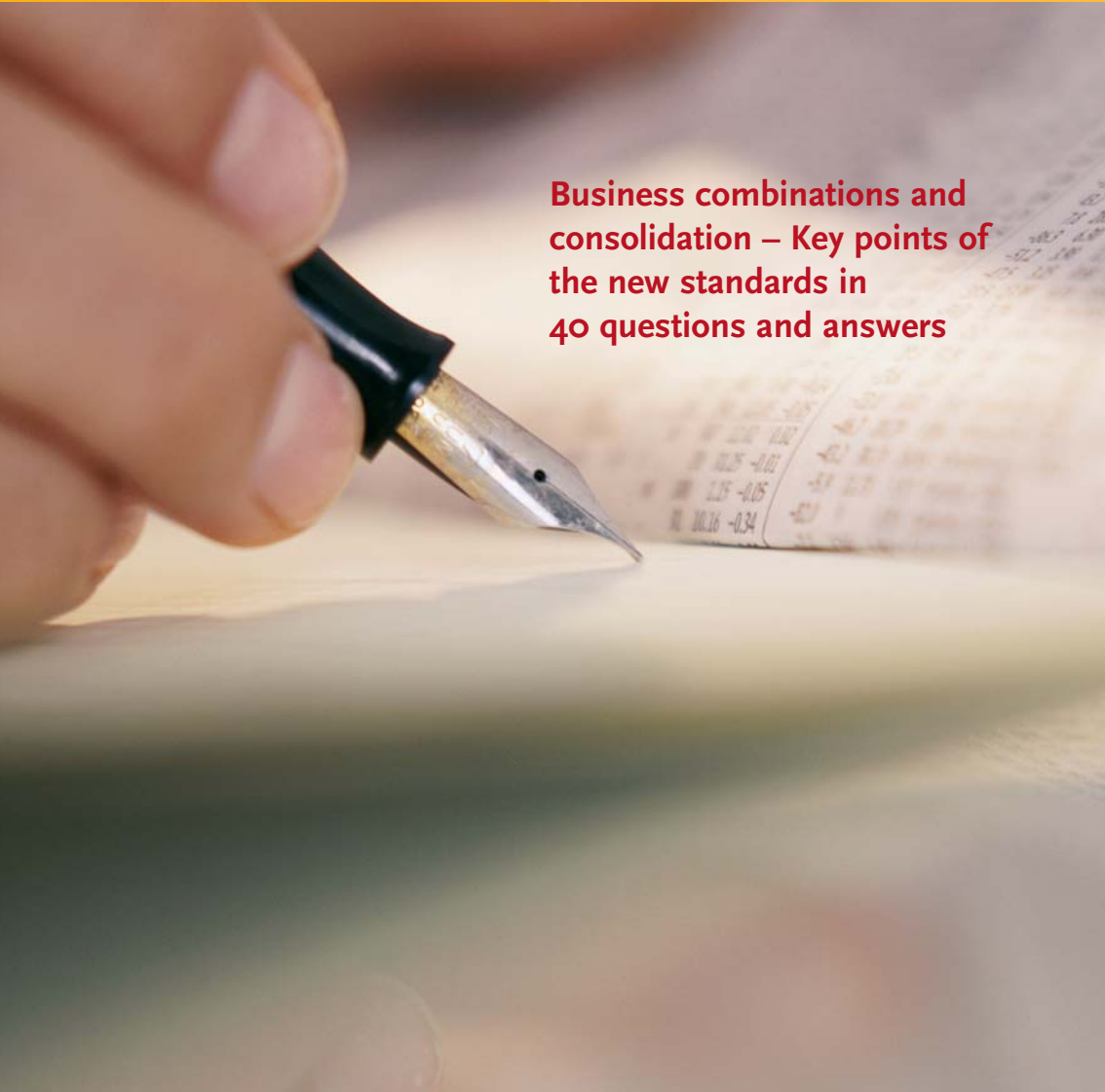


MAZARS INSIGHT

A close-up photograph of a hand holding a black fountain pen with a silver nib, positioned over a document. The document is out of focus, showing some numbers and text. The background is a soft, warm yellow.

Business combinations and consolidation – Key points of the new standards in 40 questions and answers

Introduction

Some years ago, under pressure from investors, the IASB and the FASB, the US standards body, began work to converge the two accounting standards. In 2005 they published a draft joint standard on business combinations and consolidation.

A major new step was taken with the recent publication by the SEC (the US stock market regulator) of a proposal under which American issuers would be able to apply IFRS standards.

The IASB is now under pressure to revise several standards before the date proposed for the transition of US listed companies to IFRS standards, and we can expect greater FASB involvement in the revision process.

An examination of the IASB programme already reveals that several projects have been selected, and are being conducted, by the two standard setters in tandem.

The definitive standards on business combinations, published in late 2007 (US GAAP) and early 2008 (IFRS), have introduced a large number of amendments and have clarified a number of points. We will cover the essential aspects in the form of 40 questions and answers.

Some divergences between the two accounting standards nevertheless persist in this area, in particular on the subject of “full goodwill”, and it may well be that IFRS 3 will be amended once again in the near future.

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Business combinations and consolidation – Key points of the new standards in 40 questions and answers

1. When are the revised versions of IFRS 3 and IAS 27 effective?

On 10 January 2008, the IASB published the revised versions of IFRS 3 (“Business Combinations”) and IAS 27 (“Consolidated and Separate Financial Statements”), which address the recognition of business combinations and their subsequent accounting treatments.

The revised versions of IFRS 3 and IAS 27 are required to be applied prospectively to annual reporting periods beginning on or after 1 July 2009, with an option to apply them both earlier for annual reporting periods beginning on or after 30 June 2007. Retrospective application, however, is not permitted.

For European companies ending their annual reporting periods on 31 December these standards will thus be applied for the first time between 2009 and 2010 (given the adoption by the European Union in June 2009). In practice, a business combination carried out in the first half of 2008, and recognised under the current version of IFRS 3, would have to be restated under IFRS 3R if the group decided to apply the new standards as from 2008. Furthermore, the H1 2008 accounts presented in comparison within the 30 June 2009 financial statements would have to be restated as if the business combination in question had been recognised under IFRS 3R from the beginning.

2. Did the BC2 project reach the desired degree of convergence with US standards?

These standards were the result of Phase 2 of the business combination project led jointly by the IASB and FASB, which led to the publication of an exposure draft on 30 June 2005 and the FASB's publication of FAS 141R (“Business Combinations”) and FAS 160 (“Non-controlling interests in consolidated financial statements”) on 4 December 2007.

The FASB and IASB were in large part able to reach the desired degree of convergence with regard to the treatment of business combinations; however, interactions with other standards explain why certain points are still accounted for differently (see question 4).

3. What was the main direction of the convergence?

On the whole, more changes were made to the US standards than to the IFRS.

FAS 141R, for example, differs from the previous version on several major points, such as:

- (1) recognising development expenses as assets rather than recording them immediately as expenses;
- (2) negative goodwill, representative of a “bargain purchase”, is recognised in the income statement without first reducing certain non-current assets of the acquired business; and
- (3) provisions for restructuring may be recorded in the acquiree’s accounts only where there is an obligation at the date of the business combination.

Similarly, under FAS 160, non-controlling interests must now be classified within equity.

Changes to IFRS included the elimination of the option to not account for an intangible asset separately from goodwill in cases (rare under the standard) where it was not possible to reliably determine the intangible’s fair value. The revised standard considers that the measurement will be sufficiently reliable and that it is preferable to record the asset separately from goodwill.

4. What are the most significant remaining differences between IFRS and US GAAP with regard to business combinations?

The main difference relates to the choice offered under IFRS 3R to measure non-controlling interests (NCI) either at fair value or at the NCI’s proportionate share of the fair value of the acquiree’s identifiable assets and liabilities. US GAAP requires non-controlling interests to be measured at fair value on the date of acquisition.

In addition to the measurement of non-controlling interests, there are differences relating to other items in the two sets of accounting standards. For example, the differences between the two sets of standards on the

question of deferred taxes or share-based payments are also liable to create differences in terms of the accounting treatment of business combinations.

5. What are the main changes resulting from the revision of IFRS 3?

In addition to extending the scope of IFRS 3 (see question 6), the main changes result from a more systematic use of fair value at the acquisition date:

- ▶ expensing of acquisition-related costs, such as consulting fees (accounting treatment now based on the consideration paid rather than the cost of acquisition);
- ▶ re-measurement at fair value of equity interest held prior to the acquisition date;
- ▶ “single” goodwill (i.e., no calculation in “stages”, nor additional goodwill recognised after control is obtained), determined at the acquisition date;
- ▶ measurement of non-controlling interests either at fair value or on the basis of their proportionate share of the fair value of the acquiree’s identifiable assets and liabilities; and
- ▶ adjustment of contingent consideration and deferred tax assets generally booked to the income statement (rather than against goodwill).

The revised version of IFRS 3 also provides additional guidance on the following points:

- ▶ identification of the acquirer;
- ▶ a distinction to be made, with respect to the consideration paid, between amounts that are part of the business combination transaction and other transactions (replacement of share option plans, pre-existing relations and reacquired rights, etc.); and
- ▶ accounting treatment of indemnification assets.

6. Is there any change in scope of the current IFRS 3?

The scope of IFRS 3R now includes business combinations involving mutual entities and those achieved by contract alone but still excludes the formation of joint-ventures and business combinations involving entities under common control (a subject that the IASB placed on its working plan in December 2007).

The definition of what constitutes a business has been modified. The main criterion is now whether the acquired set of activities and assets may be managed as a business. However, a business need not include all of the inputs or processes that the seller used.

Similarly, as it is now the ability to generate output rather than existing output at the date of acquisition that defines a business, start-ups should now come under the scope of the revised standard.

Finally, IFRS 3R clarified the accounting treatment of the acquisition of assets or groups of assets which do not constitute a business. Under IFRS 3R, the acquisition cost must be broken down between the various elements acquired, on the basis of their relative fair value, without recognising deferred taxes on acquisition and without determining goodwill (or negative goodwill).

7. How is goodwill determined under IFRS 3?

Goodwill is defined under IFRS 3 as the difference between the acquisition cost (price of acquisition plus directly attributable costs) and the fair value of the identifiable assets and liabilities and contingent liabilities acquired, and that it concerns only the acquirer's percentage of ownership.

The exposure draft proposed to measure non-controlling interests at fair value and to determine corresponding goodwill for these NCIs (the so-called “full goodwill” method).

Given the criticism of respondents to the exposure draft, and as the Board was unable to reach a majority view, the IASB ended up abandoning this provision, as opposed to the FASB.

The revised IFRS 3R offers the choice, for each business combination, between measuring NCIs:

- at fair value (i.e. with goodwill allocated to NCIs) or
- at their proportionate share of the fair value of the assets and liabilities of the acquired entity (i.e. with no goodwill allocated to NCIs).

In practice, goodwill is still determined as a residual, and is defined as the sum of the following items:

<ul style="list-style-type: none"> + Consideration paid + Amount of any non-controlling interests + Acquisition-date fair value of the previously held equity interest 	<p>See question 10 See question 8</p>
<ul style="list-style-type: none"> - Fair value (except for specific items identified by IFRS 3R) of the identifiable assets and liabilities acquired 	<p>See question 12 See question 18</p>

= **Goodwill**

The option available in measuring non-controlling interests (see question 8) therefore has an impact on the amount of goodwill (or negative goodwill).

Example 1

Company A acquired 60% of Company B at a price of 60. At the acquisition date, the fair value of the identifiable assets and liabilities acquired of B is measured at 80. The fair value of the non-controlling interests is measured at 40.

The table below details the method for calculating goodwill and non-controlling interests, depending on whether A opts for the full or partial goodwill method.

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			Full goodwill	Partial goodwill
Consideration paid	A	60%	60	60
Measurement of non-controlling interests	B	40%	40	32
Fair value of previously held equity interests	C	0%		
	$D = A+B+C$	100%	100	92
Net fair value of identifiable assets and liabilities acquired	E		80	80
Group share	$F = E \times 60\%$	60%	48	48
NCI share	$G = E \times 40\%$	40%	32	32
Goodwill	$= D - E$		20	12
Group goodwill	$= (A+C) - F$		12	12
NCI goodwill	$= B - G$		8	0
Non-controlling interests			40	32
NCI goodwill	$= B - G$		8	0
Share in fair value (net) of identifiable assets & liabilities/non-controlling interests	$G = E \times 40\%$		32	32

Goodwill is thus determined once and for all (“single” goodwill notion) on the basis of the fair value of the assets and liabilities acquired at the acquisition date.

The acquisition of additional equity interests therefore does not give rise to additional goodwill (regardless of the method used, i.e. full or partial goodwill, to account for the combination, see question 28).

In the case of business combinations achieved in stages (step acquisitions), IFRS 3 provided for calculating the amount of goodwill based on the fair value

of the assets and liabilities acquired at the date of each transaction (addition of “layers” of goodwill).

8. Does the use of the full goodwill method have consequences for subsequent business combinations (choice of accounting method)?

The choice of measuring non-controlling interests at fair value or at the NCI's proportionate share of the acquiree's identifiable net assets at the date of acquisition is available for each business combination. It is therefore not a choice of accounting policy.

In practice, an acquirer that opts either for full or partial goodwill on each business combination will have in its balance sheet partial and full goodwill for the combinations achieved after the date of application of the new standard, and partial goodwill for the combinations achieved prior to the date of application of the new standard.

On the other hand, an acquirer that opts for full goodwill on each business combination will have in its balance sheet full and partial goodwill due to the non-restatement of business combinations realised prior to the date of application of the new standard.

9. What are the practical consequences of the full goodwill option?

Accounting of non-controlling interests at fair value and determination of a full goodwill will result in an increase in both goodwill and NCIs (and, hence, equity).

This means that goodwill will not have to be adjusted by a theoretical amount relative to non-controlling interests (known as "gross up" of goodwill under IAS 36), for the purpose of carrying out goodwill impairment tests.

Goodwill impairments will be greater, without affecting the group share of profit (as the goodwill impairment allocated to non-controlling interests is then subtracted from these NCIs).

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In the event the non-controlling interests are later purchased, and assuming that the purchase price is higher than the NCIs' book value, the equity impact will therefore be less. The decrease in shareholder's equity will be lower through the incorporation of goodwill attributed to non-controlling interests, as this goodwill is booked to the value of the non-controlling interests (see question 28).

And, lastly, the full goodwill option is likely to modify the amount of negative goodwill on the income statement. The corollary to considering that the group potentially made a bargain purchase is that the fair value of the non-controlling interests is based on a unit price for each share which is higher than the consideration paid by the group. This automatically results in lower negative goodwill when the full goodwill method is used.

10. What changes have been made in IFRS 3R in determining the consideration paid for the acquisition?

IFRS 3R moved from a cost based calculation, including directly attributable costs, to a calculation based on the price paid for the shares acquired.

In practice, the following items are affected by the new standard:

- the costs directly attributable to the acquisition (see question 11);
- the previously held equity interest (see question 12);
- the pre-existing relationship between the acquirer and the acquiree (see question 14);
- the exchange of share options issued by the acquiree for share options issued by the acquirer (see question 15);
- consideration given to sellers who remain employees of the acquired company (see question 16); and
- contingent consideration (see question 17).

Where the consideration consists of the transfer of assets to the acquired company (rather than to its former shareholders), the consideration is determined on the basis of the book value of the transferred assets rather than on the basis of their fair value at the date of transfer, and no profit or loss impact is therefore recorded. This exception to the principle of measuring the consideration paid at fair value is justified because it is prohibited to re-measure assets still controlled by the group.

11. How are directly attributable acquisition costs booked?

The new standard requires expensing the direct costs associated with the acquisition, for example, legal, consulting or appraisal fees, which were previously included in the cost of the business combination where they were deemed to be directly attributable to the acquisition.

The IASB considers that the acquiring company receives services in exchange for these costs and that, as such, they are not part of the business combination, i.e. the transaction between the acquirer and the seller. For costs relating to purchase of NCI, see question 29.

12. How is previously held equity interest accounted for?

At the acquisition date, previously held equity interest is re-measured at fair value and any difference booked to the income statement (regardless of the accounting treatment previously used for the securities in question).

That amounts to considering that this previously held equity interest has been sold, thus generating a gain (or loss), and bought back immediately as part of the business combination.

The re-measurement of the previously held equity interests that is introduced by IFRS 3R will have an automatic impact on the amount of goodwill (even in the case where the company opts to measure non-controlling interests based on their proportionate share of the fair values of the assets and liabilities acquired).

This method of re-measuring previously held equity interests therefore differs from that provided for in the current standard in terms of 1) where the effect of the re-measurement is recognised (in profit or loss vs. equity), 2) its impact on goodwill (only with IFRS 3R, see question 7), and 3) its amount (re-measurement based on the acquiree's identifiable assets and liabilities under the current standard vs. based on the fair value of previously held equity interests under IFRS 3R).

Furthermore, the obligation to re-measure previously held equity interests, even where the acquirer does not opt for the full goodwill method, will lead to additional valuation costs (see question 39).

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13. What else does IFRS 3R say about determining the consideration paid?

In addition to the changes directly affecting profit and loss, IFRS 3R stresses that the consideration paid under the business combination for the business acquired must be distinguished from consideration paid for a related transaction (e.g., purchase of goods and services).

In other words, the fact that the amount paid to the sellers is legally related to the acquisition of shares by the acquirer does not necessarily mean this amount will be accounted for in its entirety as being representative of the consideration paid for the business acquired. It may therefore be necessary to separate, within the consideration paid, the part that is representative of the acquisition price for the business, strictly speaking, from the part that is being paid for something else.

Under the revised standard, for example, if the acquirer and the acquiree had a pre-existing relationship (e.g. a supply contract or a brand name licensing agreement), IFRS 3R considers that a distinction must be made within overall consideration between what is actually paid for the acquisition of the business and what is paid for the settlement of pre-existing relationships between the acquirer and the acquiree (see question 14).

Similarly, IFRS 3R provides guidance on replacing the acquiree's share-based compensation plan with a similar plan of the acquirer, with a view to determining the part of the replacement plan which is representative of the cost of the business combination and the part representative of a payment for future services (see question 15).

Finally, it is important to analyse any consideration paid to sellers who continue to work for the acquiree, in order to determine whether or not such consideration represents part of the acquisition cost of the acquiree or, on the contrary, represents payments for services, which shall be expensed (see question 16).

Consequently, part of the consideration paid by the acquirer could now be expensed rather than included in the cost of the business combination.

In addition to the examples provided, the standard stipulates that it is necessary to consider the following factors in order to determine what is

paid for the business combination:

- ▶ the reasons for the transaction: does it primarily benefit the acquirer or the acquiree and its former shareholders?
- ▶ who initiated the transaction: understanding who initiated the transaction may also provide insight into whether it is part of the exchange for the acquiree;
- ▶ the timing of the transaction.

14. What accounting treatment is applicable to pre-existing relationship between the acquirer and acquiree?

The acquirer must recognise a gain or a loss, related to the settlement of a pre-existing relationship, based on the type of relationship.

Where the relationship is not contractual (such as a lawsuit), the fair value of this relationship should be booked to the income statement.

Where the relationship is contractual, the gain or loss is the lesser of:

- ▶ the amount by which the contract is favourable or unfavourable when compared with terms for current market conditions.

The concept of favourable or unfavourable contracts differs from the concept of onerous contracts under IAS 37. For example, a supply contract for commodities at a price higher than that of the market is unfavourable, but not onerous where the sale of the finished goods manufactured with the raw materials purchased generates a profit.

- ▶ the amount of any stated settlement provisions in the contract available to the counterparty to whom the contract is unfavourable.

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The table below summarises the various possible cases:

Type	Example	Recognised in	Measurement
Non-contractual relationship	Lawsuit	Income statement (at the acquisition date)	Fair value
Contractual relationship	Supply contract	Income statement (at the acquisition date)	The lesser of a) the favourable/unfavourable contract position and b) compensation in the event of early termination.
Reacquired rights	Brand licensing	Asset Income statement for the fraction above the market price (see above)	Measurement of the asset based on the remaining duration of the contract (without taking renewals into account) and amortisation over the same period.

In some cases, the acquirer had granted a given right to the acquiree, such as the right to use a brand, and as a result of the business combination, the acquirer reacquires the right to use one of its assets. Any difference between the market conditions and the conditions provided for in the contract for the use of the asset in question is treated as indicated above (recognised in the income statement at the acquisition date of the settlement for the pre-existing relationship). Reacquired rights are examined in further detail in the new standard (see question 24).

Example 2

Company A signs a 5-year contract to purchase parts from Company B at set prices. At the date of the business combination, these prices are higher than those on the market. The contract provides for early termination with a penalty payment of EUR 6 million.

The fair value of the contract held by B is EUR 8 million (EUR 3 million corresponding to “market prices” and the remainder, EUR 5 million,

corresponding to a non-market factor, i.e. the fact that the prices listed in the contract are higher than those on the market).

As a consequence of the deemed early termination of the contract arising from the takeover of B by A, A will have to record a loss of EUR 5 million corresponding to the lesser of the penalty provided for in the contract (EUR 6 million) and the “off-market” portion of the contract (corresponding to the prices of the parts which are higher than the prices on the market), i.e. EUR 5 million.

EUR 5 million (relating to the settlement of a pre-existing relationship) will therefore be subtracted from the amount paid by A to determine the consideration paid for the acquisition of B.

15. What provisions apply where the acquirer exchanges the acquiree's share options for the acquirer's share options?

When the acquirer is required, by virtue of the acquisition contract or of the share options plan, or for legal reasons, to make such an exchange, at least a portion of the cost of this replacement must be considered to be part of the acquisition (i.e. of the consideration paid).

Where there is no such obligation binding the acquirer, the cost of the replacement may not be included in the consideration paid for the business combination and the replacement is therefore analysed as an amendment to the share option plan in question (in order to determine the amount to be recorded under personnel expenses resulting from the amendment of the plan).

In the first case, only the fraction paying for services rendered prior to the business combination are to be included in the acquisition cost.

The fraction of the replacement plan which is related to services rendered prior to the business combination is determined as follows:

$$\begin{array}{c}
 \text{Fair value of the acquiree's plan (at the date of acquisition)} \\
 \times \\
 \text{Vesting period completed} \\
 / \\
 \text{Maximum (total vesting period, original vesting period under the acquiree's plan)} \\
 = \\
 \text{Fraction of the consideration paid for the acquiree}
 \end{array}$$

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The total vesting period corresponds to the sum of a) the fraction of past services already rendered at the date of acquisition and b) the period of services to be rendered for the replacement plan (i.e. after the business combination). An expense must therefore be recognised in the event the acquiree's employees had completed their period of service where the replacement plan provides for an additional period of service.

The non-vested portion of a replacement plan, attributable to post-combination services, is expensed as remuneration costs in the subsequent periods. This portion includes not only the difference between the fair value of the new share options and the fair value of the former share options (recognised in the income statement after the acquisition, spread out over the remaining acquisition period), but also the portion of the fair value of the former plan which is not considered to be part of the business combination (non-vested portion).

The fair value of the replacement plan can be divided into several sections, as indicated in the table below.

Fair value of the acquirer's plan		
Fair value of the acquiree's plan		
Fraction that is part of the business combination (and, hence, is included in goodwill)	Fraction not part of the combination (to be expensed as post-combination services)	
= Fair value of acquiree's plan x vesting period completed / Max (total vesting period, original vesting period at the acquiree)	= Fair value of acquiree's plan - portion representative of reacquired rights	= Excess of the fair value of acquirer's plan over the fair value of acquiree's plan

Example 3

Company M acquires Company F and replaces F's share option plan.

F's plan vesting period is 5 years, 3 of which are completed at the acquisition date, and the fair value of F's plan was 100,000 at the acquisition date.

M's share option plan has a fair value of 110,000 and requires a one-year vesting period.

The fraction attributable to completed service is therefore 60,000.

Fair value of F's plan x Vesting period completed / max (total vesting period of, original acquiree's vesting period)

$$100,000 \times 3 \text{ years} / \max (3 \text{ years completed} + 1 \text{ year post-acquisition, 5 years}) = 100,000 \times 3 / 5 = 60,000$$

The remainder, i.e. 50,000 (110,000 from the new plan - portion attributed to the business combination, i.e. 60,000) will be expensed over the remaining vesting period (1 year).

16. When the former shareholders render post-acquisition services as employees, is the consideration paid part of the exchange for the acquiree or remuneration for post-combination services?

Where the transaction calls for contingent payments (e.g. an "earn-out clause"), it must be determined whether these contingent payments represent an adjustment to the acquisition price for the acquiree in the business combination or actually represent remuneration for post-combination services provided to the acquirer after the acquisition (i.e. employee benefits or share-based payments).

Current IFRSs provide no detail on how to distinguish consideration for the acquisition of the acquiree from consideration for remuneration of future services.

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IFRS 3R provides a list of indicators, including the level of remuneration of the person employed, the formula used to determine the contingent payment, the linkage between the contingent payments and the valuation of the acquiree, and the incremental feature of the payments to employees (i.e. contingent payments only made to employees).

However, whenever payments are automatically forfeited if employment terminates, the arrangement is considered to be remuneration for post-combination services (i.e., personnel costs), whereas the other factors mentioned above are only provided as indicators.

The revised standard goes beyond the provisions contained in the exposure draft, which only include indicative factors (taken from EITF 95-98, “*Accounting for Contingent Consideration Paid to the Shareholders of an Acquired Enterprise in a Purchase Business Combination*”).

The conclusive, rather than indicative, nature of the case mentioned above, whereby any contingent payment not made in the event of the seller/employee’s departure must be considered as a post-acquisition expense, will have to be taken into account by the persons responsible for negotiating the business combination.

17. How to account for contingent consideration not determined as at the date of the business combination?

Under the current standard, contingent consideration is included in the acquisition cost, with no time limit, where the payment of the consideration is probable and can be measured reliably.

Under the revised standard, contingent consideration is fair valued at the acquisition date, even if it is contingent in nature.

Adjustments of contingent consideration realised over the measurement period, i.e. a maximum period of 12 months following the acquisition date, must be assessed to determine:

- if the adjustment is related to new events that occurred after the acquisition date: in this case, the adjustment is booked to the income statement, or

- ▶ if the adjustment is the result of new information collected, making it possible to refine the measurement made at the acquisition date: in this case, the adjustment is included in the acquisition price.

In any event, if the contingent consideration is paid in equity instruments, no adjustment is booked.

Changes in fair value of the consideration after the measurement period are booked under IAS 39 where the contingent consideration is paid in financial instruments (adjustment based on fair value, booked in the income statement or in equity depending on the type of instrument) or under IAS 37 in the case of non-financial assets.

In any event, goodwill may not be modified after the end of the measurement period under IFRS 3R, whereas under the current standard adjustments to the acquisition price affect the cost of the business combination with no limit of time (no “measurement period” for contingent consideration in the current standard). Consequently, any modification of the debt corresponding to contingent consideration after the measurement period will have an impact on the income statement.

Example 4

Entity A acquires 100% of Entity B on 1 July 200X. A agrees to pay a contingent consideration of 10% of the operating income over the next three financial years. At the acquisition date, A values this contingent consideration at EUR 3 million.

On 31 December 200X + 2, A revises the operating income forecasts for B and anticipates a contingent consideration of EUR 4 million instead of EUR 3 million. The increase in the contingent consideration (EUR 1 million) will be expensed for financial year 200X + 2, and the goodwill recognised upon acquisition will not be modified.

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The table below details the accounting treatment for adjustments of contingent consideration depending on the type of consideration (equity instruments or other) and the adjustment date.

	Type of consideration	
	In equity instruments	In cash or other assets
During the measurement period	No adjustment	New information on the situation at the acquisition date: goodwill
After the measurement period		Adjustments resulting from post-acquisition events and/or adjustments after the measurement period: <ul style="list-style-type: none"> ▶ Financial instrument (IAS 39): fair value (counterpart: income statement or equity, depending on the instrument) ▶ Not a financial instrument: best estimate (counterpart: income statement).

18. What is the general principle for the identification and measurement of acquired assets and liabilities?

Identifiable assets and liabilities of the acquiree must be recognised at their fair value at the acquisition date (i.e. the date on which the acquirer obtains control of the acquiree). This general principle is nevertheless amended for certain asset and liability items.

The revised standard stipulates that fair value is independent of the acquirer's intentions (non-use or different use by a potential acquirer) and must be considered as a new gross value.

For example, for a receivable with a nominal value of 100 and a fair value of

92, the receivable is to be entered in the acquirer’s accounts at 92, and not the combination of a gross value of 100 and an impairment provision of 8.

Assets and liabilities must normally be classified on the basis of conditions existing at the date of the acquisition (the acquirer is therefore not bound by the classification previously used by the acquiree).

For example, the identification of embedded derivatives and the designation of hedging policies will be based on conditions existing at the acquisition date.

As an exception, in the case of lease and insurance contracts, the standard provides for a classification based on the contract’s original terms (except, naturally, if the contract terms have been modified, for example at the acquisition date, in which case the classification is based on the new terms).

The standard also provides specific principles for recognition and measurement regarding certain items:

	Exceptions to recognition principles	Exceptions to measurement principles	
Contingent liabilities (IAS 37)	X		See question 21
Assets/liabilities linked to employee benefits (IAS 19)	X	X	(*)
Deferred tax assets/liabilities (IAS 12)	X	X	See question 22
Indemnification assets	X	X	See question 23
Share-based payments (IFRS 2)		X	See question 15
Reacquired rights		X	See question 24
Held-for-sale assets (IFRS 5)		X	See question 25

(*) Assets/liabilities linked to employee benefits are valued according to the provisions of IAS 19.

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19. Has the treatment of intangible assets been modified by the revised standard?

Yes, even though the accounting treatment of intangible assets has little evolved under IFRS and must be assessed with regard to the respective changes to IFRS and US GAAP (see question 3).

The revised standard confirmed the obligation to identify and measure at fair value any ongoing development projects, an issue on which US GAAP has been modified.

As regards the non-identification of an intangible asset where its fair value cannot be reliably determined, the IASB has converged towards the position of the FASB. IFRS 3R considers that all intangibles can be valued reliably, as uncertainties on cash flow are included in the fair value measure.

Furthermore, IFRS confirms the fact that assembled workforce may not be identified as an intangible asset.

The treatment of operating leases was clarified, with the standard stipulating that the lessee must recognise an intangible asset or a liability for the difference between the contract terms and the market conditions at the acquisition date (see question 14 for the concept of the favourability/unfavourability of the contract).

In the case of the lessor, the lease terms are taken into account to determine the fair value of the asset (in the form of a component), whereas a separate intangible asset or liability must be booked to the lessee's accounts.

Finally, the standard specifies that an operating lease signed under market conditions may nevertheless have a positive value and be identified as an intangible asset in certain cases (e.g. a lease on a building in a prestigious location).

20. Does IFRS 3R define the method for determining the fair value of acquired assets and liabilities?

Unlike the current version of the standard, IFRS 3R does not provide any specific indications on how to determine the fair value of certain acquired assets and liabilities.

The current version of the standard provides details on how to determine the fair value of certain items, such as inventories, plant, property and equipment, receivables and financial instruments that are not traded on an active market.

IFRS 3R nevertheless provides guidance on certain points: for example, the fact that fair value is not determined based upon the future use of the asset by the acquirer (see question 18); the necessity of including the terms of the operating lease in the fair value of a rented asset rather than in a separate asset or liability (see question 19); and the fact that fair value constitutes a new gross value (see question 18).

Finally, it should be noted that, in May 2009, the IASB published an exposure draft on fair value measurement that should lead to the publication of a new standard in 2010.

21. Are contingent liabilities accounted for differently under IFRS 3R?

Contingent liabilities include both potential obligations whose existence will be confirmed by future events, and present obligations not recognised (either because the obligation cannot be reliably measured or because it is not probable that an outflow of resources will arise).

Under the revised standard, the only obligations that can be identified in a business combination are present obligations that can be reliably measured, but for which an outflow of resources is not probable.

Example 5: risk on a tax position where a tax audit is deemed unlikely (e.g. 10%). In this case, a contingent liability, measured at fair value, should be recorded as part of the business combination.

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Thus, as opposed to the current standard, contingent liabilities based on potential obligations are no longer recognised under the revised standard.

22. How to account for deferred taxes in a business combination?

As in the current version of the standard, IFRS 3R considers that changes in the acquirer's deferred taxes linked to the acquisition must be booked to the income statement after the acquisition because they are not part of the business combination.

Concerning changes in the acquiree's deferred taxes after the acquisition date, only new information obtained during the measurement period about facts and circumstances that existed as of the acquisition date result in additional deferred tax assets or liabilities accounted for as an adjustment in goodwill. Otherwise, changes in deferred tax assets or liabilities are booked as an adjustment to the post-acquisition profit or loss.

The current standard does not require a precise distinction between the different causes of variation in the acquiree's deferred taxes. It also requires a reduction in the book value of the goodwill equal to the deferred tax assets recognised after the measurement period ends (so that the effect on the income statement is nil).

23. How are indemnification assets granted by vendors booked?

Recognition is based on the principle of symmetry between liabilities and the corresponding assets. An indemnification asset is therefore recognised as an asset on the condition that the corresponding liability is also recognised.

An indemnification asset in a business combination is therefore recognised even if its payment is not probable, for example if the corresponding liability has little chance of resulting in an outflow of resources.

Assets are measured in the same way as liabilities, both at acquisition date

and later on, based on assumptions that are consistent with those used in measuring liabilities, and taking into account the possible risk of non payment.

Example 6

- 1) *An agreement provides for the complete indemnification of the acquirer in the event uncertain tax positions are called into question. In such case, the acquirer must measure and recognise the liability at the acquisition date, and also recognise an asset for the same amount at the acquisition date.*
- 2) *An agreement calls for the acquirer to be indemnified only for penalties incurred. In such case, the acquirer must measure and recognise the liability at the acquisition date, and recognise an asset limited to the contractual commitment (penalties), measured using the same assumptions as the liability (i.e. probability).*

24. On what basis must reacquired rights be measured?

Reacquired rights are rights granted previously by the acquirer to the acquiree to use its assets (for example, a license to use a brand name of the acquirer) and recovered through the business combination.

In such case, the business combination calls for:

- ▶ the settlement of a pre-existing relationship, which leads to the recognition of income or an expense (see question 14);
- ▶ the recognition of the reacquired right as an identifiable intangible asset measured in the acquirer's accounts on the basis of the remaining contractual term.

This asset is not measured at fair value because its measurement does not take into account any possible renewals which another acquirer would have taken into account.

In the interest of symmetry, the asset is amortised over the remaining contractual term, in order to ensure consistency between the duration used to measure the acquired right and the duration of amortisation.

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25. How are assets held for sale measured?

Assets held for sale are measured in accordance with IFRS 5, i.e. at fair value less costs to sell, rather than at fair value as stipulated in the current and revised standard.

The IASB had planned to eliminate this exception and to impose measurement at fair value, but abandoned this idea during the course of its deliberations in April 2008.

26. Until when may the acquiree's assets and liabilities be adjusted against goodwill?

The revised standard confirms the principle whereby the measurement period is limited to the period required to identify and measure the acquiree's assets and liabilities, non-controlling interests, the consideration paid and the fair value of previously held equity interests, and cannot exceed 12 months (from the acquisition date).

The measurement period ends once the acquirer has obtained the last remaining pieces of information. If the initial accounting for the business combination is incomplete, the provisional nature of the accounting treatment of the business combination should be disclosed.

The revised standard also specifies the terms under which the accounting treatment of the business combination may be adjusted after the acquisition date. Only items that would have been taken into account on the acquisition date, but on which the acquirer did not have all necessary information at that time, may result in additional assets and liabilities against goodwill. On the other hand, adjustments resulting from new events after the acquisition date are to be included in the income statement of the reporting period.

Once the measurement period has ended, the acquirer may only revise the accounting of the business combination to correct an error.

As already mentioned, any changes in the acquiree's deferred taxes after the measurement period will no longer give rise to a reduction in goodwill (see question 22).

27. What are the main changes made to IAS 27?

The following points were amended in IAS 27:

- ▶ changes in equity interests with no effect on control are now addressed by the revised standard (see question 28);
- ▶ loss of control now has an impact on the measurement of retained equity interests (see question 30);
- ▶ where the loss of control happens over several stages, the facts and circumstances must be reviewed in order to determine whether or not there is a potential link between the different transactions (see question 31); and
- ▶ the allocation of a subsidiary's losses between the Group and non-controlling interests was amended (see question 32).

28. What does IAS 27R say about changes in equity interests with no effect on control?

Changes in equity interests with no effect on control (additional acquisition or disposal) are now addressed by IAS 27R, which stipulates that their impact will be recognised in equity (the difference between the consideration paid or received and the book value of the non-controlling interests is directly recorded in equity).

The revised standard also stipulates that the value of the subsidiary's assets and liabilities, including goodwill, are not affected by these transactions. The goodwill is "single" and determined at the acquisition date (see question 7).

This accounting treatment is consistent with the economic entity approach, which considers that transactions with non-controlling interests only affect equity, as they are transactions between shareholders. Just as the parent company's repurchase of its own shares does not affect the income statement, changes in equity interests with no effect on control must also be recognised in equity, as shares in subsidiaries are considered equity instruments of the Group.

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In practice:

- ▶ where the percentage of interest falls with no loss of control, no “dilution result” is generated, and a share of the goodwill corresponding to the equity interest sold must be allocated to NCI's;
- ▶ where the percentage of interest rises, no additional goodwill is recognised. Under the full goodwill method, a reclassification is necessary between NCI's goodwill and group goodwill, up to the percentage bought. On the other hand, no change in goodwill is normally necessary when goodwill is partial.

The impact on equity will therefore usually be higher where non-controlling interests have not been measured at fair value at the acquisition date (full goodwill, see question 9).

Example 7

Acquisition of additional interests

Using the data from Example 4 (see question 17), Company A acquires the remaining 40% ten years later for 100. The book value of the non-controlling interests at this date is 70 (excluding goodwill).

The difference between the book value of the non-controlling interests and the consideration paid (100) is subtracted from equity.

Assuming that goodwill was not subject to impairment, equity will be reduced by 22 if A opted for the full goodwill method (consideration of 100 less non-controlling interests, excluding goodwill of 70 and goodwill of 8 originally allocated to non-controlling interests). The goodwill originally allocated to non-controlling interests will be reallocated to the group.

On the other hand, if A opted for the partial goodwill method, equity will be reduced by 30 (100-70). Furthermore, the group will not be able to reallocate goodwill or recognise any additional goodwill.

In addition to the matter of measuring non-controlling interests, the downside to this method is that the more value the controlled entity gains since the

acquisition, the greater equity will diminish on the later acquisition of additional interests. This is because the items supporting this valuation are seldom booked in the controlled entity's accounts (i.e. new customer contracts, ...).

29. How are costs relating to NCI purchases accounted for?

IFRS 3R, which stipulated that costs relating to business combinations must be expensed (see question 11), does not apply to increases in equity interests where the group already controls the subsidiary.

IAS 27R indicates that the difference between the fair value of the consideration paid and the book value of the non-controlling interests must be recognised in equity, without specifying how associated costs should be recognised.

The IFRIC considers that these costs should be analysed as directly related to equity transactions, and therefore booked in equity (see wording for rejection, IFRIC Update for July 2009).

Before, two possible accounting treatments to choose from existed to account for costs relating to NCI purchases (on the condition that their application is consistent):

- ▶ they could be expensed,

Expensing these costs is justified in reference to the fair value of the consideration paid under IAS 27R, rather than to the cost of purchase, and also in accordance with the new provisions of IFRS 3R.

- ▶ they could be recognised in equity.

Purchasing NCIs is an equity transaction, and IAS 32 stipulates that the associated costs should be subtracted from equity.

30. Does loss of control have an impact on the equity interests retained?

Loss of control of a subsidiary leads to the recognition of a disposal gain or loss and, as opposed to the current standard, calls for the re-measurement of the retained equity interest at fair value.

According to the IASB, taking or losing control of a subsidiary constitutes a major event justifying a change in valuation method. Therefore, on the loss of control of a subsidiary, any retained equity interest must be re-measured at fair value and booked to the income statement. The same reasoning applies when the group loses significant influence or joint control.

In the event the group loses control while retaining significant influence, it is necessary to carry out a fair value measurement (“Purchase Price Allocation”, as with any investment leading to the acquisition of significant influence).

The loss of control of a subsidiary also leads to the “recycling”, through profit or loss, of certain “other income and expenses” belonging to the majority shareholders, as if the subsidiary’s assets and liabilities had been disposed of separately. This is the case in particular for amounts relating to changes in fair value of available-for-sale financial assets, and translation differences on foreign currency-denominated assets or liabilities.

Where the loss of control results from the parent company’s decision to distribute the subsidiary’s shares to its own shareholders, this transaction must be recognised as a distribution (see IFRIC 17 “Distribution of non cash assets to owners”).

31. Is an additional analysis needed when the loss of control occurs in stages?

Under the revised standard, the group must analyse the circumstances in which the loss of control takes place in order to determine whether or not the various agreements have to be considered as a single transaction.

To determine if several agreements must be recognised as a single

transaction, all the terms and conditions of these agreements must be analysed, along with their economic consequences.

In practice, what must be considered is the timing of the various transactions, the contingent character of these transactions (i.e., the possible link between them), and the economic reality of the transactions.

For example, where certain transactions are carried out at off-market prices, the economic impact of these transactions can only be assessed globally because the equilibrium of the transaction exists only at the global level, by grouping together the different transactions.

In such case, the accounting treatment must be consistent with the analysis performed, and all of the transactions in question must be considered as leading to the loss of control.

Example 8

Company M controls 70% of Company F and plans to dispose of 19% initially, before disposing of the remaining 51% at a later date.

If the first transaction is analysed as a separate transaction, the profit or loss from the disposal of the 19% will be recognised in equity, whereas the profit or loss from the disposal of the remaining 51% will have to be booked to the income statement.

On the other hand, if both transactions are considered to be linked, then the profit or loss from the disposal of the entire 70% will be booked to the income statement.

32. Is the allocation of a subsidiary's losses modified by the new standard?

Where the allocation of a loss to minority shareholders leads to non-controlling interest having a deficit balance within consolidated shareholders' equity, the current standard requires that the excess loss be allocated to the parent company shareholders and not to non-controlling interests, unless there is an agreement stipulating that the minority shareholders are obliged to reinvest in the company to absorb the losses.

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According to the revised standard, comprehensive income is allocated to the parent company shareholders and to non-controlling interests on the basis of percentage of interest. This is the case even if it results in non-controlling interest having a deficit balance (in the event of losses).

Remember that comprehensive income includes the profit for the year as well as other items booked directly to equity (other comprehensive income such as translation differences on subsidiaries and changes in fair value of available-for-sale financial assets).

33. What are the transitional provisions of the revised standards?

IFRS 3R and IAS 27R should be applied prospectively, with the option of applying them early (see question 1).

In theory, IAS 27R should be applied retrospectively, but the scope of the exceptions provided for are such that the standard should actually be applied prospectively.

The standard also includes specific transitional provisions for business combinations by contract alone and mutual entities where these have been applying methods other than the acquisition method (pooling).

IFRS 3R stipulates that assets and liabilities that arose from business combinations prior to its initial application are not affected by the first application of the revised standard.

However, adjustments in contingent considerations for acquisitions made prior to the first application of IFRS 3R could be either:

- be booked to the income statement (rather than goodwill), due to the change in the measurement period for contingent considerations (see question 17),
- be booked as an adjustment to goodwill since it was apparently not the Board's intention to change the accounting treatment for past business combinations.

The IASB proposed to clarify that contingent consideration that arose from business combinations whose acquisition date preceded the application date of IFRS 3R are not affected by the change in IAS 39 (see the exposure draft “Improvements to IFRS” published in August 2009).

Moreover, adjustments in the acquiree’s deferred tax assets after the new standards are effective must be booked to the income statement, with no corresponding adjustment to goodwill (see question 22).

34. Do the new standards provide details on the treatment of puts granted to minority shareholders?

The revised standards provide no new details on puts granted to minority shareholders.

Remember that the current standards did not specifically refer to this subject.

In practice, several approaches are used for the initial accounting treatment of debt:

- an “equity” approach, which books debt to equity;
- an “ongoing goodwill” approach, which anticipates the impact of the business combination, where debt would be booked to a) equity (up to the amount of NCIs) and b) ongoing goodwill (for the surplus).

Subsequent changes in debt, beyond the impact of the unwinding of discount (booked to the income statement), could be booked:

- to the income statement (debt-favouring approach),
- to “ongoing goodwill” (anticipation of the acquisition approach),
- to equity (share buyback or early application of IAS 27R approach).

35. Will the treatment of puts nevertheless be affected by the adoption of the new standards?

Yes, because even though the new standards do not directly address the issue of puts granted to minority shareholders (see question 34), certain

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provisions of the revised standards should nevertheless impact on the accounting treatment of puts.

The fact that goodwill is now single means that the “ongoing goodwill” approach is no longer possible in our view (see question 7 dealing with the concept of single goodwill).

In practice, at the date of first application of the new standards, any ongoing goodwill which has been booked should:

- ▶ be maintained as is where the put was granted in the course of a business combination.

Assets and liabilities from business combinations prior to first application are not affected by the first application of the revised standard (see question 33).

- ▶ be maintained as is, or cancelled (against equity), where the put was not granted in the course of a business combination.

As the transitional provisions of IFRS 3R (referred to above) are not applicable in this case, in our opinion the group has a choice.

The cancellation of ongoing goodwill may be justified by the new approach prescribed by IAS 27R (no new goodwill upon the subsequent purchase of additional NCIs).

However, the group is not obliged to cancel ongoing goodwill, and the revised standards do not address the case of puts granted to minority shareholders.

In any event, in our view subsequent changes in debt should not be booked to ongoing goodwill.

The ongoing goodwill approach was justified by goodwill that was liable to result in the purchase of additional NCIs. As the revised standards call for the use of single goodwill, no additional goodwill may be booked for the purchase of any further equity interests in a subsidiary.

36. What key changes have the revised standards made to financial disclosures?

The main new disclosures required by IFRS 3R relate to the following:

- ▶ the fair value of previously held equity interests in the acquiree (with profit or loss linked to re-measurement, and the relevant line of the income statement);
- ▶ the method used to measure non-controlling interests (and the key inputs required for their measurement);
- ▶ a description of the transactions recorded separately from the business combination, the accounting treatment adopted, the amounts involved and the lines of the relevant financial statements;

In the case of settlement of a pre-existing relationship: indicate the method used to determine the amount of the settlement.

- ▶ the amount of the acquiree's revenue and profit or loss incurred, since the date of acquisition;
- ▶ the amount of contingent consideration recorded at the acquisition date, a description of the agreements and valuation methods, and an estimate of future consideration (range of non-discounted amounts) or an indication of the reasons why the group is unable to provide this information; and

The group must specify if the maximum contingent consideration is unlimited.

- ▶ the revised standard requires full disclosure on receivables, i.e. their fair value, their contractual amount, and the best estimate at the acquisition date of any amounts the group does not expect to recover.

IAS 27R requires the following disclosures:

- ▶ a schedule presenting the effects of any changes in a parent's ownership interest in a subsidiary that do not result in a loss of control; and

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- ▶ gain or loss booked on the loss of control of a subsidiary, with the portion attributable to recognising any retained interest in the former subsidiary at its fair value and the corresponding line items of the financial statements.

37. Should these standards be considered permanent?

In its feedback statement, the IASB announced that these standards would be subject to review two years after their application becomes mandatory.

The purpose of the feedback statement is to address the comments received by respondents to the exposure draft, the Board's response to any of their objections, and the final decision taken by the IASB.

The future review will be restricted to any problems encountered in applying the revised standards and to any points that were the focus of problematic discussions during the drafting of the standards (e.g. the choice between full goodwill and partial goodwill).

The full/partial goodwill option may end up being removed during the IASB's review, with a view to converging towards US GAAP, and especially because the IASB considers that most business combinations do not lead to the recognition of NCIs.

38. What other standards are impacted by the BC2 project?

The main changes to other standards are as follows:

- ▶ IAS 12: deferred tax assets recognised after the acquisition date must be booked to:
 - goodwill, where the deferred tax assets result from new information obtained during the measurement period that provides for a more accurate assessment of the facts and circumstances existing at the acquisition date,
 - the income statement in other cases (see question 22);
- ▶ IAS 16: the favourability/unfavourability of an operating lease, which is

taken into account to determine the fair value of the rented asset, will constitute a component (see question 19);

- ▶ IAS 21: on the partial sale of a subsidiary, a fraction of the translation differences must be allocated to the minority shareholders;
- ▶ IAS 28: retained equity interests are re-measured at fair value through profit or loss at the date on which significant influence is lost, whether the group takes control or loses all influence (see question 30);
- ▶ IAS 36: application guidance for carrying out impairment tests, depending on whether or not the subsidiary is itself a cash-generating unit (CGU) or is part of a larger CGU;
- ▶ IAS 38: the fair value of an intangible asset will always be reliably determined (see question 19). The duration of the amortisation of a reacquired right must be based on the residual duration of the contract (see question 24);
- ▶ IAS 39: contingent consideration relating to business combinations (see question 33) must be included in the scope of IAS 39.

39. How is the fair value of shares, which are not part of the transaction, determined?

IFRS 3R requires previously held equity interests to be re-measured at fair value (see question 12). Similarly, where the group loses control but still maintains significant influence over the subsidiary, the retained equity interests must be measured at fair value (see question 30).

The fair value of previously held equity interests is not necessarily equal, based on a unit price per share, to the consideration paid for the acquisition of further equity interests enabling the group to obtain control, because in principle it is necessary to take a control premium into account.

Where the subsidiary is listed, the previously held equity interests can usually be measured by reference to the market price. Where this is not the case, the calculations performed to arrive at an offer price may be used as a

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starting point to determine the control premium.

In any event, the assessment of the size of the control premium has to be carried out on a case by case basis, and in practice may require an expert opinion.

Also remember that IFRS 3R requires the group to provide, in the notes to the financial statements, the fair value of the previously held equity interests and the profit or loss from the re-measurement of the fair value (see question 36). These items will enable readers of the financial statements to understand how the control premium was calculated.

40. IFRS 3R and IAS 27R: Top 10 points to remember

1. First application between 2008 and 2010 for companies with their financial year ending on 31 December (2009 or 2010 for European companies).
2. Expanded scope.
3. Greater use of fair value:
 - a. Option of measuring NCIs at fair value; and
 - b. Re-measuring at fair value (booked to the income statement):
 - i. of previously held equity interests at the acquisition date,
 - ii. of retained equity interests on the loss of control (or significant influence).
4. Increased importance of the concept of control (taking/losing control, loss of significant influence or joint control).
5. Single goodwill, determined at the acquisition date (no longer different layers of goodwill in the case of stage acquisitions, no more calculation of additional goodwill in the case of acquisitions of further equity interests after obtaining control).
6. Option between full goodwill and partial goodwill on each business combination. Impact of the choice made in the event of subsequent changes in equity interests.

7. More items booked to the income statement on initial recognition:
 - a. Expensing of costs related to the business combination (consulting fees, etc.);
 - b. Separation between transactions that are part of the business combination (acquisition of shares) and other transactions (future services in the case of share option exchanges or contingent considerations paid to sellers who remain employees, settlement of pre-existing relationships, etc.); and
 - c. Re-measurement of previously held equity interests.
8. Obligation to identify and measure at fair value all of the acquiree's intangible assets (no longer any exemption for recognising an intangible where its fair value cannot be reliably determined).
9. Adjustments to the cost of the business combination and/or acquired assets and liabilities usually booked to the income statement (in goodwill if a) within 12 months and b) sheds light on the circumstances existing at the acquisition date),
 - a. Adjustment to the acquiree's deferred taxes; and
 - b. Adjustments to the acquisition price (contingent considerations).
10. Subsequent changes in equity interests with no effect on control booked to equity:
 - a. Increase in equity interests: no additional goodwill (only reallocation of goodwill between minority shareholders and group); and
 - b. Decrease in equity interests: no "dilution result" is recorded.

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