IFRS 3, BUSINESS COMBINATIONS (REVISED)

RELEVANT TO PAPERS F7 (INT) AND P2 (INT)

The first phase of the work of the International Accounting Standards Board (IASB) on business combinations led to the issue of IFRS 3, *Business Combinations* in March 2004. The second phase led to the issue of a revised standard with the same title in January 2008. This is the culmination of a joint project with the Financial Accounting Standards Board (FASB), the US standards setter, and is designed to improve financial reporting and international convergence. The Standard has also led to minor changes in IAS 27, *Consolidated and Separate Financial Statements*. The requirements of IFRS 3 come into effect only 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 1 July 2009 (early application is permitted). However, the issue date of the standard means that it will be examinable from December 2008. This article highlights the changes from the previous standard and, in particular, shows how they will affect the Paper F7, *Financial Reporting* exam.

This article applies to exam papers based on International Financial Reporting Standards (IFRS). It may be of interest to candidates studying UK-based papers, but it is not examinable for these papers.

MAIN CHANGES TO PAPER F7

The main changes that students of Paper F7 should be aware of are:

- new restrictions on the expenses that can form part of the acquisition costs
- revisions of the treatment of contingent consideration
- measurement of non-controlling interests (NCI – the new name for minority interests) and the knock-on effect that this has on consolidated goodwill
- considerable guidance on recognising and measuring the identifiable assets and liabilities of the acquired subsidiary, in particular the illustrative examples discuss several intangibles, such as market-related, customer-related, artistic-related and technology-related assets.

There are also changes to the accounting for a business combination achieved in stages, and to the accounting for the acquisition and disposal of shares in a subsidiary. These are **not** examinable in Paper F7, but they may be in Paper P2, *Corporate Reporting*.

Acquisition costs

In the previous IFRS 3, directly related acquisition costs such as professional fees (legal, accounting, valuation, etc) could be included as part of the cost of the acquisition. This has now been stopped and such costs must be expensed. The costs of issuing debt or equity are to be accounted for under the rules of IAS 39, *Financial Instruments: Recognition and Measurement*.

Contingent consideration

IFRS 3 defines contingent consideration as: 'Usually, an obligation of the acquirer to transfer additional assets or equity interests to the former owners of an acquiree as part of the exchange for control of the acquiree if specified future events occur or conditions are met. However, contingent consideration also may give the acquirer the right to the return of previously transferred consideration if specified conditions are met'.

The previous version of IFRS 3 required contingent consideration to be accounted for only if it was probable that it would become payable.

The revised standard requires the acquirer to recognise the acquisition-date fair value of contingent consideration as part of the consideration for the acquiree. This 'fair value' approach is consistent with the way in which other forms of consideration are valued, and fair value is defined as: 'The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction'.

Applying this definition to contingent consideration is not easy 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 under the rules of IAS 32, *Financial Instruments: Presentation*, or other applicable standard.

Changes in the fair value of any contingent consideration after the acquisition date are also discussed in the standard. If the change is due to additional information obtained after the acquisition date that affects the facts or circumstances as they existed at the acquisition date, this is treated

as a 'measurement period adjustment' and the liability (and goodwill) are remeasured. This is effectively a retrospective adjustment and is rather similar to an adjusting event under IAS 10, *Events After the Reporting Period*. However, changes due to events after the acquisition date (for example, meeting an earnings target which triggers a higher payment than was provided for at acquisition) are treated as follows:

- Contingent consideration classified as equity shall not be remeasured, and its subsequent settlement shall be accounted for within equity (eg Cr share capital/share premium Dr retained earnings).
- Contingent consideration classified as an asset or a liability that:
  - is a financial instrument and is within the scope of IAS 39 shall be measured at fair value, with any resulting gain or loss recognised either in profit or loss, or in other comprehensive income in accordance with that IFRS
  - is not within the scope of IAS 39 shall be accounted for in accordance with IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, or other IFRSs as appropriate.

Note that although contingent consideration is usually a liability, it may be an asset if the acquirer has the right to a return of some of the consideration transferred if certain conditions are met.

Goodwill and the non-controlling interest

The standard now allows the acquirer (parent) to measure any non-controlling interest (NCI) in one of two ways:

- at fair value (the 'new' method)
- at the NCI's proportionate share of the acquiree's (subsidiary's) identifiable net assets (this is the 'old' method).

The rationale of the 'new' method

It has long been argued (mainly by academics) that the traditional ('old') method of calculating goodwill only recognises the goodwill acquired by the parent, and is based on the parent's ownership interest rather than the goodwill controlled by the parent. In other words, any goodwill attributable to the NCI is not recognised.

EXAMPLE 1

Old method

Parent pays $100m for 80% of Subsidiary which has net assets with a fair value of $75m.

Goodwill of $40m (100m - (80% x $75m)) would be recognised, and the NCI would be $15m (20% x $75m).

Hypothetically, if we presumed that purchasing 100% of Subsidiary would have cost proportionately more, the consideration would have been $125m ($100m/80%) and goodwill would then be $50m ($125m - $75m) and there would be no NCI.

This demonstrates that, where an NCI exists, the traditional consolidation method only records the parent's share of the goodwill, and the NCI 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.

New method

Progressing the above example, assuming that the value of the goodwill of the NCI is proportionate to that of the parent, consolidated goodwill of $50m would be recognised (this includes both the controlling ($40m) and the NCI ($10m) in goodwill) and the NCI would be $25m ($15m + $10m attributed goodwill). In effect, consolidated goodwill and the NCI are 'grossed up' by the NCI share of goodwill ($10m, in this case).

Although this may seem new, it is in fact an extension of the methodology in IAS 36, *Impairment of Assets* when calculating the impairment of goodwill of a cash generating unit (CGU) where there is an NCI.

EXAMPLE 2

Parent owns 80% of Subsidiary. The consolidated statement of financial position contains the following amounts relating to Subsidiary (a CGU) at 31 March 2008:

	$
Identifiable net assets of Subsidiary	500
Consolidated goodwill (Parent share only – old method)	160
	660
NCI (20% x 500)	100

An impairment review of Subsidiary was conducted at 31 March 2008.

Required

Calculate the impairment loss and show how it would be allocated if the recoverable amount of Subsidiary at 31 March 2008 was:

(i) $450
(ii) $550

Answer

(i) As the recoverable amount of the CGU as a whole is $450, some of this must relate to the (unrecognised) goodwill of the NCI. Therefore, IAS 36 requires a notional adjustment for the goodwill of the NCI, before being compared to the recoverable amount of $450.

	Goodwill	Net assets	Total
Carrying amount – re Parent	160	500	660
Notional adjustment re NCI (see below)	40		40
	200	500	700
Recoverable amount			(450)
Impairment loss			250

If the goodwill of Parent is $160 and this represents 80%, then the goodwill attributable to the NCI is $40 ($160 x 20%/80%).

This impairment loss is first allocated to $200 goodwill (eliminating it) and the remainder $50 ($250 - $200) to the identifiable net assets, leaving a carrying amount of $450 ($500 - $50), which is now equal to the recoverable amount of the CGU. In this example we could have intuitively written the goodwill off and reduced the net assets to $450 without going through the notional adjustment of the 'grossing up' exercise.

(ii) If the recoverable amount is $550, then after grossing up the impairment loss would be only $150 ($700 - $550). This is first applied to goodwill but, as only Parent's share of goodwill is recognised, only 80% of the loss is applied, giving:

	$
Net assets	500
Goodwill (160 - (150 x 80%))	40
	540
NCI (20% x 500)	100

From this it can be seen that the carrying amount of the CGU is now $540, which is less than the recoverable amount ($550) of the CGU. This is because the recoverable amount takes into account the unrecognised goodwill of the NCI which would be $10 (($200 unimpaired goodwill - $150 impairment) x 20%).

The problem with this methodology is that goodwill (or what is subsumed within it) is a very complex item. If asked to describe goodwill, traditional aspects such as product reputation, skilled workforce, site location, market share, and so on, all spring to mind. These are perfectly valid, but in an acquisition, goodwill may contain other factors such as a premium to acquire control, and the value of synergies (cost savings or higher profits) when the subsidiary is integrated within the rest of the group. While the NCI can legitimately lay claim to its share of the more traditional aspects of goodwill, it is unlikely to benefit from the other aspects, as they relate to the ability to control the subsidiary.

Thus, it may not be appropriate to value the NCI's share of goodwill proportionately with that of the parent.

The revised IFRS 3 seeks to resolve this problem (under the 'new' method) by requiring the NCI to be measured at its 'fair value', rather than at 'its proportionate share of the (fair value of the) acquiree's identifiable net assets'. The difference between these two values is, effectively, the NCI share of goodwill which may or may not be proportionate to the parent's share of goodwill.

The standard illustrates the calculation of consolidated goodwill as: 'Consideration paid by parent + non-controlling interest - fair value of the subsidiary's net identifiable assets = consolidated goodwill'.

Note that the NCI in the above formula may be valued at its proportionate share of the subsidiary's net identifiable assets, in which case consolidated goodwill would be that relating to the parent only (the 'old' method). Alternatively, the NCI may be at its fair value (the 'new' method), in which case the consolidated goodwill represents that of both the parent and the NCI.

The formula represents a different approach to the previous, more traditional, method of calculating goodwill which was calculated as the difference between the consideration paid by the parent and its share of the fair value of the subsidiary's net identifiable assets. This method did not refer to the NCI because it was only intended to recognise the parent's share of goodwill.

It is important to realise that the new 'formula' only applies **at the date of acquisition**. Subsequent to acquisition, both the NCI and the fair value of the subsidiary's net assets will have changed.

The standard recognises that there may be many ways of calculating the fair value of the NCI and does not go into detail on this matter, but it recognises that the market price of the subsidiary's shares prior to the acquisition may be a reasonable basis on which to value the shareholding of the NCI.

IN THE EXAM

There are a number of ways of presenting the information to test the new method:

- As above, the subsidiary's share price just before the acquisition could be given and then used to value the NCI. It would then be a matter of multiplying the share price by the number of shares held by the NCI. In **Example 3** below, this would be 1 million x $3.25 to give $3.25m (w (ii)).
- Note that 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 NCI at the date of acquisition at $3.25m.
- An alternative approach would be to give (in the question) the value of the goodwill attributable to the NCI. In this case, the NCI's goodwill would be added to the parent's goodwill (calculated by the old method) and to the carrying amount of the NCI itself. In **Example 3** below, this would be $500,000 (w (ii)).

EXAMPLE 3

This comprehensive example is an adaptation of Question 1 from the December 2007 Paper F7 (INT) paper, and uses the method described in (i) above.

On 1 October 2006, Plateau acquired the following non-current investments:

- Three million equity shares in Savannah by an exchange of one share in Plateau for every two shares in Savannah, plus $1.25 per acquired Savannah share in cash. The market price of each Plateau share at the date of acquisition was $6, and the market price of each Savannah share at the date of acquisition was $3.25.
- Thirty per cent of the equity shares of Axle at a cost of $7.50 per share in cash.

Only the cash consideration of the above investments has been recorded by Plateau. In addition, $500,000 of professional costs relating to the acquisition of Savannah are included in the cost of the investment.

The summarised draft statements of financial position of the three companies at 30 September 2007 are:

	Plateau $'000	Savannah $'000	Axle $'000
Assets			
Non-current assets:			
Property, plant and equipment	18,400	10,400	18,000
Investments in Savannah and Axle	13,250	nil	nil
Available-for-sale investments	6,500	nil	nil
	38,150	10,400	18,000
Current assets:			
Inventory	6,900	6,200	3,600
Trade receivables	3,200	1,500	2,400
Total assets	48,250	18,100	24,000
Equity and liabilities			
Equity shares of $1 each	10,000	4,000	4,000
Retained earnings			
– at 30 September 2006	16,000	6,000	11,000
– for year ended 30 September 2007	9,250	2,900	5,000
	35,250	12,900	20,000
Non-current liabilities			
7% Loan notes	5,000	1,000	1,000
Current liabilities	8,000	4,200	3,000
Total equity and liabilities	48,250	18,100	24,000

The following information is relevant:

(i) At the date of acquisition, Savannah had five years remaining of an agreement to supply goods to one of its major customers. Savannah believes it is highly likely that the agreement will be renewed when it expires. The directors of Plateau estimate that the value of this customer-based contract has a fair value of $1m, an indefinite life, and has not suffered any impairment.

(ii) On 1 October 2006, Plateau sold an item of plant to Savannah at its agreed fair value of $2.5m. Its carrying amount prior to the sale was $2m. The estimated remaining life of the plant at the date of sale was five years (straight-line depreciation).

(iii) During the year ended 30 September 2007, Savannah sold goods to Plateau for $2.7m. Savannah had marked up these goods by 50% on cost. Plateau had a third of the goods still in its inventory at 30 September 2007. There were no intra-group payables/receivables at 30 September 2007.

(iv) Plateau has a policy of valuing NCIs at fair value at the date of acquisition. For this purpose, the share price of Savannah at this date should be used. Impairment tests on 30 September 2007 concluded that neither consolidated goodwill nor the value of the investment in Axle have been impaired.

(v) The available-for-sale investments are included in Plateau's statement of financial position (above) at their fair value on 1 October 2006, but they have a fair value of $9m at 30 September 2007.

(vi) No dividends were paid during the year by any of the companies.

Required

Prepare the consolidated statement of financial position for Plateau as at 30 September 2007.

(20 marks)

Tutorial note

Note (iv) may instead have said that the fair value of the NCI at the date of acquisition was $3,250,000. Alternatively, it may have said that the goodwill attributable to the NCI was $500,000. All these are different ways of giving the same information.

Answer

Consolidated statement of financial position of Plateau as at 30 September 2007:

	$'000	$'000
Assets		
Non-current assets:		
Property, plant and equipment (18,400 + 10,400 - 400 (w (i)))		28,400
Goodwill (w (ii))		5,000
Customer-based intangible		1,000
Investments		
– associate (w (iii))		10,500
– other available-for-sale		9,000
		53,900
Current assets:		
Inventory (6,900 + 6,200 - 300 URP (w (iv)))	12,800	
Trade receivables (3,200 + 1,500)	4,700	17,500
Total assets		71,400
Equity and liabilities		
Equity attributable to equity holders of the parent		
Equity shares of $1 each (w (v))		11,500
Reserves		
Share premium (w (v))	7,500	
Retained earnings (w (vi))	30,300	37,800
		49,300
NCI (w (vii))		3,900
Total equity		53,200
Non-current liabilities		
7% Loan notes (5,000 + 1,000)		6,000
Current liabilities (8,000 + 4,200)		12,200
Total equity and liabilities		71,400

Workings (figures in brackets are in $'000)

(i) Property, plant and equipment

The transfer of the plant creates an initial unrealised profit (URP) of $500,000. This is reduced by $100,000 for each year (straight-line depreciation over five years) of depreciation in the post-acquisition period. Thus at 30 September 2007, the net unrealised profit is $400,000. This should be eliminated from Plateau's retained profits and from the carrying amount of the plant.

(ii) Goodwill in Savannah

	$'000		$'000
Investment at cost:			
Shares issued (3,000/2 x $6)			9,000
Cash (3,000 x $1.25)			3,750
Total consideration			12,750
Equity shares of Savannah	4,000		
Pre-acquisition reserves	6,000		
Customer-based contract	11,000	x 75%	(8,250)
Parent's share of goodwill			4,500
Fair value of NCI at date of acquisition 1 million shares at $3.25			3,250
NCI share of Savannah's net assets **at date of acquisition** (11,000 x 25%)			(2,750)
NCI share of goodwill			500
Total goodwill is therefore (4,500 + 500)			5,000

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

Consideration paid by the parent (as before)	12,750
Fair value of the NCI (as before)	3,250
	16,000
Fair value of subsidiary's net assets (based on equity as before)	(11,000)
Total goodwill	5,000

Tutorial note

The consideration given by Plateau for the shares of Savannah works out at $4.25 per share, ie consideration of $12.75m for 3 million shares. This is considerably higher than the market price of Savannah's shares ($3.25) before the acquisition. This probably reflects the cost of gaining control of Savannah. This is also why it is probably appropriate to value the NCI in Savannah shares at $3.25 each, because (by definition) the NCI does not have any control. This also explains why Plateau's share of Savannah's goodwill at 90% (ie 4,500/5,000) is much higher than its proportionate shareholding in Savannah (which is 75%).

(iii) Carrying amount of Axle at 30 September 2007

	$'000
Cost (4,000 x 30% x $7.50)	9,000
Share post-acquisition profit (5,000 x 30%)	1,500
	10,500

(iv) The unrealised profit (URP) in inventory

Intra-group sales are $2.7m on which Savannah made a profit of $900,000 (2,700 x 50/150). One third of these are still in the inventory of Plateau, thus there is an unrealised profit of $300,000.

(v) The 1.5 million shares issued by Plateau 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 $1.5m and a share premium of $7.5m.

(vi) Consolidated retained earnings

	$'000
Plateau's retained earnings	25,250
Professional costs of acquisition must be expensed	(500)
Savannah's post-acquisition (2,900 - 300 URP) x 75%	1,950
Axle's post-acquisition profits (5,000 x 30%)	1,500
URP in plant (see (i))	(400)
Gain on available-for-sale investment (9,000 - 6,500) (see below)	2,500
	30,300

The gain on available-for-sale investments must be recognised directly in equity.

(vii) NCI

Equity at 30 September 2007	12,900	
Customer-based contract	1,000	
URP in inventory	(300)	x 25%
The NCI share of net identifiable assets		3,400
NCI share of goodwill (w (ii))		500
		3,900

Note that subsequent to the date of acquisition, an NCI 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 NCI is only valued **at fair value at the date of acquisition**.

FURTHER ISSUES

The original question contained an impairment of goodwill; let's say that this is $1m. IAS 36 requires a subsidiary's goodwill impairment to be allocated between the parent and the NCI on the same basis as the subsidiary's profits and losses are allocated. Thus, of the impairment of $1m, $750,000 would be allocated to the parent (and debited to group retained earnings reducing them to $29.55m ($30,300,000 - $750,000)) and $250,000 would be allocated to the NCI, writing it down to $3.65m ($3,900,000 - $250,000).

It could be argued that this requirement represents an anomaly; of the recognised goodwill (before the impairment) of $5m only $500,000 (ie 10%) relates to the NCI, but it suffers 25% (its proportionate shareholding in Savannah) of the goodwill impairment. ■

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