

The new approach to business combination introduced by the revised IFRS 3 and the revised IAS 27

An overview on the major new accounting requirements introduced by the revised IFRS 3 and revised IAS 27 on the path to convergence with US GAAP

1. Introduction

On 10 January 2008 the International Accounting Standards Board (IASB) published revised IFRS 3 Business Combinations and the related revision to IAS 27 Consolidated and Separate Financial Statements.

These new standards will be applicable to 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. Earlier application is permitted but only back to an annual reporting period that begins on or after 30 June 2007.

The revised standards represent the core of the Business Combinations Phase II project, which arose from and focuses on the convergence between IFRS and US GAAP.

In fact, the revised IFRS 3 and revised IAS 27 are the output of one of the various joint projects undertaken by the IASB and FASB (Financial Accounting Standards Board) which has also resulted in the release in December 2007 of revised FASB Statement No. 141 Business Combinations (SFAS 141) and FASB Statement No. 160 Noncontrolling Interests in Consolidated Financial Statements – an amendment of ARB No. 51.

The revised IFRS 3 has introduced the option to account for the goodwill using the “full goodwill approach”. This option allows entities to show the full extent of the assets controlled by the group but on the other hand exposes the group to the risk of greater impairment losses.

More intangible assets are expected to be recognised. This, combined with other new requirements of the revised IFRS 3 and IAS 27, are likely to result in post-combination results to decrease or become more volatile, both in the year of acquisition and subsequently.

It is therefore fundamental for IFRS preparers to have a clear understanding of all the new accounting requirements introduced by the revised standards in order to avoid unexpected accounting surprises.

2. The consolidation theories¹

Over the years, all the studies that have approached the issue relating to the preparation and presentation of group accounts have been primarily based on two major competing theories: the proprietary theory and the entity theory.

Alongside those two theories, other approaches to consolidation were developed which fall somewhere between those two major theories.

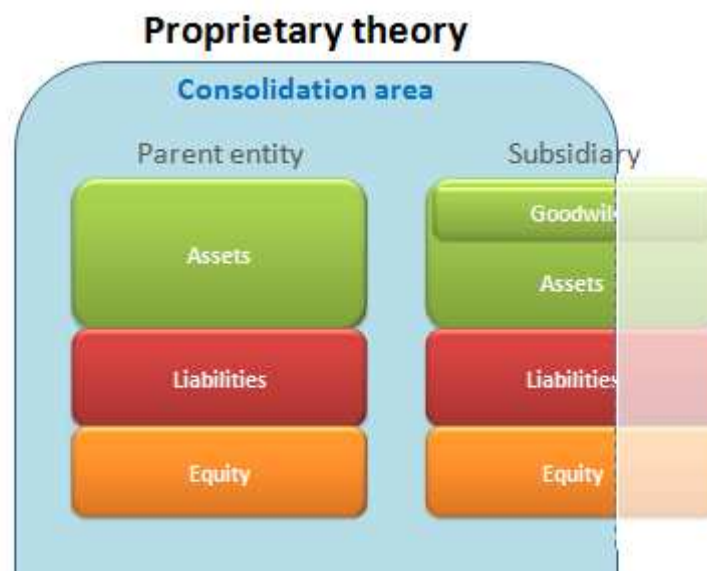
The most famous are probably the parent company theory and the parent company extension theory.

The proprietary theory

The proprietary theory emphasises the view of the group from the perspective of proprietors: the main purpose of the consolidated financial statements is to show the total interest owned by the proprietor.

This is the total interest owned by the parent directly or indirectly via the proportional ownership of the subsidiaries.

The proportionate consolidation method applies.



The entity theory

On the other hand the entity theory emphasises the economic unity of the group which is seen as a single economic entity and managed as such.

¹ See Baxter, G. C. and Spinney, J. C., A Closer Look at Consolidated Financial Statement Theory, CA Magazine (Canada), January 1975, page 32.

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Basically, the consolidated financial statements aim at showing the total resources managed by the group for the purpose of providing useful information to all the group's stakeholders, including minority interests².

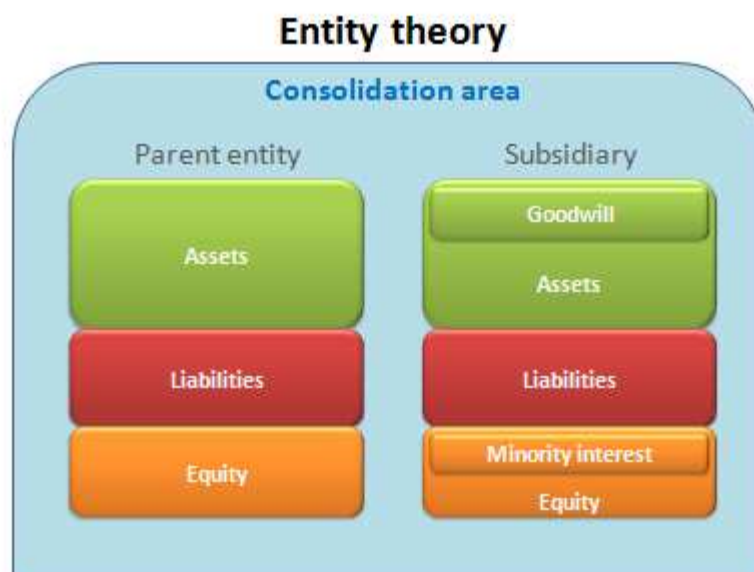
In order to pursue this goal, the focus on individual entities is deemphasised and it converges to a broader view of the entity: the economic group.

The consolidated accounts result from the aggregation of all the assets and liabilities of the individual entities of the group regardless of the percentage of ownership.

The equity interest of the controlling entity and the equity interest of minorities are both included in the group's equity, even though separately disclosed.

According to the entity concept, goodwill is calculated as the difference between the fair value of the acquiree as a whole and its net equity as a whole (full goodwill approach) and therefore the recognised goodwill represents the whole goodwill of the acquired business and not just the acquirer's share of goodwill as required by the old version of IFRS 3.

The full goodwill approach has been introduced by the revised IFRS 3.



The parent company theory

A compromise between those approaches is represented by the parent company theory

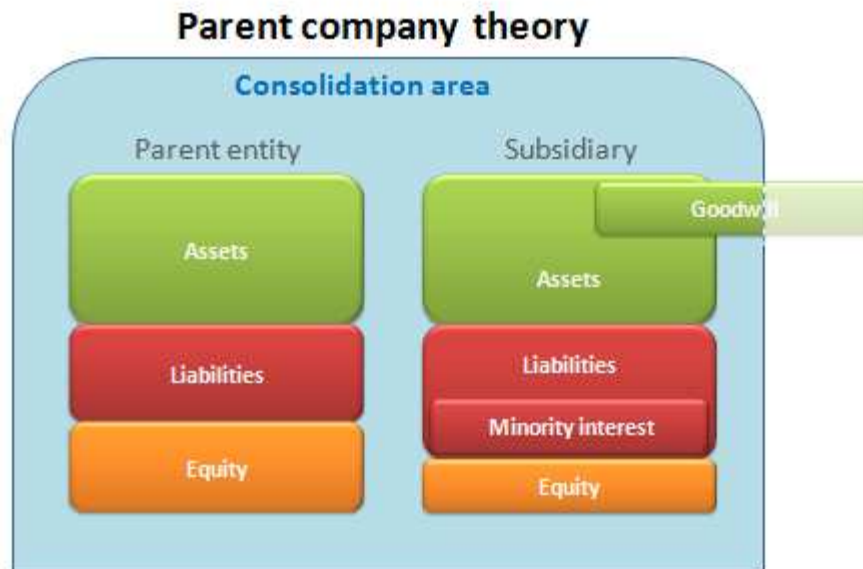
² The Revised IFRS 3 has renamed the term "minority interest" as "non-controlling interest". This change emphasises the importance of the concept of control, which represents one of the major cornerstones over which both IFRS 3 and IAS 27 are built on

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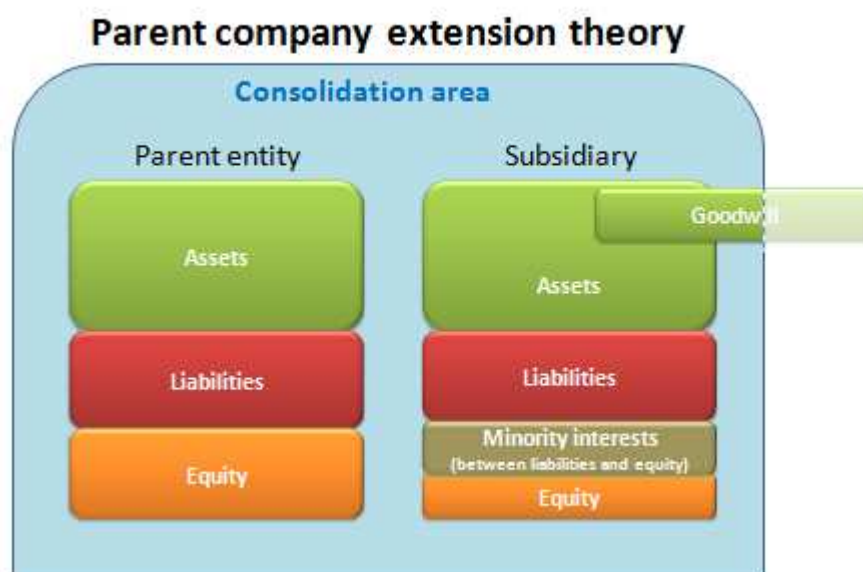
The parent company theory differentiates from the entity concepts in two major aspects:

- The presentation of the minority interests, which are presented outside equity as liabilities.
- The calculation of goodwill: goodwill is not recorded in full, but only in proportion to the controlling shareholders' ownership (purchased goodwill approach).



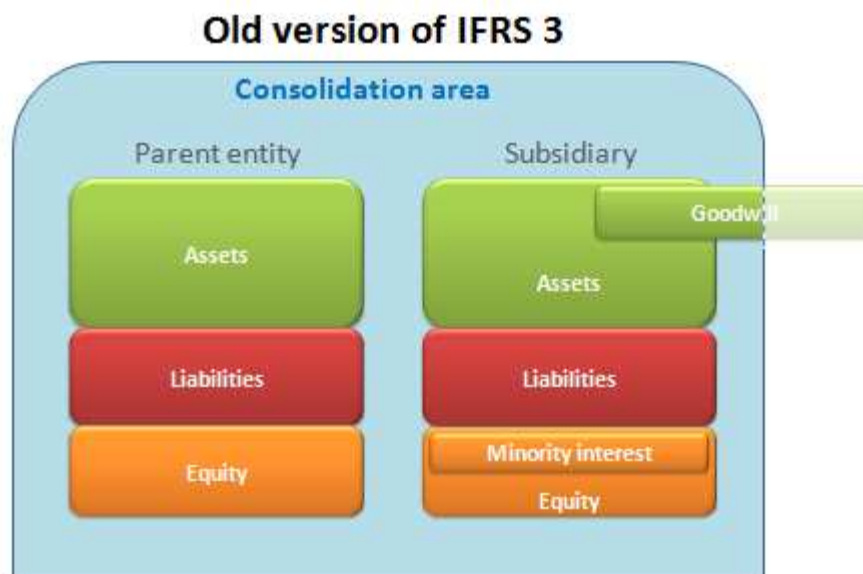
The parent company extension theory

It differentiates from the parent company theory for the presentation of the minority interests, which are considered neither equity nor liabilities and therefore are presented between liabilities and equity.



Approach followed by previous IFRS 3

Basically, the previous version of IFRS 3 follows the parent company extension theory except for the fact that the minority interests are presented within equity.



3. An overview of major changes introduced by the revised IFRS 3 and revised IAS 27

3.1 Goodwill

As illustrated in the prior section, the IASB under the previous IFRS 3 adopted a mixed model approach regarding the accounting treatment of business combinations.

In fact, according to the previous version of IFRS 3 goodwill was measured at the acquisition date as the excess of the cost of the business combination over the acquirer's interest in the fair value of the net assets of the acquiree.

As a result, goodwill was recognised only for the portion of the equity interest of the acquirer in the acquiree.

This is in contrast with one of the basic principles of IFRS (as well as the economic entity theory): the controlling entity should fully consolidate all controlled assets and assumed liabilities, not only to the extent of the percentage of ownership (proportional or pro-rata consolidation).

During deliberations on the previous version of IFRS 3, the IASB reached the conclusion that "core goodwill" meets the Framework's definition of an asset and it is therefore a resource controlled by the entity.

On this basis, there is no reason why it should not be fully consolidated as is the case with any other asset controlled by the entity.

However in the previous version of IFRS 3, the IASB preferred to stay with the "purchased goodwill approach" and therefore allow the recognition of only a portion of the controlled entities' goodwill.

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The revised version of IFRS 3 has now introduced the full goodwill approach as an alternative to the purchased goodwill approach.

The full goodwill approach results in the recognition of the whole goodwill of the acquired business and not just the acquirer's share of goodwill as required by the old version of IFRS 3.

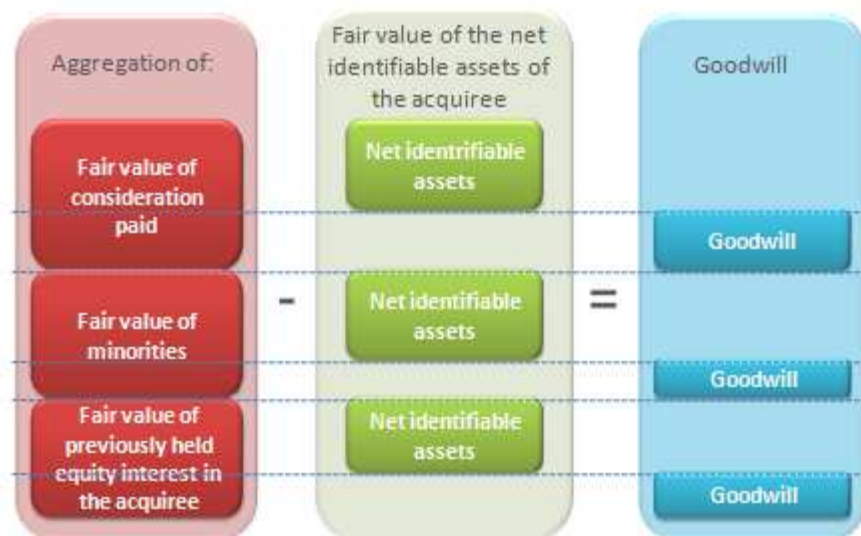
Goodwill is now measured as the difference between:

- the aggregate of:
 - the consideration transferred, generally measured at acquisition-date fair value
 - the amount of any non-controlling interest
 - the acquisition-date fair value of the acquirer's previously held equity interest in the acquire, if any.
- the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed.

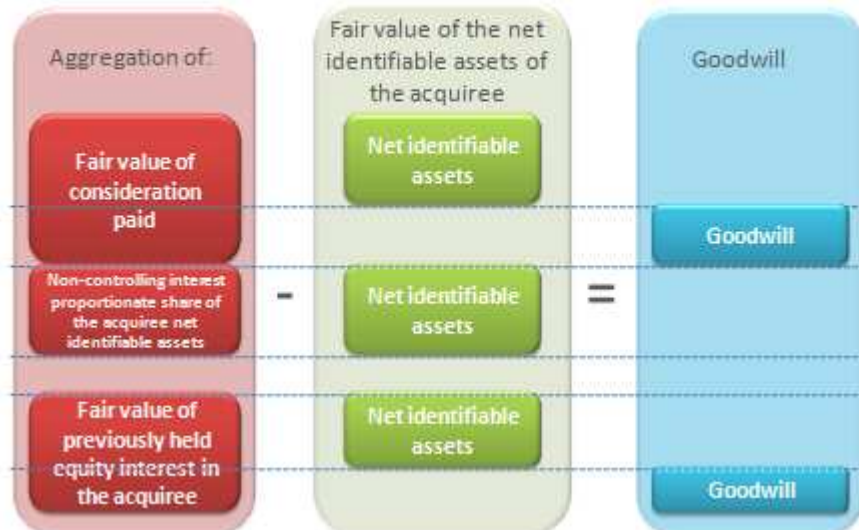
Non-controlling interests can be measured following one of the two alternative methodologies:

- at fair value (this results in the full goodwill approach), or
- at the non-controlling interest's proportionate share of the acquiree's identifiable net assets (this results in the purchased goodwill approach as per the previous IFRS 3 methodology)

Non-controlling interests at fair value (full goodwill approach)



Non-controlling interests measured as a proportionate share of the acquiree's net identifiable assets (purchased goodwill approach)



The introduction of this alternative accounting treatment arguably represents the most significant amendment in the revised IFRS 3.

The introduction of a new alternative accounting treatment – when one of the major goals of the IASB is to reduce them as much as possible - has resulted in a sensational change in approach and what appears to be a partial backward move compared to the exclusive full goodwill approach which was one of the cornerstones of the Exposure Draft.

In addition, this dual model represents a departure from FAS Statement 141R issued at the beginning of December 2007, which only permits the full goodwill approach.

This option is available on a transaction-by-transaction basis.

3.2 Intangible assets acquired as part of a business combination

In relation to the recognition of intangible assets, the revised IFRS 3 introduces limited but highly significant changes from the previous version of IFRS 3, which should result in more intangible assets being recognised.

According to the previous version of IFRS 3, intangible assets were recognised provided the definition criteria of intangible assets set out in IAS 38 were met and their fair value could be measured reliably.

IAS 38 defines intangible assets as those assets that meet the following criteria:

- Non monetary items
- Asset without physical substance
- Identifiable
- The entity has control over the asset
- The assets embodies future economic benefits

Once it has been ascertained that the intangible asset satisfies all such conditions, the intangible asset can be recognised provided the two supplementary recognition criteria are met:

- It is probable that the expected future economic benefits that are attributable to the asset will flow to the entity; and
- The cost of the asset can be measured reliably.

The previous version of IFRS 3 states that for intangible assets acquired as part of a business combination the probability recognition criterion is always met. However whether the reliability measurement criterion is met must be assessed on a case-by-case basis.

The revised version of IFRS 3 eliminates the reliability of measurement as a recognition condition and therefore requires the acquirer to recognise identifiable assets acquired regardless of the degree of probability of an inflow of economic benefits.

This change emphasises the expectation that all intangible assets that satisfy the definition criteria in IAS 38, if acquired as part of a business combination, must be recognised.

The reliability of measurement criterion is considered after the initial recognition stage and therefore it does not interfere with the initial recognition of acquired intangible assets.

This clear distinction between initial recognition and initial measurement results in preparers being unable to avoid recognising intangible assets on the basis that they cannot be reliably measured, where in actual fact measurement is really only either difficult or judgemental.

3.3 Acquisition-related costs

In the previous version of IFRS 3 transaction costs directly attributable to the business combination, such as professional fees paid to accountants, legal advisers, valuers and other consultants to effect the combination were included in the cost of the business combination.

Only general administrative costs and other costs that could not be directly attributed to the combination were recognised as an expense when incurred.

The costs of arranging and issuing financial liabilities were considered an integral part of the transaction of issuing the liability and therefore were included in the initial measurement of the liability as required by IAS 39.

The revised IFRS 3 states that acquisition-related costs are costs incurred by the acquirer to effect a business combination and, except costs of issuing debt or equity instruments accounted for under IAS 39, shall be accounted for as expenses in the periods in which they are incurred.

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In drafting the revised IFRS 3 the IASB focussed on the fact that one of the core principles underlying the accounting for business combinations is the nature of the exchange transaction.

According to this principle, a business combination is an exchange transaction where the buyer transfers cash, cash equivalents or other assets, or a combination thereof in exchange for obtaining the control over the net assets of the acquiree.

Consequently, the acquirer has to recognise and measure at fair value all the acquiree's identifiable assets and liabilities.

On this basis, revised IFRS 3 identifies the costs incurred by the acquirer to effect a business combination not as part of the fair value exchange between the buyer and seller for the net assets, but rather, they represents separate transactions in which the buyer pays for the fair value of services received.

As a result, there is no basis to recognise costs such as finder's fees, advisory, legal, accounting, valuation and indirect costs in the cost of the combination and, in turn, increase the residual amount of goodwill recognized.

That is why acquisition costs, other than costs of issuing debt or equity instruments accounted for under IAS 39 must be expensed as incurred.

3.4 Contingent considerations

It is quite common for business combination agreements to allow for adjustments to the cost of the combination that are contingent on one or more future events.

The adjustment might be contingent on a specified level of performance indicators being reached (i.e. EBIT, EBTDA, etc) or on the market price of the instruments issued being maintained.

The previous version of IFRS 3 required that the acquirer to estimate the amount of any such adjustment at the time of initial accounting for the combination even though some uncertainty exists unless such an adjustment is either not probable or cannot be measured reliably.

If that adjustment subsequently becomes probable and can be measured reliably, the additional consideration shall be treated as an adjustment to the cost of the business combination, except in a very few limited situations.

According to the revised IFRS 3 contingent consideration resolved post-acquisition should not be treated as an adjustment to the initial cost of the business combination and will follow the relevant standard depending on the nature of the consideration.

As a result, subsequent changes in the value of contingent considerations no longer result in changes in goodwill. Instead, they will result very often in a post-combination profit or loss adjustment.

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If, for instance, such contingent considerations are classified as equity instruments, they are no longer remeasured; if they are classified as financial assets, IAS 39 will apply or if they fall under the scope of IAS 37, that standard will have to be applied and so on.

This, in substance, should result in the more post-acquisition adjustments impacting profit or loss.

3.5 Step acquisition

A business combination is not necessarily carried out with one transaction only. It can be carried out via successive share purchases.

For example, if entity A holds 30% of entity B - and such stake does not allow A to control B – and A buys a further 25% of B and that allows A to control B, the date A bought the additional 25% is the acquisition date that triggers the application of IFRS 3.

For the purpose of calculating the goodwill the previous version of IFRS 3 treated each exchange transaction separately resulting in a step-by-step comparison of the cost of the individual investments with the acquirer's interest in the fair values of the acquiree's net identifiable assets.

The revised IFRS 3 states that at the acquisition date (date on which the acquirer obtains control over the acquire – the date when A buys the 25% stake in B) the acquirer remeasures its previously held equity interest in the acquiree at fair value and recognises the resulting gain or loss, if any, in profit or loss.

It is likely that the fair value remeasurement of the minority stake will result in a higher value compared to the carrying amount and, in turn, because of the new goodwill calculation methodology illustrated above, the amount of goodwill is likely to increase as well.

3.6 Loss of control

Under the previous version of IAS 27 once an investment ceased to be a subsidiary its carrying amount was regarded as the cost on initial measurement of a financial asset.

From that date the former subsidiary was no longer consolidated.

The difference between the consideration received and the consolidated net assets at the date of disposal is recognised in profit or loss.

The revised IFRS 3 requires that when an entity loses control over another entity but still retains a minority interest in that entity, the former controlling entity recognises the transaction at the date it loses control as follows:

- Derecognises the assets (including any goodwill) and liabilities of the subsidiary at their carrying amounts at the date when control was lost
- Recognises any investment retained in the former subsidiary at its fair value at the date when control was lost
- Recognises any resulting difference as a gain or loss in profit or loss

The IASB reached this conclusion on the basis that the loss of control of a subsidiary is a significant economic event similarly to obtaining control.

In fact, the economic relationship between the involved entities dramatically changes its status.

It moves from a parent-subsidary to an investor-investee relationship and therefore the IASB thinks that the fair value remeasurement with differences recorded to profit or loss is thought to best capture such a significant change.

On the other hand, when the controlling entity increases or disposes of a stake in the controlled entity and still retains control, the revised IAS 27 states that such transaction is considered as a transaction between owners in their capacity as equity owners and therefore resulting differences are recognised directly in equity.

3.7 Indemnification assets

It is quite common that business combination contracts include a clause that requires the seller to indemnify the acquirer for the outcome of a contingency or uncertainty related to all or part of a specific asset or liability (e.g. uncertain tax positions, pending litigations, etc.)

The previous version of IFRS 3 did not provide specific guidance on how to recognise these indemnification agreements often resulting in divergence in practice in how IFRS were interpreted.

The revised IFRS 3 has clarified the accounting treatment of indemnification agreements and states that the acquirer recognises an indemnification asset that is measured on a basis that is consistent with the item that is subject to the indemnification, even if that measure is not fair value.

The exception to the fair value recognition principle resolves the potential inconsistency in cases where an indemnification asset would have been measured at fair value at the acquisition date and the related liability would have been measured using a different measurement attribute.

In determining the value of the indemnification asset management shall use assumptions consistent with those used to measure the indemnified item, subject to management's assessment of the collectibility of the indemnification asset and any contractual limitations on the indemnified amount.

3.8 Reacquired rights

It can happen that as part of a business combination, an acquirer may reacquire a right that it had previously granted to the acquiree to use one or more of the acquirer's recognised or unrecognised assets (e.g. a right to use the acquirer's trade name under a franchise agreement or a right to use the acquirer's technology under a technology licensing agreement).

The previous version of IFRS 3 did not provide specific guidance on how to recognise reacquired rights.

The revised IFRS 3 states that a reacquired right is an identifiable intangible asset that the acquirer recognises separately from goodwill.

The reacquired right is accounted for as follows:

- Reacquired rights are initially measured at fair value which is measured on the basis of the remaining contractual term of the contract that gave rise to the right, without taking into account potential renewals of that contract. IASB explains that a reacquired right is no longer a contract with a third party and therefore an acquirer who controls a reacquired right could assume indefinite renewals of its contractual term, effectively making the reacquired right an intangible asset with an indefinite life. However, the IASB concluded that a right reacquired from an acquiree has in substance a finite life and therefore a renewal of the contractual term after the business combination is not part of what was acquired in the business combination.
- The fair value of a reacquired right is to be amortised over the remaining term of the contract that gave rise to the right.
- If the terms of the contract giving rise to a reacquired right are favourable or unfavourable relative to the terms of current market transactions for the same or similar items, the acquirer shall recognise a settlement gain or loss.

The last bullet point evidences that reacquired rights might end up with an immediate gain or loss to be recognised to immediately to profit or loss.

3.9 Fair value of consideration transferred

In certain cases the acquirer can transfer consideration other than cash or other monetary assets to obtain control over the net assets of the acquiree (e.g. tangible or intangible assets or a business of the acquirer).

The revised IFRS 3 has made clear that the acquirer shall remeasure the transferred assets or liabilities to their fair value as of the acquisition date and recognise the resulting gains or losses, if any, in profit or loss.

The recognition of a gain or loss in profit or loss derives from the fact that we assume that the non-monetary assets have been transferred to the former owners and therefore are no longer controlled by the acquirer.

However, sometimes those assets or liabilities are transferred to the acquiree rather than to its former owners and remain within the combined entity after the business combination.

The revised IFRS 3 states that in that situation, the acquirer shall measure those assets and liabilities at their carrying amounts immediately before the acquisition date and shall not recognise a gain or loss in profit or loss on assets or liabilities it controls both before and after the business combination.

In such a case, those assets are *de facto* measured and recorded on a book value basis.

3.10 Replacement of share-based payments awards

The previous version of IFRS 3 did not provide specific guidance on how to deal with share-based payments awards of the acquiree replaced by share-based payments awards issued by the acquirer.

The revised IFRS 3 states that exchanges of share-based payment awards in conjunction with a business combination are accounted for as modifications of share-based payment awards in accordance with IFRS 2 Share-based Payment.

The guidance of the revised IFRS 3 focuses on the determination of what part of the cost of the replacement of the share-based payments awards is part of the business combination transaction and what part is not included in applying the acquisition method.

In other words, the IFRS 3 revised provides detailed guidance on how to identify and account for the two following components:

- the portion of a replacement award that is part of the consideration transferred for the acquiree (replacement award attributable to pre-combination service), and
- the portion that is remuneration for post-combination service (replacement award attributable to post-combination service).

The quota relating to remuneration for future services to be rendered to the acquirer by former owners or other employees of the acquiree is not, in substance, consideration for the business acquired.

In determining the two components illustrated above, the IFRS preparer needs to consider all the following factors:

- Acquiree awards: whether the vesting period has been completed before the business combination
- Replacement awards: whether employees are required to provide additional services after the acquisition date
- Vesting period: how the replacement has affected the vesting period of the awards
- Measurement of the awards: the acquirer shall measure both the replacement awards granted by the acquirer and the acquiree awards as of the acquisition date in accordance with IFRS 2.

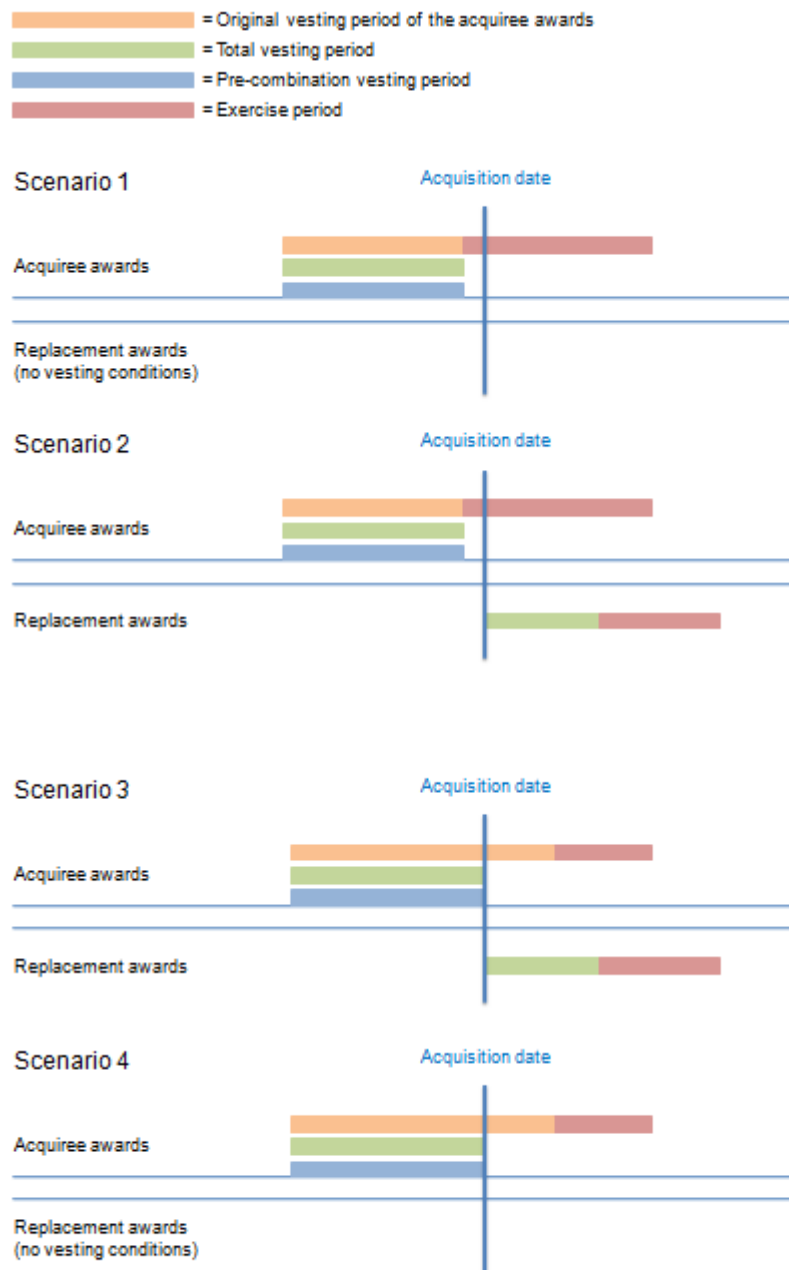
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The following table summarise the accounting treatment for replacement awards:

		Acquired awards		
		<i>Has the vesting period been completed before the business combination?</i>		
		Completed	Not completed	
Replacement awards	Are employees required to provide additional service after the acquisition date?	Not Required	1 Amount attributed to the pre-combination service <i>Market-based measure of acquiree awards at the acquisition date</i>	4 Amount attributed to the pre-combination service <i>The total vesting period is the portion of the vesting period completed before the acquisition date. The portion attributable to the pre-combination services is the market-based measure of acquiree awards at the acquisition date multiplied by the ratio of the pre-combination vesting period to the greater of the total vesting period or the original vesting period</i>
			Amount attributed to the post-combination service <i>The difference between the value of the replacement awards and the portion attributable to the pre-combination services is charged immediately in profit or loss as remuneration cost</i>	
	Required	Required	2 Amount attributed to the pre-combination service <i>The total vesting period is the sum of the vesting period of the original acquire awards plus the vesting period for the replacement award. The portion attributable to the pre-combination services is the market-based measure of acquiree awards multiplied by the ratio of the pre-combination vesting period to the total vesting period</i>	3 Amount attributed to the pre-combination service <i>The total vesting period is the sum of the portion of the vesting period completed before the acquisition date plus the vesting period for the replacement awards. The portion attributable to the pre-combination services equals the market-based measure of the acquire awards multiplied by the ratio of the pre-combination vesting period to the greater of the total vesting period or the original vesting period</i>
			Amount attributed to the post-combination service <i>The difference between the value of the replacement awards and the portion attributable to the pre-combination service is charged as remuneration cost over the vesting period of the replacement awards</i>	

The following table illustrates how vesting periods are determined:



The revised IFRS 3 highlights that the same requirements for determining the portions of a replacement award attributable to pre-combination and post-combination service apply regardless of whether a replacement award is classified as a liability or as an equity instrument in accordance with the provisions of IFRS 2.

4. A worked example: before and after the revised IFRS 3

On 1 September 2010 Entity A acquires 50% of entity B for Euro 10.000.

Prior to this, entity A held 10% of the equity of entity B, which had a fair value of Euro 1.000 immediately prior to the acquisition of the additional 50% of entity B.

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A has determined the following:

- The fair value of the 40% minority is Euro 6.000
- The fair value of the net identifiable assets of entity B is Euro 9.000

	Revised IFRS 3		Previous IFRS 3
	<i>NCI measured at Fair Value</i>	<i>NCI measured at proportionate share of the acquiree's identifiable net assets.</i>	<i>NCI measured at proportionate share of the acquiree's identifiable net assets</i>
<i>Fair Value of consideration paid (50%)</i>	10.000	10.000	10.000
<i>Value of NCI (40%)</i>	6.000	3.600	-
<i>Fair Value of the acquirer's previously held equity interest in the acquiree (10%)</i>	1.500	1.500	-
Total	17.500	15.100	10.000
Fair Value net identifiable assets	9.000	9.000	4.500
Goodwill	8.500	6.100	5.500³
<i>NCI (40%)</i>	6.000	3.600	3.600

Assuming the same fact as in the previous example, except that A does not hold a 10% minority of entity B and therefore Entity A acquires 60% of entity B for Euro 10.000, we will have the following results:

	Revised IFRS 3		Previous IFRS 3
	<i>NCI measured at Fair Value</i>	<i>NCI measured at proportionate share of the acquiree's identifiable net assets.</i>	<i>NCI measured at proportionate share of the acquiree's identifiable net assets</i>
<i>Fair Value of consideration paid (60%)</i>	10,000	10,000	10,000
<i>Value of NCI (40%)</i>	6,000	3,600	-
Total	16,000		10,000

³: The portion of goodwill relating to the 10% stake has to be added up to obtain the total goodwill

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		13,600	
Fair Value net identifiable assets	9,000	9,000	5,400
Goodwill	7,000	4,600	4,600
<i>NCI (40%)</i>	<i>6,000</i>	<i>3,600</i>	<i>3,600</i>

In this second scenario, in terms of accounting for goodwill, the revised IFRS 3 with NCI measured at proportionate share of the acquiree's identifiable net assets and the previous IFRS 3 result in the same amount.

5. Remaining Differences between revised IFRS 3 and FASB 141R:

As mentioned earlier, the revised IFRS 3 and related revisions to IAS 27 were the result of a joint project between the IASB and the FASB. The revisions should result in a higher degree of convergence between IFRS and US GAAP in the accounting for business combinations, although some potentially significant differences remain. The following list provides a brief description of the differences:

- FASB 141R requires the full goodwill method of accounting where revised IFRS 3 provides this as an option.
- Subsequent measurement and recognition of gains or losses of contingent consideration may result since under US GAAP all contingent consideration classified as a liability is remeasured at fair value through earnings unless it is a hedging instrument recognised through other comprehensive income. Under IFRS, contingent consideration classified as a liability is remeasured based on the applicable IFRS standards such as IAS 37 and IAS 39.
- Different definitions of fair value could lead to different amounts for assets or liabilities initially recognised at fair value.
- Accounting for some assets and liabilities occurs according to other standards and as a result, creates differences applicable to assets and liabilities not initially measured at fair value such as taxes, employee benefits, share-based payments, etc.
- If bargain purchase (excess of fair value of net assets over purchase price) amounts remain after reducing certain assets US GAAP requires and IFRS prohibits recognition as an extraordinary gain.
- Revised IFRS 3 includes and FASB 141R excludes from its scope combinations of not-for-profit organisations.
- Accounting for restructuring costs is similar except for consequential differences in measurement attributes in IAS 37 vs. FASB 146.

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- Under US GAAP all contractual contingent liabilities are recognised and non-contractual contingent liabilities are recognised only if “more likely than not”. Under IFRS, all contingent liabilities are recognised regardless of probability and recognition of contingent assets is prohibited.