# Explanatory Note
# on
# Accounting for Business Combination

**Issue Date: 31st July, 2022**

## Introduction

1. This Explanatory Note has been issued by the Council of The Institute of Chartered Accountants of Nepal (ICAN) under the authority conferred to it by the Section 11 (l) of Nepal Chartered Accountants Act 1997 (including first amendment 2002) to be effective from 18 July 2022.

2. This Explanatory Note deals with accounting for Business Combination carried out as per NFRS 3: Business Combination.

3. This Explanatory Note has been issued after receiving the request for pronouncement of the Explanatory Note from Accounting Standard Board, on the background of request for resolution of issues on Business Combination received from Nepal Rastra Bank.

## Objective

4. The objective of the Explanatory Note is to clarify the provision of applicable NFRS standards with respect to accounting for business combination.

## Scope

5. The Explanatory Note constitutes as a clarification statement on the fair valuation of Net Assets acquired by and considerations issued as equity instruments of the acquirer in whole or in part along with measurement of Goodwill.

6. All other stipulations of NFRS 3 and NFRS 13 apply as they are described in or dealt with by those standards. No statement made in this Explanatory Note shall bear authority to contradict or limit the authority of the standard in manner, whatsoever

## Clarifications of the Applicable Provisions of the NFRS Standard

7. Para 18 of NFRS 3 states that "***The acquirer shall measure the identifiable assets acquired and the liabilities assumed at their acquisition date fair values.***"

   It is clarified that the identifiable assets and liabilities are measured at their individual fair values as on acquisition date. Those assets and liabilities acquired are brought in the books of the acquirer at same values as at the acquisition date.

8. Para 32 of NFRS 3 states that ***"The acquirer shall recognize goodwill as of the acquisition date measured as the excess of (a) over (b) below:***

   ***(a) The aggregate of:***

   ***(i) The consideration transferred measured in accordance with this NFRS, which generally requires acquisition-date fair value (see paragraph 37)***
   ***(ii) The amount of any non-controlling interest in the acquiree measured in accordance with this NFRS; and***
   ***(iii) In a business combination achieved in stages (see paragraphs 41 and 42), the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree.***

   ***(b) The net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed measured in accordance with this NFRS.***

   The standard requires to recognize goodwill for the excess of the value derived as per (a) over (b). Goodwill may be measured in a business combination effected through exchange of equity interest of the acquirer by considering the business valuation of acquiree computed based on the similar terms as for the purpose of computing swap ratio. The excess of consideration paid by the acquirer over the business value of the acquiree is only considered as goodwill because it represents the expected synergies and other benefits arising from combining the businesses.

   The above treatment of Goodwill is clarified by way of this illustration as below:

| | | |
|---|---|---|
| A. | Consideration transferred by Acquirer<br>(No of equity instruments issued*fair value of equity instruments of acquirer as at acquisition date) | ******* |
| B. | **Less**, Business Value of Acquiree<br>(No of equity instruments of Acquiree*fair value of equity instruments of acquiree as at acquisition date) | ******* |
| **C.** | **Goodwill** | ****** |

The amount of Goodwill as arrived in (C.) above will be carried over to the books of acquirer. Resulting difference at the date of acquisition after recognition of face value of equity instruments issued shall be recognized as other components of equity.

It is clarified by way of following illustration:

| | |
|---|---|
| Dr. Identifiable Net Assets at Fair Value (as per Para 7 above) | ****** |
| Dr. Goodwill (as calculated above) | ****** |
| Cr. Share Capital | ****** |
| (No of equity instruments Issued * face value of equity instruments) | |
| Cr. Other Components of Equity (Balancing Figure) | ******* |

The fair valuation of the equity instruments issued in a business combination is clarified in paragraphs below:

9. Para 37 of NFRS 3 states that ***"The consideration transferred in a business combination shall be measured at fair value, which shall be calculated as the sum of the acquisition date fair values of the assets transferred by the acquirer, the liabilities incurred by the acquirer to former owners of the acquiree and the equity interests issued by the acquirer"***

   The NFRS 3 standard requires the valuation of equity interests issued by the acquirer at the acquisition date fair value but doesn't deal with fair valuation technique and is within the scope of NFRS 13: Fair Value Measurement. The consideration is valued at fair value only for the purpose of determination of goodwill and not for recognizing the value of equity instruments in the books of acquirer. In the books of acquirer, equity instruments issued are measured at face value.

10. Para 4 of NFRS 13 states ***"The definition of fair value focusses on assets or liabilities because they are primary subject of accounting measurement. In addition, this NFRS shall be applied to an entity's own equity instruments measured at fair value".***

    The latter part of the statement makes it clear that it is NFRS 13 that deals with the valuation of entity's own equity instruments measured at fair value.

11. Para 24 of the NFRS 13 states that ***"Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction in the principal (or most advantageous) market at the measurement date under***

***current market conditions (i.e. an exit price) regardless of whether that price is directly observable or estimated using another valuation technique."***

From the above stipulations, it is imperative that fair value is not only the price that is directly observable but also the one which is estimated using any other valuation technique, as appropriate.

12. Under **Application to liabilities and an entity's own equity instruments, General Principles** section, Para 34 of NFRS 13 states that ***"A fair value measurement assumes that a financial or non-financial liability or an entity's own equity instrument (eg. equity interests issued as consideration in a business combination) is transferred to a market participant at the measurement date. The transfer of a liability or an entity's own equity instrument assumes the following:***

    ***a) A liability would remain outstanding, and the market participant transferee would be required to fulfill the obligation. The liability would not be settled with the counterparty or otherwise extinguished on the measurement date.***

    ***b) An entity's own equity instrument would remain outstanding, and the market participant transferee would take on the rights and responsibilities associated with the instrument. The instrument would not be cancelled or otherwise extinguished on the measurement date."***

    The provision of Para 34 (b) of the standard reflects the business combination scenario dealt by this Explanatory Note. Accordingly, the following provisions of the standards that are applicable are clarified further as below.

13. Para 36 of NFRS 13 states that ***"In all cases, an entity shall maximize the use of relevant observable inputs and minimize the use of unobservable inputs to meet the objective of a fair value measurement, which is to estimate the price at which an orderly transaction to transfer the liability or equity instrument would take place between market participants at the measurement date under current market conditions."***

    The standard prioritizes the use of observable inputs over unobservable inputs to arrive at the fair value measurement.

14. Under **Liabilities and Equity Instruments held by other parties as assets,** Para 37 of NFRS 13 states that ***"When a quoted price for the transfer of an identical or a similar liability or entity's own equity instrument is not available and the identical item is held by another party as an asset, an entity shall measure the fair value of the liability or equity instrument from the perspective of a market participant that holds the identical item as an asset at the measurement date."***

The standard first requires the use of quoted price for the transfer of an entity's own equity instrument and only in the event of its unavailability, it allows other measures to be applied as dealt with by Para 38.

But, most often, though the quoted price is available, it may not be reflective of fair value that meets the definition as per NFRS 13 due to the small number of shares being traded in the market on daily basis. Likewise, due to different composition and classes of shares and the restrictions placed on them by the statute or regulations, there is possibility that a market price for a particular class of share may not be the representative price when all shares are considered together.

In component 5 of the Bases for Conclusions (BC 313) relating to NFRS 3, it is stated that **"*Although the purchase price in an all-cash transaction would not be subject to measurement error, the same may not necessarily be said of a transaction involving the acquirer's equity interests. For example, the number of ordinary shares being traded daily may be small relative to the number of shares issued in the combination. If so, imputing the current market price to all of the shares issued to effect the combination may produce a higher value than those shares would command if they were sold for cash and the cash then used to effect the combination.*"** BC 315 states that such goodwill resulting from situations described in component 5 as above is not part of the real Goodwill. It states ***"The fifth and sixth components, both of which relate to the acquirer, are also not conceptually part of goodwill. The fifth component is not an asset in and of itself or even part of an asset but, rather, is a measurement error."***

Hence, in situations where market price is available but suffers from above limitations to constitute a fair value, other measures of fair value determination as prescribed in Para 38 of NFRS 13 can be followed.

15. Para 38 of NFRS 13 states that ***"In such case, an entity shall measure the fair value of the liability or equity instrument as follows:***

    ***a) using the quoted price in an active market for the identical item held by another party as an asset, if that price is available.***

    The acquirer in a business combination can determine the fair value of equity instruments to be issued as consideration at quoted market price as on acquisition date, if the acquirer determines that there is not any reason for the market price not to reflect the fair value of acquirer's share as on that date.

    ***b) if that price is not available, using other observable inputs, such as the quoted price in a market that is not active for the identical item held by another party as an asset.***

If that price is not available or the acquirer determines that such price suffers from limitations as discussed in Para 14 above, the acquirer can use other observable inputs such as the value determined for the purpose of determining swap ratio between the acquirer and acquiree to determine the fair value of the equity instruments to be issued by the acquirer to the owners of acquiree.

The value determined for the purpose of determining swap ratio between the acquirer and the acquiree is reflective of fair value as it is agreed between the parties willing to enter an exchange transaction in a market that is not active, usually under requirements fixed by the regulator. Such price is usually negotiated based on due diligence audit carried out by the professional experts and is approved by Annual General Meeting (AGM) of both parties to the business combination.

***c) if the observable prices in a) and b) are not available using another valuation technique, such as:***

***i) an income approach (eg a present value technique that takes into account the future cash flows that a market participant would expect to receive from holding the liability or equity instrument as an asset; see paragraphs B10 and B11)***

***ii) a market approach (eg using quoted prices for similar liabilities or equity instruments held by other parties as assets; see paragraphs B5-B7)"***

This valuation technique is only considered appropriate in situations where both the observable prices as in a) or b) are not available. This may be the situations for private companies not listed in stock exchanges and where regulations do not offer any guidance or prescribe any requirements for determination of such fair value.

## Disclosure

16. The acquiring entity, in the financial statements of the combined entity, shall make adequate disclosure about the selection of method or technique of valuation of equity instruments issued as purchase consideration in a business combination, the justifications for, and circumstances under which such method or technique has been selected. All other disclosure requirements of NFRS 3 and NFRS 13 apply as they are.

## Carve-out Revision

17. After the issuance of this Explanatory Note, the Carve-out no. 3 and 4 on NFRS 3: Business Combination issued by ICAN on 2077.07.25 stands withdrawn.

## Restatement

18. This Explanatory Note shall be effective for retrospective restatement from the date and for the financial periods that the NFRS 2018 was made applicable.

## Other Related Expedients

19. The identifiable net assets of the acquiree can only be recognized in the books of the acquirer as per NFRS 3. Para 11 of NFRS 3 states that ***"To qualify for recognition as part of applying the acquisition method, the identifiable assets acquired, and liabilities assumed must meet the definitions of assets and liabilities in the Framework for the preparation and presentation of financial statements at the acquisition date.***

    The other guidance is provided in Para 51-53 of NFRS 3.

20. The goodwill resulting from a business combination should be tested for impairment in accordance with the provision of NAS 36 Impairment of Assets and hence is not dealt with by this Explanatory Note.

21. If the recognition of Business Combination results into Bargain Purchase Gain, the acquirer shall reassess whether it has correctly identified all of the assets acquired and all of the liabilities assumed in accordance with Para 36 of NFRS 3 and account it as per Para 34 of NFRS 3.