

IFRS Briefing Sheet

Revised standard IFRS 3 *Business Combinations* (2008) and amended standard IAS 27 *Consolidated and Separate Financial Statements* (2008)

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This IFRS Briefing Sheet summarises the International Accounting Standards Board's (IASB) revised standard IFRS 3 *Business Combinations* (2008), which was published on 10 January 2008. This revised standard supersedes the version of IFRS 3 *Business Combinations* as issued in 2004.

This IFRS Briefing Sheet also summarises the amendments to IAS 27 *Consolidated and Separate Financial Statements* (2008), which also were published on 10 January 2008.

The amendments to IAS 27 (2008) reflect changes to the accounting for non-controlling (minority) interest and deal primarily with the accounting for changes in ownership interests in subsidiaries after control is obtained, the accounting for the loss of control of subsidiaries, and the allocation of profit or loss to controlling and non-controlling interests in a subsidiary.

Executive Summary

The main changes from IFRS 3 (2004) are as follows:

- The scope of IFRS 3 (2008) has been extended to include business combinations involving only mutual entities and to business combinations achieved by contract alone.
- The definition of a business combination has been revised to focus on control.
- The definition of a business has been amended to clarify that it can include an integrated set of activities and assets that are not currently being operated as a business, as long as the set is capable of being operated as a business.
- All items of consideration transferred by the acquirer are measured and recognised at fair value at the acquisition date, including contingent consideration.

Background

IFRS 3 (2008) is the outcome of the second phase of the IASB's and the U.S. Financial Accounting Standards Board's (FASB) business combinations project, which was conducted as a joint project of the Boards. The first phase of the project resulted in the issue of IFRS 3 (2004) and the U.S. standard SFAS 141 *Business Combinations* (2001). The second phase of the project reconsidered the application of acquisition accounting for business combinations.

A supplement to KPMG's publication IFRS in Brief

- The acquirer can elect to measure any non-controlling interest at fair value at the acquisition date, or at its proportionate interest in the fair value of the identifiable assets and liabilities of the acquiree, on a transaction-by-transaction basis.
- Transaction costs incurred by the acquirer in connection with the business combination do not form part of the business combination transaction. As such, they are expensed as incurred, unless they relate to the issuing of debt or equity securities, in which case they are accounted for under the financial instruments standards.
- New disclosures are required.

The main changes from IAS 27 (2003) are as follows:

- When an acquisition is achieved in successive share purchases (step

acquisition), the identifiable assets and liabilities of the acquiree are recognised at fair value when control is obtained; and a gain or loss is recognised in profit or loss for the difference between the fair value of the previously held equity interest in the acquiree and its carrying amount. Any amount relating to previously held equity interests in the acquiree that was recognised directly in other comprehensive income (e.g., the investment was classified as available-for-sale) is reclassified and included in the calculation of the gain or loss recognised in profit or loss.

- Acquisitions of additional non-controlling equity interests after the business combination are accounted for as equity transactions.
- Disposals of equity interests while retaining control are accounted for as equity transactions.

- Transactions resulting in a loss of control result in a gain or loss being recognised in profit or loss. The gain or loss includes a remeasurement to fair value of any retained equity interest in the investee.
- New disclosures are required.

The following summaries do not provide a complete overview of IFRS 3 (2008) and IAS 27 (2008). They also focus only on significant differences between the new standards and IFRS 3 (2004) and IAS 27 (2003), and do not repeat the requirements of IFRS 3 (2004) and IAS 27 (2003).

Revised IFRS 3

Scope of IFRS 3 (2008)

IFRS 3 (2008) also includes in its scope business combinations:

- involving only mutual entities
- in which separate entities or businesses are brought together to form a reporting entity by contract alone.

Acquisition Method

All business combinations are accounted for by applying the acquisition method (referred to previously as the purchase method). The acquisition method consists of:

- identifying the acquirer
- determining the acquisition date
- determining the consideration transferred (purchase price)
- recognising and measuring the identifiable assets acquired and the liabilities assumed
- recognising and measuring any non-controlling interest in the acquiree
- recognising goodwill or, in the case of a bargain purchase, a gain.

Identifying the Acquirer

The acquirer is the combining entity that obtains control of the other combining entities or businesses. IFRS 3 (2008) retains the requirements of IFRS 3 (2004) in this respect.

Determining the Acquisition Date

The acquisition date is the date on which control is transferred to the acquirer. IFRS 3 (2008) retains the requirements of IFRS 3 (2004) in this respect.

Determining the Consideration Transferred

Consideration transferred is measured at fair value at the acquisition date and is calculated as the sum of the fair values of:

- the assets transferred

- the liabilities incurred by the acquirer to the previous owners of the acquiree
- equity interests issued by the acquirer.

Consideration transferred also may include contingent consideration and share-based payment awards exchanged in the business combination (see below *Share-based Payment Awards*).

A contingent consideration arrangement must be recognised at fair value at the acquisition date, and is classified as either a liability or equity based on the definitions in IAS 32 *Financial Instruments: Presentation*.

Recognising and Measuring the Identifiable Net Assets Acquired

The identifiable assets acquired and liabilities assumed in a business combination are recognised if the following *recognition principle* and condition are met respectively:

- they meet the definition of assets and liabilities at the acquisition date
- they are exchanged as part of the business combination instead of as a separate transaction.

IFRS 3 (2008) establishes a *measurement principle* that assets acquired and liabilities assumed must be measured on the acquisition date at their fair values.

There are some exceptions to the recognition and measurement principles. (See below in *Exceptions to the Recognition and / or Measurement Principles*.)

Classifying and Designating Assets Acquired and Liabilities Assumed

Assets acquired and liabilities assumed must be classified and designated on the acquisition date "on the basis of the contractual terms, economic

conditions, the acquirer's operating or accounting policies and other pertinent conditions as they exist at the acquisition date".

There are two exceptions to this general principle. The classification and designation of leases and insurance contracts are based on the contractual terms at inception of the contract, or at the date of the latest modification that resulted in a change of classification in accordance with IAS 17 *Leases* and IFRS 4 *Insurance Contracts* respectively.

Exceptions to the Recognition and / or Measurement Principles

IFRS 3 (2008) provides exceptions from, or modifications to, the recognition and measurement principles for the following:

<i>Exception to the recognition principle</i>	<i>Exceptions to both the recognition and measurement principles</i>	<i>Exceptions to the measurement principle</i>
Contingent liabilities	Deferred tax assets and liabilities	Reacquired rights
	Indemnification assets	Share-based payment awards
	Employee benefits ⁽¹⁾	Assets held for sale ⁽²⁾

(1) Recognised and measured in accordance with IAS 19 *Employee Benefits*.

(2) Measured at fair value less costs to sell in accordance with IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*.

Contingent Liabilities

Contingent liabilities that are *present* obligations arising from past events and can be measured reliably are recognised at fair value at the acquisition date.

Therefore, even though it is not probable that economic outflow will be required to settle the obligation,

a contingent liability will still be recognised in a business combination if it constitutes a *present* obligation. Contingent liabilities that are *possible* obligations are not recognised in a business combination.

Deferred Tax Assets and Liabilities

Deferred tax assets and liabilities arising from recognised assets acquired and liabilities assumed in a business combination are measured in accordance with IAS 12 *Income Taxes*, which includes recognising any tax-deductible goodwill in excess of goodwill for financial reporting purposes that meets the definition of a temporary difference.

Indemnification Assets

When the seller is obliged contractually to indemnify the acquirer for a particular liability, the acquirer will recognise an indemnification asset amount equal to the related recognised liability, subject to management's assessment of collectability of the asset.

Reacquired Rights

The acquisition of a right that had been granted previously by the acquirer to the acquiree, e.g., franchise rights, represents an intangible asset that is recognised separately from goodwill; however, it is measured by taking into account only the remaining contractual terms of the related contract. Any favourable or unfavourable aspect of the reacquired right relative to market terms or prices is recognised by the acquirer as a settlement gain or loss in profit or loss separately from the business combination transaction.

Share-based Payment Awards

When the acquirer is obliged to replace the share-based payment awards held by the acquiree's employees (acquiree's awards), if the share-based payment awards exchanged (replacement awards):

- relate to past services, then they are included in the consideration transferred; or
- require future services, then they are treated as post-combination compensation cost.

When there is no obligation on the part of the acquirer to exchange the acquiree's awards, then no adjustment to the consideration transferred is made, even if the acquirer does replace the acquiree's awards.

Share-based payment awards exchanged for acquiree's awards are measured in accordance with IFRS 2 *Share-based Payment*.

Recognising and Measuring any Non-controlling Interest in the Acquiree

The acquirer can elect, on a transaction-by-transaction basis, to measure any non-controlling interest at the acquisition date either at:

- fair value (a "full" goodwill method); or
- its proportionate interest in the identifiable assets and liabilities of the acquiree.

Goodwill

Goodwill is measured as the difference between:

- (1) the sum of:
 - a. the fair value of the consideration transferred
 - b. the recognised amount of any non-controlling interest in the acquiree
 - c. the fair value of any previously held equity interest in the acquiree for a business combination achieved in stages (see below in *Business Combination Achieved in Stages*) and
- (2) the recognised amount (generally fair value) of the identifiable assets acquired and liabilities assumed.

Measurement Period

The time period for recognising additional items or adjustments to items recognised in the business combination ends once the acquirer receives the necessary information about the facts and circumstances at the acquisition date, or determines that such information is not available. Such adjustments can be made subject to an overall limit of one year from the acquisition date, and are applied retrospectively with comparatives being restated.

Any business combination adjustments made after the measurement period has elapsed are accounted for as corrections of errors in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

Business Combination Achieved in Stages (Step Acquisition)

The acquirer remeasures its previously acquired non-controlling equity investment in the acquiree at fair value at the acquisition date and recognises any gain or loss on remeasurement in profit or loss. If, prior to the business combination, the acquirer recognised changes in the value of its non-controlling equity investment directly in other comprehensive income (e.g., the investment was classified as available-for-sale), then the amount recognised directly in other comprehensive income is reclassified and included in the calculation of the gain or loss recognised in profit or loss.

Assessing What is Part of the Exchange for the Acquiree

An acquirer must assess whether any portion of the consideration transferred, or any assets acquired or liabilities assumed, are not part of the exchange for the acquiree and therefore should not be accounted for as part of the business combination.

Examples of items that are not part of the business combination include:

- payments that effectively settle pre-existing relationships between the acquirer and acquiree (see above)
- payments to compensate employees or former owners for future services
- a reimbursement of transaction costs incurred by the acquiree on behalf of the acquirer.

Acquisition-related Costs

Costs that the acquirer incurs in connection with a business combination are excluded from the acquisition accounting. These acquisition-related costs are expensed as the costs are incurred and the services received, with the exception of costs related to the issue of debt or equity securities, which are accounted for under the financial instruments standards. Examples of acquisition-related costs include finder's fees, legal fees, due diligence fees, and other professional and consulting fees.

Subsequent Measurement

Other IFRSs generally deal with subsequent measurement. However,

the new standard does provide specific guidance on the subsequent measurement of reacquired rights, contingent liabilities, indemnification assets and contingent consideration. Certain consequential amendments on subsequent measurement also have been made to IAS 12.

Disclosures

New disclosure requirements have been introduced, including requirements to disclose:

- the acquisition-date fair value of the total consideration transferred by major class
- the fair value and contractual gross amount of receivables acquired by major class
- best estimates at the acquisition date of contractual cash flows that the acquirer does not expect to collect.

Effective Date and Transition of IFRS 3 (2008)

IFRS 3 (2008) is effective for annual periods beginning on or after 1 July

2009. Early adoption is permitted for annual periods beginning on or after 30 June 2007 providing that the entity also applies IAS 27 (2008) in the same period and discloses that fact.

The carrying amounts of any assets and liabilities that arose under business combinations prior to the application of IFRS 3 (2008) are not adjusted.

Change from the Exposure Draft (the ED) of IFRS 3 Business Combinations

In response to comments received on the proposals included in the ED (published by the IASB on 30 June 2005) the most significant change made from the ED is that IFRS 3 (2008) provides the option for the acquirer to measure non-controlling interest in the acquiree at its proportionate interest in the identifiable assets and liabilities of the acquiree. This option was not available in the ED.

Amended IAS 27

The amendments to IAS 27 (2008) relate mainly to changes in the accounting for non-controlling interest and the loss of control of a subsidiary.

Transactions with Non-controlling Interest while Retaining Control

Changes in the parent's ownership interest in a subsidiary after control is obtained that do not result in a loss of control are accounted for as transactions with equity holders in their capacity as equity holders. As a result no gain or loss on such changes is recognised in profit or loss. Any difference between the amount by which the non-controlling interest is adjusted and the fair value of the consideration paid or received, if any, is recognised directly in other comprehensive income and attributed to equity holders of the parent.

Loss of Control

When control of a subsidiary is lost, any resulting gain or loss is recognised in profit or loss. This gain or loss includes the parent's share of gains or losses relating to these individual assets and liabilities that were recognised previously directly in other comprehensive income on the same basis that would be required if the related assets / liabilities had been disposed of directly by the parent. Any retained non-controlling equity investment is remeasured to its fair value at the date that control is lost, and any resulting gain or loss is included in the gain or loss arising

on loss of control. The remaining investment is accounted for under IAS 39 *Financial Instruments: Recognition and Measurement*, IAS 28 *Investments in Associates* or IAS 31 *Interests in Joint Ventures*, as appropriate.

Guidance on "Linkage" and Attribution of Losses

Because different accounting treatments apply depending on whether or not control is lost (see above), guidance is provided on determining when two or more transactions or arrangements that result in the loss of control of a subsidiary should be treated as a single transaction.

Losses applicable to the non-controlling interest, including negative "other comprehensive income" as defined in the revised IAS 1 *Presentation of Financial Statements*, are allocated to the non-controlling interest even if doing so causes the non-controlling interest to be in a deficit position. Unless there is a contractual arrangement that specifies otherwise, the amounts allocated are in proportion to ownership interests.

Disclosures

New disclosure requirements have been introduced, including requirements to disclose:

- the amount of any gain or loss arising on the loss of control of a subsidiary
- movements between controlling and non-controlling interest.

Effective Date and Transition of IAS 27 (2008)

The amendments in IAS 27 (2008) are effective for annual periods beginning on or after 1 July 2009. Early adoption is permitted providing the entity also applies IFRS 3 (2008) in the same period and discloses that fact.

Amendments apply retrospectively except for:

- the requirement to attribute total comprehensive income between controlling and non-controlling interests even if this results in non-controlling interest having a negative balance
- accounting for changes in ownership interests after control is obtained
- remeasuring to fair value any retained non-controlling equity investment upon a loss of control.

If you would like further information on any of the matters discussed in this issue of *IFRS Briefing Sheet*, please talk to your usual local KPMG contact or call any of KPMG firms' offices.

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