

iGAAP Newsletter.

IFRS – Phase II of business combinations



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New proposals for business combinations

On 30th June, the IASB published exposure drafts of proposed changes to IFRS 3, IAS 27, IAS 37 and IAS 19. The exposure drafts relate to phase II of the Board's project on business combinations, and are part of a convergence project with FASB to reduce differences between IFRS and US GAAP.

One major impact of the proposals would be to require an acquired business to be measured at the fair value of the entire entity, and accordingly for 100% of its goodwill to be recognised by the acquirer, even where less than 100% is acquired. There would also be fewer exceptions to the principle of measuring assets acquired and liabilities assumed at fair value, for example assets previously considered contingent and not recognised would be recognised and measured at fair value. Additionally, all costs associated with the acquisition would be expensed rather than treated as part of the cost of the business acquired.

The proposed amendments to IAS 37 broadly complement the IFRS 3 exposure draft. Under the proposals, certain contingent assets and liabilities that would previously only have been disclosed would now be recognised in the balance sheet as assets and liabilities.

It is proposed that many of the changes would come into effect for accounting periods beginning on or after 1 January 2007. Comments on all the exposure drafts are due by 28th October.

Major changes proposed to accounting for business combinations

The IASB has recently issued 3 exposure drafts (EDs) which would significantly amend IFRS 3 **Business Combinations**, IAS 27 **Consolidated and Separate Financial Statements**, IAS 37 **Provisions, Contingent Liabilities and Contingent Assets** and IAS 19 **Employment Benefits**.

Taken together, the EDs would change the way companies account for business combinations and minority interests (which will be renamed non-controlling interest). They would also result in certain contingent assets and liabilities that are currently only required to be disclosed being recognised in the balance sheet as assets and liabilities. See our overall view on the proposals in the opinion on page 3.

Grossing up of goodwill

One major impact of the proposals would be to require an acquired business to be measured at the fair value of the entire entity, even where less than 100% of the business is acquired. This would result in 100% of the goodwill being recognised by the acquirer. Goodwill would be allocated to the acquirer's controlling interest based on the difference between the fair value of its equity interest in the business and the fair value of its share of the net assets acquired. The balance of the goodwill would be allocated to the non-controlling interest. This change is best illustrated with an example overpage.

Example

On 1 September 20X5, company P acquires 75% (750,000 ordinary shares) of company S for £7.5m (£10 per share). In the period around the acquisition date, S's shares are trading at about £8 per share. P pays a premium over market because of the synergies it believes it will get. It is therefore reasonable to conclude that the fair value of S as a whole may not be £10m. In fact, an independent valuation shows that the value of S is £9.7m. Assuming that the fair value of the net assets acquired is £8m, goodwill is measured as follows:

	£m
Fair value of S	9.7
Less fair value of net assets acquired	(8)
Goodwill	1.7

The amount of goodwill allocated to P's controlling interest is calculated as follows:

	£m
Consideration given by P to acquire 75% interest in S ¹	7.5
Less P's share of fair value of net assets acquired (75% x £8m)	(6)
Goodwill allocated to P's controlling interest	1.5
Goodwill allocated to non-controlling interest (£1.7m - £1.5)	0.2

Contrasting the allocation of goodwill and net assets under the current and proposed requirements:

Current requirements		Proposed requirements	
Goodwill	£1.5m	Goodwill	£1.7m
Net assets	£8m	Net assets	£8m
Minority interest	£2m	Non-controlling interest	£2.2m

¹ The consideration given is presumed to be the fair value of the 75% interest acquired.

Contingent consideration

Under the proposals, the fair value of consideration paid would include the acquisition date fair value of any contingent consideration payable. The contingent consideration would be classified as either equity or debt (in accordance with IAS 32), and adjustments to provisional fair values made in the measurement period (see below). Subsequent to initial recognition, contingent consideration classified as equity would not be remeasured. Changes in fair value of contingent consideration classified as a liability that did not qualify as "measurement period" adjustments would be accounted for in accordance with either IAS 39 or IAS 37. Such changes would not impact goodwill.

As in the present IFRS 3, the measurement period would be at most one year from the date of acquisition. This is shorter than the equivalent hindsight period under IFRS 3 which runs to the end of the next accounting period.

Acquisition costs

Under the proposed amendments to IFRS 3, acquisition costs would not be treated as part of the cost of the business acquired. These costs would usually be expensed when incurred, as they represent payment for services (e.g. legal costs), rather than assets of the acquiring company.

Transactions with non-controlling interest

Under the proposed amendments to IAS 27, minority interests would be re-named non-controlling interest. Changes in ownerships that did not result in loss of control of a subsidiary would be accounted for as transactions with shareholders. As such, these transactions would not result in gains and losses being recognised in profit or loss. They would instead be recognised in equity. Specifically, acquisitions and disposals of non-controlling interest that did not result in a change of control would not have any impact on goodwill.

Stepped acquisitions

Accounting for subsidiaries acquired in stages would change under the proposals. If a company owned an associate, and increased its holding such that it obtained control, the acquirer would first remeasure its associate to fair value, with a corresponding gain or loss recognised in profit or loss. Alternatively, if the acquirer recognised changes in the value of its investment in equity (for example as an available-for-sale asset), these amounts would be recycled into profit or loss. Thereafter the acquisition would be treated as other acquisitions, except that the fair value of the consideration transferred would include the acquisition date fair value of the associate. Again, this is best illustrated with an example:

Example

Company P purchases a 35% interest in company S for £2,000. P uses the equity method to account for S. Assume that P's Share of A's income from 1 January 2006 to 31 December 2007 is £500, so that the book value of P's interest in S at the end of 2007 is £2,500. On 31 December 2007, P purchases an additional 40% of S for £4,000, when the fair value of the entire business of S is £10,000, and the fair value of 35% of S is £3,500.

On 31 December 2007, P's existing 35% interest in S is remeasured to £3,500, resulting in a gain of £1,000 (£3,500 less the £2,500 book value) in the income statement. P would then account for the acquisition as a business combination where the fair value of 100% of A is £10,000, and the fair value of 75% is £7,500. If P purchases additional interests in S in the future, they would be accounted for as equity transactions – no assets or liabilities would be remeasured to fair value and no gains or losses would be recognised.

Contingent assets and liabilities

Under the proposed amendments to IAS 37, the terms 'provision' and 'contingent liability' would be replaced by the term 'non-financial liability'. Liabilities for which the settlement amount is contingent on one or more uncertain future events would be recognised independently of the probability of the uncertain future event(s) occurring. The uncertainty would be reflected in the measurement of the liability.

Example

A company is being sued for damages, which it is disputing. The litigation is not expected to succeed. Under existing requirements (both UK and IFRS), a contingent liability would just be disclosed, the only provision being related to the potential legal cost of defending the case. Under the proposals, a non-financial liability would be recognised. The measurement of the liability would reflect the possible outcomes of the lawsuit, the cash flows associated with those outflows, and the timing, probability and variability of the cash flows.

The amendments also eliminate the term 'contingent asset'. Items that were previously contingent assets, but that meet the definition of an asset would be within the scope of IAS 38 **Intangible Assets** (except for reimbursement rights, which remain within the scope of IAS 37).

Restructuring costs

The proposed changes to IAS 37, and consequentially to IAS 19, would require recognition of a non-financial liability for a restructuring cost only when the definition of a liability has been met, i.e. where there is a constructive obligation to another party. The amended IAS 37 would no longer give specific guidance on restructuring costs. Instead, there would be a general principle that non-financial liabilities should only be recognised when there is a constructive obligation. Thus a liability may be recognised later than under the current requirements.

The amendments to IAS 19 give specific guidance on termination benefits in line with the changes to IAS 37. Under the proposals, liabilities for voluntary termination benefits would be recognised when accepted by the employee. Involuntary termination benefits would be recognised when the company has communicated its plan to the employees, and the plan meets certain criteria. There is however an exception where termination benefits are provided in return for future services. In such cases, the benefits would be accrued over the service period.

Who do the proposals affect and when would they apply?

These exposure drafts would impact the consolidated financial statements of all listed companies and any companies preparing financial statements under IFRS. It is proposed that most of the changes would be effective for annual periods beginning on or after 1 January 2007, with earlier application encouraged.

Companies reporting under UK GAAP should be aware that the ASB has issued a press release stating that it intends to release UK equivalents of these EDs in the near future. The ASB's preface to these FREDs will draw attention to certain aspects of the IASB's proposals which cause the ASB concern.

Opinion

The exposure drafts also set out the concerns of dissenting board members. Whilst we cannot fault the theory behind the proposals, we share some of the concerns expressed. The proposals do take us a long way from established practice. The way in which acquisitions would be reflected is not intuitive and we question whether these changes will improve the understandability of financial statements.

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