

b) recognizes and measures the ***goodwill*** acquired in the business combination or a **gain from a bargain purchase**; and

c) determines what **information to disclose** to enable users of the financial statements to evaluate the nature and financial effects of the business combination.

(Ref. SLFRS 3/Para-1)

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

SLFRS- 3 Business Combinations
26th July 2012

1. Introduction & Overview

Effective Date & Transitional Provision

- Applied prospectively to business combinations for which the acquisition date is on or after the beginning of the first Annual reporting period beginning on or after **1 January 2012.**
  - 31st December 2012 Financial Statements – **1 January 2012**
  - 31st March 2013 Financial Statements – **1 April 2012**
- Earlier application is encouraged. If an entity applies this SLFRS before 1 January 2012, it shall disclose that fact and apply LKAS 27at the same time.

SLFRS- 3 Business Combinations
26th July 2012

1. Introduction & Overview

Scope Includes-

- A transaction or other event that meets the definition of a **business combination**.

Scope Excludes-

a) the formation of a joint venture.(LKAS 31)

b) the acquisition of an asset or a group of assets that does not constitute a *business*.- to be accounted using ***relative fair values*** at the date of purchase

c) a combination of entities or businesses under common control

(Ref. SLFRS 3/Para-2)

SLFRS- 3 Business Combinations
26th July 2012

1. Introduction & Overview

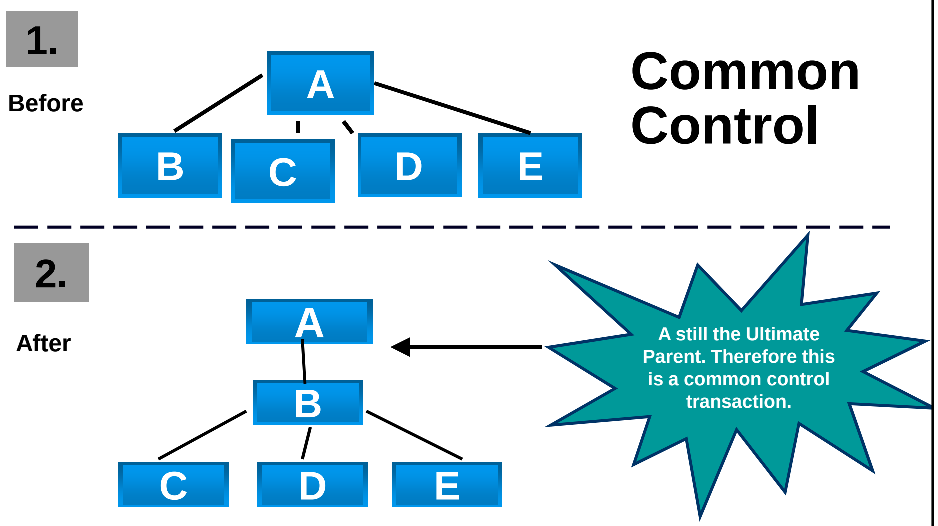
Example – Common Control Transactions

- ***Common Control- A business combination in which all of the combining entities or businesses are ultimately controlled by the same parties before and after the combination***
- Excluded from scope of SLFRS 3
- Common Practice is to account using:
  - The pooling of interests method ; or
  - The acquisition method (but only if the transaction has "substance" from perspective of the reporting entity)

SLFRS- 3 Business Combinations

26th July 2012

1. Introduction & Overview



2. Identifying a Business Combination

2. Identifying a business combination

Business Combination

- ***A transaction or other event in which an acquirer obtains control of one or more businesses.***
- Examples- Methods Used to obtain control
  - Transfer of cash, cash equivalents or other assets
  - Incurring liabilities
  - Issuing equity interests
  - Providing more than one type of consideration
  - by contract alone.
- Example of Structures
  - Subsidiaries
  - Transfer of Net assets

2. Identifying a business combination

Business Combination

- Example of Structures
  - Acquisition of Subsidiaries
  - Merger of the acquired business into the acquirer's operations
  - Transfer of net assets
  - Transfer of equity interests
  - New structures to acquire businesses

(Ref -SLFRS 3 /Para 3 / appendix B5-B6)

3. Definition of a Business

SLFRS- 3 Business Combinations
26th July 2012

3. Definition of a business

- **A business is:**
  - An integrated set of activities and assets
  - Capable of being conducted and managed to provide a return (dividends, lower costs or other economic benefits)
- Only two essential elements are required:
  - **Inputs**
    - Any economic resource that creates, or has the ability to create, outputs when one or more processes are applied to it
  - **Processes**
    - Any system, standard, protocol, convention or rule that, when applied to an input or inputs, creates or has the ability to create outputs

(Ref -SLFRS 3 /Para 3 / appendix B7-B12)

Rebuttable presumption: if goodwill exists in the acquisition, the acquisition is a business.

4. The Acquisition Method

SLFRS- 3 Business Combinations
26th July 2012

4. The Acquisition Method

Business (Inputs and Processes) + Control (IAS 27) = Business Combination ← **Acquisition Method**

If not, deemed as an asset acquisition

↓

Account as an asset acquisition using relative FV

Acquisition Method

↓

Identify the acquirer

↓

Determine the acquisition date

↓

Assets acquired, the liabilities assumed and any non-controlling interest in the acquiree

↓

Goodwill or a gain from a bargain purchase

SLFRS- 3 Business Combinations
26th July 2012

Example - Differences in accounting for business combination vs. asset acquisition

- Company P acquired 100% of the shares of Company S for 1,000, incurring transaction costs of 200.
- S has no liabilities. The only assets of S are two buildings, A and B, the total book value of which is 700.
- The tax base of the building is 700.
- The applicable income tax rate is 20%.

SLFRS- 3 Business Combinations
26th July 2012

Example - Differences in accounting for business combination vs. asset acquisition (contd.)

	Business combination	Asset acquisition
Price paid	1,000	1,000
Transaction costs	Expensed	200
Total consideration	**1,000**	**1,200**
Fair values (BC)/relative fair values (AA) of assets acquired:		
Asset A	300	1,200*300/900=400
Asset B	600	1,200*600/900=800
Total	**900**	**1,200**
Deferred tax liability	(900-700) * 20% = 40	-
Goodwill	**1,000 – 900 + 40 = 140**	-

SLFRS- 3 Business Combinations
26th July 2012

4. The Acquisition Method

- An entity shall account for each business combination by applying the Acquisition Method.
- Applying the acquisition method requires: (SLRFS 3/ Para. 4-5)

Acquisition Method

a)Identify the acquirer

b). Determine the acquisition date

c). Assets acquired, the liabilities assumed and any non-controlling interest in the acquiree

d). Goodwill or a gain from a bargain purchase

SLFRS- 3 Business Combinations
26th July 2012

4. The Acquisition Method

(a) identifying the acquirer;

For each business combination one of the combining entities shall be identified as the acquirer .

- Combining entity that obtains control (ref. LKAS 27)
- Definition (concept of) control consistent with consolidations
- LKAS 27 adopts "substance over legal form" approach

(SLRFS 3/ Para. 6-7)

4. The Acquisition Method

(a) identifying the acquirer; (contd)

The entity that obtains control of the other entities business

- Power over one half of the voting rights-ownership or contract
- Power to govern the financial and operating policies via statute or agreement
- Power to appoint or remove the majority of the members of the board or body that controls the entity.
- Power to cast the majority of votes at meetings of the board or body that controls the entity
- Existence of potential voting rights that are currently exercisable or convertible.

(LKAS 27/ Para. 13-15)

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA
SLFRS- 3 Business Combinations
26th July 2012

4. The Acquisition Method

(a) identifying the acquirer(contd.)

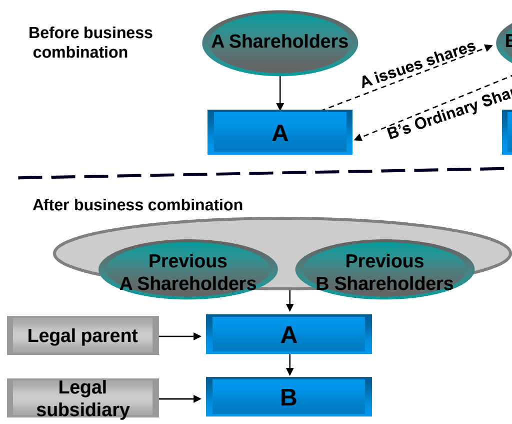
If not clear other indicators

- Generally the entity that issues it's equity interests unless in a Reverse Acquisition.
- The fair value of one entity is significantly greater than the other
- Entity giving up cash or other assets or incurring liabilities
- Entity whose management is able to dominate

(SLFRS 3/ Appendix B 13-18)

SLFRS- 3 Business Combinations
26th July 2012

Reverse Acquisitions



(SLFRS 3 Appendix B 19 -20)

The entity that issues the equity interests is *normally* the acquirer.

However, all pertinent facts and circumstances shall be considered to determine which entity has obtained control of the other.

The entity that has a "Business" as defined by SLFRS 3 will be considered the acquiree.

Where B is identified as the acquirer, this is known as a reverse acquisition (i.e., back-door listing)

***B fair values A* using the FV of the equity interest.**

SLFRS- 3 Business Combinations
26th July 2012

4. The Acquisition Method

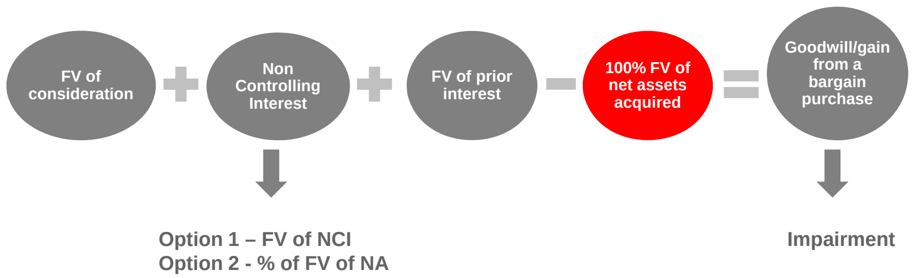
(b)- Determining the acquisition date.

- The acquirer shall identify the acquisition date, which is the date on which it obtains the control of the acquiree.
- The date where the acquirer legally transfer the consideration and acquire the assets and assume the liabilities- the closing date.
- Based on the terms of a written agreement.

(SLFRS 3/ para 8-9)

SLFRS- 3 Business Combinations
26th July 2012

4. The Acquisition Method.



Do you have the
Expertise to identify Business Combinations?
Expertise to perform the valuations?
Are you ready for the Accounting Implications?

SLFRS- 3 Business Combinations
26th July 2012

4. The Acquisition Method

(c) Net Assets Acquired-Recognition principle

As of 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.

Recognition Conditions - Asset acquired and liability assumed

- Meet the definition of assets and liabilities in the framework at the date of acquisition.
- Resulting from the business combination transaction
- New assets and liabilities such as a brand name, a patent and customer relationship
- Identify certain assets and liabilities as part of the acquisition balance sheet as specified in SLFRS 3 – Contingent liabilities

SLFRS- 3 Business Combinations
26th July 2012

4. The Acquisition Method

(c) Net Assets Acquired-Recognition principle (contd.)

Classifying or designating identifiable assets acquired and liabilities in a business combination

- At the acquisition date, the acquirer shall classify or designate the identifiable assets acquired and liabilities assumed as necessary to apply other SLFRSs subsequently
- The acquirer shall make those classifications or designations on the basis of the
  - -contractual terms
  - -economic conditions
  - -its operating or accounting policies and
  - -other pertinent conditions as they exist at the acquisition date.

SLFRS- 3 Business Combinations
26th July 2012

4. The Acquisition Method

(d) Net Assets Acquired-Measurement

Fair value

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

Limited Exceptions

- ✓ Contingent Liabilities – to be recognized in the Balance Sheet if FV can be measured reliably.
- ✓ Income taxes – LKAS 12
- ✓ Employee benefits – LKAS 19
- ✓ Indemnification assets
- ✓ reacquired rights
- ✓ Share-based payments – SLFRS 2
- ✓ Assets held for sale – LKAS 38

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

SLFRS- 3 Business Combinations
26th July 2012

4. The Acquisition Method.

Aggregate Purchase Consideration.

FV of consideration + Non Controlling Interest + FV of prior interest − 100% FV of net assets acquired = Goodwill/gain from a bargain purchase

Option 1 – FV of NCI
Option 2 - % of FV of NA

Impairment

Do you have the
Expertise to identify Business Combinations?
Expertise to perform the valuations?
Are you ready for the Accounting Implications?

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

SLFRS- 3 Business Combinations
26th July 2012

4. The Acquisition Method

(e) Goodwill

The acquirer shall recognize goodwill as of the acquisition date measured as the excess of (a) over (b) below:

(a) **The aggregate Purchase Consideration of:**

1. **the consideration transferred measured in accordance with this SLFRS, which generally requires acquisition-date fair value ;**
2. **the amount of any non-controlling interest in the acquiree measured in accordance with this SLFRS; and**
3. **in a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree**

(b) **the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed measured in accordance with this SLFRS.**

SLFRS- 3 Business Combinations
26th July 2012

4. The Acquisition Method

Gain from a bargain purchase

The acquirer shall recognize gain due to a bargain purchase price if the value of (b) is in excess of (a). Need to reassess both before recognition of gain.

(a) **The aggregate of:**

1. **the consideration transferred measured in accordance with this SLFRS, which generally requires acquisition-date fair value ;**
2. **the amount of any non-controlling interest in the acquiree measured in accordance with this SLFRS; and**
3. **in a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree**

(b) **the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed measured in accordance with this SLFRS.**

SLFRS- 3 Business Combinations
26th July 2012

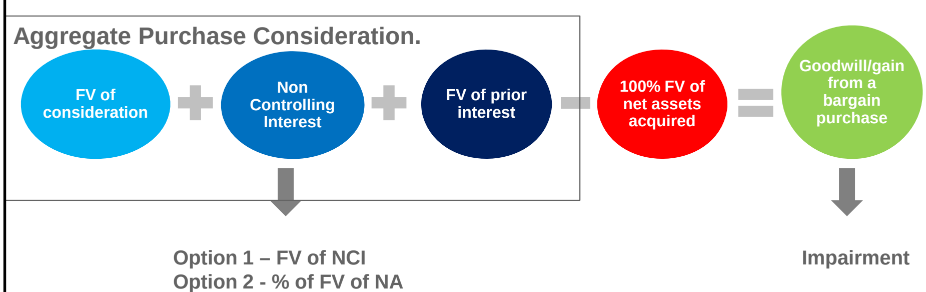
4. The Acquisition Method

- **Acquisition costs** – **Expensed in the period in which they occur**
- **Contingent consideration** – **Initial recognition at fair value**
  Classify as a liability or equity depending on terms
  Subsequent changes in equity not remeasured
  Subsequent changes in liability are adjusted against profit
- **If linked to employment conditions considered to be remuneration for services NOT contingent consideration**

5. Accounting for Non Controlling Interest (NCI)

SLFRS- 3 Business Combinations
26th July 2012

4. The Acquisition Method.



Do you have the
Expertise to identify Business Combinations?
Expertise to perform the valuations?
Are you ready for the Accounting Implications?

SLFRS- 3 Business Combinations
26th July 2012

5. Accounting for Non Controlling Interest (NCI)

- Not controlling interest – equity in a subsidiary not attributable, directly or indirectly, to a parent
- Measurement option for NCI at acquisition date:
  - Fair value
  - Proportionate share of acquiree's identifiable net assets
- NCI subsequently adjusted for share of changes in equity
- Acquisitions and disposals of NCI (no loss of control) – accounted for as equity transactions

SLFRS- 3 Business Combinations
26th July 2012

5. Accounting for Non Controlling Interest (NCI)

Example 1 – Measuring goodwill

- On 31 March 2010 XYZ acquires 75% of the shares in ABC for cash of Rs 5,000,00. The transaction costs incurred in the acquisition are Rs100,000.
- The fair value of the net assets of ABC at acquisition date is Rs 4,000,000
- The fair value of NCI is Rs 1,200,000
- How is goodwill calculated?

SLFRS- 3 Business Combinations
26th July 2012

5. Accounting for Non Controlling Interest (NCI)

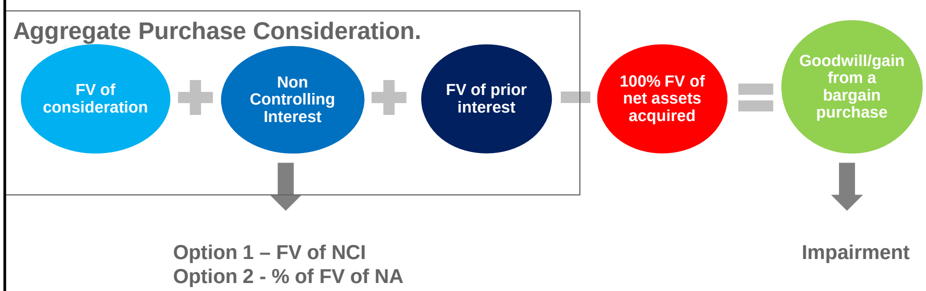
Example 1 – Measuring goodwill

	NCI at FV	NCI at portion of net assets	Existing SLAS 25
Consideration	5,000,000	5,000,000	5,100,000
+			
NCI	1,200,000	1,000,000	-
-			
Net assets	(4,000,000)	(4,000,000)	(3,000,000)
=			
Goodwill	2,200,000	2,000,000	2,100,000

6. Business Combination Achieved in Stages (step acquisition)

SLFRS- 3 Business Combinations
26th July 2012

4. The Acquisition Method.



Do you have the
Expertise to identify Business Combinations?
Expertise to perform the valuations?
Are you ready for the Accounting Implications?

SLFRS- 3 Business Combinations
26th July 2012

6. Business Combination Achieved in Stages (step acquisition)

- At date of obtaining control, previously held interests are remeasured to fair value
- The resulting gain or loss is recognised in profit or loss

Contrast with existing practice

- Each transaction is treated separately. The cost and fair value at each acquisition date is used to determine goodwill

7. Disclosure

SLFRS- 3 Business Combinations
26th July 2012

7. Disclosures

- 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:

  (a) during the current reporting period; or

  (b) after the end of the reporting period but before the financial statements are authorized for issue.

- The acquirer shall disclose information that enables users of its financial statements to evaluate the financial effects of adjustments recognised in the current reporting period that relate to business combinations that occurred in the period or previous reporting periods.

SLFRS- 3 Business Combinations
26th July 2012

Conclusion

- Principle Based Standard
- Standard includes Para. 1-64 and appendix A-B of the standard.
- Need to watch out for accounting implications!
- Questions?

- Thank You !

THANK YOU

44