IFRS Today

Our series on the most topical issues in IFRS® Standards and financial reporting

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PODCAST TRANSCRIPT

M&A – Acquiring a business

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Hello – I'm **Andrea Schriber** and I'm joined today by **Julia LaPointe** – we work together in KPMG's International Standards Group.

Today we want to talk to you about how to account for business combinations under IFRS Standards.

Julia

Hi everyone. So why are we discussing this topic today? Well, we're seeing in the marketplace that M&A activity around the world is on the rise as we're coming out of the COVID-19 crisis.

Your company may not have done an acquisition in a while or maybe you're doing one for the first time, so we wanted to provide a quick refresher on the key accounting issues that you need to keep in mind.

Andrea

And Julia, don't forget there are also some new requirements that became effective in 2020 that you may be applying for the first time.

So why is this important? You need to be aware of the accounting requirements *before* the transaction takes place so the implications can be considered when the deal is actually negotiated.

Julia

So today we'll cover: how to figure out if the thing you've bought should be characterised in accounting terms as a business, or if it's just a collection of assets; if you have bought a business, what are the key accounting considerations for the transaction; and lastly what actually goes onto your balance sheet?

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Andrea

So looking at the first step – have you bought a business?

The first step is really to determine whether for accounting purposes there *is* a business combination in the scope of IFRS 3 – which is the business combinations standard. If not, you may have just acquired some assets, which results in a different accounting outcome. For example, you don't really recognise goodwill for an asset acquisition.

The standard defines a business as an integrated set of activities and assets that is capable of being conducted and managed to provide goods and services to customers, generate investment income, or generate other income from ordinary activities.

Julia

Now that's the definition in the standard, but how does it actually work in practice? So in many cases it'll be clear that you've bought a business, like if you've bought a company with lots of employees that's already generating revenues. But when it's less clear, IFRS 3 now provides an optional test to decide whether what you've bought is *not* a business. And this is called the 'optional concentration test'.

Under this test, if substantially all of the value is concentrated in one asset or a group of similar assets, then you can conclude that it's *not* a business and you don't account for a business combination.

Andrea

However, if the test that Julia's talking about isn't met, or you've decided not to apply it, you need to do a more detailed assessment – particularly whether what you have bought includes what IFRS 3 calls 'a substantive process'.

This includes looking at whether you've bought a process that is contributing to the creation of output. For example, whether you've bought a company that has a production process and employees doing things.

So now that you've bought a business, what are the key accounting requirements for the transaction?

Julia

Well, we always need to determine the date of the business combination, so when do you recognise it in your financial statements?

Now usually it's recognised on the closing date. However, if the transaction requires approval, let's say from shareholders or a regulator, and that approval is substantive, then the date of the acquisition can't be before that approval is obtained. So this can be a really important judgement with a big impact on the financial statements, especially if the transaction happens around year end.

Another key step is to decide what is part of the business combination and what's actually a separate transaction? For example, if there are already relationships between the acquirer and the acquiree – like revenue contracts or leases – the settlement of those relationships has to be accounted for separately from the business combination. That means it's not part of the purchase accounting and the calculation of goodwill.

Andrea

You mentioned pre-existing relationships. Another transaction that's separate from the business combination is a payment to former owners that requires them to keep working. That's not a part of the consideration paid for the business, but it goes into P&L after the acquisition as the services are provided.

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Julia

Yes, that's a really great point, Andrea: we often see these payments to former owners tripping up clients.

So to summarise, you need to think about when the transaction happened, and what is part of it versus a separate transaction.

Andrea

Now let's move on to the last of our three points: what do you bring on to the balance sheet? The answer here is a little bit more complex than just adding up numbers. IFRS 3 has core principles for identification, classification and measurement. However, as always, there's lots of exceptions.

Assets and liabilities are generally recognised if they meet the basic definitions in the Conceptual Framework and were bought as part of the business combination.

Classification is usually done based on contractual terms and economic conditions at the acquisition date. And measurement is generally at fair value.

Julia

Yes, that's a really great refresher of the core principles in the standard. You also need to be aware of the special exceptions in IFRS 3 for certain types of assets and liabilities – like contingent liabilities, deferred taxes, leases and share-based payments. In many of these areas, the requirements of other standards will take precedence over those core principles in IFRS 3. For example, deferred tax assets and liabilities are measured under the income tax standard, IAS 12, instead of being measured at fair value.

So we've covered quite a bit today: how to figure out if you've bought a business; if you have bought a business, the key accounting considerations for the transaction; and lastly what goes on to your balance sheet.

Andrea

Thanks Julia, and as we said in the beginning, it's really important to think through the accounting implications before the transaction takes place. Sometimes we see clients getting surprised, for example with unexpected P&L charges and that's just not a fun situation to be in. So make sure you are aware of the accounting rules before you buy.

Also keep an eye out for the next podcast in our series where we'll focus on the other side of the transaction and what to think about when you're selling a business.

Julia

And if you want to learn more, just type 'KPMG IFRS' into your browser. You'll find our COVID-19 financial reporting resource centre and lots of other good stuff.

Thanks for listening!

Andrea

Thanks a lot!

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