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IASB revises IFRS 3 and IAS 27

On 10 January 2008, the International Accounting Standards Board (IASB) issued IFRS 3 (revised 2008) **Business Combinations** and IAS 27 (revised 2008) **Consolidated and Separate Financial Statements**. The revised Standards are mandatory for business combinations in annual financial statements beginning on or after 1 July 2009, although limited earlier application is permitted (see below). The revisions will result in a high degree of convergence between International Financial Reporting Standards (IFRSs) and US Generally Accepted Accounting Principles (GAAP), although some inconsistencies remain, which may result in significantly different financial reporting.

Overview

The revised Standards promise significant change, including:

- a greater emphasis on the use of fair value, potentially increasing the judgement and subjectivity around business combination accounting, and requiring greater input by valuation experts;
- focussing on changes in control as a significant economic event – introducing requirements to remeasure interests to fair value at the time when control is achieved or lost, and recognising directly in equity the impact of all transactions between controlling and non-controlling shareholders not involving a loss of control; and
- focussing on what is given to the vendor as consideration, rather than what is spent to achieve the acquisition. Transaction costs, changes in the value of contingent consideration, settlement of pre-existing contracts, share-based payments and similar items will generally be accounted for separately from business combinations and will generally affect profit or loss.

The revised Standards resolve many of the more contentious aspects of business combination accounting by restricting options or allowable methods. As such, they should result in greater consistency in accounting among entities applying IFRSs.

The following pages outline the major changes in IFRS 3 and IAS 27. The appendix to this newsletter provides a more detailed analysis and comparison with predecessor Standards.

Effective date and transition

The two revised Standards are mandatory for accounting periods beginning on or after 1 July 2009. In the case of IFRS 3, this will apply to business combinations in those periods. Early adoption is permitted provided that:

- both Standards are applied together;
- the revised IFRS 3 is not applied in an accounting period beginning before 30 June 2007; and
- early adoption is disclosed.

IFRS 3: what's changed?

Acquisition-related costs

In what is likely to be an unpopular move with preparers, the IASB has determined that costs incurred in an acquisition are period costs. This means that all acquisition-related costs (e.g. finder's fees; advisory, legal, accounting, valuation, and other professional or consulting fees; and general administrative costs, including the costs of maintaining an internal acquisitions department) are to be recognised as period expenses in accordance with the appropriate IFRS. Costs incurred to issue debt or equity securities will be recognised in accordance with IAS 39 Financial Instruments: Recognition and Measurement.

Step acquisitions

Changes to IAS 27 and IFRS 3 work together with the effect that a business combination leading to acquisition accounting applies only at the point where control is achieved. This has a number of implications:

- 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 Investments in Associates or IAS 31 Interests in Joint Ventures, 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(r2008) 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 (see below). Goodwill does not arise on any increase, and no gain or loss is recognised on any decrease.

Goodwill

The acquirer recognises goodwill at the acquisition date, measured as the difference between:

- the aggregate of:
  - the acquisition-date fair value of the consideration transferred;
  - the amount of any non-controlling interest (NCI) in the entity acquired; and
  - 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(r2008).

Non-controlling interests (minority interests)

In a controversial change from the Exposure Draft, IFRS 3(r2008) has an explicit option, available on a transaction-by-transaction basis, to measure any non-controlling interest (NCI) in the entity acquired either at fair value or at the non-controlling interest's proportionate share of the net identifiable assets of the entity acquired. The latter treatment corresponds to the measurement basis in the current version of IFRS 3.

For the purpose of measuring NCI 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 NCI using other valuation techniques.

The US equivalent standard, SFAS 141R, requires the NCI to be measured at fair value and does not allow any alternative.

Contingent consideration

IFRS 3(r2008) requires the consideration for the acquisition to be measured at fair value at the acquisition date. This includes the fair value of any contingent consideration payable. IFRS 3(r2008) 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 research and development project) are recognised in profit or loss.

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.

Reassessments

IFRS 3 (r2008) 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. Consideration will be required as to how financial instruments are classified, whether embedded derivatives exist (which the acquiree may not have previously recognised) and whether hedge accounting performed by the acquiree will continue to be highly effective by the acquirer.

IAS 27: what's changed?

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 NCI and the fair value of the consideration paid or received is recognised directly in equity and attributed to the owners of the parent.

Loss of control

A parent can lose control of a subsidiary through a sale or distribution, or through some other transaction or event in which it takes no part (e.g. expropriation or the subsidiary being placed in administration or bankruptcy).

When control is lost, the parent derecognises all assets, liabilities and NCI 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.

Attribution of profit or loss to non-controlling interests

The revised Standard requires an entity to attribute their share of total comprehensive income to the NCI even if this results in the NCI having a deficit balance.

Loss of significant influence or joint control

Amendments to IAS 28 and IAS 31 extend the treatment required for loss of control to these Standards. Thus, 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.

Differences remaining between IFRSs and US GAAP

With the release of IFRS 3(r2008) and IAS 27(r2008), SFAS 141R and SFAS 160, and the related changes to US GAAP, the basic principles governing business combinations and related transactions will be mostly converged. However, some important differences remain. These differences are largely, although not exclusively, a result of existing differences within the body of IFRSs and US GAAP generally that were not addressed by the IASB and the US Financial Accounting Standards Board (FASB) as part of the business combinations project. The major differences are summarised in the table below.

It is significant that in working to converge their standards, the FASB appears to have made more changes of principle than the IASB.

Changes from the Exposure Drafts

The proposed changes to IFRS 3 and IAS 27 were exposed for public comment in 2005 and attracted some very adverse comment, particularly with respect to the proposals related to transactions not involving a loss of control. These concerns were also voiced at public roundtables held by the FASB and the IASB after the comment period closed. It is evident that during their redeliberations the Boards took some notice of constituents' concerns. IFRS 3(r2008) does not focus on the fair value of the entity acquired; rather it focuses on the components of the business – assets, liabilities and other equity. Goodwill is the difference between the consideration transferred and these components. The measurement of NCI proved harder to resolve satisfactorily. The Boards have given non-controlling interests a measurement attribute, which is presumed to be fair value. However, this attribute did not command the support of the necessary majority of IASB members. Consequently, the IASB has permitted a choice, such that NCI are measured at either fair value or the NCI's share of the net identifiable assets.

Major differences remaining between IFRSs and US GAAP – business combinations and related transactions

Scope	The IASB and the FASB have different definitions of control. The IASB's definition of control is 'the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities'; the FASB's definition is based on a 'controlling financial interest', generally interpreted as an absolute majority of the voting interests. 'Control' is currently the subject of a joint FASB/ IASB project.
The definition of fair value	The IASB and the FASB use definitions of 'fair value' from previously existing Standards. The FASB definition is that in SFAS 157 **Fair Value Measurement** and the IASB uses the definition in IAS 39 **Financial Instruments: Recognition and Measurement**.
Contingencies	IFRS 3(r2008) requires recognition of a contingent liability assumed in a business combination if it is a present obligation that arises from past events and its fair value can be measured reliably. SFAS 141R requires this treatment for **contractual liabilities** only; non-contractual liabilities must be assessed as to whether it is more likely than not that the contingency gives rise to an asset or liability as defined in FASB Concept Statement 6. If the contingency meets the recognition threshold at acquisition date, it is recognised at its acquisition-date fair value.
Employee benefits	The standards each require liabilities and assets related to the acquired entity's employee benefit arrangements to be recognised and measured in accordance with the appropriate IFRS or US GAAP requirement. As these requirements are different, the amounts recognised will also be different.
Measuring NCI	SFAS 141R requires non-controlling interests to be measured at fair value. IFRS 3(r2008) provides a transaction-by-transaction choice for measuring non-controlling interests at either fair value or the proportionate interest in net assets.

Key features of revised Standards

Business Combinations

Description	IFRS 3(r2008)	Current IFRS 3
Scope of the Standard		
Mutual entities and business combinations achieved by contract alone	The scope of the revised Standard applies to these types of transactions.	Current IFRS 3 does not apply to these business combinations.
Definitions and terminology		
Business combination	"…is a transaction or other event in which an acquirer obtains control of one or more businesses."	The revised IFRS 3 places more emphasis on control over another business.
Business	"…is an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return…"	A set of integrated activities and assets that has not commenced planned principal operation is not a business.
Acquisition method	"Acquisition method" replaces the term "purchase method" and requires: (i) recognition and measurement of NCI in the entity acquired; and (ii) recognition and measurement of goodwill or bargain purchase.	The "purchase method" does not explicitly make reference to items (i) and (ii).
Contingent consideration	• Initially recognised as part of the consideration transferred. • Non-occurrence of a future event (e.g. not meeting earnings target) is not considered to be a measurement period adjustment – therefore not adjusted against goodwill. • Subsequent accounting depends on whether it is initially booked as equity or as a liability and whether the event is considered a measurement period adjustment. • Disclosure requirements.	• Initially recognised in the cost of the combination only if it meets probability and reliably measurable criteria. • If future event does not occur then any adjustments to the cost of the business combination are made against goodwill. • Subsequent adjustments to contingent consideration are made against goodwill, except in the case of equity instruments in which case the adjustment is made against equity. • No disclosure requirements regarding contingent consideration in current IFRS 3.
Consideration transferred		
Share-based payment awards	Provides guidance to assist in determining the portion of a replacement award that is part of the consideration transferred for the entity acquired.	No specific guidance.
Costs incurred in a business combination		
Acquisition costs	Costs to effect a business combination are, generally, expensed as incurred.	Costs to effect a business combination are included in the cost and therefore impact goodwill.
Recognising and measuring assets acquired and liabilities assumed on initial recognition		
Valuation allowances/provisions	Prohibits separate valuation allowance at acquisition date for assets measured at fair value but whose future cash flows are uncertain (e.g. doubtful receivables).	No specific guidance.
Assets the acquirer intends to dispose of or use in a different way from other market participants	Requires the acquirer to measure the asset at fair value.	No specific guidance.

Business Combinations (continued)

Description	IFRS 3(r2008)	Current IFRS 3
Exceptions to recognition or measurements or both on initial recognition		
Assets held for sale	Requires measurement in accordance with IFRS 5.	Current IFRS 3 requires such assets to be measured at fair value less costs to sell.
Contingent liabilities	Requires recognition of "liabilities" that meet the definition of a liability in the Framework, and only where there is a present obligation that arises from past events and its fair value can be measured reliably.	IFRS 3 currently requires recognition of possible obligations if their fair value can be measured reliably.
Employee benefits	Requires recognition and measurement in accordance with IAS 19 **Employee Benefits**.	Limited guidance in current IFRS 3 Appendix B.
Income taxes	Requires recognition and measurement in accordance with IAS 12 **Income Taxes**.	Limited guidance in current IFRS 3 Appendix B.
Indemnification assets	Requires recognition and measurement in accordance with other IFRSs.	No specific guidance.
Reacquired rights	Requires measurement based on the remaining term of the related contract.	No specific guidance.
Share-based payment awards	Requires measurement in accordance with IFRS 2 **Share-based payment**.	No specific guidance.
Acquisition method		
Measuring goodwill/ bargain purchase transactions	Difference between: (i) the consideration transferred at acquisition date, plus the amount of any NCI, plus acquisition date fair value of any previously-held equity interest in entity acquired; and (ii) the net of acquisition date amounts of identifiable assets acquired and liabilities assumed. If: (i) > (ii) = difference is goodwill; (i) < (ii) = bargain purchase is recognised in profit and loss.	Current IFRS 3 does not require: (i) measurement of any amount of NCI in calculating goodwill/ bargain purchase; (ii) remeasurement to fair value of any previously-held equity interest in the entity acquired; and (iii) the acquisition date amount of net assets acquired. Instead it considers the portion of the net identifiable assets attributable to the acquirer.
NCI in the acquire	NCI is required to be measured when determining the goodwill/ bargain purchase. NCI can be measured either using: (i) fair value of NCI; or (ii) proportionate interest of the fair value of net identifiable assets of the entity acquired.	Minority interest is stated at the minority's portion of the fair value of the net assets acquired and (contingent) liabilities assumed.
Business combinations achieved in stages (step acquisition)	• At the date of obtaining control, the acquirer remeasures any previously-held equity interest to fair value. • At the acquisition date, any previous revaluations to equity are treated as if the acquirer had disposed of its previously-held interest.	• Each transaction is treated separately by the acquirer. • The cost and fair value information at the date of each acquisition is used to determine the related goodwill.

Consolidated and Separate Financial Statements

Description	IAS 27(r2008)	Current IAS 27
Increases or decreases in a parent's ownership interest that do not result in a loss of control	Accounted for as equity transactions of the consolidated entity.	Silent on appropriate accounting treatment.
Attribution of acquired entity's losses to non-controlling interest	Losses are allocated to a NCI even if they exceed the NCI's share of equity in the subsidiary.	IAS 27 currently requires excess losses to be allocated to the parent, unless the minority interest has a binding obligation to make good the losses.
Loss of control of a subsidiary	Any retained non-controlling investment at the date control is lost is remeasured to fair value.	IAS 27 currently regards the carrying amount at the date the entity ceases to control the subsidiary as the cost.

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