THE STANDARD STANCE

An expert insight into key accounting matters

Volume 1 - August 2023

BDO

10 ACCOUNTING CONSIDERATIONS THAT COULD SURPRISE YOU WHEN ACQUIRING A COMPANY

What did you acquire – The asset or the business?

As per accounting guidance, acquiring a company does not necessarily mean that a ‘business’ has been acquired. For example, if a company is acquired which has only vacant land and no employees and no substantive processes are being transferred, then it is unlikely that a ‘business’ is being acquired.

A ‘business’ is an integrated set of activities and assets that is capable of being conducted and managed to provide goods or services to customers, generating investment income (such as dividends or interest) or generating other income from ordinary activities.

If not a business, the acquisition will be accounted for as an ‘asset acquisition’.

There are significant differences in the accounting for asset acquisitions and business combinations and a thorough understanding of the accounting implications of an acquisition is essential to avoid some unpleasant surprises post the acquisition. The distinction between asset or business acquisition is also important as it could have a material impact on the post-acquisition profit or loss, as well as on the statement of the group’s financial position.

What forms part of acquisition accounting?

Multiple agreements will likely be entered into when acquiring a company. What is surprising is that some of these agreements fall outside the purview of purchase accounting, even though they were all triggered by an acquisition.

Common examples could be employment contracts or those signed for managerial services, which many buyers and sellers pursue during an acquisition or those for settlements of pre-existing relationships. Accounting requires splitting these agreements from the purchase by carefully analysing factors such as the reasons for entering, the timing of these agreements and who initiated them. Some of these agreements could result in recognition of expenses post-acquisition even though the agreements were all signed because of the acquisition.

Who is the (accounting) acquirer?

The accounting acquirer is not necessarily the legal parent. The acquirer is the one who obtains control of the seller’s business following the guidance in Ind AS 110 *Consolidated Financial Statements*.

There are complications in figuring out the accounting acquirer in cases where a new company is formed to give effect to the acquisition. Sometimes, a legal subsidiary (usually a large operating entity or group) will be the acquirer (applying the relevant accounting guidance in Ind AS 103) if it merges with the legal parent, which is a small entity. In such situations, also referred to as ‘reverse acquisitions’ under Ind AS 103, an organisation might be surprised, that it will be the legal subsidiary that is the accounting acquirer to apply the acquisition method of accounting in accordance with Ind AS 103.

What is the date of acquisition?

The date of acquisition is important as the results of the acquired entity will be included in the group financial statements from this date. The fair value of the assets purchased, and liabilities assumed from the acquisition, will also be computed on this date.

The purchase agreement may specify a date as to when the acquisition will be effective. However, regardless of that, it should not be a surprise if the accounting date of acquisition is different and is the date on which the control is transferred. Thus, the accounting date of acquisition may or may not correspond to a date specified in the agreement.

Which instruments have been issued - equity or debt (or a mix)?

The consideration for acquisitions could be the issuance of shares/ other securities. Often, new shareholder agreements might also be entered into as part of the acquisition. Depending on their contractual terms, sometimes, shares might have to be accounted for as liabilities (or a mix of equity and liabilities). Thus, while it may be automatically assumed that shares are 'equity' in the company (based on the legal form), there could be a surprise in store when they need to be instead recorded as debt (either in full or in component) for accounting purposes.

Debt-versus-equity determination is always complex. Accountants consider several factors, including related shareholder agreements.

How are earn-outs measured?

Nowadays, earn-out arrangements are a common feature in acquisition transactions. This gives rise to contingent considerations which are measured at fair value.

When buying a start-up company, earn-outs may be tied to revenue targets. But how should revenue be recognised? In accounting terms, revenue recognition is a complicated area that involves the use of judgement. The seller and buyer may have different views on how to recognise revenue post-acquisition. Disputes of this nature sometimes lead to litigation. Hence, it is important that the accounting for earn-outs is clearly understood early on to help manage the expectations of all parties and avoid unpleasant surprises at the year-end.

How are acquisition-related costs accounted for?

Various costs are incurred in buying a company. Acquisition-related costs such as advisory fees, valuation fees, consulting fees, legal fees and stamp duties are not part of the consideration transferred. This may seem surprising as such costs may have been incurred due to the acquisition. Acquisition-related costs are recognised as expenses when incurred unless such costs are in relation to the issuance of debt or equity securities as consideration, for which specific accounting provisions apply.

What new intangibles have been recognised?

Some may find it odd that a balance sheet does not record every single asset of a business. For example, accounting rules do not allow companies to recognise intangible assets on their balance sheet when they are generated internally. However, surprisingly, the situation changes when acquiring a company. Accounting standards require some of these intangibles to be recognised on the acquirer's group balance sheet.

A common example is internally generated intellectual property. This may be more valuable than the company's physical assets, especially in many technology or research-oriented businesses. Another example could be brand value, which does not appear on the seller's balance sheet but needs to be accounted for on the acquirer's group balance sheet.

What will be the subsequent impact of a fair value increase on assets?

The assets of the acquired entity generally receive a fair value increase on their acquisition. When the group balance sheet reflects this increase after buying the company, the organisation could be surprised to see wide-ranging consequences, including lower-than-expected profit or loss post-acquisition.

For example, consider inventory which is generally carried at a lower cost and net realisable value. On acquisition, the fair value will usually be higher, and inventories will have to be recognised at their higher value on the group balance sheet. Depending on the volume of inventories on acquisition, this could affect the gross margins and other related performance measures of the group post-acquisition.

How fair is the fair value?

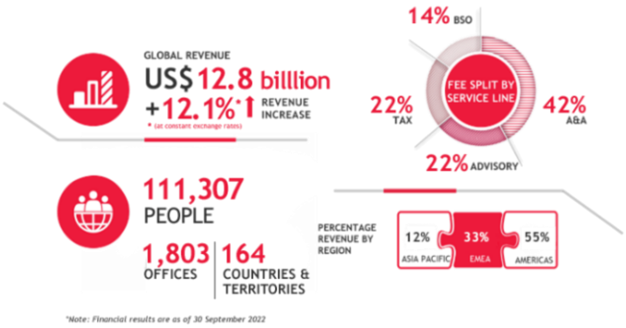
When measuring the fair value of assets and liabilities in a business combination, it must be noted that fair value is a market-based measurement, rather than an entity-specific measurement.

Fair value is the exit price and is measured using assumptions that market participants would use in pricing the asset or liability, including assumptions about risks. Surprisingly, the acquirer's intention to hold an asset or to settle or otherwise fulfil a liability is not relevant in measuring the fair value.

Take the example of the brand of the acquired entity that the acquirer does not intend to use. This may be because the acquirer intends to promote its brand or for other reasons. However, market participants might be expected to use the brand name of the acquired entity. In such a situation, the acquirer would have to recognise the brand at fair value even though its intention is not to use it.

ABOUT BDO GLOBAL

BDO is a leading professional services organisation and are global leaders of the mid-tier, with a presence in 160+ countries and over 111,300 people working out of more than 1,800 offices. We endeavor to deliver an exceptional client experience through a tailored solutions approach, while partnering with our employees and clients globally.



ABOUT BDO IN INDIA

BDO in India offers Assurance, Tax, Advisory, Business Services & Outsourcing and Digital Services for both domestic and international clients across industries. The team at BDO in India consists of over 7,500 professionals led by more than 270 partners and directors operating out of 18 offices, across 12 key cities.

OUR SERVICES

ASSURANCE
- Accounting Advisory Services
- Financial Statement Audit and Attestation Services

ADVISORY
- Forensics
- Government Advisory
- IT Risk Advisory & Assurance
- Management Consulting
- Risk Advisory Services
- Sustainability & ESG
- Business Restructuring
- Corporate Finance and Investment Banking
- Deal Value Creation
- Financial Due Diligence
- M&A Tax and Regulatory
- Strategy & Commercial Due Diligence
- Valuations

BUSINESS SERVICES & OUTSOURCING
- Global Outsourcing
- Finance and Accounting Outsourcing
- Human Resource Outsourcing
- Payroll Management and Compliance Services
- Secretarial Services and Compliance Management
- Shared Services Centre

BDO DIGITAL
- Digital Services
- Technology Products and Solutions

TAX
- Corporate Tax Services
- Financial Services Tax
- Global Employer Services
- International Tax Services
- Private Client Services
- Tax Outsourcing
- Transfer Pricing
- Customs & International Trade
- Goods & Services Tax (GST)
- Indirect Tax Assessment & Litigation Assistance
- Incentives & ESG
- Tax Technology

CONTACT US

For any content related queries, you may write in to accountingadvisory@bdo.in

For any other queries or feedback, kindly write to us at marketing@bdo.in