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THE ANANTROY BHATT KNOWLEDGE CENTRE



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Introduction to IFRS 3: Business Combinations

IFRS 3 Business Combinations outlines the accounting when an acquirer obtains control of a business (e.g. an acquisition or merger). Such business combinations are accounted for using the 'acquisition method', which generally requires assets acquired and liabilities assumed to be measured at their fair values at the acquisition date.

Definitions

- **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 IFRS 3.

- **Business** = 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.
- **Acquisition Date** = The date on which the acquirer obtains control of the acquiree.
- **Acquirer** = The entity that obtains control of the acquiree.
- **Acquiree** = The business or businesses that the acquirer obtains control of in a business combination.

Scope

IFRS 3 must be applied when accounting for business combinations, but DOES NOT apply to:

- **Joint venture** = The formation of a joint venture.
- **Non-business Group of assets** = The acquisition of an asset or group of assets that is not a business, although general guidance is provided on how such transactions should be accounted for.
- **Businesses under common control** = Combinations of entities or businesses under common control (the IASB has a separate agenda project on common control transactions).
- **Investment entity** = Acquisitions by an investment entity of a subsidiary that is required to be measured at fair value through profit or loss under IFRS 10.

Determining Whether a Transaction Is A Business Combination

IFRS 3 provides additional guidance on determining whether a transaction meets the definition of a business combination, and so accounted for in accordance with its requirements. This guidance includes:

Consideration = Business combinations can occur in various ways, such as by transferring cash, incurring liabilities, issuing equity instruments (or any combination thereof), or by not issuing consideration at all (i.e. by contract alone).

Structures = Business combinations can be structured in various ways to satisfy legal, taxation or other objectives, including one entity becoming a subsidiary of another, the transfer of net assets from one entity to another or to a new entity.

Three essential elements = The business combination must involve the acquisition of a business, which generally has three elements:

- **Inputs** – an economic resource (e.g. non-current assets, intellectual property) that creates outputs when one or more processes are applied.
- **Process** – a system, standard, protocol, convention or rule that when applied to an input or inputs, creates outputs (e.g. strategic management, operational processes, resource management) to it.
- **Output** – the result of inputs and processes applied to those inputs

Acquisition Method:

The acquisition method (also called 'purchase method') is used for all business combinations.

1. Identification of the 'acquirer'.
2. Determination of the 'acquisition date'.
3. Recognition and measurement of the identifiable assets acquired, the liabilities assumed and any non-controlling interest (also called minority interest) in the acquiree.
4. Recognition and measurement of goodwill or a gain from a bargain purchase.

STEP 1 - IDENTIFICATION OF THE 'ACQUIRER'

IFRS 10

The guidance in IFRS 10 is used to identify an acquirer in a business combination, i.e. the entity that obtains 'control' of the acquiree

IFRS 3

If the guidance in IFRS 10 does not clearly indicate which of the combining entities is an acquirer, IFRS 3 provides additional guidance which is then considered.

Guidance:

- **Transferor of Consideration** = The acquirer is usually the entity that transfers cash or other assets where the business combination is effected in this manner.
- **Issuer of equity Interests** = The acquirer is usually, but not always, the entity issuing equity interests where the transaction is effected in this manner, however the entity also considers other pertinent facts and circumstances including:
 - relative voting rights in the combined entity after the business combination.
 - the existence of any large minority interest if no other owner or group of owners has a significant voting interest.
 - the composition of the governing body and senior management of the combined entity.
 - the terms on which equity interests are exchanged.
- **Largest relative size** = The acquirer is usually the entity with the largest relative size (assets, revenues or profit)
- **Initiator** = For business combinations involving multiple entities, consideration is given to the entity initiating the combination, and the relative sizes of the combining entities.

STEP 2 - DETERMINATION OF THE 'ACQUISITION DATE'

An acquirer considers all pertinent facts and circumstances when determining the acquisition date, i.e. the date on which it obtains control of the acquiree. The acquisition date may be a date that is earlier or later than the closing date.

STEP 3 - RECOGNITION AND MEASUREMENT OF THE IDENTIFIABLE ASSETS ACQUIRED, THE LIABILITIES ASSUMED AND ANY NON-CONTROLLING INTEREST (ALSO CALLED MINORITY INTEREST) IN THE ACQUIREE.

IFRS 3 establishes the following principles in relation to the recognition and measurement of items arising in a business combination:

RECOGNITION PRINCIPAL

Identifiable assets acquired, liabilities assumed, and non-controlling interests in the acquiree, are recognised separately from goodwill.

MEASUREMENT PRINCIPAL

All assets acquired and liabilities assumed in a business combination are measured at acquisition-date fair value.

EXCEPTIONS TO THE ABOVE

Contingent Liabilities

The requirements of IAS 37 Provisions, Contingent Liabilities and Contingent Assets do not apply to the recognition of contingent liabilities arising in a business combination.

Income Taxes

The recognition and measurement of income taxes is in accordance with IAS 12 Income Taxes

Employee Benefits

Assets and liabilities arising from an acquiree's employee benefits arrangements are recognised and measured in accordance with IAS 19 Employee Benefits (2011)

Indemnification Assets

An acquirer recognises indemnification assets at the same time and on the same basis as the indemnified item.

Reacquired Rights

The measurement of reacquired rights is by reference to the remaining contractual term without renewals.

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Share-based payment transactions

These are measured by reference to the method in IFRS 2 Share-based Payment.

Assets held for sale

IFRS 5 Non-current Assets Held for Sale and Discontinued Operations is applied in measuring acquired non-current assets and disposal groups classified as held for sale at the acquisition date

STEP 4 - RECOGNITION AND MEASUREMENT OF GOODWILL OR A GAIN FROM A BARGAIN PURCHASE.

MEASUREMENT

Goodwill is measured as the difference between:

- the aggregate of (i) the value of the consideration transferred (generally at fair value), (ii) the amount of any non-controlling interest (NCI, see below), and (iii) in a business combination achieved in stages (see below), the acquisition-date fair value of the acquirer's previously-held equity interest in the acquiree, and
- the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed (measured in accordance with IFRS 3).

SIMPLIFIED GOODWILL CALCULATION

Consideration transferred
PLUS: Amount of NCI
PLUS: Fair value of previous equity interest
(LESS): Net assets recognised
GOODWILL

NEGATIVE GOODWILL

If the difference above is negative, the resulting gain is a bargain purchase in profit or loss, which may arise in circumstances such as a forced seller acting under compulsion.

REVIEW FOR COMPLETENESS

However, before any bargain purchase gain is recognised in profit or loss, the acquirer is required to undertake a review to ensure the identification of assets and liabilities is complete, and that measurements appropriately reflect consideration of all available information.

Choice in Measurement of NCI:

Choice

IFRS 3 allows an accounting policy choice, available on a transaction by transaction basis, to measure non-controlling interests (NCI) either at:

- **fair value (sometimes called the full goodwill method), or**
- **the NCI's proportionate share of net assets of the acquiree**

Application

The choice in accounting policy applies only to present ownership interests in the acquiree that entitle holders to a proportionate share of the entity's net assets in the event of a liquidation (e.g. outside holdings of an acquiree's ordinary shares). Other components of non-controlling interests at must be measured at acquisition date fair values or in accordance with other applicable IFRSs (e.g. share-based payment transactions accounted for under IFRS 2 Share-based Payment).

Step Acquisition

Previously held interest

Prior to control being obtained, an acquirer accounts for its investment in the equity interests of an acquiree in accordance with the nature of the investment by applying the relevant standard, e.g. IAS 28, IFRS 11, IFRS 9.

Re-measurement

As part of accounting for the business combination, the acquirer re-measures any previously held interest at fair value and takes this amount into account in the determination of goodwill as noted above.

Resultant gain or loss

Any resultant gain or loss is recognised in profit or loss or other comprehensive income as appropriate.

Logical reasoning

The accounting treatment of an entity's pre-combination interest in an acquiree is consistent with the view that the obtaining of control is a significant economic event that triggers a re-measurement. Consistent with this view, all of the assets and liabilities of the acquiree are fully re-measured in accordance with the requirements of IFRS 3 (generally at fair value). Accordingly, the determination of goodwill occurs only at the acquisition date.

Measurement

Using provisional amounts

If the initial accounting for a business combination can be determined only provisionally by the end of

the first reporting period, the business combination is accounted for using provisional amounts.

Adjustments

Adjustments to provisional amounts, and the recognition of newly identified asset and liabilities, must be made within the 'measurement period' where they reflect new information obtained about facts and circumstances that were in existence at the acquisition date.

Maximum time limit

The measurement period cannot exceed one year from the acquisition date and no adjustments are permitted after one year except to correct an error in accordance with IAS 8.

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Related Transactions & Subsequent Accounting

General Principals

ACCOUNT FOR SEPARATELY

Transactions that are not part of what the acquirer and acquiree (or its former owners) exchanged in the business combination are identified and accounted for separately from business combination.

SUBSEQUENTLY RELEVANT STANDARDS DO APPLY

The recognition and measurement of assets and liabilities arising in a business combination after the initial accounting for the business combination is dealt with under other relevant standards, e.g. acquired inventory is subsequently accounted under IAS 2 Inventories.

FACTORS TO CONSIDER

When determining whether a particular item is part of the exchange for the acquiree or whether it is separate from the business combination, an acquirer considers the reason for the transaction, who initiated the transaction and the timing of the transaction.

Contingent Consideration

Contingent consideration must be measured at fair value at the time of the business combination and is taken into account in the determination of goodwill. If the amount of contingent consideration changes as a result of a post-acquisition event (such as meeting an earnings target), accounting for the change in consideration depends on whether the additional consideration is classified as an equity instrument or an asset or liability:

CLASSIFIED AS EQUITY

If the contingent consideration is classified as an equity instrument, the original amount is not re-measured.

APPLICATION OF IFRS 9

If the additional consideration is classified as an asset or liability that is a financial instrument, the contingent consideration is measured at fair value and gains and losses are recognised in either profit or loss or other comprehensive income in accordance with IFRS 9 .

APPLICATION OF IAS 37 OR OTHER IFRS'S

If the additional consideration is not within the scope of IFRS 9, it is accounted for in accordance with IAS 37 or other IFRSs as appropriate.

ADJUSTMENT DURING MEASUREMENT PERIOD

Where a change in the fair value of contingent consideration is the result of additional information about facts and circumstances that existed at the acquisition date, these changes are accounted for as measurement period adjustments if they arise during the measurement period.

Acquisition Costs**ACCOUNTING TREATMENT**

Costs of issuing debt or equity instruments are accounted for under IAS 32 or IFRS 9. All other costs associated with an acquisition must be expensed, including reimbursements to the acquiree for bearing some of the acquisition costs.

EXAMPLES

Examples of costs to be expensed include finder's fees; advisory, legal, accounting, valuation and other professional or consulting fees; and general administrative costs, including the costs of maintaining an internal acquisitions department.

Pre-Existing Relationships & Reacquired Rights

If the acquirer and acquiree were parties to a pre-existing relationship (for instance, the acquirer had granted the acquiree a right to use its intellectual property), this must be accounted for separately from the business combination. In most cases, this will lead to the recognition of a gain or loss for the amount of the consideration transferred to the vendor which effectively represents a 'settlement' of the pre-existing relationship. The amount of the gain or loss is measured as follows:

NON- CONTRACTUAL

For pre-existing non-contractual relationships (for example, a lawsuit): by reference to fair value.

CONTRACTUAL

For pre-existing contractual relationships: at the lesser of:

- the favourable/unfavourable contract position and.
- any stated settlement provisions in the contract available to the counterparty to whom the contract is unfavourable.

RECOGNISING INTANGIBLE ASSETS

However, where the transaction effectively represents a reacquired right, an intangible asset is recognised and measured on the basis of the remaining contractual term of the related contract excluding any renewals. The asset is then subsequently amortised over the remaining contractual term, again excluding any renewals.

Contingent Liabilities

Until a contingent liability is settled, cancelled or expired, a contingent liability that was recognised in the initial accounting for a business combination is measured at the higher of the amount the liability would be recognised under IAS 37 Provisions, Contingent Liabilities and Contingent Assets, and the amount less accumulated amortisation under IFRS 15.

Other Issues

In addition, IFRS 3 provides guidance on some specific aspects of business combinations including:

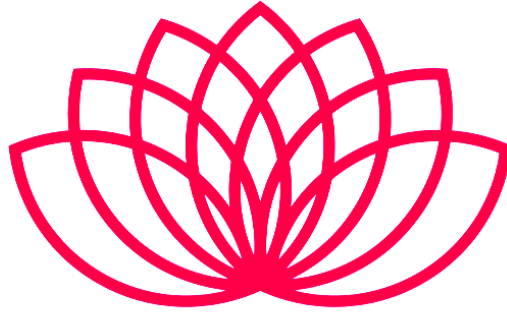
- business combinations achieved without the transfer of consideration, e.g. 'dual listed' and 'stapled' arrangements.
- reverse acquisitions.
- identifying intangible assets acquired.

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Disclosure

Main types of disclosures include (details not mentioned here):

- Disclosure of information about current business combinations.
- Disclosure of information about adjustments of past business combinations



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