Accounting for Business Combinations in Accordance with International Financial Reporting Standards (IFRS) Requirements

Executive Summary

The International Accounting Standards Board (IASB) has introduced requirements in the last few years to make those involved in business combinations more accountable for the transactions that have taken place. In particular:

- All business combinations must now be accounted for using the acquisition accounting method.
- The intangible assets arising from a business combination must be identified and recognized separately from purchased goodwill.
- Purchased goodwill is no longer permitted to be amortized; instead, it must be tested for impairment each year.

Introduction

The accounting for business combinations under IFRS is governed by four key standards:

- IFRS 3, Business Combinations;
- IAS (International Accounting Standards) 27, Consolidated Financial Statements;
- IAS 36, Impairment of Assets;
- IAS 38, Intangible Assets.

IFRS 3 sets out the requirements to be followed in accounting for a business combination. Its introduction in 2004 represented a substantial change from the standard it superseded, IAS 22. IFRS 3 signaled the end of the benign method of accounting for business combinations known as "merger accounting." Instead, all business combinations must be accounted for using the acquisition accounting method. This requires that both acquirer and acquiree are identified for each transaction, that a fair value exercise is performed on the acquiree's assets and liabilities, and that purchased goodwill arising from the transaction is capitalized in the balance sheet.

A further consequence of the introduction of IFRS 3 is that intangible assets must be recognized separately from purchased goodwill instead of being subsumed within purchased goodwill. Purchased goodwill itself is not amortized, but must be reviewed for impairment annually. The performance of the impairment review is covered by IAS 36, Impairment of Assets, and the identification and recognition of intangible assets is covered by IAS 38, Intangible Assets.

The tightening up of business combination accounting was noted by accountants PricewaterhouseCoopers: "The acquisition process will need to become more rigorous, from planning to execution."[1]

The following steps are involved in accounting for a business combination under IFRS 3:

- identification of the acquirer and the acquiree;
- performance of a fair value exercise on the acquiree's assets and liabilities;
- identification and measurement of the fair value of the intangible assets arising;
- measurement of the amount of any non-controlling interest in the acquiree;
- measurement of the amount of goodwill arising from the transaction.

A revised version of IFRS 3 was issued by the IASB in January 2008, and its requirements will be mandatory for accounting periods from July 2009 onward. While the revision is quite comprehensive, it does not change the overall approach set out above. The revision is part of the Convergence Program underway between the IASB and the Financial Accounting Standards Board (FASB), aimed at reducing the number of differences between IFRS requirements and US Generally Accepted Accounting Principles (US GAAP). In addition to tightening up certain areas, the revision developed the previous IFRS 3 by:

- providing additional guidance regarding the recognition and fair value measurement of the acquiree's assets and liabilities;
- changing the requirements for measuring goodwill and the remaining noncontrolling interest when less than a 100% stake in the acquiree is purchased or when an increase in an existing stake is involved.

Identification of Acquirer and Acquiree

IAS 27 demands that the acquirer in a business combination be identified as the party that gains control, with control being defined as "the power to govern the financial and operating policies of an entity so as to benefit from its activities." Control is presumed to exist if one entity owns more than 50% of the voting power of the other, unless it can be demonstrated that this voting power does not constitute control. Conversely, control can be seen to exist when one entity owns less than 50% of the voting rights in the other but controls it through some other means, such as a shareholder agreement. This situation was seen when ABN AMRO was acquired by the Royal Bank of Scotland (RBS)—RBS owns only 38% of the issued share capital of ABN AMRO but is able to control it through a consortium agreement with the other owners, Fortis and Santander. Thus, RBS consolidates ABN AMRO in its financial statements.

Other guidance provided in IAS 27 for identifying the acquirer includes that, generally, the acquirer is:

- larger than the acquiree;
- the party issuing equity or paying cash as consideration;
- the party that has more seats on the board of directors of the combined entity.

IFRS 3 does, however, also deal with reverse acquisitions in which smaller companies acquire larger ones through the issue of significant amounts of equity.

Fair Value Exercise on the Acquiree's Assets and Liabilities

Consistent with any acquisition accounting exercise, IFRS 3 requires that the acquired assets and liabilities are recognized initially at fair value in the consolidated financial statements of the combined entity. The standard provides some clarification regarding identification of these assets and liabilities. For instance, IFRS 3 prohibits the setting up of acquisition reorganization provisions since these are not liabilities of the acquirer at the acquisition date. Prior to IFRS 3, acquiring companies often set up substantial acquisition reorganization provisions. Costs, such as those relating to redundancy and factory closures, were charged to these provisions post acquisition rather than to the profit and loss account. Now, such costs must be charged to the profit and loss account of the combined entity post acquisition.

Identification and Measurement of the Intangible Assets Arising from a Combination

IAS 38 defines an intangible asset as "identifiable" if it can be separated from the entity—i.e. can be leased or sold separately from the entity—or if it is secured legally. By defining identifiability in terms of separability as well as legal security, the number of potentially recognizable intangible assets increases. For instance, software technology may not be legally protected by a patent, but this does not prevent it from being licensed or sold to a third party. Consequently, if a software company is acquired, those intangible assets that may be recognized include both patent protected and unprotected software. Since IFRS 3 assumes that the fair value of intangible assets arising from an acquisition can be measured reliably, if in existence such assets must be recognized in the fair value balance sheet.

It is the broadening of the net of intangible assets to include those that are not secured legally, together with the assumption that all identifiable intangible assets arising from a business combination can be measured reliably, that has greatly increased the number of intangible assets recognised separately from goodwill following a business combination.

IFRS 3 clarifies that certain intangible assets might be recognized in the consolidated financial statements but are not recognized in the financial statements of the acquiree. Thus, internally developed brands and customer relationship assets of the acquiree would not be recognized as intangible assets in the financial statements of the acquiree, because the cost of their development would be recorded as an expense. However, provided they satisfy the IAS 38 requirement to be identifiable intangible assets—i.e. if they are intangible, identifiable, controlled by the entity, and expected to give rise to future economic benefits—they are recognized in the consolidated financial statements.

Potentially, a very large number of intangible assets might need to be valued for balance sheet recognition purposes. IAS 38, however, allows the preparer of accounts to combine certain complementary intangible assets as a composite intangible asset—a brand—if the fair values of the underlying component intangible assets cannot be determined reliably or if they have similar useful lives. In practice, this concession is often used to reduce the number of intangible assets that need to be valued following a business combination. A proposed amendment to IAS 38 suggests that the concession could be extended to complementary assets other than brands.

Neither IFRS 3 nor IAS 38 provides any substantive guidance on determining the fair value of intangible assets. Instead, best practice has developed in the marketplace and tends to be driven by the auditors of the accounts. Many intangible asset valuation consultancies have commented on the difficulty of valuing these intangible assets. One such consultancy, Brand Finance, notes in its website literature: “In many instances the valuation of such assets is a complex undertaking” and “it will be important to demonstrate that best practice techniques are being applied.”

In January 2009, the International Valuation Standards Council (IVSC) issued two Exposure Drafts on the valuation of intangible assets generally and on the valuation of intangible assets for IFRS reporting purposes. These set out the key valuation methods that are used and address some of the more complex issues that can arise. They follow their issue, in July 2007, of a Discussion Paper on the topic of the valuation of intangible assets for IFRS reporting purposes.

In response to the IVSC’s Discussion Paper, the International Actuarial Association noted “We support the issuance of guidance on valuation of intangible assets for IFRS reporting purposes.”

Measuring the Amount of Any Non-Controlling Interest in the Acquiree

If, as a result of a business combination, the acquirer owns less than 100% of the acquiree, there is a remaining non-controlling interest, previously known as a minority interest, in the acquiree to be recognized. Accounting for this non-controlling interest has changed following the recent revision to IFRS 3. Previously, the non-controlling interest had to be measured at its proportionate share of the identifiable net assets, i.e. excluding its goodwill. The revision introduced the option to measure the non-controlling interest at its fair value and thus include its goodwill. Several commentators were concerned about the difficulty of measuring this fair value, especially where the acquiree company’s shares were unlisted, and for this reason the option to measure at fair value was not made mandatory. Under US GAAP, however, the non-controlling interest must be measured at fair value—no option is permitted. This represents a continuing difference between IFRS and US GAAP requirements.

Measuring the Goodwill Arising from a Business Combination

The revised IFRS 3 requires that goodwill is measured as the following:

The sum of:

- the fair value of the consideration paid;
- the amount of any non-controlling interest measured as described above;
- the fair value of any previously held non-controlling interest in the acquiree;

Less:

- the net sum of the acquisition date assets acquired and liabilities assumed, measured as required by IFRS 3.

It is important to note that goodwill itself is not measured at fair value—it is the residual amount that results from applying the calculation above. As a result of the option with respect to measurement of any non-controlling interest, the amount measured for goodwill may or may not include goodwill in such non-controlling interest.