IFRS news

Emerging issues and practical guidance*

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IFRS 3R and IAS 27R – questions and answers (part 2)

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 non-controlling interests. These changes will create challenges and may change how management negotiates and structures transactions. This supplement is the second in a series of questions and answers on the revised standards.

This instalment looks at presentation in the statement of comprehensive income and classification in the statement of cash flows resulting from the revised standards. The final instalment will consider topics related to transactions with non-controlling 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*.

Statement of comprehensive income

The revised standards require the recognition and measurement of more items in the statement of comprehensive income as part of the determination of profit or loss that were previously included in acquisition accounting. The revised standards also require certain assets and liabilities recognised in a business combination to be re-measured through the statement of comprehensive income as part of the determination of profit or loss. All of the items discussed in the questions and answers below are part of the determination of profit or loss and not 'other comprehensive income'.

The following is a list of items that give rise to presentation matters and the related requirements under the revised standards.

Description	Requirements of the revised standards
Gain on bargain purchase	Disclosure is required of the amount of any gain and the line item in the statement of comprehensive income in which any gain is included.
Gains on assets or liabilities of the acquirer transferred to the sellers (such as a business given in exchange for another)	Disclosure is required of the fair value of the individual elements of consideration, but there is no disclosure required for any gains or losses recognised.
Gain (or loss) on step acquisition	Disclosure is required of the amount of any gain or loss recognised and the line item in the statement of comprehensive income in which any gain or loss is included.

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Description	Requirements of the revised standards
Settlement of pre-existing relationships	Disclosure is required of the settlement amount of each transaction, including the gain or loss recognised and the line item in the statement of comprehensive income in which any gains or losses are included.
Acquisition-related costs other than direct costs of debt/equity issuance	Disclosure is required of the amount of acquisition-related costs of each transaction and the line item in the statement of comprehensive income in which any costs are included. There may be additional requirements depending on whether an entity uses the 'by function' or 'by nature' presentation in its statement of comprehensive income.
Changes in the value of contingent consideration	Disclosure is required of the changes in the recognised amounts of contingent consideration, including changes arising on settlement.
Changes in the value of an indemnification asset	The standard does not require any specific disclosures. However, IAS 19 and IAS 37 permit net presentation of reimbursements in the statement of comprehensive income and require disclosure of the amount of expected reimbursements and the amount recognised for contingent liabilities.
Changes in the value of contingent liabilities (most relevant to indemnities)	Disclosure is required of the changes in the recognised amounts including changes arising on settlement.

The questions and answers below address various presentation issues in the statement of comprehensive income arising from the revised standards.

1. Are gains on step acquisitions included in revenue?

Gains on step acquisitions are not normally included in revenue. Revenue is defined as the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increases in equity. IAS 1, 'Presentation of financial statements', states that an entity may engage in other activities that are incidental to its main revenue-generating activities and describes these as gains or losses. Specific examples used in IAS 1 are disposals of non-current assets and reimbursements of amounts recognised under IAS 37, 'Provisions, contingent liabilities and contingent assets'.

2. Can gains, losses and expenses relating to a business combination transaction be aggregated and recorded separately in a single line item?

Gains and losses relating to a business combination can be recorded separately in a single line in the statement of comprehensive income, subject to certain considerations. The line item needs to be properly described, with appropriate supplemental description provided in the footnotes and subject to the IAS 1 overall requirements for fair presentation. IAS 1 permits offsetting or grouping of items of income and expense when grouping reflects the substance of the transaction. The examples used are calculating the gain on disposal of a non-current asset and then reducing it by selling costs and netting a reimbursement against an outflow.

The change in value of a tax indemnification asset, however, are not offset within tax expense against the movement of the indemnified tax liability. See question and answer 3 and 12 below for more information on tax indemnification assets.

Other standards may also require or encourage items to be presented in specific line items in the statement of comprehensive income. These may include presentation of adjustments related to the time value of money as part of finance costs, and movements in the value of indemnification assets as part of the relevant line item.

3. In what line item are changes in the value of an indemnification asset recorded?

Statement of comprehensive income adjustments for changes in the value of indemnification assets and the indemnified item can generally be offset, except for income tax indemnities. An indemnification asset will change in response to changes in the indemnified item (typically a liability within the scope of IAS 12, 'Income taxes', IAS 19, 'Employee benefits', or IAS 37), although it may be in relation to an asset such as receivables or inventory. IAS 37 and IAS 1 both include guidance about reimbursements for items recognised under IAS 37 and indicate that the income and expense for a provision and a reimbursement can be presented net in the statement of comprehensive income. Movements in the indemnified liability can be offset by the movements in the indemnification asset where the liability is measured under IAS 37. There is similar guidance in IAS 19, relating specifically to reimbursements of defined benefit plan expenses; so by analogy it is acceptable to offset movements in an indemnification asset related to an IAS 19 liability in the statement of comprehensive income. Indemnification assets and liabilities would seldom, if ever, meet the IAS 1 criteria for offsetting within the balance sheet and should be presented gross.

One of the most common forms of indemnity is for income tax liabilities. Tax expense is a defined term in IAS 12 and referenced as a required line item in IAS 1. The movement in

a tax indemnification asset is not included on the income tax line item, as it does not meet the definition of tax expense in IAS 12.

4. If single-line presentation is used, how is it titled?

The title of the line item should appropriately describe the nature of the items that are included in the single amount. Examples include, 'Gains and losses relating to business combinations' and 'Gains, losses and expenses arising from the acquisition of ABC'. Corresponding note references should accompany the single line item in the statement of comprehensive income, with appropriate details disclosed in the footnotes. IAS 1 prohibits the presentation of any items as extraordinary.

5. Is the single line item operating or non-operating?

IAS 1 does not prescribe the presentation of an 'operating income' subtotal, although many entities do present the equivalent subtotal and make a distinction between operating and non-operating. The presentation of the single line item should be consistent with the presentation of other items of income and expense. Management should consider where the amounts would have been presented in the statement of comprehensive income absent a business combination. For example, if an operating profit line item is presented in the statement of comprehensive income and acquisition-related costs are included in the single line item, this would suggest that the single line item should also be included in operating profit, as such acquisition-related costs would have been reflected in operating profit absent a business combination.

6. Can gains, losses and expenses relating to more than one business combination be included in the same line item?

It is acceptable to aggregate gains, losses and expenses from more than one business combination in a single line if accompanied by appropriate description and adequate note disclosure.

7. Is an entity required to separately present gains and losses relating to business combinations in the statement of comprehensive income?

The revised standards generally require certain gains and losses arising from business combinations to be reflected in profit and loss, with corresponding disclosure of which line item such gains and losses are reflected.

8. If an entity elects to present a single line item for gains, losses and expenses relating to a business combination, are all similar items related to business combinations in the periods presented included in this single line item?

Generally all similar items are grouped together, as this is considered a consistent and fair presentation. However, there may be circumstances that call for individual gains and losses to be classified elsewhere. An example of an item that might be classified separately is a gain on a bargain purchase. The nature and significance of a bargain purchase gain might warrant separate presentation in line with the IAS 1 principle of separately disclosing material items of income and expense. In this case, there should be transparent disclosure of which gains and losses are included in the single line item and which are not, including where the other gains and losses are reflected in the statement of comprehensive income.

9. How are acquisition-related costs presented in the statement of comprehensive income?

The revised standards require acquisition-related costs, other than costs to issue debt or equity securities, to be expensed as period costs. An entity that elects to present gains and losses arising from business combinations in a single line item might also include acquisition-related costs in the single line item. However, a company is not obliged to segregate all acquisition-related costs in a single line item and may choose not to do so, particularly if it uses the 'by nature' presentation.

10. To what extent are internal acquisition-related costs included in the single line item?

The revised standards define acquisition-related costs to include 'general administrative costs, including the costs of maintaining an internal acquisitions department.' Such internal costs might include a separate department that considers potential acquisition targets, bonuses paid on successful transactions and an allocation of the costs of senior executives involved in negotiations. Management should develop an accounting policy that considers which of the internal costs relate to a particular transaction to determine the extent to which these costs are included in the single line item.

An example of a reasonable policy is to include only incremental expenses arising from business combinations, or incremental costs together with an allocation of ongoing cost based on time spent. Including 100% of internal costs in the single-line item would result in management presenting 'gains, losses and expenses from business combinations' in periods when there have been no business combinations. Therefore, while not prohibited under the standards, management may want to consider if this provides meaningful information.

11. Does a 'by nature' or 'by function' income statement presentation impact whether an entity can present a single line item for gains and losses related to business combinations?

The use of a single line item presentation for gains and losses relating to business combinations is more consistent with a 'by function' income statement presentation. However, it is also acceptable to use the single line item in a 'by nature' presentation as long as management applies the following considerations:

- The line item for employee costs is clearly labelled (in the statement of comprehensive income) as exclusive of employee costs related to business combinations.
- Total employee costs, including the amount allocated to gains and losses related to a business combination, are disclosed in the financial statements in accordance with IAS 1.
- The accounting policy addressed in question and answer 10 above are clearly disclosed.

A statement of comprehensive income presented by either nature or function is generally preferable to a mixed presentation. However, mixed presentation is acceptable if transparent disclosure is provided as described above.

12. Where are changes in a tax indemnification asset classified?

Changes in a tax indemnification asset cannot be presented in revenue or tax expense. If an entity elects to present a single-line item for gains and losses related to a business combination, the changes to a tax indemnification asset arising from a business combination are reflected in such single-line item, accompanied by appropriate note disclosure.

Classification on the statement of cash flows

Cash flows relating to business combinations are generally required to be reported separately as investing activities on the cash flow statement. However, the revised standards resulted in consequential amendments to IAS 7, 'Cash flow statements'. The 2009 annual improvements have also amended IAS 7 and affect how cash flows related to a business combination are to be classified. The following questions and answers address certain statement of cash flow classification matters.

1. How are cash flows for transaction costs incurred in a business combination classified in the statement of cash flows?

Payment for transaction costs are classified within operating activity. Transaction costs are expensed as incurred under the revised business combinations standard and are no longer recorded within goodwill. The April 2009 annual improvements revised IAS 7 to clarify that only expenditures resulting in a recognised asset in the statement of financial position are eligible for classification as investing activities.

2. How are cash flows for payments to settle a liability-classified contingent consideration arrangement arising in a business combination presented in the statement of cash flows?

Payment to settle a liability-classified contingent consideration is split between investing and operating activity. Liability-classified contingent consideration arrangements will most likely be settled at an amount that differs from that recorded on the acquisition date. This difference will be recorded in earnings in subsequent periods. Amounts paid in excess of the amount recorded on the acquisition date are classified as cash flows used in operating activities because the difference has not resulted in a recognised asset. However, payment of the acquisition date fair value of the contingent consideration is classified as cash flows used in investing activities. The nature of this portion of contingent consideration represents a payment as part of a business combination and is therefore classified as investing activity.

3. How is cash paid to acquire, or cash received to sell, a non-controlling interest in a subsidiary (exclusive of those related to transaction costs) classified in a consolidated statement of cash flows when the parent maintains control of the subsidiary?

Cash flows related to acquisition or sale of non-controlling interest is classified within financing activity. IAS 7 was amended to clarify that this cash flow is classified in the same way as other transactions with owners, resulting in classification as financing activity.

4. How are dividends paid to a subsidiary's non-controlling interest classified in the consolidated statement of cash flows?

Dividends paid, including those of a subsidiary, are classified within either financing or operating activity.

5. How is cash received in a single transaction to sell an interest in a partially-owned subsidiary classified in a consolidated statement of cash flows when the parent loses control of the subsidiary?

Cash received from the sale of an interest in subsidiary that results in a loss of control is classified within investing activity.

6. How are transaction costs associated with the purchase or sale of a non-controlling interest in a subsidiary (when

the parent maintains control of the subsidiary) classified in the consolidated statement of cash flows?

Payment of incremental, directly attributable transaction costs for the purchase or sale of non-controlling interest where control is maintained are classified as a financing activity. This is consistent with recognition of incremental, directly attributable transaction costs as a deduction from equity in accordance with IAS 32.

Summary

The mandatory adoption date of the revised standards is quickly approaching (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, the above questions and answers address some of the new challenges. Stay tuned for part three of this series that focuses on transactions with non-controlling interests.