CONSOLIDATION

CHAPTER 4

UNDERSTANDING BUSINESS COMBINATIONS

MAIN DOCUMENTS DEALING WITH GROUP ACCOUNTS

IFRS – 3 – Date of Acquisition Accounting

IFRS – 10 – Consolidated Financial Statement

IFRS – 11 – Joint Arrangements

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OBJECTIVE

The objective of this IFRS is to improve the relevance, reliability and comparability of the information that a **reporting entity** provides in its financial statements about a business combination and its effects. To accomplish that, this IFRS establishes principles and requirements for how the acquirer:

(a) recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree;

(b) recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase; and

(c) determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination.

SCOPE

This IFRS applies to a transaction or other event that meets the definition of a business combination. This IFRS does not apply to:

(a) The formation of a joint venture.

(b) The acquisition of an asset or a group of assets that does not constitute a business.

(c) A combination of entities or businesses under common control

DEFINITIONS

Acquiree: The business or businesses that the acquirer obtains control of in a business combination.

Acquirer: The entity that obtains control of the acquiree.

Acquisition date: The date on which the acquirer obtains control of the acquiree

Business: An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants.

Business combination: A transaction or other event in which an acquirer obtains control of one or more businesses. Transactions sometimes referred to as 'true mergers' or 'mergers of equals' are also business combinations as that term is used in this IFRS.

Contingent consideration: Usually, an obligation of the acquirer to transfer additional assets or equity interests to the former owners of an acquiree as part of the exchange for control of the acquiree if specified future events occur or conditions are met. However, contingent consideration also may give the acquirer the right to the return of previously transferred consideration if specified conditions are met.

Equity interests: For the purposes of this IFRS, equity interests is used broadly to mean ownership interests of investor-owned entities and owner, member or participant interests of mutual entities.

Goodwill: An asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognized.

Identifiable: An asset is identifiable if it either:

(a) is separable, i.e. capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, identifiable asset or liability, regardless of whether the entity intends to do so; or

(b) arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

Intangible asset: An identifiable non-monetary asset without physical substance

Mutual entity: An entity, other than an investor-owned entity, that provides dividends, lower costs or other economic benefits directly to its owners, members or participants. For example, a mutual insurance company, a credit union and a co-operative entity are all mutual entities.

IDENTIFYING A BUSINESS COMBINATION

An entity shall determine whether a transaction or other event is a business combination by: -

a) applying the definition in this IFRS; and

b) the assets acquired and liabilities assumed constitute a business

THE ACQUISITION METHOD

An entity shall account for each business combination by applying the acquisition method.

Applying the acquisition method requires:

(a) Identifying a business combination

(b) Identifying the acquirer;

(c) Determining the acquisition date;

(d) Recognizing and measuring the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree; and

(e) Recognizing and measuring goodwill or a gain from a bargain purchase.

Identifying a business combination

Acquirer obtains control as a result of a transaction or an event

To meet the definition of business combination, an acquirer must obtain control. This means that there must be a triggering economic event or transaction and not, for example, merely a decision to start preparing combined or consolidated financial statements for an existing group.

Economic events that might result in an entity obtaining control include:

(a) transferring cash or other assets (including net assets that constitute a business);

(b) incurring liabilities;

(c) issuing equity instruments;

(d) a combination of the above;

(e) a transaction not involving consideration, such as a combination by contract alone (e.g. a dual listed structure –).

Possible structures

The structure of a business combination may be determined by a variety of factors, including legal and tax strategies. Other factors might include market considerations and regulatory considerations. Examples of structures include:

(a) one business becomes a subsidiary of another;

(b) two entities are legally merged into one entity;

(c) one entity transfers its net assets to another entity;

(d) an entity's owners transfer their equity interests to the owners of another entity;

(e) two or more entities transfer their net assets, or the owners transfer their equity interests, to a newly-formed entity (sometimes termed a 'roll-up' or 'put-together' transaction); and
(f) a group of former owners of one entity obtains control of a combined entity.

Identifying a business

A business is an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants.

A business as consisting of inputs and processes applied to those inputs that have the ability to create outputs. Although outputs are usually present, they are not required for an integrated set of activities and assets to qualify as a business.

The following points are summarized:

(a) inputs are economic resources including employees, materials and non-current assets (including rights of use);
(b) processes are systems, standards, protocols, conventions or rules that when applied to inputs, create outputs. Examples would include strategic management, operations and resource management. Accounting, billing, payroll and similar administrative systems typically are not used to create outputs.;
(c) outputs provide a return in the form of dividends, lower costs or other economic benefits to stakeholders;
(d) as a result of an acquisition, an acquirer may combine the acquiree's inputs and processes with its own with the result that it is not necessary that all pre-acquisition inputs and processes remain unchanged;
(e) a business may not have outputs (e.g. where it is in a development stage);
(f) a business may or may not have liabilities; and
(g) the assessment as to whether a particular set of assets and activities is a business is made by reference to whether the integrated set is capable of being conducted and managed as a business by a market participant – it is not relevant whether the seller operated the set as a business or whether the acquirer intends to operate the set as a business.

Accounting for a transaction that is not a business combination

Where a transaction or other event does not meet the definition of a business combination due to the acquiree not meeting the definition of a business, it is termed an 'asset acquisition'. In such circumstances, the acquirer:

- identifies and recognizes the individual identifiable assets acquired (including those assets that meet the definition of, and recognition criteria for, intangible assets in IAS 38 Intangible Assets) and liabilities assumed; and
- allocates the cost of the group of assets and liabilities to the individual identifiable assets and liabilities on the basis of their relative fair values at the date of purchase. Such a transaction or event does not give rise to goodwill.

IFRS 10

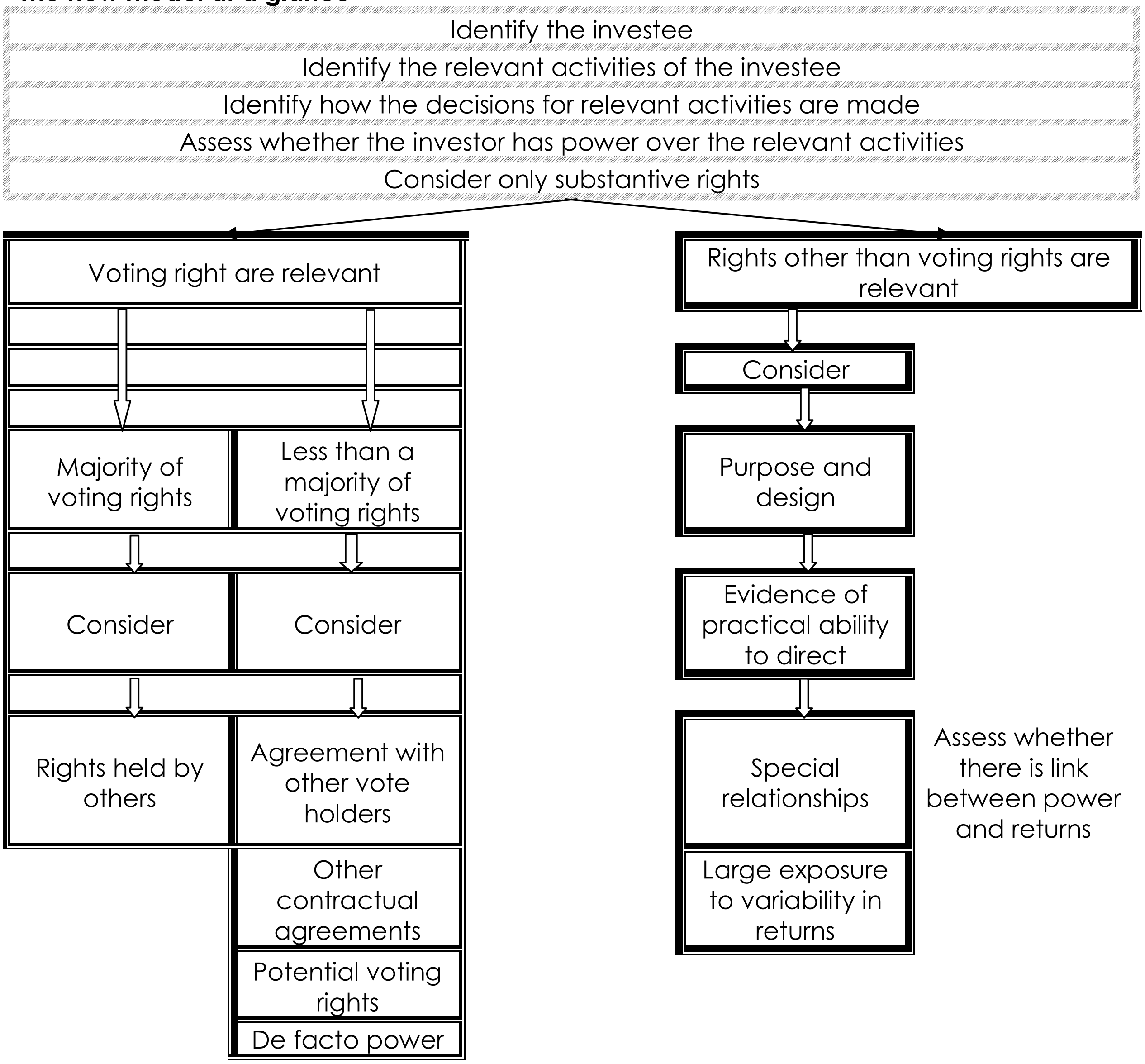
Identifying the acquirer

For each business combination, one of the combining entities shall be identified as the acquirer. The guidance in IFRS 10 shall be used first to identify the acquirer i.e. control is presumed to exist if the investor has all the following: -

a) Power over the investee;
b) Exposure, or rights, to variable returns from its involvement with the investee; and
c) The ability to use its power over the investee to affect the amount of the investor's return

Control = Power + Exposure to variability in return + Link between power and returns

The new model at a glance



- An investor has power over an investee when the investor has existing rights that give it the current ability to direct the *relevant activities*, i.e. the activities that significantly affect the investee's returns.
- Power arises from rights. Sometimes assessing power is straightforward, such as when power over an investee is obtained directly and solely from the voting rights granted by equity instruments such as shares, and can be assessed by considering the voting rights from those shareholdings.
- In other cases, the assessment will be more complex and require more than one factor to be considered, for example when power results from one or more contractual arrangements.

- An investor with the current ability to direct the relevant activities has power even if its rights to direct have yet to be exercised. Evidence that the investor has been directing relevant activities can help determine whether the investor has power, but such evidence is not, in itself, conclusive in determining whether the investor has power over an investee.
- If two or more investors each have existing rights that give them the unilateral ability to direct different relevant activities, the investor that has the current ability to direct the activities that most significantly affect the returns of the investee has power over the investee.
- An investor can have power over an investee even if other entities have existing rights that give them the current ability to participate in the direction of the relevant activities, for example when another entity has *significant influence*. However, an investor that holds only protective rights does not have power over an investee, and consequently does not control the investee.

Consideration of purpose and design

The investor considers the purpose and design of the investee at various steps of the analysis. First it is considered so as to identify: -

- The relevant activities;
- How decisions about such activities are made;
- Who has the current ability to direct those activities; and
- Who receive the returns there from

Identify the investee

The term investee is not defined however, it includes an entity or a **deemed entity** (SILO) that is or may be a subsidiary of an investor.

Identify the relevant activities of the investee

Relevant activities of the investee are the activities of the investee that significantly affect the investee's return.

There may be investees: -

- With a range of operating and financing activities significantly affecting their return

  The range of operating activities significantly affect returns are sales of goods, management of financial assets, acquisitions and disposal of operating assets, management research and development activities and determination of the funding structure.

  In such cases the decision about affecting the returns may be linked to decisions such as operating and capital decisions.
- For which several investors each direct different relevant activities

  In such cases the investor that has the current ability to direct the activities that most significantly affect the returns of the investee has the power.
- For which relevant activities occur only when particular circumstances or events occur

  In this case only the decisions when those events occur can affect the returns significantly and therefore be relevant activities.

Substantive Rights

For the purpose of assessing power, only substantive rights held by the investors and other parties are considered. An investor is explicitly required to consider both substantive rights that it holds and substantive rights held by others. To be substantive rights needs to be exercisable when decisions about the relevant activities need to be made, and the holder needs to have a practical ability to exercise these rights.

Determining whether rights are substantive requires judgment taking into account all available facts and circumstances. Factors to consider include: -

Whether there are barriers that prevent the holder from exercising the rights	Whether several parties need to agree for the rights to become exercisable or operational	Whether the party that holds the rights would benefit from their exercise
Examples of such barriers	There needs to be a mechanism in place that provides the holders with the practical ability to exercise their rights collectively it they choose to do so: -	The rights are more likely to be substantive when the potential voting rights in money or when the investor can realize other benefit (e.g. synergies) with the investee by exercising the potential voting rights.
• Financial penalties or incentives • A conversion / exercise price that creates a financial barrier • Terms and conditions that make it unlikely that the rights will be exercised • The absence of an explicit, reasonable mechanism by which the holder can exercise the right • The inability of the rights holders to obtain the information necessary to exercise its rights • Operational barrier / incentives that would prevent the holder from exercising its rights	• The absence of such a mechanism is an indicator that the rights may not be substantive • The more parties that are required to agree to exercise that rights, the less likely it is substantive • Removal rights exercisable by a board of directors are more likely it is that those rights are substantive	

Substantive Vs Protective rights

Protective rights are related to fundamental changes in the activities of an investee or are rights that apply in exceptional circumstances, and as such cannot give the holder power or prevent other parties from having power and therefore control over the investee. Not all rights contingent on future events are protective.

The examples of protective rights are: -

- Amendments to the entity's constitution;
- Pricing of related party transactions;
- Liquidation of the entity or commencement of bankruptcy proceedings and;
- Share issues or repurchase

ASSESS WHETHER THE INVESTOR IS EXPOSED TO VARIABILTIY IN RETURNS

In assessing whether an investor controls an investee, the investor considers whether it is exposed or has rights, to variability in returns from its involvement with the investee.

Returns vary as a result of the performance of an investee and can be only positive, only negative or wholly positive and negative. Sources of returns include: -

- Dividends or other economic benefits such as interest from debt securities and changes in the value of the investor's investment in the investee;
- Remuneration for servicing an investee's assets or liabilities, fees and exposure to loss from providing credit or liquidity support;
- Tax benefits;
- Residual interest in the investee's assets and liabilities on liquidation; and/or
- Returns that are not available to other interest holders, such as the investor's ability to use the investee's assets in combination with its own to achieve economies of scale, cost savings or other synergies.

For example holding a bond with fixed interest payments is a source of variable returns because the interest payments are subjects default risk and expose the investor to the credit risk of the bond's issuer. The variability of the returns depends on the credit risk.

ASSESS WHETHER THERE IS LINK BETWEEN POWER AND RETURNS

IFRS 10 introduces the concept of delegated power. The decision maker needs to assess whether it is acting as a principal or as an agent on behalf of other investors when directing the activities of an investee. If it has the power to direct the activities of an entity that it manages to generate returns for itself then it is a principal. If it is engaged to act on behalf and for the benefit of another party or parties then it is an agent and does not control the investee when exercising its decision making authority.

Unless a single party holds substantive rights to remove the decision maker without cause, the decision maker considers the overall relationship between itself and other parties and all of the following factors to determine whether it is an agent: -

- The scope of its decision making authority over the investee;
- The rights held by other parties, including substantive removal rights held by a single party;
- Its remuneration (level of linkage with the investee's performance) and;
- Its exposure to variability of returns because of other interests that it holds in the investee

Parties that might act as de facto agent are: -

- Related parties of the investor
- A party that received its interest in the investee as a contribution or loan from the investor
- A party that has agreed not to sell, transfer or encumber its interest in the investee without the investor's prior approval;
- A party that cannot finance its operations without subordinated support from the investor;
- A party for which a majority of the members of the governing body or key management personnel is the same as that of the investor;
- A party that has the close business relationship with the investor.

IFRS – 3

If a business combination has occurred but by applying guidance in IFRS 10 does not clearly indicate which of the combining entities the acquirer is, the following factors must be considered.

i) In a business combination effected primarily by transferring cash or other assets or by incurring liabilities, the acquirer is usually the entity that transfers the cash or other assets or incurs the liabilities.

ii) In a business combination effected primarily by exchanging equity interests, the acquirer is usually the entity that issues its equity interests. However, in some business combinations, commonly called 'reverse acquisitions', the issuing entity is the acquiree. Other pertinent facts and circumstances shall also be considered in identifying the acquirer in a business combination effected by exchanging equity interests, including:

(a) the relative voting rights in the combined entity after the business combination—The acquirer is usually the combining entity whose owners as a group retain or receive the largest portion of the voting rights in the combined entity.

(b) the existence of a large minority voting interest in the combined entity if no other owner or organized group of owners has a significant voting interest—The acquirer is usually the combining entity whose single owner or organized group of owners holds the largest minority voting interest in the combined entity.

(c) the composition of the governing body of the combined entity—The acquirer is usually the combining entity whose owners have the ability to elect or appoint or to remove a majority of the members of the governing body of the combined entity.

(d) the composition of the senior management of the combined entity—The acquirer is usually the combining entity whose (former) management dominates the management of the combined entity.

(e) the terms of the exchange of equity interests—The acquirer is usually the combining entity that pays a premium over the pre-combination fair value of the equity interests of the other combining entity or entities.

iii) The acquirer is usually the combining entity whose relative size is significantly greater than that of the other combining entity or entities.

iv) In a business combination involving more than two entities, determining the acquirer shall include a consideration of, among other things, which of the combining entities initiated the combination, as well as the relative size of the combining entities.

v) A new entity formed to effect a business combination is not necessarily the acquirer. If a new entity is formed to issue equity interests to effect a business combination, one of the combining entities that existed before the business combination shall be identified as the acquirer.

In contrast, a new entity that transfers cash or other assets or incurs liabilities as consideration may be the acquirer.

Determining the acquisition date

The acquirer shall identify the acquisition date, which is the date on which it obtains control of the acquiree.

The date on which the acquirer obtains control of the acquiree is generally the date on which the acquirer legally transfers the consideration, acquires the assets and assumes the liabilities of the acquiree—the closing date. However, the acquirer might obtain control on a date that is either earlier or later than the closing date. For example, the acquisition date precedes the closing date if a written agreement provides that the acquirer obtains control of the acquiree on a date before the closing date. An acquirer shall consider all pertinent facts and circumstances in identifying the acquisition date.

Recognition and Measurement

Recognition principle

As of the acquisition date, the acquirer shall recognize, separately from goodwill, the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree. Recognition of identifiable assets acquired and liabilities assumed is subject to the conditions specified under this IFRS.

Recognition conditions

To qualify for recognition as part of applying the acquisition method, an item should:

- meet the definition of an asset or liability in the Framework for the Preparation and Presentation of Financial Statements at the acquisition date; and
- be part of the business acquired (the acquiree) rather than the result of a separate transaction.

The following are outcomes as a result of applying the first recognition condition above.

- Post-acquisition reorganization costs that the acquirer expects but is not obliged to incur in the future to affect its plan to exit an activity of an acquiree or to terminate the employment of or relocate an acquiree's employees are not liabilities at the acquisition date.
- Unrecognized assets and liabilities. The acquirer may recognize some assets and liabilities that the acquiree had not previously recognized in its financial statements. For example, the acquirer recognizes the acquired identifiable intangible assets (e.g. brand names, patents or customer relationships and operating leases) that the acquiree did not recognize as assets in its financial statements because it developed them internally and charged the related costs to expense.

Classifying or designating identifiable assets acquired and liabilities assumed in a business combination

Conditions at the acquisition date

IFRS 3 requires that, at the acquisition date, the identifiable assets acquired and liabilities assumed should be classified or designated as necessary to apply other IFRSs subsequently. The acquirer makes those classifications or designations on the basis of contractual terms, economic conditions, its operating or accounting policies, and other pertinent conditions as they exist at the acquisition date.

Examples of classifications or designations made at the acquisition date include:

(a) classification of financial assets as at fair value through profit or loss, available-for-sale or held-to-maturity;
(b) classification of financial liabilities as at fair value through profit or loss;
(c) designation of a derivative as a hedging instrument; and
(d) assessment of whether an embedded derivative should be separated from a host contract.

Conditions not at the acquisition date

The Standard provides two exceptions to the principle (set out above) that classifications or designations are based on the terms of instruments and conditions at the acquisition date. The two exceptions relate to:

(a) the classification of a lease contract as either an operating lease or a finance lease in accordance with IAS 17 Leases; and
(b) the classification of a contract as an insurance contract in accordance with IFRS 4 Insurance Contracts. The acquirer classifies such leases and insurance contracts on the basis of the contractual terms and other factors at the inception of the contract (or, if the terms of the contract have been modified in a manner that would change its classification, at the date of that modification, which might be the acquisition date).

Measurement principle for assets and liabilities

Identifiable assets acquired and liabilities assumed are measured at their acquisition-date fair values.

Assets with uncertain cash flows (valuation allowances)

An acquirer is not permitted to recognize a separate valuation allowance as of the acquisition date for assets acquired in a business combination that are measured at their acquisition-date fair values because the effects of uncertainty about future cash flows are included in the fair value measure. For example, because IFRS 3 requires the acquirer to measure acquired receivables, including loans, at their acquisition-date fair values, the acquirer does not recognize a separate valuation allowance for the contractual cash flows that are deemed to be uncollectible at that date.

Assets that the acquirer wants to use in different way

Assets that the acquirer intends not to use or to use in a way that is different from the way other market participants would use them, in these circumstances the fair value is determined in accordance with its use by market participants.

For competitive or other reasons, the acquirer may intend not to use an acquired asset (e.g. a research and development intangible asset or a brand name of an acquired competitor that is to be taken out of service), or it may intend to use the asset in a way that is different from the way in which other market participants would use it. In these circumstances, the general principle applies and the fair value of the asset is determined in accordance with its use by other market participants.

Non-controlling interest in an acquiree

Choice of method

For each business combination, any non-controlling interest in the acquiree is measured either:

- at fair value; or
- at the non-controlling interest's proportionate share of the acquiree's identifiable net assets.

This choice is available for each business combination, so an entity may use fair value for one business combination and the proportionate share of the acquiree's identifiable net assets for another.

Measuring the fair value of non-controlling interests

For the purpose of measuring non-controlling interests at fair value, it may be possible to determine the acquisition-date fair value on the basis of active market prices for the equity shares not held by the acquirer. When a market price for the equity shares is not available because the shares are not publicly traded, the acquirer should measure the fair value of the non-controlling interests using other valuation techniques.

The fair values of the acquirer's interest in the acquiree and the non-controlling interest on a per- share basis may differ. The main difference is likely to be the inclusion of a control premium in the per-share fair value of the acquirer's interest in the acquiree or, conversely, the inclusion of a discount for lack of control in the per-share fair value of the non-controlling interest.

Subsequent measurement of non-controlling interests

Whichever choice is made as regards the initial measurement of non-controlling interests, the amount initially recognized when accounting for the business combination is subsequently adjusted by the non-controlling interests' share of changes in equity from the date of the combination.

In other words, where an entity elects to measure a non-controlling interest based on fair value at the date of the business combination, subsequent changes in the fair value of the non-controlling interest are not recognized.

Debit balances on non-controlling interests

IFRS 10 requires that total comprehensive income be attributed to the owners of the parent and to the non-controlling interests, even if this results in the non-controlling interests having a deficit balance.

Exceptions to the recognition or measurement principles

This IFRS provides limited exceptions to its recognition and measurement principles. These may be: -

(a) recognizing either by applying recognition conditions in addition to those in above paragraphs or by applying the requirements of other IFRSs, with results that differ from applying the recognition principle and conditions.

(b) measured at an amount other than their acquisition-date fair values.

EXCEPTION TO THE RECOGNITION PRINCIPLE

The IFRS provides limited exceptions to the recognition and measurement principles discussed above. These exceptions are applied to recognition or measurement or both recognition and measurement.

Exceptions to Recognition

Contingent liabilities

The requirements in IAS 37 do not apply in determining which contingent liabilities to recognize as of the acquisition date. Instead, the acquirer shall recognize as of the acquisition date a contingent liability assumed in a business combination if it is a present obligation that arises from past events and its fair value can be measured reliably. Therefore, contrary to IAS 37, the acquirer recognizes a contingent liability assumed in a business combination at the acquisition date even if it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation.

Exceptions to both the recognition and measurement principles

Income taxes

The acquirer shall recognize and measure a deferred tax asset or liability arising from the assets acquired and liabilities assumed in a business combination in accordance with IAS 12 Income Taxes.

The acquirer shall account for the potential tax effects of temporary differences and carry forwards of an acquiree that exist at the acquisition date or arise as a result of the acquisition in accordance with IAS 12.

Employee benefits

The acquirer shall recognize and measure a liability (or asset, if any) related to the acquiree's employee benefit arrangements in accordance with IAS 19 Employee Benefits.

Indemnification assets

The seller in a business combination may contractually indemnify the acquirer for the outcome of a contingency or uncertainty related to all or part of a specific asset or liability. For example, the seller may indemnify the acquirer against losses above a specified amount on a liability arising from a particular contingency; in other words, the seller will guarantee that the acquirer's liability will not exceed a specified amount. As a result, the acquirer obtains an indemnification asset. The acquirer shall recognize an indemnification asset at the same time that it recognizes the indemnified item measured on the same basis as the indemnified item, subject to the need for a valuation allowance for uncollectible amounts. Therefore, if the indemnification relates to an asset or a liability that is recognized at the acquisition date and measured at its acquisition-date fair value, the acquirer shall recognize the indemnification asset at the acquisition date measured at its acquisition-date fair value. For an indemnification asset measured at fair value, the effects of uncertainty about future cash flows because of collectability considerations are included in the fair value measure and a separate valuation allowance is not necessary.

In some circumstances, the indemnification may relate to an asset or a liability that is an exception to the recognition or measurement principles. For example, an indemnification may relate to a contingent liability that is not recognized at the acquisition date because its fair value is not reliably measurable at that date. Alternatively, an indemnification may relate to an asset or a liability, for example, one that results from an employee benefit that is measured on a basis other than acquisition-date fair value. In those circumstances, the indemnification asset shall be recognized and measured using assumptions consistent with those used to measure the indemnified item, subject to management's assessment of the collectability of the indemnification asset and any contractual limitations on the indemnified amount.

Exceptions to the measurement principle

Non-current assets held for sale

The non-current assets held for sale are measured at fair value less cost of disposal.

Share based payment awards outstanding at the date of acquisition

Acquirers often exchange share-based payment awards (i.e., replacement awards) for awards held by employees of the acquired business. These exchanges frequently occur because the acquirer wants to avoid having non-controlling interests in the acquiree, and/or to motivate former employees of the acquiree to contribute to the overall results of the combined, post-acquisition business. Such exchanges are accounted for as a modification of a plan in accordance with IFRS 2 *Share-based Payments.*

If the acquirer is obligated to issue replacement awards in exchange for acquiree share-based payment awards held by employees of the acquiree, then all or a portion of the market-based measure of the acquirer's replacement awards should be treated as part of the consideration transferred by the acquirer. The effect will be to increase goodwill and record a corresponding amount in equity. The acquirer is considered to have an obligation if the employees or the acquiree can enforce replacement.

Such an obligation may arise from the terms of the acquisition agreement, the terms of the acquiree's award scheme or legislation. If the acquirer is not obligated to issue replacement awards but elects to do so, none of the replacement awards are treated as part of the consideration transferred, therefore having no impact on goodwill and equity. Rather, the replacement awards are a post-combination modification, giving rise to employee compensation expenses.

Therefore, where management is considering replacement of the acquiree's share-based payment schemes, careful consideration should be given at the time of negotiating the arrangement to ensure management's intention is correctly reflected.

The portion of the replacement award that is treated as consideration transferred is the amount attributable to past service that the employee has provided to the acquiree, based on the market-based measure of the awards issued by the acquiree (not the market-based measure of the replacement awards issued by the acquirer). When additional service conditions are imposed by the acquirer, this affects the total vesting period and, therefore, the portion of the awards that is considered pre-combination service.

As a result, the portion of replacement award treated as part of the consideration transferred (i.e., the portion related to past services) is determined as follows:

Market-based measure at the acquisition date of the replaced (i.e., acquiree) x award Complete vesting period Greater of total vesting period and original vesting period

The excess of the market-based measure at the acquisition date of the replacement (i.e., acquirer) award over the amount treated as consideration transferred is recognized as compensation cost over the period from the acquisition date until the end of the vesting period. Effectively, this means the excess of the market-based measure of the replacement awards over the market-based measure of the acquiree award, if any, is recognized as compensation cost in the acquirer's post-combination financial statements. Therefore, management must carefully consider the terms of replacement awards to avoid surprises.

Pre-existing relationships and reacquired rights

IFRS 3(2008) deals with reacquired rights and the wider issue of pre-existing relationships in three inter-related sections:

- first, the section on identifying and measuring assets acquired includes a requirement to identify and recognize reacquired rights;
- second, the section on determining what is part of the business combination requires an adjustment to be made to the purchase consideration for transactions that in effect settle pre-existing relationships between the acquirer and the acquiree; and

- third, the section on subsequent measurement and accounting includes a requirement in respect of reacquired rights.

Recognition of reacquired rights as an intangible asset

As part of a business combination, an acquirer may reacquire a right that it had previously granted to the acquiree to use one or more of the acquirer's recognized or unrecognized assets. Examples of reacquired rights include a right to use the acquirer's trade name under a franchise agreement or a right to use the acquirer's technology under a technology licensing agreement. A reacquired right is an intangible asset that the acquirer recognizes separately from goodwill.

There are two specific requirements regarding the measurement of a reacquired right.

- Ignoring the potential for contract renewal. The acquirer is required to measure the value of a reacquired right recognized as an intangible asset on the basis of the remaining contractual term of the related contract, regardless of whether market participants would consider potential contractual renewals in determining its fair value.
- Recognition of a settlement gain or loss. If the terms of the contract giving rise to a reacquired right are favorable or unfavorable to the acquirer relative to the terms of current market transactions for the same or similar items, the acquirer should recognize a settlement gain or loss. The consequence of this requirement is that the consideration for the business combination is adjusted down (and that amount recognized as an expense) where part of the consideration effectively settles an unfavorable exposure from the acquirer's perspective, and adjusted up (a gain) where the consideration is lower due to the effective settlement of a favorable arrangement from the acquirer's perspective.

The effect of these requirements is that the amount recognized for the reacquired right asset is based on the 'at market' valuation of the contract, but only by reference to the contracted term of the right.

Measurement of gain or loss on settlement of a pre-existing relationship

The acquirer and acquiree may have a relationship that existed before they contemplated the business combination, referred to as a 'pre-existing relationship'. A pre-existing relationship between the acquirer and the acquiree may be contractual (e.g. vendor and customer, or licensor and licensee) or non-contractual (e.g. plaintiff and defendant).

If the business combination in effect settles a pre-existing relationship, the acquirer recognizes a gain or loss, measured as follows:

(a) for a pre-existing non-contractual relationship (such as a lawsuit), fair value;

(b) for a pre-existing contractual relationship, the lesser of (i) and (ii):

    (i) the amount by which the contract is favorable or unfavorable from the perspective of the acquirer when compared with terms for current market transactions for the same or similar items. (An unfavorable contract is a contract that is unfavorable in terms of current market terms. It is not necessarily an onerous contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it); and

    (ii) the amount of any stated settlement provisions in the contract available to the counterparty to whom the contract is unfavorable.

    If (ii) is less than (i), the difference is included as part of the business combination accounting. The amount of gain or loss recognized may depend in part on whether the acquirer had previously recognized a related asset or liability, and the reported gain or loss therefore may differ from the amount calculated by applying the above requirements.

A pre-existing relationship may be a contract that the acquirer recognizes as a reacquired right. If the contract includes terms that are favorable or unfavorable when compared with pricing for current market transactions for the same or similar items, the acquirer recognizes, separately from the business combination, a gain or loss for the effective settlement of the contract, measured in accordance with IFRS 3(2008).

SUBSEQUENT MEASUREMENT

Re-acquired Rights

A reacquired right recognized as an intangible asset should be amortized over the remaining contractual period of the contract in which the right was granted. An acquirer that subsequently sells a reacquired right to a third party should include the carrying amount of the intangible asset in determining the gain or loss on the sale. In such cases, care should be taken to ensure that the intangible asset being sold is the same asset that was previously reacquired.

Thus, the reacquisition through a business combination of a 'master franchise agreement', and the subsequent granting of sub-franchises for specific geographical areas to third parties, would be dealt with separately and the master franchise agreement retained in the acquirer's statement of financial position.

Share-based payment awards

The acquirer shall measure a liability or an equity instrument related to the replacement of an acquiree's share-based payment awards with share-based payment awards of the acquirer in accordance with the method in IFRS 2

Assets held for sale

The acquirer shall measure an acquired non-current asset (or disposal group) that is classified as held for sale at the acquisition date in accordance with IFRS 5 Non-current Assets Held for Sale and Discontinued Operations at fair value less costs to sell.

CONSIDERATION TRANSFERRED

IFRS 3(2008) requires the consideration transferred in a business combination to be measured at fair value. This is calculated as the sum of the acquisition-date fair values of:

- the assets transferred by the acquirer;
- the liabilities incurred by the acquirer to former owners of the acquiree; and
- the equity interests issued by the acquirer.

However, any portion of the acquirer's share-based payment awards exchanged for awards held by the acquiree's employees that is included in the consideration transferred in the business combination should be measured in accordance with IFRS 2 Share-based Payment.

Potential forms of consideration include cash, other assets, a business or a subsidiary of the acquirer, contingent consideration, ordinary or preference equity instruments, options, warrants and member interests of mutual entities.

The consideration transferred may include assets or liabilities of the acquirer with carrying amounts that differ from their fair values at the acquisition date (e.g. non-monetary assets or a business of the acquirer). If so, the acquirer should re-measure the transferred assets or liabilities to their fair values as of the acquisition date and recognize any resulting gains or losses in profit or loss.

However, sometimes the transferred assets or liabilities remain within the combined entity after the business combination (e.g. because the assets and liabilities were transferred to the acquiree rather than to its former owners), and the acquirer therefore retains control of them. In that situation, the acquirer should measure those assets and liabilities at their carrying amount immediately before the acquisition date. No gain or loss should be recognized in profit or loss in respect of assets or liabilities controlled by the acquirer both before and after the business combination.

Subsequent accounting

The consideration the acquirer transfers in exchange for the acquiree includes any asset or liability resulting from a contingent consideration arrangement. The acquirer shall recognize the acquisition-date fair value of contingent consideration as part of the consideration transferred in exchange for the acquiree.

The acquirer shall classify an obligation to pay contingent consideration as a liability or as equity on the basis of the definitions of an equity instrument and a financial liability in IAS 32 Financial Instruments: Presentation, or other applicable IFRSs. The acquirer shall classify as an asset a right to the return of previously transferred consideration if specified conditions are met.

Some changes in the fair value of contingent consideration that the acquirer recognizes after the acquisition date may be the result of additional information that the acquirer obtained after that date about facts and circumstances that existed at the acquisition date. Such changes are measurement period adjustments in accordance with above paragraphs. However, changes resulting from events after the acquisition date, such as meeting an earnings target, reaching a specified share price or reaching a milestone on a research and development project, are not measurement period adjustments. The acquirer shall account for changes in the fair value of contingent consideration that are not measurement period adjustments as follows:

(a) Contingent consideration classified as equity shall not be re-measured and its subsequent settlement shall be accounted for within equity.

(b) Contingent consideration classified as an asset or a liability that:

- (i) is a financial instrument and is within the scope of IAS 39 shall be measured at fair value, with any resulting gain or loss recognized either in profit or loss or in other comprehensive income in accordance with that IFRS.
- (ii) is not within the scope of IAS 39 shall be accounted for in accordance with IAS 37 or other IFRSs as appropriate.

Acquisition related costs

Acquisition related costs the acquirer incurs to effect business combination like finder's fees, advisory, legal, accounting, valuation and other professional or consulting fees; general administrative expenses, including costs incurred on maintaining an internal acquisition department, are recognized as an expense in the period of incurrence. However, costs of issuing equity instrument by the acquirer are recognized in equity and costs of issuing debt instruments are recognized as borrowing cost under IAS -23 and 39.

Measurement Period

If the initial accounting for a business combination is incomplete by the end of the reporting period in which the combination occurs, the acquirer shall report in its financial statements provisional amounts for the items for which the accounting is incomplete. The measurement period ends as soon as the acquirer receives the information it was seeking about facts and circumstances that existed as of the acquisition date or learns that more information is not obtainable. However, the measurement period shall not exceed one year from the acquisition date.

The measurement period provides the acquirer with a reasonable time to obtain the information necessary to identify and measure the following as of the acquisition date in accordance with the requirements of this IFRS:

(a) the identifiable assets acquired, liabilities assumed and any non-controlling interest in the acquiree;

(b) the consideration transferred for the acquiree (or the other amount used in measuring goodwill);

(c) in a business combination achieved in stages, the equity interest in the acquiree previously held by the acquirer; and

(d) the resulting goodwill or gain on a bargain purchase.

The acquirer shall consider all pertinent factors in determining whether information obtained after the acquisition date should result in an adjustment to the provisional amounts recognized or whether that information results from events that occurred after the acquisition date. Pertinent factors include the date when additional information is obtained and whether the acquirer can identify a reason for a change to provisional amounts

During the measurement period, the acquirer shall recognize adjustments to the provisional amounts as if the accounting for the business combination had been completed at the acquisition date. Thus, the acquirer shall revise comparative information for prior periods presented in financial statements as needed, including making any change in depreciation, amortization or other income effects recognized in completing the initial accounting.

After the measurement period ends, the acquirer shall revise the accounting for a business combination only to correct an error in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

Recognizing and measuring goodwill or a gain from a bargain purchase

The acquirer shall recognize goodwill as of the acquisition date measured as the excess of (a) over (b) below:

(a) the aggregate of:

- (i) the consideration transferred measured in accordance with this IFRS, which generally requires acquisition-date fair value;
- (ii) the amount of any non-controlling interest in the acquiree measured in accordance with this IFRS; and
- (iii) in a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree.

(b) the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed measured in accordance with this IFRS.

In a business combination in which the acquirer and the acquiree (or its former owners) exchange only equity interests, the acquisition-date fair value of the acquiree's equity interests may be more reliably measurable than the acquisition-date fair value of the acquirer's equity interests. If so, the acquirer shall determine the amount of goodwill by using the acquisition-date fair value of the acquiree's equity interests instead of the acquisition-date fair value of the equity interests transferred.

Bargain purchases

Occasionally, an acquirer will make a bargain purchase, which is a business combination in which the amount in paragraph (b) exceeds the aggregate of the amounts specified in paragraph (a) above.

If that excess remains after applying the requirements in following paragraph, the acquirer shall recognize the resulting gain in profit or loss on the acquisition date. The gain shall be attributed to the acquirer.

Case Studies on IFRS -3

Example 1

X grants a franchise right to Y to operate under X's name in the northeast region of the country in which it operates. Two years later, X decides to expand its business and enters into an agreement to acquire 100% of Y for CU50,000. Y's business consists of the franchise right (fair value CU20,000), a customer list (fair value CU10,000), some operating assets and liabilities (net fair value CU15,000), an assembled workforce (recognized as part of goodwill) and processes. At the time of the acquisition, the franchise right is at market terms and, therefore, X does not recognize an off-market settlement gain or loss. Assume that the franchise right has a fixed term and is not renewable.

Required: Calculated goodwill

Example 2

Facts as in above example, except that the franchise right contract terms are favorable to X compared to market terms at the acquisition date by CU3,000. As before, X recognizes an identified intangible asset for the reacquired right at its fair value of CU20,000. This right will be amortized over the remaining term of the franchise agreement.

Required: Calculated goodwill

Example 3

Suppose that AC acquires TC on 30 September 20X7. AC seeks an independent valuation for an item of property, plant and equipment acquired in the combination, and the valuation was not complete by the time AC authorized for issue its financial statements for the year ended 31 December 20X7. In its 20X7 annual financial statements, AC recognized a provisional fair value for the asset of CU30,000. At the acquisition date, the item of property, plant and equipment had a remaining useful life of five years. Five months after the acquisition date, AC received the independent valuation, which estimated the asset's acquisition-date fair value as CU40,000.

In its financial statements for the year ended 31 December 20X8, AC retrospectively adjusts the

20X7 prior year information as follows:

(a) the carrying amount of property, plant and equipment as of 31 December 20X7 is increased by CU9,500. That adjustment is measured as the fair value adjustment at the acquisition date of CU10,000 less the additional depreciation that would have been recognized if the asset's fair value at the acquisition date had been recognized from that date (CU500 for three months' depreciation);

(b) the carrying amount of goodwill as of 31 December 20X7 is decreased by CU10,000; and

(c) depreciation expense for 20X7 is increased by CU500.

In accordance with IFRS 3, AC discloses:

(a) in its 20X7 financial statements, that the initial accounting for the business combination has not been completed because the valuation of property, plant and equipment has not yet been received;

(b) in its 20X8 financial statements, the amounts and explanations of the adjustments to the provisional values recognized during the current reporting period. Therefore, AC discloses that the 20X7 comparative information is adjusted retrospectively to increase the fair value of the item of property, plant and equipment at the acquisition date by CU9,500, offset by a decrease to goodwill of CU10,000 and an increase in depreciation expense of CU500.

Discuss relevant treatment along with computation of goodwill under IFRS-3?

Example 4

You are the accounting director at Global Accounting Services, a prestigious international auditing firm. In your capacity as such are required to advise clients about various accounting issues assist audit teams with complex accounting transactions and host quarterly accounting seminars for your clients.

During one such seminar the financial directors of three clients requested your advice regarding the accounting implications of certain transactions that their firms had entered into during the year: -

a) Venture limited (VL), a private equity trader, purchased the net assets of Going-Green Limited (GG). Produces electric vehicles that are less damaging to the environment compared to petrol driven vehicles.

VL's board of directors is of the opinion that the global warming threat will shortly increase the demand for electric cars as consumers become more environmentally responsible. They believe that the equity of GG will soon be listed and is significantly under-valued; therefore, it may greatly appreciate in price in the near future.

The financial sector director argues that, since GG is a business, VL can account for the acquisition in terms of IFRS-3, together with its own operations.

b) Fiasco Limited (FL), a producer of footballs, had secured a significant contract to produce footballs for the FIFA 2010. Unknown to FIFA, an ongoing was in Polyasia has meant that FL cannot currently produce footballs at all!

To avoid losing the contract, FL purchased all the equity in Elastic Limited (EL). EL is a startup business with 7 employees and a patented method to produce synthetic rubber cheaply. It does not, however, have any production equipment. The South African market has expressed great interest in this new synthetic rubber and it is expected that production will begin in next 6 months.

The financial director FL does not believe that IFRS 3 is applicable here as he sees no evidence that EL is an operational business as yet.

c) Sole Limited (SL) produces footwear for both men and women but it has problem.

Two rare machines used to produce the heels and soles of shoes respectively, have broken down and cannot be repaired. To enable SL to continue produce: -

i) Heels, SL purchased Shoe Tech Limited (ST) a company that leases out specialized shoe manufacturing machines; and

ii) Soles, SL purchased a sole manufacturing machine at a liquidation auction of a competitor.

The financial director of SL is adamant that both purchases qualify as a business combination in terms of IFRS 3

Required: - determine if each of the transactions is a valid business combination using definitions and interpretations of IFRS 3?

Example 5

After the seminar that day you return to your office and brows through your e-mails. You discover an urgent query sent to you by the audit manager of three clients that either purchased or created business. The manager requires your help as he cannot recall the definitions and nuances as described in IFRS 10 and IFRS 3.

The urgent query details the following: -

a) Mega purchased (MW) 80% of Public Works Limited (PW) from the Government leaving the Government stake to 20%. MW may appoint or remove a majority of the directors of PW and may cast a majority of the voting rights at shareholder's meetings. An article in the purchase agreement with the Government mentioned that any resolution passed by the shareholders can be vetoed by the Government if it is deemed not in the public interest.

b) Unwise Limited (UW) purchased 40% of outstanding shares of Toxic Debt (TD). UW also subscribed $ 700,000 of TD planned $ 1,200,000 class -A debentures. These may be currently converted into TD shares at the rate of 1 for every 2 $ loan. The management of UW has indicated that it will not convert these debentures into shares.

At acquisition date, only 80% of the planned debentures were issued. TD also has two classes of options in the market, none of which are held by UW. Class A options can be converted in 300,000 shares any time in eight months time while class B options can be converted in 200,000 shares in 3 years time.

c) Swindler Bank Limited (SB) is a derivative dealer but it has a problem. The global credit crises have reduced its credit rating to such an extent that it can no longer attract counterparties to its derivative products. To overcome this, SB management have personally created an entity called Rogue. All of Rogue's assets once belonged to SB.

The transfer of these assets was partly gratuitous and partly in exchange for 20% of Rogue's equity. Rogue has no liabilities and has a better credit rating that SB. This superior credit rating has allowed Rogue to attract customers for the derivative products offers and certain customers have also been referred by Rogue to SB for other services.

At the end of each month any cash in excess of the following month's budgeted requirements is remitted to SB by electronic fund transfer.

Required: - explain in each case, if control is deemed to exist?

Example 6

IAS Global sponsors monthly accounting, auditing and tax updates to all of its directors. After each update a test is written by the attendees based on the information lectured. During the current update you notice that IFRS 3 dominates the lecture but it is now tie for you to complete the test and answer the following questions.

a) Marvel Limited (ML) transferred its liabilities to Wonder Limited (WL) in exchange for WL being able to elect a majority of ML's directors.

Awe Limited (AL) another company transferred its equity shares to WL's shareholders as consideration for its 80% share of the equity of WL. AL is significantly larger that WL based on market capitalization and together with Spectacular Limited governs the operating and financial policies of WL.

Determine the acquirer in the above transaction?

b) Sloth Limited (ST) 20% of Slow Limited (SL) on 30 June 2009 for cash. Three months later the operations of SL improved and ST decided to increase its investment in SL. ST acquired further 40% of SL through issue of its equity shares on that date and the shares were transferred to the custodial bank of the former owners of SL.

Due to local anti monopoly laws the purchase was reviewed by the local competition commission. The commission ruled on 18 august 2009 that the purchase did not violate any laws and all securities taxes were settled on 23 August 2009.

Required: - determine the acquisition date based on the above?

c) Trump Limited (TL) transferred cash to purchase 60% of Apprentice Limited (AL) on 28 February 2009. Prior to this TL had the ability through agreement with the other shareholders of AL to cast majority of votes in AL.

Required: - determine the acquisition date in the above transaction?

Example 7

P acquired Q in two stages.

- In 20X1, P acquired a 30% equity interest for cash consideration of CU32,000 when the fair value of Q's identifiable net assets was CU100,000.
- In 20X5, P acquired a further 50% equity interest for cash consideration of CU75,000. On the acquisition date, the fair value of Q's identifiable net assets was CU120,000. The fair value of P's original 30% holding was CU40,000 and the fair value of the 20% non-controlling interest is assessed as CU28,000.

Required: Calculated goodwill