

# IFRS News

Shedding light on the IASB's activities\*

IFRS 3R – supplement • January 2008

## IFRS 3R Business Combinations – Q&A

Solutions to some of the more challenging aspects of IFRS 3R are provided in this supplement. These Q&As have been extracted from the PwC publication 'IFRS 3R: Impact on earnings – the crucial Q&A for decision-makers', released later this month.

### Is it true that some business combinations will result in gains in the income statement?

Yes, it is. Any previous stake is seen as being 'given up' to acquire the business. A gain or loss is recorded on its disposal. If the acquirer already held an interest in the acquired entity before acquisition, the standard requires the existing stake to be re-measured to fair value at the date of acquisition, taking any movement to the income statement (together with any gains previously recorded in equity that relate to the existing stake). If the value of the stake has increased, there will be a gain to recognise in the income statement of the acquirer at the date of the business combination. A loss would only occur if the existing interest has a book value in excess of the proportion of the fair value of the business obtained – and no impairment had been recorded previously. This loss situation is not expected to occur frequently.

The standard also requires any gain on a 'bargain purchase' (negative goodwill) to be recorded in the income statement. This is not a change from previous requirements.

### Does the type of consideration (what is paid for the business) affect how much goodwill is recognised?

No, it does not. Regardless of how payments are structured, the consideration is recognised in total at its fair value at the date of the acquisition. Paying the same amount in today's values in different ways will not make a difference to the amount of goodwill recognised.

The form of the consideration will not affect the amount of goodwill but the structure of the payments will have a significant effect on the post-acquisition income statement.

Payments that are contingent and deemed to be part of the acquisition price will be measured at fair value and included in the business combination accounting on day one. Equity instruments that are contingent consideration are not subsequently re-measured. Debt instruments are subsequently re-measured through the income statement.

Changes in the carrying amount of contingent consideration will often not be offset by profits and losses of the acquired subsidiary. A substantial payment to the previous owners may be required if an in-process research and development (IPR&D) project meets key approval milestones. The successful IPR&D project may generate substantial profits over 20 years. The increased amounts due under the contingent consideration arrangement are likely to be recognised as expense in the income statement before the project generates any revenue at all.

### How is goodwill measured?

Goodwill continues to be a residual. It may well be a different residual under IFRS 3R compared to the previous standard. This is partly because all of the consideration, including any previously held interest in the acquired business, is measured at fair value. It is also because goodwill can be measured in two different ways.

The first way is similar to the method under current IFRS: goodwill is the difference between the consideration paid and the purchaser's share of identifiable net assets acquired. This is a 'partial goodwill' method because the non-controlling (minority) interest is recognised at its share of identifiable net assets and does not include any goodwill. Goodwill can also be measured on a 'full goodwill' basis, where goodwill includes the minority interest's share.

### What is the effect of recognising full goodwill?

Recognising full goodwill will increase reported net assets on the balance sheet. 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.

Measuring non-controlling interest at fair value may prove difficult in practice. 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 to buy the non-controlling interest in a subsidiary at a future date may want to record non-controlling interest at fair value and recognise full goodwill in a business combination. If the non-controlling interest 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 reduction in equity.

### What happens if a non-controlling interest is bought or sold?

Any transaction with a non-controlling interest that does not result in a change of control is recorded directly in equity; the difference between the amount paid or received and the non-controlling interest is a debit or credit to equity. This means that an entity will not record any additional goodwill upon purchase of a non-controlling interest nor recognise a gain or loss upon disposal of a non-controlling interest.

### How is the partial sale of a subsidiary with a change in control accounted for?

A group may decide to sell its controlling interest in a subsidiary

but retain significant influence in the form of an associate, or retain only a financial asset. If it does so, the retained interest is remeasured to fair value, and any gain or loss compared to book value is recognised as part of the gain or loss on disposal of the subsidiary. Consistent with a 'gain' on a business combination, the standards take the approach that loss of control involves exchanging a subsidiary for something else rather than continuing to hold an interest.

### Do previous transactions need to be restated when the new standards are applied?

No. Business combinations and transactions with minorities that occurred prior to the adoption of IFRS 3R and IAS 27R are not restated. The standards are to be applied prospectively to all business combinations for which the transaction date is on or after the first accounting period beginning on or after 1 July 2009. It can be adopted early.

Some future accounting related to previous business combinations will change once the standard is adopted. Deferred tax assets that are recognised relating to a previously acquired business will be accounted for under the new standard. Instead of affecting goodwill, they will be recognised in profit or loss. The purchases or sales of a non-controlling interest that existed at the date of adoption of IFRS 3R and IAS 27R may also be different.

**'IFRS 3R: Impact on earnings – the crucial Q&A for decision-makers'** is aimed at finance directors, financial controllers and deal-makers. It provides background to the standard, considers the impact on the financial statements and controls, and provides summary differences with US GAAP. To order your copy, contact your local PwC office of order online at [www.cch.co.uk/ifrsbooks](http://www.cch.co.uk/ifrsbooks)

#### Contacts:

michael.w.gaul@uk.pwc.com; Tel: +44 20 7213 5671

mary.dolson@uk.pwc.com; Tel: +44 20 7808 2930