

# New rules for acquisitions and disposals

## What is the issue?

In March 2008 the AASB issued revised standards on accounting for business combinations (AASB 3) and reporting in consolidated and separate financial statements (AASB 127). The revisions make significant changes to the way that entities account for acquisitions and disposals. The revised standards apply to entities with annual reporting periods beginning on or after 1 July 2009

Impact on profit and loss	✓
Impact on balance sheet	✓
Impact on disclosures	✓
Impact on stakeholder communication	✓

with early adoption permitted. This edition of *IFRS in brief* focuses on the revisions to the standards, their impact on current practice, how entities should prepare for the mandatory adoption of the standards, and why some entities should seriously consider adopting the revised standards early.

## Who does it impact?

All entities that are planning, or have recently completed, an acquisition or disposal.

## Why should management focus on the changes?

Management shouldn't underestimate the revisions to the standards. They make several fundamental changes, and some entities will find that earnings are significantly affected in the year of a transaction and for several years afterwards. Management should be aware that entities with control over a transaction can modify the timing and structure of a deal to minimise the earnings impacts of the revised standards. Further, there will also be a positive earnings impact on some transactions, so management should weigh up the benefits vs the drawbacks of early application of the revised standards (see over the page for more info).

## What are the main impacts of the revisions to the standards?

Many of the changes will add to earnings volatility. For example, under the revised standards:

- Gaining or losing control triggers an immediate re-measurement of existing or retained interests to fair value, resulting in an extra gain or loss at the time of the transaction. This isn't permitted under the existing standards.
- Settlement of a pre-existing relationship between the acquirer and target could impact an entity's earnings at the time of the acquisition
- All earn-outs will be recognised at fair value, and in most cases the fair value will be re-measured every reporting date (including interim periods), resulting in a gain or loss which will affect earnings. Currently, earn-outs are recognised only if payment is probable, and subsequent adjustments to expected earn-out payments affect goodwill.
- The accounting for all financial instruments will be re-assessed upon acquisition. For example, hedges that become ineffective will affect an entity's earnings in future periods. Currently, entities aren't required to re-assess financial instruments at acquisition date.
- Acquisition related transaction costs will be expensed as incurred, so there could be a significant impact on an entity's earnings. Currently, transaction costs form part of consideration and, therefore, goodwill.

## What do impacted entities need to do?

- Understand the impacts of the revised standards on deal structures, financial reporting, stakeholder communications, and the financial outcomes of planned acquisitions. More thorough due diligence will be required because of the impact on earnings and the increased use of fair values.
- Mitigate the adverse impacts of the revisions by adapting your acquisition strategy (eg, accelerate planned deals to complete before 1 July 2009) or amending contract terms (eg, reduce the impact of earn-outs).
- Remember that early adoption is permitted for financial years beginning on or after 30 June 2007.
- Communicate the effects of the revised standards to staff outside the finance function (eg, those staff responsible for the acquisition strategy or stakeholder communication).
- Engage valuation experts to cope with the expanded use of fair value in the new standards, which will call on valuation skills more frequently.
- Communicate the impacts of acquisitions on earnings to stakeholders at the date of acquisition and beyond.

## PwC insight: Transaction costs don't currently impact on the separate financial statements

One of the key changes under the revised standards is that transaction costs will be expensed as incurred. An unexpected outcome of the change is that it only impacts the business combination accounting in the consolidated financial statements (per AASB 3 Revised) - not the entity's separate financial statements (per AASB 127 Revised). Therefore, these costs would be capitalised as part of the cost of the investment in the acquiring entity's separate financial statements, having no impact on that entity's dividend paying ability. We expect the IASB to align the revised standards so that the same treatment for transaction costs is reflected in the entity's separate financial statements. In the meantime, entities should watch this space.

# New rules for acquisitions and disposals - why to consider early adopting the rules

## What is the issue?

The revised business combinations and consolidation standards will be mandatory post 2009. While many entities will continue to apply the existing standards until they become mandatory, some entities will benefit from applying the revised standards now. Early adoption is permitted for entities with annual reporting periods beginning on or after 30 June 2007.

Impact on profit and loss	✓
Impact on balance sheet	✓
Impact on disclosures	✓
Impact on stakeholder communication	✓

## Which entities should consider early adopting the revised standards?

Although the revised standards aren't mandatory until 2009, all entities should consider them now and decide when is the best time to adopt them. Entities that may benefit from adopting the standard early are those that are planning or have recently completed an acquisition via a step acquisition; that have recently lost control of a subsidiary; or are about to recognise a target's deferred tax balances arising from acquisitions from earlier accounting periods.

## What are the possible benefits of early adopting the revised standards?

Entities may wish to take advantage of the standards' key positive impacts on earnings. For example:

**Changes to holding period gains on acquisition.** Where entities hold an existing non-controlling interest in the target and acquire a controlling interest, the existing interest is re-measured to fair value. Any gain or loss in value is recognised in the income statement. The existing standards require the change in the net identifiable assets of the target to be recorded in equity as a revaluation.

**Changes to holding period gains on partial disposal.** Where entities dispose of a controlling interest but retain a minority interest, a gain arises on the shares sold as well as the interest retained. The interest retained is re-measured to fair value and any resulting gain or loss is recorded in the income statement.

**Changes to deferred tax assets.** Changes to deferred tax assets more than 12 months after an acquisition are no longer adjusted against goodwill. For example, if a target had tax losses that weren't expected to be recovered, they would not be recognised as a deferred tax asset at the acquisition date. Under the revisions, if the losses subsequently become recoverable, recording the deferred tax asset now reduces the income tax expense. This applies even if the revised standards weren't applied at the time of the acquisition.

## What are the possible disadvantages of early adopting the revised standards?

Early adoption of the standards will not bring advantages for every entity. Although in most cases entities will be able to limit their exposure to any adverse effects through careful planning (such as by amending the structure of their deals), entities should carefully consider all of the disadvantages of early adoption, such as those that negatively affect an entity's earnings. For example:

**Changes to accounting for transaction costs.** The revised standards require entities to expense transaction costs (other than those related to funding the acquisition) in the consolidated financial statements.

**Changes to accounting for earn-outs.** New requirements for the measurement and recognition of earn-outs and the assets and liabilities of the target may adversely effect entities' earnings, both at the time of the acquisition and in subsequent periods.

Regardless of whether an entity will early adopt the standards or wait until they become mandatory, there is more work to do in this area. Entities need to think about the impacts of the revised standards on their business and understand how they will take advantage of the opportunities and mitigate any adverse impacts when they are adopted.

For those entities considering early adoption of the revisions, remember that both AASB 3 Revised and AASB 127 Revised must be applied to the same period. More information on AASB 127 Revised will follow in a future edition of *IFRS in brief*.



### PwC guidance: IFRS 3 (Revised): Impact on earnings. The crucial Q&A for decision-makers

PwC has published a Q&A paper on the international equivalent of AASB 3 Revised to help dealmakers and preparers of financial statements communicate the consequences of a business combination on the current year's financial statements and how a business combination may affect the future years' earnings. It can be downloaded for free from [www.pwc.com/au/ifrs](http://www.pwc.com/au/ifrs).

### Resources to help you keep up to date with IFRS developments

- **IFRS News** summarises news from the International Accounting Standards Board (IASB) and International Financial Reporting and Interpretations Committee (IFRIC). It is published monthly at [www.pwc.com/ifrsnews](http://www.pwc.com/ifrsnews)
- **AASB Action Alert** covers the activities of the Australian Accounting Standards Board and how it will respond to recent IASB pronouncements. It is usually published monthly and is available at [www.aasb.com.au](http://www.aasb.com.au)
- **IASB Update** covers the activities of the IASB and decisions reached at its most recent meeting. It is usually published monthly and is available at [www.iasb.org](http://www.iasb.org)
- **IFRIC Update** covers the activities of IFRIC and tentative decisions reached at its most recent meeting. It is usually published every two months and is available at [www.iasb.org](http://www.iasb.org)