New approaches regarding business combinations

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NEW APPROACHES REGARDING BUSINESS COMBINATIONS

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Abstract: The accounting for business combinations is a very important area, therefore it needs a high quality accounting standard that could be used for both domestic and cross-border financial reporting. IASB issued in January 2008 the revised IFRS 3 *Business Combinations*, which aims to help both users and preparers of the consolidated financial statements by improving the relevance, reliability and comparability of the information reported by companies around the world. This article aims to highlight few significant changes in the accounting treatment of business combinations that have arisen from the revised IFRS 3, focusing on the accounting principles surrounding the recognition and measurement of the identifiable net assets of the acquiree and any non-controlling interest in the acquiree and on the implications for calculating and measuring goodwill.

Keywords: control, acquisition method, fair value, non-controlling interest, goodwill

1. Introduction

Business combinations are an important feature of the capital markets. Therefore it is necessary to establish principles and requirements in order to improve financial reporting and investor/analyst communications. Adoption of International Financial Reporting Standards (IFRS), and particularly referring to business combination, has had a significant impact on the accounting rules governing mergers and acquisitions.

In 2006, more than 13.000 mergers and acquisition (M&A) transactions took place worldwide. Almost 50% of the transactions, reflecting a combined value of 1,03 trillion Euros, were accounted for using US Generally Accepted Accounting Principles (GAAP), and most of the remainder, reflecting combined value of 1,26 trillion Euros, were accounted for using IFRS or accounting frameworks converging to IFRS. (IASB - Project Summary 2008)

When it comes to assess how the activities of the acquirer and its acquired business will combine, both investors and their advisers confront with many difficulties. In cross-border M&A, comparing financial statements becomes more difficult when acquirers are accounting for acquisitions in different ways, no matter those differences are a consequence of differences between US GAAP and IFRS or because IFRS or US GAAP are not being applied on a consistent basis. Nowadays, as a result of the **first major joint project** between the **International Accounting Standards Board** (IASB) and **Financial Accounting Standards Board** (FASB, the US standard-setter), aiming at taking a broader view at business combination accounting and at **unifying the accounting treatment at a worldwide level**, the accounting requirements in IFRS and US GAAP are substantially the same. (IASB - Press Release 2008)

The business combinations project became part of the initial agenda of the IASB in 2001, being designed to unify M&A accounting across the world's major capital markets. After issuing IFRS 3 *Business Combination* in 2004, as a replacement of IAS 22 *Business Combinations*, the Council passed at the second phase of the project which took a broader look at business combination accounting and was undertaken with the FASB. In 2008, IASB revised IFRS 3 and amended IAS 27 *Consolidated and Separate Financial Statements*. In the same way, FASB revised in 2007 its equivalent standards SFAS 141 *Business Combinations* and SFAS 160 *Noncontrolling Interests in Consolidated Financial Statements*.

2. Significant changes in IFRS 3 (Revised) - comparative approach

The IFRS 3R replaces IFRS 3 (issued in 2004) and comes into effect for 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. Its **objective** is **to improve the relevance, reliability and comparability of the information that a reporting entity provides in its financial statements about the business combination issue and its effects**. In order to achieve this objective, IFRS 3R establishes principles and requirements for how the acquirer:

(a) recognises and measures in its financial statements the *identifiable assets* acquired, the *liabilities* assumed and any *non-controlling interest* in the acquiree;

(b) recognises and measures the *goodwill* acquired in the business combination or a *gain from a bargain purchase*; and

(c) determines what *information to disclose* to enable users of the financial statements to evaluate the nature and financial effects of the business combination.

A. The scope of the standard is extended

The scope of IFRS 3R has been extended to cover business combinations involving mutual entities (e.g. mutual insurance companies, credit union and co-operative entities), and those achieved where there is no consideration (e.g. combination by contract alone). Joint ventures and transactions under common control remain outside the scope of the standard.

B. The definition of business combination is focused on "control"

A new approach regards the definition of the business. This is extended to include integrated activities and assets that are capable of being conducted and managed as a business and that provide:

- dividends, lower costs, increased share prices, or
- other economic benefits to owners, members or participants.

This means that, to meet the definition of a business, assets and activities need not be conducted and managed as a business at the acquisition date, so long as they can be in the future.

According to the new business definition, which gives more emphasis to business rather then entities, **a business combination is a transaction or other event in which an acquirer obtains control of one or more businesses**. This leads to the conclusion that the revised standard focuses on control, in order to determine whether a transaction gives rise to a business combination. This is a different approach comparing to the current one, where a business combination is defined as the bringing together of separate entities or businesses into one reporting entity, without mentioning the control explicitly.

C. The application of acquisition method of accounting is changed

The acquisition method (the "purchase method" in the 2004 version) is used for all business combinations. Steps in applying this method are:

1. Identification of the "acquirer" - the combining entity that obtains control of the acquiree.

2. Determination of the "acquisition date" - the effective date on which the acquirer obtains control of the acquiree.

3. Recognition and measurement of the identifiable assets acquired, the liabilities assumed and any non-controlling interest (NCI, formerly called "minority interest") in the acquiree.

4. Recognition and measurement of goodwill or a gain from a bargain purchase option.

If for the first and second steps, the revised standard generally retains the approach set out in the existing one, substantial changes are proposed to the others.

Step 3. Recognition and measurement of the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree

The current practice of accounting business combinations is a cost-based approach, whereby the cost of the acquired entity is allocated to the assets acquired and liabilities (and contingent liabilities) assumed. In contrast, the new standard is based on the principle that, upon obtaining control of another entity, the underlying exchange transaction should be measured at **fair value**, and this should be the basis on which the assets, liabilities and equity (other than that purchased by the controller) of the acquired entity are measured. As a consequence, all items of consideration transferred by the acquirer are measured and recognised at fair value at the acquisition date, including contingent consideration.

a. Recognising and measuring assets acquired and liabilities assumed

Identifiable assets acquired and liabilities assumed are recognised and measured at fair value as of the acquisition date (with certain exceptions such as deferred taxes and pension obligations). Guidance is provided on recognising and measuring particular assets and liabilities, until the IFRS on *fair value measurement guidance* will be published in the first half of 2010 (according to IASB Work Plan). The classification and designation of all assets acquired and liabilities assumed are reassessed by the acquirer at the acquisition date, based on: contractual terms, economic conditions, accounting policies and any other factors which are relevant at that date.

A particular case is the *identifiable intangible assets*, which have to be recognised separately from goodwill if are either contractual or separable. Therefore, whenever an intangible asset can be separately identified, it must be recognised and measured (e.g. brand name, trade name, licensing agreements, customer lists, patented technology). This increases the accounting complexity for some business combinations, adding time and costs, and leads to higher post-combination charges being recognised.

Recognising and measuring intangible assets is not a new requirement, it also exists in the current standard, the recognition criterion being the possibility of reliably measurement. The revised standard imposes recognition when these assets can be separated or meet the contractual-legal criterion, and provides additional guidance, because this matter has always been one of the difficult areas of IFRS 3 to apply in practice.

Some specialists' opinion is that the standard's purpose to provide transparency on acquisitions for investors has not been achieved, this allowing creative accounting. Research from Intangible Business, one of the world’s largest independent brand valuation consultancies, has revealed that, despite the introduction of IFRS 3 in 2004, goodwill arising from acquisitions of FT Global 500 companies has accounted for 47% of total deal value (a sum of £105billion) and 53% of this goodwill, £57billion, was not described at all – even though the standard requires it (Krijgsman 2007). Thayne Forbes, joint managing director of Intangible Business, said: “The implications of this inadequate reporting are far reaching. It renders annual reports more useless than they currently are, it makes a standard ineffective when applied and the financial bodies that govern them, it sets a dangerous precedent for future years and it opens a new era of creative accounting that distances shareholders and investors further from reality” (Forbes 2007).

An eloquent example is the $1.19bn price tag on Google’s purchase of YouTube (2006), which was one major deal that saw $1.13bn of goodwill balanced out by only $0.24bn of intangible assets, even though the YouTube brand name was widely thought to be the driver for the deal (Jetuah 2008).

b. Identifying and measuring consideration

Consideration transferred (the former “cost of the business combination”) is measured at fair value. This is calculated as the sum of the acquisition-date fair values of:

- the assets transferred by the acquirer;
- the liabilities incurred by the acquirer to acquiree's former owners;
- the equity interests issued by the acquirer.

Potential forms of consideration include cash, other assets, a business or a subsidiary of the acquirer, contingent consideration, ordinary or preference equity instruments, options, warrants and member interests of mutual entities. (Holt 2009)

A new approach concerns **contingent consideration**, defined by IFRS 3 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. The current standard requires contingent consideration to be accounted for only if it is 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 paid to acquiree.

Example 1: Co A acquires 100% of the equity of Co B. The purchase consideration will be paid as: an immediate payment of $6m and two further payments of $2m if the return on capital employed exceeds 10% in each of the subsequent financial years ending 31 December. All indicators have suggested that this target will be met. Co A uses a discount rate of 6% in any present value calculations.

The two conditional payments are contingent consideration and their fair value is $3,67m = $(2m/1.06 + 2m/1.124). This will be added to the immediate cash payment of $6m to give a total consideration of $9,67m.

The nature of the contingent consideration is important as it may meet the definition of a liability or equity. The contingent consideration, unless it is equity, is subsequently re-measured through earnings rather than the current practice of re-measuring through goodwill. An increase in the liability for good performance by the subsidiary will result in an expense in the income statement, and under-performance against targets will result in a reduction in the expected payment being recorded as a gain.

The change that will have an immediate impact is that to expense **transaction costs** associated with a business combination, rather than capitalise them to the cost of acquisition. These costs could include legal, financial and accounting fees for due diligence performed before the acquisition occurs (this is not the case of costs incurred to borrow money or issue the shares used to buy the business). The Board concluded that acquisition related costs are not part of the fair value exchange between the buyer and seller. They are separate transactions in which the buyer pays for the fair value of the services received. This change reflects the Board's move to focus on what is given to the acquiree as consideration, rather than on what is spent by the acquirer to achieve the business.

However, whilst the shock to the profit and loss statement could be significant in the year of acquisition, in future years reported profits could be less volatile as the annual goodwill impairment test will be on a reduced initial balance, compared with the existing standard.

c. Measuring non-controlling interest (NCI)

As we already noted, the underlying principle in IFRS 3R is for all components of the business acquired to be recognised at their fair value. This effectively means that the **equity attributable to non-controlling interest is measured at fair value**. In acknowledging the strong disagreement of many of its constituents with this opinion, IASB introduced an option as to how NCI is measured. Therefore, on a transaction-by-transaction basis, the acquirer can elect to measure any NCI either:

- at its **fair value at the acquisition date,** determined on the basis of market prices for equity shares not held by the acquirer or, if these are not available, by using a valuation technique; or
- at the **non-controlling interest's share of the fair value of the identifiable assets and liabilities of the acquiree** (the current basis); the direct result is that recognised goodwill represents only the acquirer's share.

The choice is made for each business combination, not being an accounting policy choice, and will require management to carefully consider their future intentions regarding the acquisition of the NCI, as the two methods, combined with the revisions for changes in ownership interest of a subsidiary, will potentially result in significantly different amounts of goodwill.

Step 4. Recognising and measuring goodwill or, less frequently, a gain from a bargain purchase

Concerning the matter of the moment when goodwill has to be recognised, there is a major change related to business combination achieved in stages: under IFRS 3R a business combination occurs only at the date when an acquirer obtains control of an acquiree. As a consequence, goodwill is recognised and measured for the first time, at the acquisition date, when the control is obtained. This requirement is closely linked to the revised definition of the business combination. Under current standard goodwill is calculated separately for each stage of a step acquisition. Further on, goodwill is derecognised when control is lost and any changes in ownership interests do not change the goodwill balance recognised.

Regarding the measuring goodwill, both the current and revised versions of IFRS 3 calculate goodwill as a residual amount. The revised IFRS 3, however, requires the acquirer, after having recognised the identifiable assets and liabilities and any non-controlling interest, to identify goodwill acquired as the excess of (a) over (b) below:

(a) the aggregate of:

(i) the consideration transferred measured in accordance with the standard, which generally requires acquisition-date fair value;

(ii) the amount of any non-controlling interest in the acquiree also measured in accordance with the standard; and

(iii) in a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree;

(b) the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed, measured in accordance with IFRS 3R.

If the difference above is negative, the resulting gain is recognised as a bargain purchase in profit or loss.

As we noted above, in a significant change, the revised IFRS 3 gives the acquirer the option to either account for the NCI at fair value or at the non-controlling interest's proportionate share of the acquiree's net identifiable assets. Measuring the non-controlling interests at fair value means that *goodwill is recognised and measured at an amount equal to the total fair value exchanged in the purchase transaction less the full fair value of the identifiable assets and liabilities assumed* ("the full goodwill method"). While this does not represent a change where 100% of a business is acquired, it is very significantly different where an acquirer owns less than 100%. This is because IFRS 3R permits goodwill attributable to the non-controlling interests to be recognised in the consolidated balance sheet, with the amount attributed to the non-controlling interest in equity being increased accordingly. This implies that the full goodwill method is not as simple as taking the goodwill calculated by measuring the non-controlling interest at its proportionate share of the acquisition-date fair value of the acquiree's net assets and grossing up that amount. The reason is that the acquirer is likely to pay a premium for control, grossing up the goodwill on this basis, which would result in an inappropriate goodwill amount being recognised in the group annual financial statements. (Modack 2008-2009)

The other option is to measure *goodwill as the difference between the consideration paid and the purchaser's share of identifiable net assets* *acquired*. This is the "partial goodwill method" because NCI is recognised at its share of identifiable net assets and does not include any goodwill. The problem with this method 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 "full" method) by requiring the NCI to be measured at its fair value. 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.

Example 2: Co A acquires 80% of the shares of a subsidiary, the fair value of its identifiable net assets being \$5,5m. The consideration transferred is \$5,3m. The NCI is fair valued at \$1,2m. Goodwill based on the partial and full methods would be:

	Partial goodwill \$m	***Full goodwill*** \$m
▪ *Consideration transferred*	5,3	5,3
(-) Fair value of identifiable net assets	5,5	5,5
(+) NCI	1,1 (20% × 5,5)	1,2
= Goodwill	**0,9**	**1,0**

It can be seen that goodwill is effectively adjusted for the change in the value of the NCI, which represents the goodwill attributable to the NCI of \$0,1m (\$1m - \$0,9m).

- Journal entries in case of the full goodwill method:

DR Goodwill	*\$1m*	
DR Net Assets	*\$5,5m*	
CR Consideration		*\$5,3m*
CR NCI		*\$1,2m*

- Journal entries in case of the partial goodwill method:

DR Goodwill	*\$0,9m*	
DR Net Assets	*\$5,5m*	
CR Consideration		*\$5,3m*
CR MI		*\$1,1m*

To conclude, 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 attributably 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 (Scott 2008).

Some of the effects of recognising partial goodwill:

▪ Both the NCI and goodwill are lower, because no goodwill is ascribed to the non-controlling interest. This difference will result in a smaller impairment loss if a cash-generating unit is subsequently found to be impaired (as goodwill is lower).

▪ Since transactions with NCI are treated as transactions with equity holders, any subsequent acquisition of non-controlling interest at fair value will result in smaller reduction in the controlling interest's (parent's) equity.

Some of the effects of recognising full goodwill:

▪ Reported net assets on the balance sheet will increase. The potential downside is that any future impairment of goodwill will be greater. Impairments of goodwill should not occur with greater frequency, as the current impairment test is adjusted for a less than wholly owned subsidiary.

▪ Difficulties in practice may occur in measuring NCI at fair value. However, goodwill impairment testing may be easier under full goodwill, as there is no need to gross-up goodwill for partially owned subsidiaries.

▪ A company planning a cash buy-out of the NCI in a subsidiary at a future date may want to record it at fair value and recognise full goodwill in a business combination. If NCI is later purchased, there will be a lower difference between the consideration paid for the non-controlling interest and its recorded value, and thus a smaller percentage reduction of equity.

3. Conclusions

Business combinations have been one of the most contentious issues in the convergence of accounting standards. Hence, ongoing efforts in benefits for preparers by improving the underlying principles compared to the existing standards and by adding guidance in areas where those have been not sufficiently clear or silent. In January 2008, IASB issued the revised standard IFRS 3, which promises significant changes, including:

• a greater emphasis on the use of fair value, potentially increasing the accounting judgement and requiring greater input by valuation experts;

• focussing on changes in control as a significant economic event, requiring to re-measure interests to fair value when control is achieved or lost;

• focussing on what is given to the acquiree as consideration, rather than what is spent to achieve the acquisition.

The revised standard solves 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 IFRS.

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