



HM TREASURY

Financial Reporting Advisory Board Paper

IFRS 3 Business Combinations

Issue:	Applying IFRS 3 <i>Business Combinations</i> in the context of resource accounts covered by the Government Financial Reporting Manual
Impact on guidance:	The proposed text in Annex A relates to the IFRS-based FReM.
IAS/IFRS adaptation?	No.
IPSAS compliant?	No, IPSASB will not consider business combinations until 2007.
Interpretation for the public sector context?	No. However, combinations involving businesses under common control are specifically excluded from the scope of IFRS 3. It is therefore proposed that mergers involving public sector bodies continue to be accounted for as mergers. This proposal will be reviewed once the IASB have finalised Phase II of its Business Combinations project.
Impact on budgetary regime?	No, there is no change in the existing approach.
Alignment with National Accounts	N/A
Impact on Estimates?	No, there is no change in the existing approach.
Recommendation:	That the FRAB approves the continued use of merger accounting for transfers of functions within the public sector.
Timing:	Not yet known: depends on future decision on date for moving to EU-adopted IFRS.

DETAIL

Background

1. The Board considered the impact of the draft IFRS 3 at its November 2005 meeting at which the Treasury presented Paper FRAB (76) 08 on the ASB's July 2005 Exposure Draft (ED) 36, *Business*

Combinations. In addition to exposing the draft IFRS 3 in the UK, ED 36 also exposed part of IAS 27 - Consolidated and Separate Financial Statements.

2. FRED 36 proposed that IFRS 3 replace FRS 6 – *Acquisitions and Mergers*, FRS 7 – *Fair Value in Acquisition Accounting* and amended FRS 2 - *Accounting for Subsidiary Undertakings*. FRED 36 also provided guidance on the treatment of goodwill covered by FRS 10 – *Goodwill and Intangible Assets*.

3. The draft IFRS 3 exposed by ED 36 provided guidance that was in some instances significantly different from that contained in the above-mentioned UK standards. The IFRS 3 actually issued by the IASB in December 2005 is considerably closer to existing UK GAAP than was its earlier draft.

Main Features of IFRS 3

4. The main features of IFRS 3 are set out below.

5. All business combinations within the scope of IFRS 3 are to be accounted for by applying the purchase method (commonly referred to as the acquisition method in the UK).

6. IFRS 3 excludes from its scope;

- business combinations in which separate entities or businesses are brought together to form a joint venture;
- business combinations involving entities or businesses under common control;
- business combinations involving two or more mutual entities;
- business combinations in which separate entities or businesses are brought together to form a reporting entity by contract alone without the obtaining of an ownership interest (for example, combinations in which the separate entities are brought together by contract alone to form a dual listed corporation).

7. An acquirer is identified for every business combination within the scope of IFRS 3. The acquirer being the combining entity that obtains control of the other combining entity.

8. The acquirer measures the cost of a business combination as the aggregate of: the fair values, at the date of exchange of the assets given, liabilities incurred or assumed, and equity instruments issued by the acquirer, in exchange for control of the acquiree, plus any costs directly attributable to the business combination.

9. The acquirer recognises separately at the date of acquisition the acquiree's identifiable assets, liabilities and contingent liabilities that satisfy the following recognition criteria at that date, regardless of whether they had been previously recognised in the acquiree's financial statements:

- in the case of an asset other than an intangible asset, it is probable that any associated future economic benefit will flow to the acquirer, and its fair value can be measured reliably;

- in the case of a liability other than a contingent liability, it is probable that an outflow of resources embodying economic benefit will be required to settle the obligation, and its fair value can be measured reliably;
- in the case of an intangible asset or a contingent liability, its fair value can be measured reliably.

10. The identifiable assets, liabilities and contingent liabilities that satisfy the above recognition criteria are to be measured initially by the acquirer at their fair values at the acquisition date, irrespective of the extent of any minority interest.

11. Goodwill acquired in a business combination is recognised by the acquirer as an asset from the acquisition date, initially measured as the excess of the cost of the business combination over the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities recognised as above.

12. IFRS 3 prohibits the amortisation of goodwill acquired in a business combination and instead requires goodwill to be tested for impairment annually, or more frequently if events or changes in circumstances indicate that the asset might be impaired, in accordance with IAS 36 *Impairment of Assets*.

13. IFRS 3 requires the acquirer to reassess the identification and measurement of the acquiree's identifiable assets, liabilities and contingent liabilities and the measurement of the cost of the business combination if the acquirer's interest in the net fair value of the items recognised as detailed above exceeds the cost of the combination (what FRS 10 refers to as '*negative goodwill*'). Any excess remaining after the reassessment must be recognised by the acquirer immediately in profit or loss.

Comparison with the requirements of UK GAAP

14. The overriding difference between IFRS 3 and UK GAAP is that IFRS 3 effectively outlaws the use of merger accounting. In the UK FRS 6 allows for the use of merger accounting where strict criteria are met. In all other cases acquisition accounting is used.

15. FRS 6 specifically allows the use of merger accounting for group reconstructions even though such combinations might not meet strict merger accounting criteria. Group reconstructions can be accounted for as mergers where: '*companies legislation does not prohibit its use, the ultimate shareholders remain the same as do their rights in relation to other shareholders and no minority interests in the group are altered*'.

16. IFRS 3 provides guidance (in its *Application Supplement – Allocating the cost of a business combination*) on the fair value measures to be applied to assets and liabilities acquired. In the UK guidance on fair values is provided by FRS 7 *Fair Values in Acquisition Accounting*. There is little difference between the fair value measures in IFRS 3 and FRS 7.

17. IFRS 3 also provides guidance on accounting for goodwill. In the UK FRS 10 provides guidance. The method of calculating goodwill contained in the draft IFRS 3 exposed by the IASB was very different to that in FRS 10. However, the method of calculating goodwill in the issued standard is in-line with that in FRS 10.

18. IFRS 3 prohibits the amortisation of goodwill. Goodwill should instead be subject to an annual impairment review, or more frequent review if events or changes in circumstances suggest that goodwill might be impaired (as per IAS 36). FRS 10 contains a rebuttable assumption that goodwill and intangibles have a useful economic life of less than 20 years and should be amortised accordingly. Where goodwill is assessed as having a life of greater than 20 years the asset should be subject to an annual impairment review. Regardless, goodwill and intangibles should be subject to impairment reviews where, like IAS 36, events or changes in circumstances suggest that it might be impaired.

19. IFRS 3 requires that *negative goodwill* is immediately taken to profit and loss. FRS10 requires negative goodwill up to the value of the non-monetary assets acquired to be recognised in the period that the assets are recovered, whether through depreciation or sale. Any excess is released to the P&L over the period that will benefit from the negative goodwill.

20. There is a minor difference in the re-measurement window in IFRS 3 as compared to FRS 6. IFRS 3 allows a 12 month period of re-measurement during which time the value assigned to acquired assets and liabilities can be amended and goodwill adjusted accordingly. FRS 6 allows for adjustment up to the end of the second reporting period after the combination.

Impact of IFRS 3 on the Public Sector

21. The existing FReM interprets the requirements of FRS 6: *'the merger of two or more entities into one new entity, or the transfer of functions from the responsibility of one departmental group to another (commonly known as Machinery of Government changes), will be accounted for using merger accounting'*. The basis of this interpretation is that bodies covered by the FReM are deemed to be under common control and therefore such changes are viewed as group reconstructions (FRS 6, 13 refers).

22. Machinery of government changes are those stemming from the streamlining of the public sector where for reasons of improved service delivery functions are moved from one part of the public sector to another. This can be as wide as two large departments being brought together to form a new entity or as narrow as a small function moving from one department to another.

Applying IFRS 3

23. Public sector bodies are deemed to be under common control and therefore business combinations involving such bodies are outside the scope of IFRS 3.

24. It is proposed that the UK public sector continues to use merger accounting for transfers of functions and machinery of government changes within the sector. This proposal will be re-considered once IASB have finalised Phase II of its Business Combinations project.

25. Combinations involving an entity or entities within the public sector with an entity outside the sector will follow the requirements of IFRS 3.

26. Transfers of assets within the public sector, which do not represent a transfer of functions or a machinery of government change, will be accounted for using the fair values measures in IFRS 3.

Impact on disclosures in resource and other accounts

27. For those combinations accounted for as mergers the existing disclosure requirements in FRS 6 will be retained.

IAS/IFRS compliance

28. IASB are to consider the accounting for businesses under common control as part of Phase II of its Business Combinations project.

IPSAS compliance

29. There is no coverage in IPSAS standards for business combinations. Under IPSASB's work plan for 2006-2008 business combinations will be considered in 2007.

Proposed text for the IFRS-based Government Financial Reporting Manual

30. See Annex A for the proposed text of the IFRS-based FReM.

Impact on the budgetary regime

31. None.

Summary and recommendation

32. Transfers of functions and machinery of government changes do not sit comfortably with acquisition accounting. The application of acquisition accounting to such changes could potentially involve Departments in unnecessary and complex work (i.e. attempting to establish functions and apply fair values to their component assets and liabilities). Merger accounting better reflects the reality of such changes in that the purpose is merely to locate functions in the most appropriate body and there is no intention to profit from the change.

33. Merger accounting should continue to be used for all machinery of government changes and transfers of functions within the public sector. The use of merger accounting will be reviewed once the IASB have announced the outcome of Phase II of its Business Combinations project.

34. Tangible fixed asset transfers between public bodies covered by the FReM should be transferred at fair value using the fair value measures in IFRS 3.

35. The Board is invited to approve the proposed text for the IFRS-based FReM at Annex A.

HM Treasury

31 October 2006

PROPOSED TEXT FOR THE IFRS-BASED GOVERNMENT FINANCIAL REPORTING MANUAL

IFRS 3 Business Combinations

Objectives of IFRS 3

The objective of IFRS 3 is that those business combinations (except a limited number of combinations that are excluded from its scope) should be accounted for using the purchase method (also known as the acquisition method). IFRS 3 requires that all such combinations are accounted for at fair value at the date of the combination and that goodwill arising from such transaction is accounted for as an asset. Goodwill is not amortised but subject to impairment testing as required by IAS 36 *Impairment of Assets*.

Applicability and Scope

IFRS 3 applies to all combinations involving an entity or entities within the public sector with an entity outside the sector.

IFRS 3 excludes from its scope business combinations involving entities or businesses under common control. Public sector bodies are deemed to be under common control. As such, the merger of two or more public sector bodies into one new body, or the transfer of functions from the responsibility of one part of the public sector to another will be accounted for using merger accounting as detailed below

Merger Accounting

The carrying value of the assets and liabilities of the combining bodies or functions are not adjusted to fair value on consolidation. Appropriate adjustments should be made to achieve uniformity of accounting policies in the combining bodies.

The results and cash flows of all the combining bodies (or functions) should be brought into the financial statements of the combined body from the beginning of the financial year in which the combination occurred, adjusted so as to achieve uniformity of accounting policies. The corresponding figures should be restated by including the results for all the combining bodies (or functions) for the previous period and their balance sheet for the previous balance sheet date, adjusted as necessary to achieve uniformity of accounting policies.

For all such adjustments required to achieve uniformity of accounting policies the double entry will be with the General Reserve.

Disclosure

An entity that receives a transfer of functions should disclose in its financial statements that the transfer has taken place (including a brief description of the transferred function), giving the date of the transfer, the name of the transferring body and the effect on the financial statements.

A body that transfers functions to another entity should provide the same information about the transfer in its financial statements.

Other Requirements

Transfers of fixed assets that are not machinery of government changes or part of a transfer of functions should be transferred at fair value following the fair value measures in IFRS 3.