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SLFRS 3
Business Combinations

Nishan Fernando FCA
Nishani Perera ACA

CA
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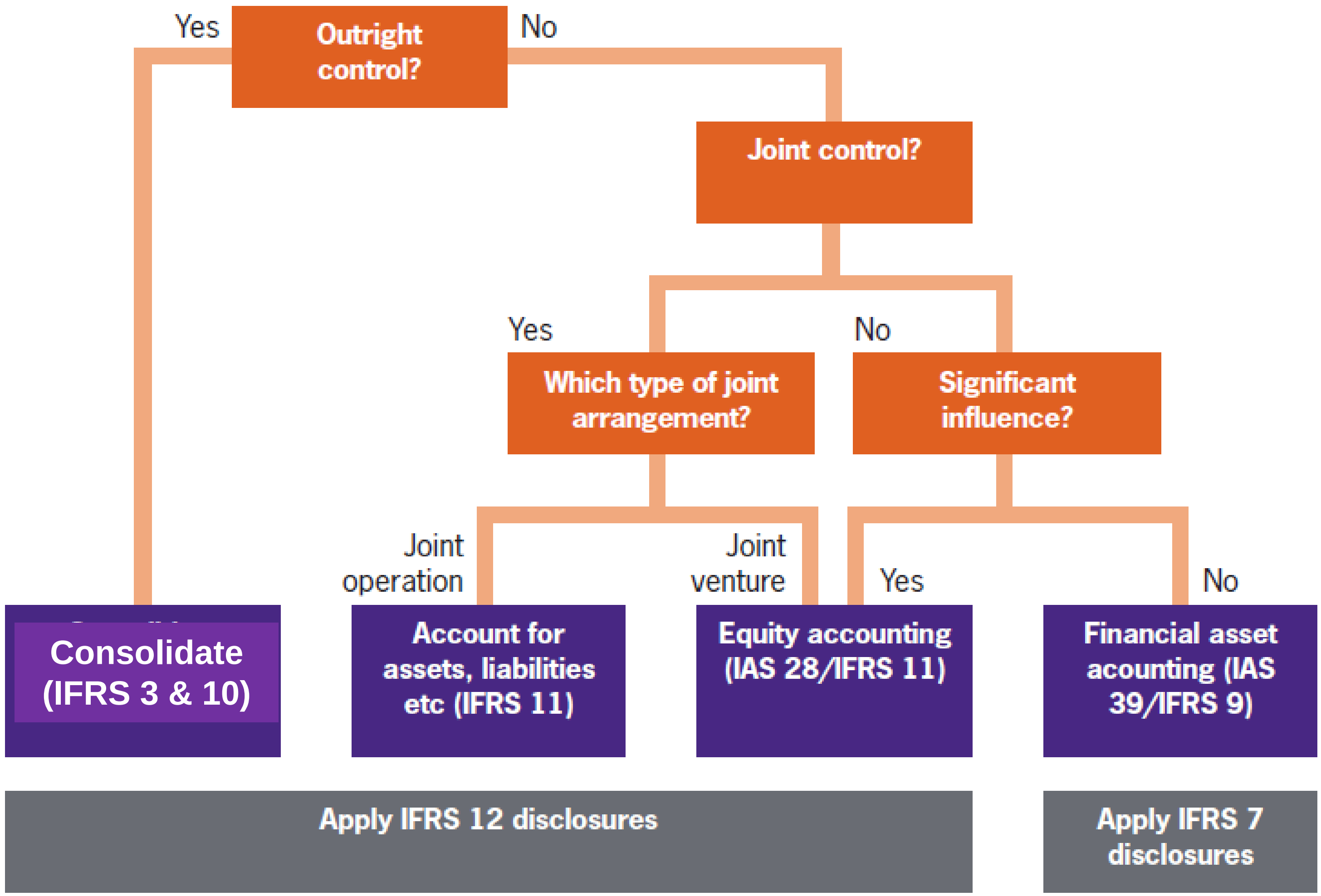
Consolidation Package – The Big Picture



Significant aspects of SLFRS 3
Scope

- The scope of SLFRS 3 includes:
  - Business combinations involving only mutual entities, and
  - Business combinations achieved by contract alone.
- What is not covered by SLFRS 3?
  - Formation of joint ventures.
  - Acquisition of asset or group of assets that does not constitute a business.
  - Combination of entities under common control.

Significant aspects of SLFRS 3

- What constitutes a ‘business combination’?
- What is a business combination?
  - A transaction or other event in which an **acquirer**
  - obtains control of one or more **businesses**.
  - Transactions sometimes referred to as ‘true mergers’ or ‘mergers of equals’ are also business combinations as that term is used in SLFRS 3R.

What constitutes a 'business combination'?

Do the assets acquired and liabilities assumed constitute a business?

Yes

Business combination
&
SLFRS 3 applicable.

Acquisition method

No

Asset acquisition

•What is a business?

- A business is an integrated set of activities and assets that is capable of being conducted and managed for the purpose of:
  - providing a return in the form of dividends,
  - lower costs, or
  - other economic benefits
- directly to investors or other owners, members or participants.
- Assets and activities need not be conducted and managed as a business as at acquisition date, so long as they can be in the future.

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Significant aspects of SLFRS 3 What constitutes a ‘business

•Example A - Does this constitute a business combination?

- IT department is a cost centre to K&K Co a legal firm.
- IT Outsourced Ltd, specialises in the provision of IT services to legal firms.
- K&K Co sells its IT department to IT Outsourced Ltd, consisting of plant and equipment, working capital and staff.
- Assets and staff transferred to IT Outsourced Ltd are capable of being operated as a business.

Significant aspects of SLFRS 3 What constitutes a ‘business

- Example B - Does this constitute a business
  - Company E’s contains assets of:

– Electricity grids	CU 10,000,000
– Tracking system	CU 2,500,000
– Working capital	CU 500,000

  - Company A acquires from Company E the electricity grids and the tracking system for CU14,000,000.
  - Consider the relevant industry, certain industries requires relative low inputs of working capital and labour.

Significant aspects of SLFRS 3
What constitutes a ‘business combination’?

- Example C - Does this constitute a business combination?
  - Company A, a mining entity buys a new mining tenement that is in its early development stage. Can the mining tenement constitute as a business even if production has not commenced?

- Example D - Does this constitute a business combination?
  - Company A buys Company B, the only asset Company B has is a mining license.

SLFRS 3: Business Combinations

- **The acquisition method**
  - Four stages
    - Identifying the acquirer
    - Determining the acquisition date
    - Recognising and measuring identifiable assets acquired, liabilities assumed and non-controlling interests
    - Recognising and measuring goodwill/ bargain purchase
- **Subsequent measurement and accounting**
  - Re-acquired rights
  - Contingent liabilities
  - Indemnification assets
  - Contingent consideration
  - Measurement period

Significant aspects of SLFRS 3 Identifying the acquirer

• Definition of Acquirer

- The entity that obtains control of the acquiree (SLFRS 3, Appendix A)

Guidance in Appendix B (B14-B18)

- Cash payment: Entity that pays consideration
- Exchanging equity:
  - Entity that issues new shares (not for reverse acquisitions)
  - Relative voting rights in the combined entity after the business combination
  - 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 composition of the governing body of the combined entity*
  - *the composition of the senior management of the combined entity—*
  - *the terms of the exchange of equity interests*

Significant aspects of SLFRS 3 Identifying the acquirer (continued)

- Relative Size

- When more than two entities
  - Who initiated the combination?
  - Relative size

- Newly formed Entity
  - Issued equity interests=> apply previous steps
  - Cash => New formed entity may be acquirer

Reverse Acquisition

- **Acquirer is entity whose equity interests have been acquired; acquiree is the issuing entity**
- **E.g. a private entity arranges to have itself "acquired" by a smaller public entity in order to obtain a stock exchange listing**
  - Smaller public entity (issuing entity) is the legal parent; larger private entity is the legal subsidiary
  - But legal subsidiary is the acquirer for purposes of SLFRS 3, if it has control

Significant aspects of SLFRS 3 Transaction costs

- Acquisition-related costs are expensed in the periods in which the costs are incurred and the services are received.
  - Finder's fees, advisory, legal, accounting, valuation and other professional or consulting fees, costs of internal acquisition department, etc.

- Exception:
  - Costs of issuing debt/equity will continue to be offset against the initial carrying amount of the financial instruments in accordance with LKAS 32 & LKAS 39.

Significant aspects of SLFRS 3 Acquisition date

- Standard
  - Acquisition date is the date on which an acquirer obtains control of the acquiree (SLFRS 3.8)
  - Generally the date on which the acquirer legally transfers the consideration, acquires the assets and assumes the liabilities (SLFRS 3.9)
  - Acquirer might obtain control on a date that is either earlier or later than the closing date (SLFRS 3.9)

Significant aspects of SLFRS 3 Acquisition date - Example 1

- Acquirer Ltd. signed an agreement with Seller Ltd. 26 July 2011.
- Consideration and shares were transferred on the same date.
- Extracts of the agreement:
  - "*Acquirer Ltd. benefits from assets and is responsible for liabilities of the Fund as of January 1st 2011"*
  - *"After the signing of the Share Purchase Agreement Acquirer Ltd. assumes all rights and full responsibility over the assets of the Fund and enjoys the benefits from the assets of the portfolio companies as of 1st January 2011."*
  - *Seller Ltd. will refund to Acquirer Ltd. the amount of a dividend paid on 31 March 2011*
- Heads of terms signed on 1 April 2011 prohibited Seller Ltd. from paying any further dividends
- Question: What acquisition date should be used?

Significant aspects of SLFRS 3 Acquisition date - Example 2

- Acquirer Ltd. signed an agreement with Seller Ltd. 26 July 2011.
- Consideration and shares were transferred on the same date.
- For facilitating the acquisition three of total five board members that are related parties of Acquirer Ltd were appointed as at 1st March 2011.
- Under the terms of Seller's shareholder agreement, all power over the operating and financial policies of Seller Ltd. has been delegated to the Board

- Question: What acquisition date should be used?

Recognition and measurement

Recognition principle (SLFRS 3.10–17):

- separate recognition of identifiable assets acquired, liabilities and contingent liabilities assumed

Measurement principle (SLFRS 3.18–20):

- assets and liabilities that qualify for recognition are measured at their acquisition-date fair values
- measurement at fair value provides relevant information that is more comparable and understandable (SLFRS 3.BC198)

Exceptions to the measurement Principle

Reacquired rights

- measured at fair value based on remaining contractual term ignoring the fair value effect of renewal

Share-based payment transactions

- replacement awards: measured in accordance with SLFRS 2

Assets held for sale

- measured in accordance with SLFRS 5 (ie fair value less costs to sell)

Exceptions to both the recognition and measurement principles

Income taxes

- deferred tax assets or liabilities arising from acquired assets or liabilities accounted for using LKAS 12

Employee benefits

- accounted for using LKAS 19

Indemnification Assets

- Recognise both indemnification asset and the indemnified item at the same time

Measuring Goodwill

- **The acquirer shall recognise goodwill at the acquisition date, measured as the excess of:**
  - The aggregates of:
    - Consideration transferred measured in accordance with SLFRS 3 (generally fair value)
    - The amount of any NCI in the acquiree (two measurement choices under SLFRS 3), and
    - In business combinations achieved in stages, the acquisition-date fair value of the acquirer's previously held equity interest in the entity
  - Less:
    - the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed measured in accordance with SLFRS 3

Measuring Goodwill

1.	Fair value of consideration transferred	x
2.	Add: non-controlling interest in entity acquired (alternative measures)	**x**
3.	Add: acquisition-date fair value of existing holdings in acquiree	x
		x
4.	Less: net identifiable assets acquired	(x)
	Goodwill	**x**

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Bargain Purchase

- **A ‘bargain purchase’ is a business combination in which the net fair value of the identifiable assets acquired exceeds the aggregate of:**
  - Consideration transferred, plus
  - Non-controlling interests, plus
  - Fair value of any previously held equity interest in the acquiree
- **Might arise in BC that is a forced sale in which the seller is acting under compulsion**
- **If, after applying the requirements of SLFRS 3, it is determined that the acquisition is a bargain purchase, the acquirer recognises the resulting gain in profit or loss on the acquisition date**
  - Gain is attributed to the acquirer

Bargain Purchase

- **Before recognising a gain, an acquirer must review procedures used to measure the amounts that SLFRS 3 requires to be recognised at the acquisition date for all of the following:**
  - Identifiable assets acquired and liabilities assumed
  - Non-controlling interest in the acquiree, if any
  - For a business combination achieved in stages, the acquirer’s previously-held equity interest in the acquiree, and
  - Consideration transferred
- **Objective is to ensure that the measurements appropriately reflect consideration of all available information as of the acquisition date**

Significant aspects of SLFRS 3
Deferred consideration

Deferred consideration should be discounted to its present value

Example – date of acquisition is 1 January 2014

- Consideration of CU4.2m to be paid in instalments of CU2.1m on
  1 January 2014 and CU2.1m on 1 January 2016
- Acquirer's incremental borrowing rate = 5%
- Initially measure consideration at CU4,005 and record a financial liability; CU95 will be expensed as a finance cost in 2014 and CU100 in 2015 at an effective rate of interest of 5%

	Cash	Factor	PV
1/1/14	(2,100)	1.0000	(2,100)
1/1/16	(2,100)	0.9070	(1,905)
Total	(4,200)		(4,005)

Significant aspects of SLFRS 3 Contingent consideration

- Consideration transferred by the acquirer, including contingent consideration, must be measured and recognised at fair value at the acquisition date.
  - Provisional amounts may be determined at acquisition date.
  - Provisional accounting may apply for 12 months.
  - That is, an adjustment can be made if it relates to a condition that existed at acquisition date.
  - Subsequent adjustment:
    - Changes in fair value taken directly to P/L
    - no adjustment to goodwill

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Significant aspects of SLFRS 3 Contingent consideration – Example 1

- Consideration transferred by the acquirer, including contingent consideration, must be measured and recognised at fair value at the acquisition date.
  - Acquirer Ltd paid CU 5,400 to acquire Steak Ltd.
  - Fair value of the net assets of Steak Ltd is CU 3,800.
  - Acquirer Ltd also agrees to pay 5 % of revenue for all business that is referred by the seller of Steak Ltd within the three years.
  - The budget of Steak Ltd anticipates total referred income of CU 17,500 over the three year period.

Significant aspects of SLFRS 3 Contingent consideration –

Example 1
Initial recognition

- Calculation of the PV of the contingent consideration
  - 17,500*5% = 875

Initial journal entry (At date of acquisition)

•Dr Net assets	3,800	
•Dr Goodwill	2,475	
• Cr Cash		5,400
• Cr Liability		875

•[NB – example ignores discounting of the contingent consideration]

Significant aspects of SLFRS 3
Contingent consideration – Example 1

- Subsequent measurement
  - At the first balance sheet date it becomes clear that Acquirer Ltd overpaid for the acquisition of Steak Ltd. Acquirer Ltd plans to take legal action. As a result it becomes unlikely that the seller of Steak Ltd. will refer any revenue.
  - Fair Value of liability is zero

Journal entry (At balance sheet date)

Dr Liability	875	
Cr Profit or loss		875

Contingent consideration to employees or selling shareholders

- Payment contingent consideration or separate transaction? (SLFRS 3.52(b))
  - Benefit of acquirer = separate transaction
  - Benefit of the acquiree = consideration

Factors to be considered (SLFRS 3.B54)

- Why
- Who
- When

Contingent consideration to employees or selling shareholders

- Indicators (SLFRS 3.B55)

a) Continuing employment
b) Duration of continuing employment
c) Level of remuneration
d) Incremental Payments to employees
e) Number of shares owned
f) Linkage to the valuation
g) Formula for determining consideration

Acquisition Costs that are not Part of Consideration Transferred

- **Acquirer may incur costs in addition to the ‘consideration transferred’ that are associated with the acquisition**
  - Examples: legal, advisory, finder’s fee, valuation, professional, consultancy, accounting
- **Such costs associated with the acquisition are not part of the ‘consideration transferred’**
  - They must be expensed as period costs
    - Would include any reimbursements to the acquiree for bearing some of the acquisition costs

Measurement Period

- **Fair values assigned to assets/liabilities may be determined initially on a provisional basis if the accounting is not complete**
- **Adjustments during the measurement period (not to exceed 12 months) – are accounted retrospectively, assuming new information was obtained about facts and circumstances that existed at the acquisition date**
- **Adjustments after the measurement period:**
  - Error correction – retrospective adjustment to goodwill
  - Changes in estimates – no adjustment to goodwill; charge to profit or loss of period

Measurement of Non-Controlling Interest (NCI) and Goodwill

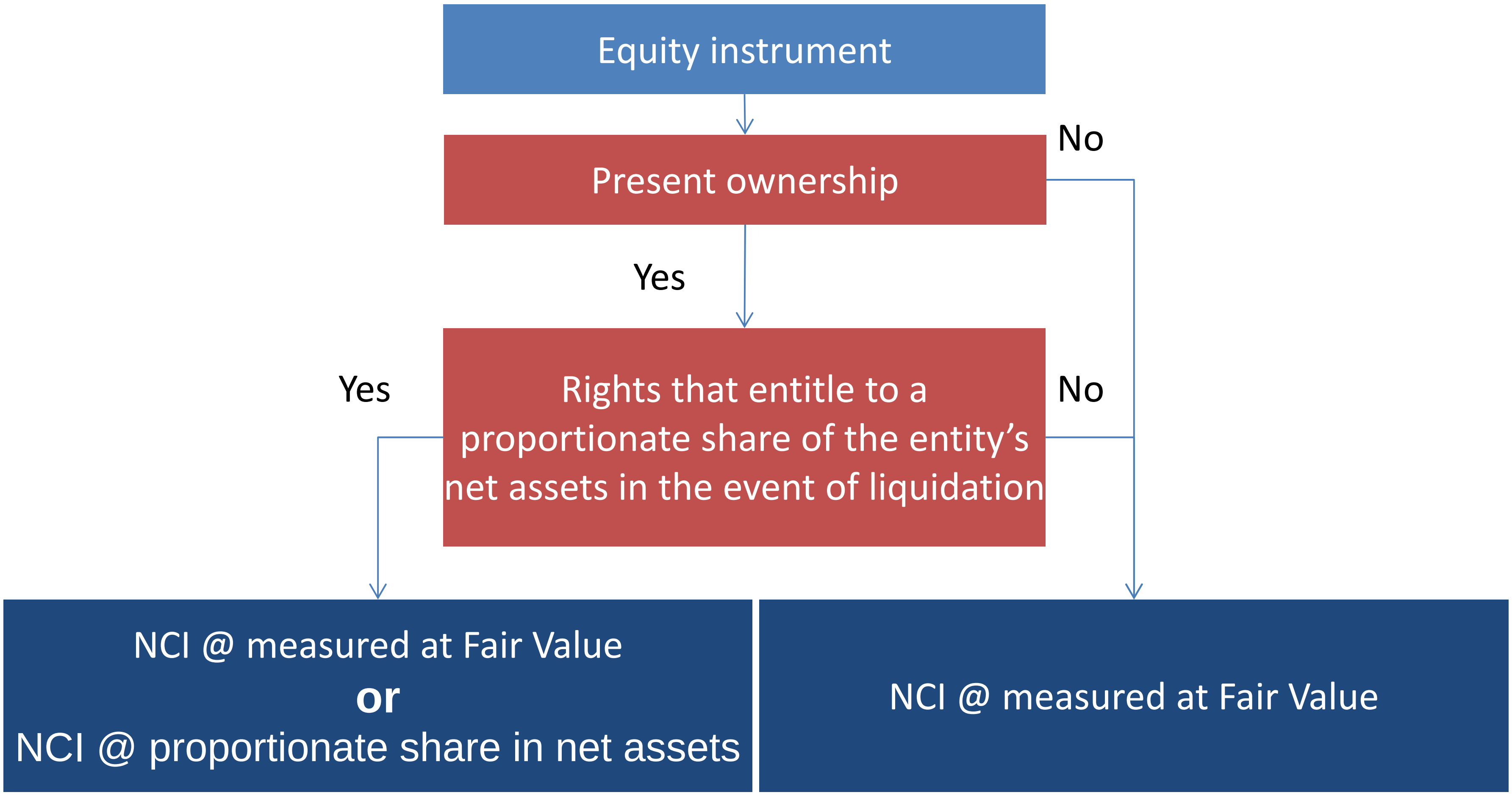
Measurement of Non-Controlling Interest Overview

- Improvements 2011 – No change when
  - Acquiree has present ownership interests and
  - Acquiree has rights that entitle to a proportionate share of the entity's net assets in the event of liquidation
  - Choice
    - NCI @ measured at Fair Value **or**
    - NCI @ proportionate share in net assets

Improvements 2011 – NCI @ Fair Value when

- No present ownership or right to a proportionate share of the entity's net assets in the event of liquidation

Measurement of Non-Controlling Interest Illustrated



Goodwill and NCI Example A

- A parent company, Sienna, acquires 80% of the 10,000 shares (i.e., 8,000 shares) in Rome for CU100,000 in a business combination
- Fair value of the identifiable net assets of Rome at acquisition is estimated at CU50,000
- Fair value of the 20% holding not acquired by Sienna is estimated at CU8 per share (CU8 x 2,000 shares = CU16,000)
- Calculate the goodwill and NCI arising on acquisition:
  1. Measuring NCI at share of fair value of net identifiable assets, and
  2. Measuring NCI at fair value (‘full goodwill’ method)

NCI at Share of Assets
Answer A1

- **Goodwill:**

	CU'000
Fair value of 80% stake	100
Add: NCI (20% x CU50)	10
	110
Less: 100% of identifiable net assets of acquiree	(50)
Goodwill	60

- **NCI:**

20% of fair value of identifiable net assets	10

NCI at Fair Value
Answer A2

- **Goodwill:**

	CU'000
Fair value of 80% stake	100
Add: fair value of NCI (2,000 @ CU8)	16
	116
Less: 100% of identifiable net assets of acquiree	(50)
Goodwill	66

- **NCI:**

Fair value of 20% holding	16

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Goodwill and NCI Example B

- Acquirer Ltd acquires 70% of Steak Ltd for CU 1,400.
- Carrying value of Steak Ltd. net assets at time of acquisition is CU 1,300.
- Fair Value of Steak Ltd. net assets at time of acquisition equals CU 1,500.
- Fair Value of NCI is CU 600 (30% x 1500 plus 150)

Measurement of Non-Controlling Interest Answer B

NCI @ proportionate share in net assets		NCI at fair Value	
Consideration	1,400	Consideration	1,400
NCI @ proportionate share in net assets	450	NCI at fair Value	550
FV of assets acquired	(1,500)	FV of net identifiable assets	(1,500)
Goodwill	350		450
Dr Net assets	1,500	Dr Net assets	1,500
Dr Goodwill	350	Dr Goodwill	450
Cr Consideration	1,400	Cr Consideration	1,400
Cr NCI	450	Cr NCI	550

Step Acquisition

Step Acquisition Effects

- 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
  - recognise the resulting gain or loss, if any, in profit or loss.

- What does this mean?
  - Possible to generate a profit by obtaining control of an entity previously held as an investment or an associate.

Step Acquisition Example

- Original 30 % holding purchased in 2004
  - Consideration
    CU 6.3m
  - Fair value of net assets
    CU 14.2m
- Additional 50% purchased in 2010
  - Equity accounted carrying value of original 30% holding
    CU 4.9m
  - Cash consideration
    CU 11.0m
  - Fair value of 100% of the net assets
    CU 18.7m
  - Fair value of original 30% holding
    CU 6.3m

Step Acquisition
Example Difference between

- At the date that control passes, there is a difference between: the carrying value of the investment in the associate (CU 4.9m) and the fair value of the investment in the associate (CU 6.3m).
- Take the difference of CU 1.4m to the income statement

•Journal entry

•Dr Goodwill	2.3m	
•Dr Net assets of sub	18.7m	
• Cr Cash		11.0m
• Cr Carrying value of associate		4.9m
• Cr P&L	1.4m	
• Cr Non-controlling Interest (20 % of net assets)		3.7m

•

Step Acquisition
Calculation of Goodwill

- Acquisition date fair value of original holding CU 6.3m
- Cash paid for additional holding <u>CU 11.0m</u>
- Total cost CU 17.3m
- Fair value of net assets acquired (CU 18.7m x (30% + 50%)) <u>(CU 15.0m)</u>
- **Goodwill CU 2.3m**

•Or

- Acquisition date fair value of original holding CU 6.3m
- Cash paid for additional holding CU 11.0m
- NCI (CU 18.7m*20%) <u>CU 3.7m</u>
- Total value CU 21.0m
- Fair value of net assets <u>(CU 18.7m)</u>
- **Goodwill CU 2.3m**

Step Acquisition Example (continued)

- In 2011 the remaining 20% is purchased
  - Consideration CU 4.1 m
  - Fair value of net assets CU 19.2m
- No profit implications or additional goodwill with the acquisition of additional holdings in a controlled entity.
- Difference between Consideration and NCI is accounted for in equity

- Journal entry?
  - Dr NCI CU 3.8m
  - Dr Equity CU 0.3m
  - Cr Cash CU 4.1m

Step Acquisition Example (continued)

- In 2012 55% of holdings are disposed
  - Consideration
    CU 12.5 m
  - Net assets
    CU 20.8m
- Loss of control.
- Associate is recognised at fair Value

•Journal entry?

•Dr Carrying value of associate (12.5m*45%/55%)		CU 10.2m
•Dr Cash	CU 12.5m	
• Cr P/L	CU 1.9m	
• Cr net assets	CU 20.8m	

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THANK YOU