

IFRS 3 and Goodwill



With the introduction of Revised Schedule VI, India has shown its intent to Converge Indian Accounting Standards (Ind AS) with International Financial Reporting Standards (IFRS) read with 41 International Accounting Standards (IAS) and related interpretations. Amongst the IFRSs, IFRS 3 i.e. Ind AS 103 – “*Business Combination*” is a standard that has very little similarity with the existing Indian GAAP. IFRS 3 deals with accounting under various types of Business Combinations in the form of Acquisitions, Mergers, Reverse Mergers, etc. Though The Institute of Chartered Accountants of India (ICAI) has issued a standard to deal with Amalgamations and Mergers i.e. AS 14 – “*Amalgamation*”, the principles prescribed in IFRS 3 are more stringent. Unlike AS 14 which has provided two options for accounting amalgamations viz. a) Purchase method and b) Pooling of Interest method, IFRS 3 only considers Purchase method of accounting. Let us understand the accounting method under IFRS 3 and its related impacts under IAS 12 – “*Income Taxes*” and IAS 36 – “*Impairment of Assets*”.

Purchase Method under IFRS 3/Ind AS 103

Purchase method requires the Acquiring Company to fair value all the identified Assets and Liabilities and also recognise additional liabilities if any, at fair values on balance sheet. It requires allocating the Purchase Price to all the items on the balance sheet and also off the balance sheet i.e. contingent liabilities.

Excerpt from Para 36 of IFRS 3

“The acquirer shall, at the acquisition date, allocate the cost of a business combination by recognising the acquiree’s identifiable assets, liabilities and contingent liabilities that satisfy the recognition criteria, at their fair values at that date, except for noncurrent assets (or disposal groups) that are classified as held for sale in accordance with IFRS 5, Non-current Assets Held



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for Sale and Discontinued Operations, which shall be recognised at fair value less costs to sell.”

Note: Indian GAAP under purchase method does not require valuation of intangible assets, unless paid and contingent liabilities. Thus, they do not appear on the balance sheet post acquisition.

Deferred Tax

While assigning fair values to assets and liabilities under IFRS 3, the difference between the respective book values and carrying values give rise to Temporary difference, since these fair values are not considered for Tax Reporting purposes. This difference in the nature of upward/downward fair valuation of assets and liabilities only in accounting books, creates a temporary difference and thus deferred tax. Refer para 19 of IAS 12 below:

Para 19 of IAS 12

“The cost of a business combination is allocated, by recognising the identifiable assets acquired and liabilities assumed at their fair values at the acquisition date. Temporary differences arise, when the tax bases of the identifiable assets acquired and liabilities assumed, are not affected by the business combination or are affected differently. For example, when the carrying amount of an asset is increased to fair value but the tax base of the asset remains at cost to the previous owner, a taxable temporary difference arises, which results in a deferred tax liability. The resulting deferred tax liability affects goodwill.”

Goodwill on Business Combination

If the acquirer’s interest in the net fair value of the identifiable assets, liabilities and contingent liabilities recognised is **less** than the cost of the business combination, it gives rise to Goodwill and if it is **more**, then it is a case of “Negative Goodwill”. Unlike Indian GAAP, Negative Goodwill i.e. Capital Reserve, where this gain is directly taken to equity, as under IFRS 3, it

is taken through profit and loss account.

It is pertinent to note that Ministry of Corporate Affairs has carved out the treatment of Negative Goodwill i.e. Capital reserve, while converging Indian Standards towards IFRS 3. It will create a GAAP difference in which Converged Indian Accounting Standard will take the Negative Goodwill directly to Reserves as against IFRS 3, which will consider this gain in the income statement.

Deferred Tax on Goodwill under IAS 12

“15. A deferred tax liability shall be recognised for all taxable temporary differences, except to the extent that the deferred tax liability arises from:

- (a) the initial recognition of goodwill; or
- (b) the initial recognition of an asset or liability in a transaction which:
 - (i) is not a business combination; and
 - (ii) at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).”

66. *Temporary differences may arise in a business combination. In accordance with IFRS 3, Business Combinations, an entity recognises any resulting deferred tax assets or deferred tax liabilities as identifiable assets and liabilities at the acquisition date. Consequently, those deferred tax assets and liabilities affect goodwill or the amount of any excess of the acquirer’s interest in the net fair value of the acquiree’s identifiable assets, liabilities and contingent liabilities over the cost of the combination. However, in accordance with paragraphs 15(a), an entity does not recognise deferred tax liabilities arising from the initial recognition of goodwill.*”

Thus, Goodwill is the only asset under Business Combinations, that is being exempted to create deferred tax. However, it is interesting to note that when the rules of IFRS 3 and IAS 12 are applied for a Business Combination, then even if the deal is done at Arm’s Length Price, it will still lead to “Artificial Goodwill” generated ‘on account of deferred tax accounting’ as mentioned in para 19 of IAS 12 quoted above.

Let us appreciate the case with the help of a case study.

Case Study:

Company A is a Company involved in mining and manufacturing and has acquired a Company B who possess “Ore” reserves. While deciding the acquisition price for the B, Company A considered the future

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cost of extraction and long term selling price and thus arrived at present value of the net Cash flows on the Company at ₹200 crore, including some fixed assets amount to ₹10 crore. Thus, ₹190 crore is paid for the future profit in today's terms. The tax rate of Company A is 30%.

Accounting treatment:

The acquisition falls under Business Combination governed by IFRS 3, which requires fair valuation of assets and liabilities.

Company A identified the Ore reserves as assets for fair valuation and for which such a consideration was paid.

Logically, when we follow the principles under para 15 of IFRS 3, we would expect that if we have paid for actual assets then this transaction should not have any Goodwill. However, it is just an illusion. The accounting of IAS 12 here generates artificial Goodwill which otherwise was non-existent.

As part of fair valuation exercise, Company A carried out the fair valuation exercise using Discounted Cash Flow approach.

Since it is an acquisition of an entity, the acquiree entity (i.e. B) will continue to maintain its books at carrying value of ₹10 and thus the tax books will also have ₹10. When we fair value for acquirer's (i.e. A) accounting under IFRS 3 for consolidating entity B, A will record assets at fair value and thus differ from the value in Tax books. This will lead to a temporary difference, which will reverse in the form of higher depreciation going forward.

It can be seen from the above table that, if we do not create deferred tax liability, there is no Goodwill. If we create deferred tax liability then it gives rise to Goodwill. If ₹200 is the price determined based on Discounted Cash Flow (DCF) of the business, we would expect entity A should not have any Goodwill. However, it is not so. Under IFRS, we will still have Goodwill on account of deferred tax implications and the total assets increase to ₹257 as seen in the table above.

It is pertinent to note that this has a corresponding impact originating from IAS 36 on Impairment of assets. Under IAS 36, Goodwill has to be tested for Impairment at least annually, even if there are no triggers to suggest that. Goodwill is tested for impairment and justified to be on the balance sheet by supporting with Discounted Future Cash flows. In the current case scenario, the DCF of the business was only ₹200, the Goodwill of ₹57 will then need to be impaired immediately.

Point that emerges:

- Does goodwill created purely on account of deferred tax need to be tested on the balance sheet date?
- Even if it has to be tested, does the Company need

Business Combination note and Goodwill equation

Rupees (₹) in Crore

Particulars	Carrying Value	FV Adj.	Fair Value with Def Tax	Fair Value without Def Tax
Purchase price			200	200
Less: Net Assets of the Company				
Fixed assets	10	-	10	10
Mineral Reserves	-	190	190	190
Deferred tax liability @ 30%		-57	-57	0
Net assets of Company B	10	133	143	200
Goodwill			57	0
- On account of Deferred tax liability.			57	-
Total Assets			257	200

higher cash-flows to justify Goodwill or rather compare Gross asset net of deferred tax liability with the same cash flow instead? OR

- c) Test Goodwill related to deferred tax liability independently based on its reversal in future years in the form of deferred tax credit in Profit and Loss account?

Need to relook:

The acquirer acquires the Company based on post tax discounted cash flows, which we consider to be the best acquisition price.

If the acquisition is made at the above fair price based on DCF, then there should be no Goodwill since the acquirer has paid for its real value at par.

However, under IFRS, when this Company does Purchase accounting, it will have to create a deferred tax liability and thus the mathematical equation will give rise to “Artificial Goodwill”.

Preferred Approach:

Goodwill arising on Deferred Tax liability should be tested independently, based on its unwinding in the form of deferred tax credit in the P&L in future years.

In other words, such Goodwill should be tested for impairment based on its own reversal and not based on additional future cash flows.

Deduction:

It is understood from the preface by Standard setters in International Accounting Standards Board (IASB) that all the transactions should be accounted in substance at its true value. Thus, recording the value of assets and liabilities of the Acquiree Company in the balance sheet that represents the actual purchase price is more logical accounting treatment. However, the area that needs deliberation is the creation of Goodwill on account of deferred tax and how it is to be tested for impairment. ■

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