

Changes to accounting for business combinations

What is the issue?

Yesterday the IASB amended the international first-time adoption of IFRS standard, IFRS 1, and the international consolidation standard, IAS 27. We expect the AASB to follow suit next month. The amendments introduce significant changes to accounting for the cost of investments in subsidiaries, associates and joint ventures, specifically how:

- parent entities account for dividends that are received from their investments in a subsidiary, jointly controlled entity, or associate (impact one); and
- a new parent entity accounts for its investment in an existing subsidiary (impact two - see next page).

We expect the amendments to apply to Australian entities with annual financial reporting periods beginning from 1 January 2009, with early adoption permitted.

This edition of *IFRS in brief* focuses on these two changes and their impact on Australian entities.

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

Accounting for dividends (impact one)

Who does it impact?

Entities that receive a dividend from their investments in subsidiaries, jointly controlled entities or associates.

Why is it important to be aware of?

It's important for two reasons. Firstly, the amendments have made some key changes to the international impairment standard (equivalent to AASB 136 *Impairment of Assets*), which will increase parent entities' impairment testing responsibilities. When a parent receives a dividend from its investment in a subsidiary, jointly controlled entity or associate, it will need to assess whether that dividend triggers a test for impairment of the investment. This means more work for the entity's CFO and finance team, and potentially for those responsible for the entity's stakeholder communication.

Secondly, parent and investor entities must recognise dividends as revenue in the income statement regardless of whether these represent profits earned by a subsidiary, jointly controlled entity or associate prior to their acquisition by the group or after that date. The current standard requires dividends from pre-acquisition profits to be accounted for by reducing the parent or investor entity's cost of the investment. For some entities, this means an increase in the level of earnings recognised in the income statement and the amount of profit available to be passed on as dividends to the ultimate shareholders.

What do parent and investor entities need to do?

- Consider whether the receipt of a dividend from their investments is an impairment trigger under AASB 136. For example, there is an impairment trigger if:
 - As a result of the payment of dividends, the carrying amount of the consolidated net assets of the subsidiary (including goodwill) is less than the carrying amount of the investment in the parent entity's separate financial statements. If it is, this indicates that the investment amount may not be recoverable. For example, this may arise where a subsidiary pays a dividend immediately after it has been acquired.
 - The dividend received exceeds the income generated by the subsidiary in the period that it is declared. If it does, this suggests that value in the subsidiary is being transferred to the parent entity. It may also indicate that the subsidiary isn't capable of generating sufficient revenue to support the carrying amount of the parent entity's investment.
- Test their investments for impairment if there is an impairment trigger. This will involve determining the fair value of the investment and/or its 'value in use' (refer to IFRS in Brief – 24 April 2008 for information on what's involved). An investment is impaired if its carrying amount exceeds its recoverable amount, which is the higher of the 'fair value less costs to sell' or 'value in use' calculation.
- Consider whether to change their dividends policy, specifically what they distribute to ultimate shareholders.

PwC insight: A practical development

The changes to the way that a parent entity treats pre-acquisition dividends removes the potential for 'dividend traps'. A dividend trap is where profits held in an existing group can't be paid to the ultimate shareholders because they become trapped in the accounting for the investment.

The amendments also reduce the complexity involved in tracking pre and post acquisition dividends within consolidated groups, which is a significant change and timesaver for many entities.

Accounting for a new parent's investment in an existing subsidiary (impact two)

What is the issue?

The second impact of the IASB's amendments concern changes to the accounting for a new parent entity's investment in an existing subsidiary. This is a common scenario in Australia - many entities restructure their organisation by creating a new parent entity to enhance the flexibility of the group or minimise a risk for the group. For many entities, the amendments to the consolidation standard are long overdue. In simple terms, the amendments correct a previous disconnect between the requirements of the business combinations standard (IFRS 3) and the consolidation standard (IAS 27) about the appropriate accounting treatment for such internal reorganisations.

Impact on profit and loss	✘
Impact on balance sheet	✘
Impact on disclosures	✔
Impact on stakeholder communication	✔

Who does it impact?

Entities that undertake an internal reorganisation where a new group parent entity is created or where a new intermediate parent entity is inserted into a group (that is, a parent entity that is not necessarily the ultimate parent of the consolidated group). It also impacts entities that are not parent entities that form a new entity to become their parent.

All of these new entities need to apply the amendments if they meet the following three conditions:

- 1) The new entity issues shares in exchange for the existing shares of the original parent entity;
- 2) There is no change to the net assets of the new group compared to the original group; and
- 3) There is no change to the shareholders' interests in the net assets of the new group compared to the original group.

Why is it important to be aware of?

Most entities will find the amendments advantageous and some may wish to retrospectively apply them or early adopt them. The amendments address two frustrations that entities had with the former accounting rules.

Firstly, the amendments to how a group measures the cost of an investment by a new parent entity could reduce the risk of impairment write downs in some internal group structures. For many groups, the previous accounting increased the risk of an impairment loss because the new parent entity had to recognise its new investment at the current fair value of the group. This seemed harsh for the new parent entity because there had been no change in substance to the group's ultimate shareholders. Under the amendments, new parent entities must base the cost of the investment on their share of the equity shown in the separate financial statements of the original parent.

Secondly, new parent entities, like other entities, will have the freedom to pay pre acquisition dividends to its ultimate shareholders (this issue is discussed over the page). The previous accounting reduced the dividends that could be paid to the ultimate shareholders because all of the net assets below the new parent entity were considered pre-acquisition and the dividends paid to them were accounted for as a reduction in the cost of the new parent entity's investment.

What do entities need to do?

- Entities planning to undertake an internal reorganisation whereby a new parent entity is inserted into a group structure should consider the potential impacts of the amendments and whether to early adopt them.
- Entities that have previously undertaken such an internal reorganisation should revisit the accounting and consider whether there would be any benefits in retrospectively applying the amendments.
- At the date that it is created, the new parent entity will need to measure the cost of its investment based on the carrying amounts of equity, assets and liabilities.

PwC insight: A logical development

PwC believes the amendments are logical, namely because where a new parent entity has been inserted into a group through an internal reorganisation, the position of the group's ultimate shareholders doesn't change. The amendments are consistent with the accounting applied in the consolidated financial statements and they allow groups to continue to pay dividends as if the restructure had not occurred.

However, entities that wish to measure the new parent entity's investment at the fair value of the group will find the amendments restrictive. These entities can no longer use this as a measure of cost, unless they commit to continuously recognising the investment at fair value in the parent entity's accounts at each reporting date. Entities that choose this approach will have more work to do on a regular basis.

Resources to help you keep up to date with IFRS developments

- **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
- **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