

BUSINESS COMBINATIONS: IFRS 3 (REVISED)

RELEVANT TO ACCA QUALIFICATION PAPER P2

This first article in a two-part series provides an introduction to IFRS 3 and IAS 27, including piecemeal acquisitions and disposals. The second article – in the April 2009 issue of *student accountant* – will tackle complex groups.

IFRS 3 (Revised), *Business Combinations*, will result in significant changes in accounting for business combinations. IFRS 3 (Revised) further develops the acquisition model and applies to more transactions, as combinations by contract alone and of mutual entities are included in the standard. Common control transactions and the formation of joint ventures are not dealt with by the standard. IFRS 3 (Revised) affects the first accounting period beginning on or after 1 July 2009. It can be applied early, but only to an accounting period beginning on or after 30 June 2007. Importantly, retrospective application to earlier business combinations is not allowed.

PURCHASE CONSIDERATION

Some of the most significant changes in IFRS 3 (Revised) are in relation to the purchase consideration, which now includes the fair value of all interests that the acquirer may have held previously in the acquired business. This includes any interest in an associate or joint venture, or other equity interests of the acquired business. Any previous stake is seen as being 'given up' to acquire the entity, and a gain or loss is recorded on its disposal.

If the acquirer already held an interest in the acquired entity before acquisition, the standard requires the existing stake to be re-measured to fair value at the date of acquisition, taking into account any movement to the income statement together with any gains previously recorded in equity that relate to the existing holding. If the value of the stake has increased, there will be a gain recognised in the statement of comprehensive income (income statement) of the acquirer at the date of the business combination. A loss would only occur if the existing interest has a book value in excess of the proportion of the fair value of the business obtained and no impairment had been recorded previously. This loss situation is not expected to occur frequently.

The requirements for recognition of contingent consideration have been amended. Contingent consideration now has to be recognised at fair value even if payment is not deemed to be probable at the date of the acquisition.

EXAMPLE 1

Josey acquires 100% of the equity of Burton on 31 December 2008. There are three elements to the purchase consideration: an immediate payment of

\$5m, and two further payments of \$1m if the return on capital employed (ROCE) exceeds 10% in each of the subsequent financial years ending 31 December. All indicators have suggested that this target will be met. Josey uses a discount rate of 7% in any present value calculations.

Requirement:

Determine the value of the investment.

Solution

The two payments that are conditional upon reaching the target ROCE are contingent consideration and the fair value of $\$(1m/1.07 + 1m/1.07^2)$ ie \$1.81m will be added to the immediate cash payment of \$5m to give a total consideration of \$6.81m.

All subsequent changes in debt-contingent consideration are recognised in the income statement, rather than against goodwill, as they are deemed to be a liability recognised under IAS 32/39. An increase in the liability for good performance by the subsidiary results in an expense in the income statement, and under-performance against targets will result in a reduction in the expected payment and will be recorded as a gain in the income statement. These changes were previously recorded against goodwill.

The nature of the contingent consideration is important as it may meet the definition of a liability or equity. If it meets the definition of an equity, then there will be no re-measurement as per IAS 32/39. The new requirement is that contingent consideration is fair valued at acquisition and, unless it is equity, is subsequently re-measured through earnings rather than the historic practice of re-measuring through goodwill. This change is likely to increase the focus and attention on the opening fair value calculation and subsequent re-measurements.

The standard also requires any gain on a 'bargain purchase' (negative goodwill) to be recorded in the income statement, as in the previous standard.

Transaction costs no longer form a part of the acquisition price; they are expensed as incurred. Transaction costs are not deemed to be part of what is paid to the seller of a business. They are also not deemed to be assets of the purchased business that should be recognised on acquisition. The standard requires entities to disclose the amount of transaction costs that have been incurred.

The standard clarifies accounting for employee share-based payments by providing additional guidance on valuation, as well as on how to decide whether share awards are part of the consideration for the business combination or are compensation for future services.

GOODWILL AND NON-CONTROLLING INTERESTS (NCIs)

The revised standard gives entities the option, on an individual transaction basis, to measure NCIs (minority interests) at the fair value of their proportion of identifiable assets and liabilities, or at full fair value. The first method will result in the measurement of goodwill, a process which is basically the same as in the existing IFRS. However, the second method will record goodwill on the NCI as well as on the acquired controlling interest. Goodwill continues to be a residual but it will be a different residual under IFRS 3 (Revised) if the full fair value method is used as compared to the previous standard. This is partly because all of the consideration, including any previously held interest in the acquired business, is measured at fair value, but it is also because goodwill can be measured:

- as the difference between the consideration paid and the purchaser's share of identifiable net assets acquired: this is a 'partial goodwill' method because the NCI is recognised at its share of identifiable net assets and does not include any goodwill
- on a 'full goodwill' basis: this means that goodwill is recognised for the NCI in a subsidiary as well as the controlling interest.

EXAMPLE 2

Missile acquires a subsidiary on 1 January 2008. The fair value of the identifiable net assets of the subsidiary were \$2,170m. Missile acquired 70% of the shares of the subsidiary for \$2.145m. The NCI was fair valued at \$683m.

Requirement:

Compare the value of goodwill under the partial and full methods.

Solution

Goodwill based on the partial and full goodwill methods under IFRS 3 (Revised) would be:

Partial goodwill	\$m
Purchase consideration	2,145
Fair value of identifiable net assets	(2,170)
NCI (30% x 2,170)	<u>651</u>
Goodwill	<u>626</u>
Full goodwill	\$m
Purchase consideration	2,145
NCI	<u>683</u>
	2,828
Fair value of identifiable net assets	(2,170)
Goodwill	<u>658</u>

It can be seen that goodwill is effectively adjusted for the change in the value of the NCI, which represents the goodwill attributable to the NCI of \$32m (\$658m - \$626m). Choosing this method of accounting for NCI only makes a difference in an acquisition where less than 100% of the acquired business is purchased. The full goodwill method will increase reported net assets on the balance sheet, which means that any future impairment of goodwill will be greater. Although measuring NCI at fair value may prove difficult, goodwill impairment testing is likely to be easier under full goodwill, as there is no need to gross-up goodwill for partially owned subsidiaries.

FAIR VALUING ASSETS AND LIABILITIES

IFRS 3 (Revised) has introduced some changes to the assets and liabilities

recognised in the acquisition balance sheet. The existing requirement to recognise all of the identifiable assets and liabilities of the acquiree is retained. Most assets are recognised at fair value, with exceptions for certain items such as deferred tax and pension obligations. The IASB has provided additional clarity that may well result in more intangible assets being recognised. Acquirers are required to recognise brands, licences and customer relationships, and other intangible assets.

There is very little change to current guidance under IFRS 3 (Revised) as regards contingencies. Contingent assets are not recognised, and contingent liabilities are measured at fair value. After the date of the business combination, contingent liabilities are re-measured at the higher of the original amount and the amount under the relevant standard.

There are other ongoing projects on standards that are linked to business combinations, for example on provisions (IAS 37) and on deferred tax (IAS 12), that may affect either recognition or measurement at the acquisition date or in subsequent accounting.

The acquirer can seldom recognise a reorganisation provision at the date of the business combination. There is no change from the previous guidance in the new standard: the ability of an acquirer to recognise a liability for terminating or reducing the activities of the acquiree is severely restricted. A restructuring provision can be recognised in a business combination only when the acquiree has, at the acquisition date, an existing liability for which there are detailed conditions in IAS 37, but these conditions are unlikely to exist at the acquisition date in most business combinations.

An acquirer has a maximum period of 12 months from the date of acquisition to finalise the acquisition accounting. The adjustment period ends when the acquirer has gathered all the necessary information, subject to the 12-month maximum. There is no exemption from the 12-month rule for deferred tax assets or changes in the amount of contingent consideration. The revised standard will only allow adjustments against goodwill within this one-year period.

The financial statements will require some new disclosures which will inevitably make them longer. Examples are: where NCI is measured at fair value, the valuation methods used for determining that value; and in a step acquisition, disclosure of the fair value of any previously held equity interest in the acquiree, and the amount of gain or loss recognised in the income statement resulting from re-measurement.

IAS 27 (REVISED), CONSOLIDATED AND SEPARATE FINANCIAL STATEMENTS

This revised standard moves IFRS toward the use of the economic entity approach; current practice is the parent company approach. The economic entity approach treats all providers of equity capital as shareholders of the entity, even when they are not shareholders in the parent company. The parent company approach sees the financial statements from the perspective of the parent company's shareholders.

For example, disposal of a partial interest in a subsidiary in which the parent company retains control, does not result in a gain or loss but in an increase or decrease in equity under the economic entity approach. Purchase of some or all of the NCI is treated as a treasury transaction and accounted for in equity. A partial disposal of an interest in a subsidiary in which the parent company loses control but retains an interest as an associate, creates the recognition of gain or loss on the entire interest. A gain or loss is recognised on the part that has been disposed of, and a further holding gain is recognised on the interest retained, being the difference between the fair value of the interest and the book value of the interest. The gains are recognised in the statement of comprehensive income. Amendments to IAS 28, *Investments in Associates*, and IAS 31, *Interests in Joint Ventures*, extend this treatment to associates and joint ventures.

EXAMPLE 3

Step acquisition

On 1 January 2008, A acquired a 50% interest in B for \$60m. A already

held a 20% interest which had been acquired for \$20m but which was valued at \$24m at 1 January 2008. The fair value of the NCI at 1 January 2008 was \$40m, and the fair value of the identifiable net assets of B was \$110m. The goodwill calculation would be as follows, using the full goodwill method:

	\$m	\$m
1 January 2008 consideration	60	
Fair value of interest held	<u>24</u>	
		84
NCI		<u>40</u>
		124
Fair value of identifiable net assets		<u>(110)</u>
Goodwill		<u>14</u>

A gain of \$4m would be recorded on the increase in the value of the previous holding in B.

EXAMPLE 4

Acquisition of part of an NCI

On 1 January 2008, Rage acquired 70% of the equity interests of Pin, a public limited company. The purchase consideration comprised cash of \$360m. The fair value of the identifiable net assets was \$480m. The fair value of the NCI in Pin was \$210m on 1 January 2008. Rage wishes to use the full goodwill method for all acquisitions. Rage acquired a further 10% interest from the NCIs in Pin on 31 December 2008 for a cash consideration of \$85m. The carrying value of the net assets of Pin was \$535m at 31 December 2008.

	\$m	\$m
Fair value of consideration for 70% interest	360	
Fair value of NCI	<u>210</u>	570
Fair value of identifiable net assets		<u>(480)</u>
Goodwill		<u>90</u>

Acquisition of further interest

The net assets of Pin have increased by \$(535 - 480)m ie \$55m and therefore the NCI has increased by 30% of \$55m, ie \$16.5m. However, Rage has purchased an additional 10% of the shares and this is treated as a treasury transaction. There is no adjustment to goodwill on the further acquisition.

	\$m
Pin NCI, 1 January 2008	210
Share of increase in net assets in post-acquisition period	<u>16.5</u>
Net assets, 31 December 2008	226.5
Transfer to equity of Rage (10/30 x 226.5)	<u>(75.5)</u>
Balance at 31 December 2008 – NCI	<u>151</u>

Fair value of consideration	85
Charge to NCI	<u>(75.5)</u>
Negative movement in equity	<u>9.5</u>

Rage has effectively purchased a further share of the NCI, with the premium paid for that share naturally being charged to equity. The situation is comparable when a parent company sells part of its holding but retains control.

EXAMPLE 5

Disposal of part of holding to NCI

Using **Example 4**, instead of acquiring a further 10%, Rage disposes of a 10% interest to the NCIs in Pin on 31 December 2008 for a cash consideration of \$65m. The carrying value of the net assets of Pin is \$535m at 31 December 2008.

Pin net assets at 1 January 2008	480	\$m
Increase in net assets	<u>55</u>	
Net assets at 31 December 2008	535	

Fair value of consideration	65
Transfer to NCI (10% x (535 net assets + 90 goodwill))	<u>(62.5)</u>
Positive movement in equity	<u>2.5</u>

The parent has effectively sold 10% of the carrying value of the net assets (including goodwill) of the subsidiary (\$62.5m) at 31 December 2008 for a consideration of \$65m, giving a profit of \$2.5m, which is taken to equity.

DISPOSAL OF CONTROLLING INTEREST WHILE RETAINING ASSOCIATE HOLDING

IAS 27 sets out the adjustments to be made when a parent loses control of a subsidiary:

- Derecognise the carrying amount of assets (including goodwill), liabilities and NCIs
- Recognise the fair value of consideration received
- Recognise any distribution of shares to owners
- Reclassify to profit or loss any amounts (the entire amount, not a proportion) relating to the subsidiary's assets and liabilities previously recognised in other comprehensive income, as if the assets and liabilities had been disposed of directly
- Recognise any resulting difference as a gain or loss in profit or loss attributable to the parent
- Recognise the fair value of any residual interest.

EXAMPLE 6

Disposal of controlling interest

On 1 January 2008, Rage acquired a 90% interest in Machine, a public limited company, for a cash consideration of \$80m. Machine's identifiable net assets had a fair value of £74m and the NCI had a fair value of \$6m. Rage uses the full goodwill method. On 31 December 2008, Grange disposed of 65% of the equity of Machine (no other investor obtained control as a result of the disposal) when its identifiable net assets were \$83m. Of the increase in net assets, \$6m had been reported in profit or loss, and \$3m had been reported in comprehensive income. The sale proceeds were \$65m, and the remaining equity interest was fair valued at \$25m. After the disposal, Machine is classified as an associate under IAS 28, *Investments in Associates*. The gain recognised in profit or loss would be as follows:

Fair value of consideration	65	\$m
Fair value of residual interest to be recognised as an associate	25	
Gain reported in comprehensive income	<u>3</u>	
		93

Less net assets and goodwill derecognised:		
net assets	(83)	
goodwill (80 + 6 - 74)	<u>(12)</u>	
Loss on disposal to profit or loss	<u>(2)</u>	

After the sale of the interest, the holding in the associate will be fair valued at \$25m.

As can be seen from the points raised above, IFRS 3 (Revised) and IAS 27 (Revised) will potentially mean a substantial change to the ways in which business combinations, and changes in shareholdings, will be accounted for within the real world.

Complex group structures have not been considered within this article and will be tackled in a future article. ■

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