CHANGES IN ACCOUNTING FOR BUSINESS COMBINATIONS
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INTRODUCTION

With respect to the preparation of consolidated financial statements, the key accounting standards are: IAS 27 *Consolidated and Separate Financial Statements*; IFRS 3 *Business Combinations*; IAS 28 *Investments in Associates*; and IAS 31 *Interests in Joint Ventures*. This article focuses upon the recent changes to IAS 27 and IFRS 3, both of which were revised in January 2008, marking the culmination of a joint project between the International Accounting Standards Board and the Financial Accounting Standards Board designed to improve financial reporting and international convergence. The requirements of IFRS 3 (2008) come into effect for those business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after 1st July 2009 (early adoption is permitted).

IAS 27(2008) – WHAT HAS CHANGED?

1. Acquisitions and disposals that do not result in a change of control

Changes in a parent's ownership interest in a subsidiary that do not result in a loss of control are accounted for within shareholders' equity as transactions with owners acting in their capacity as owners. No gain or loss is recognised on such transactions and goodwill is not re-measured. Any difference between the change in the non-controlling interest (previously referred to as 'minority interest' – see IFRS 3 (2008) below) and the fair value of the consideration paid or received is recognised directly in equity and attributed to the owners of the parent.

2. Loss of control

A parent can lose control of a subsidiary through a sale or distribution. When control is lost, the parent derecognises all assets, liabilities and non-controlling interest at their carrying amount. Any retained interest in the former subsidiary is recognised at its fair value at the date control is lost. If the loss of control of the former subsidiary involves the distribution of equity interests to owners of the parent acting in their capacity as owners, that distribution is recognised at the date control is lost. A gain or loss on loss of control is recognised as the net of the proceeds, if any, and these transactions. Any such gain or loss is recognised in profit or loss.

3. Loss of significant influence or joint control

When an investor loses significant influence over an associate, it derecognises that associate and recognises in profit or loss the difference between the sum of the proceeds received and any retained interest, and the carrying amount of the investment in the associate at the date significant influence is lost. A similar treatment is required when an investor loses joint control over a jointly controlled entity.

4. Attribution of profit or loss to non-controlling interests

The share of total comprehensive income should be attributed to the non-controlling interest even if this results in the non-controlling interest having a deficit balance.

IFRS 3 (2008) – WHAT HAS CHANGED?

1. Acquisition-related costs

Costs incurred in an acquisition (e.g. finder's fees; advisory, legal, accounting, valuation, and other professional or consulting fees; and general administrative costs) are expensed in the period incurred. Costs incurred to issue debt or equity securities are recognised in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*. (Under IFRS 3 (2004) directly related acquisition costs could be included as part of the cost of acquisition.)

2. Step acquisitions

A business combination leading to acquisition accounting applies only at the point where control is achieved. Where the acquirer has a pre-existing equity interest in the entity acquired: that equity interest may be accounted for as a financial instrument in accordance with IAS 39, as an associate or a joint venture using the equity method in accordance with IAS 28 or IAS 31, or as a jointly controlled entity using the proportionate consolidation method in accordance with IAS 31. If the acquirer increases its equity interest sufficiently to achieve control (described in IFRS 3 (2008) as a 'business combination achieved in stages'), it must remeasure its previously-held equity interest in the acquiree at acquisition-date fair value and recognise the resulting gain or loss, if any, in profit or loss. Once control is achieved, all other increases and decreases in ownership interests are treated as transactions among equity holders and reported within equity. Goodwill does not arise on any increase, and no gain or loss is recognised on any decrease.

3. Goodwill

Goodwill represents future economic benefits that are not capable of being individually identified and separately recognised. It is essentially the residual cost after allocating fair value to identifiable net assets taken over. Goodwill is measured as the difference between:

- the aggregate of:
  - (i) the acquisition-date fair value of the consideration transferred;
  - (ii) the amount of any non-controlling interest in the entity acquired (see point 4. for two measurement options); and
  - (iii) in a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously-held equity interest in the entity acquired; and

- the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed, both measured in accordance with IFRS 3.

If the difference above is positive, the acquirer should recognise the goodwill as an asset.

If the difference above is negative, the resulting gain is recognised as a bargain purchase in profit or loss.

After initial recognition, the acquirer should measure goodwill at cost less accumulated impairment losses. It should not be amortised but instead tested annually for impairment, or more frequently, if events indicate that it might be impaired, in accordance with IAS 36 *Impairment of Assets*.

4. Non-controlling interests (previously referred to as minority interests)

IFRS 3 has an explicit option, available on a transaction-by-transaction basis, to measure any non-controlling interest in the entity acquired either at: (i) the non-controlling interest's proportionate share of the net identifiable assets of the entity acquired (old method); or (ii) fair value, in which case the consolidated goodwill represents that of both the parent and the non-controlling interest (new method). The former treatment corresponds to the measurement basis in IFRS 3 (2004). For the purpose of measuring non-controlling interest at fair value, it may be possible to determine the acquisition-date fair value on the basis of market prices for the equity shares not held by the acquirer. When a market price for the equity shares is not available because the shares are not publicly-traded, the acquirer must measure the fair value of the non-controlling interest using other valuation techniques. It is important to realise that the new 'approach' only applies <u>at the date of acquisition</u>. Subsequent to acquisition, both the non-controlling interest and the fair value of the subsidiary's net assets will have changed.

Example (Old Method)

P pays €200m for 75% of S which has net assets with a fair value of €150m. Goodwill of €87.5m (€200m - (75% x €150m)) would be recognised, and the non-controlling interests would be €37.5m (25% x €150m). Hypothetically, if we assume that purchasing 100% of S would have cost proportionately more, the consideration would have been €266.67m (€200m/75%) and goodwill would then be €116.67m (€266.67m - €150m) and there would be no non-controlling interests. This demonstrates that, where a non-controlling interest exists, the traditional consolidation method only records the parent's share of the goodwill, and the non-controlling interest is carried at its proportionate share of the fair value of the subsidiary's net assets (which excludes any attributable goodwill). The argument goes that as we consolidate the whole of a subsidiary's other assets (and liabilities), why should goodwill be any different? After all, it is an asset!

Example (New Method)

Progressing the above example, assuming that the value of the goodwill of the non-controlling interest is proportionate to that of the parent, consolidated goodwill of €116.67m would be recognised (this includes both the controlling (€87.5m) and the non-controlling interest (€29.17m) in goodwill) and the non-controlling interest would be €66.67m (€29.17m + €37.5m attributed goodwill). In effect, consolidated goodwill and the non-controlling interest are 'grossed up' by the non-controlling interest's share of goodwill (€29.17m, in this case). Although this may seem new, it is in fact an extension of the methodology in IAS 36 when calculating the impairment of goodwill of a cash generating unit where there is a non-controlling interest.

Example (Both Methods)

P pays €400m to purchase 75% of the shares of S. The fair value of 100% of S's identifiable net assets is €300m.

If P elects to measure non-controlling interests at their proportionate interest in net assets of S of €75m (25% x €300m), the consolidated financial statements show goodwill of €175m (€400m + €75m - €300m).

If P elects to measure non-controlling interests at fair value and determines that fair value to be €100m, then goodwill of €200m is recognised (€400m + €100m - €300m). The fair value of the 25% non-controlling interest in S will not necessarily be proportionate to the price paid by P for its 75%, primarily due to control premium or discount.

5. Contingent consideration

IFRS 3 requires the acquisition consideration to be measured at fair value at the acquisition date, including the fair value of any contingent consideration payable. IFRS 3 permits very few subsequent changes to this measurement and only as a result of additional information about facts and circumstances that existed at the acquisition date. All other changes (e.g. changes resulting from events after the acquisition date such as the acquiree meeting an earnings target, reaching a specified share price, or meeting a milestone on a project) are recognised in profit or loss. While this fair value approach is consistent with the way other forms of consideration are valued, it is not easy to apply in practice as the definition is largely hypothetical. It is highly unlikely that the acquisition date liability for contingent consideration could be or would be settled by 'willing parties in an arm's length transaction'. In an exam question, the acquisition date fair value (or how to calculate it) of any contingent consideration would be given. The payment of contingent consideration may be in the form of equity or a liability (issuing a debt instrument or cash) and should be recorded as such in accordance with IAS 32 *Financial Instruments: Presentation*, or other applicable standard. The previous version of IFRS 3 required contingent consideration to be accounted for only if it was probable that it would become payable.

6. Re-acquired rights

Where the acquirer and acquiree were parties to a pre-existing relationship (e.g. the acquirer had granted the acquiree a right to use its intellectual property), there are two implications for acquisition accounting: firstly, where the terms of any contract are not market terms, a gain or loss is recognised and the purchase consideration adjusted to reflect a payment or receipt for the non-market terms; and secondly, an intangible asset (being the rights re-acquired) is recognised at fair value and amortised over the contract term.

7. Reassessments

IFRS 3 clarifies that an entity must classify and designate all contractual arrangements at the acquisition date with two exceptions: (i) leases, and (ii) insurance contracts. In other words, the acquirer applies its accounting policies and makes the choices available to it as if it had acquired those contractual relationships outside of the business combination. The existing treatment applied by the acquiree for classification of leases and insurance is applied by the acquirer and therefore is not reassessed. Reassessing assets and liabilities is particularly relevant when acquiring financial assets and financial liabilities in a business combination.

COMPREHENSIVE EXAMPLE

On 1st January 2009 Rooney plc (Rooney) acquired 3,000,000 equity shares in Ferguson Limited (Ferguson) by an exchange of one share in Rooney for every two shares in Ferguson, plus €1.25 per acquired Ferguson share in cash. The market price of each Rooney share at the date of acquisition was €6, and the market price of each Ferguson share at the date of acquisition was €3.25.

Rooney has a policy of valuing non-controlling interests at fair value at the date of acquisition. For this purpose, the share price of Ferguson at this date should be used.

An extract from the draft statement of financial position of Ferguson at 31st December 2009 showed:

	€
€1 Equity shares	4,000,000
Retained earnings	
– at 31st December 2008	6,000,000
– for year ended 31st December 2009	2,900,000
	12,900,000

Requirement:

Based upon the information provided, calculate the:

(i) goodwill arising on the acquisition of Ferguson; and
(ii) non-controlling interests to be included in Rooney's consolidated statement of financial position at 31st December 2009.

Solution
Rooney purchased 3,000,000/4,000,000 shares in Ferguson (i.e. 75%), paying €12,750,000 ((1,500,000 shares x €6) + (3,000,000 shares x €1.25)).

(i) Goodwill in Ferguson

	€'000	€'000
Investment at cost:		
Shares issued (3,000,000/2 x €6)		9,000
Cash (3,000,000 x €1.25)		3,750
Total consideration		12,750
Equity shares of Ferguson	4,000	
Pre-acquisition reserves	6,000	
	75% x 10,000	(7,500)
Rooney's share of goodwill		5,250
Fair value of non-controlling interest at date of acquisition – 1,000,000 shares at €3.25		3,250
Non-controlling interest's share of Ferguson's net assets at date of acquisition (€10,000,000 x 25%)		(2,500)
Non-controlling interest's share of goodwill		750
Total goodwill is therefore (€5,250,000 + €750,000)		6,000

This applies the old methodology for calculating the goodwill with the non-controlling interest's goodwill calculated separately. Applying the new method of calculating goodwill gives the same total figure, but it is a little simpler:

	€'000
Consideration paid by the parent (as before)	12,750
Fair value of the non-controlling interest (as before)	3,250
	16,000
Fair value of subsidiary's net assets (based on equity as before)	(10,000)
Total goodwill	6,000

(ii) Non-controlling interest

	€'000
Equity at 31st December 2009	12,900
The non-controlling interest's share of net identifiable assets (x 25%)	3,225
Non-controlling interest share of goodwill (see (i))	750
	3,975

Note that subsequent to the date of acquisition, a non-controlling interest is valued at its proportionate share of the carrying value of the subsidiary's net identifiable assets (equal to its equity) plus its attributed goodwill (less any impairment). The non-controlling interest is only valued at fair value at the date of acquisition.

Tutorial Notes

(a) There are a number of ways of presenting the information to test the new method for calculating the non-controlling interest at the date of acquisition. As above, the subsidiary's share price just before the acquisition could be given and then used to value the non-controlling interest. It is then a matter of multiplying the share price by the number of shares held by the non-controlling interest:

e.g. 1,000,000 x €3.25 = €3,250,000 (see (i) above).

In practice the parent is likely to have paid more than the subsidiary's pre-acquisition share price in order to gain control.

The question could simply state that the directors valued the non-controlling interest at the date of acquisition at €3,250,000.

An alternative approach would be to give in a question the value of the goodwill attributable to the non-controlling interest. In this case, the non-controlling interest's goodwill would be added to the parent's goodwill (calculated by the old method) and to the carrying amount of the non-controlling interest itself (e.g. €750,000 (see (i) above)).

(b) The consideration given by Rooney for the shares of Ferguson works out at €4.25 per share, i.e. consideration of €12,750,000 for 3,000,000 shares. This is considerably higher than the market price of Ferguson's shares (€3.25) before the acquisition. This probably reflects the cost of gaining control of Ferguson. This is also why it is probably appropriate to value the non-controlling interest in Ferguson shares at €3.25 each, because (by definition) the non-controlling interest does not have any control. This also explains why Rooney's share of Ferguson's goodwill at 87.5% (i.e. €5,250,000/€6,000,000) is much higher than its proportionate shareholding in Ferguson (which is 75%).

(c) The 1,500,000 shares issued by Rooney in the share exchange, at a value of €6 each, would be recorded as €1 per share as capital and €5 per share as premium, giving an increase in share capital of €1,500,000 and a share premium of €7,500,000.

(d) If goodwill had been impaired by €1,000,000. IAS 36 requires a subsidiary's goodwill impairment to be allocated between the parent and the non-controlling interest on the same basis as the subsidiary's profits and losses are allocated. Thus, of the impairment of €1,000,000, €750,000 would be allocated to the parent and €250,000 would be allocated to the non-controlling interest, writing it down to €3,725,000 (€3,975,000 - €250,000). It could be argued that this requirement represents an anomaly: of the recognised goodwill (before the impairment) of €6,000,000 only €750,000 (i.e. 12½%) relates to the non-controlling interest, but it suffers 25% (its proportionate shareholding in Ferguson) of the goodwill impairment.