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The transition to reporting business combinations under NZ IFRS should not be too traumatic, but the longer term prospect of converging standards could mean fundamental changes in how control is defined and which entities should be consolidated.

One of the key motivations for the decision to adopt New Zealand equivalents to International Financial Reporting Standards (NZ IFRS) is the desire for users to be able to compare easily financial statements of New Zealand entities with their counterparts overseas. Perhaps the most fundamental requirement is to ensure comparability of the reporting entity. For group financial statements this means a consistent determination of what a subsidiary is and how the consolidation of such entities should be performed. In the past, there has been divergence among the requirements of the various national and international standards in both these areas. Such divergence is very evident between the standards of the International Accounting Standards Board (IASB) (and similar national standards, such as New Zealand's) and US standards. This is therefore a rich area for convergence by the IASB and the United States' Financial Accounting Standards Board (FASB). Convergence does not necessarily mean one standard setter agreeing to adopt the existing standards of another; sometimes it means both standard setters reconsidering an issue and developing a joint solution. This is how the IASB and the FASB are approaching accounting for business combinations and consolidations.

PAT HANLY, *Inside the Garden*, 1968, watercolour. The University of Auckland Collection

For New Zealand entities moving to NZ IFRS, the transition, at least in the short term, should not be too traumatic. Although there are a number of significant differences between the current requirements[1] and the requirements under NZ IFRS,[2] the fundamental concepts, including the determination of which entities should be consolidated, remain broadly similar. The differences that do exist are analysed first in this paper.

Potentially of far greater significance is how international standards for business combinations may change. In this regard, the proposed amendments to NZ IFRS 3 and NZ IAS 27 exposed in June 2005 are particularly relevant. The amendments proposed in these exposure drafts are analysed second.

Finally, this paper addresses how standards relating to group financial statements might be further amended. In this regard, the current IASB's project on control[3] is particularly important.

Significant differences between existing New Zealand Financial Reporting Standards (NZ FRS) and current NZ IFRS

The fundamental requirements relating to accounting for business combinations are:

- measure the cost of the business combination at the date of acquisition
- measure the identifiable assets and liabilities of the acquiree at fair value
- recognise the difference between the parent's share of the fair value of the net assets of the acquiree and purchase price as either goodwill or discount on acquisition

As mentioned above, these fundamental requirements are the same under existing NZ FRS and NZ IFRS. However, there are a large number of differences in the detail. The following analysis highlights the more significant of these differences.

Scope

FRS-36 applies to all business combinations except intra-group reconstructions.[4] In addition, where a subsidiary is either required (for example, by the Commerce Commission), or intends to relinquish control within twelve months of acquisition, FRS-37 contains an exemption from the requirement to consolidate the subsidiary.

Under NZ IFRS the scope exclusions are:

(a) combinations by businesses under common control
(b) business combinations in which separate entities or operations are brought together to form a joint venture
(c) combinations involving two or more mutual entities
(d) business combinations in which separate entities or operations are brought together to form a reporting entity by contract alone (for example, certain types of stapled securities)

NZ IFRS 3 does not include a similar exemption to FRS-37 from the requirement to consolidate a subsidiary where control is temporary. Instead, it requires the assets and liabilities of such subsidiaries to be accounted for in accordance with the requirements of NZ IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*.

Examples of common control transactions include: short-form amalgamations under the Companies Act; and the creation of a "New Co" formed to acquire selected operations of an existing group, with the object of spinning-off the New Co as a new listed company. Although the rationale for exclusion for combinations by businesses under common control is the same as the exclusion for intra-group reconstructions, the definitions of these two are such that a great many more combinations fall outside the scope of NZ IFRS 3 than do outside FRS-36. The exclusion for combinations involving two or more mutual entities is also important given the importance of the co-operative movement in New Zealand. Unhelpfully, neither FRS-36 nor NZ IFRS 3 specify how combinations outside their respective scopes should be accounted for. However, in this circumstance a free choice of policy is not permitted under NZ IFRS, because the hierarchy set out in NZ IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors* must be applied to determine the appropriate treatment.

Measurement of the cost of the business combination at the date of acquisition

Under both NZ FRS and NZ IFRS, a business combination is measured at the fair value of the consideration, plus any directly attributable costs.

In addition, under FRS-36 (but not under NZ IFRS 3), to the extent the business combination represents a donation or subsidy to the acquirer, the fair value of the net assets acquired is also recognised as a component of cost. This difference can be attributed to the fact that New Zealand financial reporting standards were developed to apply to the financial statements of all entities, not just profit oriented entities, which is the case for IASB standards.

Recognition and measurement of identifiable assets and liabilities of the acquiree

Although both NZ FRS and NZ IFRS require identifiable assets and liabilities acquired to be recognised

Steve Todd is a member of the Financial Reporting Standards Board of the New Zealand Institute of Chartered Accountants. He is also a fellow of the Institute of Chartered Accountants in England and Wales and is a member of the New Zealand Institute of Chartered Accountants.

at their fair values at acquisition date, there are differences. The most significant is that, under FRS-36, a provision must be recognised for the acquirer's plans to restructure the acquired business shortly after acquisition date, provided the plan meets the criteria set out in the standard. Under NZ IFRS 3, a restructuring provision may be recognised only if the acquiree would have recognised the provision even in the absence of the business combination. In other words, a restructuring provision (liability) can only be recognised as part of the business combination if that liability existed in the acquiree at the date of acquisition. Ironically, this difference exists solely as a result of convergence of FRS-36 with the international standard existing when FRS-36 was finalised in 2001.

A second significant difference relates to contingent liabilities, such as unresolved legal disputes or disputes with the Inland Revenue Department. In common with the normal treatment of contingent liabilities, no liability is recognised under FRS-36 for an acquiree's contingent liabilities at date of acquisition. In contrast, NZ IFRS 3 requires recognition of these items at their fair value: that is, the amount that a knowledgeable, willing third party would demand to assume responsibility for the liability.

PAT HANLY, *Innocence & Energy (from "The Seven Ages of Man" series)*, 1975, enamel on board. The University of Auckland Collection

Other differences with respect to the identification and measurement of assets and liabilities acquired are more in the way of emphasis and detail rather than substance. For example, there is considerably more emphasis in NZ IFRS 3 on the identification of intangible assets separate from goodwill. This is unsurprising given there is no NZ FRS on the recognition and measurement of intangibles, whereas international standards have IAS 38, *Intangible Assets*.

In practice, the more obvious intangible assets have been recognised in the past under NZ FRS; for example, casino licences by SKYCITY Entertainment Group Ltd, broadcast and programming rights by Sky Network Television Ltd, and brands by Fletcher Building Ltd. However, under NZ IFRS, some less obvious assets will need to be considered. These will include customer lists and relationships, order and production backlogs, and servicing contracts. Many of these assets will have limited useful lives and therefore will have to be amortised, often over quite short periods.

Goodwill and discount on acquisition (negative goodwill)

Under both NZ FRS and NZ IFRS, goodwill and discounts on acquisition are measured as the difference between the cost of acquisition and the acquirer's share of the net identifiable assets of the acquiree on acquisition. But that is where the similarity ends. The key difference is that, under FRS-36, goodwill must be amortised over its useful life, which cannot exceed 20 years; under NZ IFRS 3, goodwill must not be amortised. In place of amortisation, goodwill (and any intangible assets with indefinite lives) must be subjected to rigorous impairment tests at least annually. This will mean that, instead of a steady annual goodwill amortisation expense, there will be significant one-off impairment expenses when acquisitions do not perform as well as planned. As an example, in its first IFRS compliant financial statements for the year ended 31 March 2006, Vodafone Group Plc wrote down goodwill by more than £23 billion.[5]

With respect to a discount on acquisition, FRS-36 requires that this be eliminated by proportionately reducing the fair values of the non-monetary assets of the acquiree. Only if a discount remains after reducing the non-monetary assets to nil should a discount be recognised as a gain in the consolidated income statement. Conversely, NZ IFRS 3 requires immediate recognition of the full amount of any discount on acquisition as income, subject solely to a requirement to reassess the fair values of the assets and liabilities acquired. Historically, genuine discounts on acquisition have been rare.

Other differences
The principal other difference relates to step acquisition accounting after control is achieved (for example, a parent of a 60% owned subsidiary acquiring an additional 20%). Under FRS-37, such a transaction is required to be treated in a similar manner to a business combination that results in control. That is, the assets and liabilities are re-measured to new fair values at the date of the acquisition of the additional interest; additional goodwill is measured and recognised on the additional interest acquired. Effectively, this results in the revaluation of the subsidiary's assets and liabilities in the consolidated financial statements, even if the group's policy is to measure assets at historical cost.

Under NZ IFRS, this situation is not specifically addressed. However, because the transaction is not a business combination as defined in NZ IFRS 3, the FRS-37 approach of performing a new fair value exercise is not permitted.

Proposed amendments to NZ IFRS

Currently one of the main objectives of the IASB is convergence with generally accepted accounting principles in the United States (US GAAP). Both the IASB and the US Financial Accounting Standards Board (FASB) see accounting for business combinations and consolidations as a prime area ripe for convergence. Therefore, they have undertaken a joint project to address them.

The first product of this project was the publication by both the IASB[6] and the FASB in June 2005 of exposure drafts to revise their respective standards relating to business combinations and consolidation. These exposure drafts are virtually identical with the exception of cross references to other documents within IFRS and US authoritative accounting literature. The degree of commonality on such a complex and controversial topic is remarkable: it remains to be seen whether it will be possible to maintain this through to the final standards. It is also notable, and perversely comforting, that the proposed changes from current standards are much more significant under US GAAP than under IFRS.

There are three main areas affected by the proposals contained in the exposure drafts. These are:

(a) scope
(b) measurement of the business combination transaction
(c) accounting for consolidations on an "economic entity" approach

Scope
ED IFRS 3(R) proposes removing the scope exclusions for business combinations involving only mutual entities and business combinations achieved by contract alone. Although these proposals reduce the range of business combinations excluded from the scope of the proposed standard, business combinations involving only entities or operations under common control remain excluded (as do formations of joint ventures).

Measurement of the business combination transaction
As explained in the first part of this paper, currently business combinations are measured at the fair value of the consideration paid. The exposure draft proposes a significant change in direction by requiring the transaction to be measured at the fair value of the business acquired. For an arm's length transaction where each party believes to have achieved fair value this may sound like semantics with no practical effect. However, this proposed change in direction does result in a number of highly significant changes from current practice.

The first major difference is that direct costs of acquisition incurred by the acquirer, for example legal and merchant banking fees, do not form part of the fair value of the business being acquired. Therefore, it is proposed that these be expensed by the acquirer as incurred.

The second major difference is that, as the transaction is proposed to be measured at the fair value of the entire business acquired, 100% of the goodwill relating to the acquired business is recognised, regardless of whether the acquirer acquires 100% of the acquiree. For example, if a parent acquires 60% of a new subsidiary, under current standards, the consolidated financial statements will reflect 100% of the separately identified assets and liabilities of the new subsidiary, but the goodwill relating only to its 60% interest. Under the ED IFRS 3(R) proposals, the consolidated financial statements will continue to reflect 100% of the separately identified assets and liabilities, but will also recognised 100% of the goodwill; i.e., the goodwill attributable to the minority interest is recognised. This could have the potential to raise practical problems of measurement. For example, it is commonly assumed that a premium attaches to the ability to control a subsidiary. Therefore, in our 60% subsidiary example, it may not always be the case that goodwill is split proportionately 60/40.

A further proposed change relates to the treatment

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of contingent consideration (for example, clauses in sale and purchase agreements where additional consideration is paid to the vendor depending on the outcome of future events, such as subsequent profits). Under current NZ IFRS 3, any changes in the total consideration paid as a result of such contingent consideration clauses is adjusted against the original business combination accounting, with a consequent change to the amount of goodwill recognised. Under the ED IFRS 3(R) proposals, any changes to the initial estimate of the contingent consideration initially recognised at acquisition date (at its fair value at that date) would be accounted for as a gain or loss in the subsequent consolidated financial statements.

The last major change relates to accounting for step acquisitions up to the date control is achieved. Under the ED IFRS 3(R) proposals, any investment in the acquiree prior to the date the parent obtains control (i.e., at the business combination date) is re-measured to fair value at that date and a gain or loss is recognised in the consolidated income statement. Furthermore, if, under the previous accounting for the investment, changes in value had been recognised directly in equity (for example, if it was classified as available for sale), at the date of the business combination any amount accumulated in equity shall also be recognised as a gain or loss in the consolidated income statement. The IASB explain that the reason for this is that the gaining of control of the acquiree is an event that should require re-measurement. In effect, the IASB argues that, in substance, there has been a disposal of one asset (the earlier non-controlling interest) and the acquisition of another (the controlling interest).

Accounting for consolidations on an "economic entity" approach

The proposals with respect to the "economic entity" approach to consolidations go right to the heart of fundamental accounting concepts and the purpose of general purpose financial reporting.

To date, there has been an unwritten rule that the primary users of consolidated financial statements are the shareholders of the parent and that financial reporting should reflect the needs of that primary user group. For this reason, income statements have typically included a deduction for "minority interest", to leave a bottom line being the profit attributable to the parent shareholders. In addition there has been some controversy over where minority interest should be reported within the balance sheet. Although minority interest has been recognised within equity in New Zealand for many years, this has only recently been the case under IFRS, and is still not the case in the US. If it is concluded that minority interest is part of equity, the IASB argue that the logical consequences of this conclusion must flow through to the rest of the financial statements. These consequences form some of the more controversial proposals in the exposure draft.

Perhaps the most controversial proposal relates to partial disposals of subsidiaries without loss of control. Under current standards, including NZ IAS 27, if a parent sells part of its investment in a subsidiary but retains control (for example, by selling down from 90% to 60%), a gain or loss on that partial disposal will be recognised in the consolidated income statement. Under the ED IAS 27(R) proposals such a transaction would be accounted for as a transaction between the entity reporting (the group) and one of its owners (the minority interest). As such no gain or loss would be recognised and the transaction would be recorded through the statement of movements in equity. Effectively the proposals would treat a partial disposal without loss of control as an issuance of equity instruments: Assuming cash is paid by the minority for the shares, cash flows into the group (from the minority interest) in exchange for the issuance (effectively out of group treasury) of shares to the minority interest.

Even where there is a disposal with loss of control, the resulting gain or loss recognised in the consolidated income statement could be different under the ED IAS 27(R) proposals than under current standards. This would be the case where a non-controlling interest is retained by the former parent. In these circumstances, the proposals would require the non-controlling interest retained to be re-measured to fair value at the date of partial disposal and for the gain or loss on disposal to include the effect of this re-measurement. Under the current NZ IAS 27, the initial measurement of the non-controlling interest retained would be its carrying amount at the date the investee ceased to be a subsidiary. In the same way that it is proposed that a partial disposal without loss of control should be accounted for as a transaction between the reporting entity and one of its equity owners, it is proposed that the acquisition of an additional investment in a subsidiary after control (for example, the acquisition by the parent of an additional 20% of a previously 70% owned subsidiary) is also accounted for as a transaction with equity owners. In this case under the proposals, the acquisition is effectively treated like a repurchase of part of the equity (the minority interest) of the economic entity (being the group): Assuming cash is paid to the minority for their shares, cash leaves the group in exchange for the return of equity instruments in the group. Importantly, there would be no re-measurement to fair value of the subsidiary's assets and liabilities and no additional goodwill would be recognised (as 100% of goodwill would already have been recognised when control was initially obtained).

Prospects for ED IFRS 3(R) and ED IAS 27(R) and the longer term projects of the IASB

The comment period for the exposure drafts ended on 28 October 2005. In addition, the IASB and FASB have conducted "roundtable" discussions with submitters.

It is fair to say that submitters generally disagreed with the proposals. A quick, and non-scientific, review of the submissions highlighted two principal themes:

(a) There was a general rejection of the movement away from a parent shareholder perspective to the economic entity approach. Submitters continued to believe that the overriding purpose of general purpose financial statements was to report to parent company equity holders and that financial reporting standards should continue to serve that purpose.

(b) There was a feeling that the current standards generally served their purpose and worked well. In the absence of any undercurrent of unhappiness with the current standards there was an attitude of, "If it's not broken, why fix it?"

It is also worth noting that five members of the IASB (out of fourteen) published alternative views to the exposure draft.

Given the strength of opposition to the exposure draft, it is very possible that there will be significant changes to the proposals before they are finalised. Whether the principal conceptual thought underpinning the proposals survives is impossible to predict, particularly given the fact that this is a joint project with the FASB. For these reasons it will be particularly interesting to track the progress of the project over the coming months.

The outcome of this project is likely to have a major impact on the progress of other projects, particularly the project on control (including special purpose entities). The control project is still at an early stage and is quite likely to be subject to delay if more staff time is taken up having to substantially redraft the proposals in ED IFRS 3(R) and ED IAS 27(R). The principal objective of the control project is to redefine "control" for the purpose of identifying which entities are subsidiaries and should therefore be consolidated. This will be a particularly important project from a New Zealand perspective given the difficulty in determining control in a sector neutral environment.

Conclusion

The importance of accounting for business combinations and subsequent consolidation is highlighted by the fact that the IASB and the FASB have chosen to work on these issues jointly. The proposals published by the two boards raise interesting conceptual issues that will potentially impact a whole range of wider issues. In particular:

The proposal to measure the business combination transaction at the fair value of the business acquired. This has the potential to affect future standards on the initial recognition and measurement of the acquisition of all assets and assumption of all liabilities.

The proposal to adopt an economic entity model in place of the model based on the primacy of the parent shareholders. This has the potential to affect a range of issues including the structure of the financial statements and the performance reporting project.

How this project finally unfolds will say much about how the two boards are able to resolve issues together and come to common solutions. It will also give a strong indication of how fast the boards are likely to travel down the conceptual paths they seemingly would like to follow. For these and other reasons, the future progress and ultimate outcome of this project will be well worth following and analysing.

References:

1. Current New Zealand requirements are set out in FRS-36, *Accounting for Acquisitions Resulting in Combinations of Entities or Operations* (FRS-36) and FRS-37, *Consolidating Investments in Subsidiaries* (FRS-37).
2. NZ IFRS requirements are set out in NZ IAS 27, *Consolidated Financial Statements and Accounting for Investments in Subsidiaries* (NZ IAS 27), NZ SIC 12, *Consolidation – Special Purpose Entities* (NZ SIC 12) and NZ IFRS 3, *Business Combinations* (NZ IFRS 3).
3. IASB project titled, *Consolidations (including Special Purpose Entities).*
4. Intra-group reconstructions are transfers of operations or ownership interests in entities that occur within an entity reporting where the resources controlled by the entity do not change as a result of the transfer.
5. Interestingly, the full amount of this impairment loss has been reversed in Vodafone's US GAAP reconciliation note. Clearly, there is some way to go in the convergence of the IASB and FASB impairment standards.
6. Exposure Draft, *Amendments to IFRS 3, Business Combinations* (ED IFRS 3(R)) and Exposure Draft, *Amendments to IAS 27, Consolidated and Separate Financial Statements* (ED IAS 27(R)).