IFRS LINK

Changes to IFRS 3 - Business Combinations

Introduction

On 10 January 2009, the International Accounting Standards Board issued a revised IFRS 3: Business Combinations, as well as some revisions to IAS 27: Consolidated and Separate Financial Statements, required to maintain consistency between the two standards. These revised standards are effective for all accounting periods beginning on or after 1 July 2009, but early adoption is allowed for accounting periods beginning on or after 30 June 2007. Where an entity elects for early adoption, it must adopt both IFRS 3 *and* IAS 27 at the same time.

The revisions are aimed at converging the accounting principles for business combinations under IFRS with those required by US GAAP (the revised US standard - SFAS 141 - was issued at the same time as IFRS 3), although it should be noted that some differences still remain.

The key features of the revised IFRS 3 are:

- Changes to the calculation of goodwill on acquisitions;
- Changes to the measurement of the consideration transferred on a business combination, including the treatment of contingent consideration;
- Choice of measurement options for non-controlling interests forming part of the acquisition;
- Changes to the treatment of re-acquired rights where the acquirer re-acquires a right previously granted to the acquiree; and
- Changes to the accounting treatment of step acquisitions.

Calculation of goodwill on acquisitions

All business combinations are accounted for using the acquisition method (known as the 'purchase method' in the previous version of IFRS 3).

The acquisition method is identified as a four-step process as follows:

1) Identification of the acquirer (the entity that gains control of the acquiree).
2) Determining the date the acquirer gained control of the acquiree.
3) Recognition and measurement of the identifiable assets acquired, liabilities assumed and any 'non-controlling interests' (NCI's) – formerly known as 'minority interests'.
4) Recognition and measurement of the goodwill acquired (or the gain from a bargain purchase where the value of net assets acquired exceeds the consideration paid).

Measurement of the consideration paid in a business combination

Under the old IFRS 3, the consideration paid in a business combination included:

- the fair value of the assets given, liabilities assumed, and equity instruments issued by the acquirer in exchange for control of the acquiree; and
- any costs directly attributable to the business combination (such as professional fees).

The revised IFRS 3 no longer permits directly attributable costs to form part of the business combination and calculation of goodwill. These costs should now be charged to the income statement in the period in which they are incurred. This provision is not retrospective and past transactions will not need to be restated at initial adoption.

Contingent Consideration

In many business combinations, the amount paid by the acquirer may be contingent upon the occurrence of future events. Under the previous version of IFRS 3 the acquirer was required to include as part of the consideration any contingent amounts which it considered were probable and capable of reliable measurement. Where there was a subsequent adjustment to the contingent consideration paid for the combination (i.e. a contingent amount included in the combination did not occur, required adjustment, or an amount not originally included in the combination subsequently became payable) the cost of the business combination and the value of goodwill was subsequently adjusted.

Under the revised IFRS 3, contingent consideration is recognised at its fair value at acquisition date. Any subsequent changes to contingent consideration amounts are not adjusted in the cost of the business combination. Instead, they are dealt with as follows:

- Contingent consideration amounts which were classified as equity in the books of the acquirer are not revalued, and their subsequent settlement is measured in equity;
- Contingent consideration amounts which are financial instruments under IAS 39 are measured at fair value with any resulting gain or loss recognised in profit and loss; and
- Contingent consideration amounts which are not within the scope of IAS 39 are accounted for by reference to the most appropriate IFRS – in most cases this will be IAS 37 (Provisions, Contingent Liabilities or Contingent Assets). Therefore, subsequent adjustments will be recognised in the income statement.

Provisional Values

Although subsequent changes to contingent consideration are not adjusted in the cost of a business combination, retrospective adjustments are allowed in limited circumstances.

In some instances, the accounting for a business combination will be incomplete at the end of the reporting period in which the combination occurs. In these instances, both the new and previous standards require the entity to account for the combination on a 'provisional' basis. Under the old version of IFRS 3 subsequent adjustments to provisional values were recognised in the period they were determined. However, now during the 'measurement period' the entity must retrospectively adjust those amounts by way of prior period adjustment. As well as retrospectively adjusting those amounts accounted for provisionally, the entity may also recognise additional assets or liabilities during the measurement period, where it obtains new information about facts or circumstances that existed at acquisition date, and if known at acquisition date, would have resulted in those assets or liabilities being recognised at that date.

It is important to make a clear distinction between information about facts and circumstances that existed at acquisition date, and information relating to events that occurred after acquisition date. Events that occur after acquisition date do not result in an adjustment to the cost of the business combination and the value of goodwill.

Measurement period

The measurement period is the period from the date of acquisition during which the entity may retrospectively adjust elements of the combination that were initially accounted for on a provisional basis. The measurement period ends when the entity obtains all the information it requires about facts or circumstances that existed at acquisition date, or the entity discovers that the information is not obtainable. In any event, the measurement period must not exceed one year from acquisition date.

Measurement options for non-controlling interests

Under the previous version of IFRS 3, the non-controlling interest in the acquiree was stated at the non-controlling interest's proportion of the fair value of the net assets acquired.

Under the revised IFRS 3, there are now two options for the measurement of non-controlling interests:

- Measurement of the non-controlling interest's share of the net assets acquired in proportion to the percentage of shares held (the old IFRS 3 method); or
- Measurement of the non-controlling interest at fair value (also known as the 'full goodwill method').

It should be noted that the different methods for treating NCI's are available on a transaction by transaction basis. An entity may measure the NCI of one combination according to its share of net assets, whilst measuring the NCI of another combination using the fair value method. For each combination, the method of valuing the NCI is required to be disclosed.

Treatment of 're-acquired rights'

In some cases, the acquirer will grant a right to the acquiree as part of a business combination. Common examples include:

- Granting the acquiree the right to use branding or trademarks under a franchise agreement; or
- Granting the acquiree the right to use technology or intellectual property.

In instances where the acquirer subsequently re-acquires that right from the acquiree, the transaction must be accounted for separately from the business combination. That is, there is no adjustment to goodwill, but rather it is treated as a separate acquisition of an intangible asset.

In instances where the contract which gives rise to the re-acquired right is more/less favourable than current market terms for similar transactions, a settlement gain/loss is recognised upon re-acquisition. It should be noted that when measuring the value of a re-acquired right, only the *current contract term* is considered – despite the fact that other market participants may consider potential contract extensions in their determination of the value of the re-acquired right.

After acquisition, the re-acquired right is amortised over the remaining period of the contract in which the right was created. If the right is subsequently sold by the acquirer to a third party, then any excess/deficit over the amortised value is recognised in profit and loss.

Accounting for 'step acquisitions'

In some cases, a business combination may occur in more than one stage – for example, the acquirer may gain their controlling interest by purchasing parcels of shares over time until control is obtained. This is known as a 'step acquisition'. A step acquisition may mean that prior to control being obtained, the interest is recognised as an available-for-sale investment, an investment in an associate, or a joint venture. In these cases, the interest should be accounted for under the appropriate standard up to the point control is obtained, when IFRS 3 should then be applied.

Under the previous version of IFRS 3, step acquisitions involved assessing the cost of the combination and the fair value of net assets acquired at each stage of the combination.

Under the revised IFRS 3, acquisition accounting for a business combination is only applied once – at the time control is obtained. As a result of this approach:

- Goodwill is measured once – at the time control is obtained;
- Previous equity interests which were held by the acquirer prior to it obtaining control are re-measured at fair value on the date control is obtained, and any resulting gain or loss is recognised in profit and loss;
- If the controlling interest is increased after the date control is obtained (for example, by buying out non-controlling interests) then the transaction is accounted for as an equity transaction, and there are no further adjustments to goodwill.

Worked example 1 – Alternative measurement methods for non-controlling interests:

ABC gains control of XYZ by purchasing 75% of its shares for $1,500. The fair value of the net assets acquired is $1,000.

Under the proportional method, the value of the non-controlling interest would be $250 (25% x $1,000) and the value of the goodwill on acquisition would be $750 ($1,500 + $250 - $1,000).

Under the full goodwill method, ABC can elect to assign a fair value to the non-controlling interest. Assuming ABC determines the fair value of the non-controlling interest to be $400, goodwill of $900 would be recognised ($1,500 + $400 - $1,000).

Clearly in the second example, the value of the 25% non-controlling interest is not proportional to the 75% interest held by ABC. This discrepancy is described by IFRS 3 para. B45 as a 'control premium' or 'minority discount', which recognises that the acquirer's interest in the net assets may be enhanced by the existence of control, and the non-controlling interest may be discounted by the lack of control.

Worked example 2 – Investment becoming a subsidiary

- In 20X1, ABC acquires a 15% interest in XYZ for $10,000.
- The interest is classified as an available-for-sale financial asset, and through to 20X5 a fair value gain of $2,000 is recognised in equity.
- In 20X6, ABC acquires an additional 60% interest in XYZ for $60,000.
- The fair value of XYZ's net assets at acquisition date is $80,000.
- The non-controlling interest is measured as its percentage of net assets (25%).
- The fair value of the previously held investment is $12,500.

Accounting for the business combination:

- In 20X6, ABC recognises a $2,500 gain in the income statement:

- Gain on 'disposal' of 15% investment ($12,500 - $12,000)	$500
- Gain previously reported in equity ($12,000 - $10,000)	$2,000
	$2,500

- In 20X6, ABC recognises goodwill of $12,500:

- Fair value of consideration paid	$60,000
- Non-controlling interest ($80,000 x 25%)	$20,000
- Fair value of previous interest	$12,500
	$92,500
- Fair value of net assets	$80,000
- Goodwill	**$12,500**

Worked example 3 – Increase in the controlling interest after control has been achieved

- In 20X1, ABC acquired 75% of XYZ for $90,000
  - The net assets of XYZ were $100,000
  - Goodwill by reference to net assets was $15,000
- In subsequent years, XYZ's net assets increased to $120,000
  - The value of the non-controlling interest becomes $30,000 ($120,000 x 25%)
- In 20X6, ABC acquires the remaining 25% of XYZ for $35,000
  - The adjustment in equity is negative $5,000 ($30,000 - $35,000)

NEXIA INTERNATIONAL

For further details about the articles contained in this publication, please contact Yvonne Lang at:

Nexia Smith & Williamson
25 Moorgate, London, EC2R 6AY, UK

tel: + 44 (0) 20 7131 4000
fax: + 44 (0) 20 7131 4001
email: yvonne.lang@smith.williamson.co.uk