IFRS news

Emerging issues and practical guidance*

Supplement – October 2009

IFRS 3R and IAS 27R – questions and answers (part 3)

The revised standards on business combinations and consolidation (IFRS 3 (revised) and IAS 27 (revised)) significantly change the accounting for business combinations and transactions with noncontrolling interests. These changes will create challenges and may change how management negotiates and structures transactions. This supplement is the third in a series of questions and answers on the revised standards.

This instalment looks at various issues related to noncontrolling interests. A complete discussion of the revised standards is available in PricewaterhouseCoopers' *Global Guide to Accounting for Business Combinations and Noncontrolling Interests* and *IFRS Manual of Accounting.*

Transaction costs incurred to acquire or issue non-controlling interests

A parent company may acquire an existing non-controlling interest (NCI) in one of its subsidiaries or sell new or existing shares in a subsidiary to create or expand NCI. All transactions with shareholders that do not result in a change in control are accounted for as equity transactions [IAS 27.30 (2008)]. However, the accounting for transaction costs incurred to acquire, create or expand NCI is not specifically addressed by the revised standards.

Acquisition-related costs of a business combination are expensed as incurred (other than costs to issue debt or equity securities). This new requirement reflects the Board's decision that acquisition-related costs are not part of the fair value exchange between the buyer and seller for the business acquired. However, IAS 1 and IAS 32 require directly attributable transaction costs of an equity transaction to be deducted from equity. The following questions and answers discuss the treatment of transaction costs and the composition of incremental and directly attributable costs. The tax consequences of transaction costs are ignored in the examples below. Transaction costs should be reduced by any related income tax benefit before being deducted from equity.

1. **How does an entity account for transaction costs incurred to acquire existing NCI?**

   Transaction costs directly attributable to the acquisition of NCI are deducted from equity. The IFRIC discussed this matter in their July 2009 meeting and concluded the guidance in IAS 1 and IAS 32 required such transaction costs to be deducted from equity. They did not formally add this matter to their agenda, as they do not expect significant divergence in practice.

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The following illustrates the effect on parent equity.

	C
Cash paid to selling shareholders	600
Derecognise 30% NCI, at recorded amount	(350)
Reduction in parent equity	250
Incremental, directly attributable costs	50
Total reduction in parent equity	**300**

2. How does an entity account for transaction costs incurred to create NCI in a subsidiary?

Transaction costs incurred in issuing new shares or selling existing shares owned by the parent to a third party creating NCI are deducted from equity as long as control is maintained. The amount of NCI is calculated by reference to the parent's basis in the subsidiary. Consider the following example involving the creation of NCI through issuance of new shares by a subsidiary:

- Parent A owns 100% of subsidiary B.
- Parent A's carrying value for subsidiary B reflects net assets of C2,000.
- Subsidiary B issues new shares representing 25% interest.
- Consideration received for the 25% interest is C750.
- Transaction costs of C85 are incurred, of which C50 are incremental and directly attributable to the transaction.

The consideration received, less the amount of NCI and less directly attributable transaction costs is recorded as a net adjustment to parent equity, as follows:

	C
Cash paid by new shareholders	750
25% non-controlling interest	(666) *
Excess, recorded as parent equity	84
Incremental, directly attributable costs	(50) **
Net excess, recorded as parent equity	**34**

* Parent's basis in subsidiary B of (C2,000 + C750 - C85) x 25% = C666.
** The other C35 of transaction costs are reflected as period costs in the income statement.

3. What costs are considered incremental and directly attributable?

IAS 32 describes certain costs as incremental and directly attributable, including registration costs, regulatory fees, amounts paid to professional advisors (legal, accounting, valuers), printing costs and stamp duty. These costs include fees paid for investment banking advice, price negotiations, completion accounts, valuations or similar expenses. However, many of the typical acquisition costs that are identified in IFRS 3 (revised) are not considered incremental or directly attributable. These costs, to be expensed as incurred, include:

- General administration costs, such as staff costs of the company's finance and legal departments.
- Costs of maintaining an acquisitions department.
- Costs of senior management.
- Other overhead costs.

Incidental financing costs that do not qualify for treatment as transaction costs under IAS 39, such as arrangement fees for bridge financing facilities, participation fees and costs of researching alternative financing arrangements, are also expensed as incurred.

Retained investments upon de-consolidation of a subsidiary

A parent company de-consolidates a subsidiary and records a gain or loss on the date it loses control of the subsidiary. The calculation of the gain or loss requires any investment retained in the former subsidiary to be recognised at fair value at the date control is lost.

A retained non-controlling investment includes the retained equity investment (either as an associate or AFS investment) in the former subsidiary upon de-consolidation. There may also be other interests retained by the parent, such as preferred shares, debt or other contractual arrangements. The parent company should consider each arrangement in determining the amount of gain or loss to be recognised upon de-consolidation of the subsidiary.

When a subsidiary is de-consolidated upon loss of control, the parent company assesses all aspects of any continuing relationship with the former subsidiary. The parent should identify whether assets or liabilities created by continuing or new arrangements with the former subsidiary should be recognised upon de-consolidation. Examples of continuing relationships between the parent and the former subsidiary are lease contracts, loans, and purchase and supply contracts. Any assets or liabilities recognised will impact the amount of gain or loss to be recorded on the sale transaction.

Consider the following example and the accounting for an off-market lease retained by a newly de-consolidated subsidiary:

- Company A owns 100% of subsidiary B.
- Subsidiary B rents an office building from company A at a nominal rent.
- Company A sells 60% interest (loss of control) of subsidiary B to an unrelated third party for C1,500.
- Company A de-consolidates subsidiary B on the date the shares are sold. The net assets of subsidiary B were C950 at the date of sale. The fair value of the 40% retained interest is C800.
- The lease contract is assumed by the buyer once the deal is closed. As part of the negotiations it was agreed that the

nominal rent will continue for five years and then revert to market rates. The fair value of the off-market lease is C300.

The off-market lease is unfavourable to company A as they will receive lower rental rates over the next five years compared to market rates. Company A will recognise the unfavourable lease contract by determining the portion of the total proceeds that compensates for the off-market lease. The compensation amount reduces the total amount received by company A in deriving the consideration transferred for the 60% interest of subsidiary B. Likewise, the gain is reduced (or the loss increased) upon deconsolidation. The gain is calculated as follows:

	C
Proceeds of sale	1,500
Less: fair value of lease	(300) *
Consideration for 60% interest	1,200
FV of retained investment	800 **
	2,000
Less: net book value of Subsidiary B	(950)
Gain on sale	1,050

* Company A will record deferred rental income of C300 to be amortised to income over five years.
** This amount will be recorded as the 'initial cost' of company A's investment in associate in accordance with IAS 27R paragraph 37.

Recycling of NCI equity adjustments upon deconsolidation of a subsidiary

A parent company records a gain or loss when it loses control of a subsidiary. The determination of the gain or loss includes a reclassification to income of amounts recognised in other comprehensive income (equity) in relation to that subsidiary. The revised standards, however, do not mention whether equity adjustments on previous transactions with NCI should be recycled to the income statement when a subsidiary is deconsolidated. Consider the following fact pattern:

- Company A owns 70% of subsidiary B
- Company A buys the remaining 30% interest. Under the revised standards, the difference between the fair value of consideration paid and carrying value of NCI is recorded in equity.
- (One year later) company A sells 100% of subsidiary B.

IAS 27 (revised) paragraphs 34 and 35 provide specific guidance on the accounting for the loss of control of a subsidiary. The guidance requires derecognition of net assets and any NCI and recognition at fair value of any retained investment along with consideration received. Paragraph 35 specifically requires any components of other comprehensive income attributable to the NCI or subsidiary to be reclassified from equity to profit or loss similar to the requirement if the parent had directly disposed of the related assets and liabilities. The resulting difference of all these amounts results in the gain or loss recorded to profit or loss.

Equity adjustments related to previous NCI transactions of that subsidiary are not recycled to profit or loss. Such equity adjustments resulted from transactions among shareholders and are not directly attributable to the NCI. Further, the equity adjustments are not components of other comprehensive income; they do not fall under the requirements of paragraph 35. The equity adjustments should therefore remain as part of historical equity of the parent.

Summary

The mandatory adoption date of the revised standards has arrived (that is, for annual periods starting on or after 1 July 2009). Recognising that the new guidance will change the way companies account, present and classify business combinations as well as the way they account for transactions with NCI, the above questions and answers address some of the new challenges.