



Technical Accounting Alert

Revised AASB 3 *Business Combinations* and AASB 127 *Consolidated Financial Statements*

Introduction

On 10 January 2008 the IASB published two revised Standards on accounting for business combinations and consolidated and separate financial statements:

- IFRS 3 *Business Combinations* (revised 2008) ("IFRS 3R"); and
- IAS 27 *Consolidated and Separate Financial Statements* (revised 2008) ("IAS 27R").

The equivalent standards were released in Australia in March 2008 as AASB 3 ("AASB 3R") and AASB 127 ("AASB 127R"), along with omnibus standards AASB 2008-3.

Background

The International Standards (IFRS 3R and IAS 27R) on which Australian Accounting Standards are based have been developed jointly by the IASB and its US counterpart, the Financial Accounting Standards Board (FASB). IFRS 3R is the first major new standard to be produced jointly with the FASB. However, the two Boards reached different conclusions in a few areas with the result that the IFRS 3R and the equivalent new US Standard (SFAS 141 (Revised 2007)) are not identical.

Overview

The revised Standards introduce major changes to the accounting requirements for business combinations, transactions with non-controlling interests (a new term for "minority interests") and the loss of control of a subsidiary. AASB 3R in particular is a lengthy publication and covers several complex accounting issues. This new Standard includes an Application Guidance section and is supported by two separate booklets containing Implementation Examples and a Basis for Conclusions. This alert provides an overview of the most significant changes.

Summary of major changes

Business combinations

- Goodwill in a business combination is determined at the acquisition date as the consideration transferred, plus the fair value of any previously held investment, the amount of any non-controlling interest less the fair values* of the identifiable assets and liabilities. As a result of measuring goodwill only at the acquisition date the "business combination achieved in stages" approach in the previous version of AASB 3 no longer applies.
- Non-controlling interests in the acquiree can be measured either at (i) fair value; or (ii) the proportionate interest in the identifiable net assets. If fair value is used, the effect is that 100% of the goodwill of the acquiree is recognised even if the parent's interest in acquiree is less than 100% (sometimes referred to as the "full goodwill" method).
- Contingent consideration is measured at fair value at the acquisition date. If the contingent consideration arrangement gives rise to a financial liability, any subsequent changes are recorded in the income statement.

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- Costs of the combination are recorded as an expense in the income statement.
- The acquiree's original classifications and designations (e.g. classification of financial assets and liabilities) are reassessed at the acquisition date, with the exception of lease classification.
- New or more specific requirements are introduced concerning:
 - separating components of the consideration payable when, in substance, they relate to something other than the consideration transferred in exchange for the acquiree (e.g. settlement of existing contracts between acquirer and acquiree, post-combination management compensation);
 - replacement share-based payments;
 - favourable or unfavourable operating leases of the acquiree;
 - reacquired rights; and
 - indemnification assets.

** with a few exceptions*

Consolidated and separate financial statements

- Transactions with non-controlling interests in which control is not gained or lost (eg part disposals of shares in a subsidiary and purchases of shares held by non-controlling interests) are accounted for as equity transactions. No income statement gain or loss is recorded and no adjustment is made to goodwill.
- On loss of control of a subsidiary, any retained investment is recognised at its fair value at the date control is lost. This fair value is included in the calculation of the gain or loss.

New accounting for business combinations

Many of the previous requirements of AASB 3 are retained in AASB 3R. The basic model is still the acquisition method (previously referred to as the "purchase method"). The major features of the acquisition method include:

- identifying an acquirer; and
- recognising the acquiree's identifiable assets (including intangible assets), mainly at fair value.

The following paragraphs describe some of the specific requirements of AASB 3R with an emphasis on the changes compared to the previous version of AASB 3.

Scope

Like the previous version of AASB 3, AASB 3R does not apply to:

- business combinations effected by forming a joint venture;
- business combinations between entities under common control; and
- purchases of a group of assets that does not constitute a business.

However, the Standard does apply to combinations effected by contract alone (e.g. dual listed company arrangements) and business combinations between mutual entities. These were outside the scope of the previous version of AASB 3.

Business combination or asset purchase?

To determine if a transaction is a business combination within the scope of AASB 3R, it will be necessary to consider whether the acquired entity or group of assets constitutes a business. AASB 3R introduces revised definitions of "business combination" and "business". The changes to these definitions are not expected to have a widespread impact (although they should of course be considered carefully). For example, transactions involving the purchase of an entity that is not a business are not business combinations.

The most important scope-out in practice is likely to be the exemption for business combinations between entities under common control. The previous guidance on the meaning of common control has been carried forward (including the non-applicability of the scope exemption where common control is transitory).

Identifying the acquirer

Consistent with the previous version of AASB 3, an acquirer must be identified for every business combination. AASB 3R includes definitions of the terms acquirer and acquiree. The definitions clarify that the acquiree must be a business (it need not be an entity). The acquirer is the entity that obtains control over the acquiree. AASB 3R includes additional indicators to assist in identifying the acquirer. The underlying principles are unchanged.

AASB 3R retains the rule that a new entity formed to issue shares to effect a business combination cannot be the acquirer. However, it clarifies that a new entity that pays cash **may** be the acquirer.

Adding a new parent company

It is common in many groups to enter into a transaction involving adding a new parent company to the top of the group. In most such cases, the new parent entity would not be the acquirer based on the criteria in AASB 3R. It is more likely that one of the existing group entities would be the acquirer because it (in substance) controls the new parent. The new parent is also unlikely to be a business. Accordingly such transactions are not normally business combinations.

This example illustrates the inter-relationship between identifying the acquirer and applying the definition of a business. The same conclusion would be reached under the previous version of AASB 3. However, the definitions and guidance in AASB 3R should clarify the position still further.

The acquisition date

The acquisition date is defined consistently in both the AASB 3R and the previous version of AASB 3 as the date the acquirer obtains control of the acquiree. AASB 3R includes some additional guidance on determining the acquisition date, noting that this may not be the same as the closing date.

In AASB 3R the consideration transferred and identifiable assets and liabilities and goodwill are measured on the **acquisition date**. The previous version of AASB 3 required measurement of the cost of the combination at the **date of exchange**.

The acquiree's identifiable assets and liabilities

The basic approach to recording the acquiree's assets and liabilities is the same - most assets and liabilities are recorded at **fair value**. The previous version of AASB 3 required fair value measurement for all identifiable assets, liabilities and contingent liabilities (other than those held for sale in accordance with AASB 5 *Non-current Assets Held for Sale and Discontinued Operations*). Rather confusingly, it also included various special rules on how to measure fair value for specific items which are not necessarily consistent with the definition of fair value. AASB 3R deletes these special rules on measuring fair value contained in AASB 3.B16. It also requires that:

- **deferred tax** assets and liabilities are measured under AASB 112 *Income Taxes*, not at fair value (consistent with AASB 3);
- liabilities and assets (if any) relating to **employee benefits** are measured under AASB 119 *Employee Benefits* (AASB 119) (a broader reference to AASB 119 compared to the previous version of AASB 3).

Note:

Fair value

*Previous versions of the Basis for Conclusions, which accompany IFRS 3 and is referred to in AASB 3, contain guidance on measuring fair value (at IFRS 3.B16) which appears inconsistent with the definition of fair value. For example, raw material inventory is valued at **replacement cost** (IFRS.B16.(d)(iii)). Onerous contracts are measured at the **present value of the amount to be disbursed** (IFRS.B16.(k)).*

Fair value is defined in both AASB 3 and AASB 3R as:

"the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date"

The removal of this specific guidance in IFRS 3R will place greater emphasis on the basic definition of fair value as an exit value. The impact of this in practice might be limited, at least until the IASB's continuing project on fair value measurement is concluded.

AASB 3R contains a number of other specific requirements for the recognition and measurement of the acquiree's assets and liabilities (including some departures from the fair value principle). The most significant are discussed below.

Assets with uncertain cash flows

AASB 3R includes a specific requirement that assets with uncertain cash flows (such as trade receivables for which a certain level of "bad debts" is expected) are recorded as a single fair value amount, not as an asset and a separate valuation allowance.

Operating leases

AASB 3R includes specific guidance on fair values of assets that are subject to operating leases with favourable or unfavourable terms. Broadly:

- for the lessor, the fair value of an asset that is subject to an operating lease takes account of the terms of the lease (and hence no separate asset or liability is recognised);
- for a lessee in an operating lease, a separate asset or liability is recognised.

Assets that the acquirer does not intend to use (or use in another way)

AASB 3R clarifies that the requirement to recognise an acquiree asset at fair value applies even if the acquirer does not intend the use the asset (or to use it in some other way).

Contingent liabilities and assets

The previous version of AASB 3 required recognition at fair value of an acquiree's contingent liabilities. Subsequently, contingent liabilities are measured at the higher of (i) the amount that would be recognised under AASB 137 *Provisions, Contingent Liabilities and Contingent Assets* (AASB 137); and (ii) the fair value at acquisition less, if appropriate, cumulative amortisation.

AASB 3R contains the same requirements with a subtle but potentially significant difference. Contingent liabilities as defined in AASB 137 comprise two types of obligation, which can be broadly described as:

- **possible** obligations arising from past events whose existence will be confirmed by uncertain future events; and
- **present** obligations arising from past events for which an outflow of economic resources is not probable, or which cannot be measured with sufficient reliability.

AASB 3R requires recognition only of **present** obligations whose fair value can be measured reliably.

Example - Lawsuit

An acquiree in a business combination is being sued over an alleged breach of copyright. The acquiree's management believe that the claim is unjustified. This view is supported by the acquiree's legal advisers. Nonetheless, the legal advisers indicate that there is a small chance (of approximately 10%) that a court of law would uphold the claim.

This is an example of a "possible obligation" that meets AASB 137's definition of a contingent liability. In accordance with the previous version of AASB 3, the lawsuit would be recognised as a liability at fair value in the purchase accounting. However, on the balance of evidence there is no "present obligation". Accordingly, the lawsuit would not be recorded as a separate liability under AASB 3R.

In practice, judgement will be required to determine whether, on the balance of evidence, a present obligation exists.

Note:

The IASB's ongoing project (which will influence future Australian Accounting Standards) to revise IAS 37 may provide additional guidance on this in due course, and may also lead to consequential amendments to IFRS 3R, which may in turn affect AASB 137 and AASB 3.

Contingent assets (as defined in AASB 137) are not recognised under either the new or the former standard.

Indemnification assets

AASB 3R introduces a new term – “indemnification assets” - for arrangements in which the seller in a business combination contractually indemnifies, in whole or in part, the acquirer for the outcome of a particular contingency or uncertainty (e.g. the eventual outcome of a disputed tax position). Indemnification assets are measured, both initially and subsequently, based on the measurement of the indemnified item.

The previous version of AASB 3 did not include any equivalent concept. In practice, many indemnification arrangements have been regarded as a form of contingent consideration.

Reacquired rights

AASB 3R explicitly requires recognition of an intangible asset in relation to “reacquired rights”. A reacquired right arises when the acquirer has granted a right to the acquiree to use one or more of the acquirer's assets, such as a technology licensing agreement.

Example - Reacquired franchise

A company in the fast-food industry has granted a restaurant operator an exclusive 5 year right to operate franchised restaurants in Country X. One year later, the company acquires the restaurant operator. The reacquired right to operate restaurants in Country X is recognised as a separate intangible asset in the business combination accounting. It is not treated as a settlement of a pre-existing relationship because it continues to exist. In valuing the right, no value is attributed to the possibility of contract renewals (unlike many other contract-based intangibles). The reacquired right must be amortised over the remaining 4 year term. The reason for this evident departure from normal fair value measurement is that a reacquired right is no longer a contract with a third party.

Assets held for sale

Consistent with the previous version of AASB 3, AASB 3R requires that non-current assets or disposal groups classified as held for sale at acquisition in accordance with AASB 5 are valued at fair value less costs to sell.

Intangible assets

AASB 3R's approach to separate recognition of the acquiree's intangible assets is largely the same. Intangibles must be recognised separately from goodwill when they are identifiable. An intangible asset is identifiable if it:

- is separable; or
- arises from contractual or legal rights.

Note:

*IFRS 3R's Application Guidance section includes additional guidance on these criteria. Several examples of types of intangible asset commonly acquired in a business combination are provided in the Implementation Examples (IE16 - IE44). Most of the intangible asset guidance in the previous version of IFRS 3 is carried forward (with minor modification) into IFRS 3R. IFRS 3R also includes some new guidance on items that do **not** qualify for recognition, for example:*

- the acquirer's **assembled workforce** - the existing collection of employees that enables the acquired business to be operated from the acquisition date - which is not regarded as an identifiable asset (IFRS 3 has the same "rule" in practice as a result of the existing guidance in IAS 38 Intangible Assets);
- potential **future contracts** with prospective new customers.

Customer-related intangibles

The identification and fair value measurement of intangibles is one of the most challenging aspects of business combination accounting. AASB 3R carries forward these same requirements and guidance. Because most business have customers, the identification and measurement of customer related assets such as:

- customer lists
 - order backlog
 - customer contracts and related customer relationships; and
 - noncontractual customer relationships
- is of particular interest.

AASB 3R takes a broad view of the circumstances when customer-related intangibles meet the criteria to be recognised separately from goodwill. For example, when an acquirer does business with its customers through contracts (including purchase orders), not only the contracts but also the related customer relationships are considered to meet the "contractual-legal" criterion.

Classifications and designations

In some situations, Australian Accounting Standards provide for different accounting depending on how a particular asset or liability is classified or designated. For example, the accounting for particular financial assets and liabilities differs depending on whether the instrument is classified as trading, available for sale, or held to maturity in accordance with AASB 139 *Financial Instruments: Recognition and Measurement*.

The accounting for some financial instruments in accordance with AASB 139 depends on whether the instrument is part of a designated hedge relationship. AASB 139 requires assessment of whether an embedded derivative should be separated from the host contract. AASB 3R requires that most such classifications, designations and assessments are (re-)made at the acquisition date, based on the circumstances (and intentions of management where relevant) at that date. There are two exceptions to this general approach:

- classification of a contract as an insurance contract or a deposit contract in accordance with AASB 4 *Insurance Contracts*; and
- lease classification (operating or finance) in accordance with AASB 117 *Leases*.

In these two cases, the classification is made based on the contractual terms and other factors at the inception of the contract (or the date of modification if applicable). Accordingly, if the acquirer has previously applied AASB's, the acquirer's classifications should not need to be amended in these cases.

The consideration transferred

While the previous version of AASB 3 refers to “the cost of a business combination”, AASB 3R uses the term “the consideration transferred”. The major difference of principle is that the consideration transferred refers to what the former owners of the acquiree receive. It does not include other costs of the combination such as professional fees incurred. Under AASB 3R, such costs are expensed.

Other important differences (**some** of which are perhaps clarifications or interpretations rather than new requirements) cover:

- contingent consideration;
- replacement share-based payments;
- business combinations achieved in stages; and
- determining what is part of the business combination transaction.

Contingent consideration

Under AASB 3R, contingent consideration (obligations to transfer additional assets or equity to the former owners if specified future events occur or conditions are met) is measured at **fair value**. This is an important change to AASB 3, which regards contingent consideration as a possible adjustment to the cost of the combination. Under AASB 3 this adjustment is recorded only when it becomes “probable” and can be measured reliably.

The subsequent accounting for contingent consideration arrangements depends on whether the obligation is equity (in accordance with AASB 132 *Financial Instruments: Presentation*), a financial liability or some other type of liability. If equity, the initial credit is to equity and no subsequent remeasurements are recorded. A financial liability is accounted for in accordance with AASB 139 (which will be amended to remove the scope exclusion for contingent consideration contracts).

Example - Contingent consideration payable in shares

An acquirer purchases a business in the pharmaceutical sector. The sale and purchase agreement specifies the amount payable as:

- cash of \$100m to be paid on the acquisition date; and
- an additional 1,000,000 shares of the acquirer to be paid in 2 years time if a specified drug receives regulatory approval in that time.

In accordance with AASB 3R, the consideration transferred comprises the cash paid plus the fair value of the contingent obligation to pay 1,000,000 shares in 2 year's time. The fair value of the contingent element would be based on a 2 year forward price, and would be reduced by the effect of the performance conditions.

Because this obligation can be settled only by issuing a fixed number of shares, it is an equity instrument (AASB 132.16(b)(i)). Accordingly, the initial fair value of the contingent consideration is credited to equity. There is no subsequent adjustment (although the credit might be reclassified within equity on settlement in shares or on expiry of the obligation).

Had the contingent arrangement involved issuing either cash or a variable number of shares depending (for example) on the extent to which targets are achieved, it would be a financial liability. The obligation would be measured in accordance with AASB 139 until settlement. Changes in the carrying amount would be recorded in the income statement.

Replacement share-based payments

An acquiree in a business combination might have established a share-based payment scheme for its employees. In such cases, it is common for the acquirer to replace the acquiree's scheme with its own scheme. This might reflect a wish by the acquirer not to create a new non-controlling interest in the acquiree and also that there may no longer be a liquid market in the acquiree's shares.

If an acquirer replaces the awards as a matter of choice (ie even though the employees are not able to enforce replacement), the normal modification requirements of AASB 2 *Share-based Payment* apply. When the acquirer has an **obligation** to replace an acquiree's share-based payment awards, the acquirer must:

- determine **acquisition date** fair value of both the existing and the new scheme;
- allocate to the consideration transferred an amount equal to the acquisition date fair value of the old scheme, pro-rated based on the extent to which pre-combination service has been rendered; and
- record a share-based payment expense over the remaining service period, based on the excess fair value of the new scheme over the amount allocated to the consideration transferred.

In effect, the replacement scheme is partly to purchase from the employees their equity in the acquiree and partly to compensate them for future service.

Example - Replacement share-based payment award

Acquirer P purchases acquiree (S). S has an equity-settled share-based payment scheme. When originally granted, S's awards had a service period of four years. At the acquisition date, S's employees had rendered two years' service (and would therefore have been required to render more years of service for their awards to vest).

In accordance with the acquisition agreement, P is obliged to replace S's awards. Assume P issues replacement awards that require **one** year of post-acquisition service in exchange for S's awards. Some (but only a portion) of S's award is attributable to pre-acquisition service. Accordingly, an allocation is required between consideration transferred and future share-based compensation expense.

Assume the fair-value-based measure of the awards at the acquisition date is as follows:

- S's awards: \$100
- P's replacement award: \$110

The replacement awards require only one year of post-acquisition service. Because employees have already rendered two years of service, the total requisite service period is now **three** years. The portion attributable to pre-acquisition services equals the fair value-based measure of the acquiree award (\$100) multiplied by the ratio of the pre-acquisition service period (two years) to the **greater of** the total service period (three years) or the original service period of S's award (four years). Thus, \$50 ($\$100 \times 2 \div 4$ years) is attributable to pre-acquisition service. This amount is part of the consideration transferred for the acquiree.

The remaining \$60 ($110 - 50$) is attributable to service in future periods. This amount is recorded as a share-based payment expense in P's subsequent financial statements. The \$60 expense is recorded over the remaining service period of 1 year.

Note:

The Application Guidance section of IFRS 3R and the accompanying Implementation Examples provide further guidance (B56 - B62 and IE61 - IE71) on replacement share awards.

Determining what is part of the business combination transaction

AASB 3R recognises that the consideration transferred to the former owners of an acquiree is not always only to pay for the acquiree. For example:

- the acquirer and acquiree might have a pre-existing relationship such as a supply contract, or ongoing litigation. As a result of the business combination, this contract or lawsuit is effectively settled; and
- with contingent consideration arrangements payable to former shareholders who are also employees, the nature of the arrangement might wholly or partly represent an employee benefit rather than consideration for the acquiree.

Where the acquirer and acquiree have a pre-existing relationship, AASB 3R requires that the acquirer recognises a gain or loss reflecting the effective settlement of that relationship. For example, if the acquiree had initiated a legal claim (lawsuit) against the acquirer an amount equal to the fair value of that claim would be recorded as an expense by the acquirer at the acquisition date. Of the total amount of consideration transferred to the former owners, that amount would be deducted to determine the consideration for the acquisition.

With contractual relationships, the gain or loss is determined as the **lower** of:

- the amount by which the contract is favourable or unfavourable to the acquirer compared to current market terms; and
- the contract's stated settlement amount (if any).

It should be noted that the amount by which the contract is favourable or unfavourable might not be the same as its fair value. The contract might have value for other reasons.

Example - Effective Settlement of a Supply Contract

P purchases raw materials from S under a five-year, fixed price per unit contract with specified minimum quantities. Currently, the fixed rates are higher than market rates for similar materials. The contract includes a clause allowing S to cancel the contract at any time by paying a \$6 million penalty. Two years into the contract term (ie 3 years remaining) P acquires S and pays \$100m to S's former owners.

P estimates that the contract is unfavourable to market terms by \$5m. The total fair value of the contract is estimated to be \$7m (with the additional \$2m being attributable to selling effort, the related customer relationship etc).

P recognises an expense of \$5m separately from the business combination. The stated settlement price is \$6m which is higher, and P records the lower amount. If P had previously recognised a provision for an onerous contract in accordance with AASB 137, the expense recorded would be net of the provision.

The additional \$2m of fair value in the contract (the "at-market" component) is effectively included in goodwill. It does not represent a reacquired right that the acquirer might subsequently reissue to a third party.

Note:

The Application Guidance to IFRS 3R includes a useful list of indicators to assist in determining whether an arrangement for payments to employees is part of the exchange for the acquiree or is an employee benefit transaction separate from the business combination (B55).

Goodwill and non-controlling interests

In accordance with the previous version of AASB 3:

- goodwill is determined as the difference between the residual cost of the combination after recognising the acquirer's interest in the fair value (or other recognised amounts) of the acquiree's identifiable assets, liabilities and contingent liabilities; and
- non-controlling (or minority) interest is determined as the net fair value of the proportionate interest in the acquiree's identifiable assets, liabilities and contingent liabilities.

AASB 3R introduces new requirements for measuring both these items:

- goodwill is measured as the aggregate of the **acquisition date**:
 - fair value of the consideration transferred; plus
 - fair value or recognised amount of non-controlling interest; plus
 - fair value of any previously held equity interests (see below); less
 - fair value (or other recognised amounts) of the acquiree's assets and liabilities.
- non-controlling interest is measured **either** at its fair value **or** as the non-controlling interest's proportionate share of the net fair value (or other recognised amounts) of the acquiree's assets and liabilities.

Note:

The IASB's decision to allow a choice of measurement basis for the non-controlling interest creates a difference between IFRS 3R and its US equivalent SFAS 141 (Revised 2007). The latter requires fair value. The IASB reasons for allowing a choice are partly practical - measuring the non-controlling interest at fair value requires the use of a valuation technique if the shares are not quoted in an active market. In principle, the IASB believe fair value measurement is the better approach.

When the non-controlling interest is measured at fair value, the effect is that 100% of the goodwill in the acquiree is recognised (ie both the parent's and the non-controlling interest's share). This is sometimes described as a "full goodwill" model. If the alternative approach is used, the goodwill so determined is only the parent's share (consistent with the previous AASB 3 "purchased goodwill" model).

Whichever basis is used to measure non-controlling interests, AASB 3R uses acquisition date values to measure goodwill. AASB 3R changes the measurement of some of the acquiree's assets and liabilities and also certain components of the consideration. This will also affect the amount of goodwill.

Goodwill and non-controlling interests (NCI)

This highly simplified example illustrates the differences between AASB 3 requirements on measuring goodwill and NCI, and the two approaches permitted by AASB 3R. Assume that an acquirer pays \$800 for 80% of an acquiree. There are no previously held interests. The fair value (or other recognised amounts) of the acquiree's identifiable net assets and contingent liabilities is assessed as \$750 (for simplicity, it is assumed that the same acquiree assets and liabilities are recognised at the same amounts under both Standards). Transaction costs of \$50 are incurred. The fair value of the NCI is determined (using a valuation technique to be \$180.

The amounts of goodwill and NCI to be recognised would be as follows:

	AASB 3	AASB 3R NCI at FV	AASB 3R NCI at share of net assets
Consideration for 80% of acquiree	800	800	800
Costs of combination	50		
FV of 100% of identifiable net assets		750	750
FV of 80% of identifiable net assets	600		
NCI at fair value*		180	
NCI at 20% of identifiable net assets	150		150
Deemed consideration	850	980	950
Goodwill	250	230	200
Recognised amount of NCI	150	180	150

* based on share price or valuation technique

Business combinations achieved in stages

AASB 3R significantly changes the required accounting for a business combination achieved in stages (i.e. a situation in which the acquirer holds non-controlling equity interests in the acquiree prior to the business combination). Under AASB 3R existing investment is remeasured to its fair value. Any resulting gain or loss is recorded in the income statement. If the acquirer has accounted for recognised previous value changes in equity (eg because the investment was classified as available-for-sale (AFS) in accordance with AASB 139), those gains or losses are removed from equity and recognised in the income statement.

The fair value of the previous equity interests is included in the determination of goodwill (effectively as additional consideration).

This approach differs from the previous version of AASB 3. Broadly, that Standard required measurement of goodwill at each stage of the combination, using the original cost of each investment and the proportionate fair value of the acquiree's net assets at each stage.

Example - Previously held AFS investment

Several years ago P acquired a 10% holding in the equity shares of S at a cost of CU500. The investment was classified as AFS in accordance with AASB 139. P then acquired the remaining 90% of S's equity shares in a business combination. At the acquisition date the fair value of the original 10% holding had increased to CU2,500. P has recorded the fair value increase within an "AFS reserve" within equity.

At the acquisition date, P removes the CU2,000 gain from the AFS reserve and recognises it in the income statement (along with related deferred tax). The CU2,500 is included in the calculation of goodwill.

Reverse acquisitions

AASB 3R retains the concept of "reverse acquisitions". The new standard includes broadly similar guidance to the previous version of AASB 3. A **reverse acquisition** occurs when the entity that issues securities (the legal acquirer) is identified as the acquiree for accounting purposes. The entity whose equity interests are acquired (the legal acquiree) must be the acquirer for accounting purposes for the transaction to be considered a reverse acquisition. For example, reverse acquisitions sometimes occur when a private operating company wants to become a public company but does not want to register its equity shares. To accomplish that, the private company will arrange for a public company to acquire its equity interests in exchange for the equity interests of the public entity. In this example, the public company is the **legal acquirer** because it issued its equity interests, and the private company is the **legal acquiree** because its equity interests were acquired. Application of the guidance in AASB 3R on identifying the acquirer would however result in the public company being the **acquiree** for accounting purposes.

The accounting acquiree must meet the definition of a business for the transaction to be accounted for as a reverse acquisition.

Note:

The Implementation Examples to IFRS 3R include a comprehensive example of accounting for a reverse acquisition (IE1 - IE15). The key points are that:

- *the consolidated financial statements of the legal acquirer are presented as a continuation of the legal acquiree's financial statements;*
- *the acquisition-date fair value adjustments relate to the legal acquirer's business; and*
- *the consideration transferred is determined on a notional basis, based on the number of shares the legal acquiree would have had to issue if it had purchased the legal acquirer.*

Changes to AASB 127 and accounting for transactions with the non-controlling interest
The main changes effected by the new version of AASB 127 compared to the 2000 version ("AASB 127") are described below.

Non-controlling interests and changes in ownership interest

Attribution of losses

AASB 127R requires an entity to attribute total comprehensive income to the owners of the parent and to the non-controlling interest even if this results in non-controlling interest having a deficit balance. AASB 127 required excess losses to be allocated to the owners of the parent, except to the extent that the non-controlling interest had a binding obligation and was able to make an additional investment to cover the losses.

Changes in ownership interests in subsidiaries

AASB 127R requires changes in a parent's ownership interest in a subsidiary that do not result in the loss of control to be accounted for as equity transactions. AASB 127 does not provide guidance on the accounting for changes in a parent's ownership interest in a subsidiary.

Example - Part-disposal of a subsidiary

P owns 100% of S, and has control over S in accordance with AASB 127R. The carrying value of S's identifiable net assets and goodwill in P's consolidated financial statements is CU1,000,000. P disposes of 40% of its investment in S to an outside investor for CU500,000. P retains control over S.

Under AASB 127R this "part-disposal" is accounted for as an equity transaction. The notional "gain" of CU100,000 ($500,000 - 40\% \times 1,000,000$) is recorded directly in equity and attributed to the controlling interests. The entry is:

Dr Cash	500,000	
Cr Non-controlling interests (equity)	400,000	
Cr Equity (controlling interest)		100,000

AASB 127R requires disclosure of a schedule showing the effects of any equity transactions with non-controlling interests on the equity attributable to the parent.

Presentation

AASB 127R requires an entity to present minority non-controlling interests in the consolidated statement of financial position within equity, separately from the parent owners' shareholders' equity. Although the previous version of AASB 127 precluded presentation of minority non-controlling interests within liabilities, it did not require presentation within equity.

Loss of control of a subsidiary

AASB 127R specifies how an entity measures any gain or loss arising on the loss of control of a subsidiary and requires any such gain or loss to be **recognised in profit or loss**.

Any investment retained in the former subsidiary is measured at its **fair value** at the date when control is lost. AASB 127 required the carrying amount of an investment retained in the former subsidiary to be regarded as its cost on initial measurement of the financial asset in accordance with AASB 139.

In more detail, the accounting for loss of control of a subsidiary involves:

- derecognising the assets (including any goodwill) and liabilities of the subsidiary at their carrying amounts at the date control is lost;
- derecognising the carrying amount of any non-controlling interest in the former subsidiary at the date control is lost (including any components of other comprehensive income attributable to the non-controlling interest);
- recognising the fair value of the proceeds (if any);
- if the transaction that resulted in the loss of control involves a distribution of shares of the subsidiary to owners in their capacity as owners, recognising that distribution;
- recognising any investment retained in the former subsidiary at its fair value at the date when control is lost; and
- recognising any resulting difference as a gain or loss in profit or loss attributable to the parent.

AASB 127R also clarifies that, on losing control of a subsidiary, a parent recognises any components of other comprehensive income related to that subsidiary on the same basis that would be required if the parent had directly disposed of the related assets or liabilities. This includes the parent's share of any gains or losses:

- on exchange differences that were recognised as components of other comprehensive income in accordance with AASB 121 *The Effects of Changes in Foreign Exchange Rates*;
- related to the effective portion of hedging instruments designated as cash flow hedges recognised as components of other comprehensive income in accordance with AASB 139; and
- related to other assets and liabilities such as available-for-sale financial assets for which fair value movements were recognised as components of other comprehensive income.

Example - Loss of control of a subsidiary

P owns 100% of S, and has control over S in accordance with AASB 127R. The carrying value of S's identifiable net assets and goodwill in P's consolidated financial statements is \$1,000,000. P disposes of 90% of its investment in S to an outside investor for \$1,200,000 and loses control of S. P's retained investment of 10% of S has a fair value of \$110,000.

At the date of loss of control, S held various AFS financial assets in respect of which a cumulative gain of \$50,000 had been recognised directly within an AFS reserve within comprehensive income (equity).

The summary entries required to record the loss of control are:

Dr Cash 1,200,000
Dr Financial asset 110,000
Cr S's identifiable net assets and goodwill 1,000,000
Cr Income statement 310,000

Dr AFS reserve 50,000
Cr Income statement 50,000

AASB 127R requires disclosure of the gain or loss recognised on loss of control, including the portion of that gain or loss attributable to recognising any investment retained in the former subsidiary at fair value (\$10,000 in this example), and the line item in the income statement in which the gains or losses are recognised.

Effective date and transition

The transition requirements of AASB 3R and AASB 127R are rather complex. The main requirements are summarised here but careful study of the Standards is necessary.

AASB 3R should be applied **prospectively** to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after **1 July 2009**. To illustrate:

- for an entity whose annual reporting period begins on 1 July, AASB 3R must be applied to all business combinations with an acquisition date of 1 July 2009 and later;
- for an entity whose annual reporting period begins on 1 January, AASB 3R must be applied to all business combinations with an acquisition date of 1 January 2010 and later.

Earlier application is permitted. However:

- if AASB 3R is applied before the effective date, AASB 127R must be applied at the same time;
- AASB 3R may not be adopted prior to the beginning of an annual period beginning on or after 30 June 2007. Therefore, an entity whose annual period begins on 1 January may early adopt for the year beginning 1 January 2008 but not for the year beginning 1 January 2007.

The amendments to AASB 127 must be applied for annual periods beginning on or after 1 July 2009. Earlier application is again permitted. However, an early adopter must also apply AASB 3R if relevant. Although the general requirement is to apply amendments **retrospectively**, the most significant amendments are applied **prospectively**. Specifically, prospective application is required of:

- the amendment requiring attribution of total comprehensive income to the owners of the parent and to the non-controlling interest even if this results in non-controlling interest having a deficit balance;
- the requirements on accounting for changes in ownership interests in a subsidiary after control is obtained; and
- the requirements on accounting for the loss of control of a subsidiary.

Further information

For further information on any of the information included in this TA alert, please contact your local Grant Thornton Australia representative or a member of the National Audit Support team at NAS@grantthornton.com.au