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Proposals released on Accounting for Business Combinations

On June 30 this year, the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board published joint proposals to improve and align the accounting for business combinations. The IASB has published its proposals as draft amendments to IFRS 3 **Business Combinations**. At the same time, the IASB has proposed complementary amendments to IAS 27 **Consolidated and Separate Financial Statements,** IAS 37 **Provisions, Contingent Liabilities and Contingent Assets**, and IAS 19 **Employee Benefits**.

The principal proposals are examined in detail in this newsletter. Several involve quite radical changes. Taken together, the exposure drafts would change the way entiities account for business combinations and minority interests (which would be re-named non-controlling interests). 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.

The proposals are expected to provoke significant debate. The way in which acquisitions and transactions with non-controlling interests would be reflected under the proposed model is not intuitive for many accountants and would take us a long way from established practice. We therefore encourage readers to spend some time considering the proposals, and their potential impact in practice.

If accepted, most of the proposed changes would come into effect from 1 January 2007. The IASB has requested comments on all the exposure drafts on or before 28 October 2005.

Business combinations (IFRS 3)

Terminology

The proposed changes to IFRS 3 and IAS 27 (see next section) introduce the term 'non-controlling interest' in place of the current term 'minority interest'. This change reflects the view that such interests are a component of equity. They are considered part of the ownership interest in the consolidated group, because they do not meet the definition of a liability in the **Framework for the Preparation and Presentation of Financial Statements**. However, nothing in the Exposure Draft (ED) would prevent entities using the description 'minority interest' in their financial statements, should they wish to do so.

Principal changes

The changes proposed for IFRS 3 are numerous and complex. The following table highlights the main changes, the most significant of which are discussed in the subsequent paragraphs.

Current version of IFRS 3	Proposed changes
Business combinations are recognised and measured at the acquisition date on the basis of the accumulated cost of the combination for the acquirer.	Business combinations would be recognised and measured as of the acquisition date at the full fair value of the acquiree. This principle would apply even if the business combination is achieved in stages, or if less than 100 per cent of the equity interests in the acquiree are owned by the acquirer at the acquisition date.
Direct costs of the business combination are included in the cost of acquisition.	Such costs would be accounted for separately from the business combination accounting – i.e. generally expensed as incurred.
Contingent consideration is included in the measurement of the cost of the business combination at the acquisition date only if it is probable and if it can be measured reliably. Subsequent changes in the estimate of contingent consideration are treated as adjustments to goodwill.	Contingent consideration arrangements would be recognised at fair value as of the acquisition date. Subsequent changes in the fair value of contingent consideration classified as liabilities would be recognised in accordance with IAS 39, IAS 37 or other Standards, as appropriate, with a consequential effect on profit or loss.
Goodwill is the difference between the cost of the interest acquired and the acquirer's proportionate interest in the fair value of the identifiable assets acquired and liabilities assumed.	In business combinations in which the acquirer holds less than 100 per cent of the equity interests in the acquiree at the acquisition date, goodwill would be measured as the difference between the fair value of the acquiree, as a whole, and the fair value of the identifiable assets acquired and liabilities assumed.

Contingent consideration arrangements would be recognised at fair value as of the acquisition date.

And all of this means ...? The following paragraphs explore some of the most important implications of the proposed changes.

Grossing up of goodwill

100 per cent of the acquiree's goodwill would be recognised in the consolidated financial statements, even where less than 100 per cent of the subsidiary is held.

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 per cent of the business is acquired. This would result in 100 per cent of the acquiree's goodwill being recognised in the consolidated financial statements. Goodwill would generally 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 illustrated in Example 1 on the next page.

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 **Financial Instruments: Disclosure and Presentation**), and adjustments to provisional fair values made in the measurement period (at most one year from the date of acquisition). 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.

Acquisition costs

Acquisition costs would usually be expensed when incurred, as they represent payments for services (e.g. legal costs), rather than assets of the acquiring entity.

Under the proposed amendments, 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 payments for services (e.g. legal costs), rather than assets of the acquiring entity. This proposal differs from accepted practices that allow direct acquisition-related costs to be included in the costs of certain acquired assets (e.g. property, plant and equipment).

Example 1

On 1 September 2007, A Limited acquires 75% (750,000 ordinary shares) of B Limited for CU7.5m (CU10 per share). In the period around the acquisition date, B Limited's shares are trading at about CU8 per share. A Limited pays a premium over market because of anticipated synergies. It is therefore reasonable to conclude that the fair value of B Limited as a whole may not be CU10m. In fact, an independent valuation shows that the value of B Limited is CU9.7m. Assuming that the fair value of the net assets acquired is CU8m, goodwill is measured as follows:

	CUm
Fair value of B Limited	9.7
Less fair value of net assets acquired	(8.0)
Goodwill	1.7

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

Consideration given by A Limited to acquire 75% interest in B Limited[1]	7.5
Less A Limited's share of fair value of net assets acquired (75% x CU8m)	(6.0)
Goodwill allocated to A Limited's controlling interest	1.5
Goodwill allocated to non-controlling interest (CU1.7m – CU1.5)	0.2

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

Current requirements		**Proposed requirements**	
Goodwill	CU1.5m	Goodwill	CU1.7m
Net assets	CU8m	Net assets	CU8m
Minority interest	CU2m	Non-controlling interest	CU2.2m

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

In step acquisitions, the consideration would include the acquisition date fair value of existing holdings.

Step acquisitions

Accounting for subsidiaries acquired in stages would change under the proposals. If an entity 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. 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. This is best illustrated with an example.

Example 2

A Limited holds a 35% interest in B Limited. The carrying amount of A Limited's interest in B Limited at the end of 2007 is CU2,500. On 31 December 2007, A Limited purchases an additional 40% of B Limited for CU4,000, when the fair value of the entire business of B Limited is CU10,000, and the fair value of 35% of B Limited is CU3,500.

On 31 December 2007, A Limited's existing 35% interest in B Limited is remeasured to CU3,500, resulting in a gain of CU1,000 (CU3,500 less the CU2,500 carrying amount) in the income statement. A Limited would then account for the acquisition as a business combination where the fair value of 100% of B Limited is CU10,000, and the fair value of 75% is CU7,500.

If A Limited were to purchase additional interests in B Limited in the future, they would be accounted for as equity transactions – no assets or liabilities would be remeasured to fair value, and no additional goodwill or gains or losses would be recognised.

Consolidation (IAS 27)

The changes to IAS 27 derive principally from the conclusion that interests previously described as minority interests ('non-controlling' interests) are a component of equity. Consequently, transactions with such interests are considered to be transactions with equity participants which should be reflected in equity, and which do not give rise to a profit or loss unless they result in a loss of control.

Transactions with non-controlling interests would be accounted for as transactions with equity participants which do not give rise to a profit or loss unless they result in a loss of control.

Note that the accounting guidance proposed for the loss of control of a subsidiary would also extend to events or transactions in which an investor loses significant influence over an associate or joint control over a joint venture.

Change in interest in a subsidiary that does not result in a loss of control

Following the proposed revisions, IAS 27 would require that changes in the parent's ownership interest in a subsidiary that do not result in loss of control of the subsidiary should be accounted for as transactions with equity holders in their capacity as equity holders.

Therefore, such changes would not result in a gain or loss being recognised in profit or loss. Also, no change in the carrying amounts of assets (including goodwill) or liabilities would be recognised as a result of such transactions. Any difference between the fair value of the consideration paid in the transaction and the amount by which the non-controlling interest is increased or reduced would be recognised directly in equity and attributed to the equity holders of the parent.

Example 3

A Limited owns 80 percent of its subsidiary, and carries its net assets at CU100. Assume the parent's interest is CU80 and the non-controlling interest in the subsidiary is CU20. A Limited buys out the remaining 20 percent of the subsidiary for CU30.

Under the proposals, the journal entries would be as follows:

	Debit	Credit
Non-controlling interest in subsidiary (a component of consolidated equity)	CU20	
Equity attributable to the equity holders of the parent	CU10	
Cash		CU30

In this example, the excess recognised as an adjustment to the consolidated equity attributable to the equity holders of the parent reflects the premium paid by the parent entity in excess of the carrying amount of the 20 per cent ownership interest acquired. The ED does not specify where in equity this charge/credit should appear – possibly as additional paid-in capital, or as some sort of "consolidation" reserve.

Example 4

B Limited owns 80 per cent of its subsidiary and carries its net assets at CU120. Assume the parent's interest is CU96 and the non-controlling interest in the subsidiary is CU24. B Limited disposes of one-quarter of its shareholding (i.e. 20 per cent of the subsidiary) for CU40, and retains control of the subsidiary.

Under the proposals, the journal entries would be as follows:

	Debit	Credit
Cash	CU40	
Non-controlling interest in subsidiary		CU24
Equity attributable to the equity holders of the parent		CU16

Although not specifically dealt with in Standards currently, common practice in the above scenario would be to recognise a gain of CU16 in profit or loss. The revised Standard would not allow the recognition of a gain as it results from a transaction with an equity participant.

Measurement of the gain or loss arising on the loss of control over a subsidiary

The ED proposes that the gain or loss arising on the loss of control over a subsidiary is measured as the difference between:

- the aggregate of the fair value of the proceeds, if any, from the transaction or event that resulted in the loss of control and the fair value of any investment remaining in the former subsidiary at the date control is lost; and
- the aggregate of the parent's interest in the carrying amount in the consolidated financial statements of the former subsidiary's net assets immediately before control is lost.

Example 5

During the period, A Limited disposed of part of its shareholding in B Limited, so that its interest was reduced from 100% to 40%, and A Limited lost control of B Limited. The investment will be accounted for as an associate following the transaction.

On the date of disposal, the carrying amount of B's net assets in A Limited's consolidated financial statements was CU800. Proceeds of disposal for the 60% interest were CU500. The fair value of the residual 40% holding was CU400.

The consolidated gain on disposal is calculated as follows:

	CU
Cash proceeds	500
Add: fair value of retained investment	400
	900
Less: carrying amount of net assets of B Limited	800
Gain on disposal	100

Under the current version of IAS 27, for the purposes of the above calculation, common practice is to calculate the gain or loss on disposal as the difference between the proceeds (CU500) and the carrying amount of the proportion of the net assets disposed of (CU800 x 60% = CU480). Therefore, the proposals would impact the gain or loss recognised by taking into account the fair value of the residual interest.

The proposals would impact the gain or loss recognised on the loss of control over a subsidiary by taking into account the fair value of the residual interest.

Remeasurement of any residual interest held after the loss of control over a subsidiary

Under the proposals, following the loss of control of a subsidiary, any investment remaining in the former subsidiary would be accounted for from the date control is lost in accordance with IAS 39 **Financial Instruments: Recognition and Measurement**, IAS 28 **Investments in Associates** or IAS 31 **Interests in Joint Ventures** as appropriate.

The fair value of the remaining investment at the date of loss of control would be regarded as the fair value on initial recognition of a financial asset in accordance with IAS 39 or, when appropriate, the cost on initial recognition of an investment in an associate or jointly controlled entity.

In Example 5, the residual interest has effectively been remeasured to fair value. The fair value of CU400 is dealt with as the cost on initial recognition of the associate for the purposes of IAS 28.

... losses applicable to non-controlling interests would be attributed to those interests, even if doing so would result in a non-controlling interest being reported as a deficit.

Losses applicable to the non-controlling interest

The current version of IAS 27 states that losses attributable to the minority (non-controlling) interest in excess of the minority's interest in the subsidiary's equity are allocated against the majority interest except to the extent that the minority has a binding obligation and is able to make an additional investment to cover the losses.

Under the revised Standard, losses applicable to non-controlling interests would be attributed to those interests, even if doing so would result in a non-controlling interest being reported as a deficit.

Non-financial liabilities (IAS 37)

Terminology

The proposed changes to IAS 37 would once again result in a change in terminology in this area. Firstly, the term "provision" used in the current version of IAS 37 would be replaced by "non-financial liability". In fact, the title of the revised IAS 37 would be changed to "Non-financial liabilities". Essentially, this proposed change is intended to clarify that the revised Standard would be wider in scope than IAS 37 and would apply to all non-financial liabilities that are not within the scope of other Standards.

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Secondly, the terms "contingent asset" and "contingent liability" would be abandoned, in favour of the term "contingency". This proposed change reflects the IASB's view that items meeting the definition of assets or liabilities for which the settlement amount is contingent on one or more uncertain future events should be recognised independently of the probability of the uncertain future event(s) occurring. The uncertainty would be reflected in the measurement of the asset or the liability.

Again, nothing in the proposals would prevent existing terms, or other descriptive terms, being used in the financial statements.

Example 6

An entity is being sued for damages, which it is disputing. The litigation is not expected to succeed. Under existing requirements, assuming that the possibility of success was more than remote, a contingent liability would be disclosed, but no provision would be recognised (except in relation to the potential legal cost of defending the case), because it is not probable (i.e. it is not 'more likely than not') that an outflow of resources will occur.

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 outcomes, and the timing, probability and variability of cash flows.

Items previously described as contingent assets that satisfy the definition of an asset would in future fall within the scope of IAS 38 **Intangible Assets** (except for reimbursement rights, which would remain within the scope of IAS 37).

Measurement principle

The ED proposes that non-financial liabilities should be measured at the amount that an entity would rationally pay to settle the present obligation or transfer it to a third party on the balance sheet date (i.e. an 'exit value').

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The proposals continue to support the use of expected cash flow estimation techniques but, in contrast to the current version of IAS 37, support the use of such techniques for measuring single obligations as well as classes of similar obligations. This could result in significantly different answers in practice.

Note that the proposals do not include any 'reliably measureable' requirement for non-financial liabilities, which is likely to be controversial.

Future events

IAS 37 currently specifies that, in measuring non-financial liabilities, future events should be taken into account if there is sufficient objective evidence that they will occur. The ED, in contrast, requires the inclusion of the impact of all future events that may effect the amount that will be required to settle the obligation. This proposed change would impact in areas such as assumptions about future changes in technology. Currently, for example, in measuring an obligation to clean up environmental damage, an entity is not permitted to anticipate the development of a completely new technology for cleaning-up unless there is sufficient objective evidence as regards that development. Under the proposals, assumptions would be made about future developments in technology and probabilities would be attached to those anticipated future developments reflecting the likelihood that they will occur.

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... the requirement for the reimbursement to be "virtually certain" would be removed.

Reimbursements

IAS 37 currently states that when expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement should be recognised when it is virtually certain that the reimbursement will be received. Consistent with the revised analysis of a contingent asset, the ED proposes that if an entity has an unconditional right to receive reimbursement, that right should be recognised as an asset if it can be measured reliably. Therefore, the requirement for the reimbursement to be "virtually certain" would be removed.

The amended IAS 37 would no longer give specific guidance on restructuring costs, so that the appropriate accounting treatment would be determined by reference to the general principle.

Restructuring costs

Proposed changes to IAS 37 would require recognition of a non-financial liability for a restructuring cost only when the definition of a liability has been met, i.e. when there is an actual or a constructive obligation to another party. The amended IAS 37 would no longer give specific guidance on restructuring costs, so that the appropriate accounting treatment would be determined by reference to the general principle.

Termination benefits (IAS 19)

The proposed amendments to IAS 19 would amend the definition of termination benefits so as to clarify that benefits that are payable in exchange for an employee's decision to accept voluntary redundancy are termination benefits only if they are offered for a short period. Other employee benefits that are offered to encourage employees to leave service before normal retirement date are post-employment benefits.

The proposed amendments would also give specific guidance on termination benefits, in line with the proposed changes to IAS 37.

The proposed amendments would also give specific guidance on termination benefits, in line with the proposed 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 entity 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.

Effective dates

If accepted, most of the proposed changes would come into effect from 1 January 2007, with limited scope for early adoption.

Amendments to IFRS 3

As is always the case with business combinations, the proposals on effective dates and transition requirements are complex. Generally, the proposed changes would come into effect for business combinations for which the acquisition date is on or after the beginning of the first annual period beginning on or after 1 January 2007. Therefore, for December year-end entities, the changes would impact combinations on or after 1 January 2007.

Earlier application would be encouraged – but only from the beginning of an accounting period beginning on or after the date of release of the final revised Standard. Therefore, if the revised Standard is issued, as expected, in the second half of 2006, entities with an accounting period beginning between the date of issue and 1 January 2007 will have the option of early adoption.

Application would be prospective (i.e. no restatement of previous business combinations) with very limited exceptions for specific categories of assets and liabilities.

Amendments to IAS 27

The ED does not specify an effective date – but we would expect any revised Standard to apply for annual periods beginning on or after 1 January 2007. Earlier application would be encouraged – but entities would not be permitted to apply the revisions to IAS 27 early, unless they also applied the changes to IFRS 3 and IAS 37 from the same date. As noted above in relation to the revised IFRS 3, the scope for early application would in practice be very limited.

The revised requirements of IAS 27 discussed in this newsletter would be applied prospectively – therefore, there would be no restatement of transactions occurring before the date of adoption of the revised Standard.

Amendments to IAS 37 and IAS 19

The revised Standards would be applied prospectively for accounting periods beginning on or after 1 January 2007. Earlier application would be encouraged – but only from the beginning of an accounting period beginning on or after the date of release of the final revised Standard. Therefore, if the revised Standard is issued, as expected, in the second half of 2006, entities with an accounting period beginning between the date of issue and 1 January 2007 will have the option of early adoption.

No restatement of comparative information would be permitted.

Comment deadline

A final reminder – the matters discussed above are only proposals, and they are likely to be the subject of quite heated debate.

The comment deadline is 28 October 2005.

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