IFRS 3, BUSINESS

RELEVANT TO ACCA QUALIFICATION PAPER F7

IFRS 3, *Business Combinations* was issued in January 2008 as the second phase 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 in this area. The standard has also led to minor changes in IAS 27, *Consolidated and Separate Financial Statements*. The requirements of the revised IFRS 3 have been examinable since December 2008. This article relates to the relevance of IFRS 3 to Paper F7, *Financial Reporting*.

This article is also of interest to candidates studying UK-based papers, as under UK regulation consolidated goodwill is calculated using the non-controlling interest's (NCI) proportionate share of the subsidiary's identifiable net assets (referred to as method (ii) below).

The revised IFRS 3 introduces:

- Restrictions on the expenses that can form part of the acquisition costs
- New principles for the treatment of contingent consideration
- A choice in the measurement of non-controlling interests (which have a knock-on effect to 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.

ACQUISITION COSTS

All acquisition costs, even those directly related to the acquisition such as professional fees (legal, accounting, valuation, etc), 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' (this would be an asset).

IFRS 3 requires the acquirer to recognise any contingent consideration as part of the consideration for the acquiree. It must be recognised at its fair value which is 'the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction'. This 'fair value' approach is consistent with the way in which other forms of consideration are valued. Applying this definition to contingent consideration may not be 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'. An exam question would give the fair value of any contingent consideration or would specify how it is to be calculated. The payment of contingent consideration may be in the form of equity, a liability (issuing a debt instrument) or cash.

IFRS 3, *BUSINESS COMBINATIONS*, REQUIRES THE ACQUIRER TO RECOGNISE ANY CONTINGENT CONSIDERATION AS PART OF THE CONSIDERATION FOR THE ACQUIREE.

Studying Paper F7?
Performance objectives 10 and 11 are relevant to this exam

COMBINATIONS

If there is a change to the fair value of contingent consideration due to additional information obtained after the acquisition date that affects the facts or circumstances as they existed at the acquisition date, it is treated as a 'measurement period adjustment' and the contingent 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*. Changes in the fair value of contingent consideration 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 NON-CONTROLLING INTERESTS

The acquirer (parent) measures any non-controlling interest either:

(i) at fair value as determined by the directors of the acquiring company (often called the 'full goodwill' method); or

(ii) at the non-controlling interest's proportionate share of the acquiree's (subsidiary's) identifiable net assets (this is the UK method).

The differential effect of the two methods is that (i) recognises the whole of the goodwill attributable to an acquired subsidiary, whereas (ii) only recognises the parent's share of the goodwill.

EXAMPLE 1

Parent pays $100m for 80% of Subsidiary which has net assets with a fair value of $75m. The directors of Parent have determined the fair value of the NCI at the date of acquisition was $25m.

Method (i)	Consideration	**$**
	Parent	100
	NCI	25
		125
	Fair value of net assets	(75)
	Consolidated goodwill on acquisition	50

In the consolidated statement of financial position the non-controlling interests would be shown as $25m.

In the above example the value of the non-controlling interests of $25m as determined by the directors of Parent is proportionate to that of Parent's consideration ($100m x 20%/80%). This is not always (in fact rarely) the case.

Method (ii)	Consideration	**$**
	Parent	100
	Share of fair value of net assets acquired ($75m x 80%)	(60)
	Consolidated goodwill	40

In the consolidated statement of financial position the non-controlling interest would be shown at its proportionate share of the subsidiary's net assets of $15m ($75m x 20%).

The two methods are an extension of the methodology used in IAS 36, *Impairment of Assets* when calculating the impairment of goodwill of a cash generating unit (CGU) where there is a non-controlling interest.

EXAMPLE 2

Parent owns 80% of Subsidiary (a CGU). Its identifiable net assets at 31 March 2010 are $500.

Scenario 1

	$
Net assets included in the consolidated statement of financial position	500
Consolidated goodwill (calculated under method (i))	200
	700
NCI	140

Scenario 2

	$
Net assets included In the consolidated statement of financial position	500
Consolidated goodwill (calculated under method (ii))	160
	660
NCI	100

An impairment review of Subsidiary was carried out at 31 March 2010.

Required:
For scenarios 1 and 2, calculate the impairment losses and show how they would be allocated if the recoverable amount of Subsidiary at 31 March 2010 if the impairment review concluded that the recoverable of Subsidiary was:
(i) $450
(ii) $550

Answer

Scenario 1

(i) The impairment loss is $250 (700 - 450). This loss will be first applied to goodwill (eliminating it) and then to the other net assets reducing them to $450, ie equal to the recoverable amount of the CGU. The statement of financial position would now be:

	$
Net assets (to be consolidated)	450
Consolidated goodwill	nil
	450
NCI (140 - (250 x 20%)) (see below))	90

Note: IFRS 3 requires that any impairment loss should be written of to the controlling and non-controlling interests on the same basis as that in which profits loss are allocated.

(ii) With a recoverable amount of $550, the impairment loss will be $150 and applied to the goodwill reducing it to $50. The statement of financial position would now be:

	$
Net assets (to be consolidated)	500
Consolidated goodwill (under method (i))	50
	550
NCI (140 - (150 x 20%))	110

Scenario 2

Where method (ii) has been used to calculate goodwill and the non-controlling interests, IAS 36 requires a notional adjustment to the goodwill of Subsidiary, before being compared to the recoverable amount. This is because the recoverable amount relates to the value of Subsidiary as a whole (ie including all of its goodwill). The notional adjustment is always based on the non-controlling interest in goodwill being proportional to that of the parent.

	Goodwill $	Net assets $	Total $
Carrying amount – re Parent	160	500	660
Notional adjustment re NCI (see below)	40		40
	200	500	700

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

In this case, because the fair value of the non-controlling interests in scenario 1 is proportional to the consideration paid by Parent, the notional adjustment leads to the same impairment losses of $450 for (i) and $550 for (ii) as under scenario 1 (see *). Applying these:

(i) the impairment loss of $250 is again applied to eliminate goodwill and the remaining $50 is applied to reduce the other net assets. The non-controlling interest will be reduced by $10 being its share (20%) of the reduction of other net assets. This gives exactly the same statement of financial position as under scenario 1.

	$
Net assets (to be consolidated)	450
Consolidated goodwill	nil
	450
NCI (100 - 10 (50 x 20%))	90

(ii) the impairment loss of $150 would be applied to goodwill leaving the other net assets unaffected. 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 (unaffected)	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 (goodwill of $200 - $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 non-controlling interests may legitimately lay claim to their share of the more traditional aspects of goodwill, they are 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 non-controlling interests on the same basis (proportional to) as the controlling interests (see method (i) below).

IFRS 3 illustrates the calculation of consolidated goodwill at the **date of acquisition** as:

Consideration paid by parent + non-controlling interest
- fair value of the subsidiary's net identifiable assets
= consolidated goodwill.

The non-controlling interest in the above formula may be valued at its fair value (method (i)) or its proportionate share of the subsidiary's net identifiable assets (method (ii)).

Subsequent to acquisition the carrying amount of the non-controlling interest (under either method) will change in proportion it is share of the post acquisition profits or losses of the subsidiary. Consolidated goodwill (under either method) will remain the same unless impaired.

The standard recognises that there may be many ways of calculating the fair value of the non-controlling interest (method (i)), one of which may be to use the market price of the subsidiary's shares prior to the acquisition (where this exists). In the Paper F7 exam this is the most common method; an alternative would be to simply give the fair value of the non-controlling interests in the question.

EXAMPLE 3

This comprehensive example is an adaptation of Question 1 from the December 2007 Paper F7 (INT) paper, and calculates goodwill based on the fair value of the non-controlling interests (method (i) above) by valuing the non-controlling interests using the subsidiary's share price at the date of acquisition (see note (iv) of the question).

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	**Savannah**	**Axle**
	$'000	**$'000**	**$'000**
Assets			
Non-current assets:			
Property, plant and equipment	18,400	10,400	18,000
Investments in Savannah and Axle	13,250	nil	nil
Financial asset 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) At the date of acquisition the non-controlling interest in Savannah is to be valued at its fair value. For this purpose Savannah's share price at that date can be taken to be indicative of the fair value of the shareholding of the non-controlling interest. Impairment tests on 30 September 2007 concluded that neither consolidated goodwill nor the value of the investment in Axle had been impaired.

(v) The financial asset 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
– financial asset		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
Non-controlling interest (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).

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.

(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
Controlling interest:		
Shares issued (3,000/2 x $6)		9,000
Cash (3,000 x $1.25)		3,750
		12,750
Non-controlling interests		
(1 million shares at $3.25)		3,250
Total consideration		16,000
Equity shares of Savannah	4,000	
Pre-acquisition reserves	6,000	
Customer-based contract	1,000	(11,000)
Consolidated 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 higher than the market price of Savannah's shares ($3.25) before the acquisition and could be argued to be the premium paid to gain control of Savannah. This is also why it is (often) appropriate to value the NCI in Savannah shares at $3.25 each, because (by definition) the NCI does not have control.

(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 financial asset investments (9,000 - 6,500)	2,500
	30,300

(vii) NCI

Fair value at acquisition	3,250
Post-acquisition profit (2,900 - 300 URP) x 25%	650
	3,900

Note that subsequent to the date of acquisition, the non-controlling interest is valued at its fair value at acquisition plus its proportionate share of Savannah's (adjusted) post acquisition profits.

FURTHER ISSUES

The original question contained an impairment of goodwill; let's say that this is $1m. IAS 36 (as amended by IFRS 3) requires a goodwill impairment of a subsidiary (if a cash generating unit) to be allocated between the parent and the non-controlling interests in 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 non-controlling interests, writing it down to $3.65m ($3,900,000 - $250,000).

It could be argued that this requirement represents an anomaly. It can be calculated (though not done in this example) that of Savannah's recognised goodwill (before the impairment) of $5m only $500,000 (ie 10%) relates to the non-controlling interests, but the NCI suffers 25% (its proportionate shareholding in Savannah) of the goodwill impairment.

Steve Scott is examiner for Paper F7

THE ORIGINAL QUESTION CONTAINED AN IMPAIRMENT OF GOODWILL; LET'S SAY THAT THIS IS $1M. IAS 36 (AS AMENDED BY IFRS 3) REQUIRES A GOODWILL IMPAIRMENT OF A SUBSIDIARY (IF A CASH GENERATING UNIT) TO BE ALLOCATED BETWEEN THE PARENT AND THE NON-CONTROLLING INTERESTS IN ON THE SAME BASIS AS THE SUBSIDIARY'S PROFITS AND LOSSES ARE ALLOCATED.