BUSINESS COMBINATION & CORPORATE RESTRUCTURING IND AS 103

Chapter 3

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Ind AS 103 & Ind AS 110 are highly interlinked and hence, while discussing Ind AS 103, we are giving you a brief idea about Ind AS 110. Have patience while learning the new concept. Remember, you should read this chapter **only after** understanding Ind AS 28 – "Investments in Associates and Joint Ventures".

Introduction

Before getting into accounting aspects, let us first understand what actually corporate restructuring is.

The process of reorganizing: (a) one or more aspects of the business of a company; or (b) financial structure for increasing its efficiency and profitability is known as corporate restructuring. According to Mr. Prasanna Chandra "Corporate restructuring refers to a broad array of activities **that expand** or contract a **firm's operations or substantially modify its financial structure** or bring about a **significant change in its organizational structure and internal functioning**." Thus, the term "corporate restructuring" is an umbrella term that encompasses four distinct groups of activities viz. **Expansion, Contraction, Financial restructuring and Organizational Restructuring**. It is a strategic tool used by the corporate houses to boost value to the organization as well as to the investors.

The need for reorganizing a company may be felt due to a number of different factors such as to make the company more competitive, to overcome a currently adverse economic climate, or for moving towards an entirely new direction. The process of corporate restructuring essentially involves significant reorganization of assets and liabilities of the organization so as to conduct the business operations in an efficient, effective and competitive manner with the underlying objective of improving the quality and quantity of the future cash flow streams and thereby increasing the organization's market share, brand power, and synergies. In a nutshell, corporate restructuring is a comprehensive process by which a company can consolidate its business operations and strengthen its financial position for achieving its short-term and long-term corporate objectives.

Asset and capital restructuring can be termed as external or Internal restructuring. This is based on the significance and impact of the restructuring process on a company's internal or external stakeholders.

In case of Internal restructuring only the company is involved. Essentially, it results into change in rights of internal stake holders. Examples include – Capital restructuring like redemption of Preference shares, buy back of equity shares, etc.; Demerger (which is opposite to merger) i.e. dividing one company into two or more;

Whereas external restructuring includes merger, acquisition etc., where more than one company is involved.

Let us have little idea about the following words:

Demerger

Demerger is an arrangement whereby **some part/undertaking of one company is transferred to another company** which operates completely separate from the original company.

New company is opened with an intention to purchase the part of original company. Shareholders of the original company are usually given an equivalent stake of ownership in the new company. In simple words, demerger is splitting the existing company into two or more companies.

Example: ABC Ltd. is an existing company with two divisions, viz, Oil and Textiles. It opens a new company called ABC Oil Ltd., and transfers the assets and liabilities of oil business to the new/resultant company. In this case, ABC Oil Ltd., issues its shares either to ABC Ltd., **or** its shareholders directly as a consideration of transfer of oil business.

Advantages of Demerger

- To give effect to kind of family partitions in case of family owned enterprises;
- To limit the liability of particular division; and
- To facilitate focus on each division's specific issues and thereby leads to development.

Mergers

It is a legal process by which **two or more companies are joined together to form a new entity** or one or more companies are absorbed by another company and as a consequence the **amalgamating company loses its existence** and **its shareholders become the shareholders of the new or amalgamated company**.

Now let us enter into Ind AS 103 – Business combinations in depth. *Follow it carefully. This knowledge is relevant for Chapter - Consolidation of financial statements also. Have patience, we will explain you each and every word of it with examples.*

This standards address the following points:

1. Definition of a **business;**
2. Identification of Acquirer;
3. Recognition and measurement of the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree;
4. Recognition and measurement of the goodwill or a gain from a bargain purchase;
5. Items excluded from a business combination;
6. Subsequent measurement and accounting; and
7. Disclosures.

Remember there is **only Acquisition/purchase method** as per this Ind AS **except only one case** i.e. business **combination of entities under common control**, **we follow pooling of interest method** (*this is explained towards the end of this chapter*).

What is a business combination?

It is a transaction or other event in which **an ACQUIRER OBTAINS CONTROL of one or more BUSINESSES;** This includes **true mergers** also as per Ind AS. One may call it as merger – but there is only one method of accounting i.e. acquisition method as per Ind AS. *(There isn't any bifurcation as such into Merger and purchase like how it was in AS 14. Every business combination is accounted as per acquisition method except for accounting for common control business combination).*

Who is called "Acquirer"?

It is the entity which **gets the control** of acquiree;

We need to spend considerable amount of time on the words i.e. Control and Business; Which is very crucial for the standard. We need your utmost attention.

What is a "Business"?

As defined by Ind AS 103,

"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". *(Read carefully once again)*

There should be the following **three** elements in business:

1. Inputs;
2. Processes; and
3. Output.

(a) **Inputs:**

An input is an **economic resource** that **creates** or has the ability to create - **outputs** when one or more processes are applied to it.

Examples include

- Non-current assets (Including PPE, Intangibles or right to use of assets);
- Intellectual property;
- Employees;
- Materials.

(b) **Process:**

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

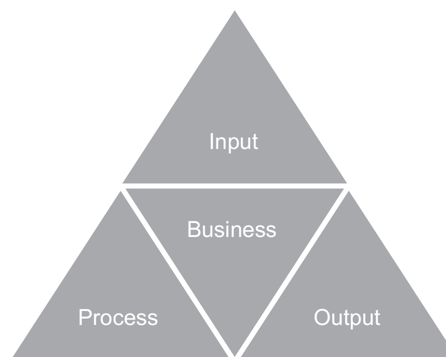
Examples: Strategic management processes, operational processes and resource management processes.

Processes are usually documented. **An organised human resource that has the skill and experience to follow rules** can constitute the processes that, when applied to inputs, can create outputs.

Only inputs and process do not constitute a business for example – Payroll process and administrative systems typically are not the process to create an output. There must be an output i.e. return to the investors;

(c) **Output**:

It is the result of inputs and process **into return in the form of dividends**, **lower costs** or **other economic benefits (money or money's worth)** directly to investors or other owners, members or participants;



Suppose, a business does not have all of the inputs or processes but the buyer of business is capable of acquiring and continuing to produce outputs, for example, by using its existing business, process and inputs – that also treated as business for the definition purpose.

In the absence of evidence to the contrary, a particular set of assets and activities in which goodwill is present shall be presumed to be a business. However, a business need not have goodwill.

What happens if it is not a "business"? (Not satisfied above definition)

It is treated as if the entity acquired – "an Asset" or "Group of assets". This affects the accounting. Group of assets will be accounted **at COST**. The total **cost is allocated** between the individual assets and liabilities in the **ratio of their fair values** on the date of purchase. Goodwill accounting is not required in this case.

Concept capsule 1

A Ltd. acquired three assets namely land, machinery and vehicles for an amount of ₹ 50 lakh. The fair value of these assets respectively on the date of acquisition is ₹ 25 lakh, ₹ 15 lakh and ₹ 20 lakh; Assume it does not satisfy the definition of business as per Ind AS 103. Pass necessary journal entry for its accounting.

Suggested answer

As per Ind AS 103, as it is not a business – it should be accounted as Group of assets. It will be accounted **at COST**. The total **cost is allocated** between the individual assets and liabilities in the **ratio of their fair values** on the date of purchase. No goodwill accounting in this case.

The total cost of ₹ 50 lakh should be allocated in the ratio of 25 : 15 : 20

Land a/c	Dr	20,83,333 (₹ 50,00,000 × 25/60)	
Machinery a/c	Dr	12,50,000 (₹ 50,00,000 × 15/60)	
Vehicles a/c	Dr	16,66,667 (₹ 50,00,000 × 20/60)	
To Cash a/c			50,00,000

This Ind AS 103 is not applicable for:

1. The acquisition of an asset or a group of assets that does not constitute a business; *(as discussed above)*
2. The accounting for the **formation of a joint arrangement** in the financial statements of the joint arrangement itself;
3. Combinations of entities or businesses under common control; *(but the accounting guidance is given in appendix to the standard which is discussed later in this chapter)*
4. The acquisition by an **investment entity** of an investment in a subsidiary that is required to be measured at fair value through profit or loss (FVTPL) *(Refer Ind AS 110)*

Concept capsule 2

A Ltd. acquires 100% equity of B Ltd. which owns 3 investment properties (Land and building held for rents and capital appreciation). The properties are multi-tenant residential apartments subject to short-term renting agreements. B Ltd. has to provide substantial maintenance and security services which are outsourced to specialist providers. B Ltd. has 5 employees who directly deal with tenants and the outsourced contractor to resolve any issues relating to security and maintenance. These employees are involved in variety of lease management tasks, that is identification and selection of tenants, rent negotiation, marketing activities etc. to increase quality of tenants and rental income.

Whether it would be included in the term "business"?

Suggested answer

Yes.

B Ltd. consists of a

(a) **Group of revenue generating assets** together with employees (Inputs);

(b) Activities which make it an integrated set of activities and assets i.e. maintenance, security, management (Processes)

(c) There is a return to investors.

Considering the above, Acquiring B Ltd. is an acquisition of **business**.

Note

If B Ltd. consists of 3 properties which are rented normally and does not do any other activity related to those properties (like providing security), it would not be regarded as business.

Concept capsule 3

Company X is a liquor manufacturer and has been in the field 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 and machinery and holds raw material inventory and finished products.

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

Suggested answer

In the given case, there are

Inputs – A variety of assets that are used by its employees;

(1) Processes – Manufacturing and trading activities;

(2) Output – with the help of inputs and activities, it creates different products and sell them which ultimately generates a return to the investors directly.

(3) Considering the above, it is clear that Company X is a business. Company X obtains control on 1st January, 20X1 by acquiring 100% of the voting rights. This is a business combination as per Ind AS 103.

Concept capsule 4

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 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?

Suggested answer

As per Ind AS 103, business should have input, process and output components. 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.

With the help of inputs and processes the company is capable of producing **outputs** and 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. Based on this, it is presumed that it is **able to get the customers in the future**. Considering the discussed points, Company A constitutes a business as per Ind AS 103.

Concept capsule 5

Modifying the above illustration, 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?

Suggested answer

Though the sales force has not been taken over, 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 B has acquired business. *(But, if the workforce is special to Company A, then we'll have evaluate further as to whether it is an asset acquisition or a business combination)*

Further, if Company B is also into similar line of business, then the existing sales force of 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 even though Company B has not acquired sales force.

Concept capsule 6

A real estate investment entity, ABC Ltd., has acquired an empty building during the year. The building has no tenants on acquisition and also contains no furniture. ABC Ltd., will undertake the day-to-day property management. No existing employees were hired by ABC Ltd., Does this constitute a business?

Suggested answer

In the given case, Input is the building; Apparently, no process has been acquired. Output is the access to economic benefits arising from future tenants lease income;

Generally processes in this business include a system to find tenants, run day to day operations and strategically position the property in order to secure future tenants and these processes are obviously missing. Moreover, these missing processes cannot be easily replicated by ABC Ltd in a relatively short period.

Considering the above, we can conclude that it is an asset acquisition rather than a business.

Concept capsule 7

Company B is a development stage pharma company with a license to develop a new drug. Company A acquires 100% shares in Company B. Due to lack of funds, Company B has **no employees and no other assets**. Clinical trials and/or development are not being performed and Company B has no intention to pursue the plan to produce outputs in future. Company A plans to raise funds in the entity and commence initial clinical trials for the drug. Whether Company B represents a business?

Suggested answer

As per Ind AS 103, 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".

One should consider the following factors also in case of development stage company (Not exhaustive factors)

- Planned principal activities have commenced;
- There are employees, intellectual property and other inputs and there are processes that could be applied to those inputs;
- A plan to produce outputs is being pursued; and
- There will be an ability to obtain access to customers who will purchase the outputs.

Not all of these factors need to be present for the acquired set to be considered a business.

In the given case, though Company B **has an input** (license to develop a new drug), it **lacks processes** to create outputs. Also, Company B has no employees and is not pursuing a plan to produce outputs as presently no research and development is being performed.

Therefore, Company B does not represent a business and accordingly Company A should account for this as an asset acquisition as prescribed by Ind AS 103.

Concept capsule 8

Company D is a development stage pharma company that has a license for a new drug, final clinical trials are currently being performed by Company D's employees (one of whom founded Company D and discovered the drug) and it has a plan to eventually produce the drug. Company D's administrative and accounting functions are performed by contract employees. Company C acquires all of the shares in Company D. Whether Company D represents a business?

Suggested answer

You must refer the discussion in above concept capsule

Company D is performing final clinical trials and is pursuing a plan to produce outputs (i.e. a commercially developed drug to be sold or licensed). Accordingly, acquisition of shares in Company D results in Company C acquiring inputs (license for drug and employees) and processes (operational and management processes associated with the performance and supervision of the clinical trials).

Hence, in the given scenario, the acquisition of shares in Company D represents a business combination.

Concept capsule 9

Company A Ltd. purchases five investment properties that are fully rented to tenants. A Ltd. also takes over the contract with the property management company, which has unique knowledge related to investment properties in the area and makes all decisions, both of strategic nature and related to the daily operations of the property. Ancillary activities necessary to fulfill the obligations arising from these lease contracts are also in place, specifically activities related to maintaining the building and administering the tenants. Whether the acquired set constitutes a business or not?

Suggested answer

In the given case, the acquired set of investment properties can be construed to be a business because it contains all of the inputs and processes necessary for it to be capable of creating outputs to provide a return to A Ltd.

Inputs: Non-current assets (land and buildings) and contracts.

Processes: Management with unique knowledge related to investment properties in the area.

Outputs: The intended outputs include rental income.

In contrast, if the property management contract is not taken over, then the group of assets might **not be a business**. The acquired set might not represent an integrated set of activities and assets because the key element of the infrastructure of the business, i.e. property management, is not taken over. If so, then A Ltd. would account for the transaction as the purchase of individual investment properties, and not as the purchase of a business.

Deciding whether acquisition of investment properties in the given case constitutes a business is a matter of professional judgement which requires careful assessment of facts and circumstances.

Concept capsule 10

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. The 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?

Suggested answer

This is a mere acquisition of two assets i.e. equipment and a patent for ₹ 1,400 crore (Cash + FV of land); (not a business combination). As discussed above, it should be accounted for at cost i.e. 1400 crore and it should be allocated between the assets based on relative fair values on the date of acquisition i.e. in the ratio of 1:2 (500:1000).

The equipment is recorded at ((₹ 500/₹ 1,500) × ₹ 1,400 = ₹ 467 crore).

The patent is recorded at ((₹ 1,000/₹ 1,500) × ₹ 1,400 = ₹ 933 Crore).

The following journal entry should be recorded:

Equipment a/c .. Dr 467

Patent a/c ……..Dr 933

To Land	100
To Cash	1,000
To P&L	300

(Being assets recorded at cost and gain on exchange is transferred to P&L)

Concept capsule 11

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. Does this constitute a business?

Suggested answer

The shell company does not contain an integrated set of activities and assets and hence, 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 will be recognised.

Concept capsule 12

A Ltd. is manufacturer of wide range of products. They have specialized payroll and accounting system which helps in managing the entire business. B Ltd. acquires assets, liabilities, workforce and the trademarks of A Ltd. but **does not acquire** the payroll and accounting system. Would it still be covered under Ind AS 103?

Suggested answer

Yes, all the other things acquired make up the integrated set of activities and assets capable of providing return to investors. Therefore, it constitutes a business as per Ind AS 103. The payroll and accounting systems are typically administrative functions not directly used to create outputs and hence, they are generally not considered an essential element in the assessment of whether an integrated set of activities and assets or not..

Let us relook at the business combination definition

Business combination is a transaction or other event in which an **ACQUIRER OBTAINS CONTROL** of one or more BUSINESSES;

There are two elements in this definition:

1. the **acquirer obtains CONTROL** of an acquiree ("control" as defined in Ind AS 110); and
2. it must be a **BUSINESS**

How to get control over acquiree?

Two ways – i.e. by acquiring

1. **Net assets of the entity**; or
2. **Significant equity interest in the entity**; or
3. By entering into a contract (rare circumstance) (in this case the entity acquires neither net assets nor equity). In this situation – Non-controlling interest i.e. minority interest = 100%.

In the first case, acquirer is acquiring only the business but not stake in the acquiree but whereas in the second came he is becoming a member of acquiring company by way of buying equity shares;

What will be given as consideration to get control? (In case of Options 1 & 2 above)

Variety of ways, for example:

- By transferring cash, cash equivalents or other assets (including net assets that constitute a business);
- By incurring liabilities i.e. by issuing debentures;
- By issuing equity interests i.e. by issuing equity shares;
- Combination of above; or

Note that in case of third option given above, there will not be any transfer of consideration and the likelihood of such cases is rare.

What do you mean by "**Control**"?

The word **Control is defined by Ind AS 110**. It is discussed in depth in the chapter "Consolidation of financial statements". We have provided a brief discussion below for your information.

As per Ind AS 110 'Consolidated Financial Statements',

An investor controls an investee/acquiree 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.

It is very broad definition. It doesn't depend only on acquisition of voting rights. It depends on the following as well:

- Potential voting rights; *(these are securities/contracts which **may give** an equity share to the holder – Explained in depth in Ind AS 33- EPS like convertible debentures/convertible preference shares/options)*
- Rights of non-controlling shareholders; and
- Other contractual right of the investor if those are substantive in nature.

The following are the **indicators of control**

(a) More than 50% voting rights;

(b) Power to appoint and remove board of directors;

(c) Investors have currently **exercisable potential voting rights**.

Note:

Potential voting rights which are **currently exercisable** and **have economic substance** [when are worth exercising] would be considered while determining control.

Few examples on the application of definition of 'control':

Concept capsule 13

On 1st January, 2018, ABC Ltd. owns a majority share of its investee's voting equity interests. The other investors in the investee hold contractual rights (for example, board membership rights accompanied by veto rights on operating matters, or other substantive participation rights) which preclude (prevent) ABC Ltd. from exercising control over the investor. The contractual rights of other investors are for 5 years which would lapse on 31st December, 2022 as per the terms of the contract. Does this scenario represent a Business Combination and when should this be accounted for?

Suggested answer

In this case, **on 1st January, 2023**, it represents a change in the rights of other shareholders (elimination or expiration of the contractual rights precluding control) which result in ABC Ltd. obtaining control of the investee and qualifying as a business combination and hence, it should be accounted as a business combination w.e.f. 1st Jan, 2023.

Concept capsule 14

PQR Ltd. owns an equity investment in an investee that gives it significant influence but not control. During the year, the investee repurchased (bought back) its own shares from other parties and the same were extinguished which resulted in an increase in the PQR Ltd.'s proportional interest in the investee (to 60% of the voting rights), which results in PQR Ltd. acquiring control of the investee. Does this lead to business combination?

Suggested answer

Buy-back of shares by investee of its own shares from other parties results in PQR Ltd. obtaining control of the investee (presuming no other indicator impacting control). This transaction qualifies as a business combination and the acquisition method should be applied by PQR Ltd.

Concept capsule 15

Company P Ltd., a manufacturer of textile products, acquires 40,000 of the equity shares of Company X (a manufacturer of complementary products) out of 1,00,000 shares in issue (i.e. 40%). As part of the same agreement, 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. These two shareholders also have currently exercisable options to acquire 2,000 additional shares each. Assess whether control is acquired by Company P.

Suggested answer

As per Ind AS 110, in assessing whether Company P has obtained control over Company X, Company P should consider not only the existing 40,000 shares but also its option to acquire another 25,000 shares (a so-called potential voting rights). In this assessment, the specific terms and conditions of the option agreement and other factors are considered:

- 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)
- Actually the exercisable price here is at a premium price to market price – we may assume that the company may not acquire. But as per the question as it is a small amount, by acquiring the shares, the entity gets majority ownership and which might be very useful to Company P. This way, one might consider the **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 (which is currently exercisable), **it has obtained control** of Company X.

Identification of Acquirer

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

Why to identify acquirer?

As per Ind AS 103, **business combination should be accounted by following "PURCHASE/ACQUISITION METHOD".** As per this method, **Acquiree's** (other than acquirer) **net assets,** consideration given by acquirer,