Treatment of Acquisition Related Costs in Ind AS Compliant Financials

Executive Summary

Mergers and Acquisitions (M&A) occur when business come together and combine to achieve corporate objectives. In an acquisition, a company purchases another company's identifiable business segments or assets. In the past recent years, economic optimism and availability of large capital has stimulated domestic merger and acquisitions. The increasing number of mergers and acquisitions requires companies to have a clear set of accounting policies which deals with business combinations and accounting for such transactions in standalone and consolidated financial statements. The accounting standard that governs accounting for business combinations, which is a matter affecting consolidated financials, is Ind AS 103 – Business Combinations. Ind AS 27 - Separate Financial Statements deals with accounting for investments in n subsidiaries, joint ventures, and associates in standalone financial statements. In this article, we will focus on accounting for acquisition related expenses in standalone and consolidated Ind AS compliant financials. Through Ind AS 103 explicitly lays out that acquisition related expenses cannot be capitalized as part of consideration paid for acquisition of shares of acquiree, Ind AS 27 is silent with respect to treatment of acquisition related expenses in standalone or separate financial statements of acquirer.

Analysis of Ind AS

Ind AS 27 is applied in accounting for investments in subsidiaries, joint ventures and associates when an entity elects, or is required by law, to present separate financial statements. An entity does not prepare separate financial statements as defined by Ind AS 27 when an entity does not have investments in subsidiaries, joint ventures or associates. Separate financial statements are those presented in addition to consolidated financial statements or in addition to financial statements in which investments in associates or joint ventures are accounted for using the equity method.

As per para 10 of Ind AS 27, when an entity prepares separate financial statements, it shall account for investments in subsidiaries, joint ventures, and associates either: (a) at cost, or (b) in accordance with Ind AS 109 - Financial Instruments. The entity shall apply the same accounting for each category of investments. Hence, entities can choose to present investments in subsidiaries, joint ventures, and associates at cost or either at fair value through profit or loss or fair value through other comprehensive income under Ind AS 109. If an entity elects to measure its investments in subsidiaries, associates or joint ventures at fair value through profit or loss in accordance with Ind AS 109, it shall also account for those investments in the same way in its separate financial statements.

'At cost' is not defined in Ind AS 27 and this is where the confusion arises. Cost is defined in the IFRS glossary of terms and this definition is extracted from IAS 16 – Property, Plant and Equipment, IAS 38 – Intangible Assets, and IAS 40 – Investment Property. Cost is defined as 'the amount of cash or cash equivalents paid or the fair value of the other consideration

given to acquire an asset at the time of its acquisition or construction, or, when applicable, the amount attributed to that asset when initially recognised in accordance with the specific requirements of other IFRSs, e.g., IFRS 2 – Share-based Payment'. Similar definitions of cost are also given in Ind AS 16- Property, Plant and Equipment, Ind AS 38 – Intangible Assets and Ind AS 40 – Investment Property.

Transaction Costs

Transaction costs for assets measured at cost are generally included in the 'cost' value. Though Ind AS 109 is not applicable for investments in subsidiaries, joint ventures and associates measured at cost, we need to draw inference from it on measurement at initial recognition of a financial asset and the definition of transaction cost.

As per para 5.1.1 of Ind AS 109, except for trade receivables within the scope of paragraph 5.1.3, at initial recognition, an entity shall measure a financial asset or financial liability at its fair value plus or minus, in the case of a financial asset or financial liability not at fair value through profit or loss, *transaction costs* that are directly attributable to the acquisition or issue of the financial asset or financial liability. Transaction cost has been defined in Ind AS 109 as 'Incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability. An incremental cost is one that would not have been incurred if the entity had not acquired, issued, or disposed of the financial instrument. Transaction costs include fees and commission paid to agents (including employees acting as selling agents), advisers, brokers and dealers, levies by regulatory agencies and security exchanges, and transfer taxes and duties. Transaction costs do not include debt premiums or discounts, financing costs or internal administrative or holding costs.'

Following the definition of transaction cost included in Ind AS 109 applicable to financial assets not measured at fair value, which is the closest proxy for investments in subsidiaries, transaction costs should constitute only incremental costs that are directly attributable to the acquisition of the asset, i.e., costs that would not have been incurred if the entity had not acquired the asset. Therefore, going by Ind AS 109, expenses like financial advisory, accounting advisory or legal fees paid prior to acquisition should not be added to the cost of investment. As this matter is not directly addressed by Ind AS 27, some prepares adopted an approach to transaction costs similar to Ind AS 16/ Ind AS 38/ Ind AS 40 where all directly attributable costs, like due diligence, legal, accounting and other professional advisers, printing costs, stamp duties, etc are included in the cost of an asset. This approach has also been supported by IFRIC update in July 2009 where IFRIC deliberated and noted 'that IFRSs consistently require assets not measured at fair value through profit or loss to be measured at initial recognition at cost. Generally stated, cost includes the purchase price and other costs directly attributable to the acquisition or issuance of the asset such as professional fees for legal services, transfer taxes and other transaction costs. Therefore, the cost of an investment in an associate at initial recognition determined in accordance with paragraph 11 of IAS 28 comprises its purchase price and any directly attributable expenditures necessary to obtain it.' This update can also be applied for accounting investment in subsidiaries and joint ventures in separate financial statements of the acquirer. Both the approaches are being followed globally and are acceptable. Since more than one

interpretation of accounting for acquisition related transaction costs in possible. Accordingly, an entity should disclose its accounting policy for such costs and the amount recognised in the separate financial statements.

Coming to treatment of acquisition related expenses in consolidated financial statements, Ind AS 103 - Business Combinations oulines the accounting when an acquirer obtains control of a business. Such business combinations are accounted for using the 'acquisition method', which requires assets acquired and liabilities assumed to be measured at their fair values at the acquisition date. Para 53 of Ind AS 103 stated that 'acquisition-related costs are costs the acquirer incurs to effect a business combination. Those costs include finder's fees; advisory, legal, accounting, valuation and other professional or consulting fees; general administrative costs, including the costs of maintaining an internal acquisitions department; and costs of registering and issuing debt and equity securities. The acquirer shall account for acquisition-related costs as expenses in the periods in which the costs are incurred and the services are received except for costs to issue debt or equity securities which shall be recognised in accordance with Ind AS 32 and Ind AS 109.' All acquisition costs, even though directly related to the acquisition such legal and financial advisory fees must be expensed in the Statement of Profit and Loss. Therefore, there is little to debate on the fact that Ind AS 103 requires transaction costs to be expensed in Statement of Profit and Loss and not be included as part of cost of investment while computing goodwill/capital reserve as per Ind AS 103, as the case maybe.

Position under IGAAP

The standard which deals with accounting for investments in separate financial statements under the old Indian GAAP is AS 13 - Accounting for Investments. As per para 9 of AS 13, the cost of an investment includes acquisition charges such as brokerage, fees and duties. It is not clearly defined if only the incremental acquisition costs or the entire transaction costs that are attributable to cost of investments should be capitalized. Therefore, companies should clearly disclose the accounting policy for dealing with such costs in the separate financial statements.

AS 21 - Consolidated Financial Statements deals with preparation and presentation of consolidated financial statements. As per para 13 of AS 21, 'while computing goodwill or capital reserve on the date of acquisition, the *cost to the parent of its investment* in each subsidiary and the parent's portion of equity of each subsidiary, at the date on which investment in each subsidiary is made, should be eliminated'. Plain reading of para 13 suggests that the parent needs to eliminate the entire cost of investment, including the transaction costs capitalised as per the accounting policy of the company while computing the goodwill/capital reserve, as the case maybe.

Illustration

Let us try to understand the treatment of acquisition related expenses in standalone and consolidated Ind AS financial statements with the help of an example. Suppose ABC Limited acquired 100% equity interest in DEF Limited on 1st April 2022 for INR 500 crore. It also incurred transaction costs including commission paid to broker, levies by security exchanges

and stamp duty amounting to INR 5 crore. In the standalone financial statements of ABC Limited, ABC Limited will record investment at INR 505 crore which is the purchase price and transaction costs incurred in relation to acquisition of equity interest in DEF Limited. The fair value of net assets of DEF Limited on the date of acquisition is INR 400 Cr. ABC Limited needs to prepare its financial statements under Ind AS. In consolidated financial statement of ABC Limited, while computing goodwill/capital reserve on business combination under Ind AS 103, ABC Limited will consider consideration paid as INR 500 crore and transfer transaction costs of INR 5 crore in consolidated statement of profit and loss.

Standalone Balance Sheet

Particulars	INR Cr
Non-Current Investments	
- Investment in DEF Limited	505.00

Consolidated Balance Sheet

Particulars	INR Cr
Fair Value of Consideration	500.00
Less: Fair Value of Net Assets of DEF Limited on the date of acquisition	400.00
Goodwill to be recorded	100.00

Consolidated Statement of Profit and Loss

Particulars	INR Cr
Other Expenses	
- Legal & Professional Fee	4.00
- Rates & Taxes	1.00
	5.00

If the company was preparing its financials under IGAAP, it would record its investment at INR 505 Cr in its standalone balance sheet. For the purpose of computation of goodwill at the date of acquisition, it would consider the cost of investment as INR 505 Cr including transaction costs and eliminate the same against the *book value* of net assets instead of fair value as is required under Ind AS 103.

References:

- Ind AS 103
- Ind AS 27
- Ind AS 109
- Ind AS 16
- IFRIC update July 2009
- IFRS Glossary