

HONG KONG SOCIETY OF ACCOUNTANTS

Financial Accounting Standards Committee

Urgent Issues & Interpretations Sub-Committee

Interpretation

12

Business combinations - Subsequent adjustment of fair values and goodwill initially reported

Interpretations are authoritative guidance on the application of Statements of Standard Accounting Practice with which enterprises should comply if their financial statements purport to give a true and fair view. Unless indicated otherwise, Interpretations have the same status as the background material and implementation guidance contained in Statements of Standard Accounting Practice. Interpretations are not intended to apply to immaterial items.

References: SSAP 2 *Net profit or loss for the period, fundamental errors and changes in accounting policies*

SSAP 17 *Property, plant and equipment*

SSAP 30 *Business combinations*

SSAP 31 *Impairment of assets*

ISSUES

1. In initially accounting for a business combination, an acquirer may not have available all evidence to be able to identify and to estimate reliably the fair values of the assets and liabilities acquired or the identifiable assets and liabilities may not yet satisfy the criteria for recognition. This may be due to the complexity of the business acquired, the need to produce and report financial information on a timely basis, or for other reasons.
2. SSAP 30 paragraph 68 indicates that in accounting for a business acquisition, "identifiable assets and liabilities, which are acquired but do not satisfy the criteria ... for separate recognition when the acquisition is initially accounted for, should be recognised subsequently as and when they satisfy the criteria. The carrying amounts of identifiable assets and liabilities acquired should be adjusted when, subsequent to acquisition, additional evidence becomes available to assist with the estimation of the amounts assigned to those identifiable assets and liabilities when the acquisition was initially accounted for. The amount assigned to goodwill or negative goodwill should also be adjusted, when necessary, to the extent that:
 - (a) the adjustment does not increase the carrying amount of goodwill above its recoverable amount, as defined in SSAP 31 "Impairment of assets"; and
 - (b) such adjustment is made by the end of the first annual accounting period commencing after acquisition (except for the recognition of an identifiable liability under SSAP 30 paragraph 30, for which the time-frame in SSAP 30 paragraph 30(c) applied);

otherwise the adjustments to the identifiable assets and liabilities should be recognised as income or expense.

3. The issues are, in making adjustments in the limited circumstances described by SSAP 30 paragraph 68:
 - (a) whether an adjustment to the initial fair values of identifiable assets and liabilities acquired should include the effects of depreciation and other changes which would have resulted if the adjusted fair values had been applied from the date of acquisition;
 - (b) whether a related adjustment of goodwill or negative goodwill should include the effect of amortisation of the adjusted amount assigned to goodwill or negative goodwill from the date of acquisition; and
 - (c) how the adjustments to identifiable assets and liabilities acquired, and to goodwill or negative goodwill, should be presented.
4. This Interpretation does not apply to the reversal of provisions initially made for terminating or reducing the activities of the acquiree as it is dealt with in SSAP 30 paragraphs 72 and 73.

CONCLUSIONS

5. An adjustment to the carrying amount of identifiable assets and liabilities acquired, made in the limited circumstances described under SSAP 30 paragraph 68, should be calculated as if the adjusted fair values had been applied from the date of acquisition. As a result, the adjustment should include both the effect of the change to the fair values initially assigned and the effect of depreciation and other changes which would have resulted if the adjusted fair values had been applied from the date of acquisition.
6. If the adjustment to identifiable assets and liabilities is made by the end of the first annual accounting period commencing after acquisition, the carrying amount of goodwill or negative goodwill should also be adjusted, when necessary, to the amount which would have been determined if the adjusted fair values had been available at the date of acquisition. As a result, goodwill amortisation or recognition of negative goodwill is also adjusted from the date of acquisition. However, an adjustment to the carrying amount of goodwill should be made only to the extent that it does not increase the carrying amount of goodwill above its recoverable amount.
7. Adjustments to depreciation and amortisation, impairment charges, and other amounts, determined under paragraphs 5 and 6 of this Interpretation, should be included in net profit or loss in the respective classification of income or expense presented on the face of the income statement. Only items subsequent to the acquisition date which are required or are permitted to be credited or charged directly to equity under other Statements would be recognised in equity; this Interpretation does not alter the treatment under those other Statements.

DISCLOSURE

8. Adjustments to the carrying amounts of identifiable assets or liabilities or goodwill or negative goodwill should be disclosed and explained in the financial statements of the period in which the adjustment is made. The amount of an adjustment which relates to prior and comparative periods should also be disclosed.

BASIS FOR CONCLUSIONS

9. SSAP 30 paragraph 68 leaves a period of time for an acquirer, in very limited circumstances, to make a final determination of the amounts assigned to the identifiable assets and liabilities acquired and, as a consequence, make an adjustment to goodwill or negative goodwill. SSAP 30 paragraph 69 indicates that the time-limit is intended to prevent goodwill and negative goodwill from being re-assessed and adjusted indefinitely. However, in requiring adjustment of the assignment of fair value to identifiable assets and liabilities acquired, SSAP 30 paragraph 68 does not provide a basis for ignoring changes required or permitted by other Statements, such as depreciation, amortisation, adjustments to fair value, accounting for a gain on the sale of an asset, etc. As a result, adjustments to depreciation and amortisation, impairment charges, and other amounts are determined as if the adjusted fair values had been applied from the date of acquisition and are included in the respective classification of income or expense presented on the face of the income statement. In addition, an enterprise applies the requirements of SSAP 31 in determining the recoverable amount of goodwill. SSAP 30 paragraph 68(a) requires that this amount serves as a limit on an adjustment which increases goodwill. When the carrying amount of goodwill has not been decreased because of the time-limit in SSAP 30 paragraph 68(b), the recoverable amount of goodwill is used in determining whether the carrying amount of goodwill is impaired.
10. Under SSAP 30 paragraph 68, unless an adjustment to the carrying amount of identifiable assets and liabilities is appropriately recognised as an adjustment to goodwill or negative goodwill, it is recognised as income or expense. However, this does not change the accounting subsequent to the date of the acquisition under Statements which require or permit items to be credited or charged directly to equity. For example, for an adjustment made to the value initially recognised as acquired property, plant and equipment which is revalued subsequent to the date of the acquisition under SSAP 17 paragraph 31, the related revaluation surplus included in equity under SSAP 17 paragraph 39 is determined based on the adjusted fair value of the acquired property, plant and equipment. However, under paragraph 5 of this Interpretation, a decrease to the amount initially assigned to the asset would also result in an adjustment to decrease depreciation of the asset; this decrease would be reflected as a reduction to depreciation expense.
11. SSAP 30 paragraph 82 requires disclosure if the fair values of identifiable assets and liabilities can only be determined on a provisional basis. This implies that in such circumstances, the enterprise is aware that reliable estimates cannot yet be made and therefore the adjustment is not accounted for as a change in estimate addressed in SSAP 2 paragraphs 22 to 29.
12. SSAP 30 paragraph 82 also requires an enterprise to disclose and explain subsequent adjustments to provisional fair values.

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Appendix

This appendix is illustrative only and does not form part of the Interpretation. The purpose of the appendix is to illustrate the application of the Interpretation to assist in clarifying its meaning. The appendix does not address the deferred tax consequences of the adjustments indicated.

EXAMPLE APPLICATION OF INTERPRETATION 12

Example 1

1. An enterprise reports financial statements for annual periods ending 31 December and does not report interim financial information. The enterprise made an acquisition on 30 September 2001. In its financial statements for the annual period ending 31 December 2001, the enterprise initially recognised goodwill of \$100,000 to be amortised over 20 years. The carrying amount of goodwill at 31 December 2001 was \$98,750 (the initial amount of \$100,000 less amortisation of \$1,250).
2. During 2002, the enterprise receives the results of a valuation study and concludes that \$20,000 of the \$100,000 initially allocated to goodwill should be allocated to property, plant and equipment assets having a remaining useful life of 5 years at the date of acquisition.
3. The adjustment to the carrying amount of property, plant and equipment assets is measured at the adjusted fair value at the date of the acquisition of \$20,000, less the amount which would have been recognised as depreciation of the adjusted fair value (\$1,000 at 31 December 2001).
4. As the adjustment is made by the enterprise prior to the end of the first annual accounting period commencing after acquisition, the carrying amount of goodwill is also adjusted for the reduction in value at the date of the acquisition of \$20,000, and a reduction in amortisation (\$250 at 31 December 2001).
5. The \$1,000 increase in the depreciation of property, plant and equipment and the reduction in goodwill amortisation of \$250 have the net effect of reducing net profit for the year ended 31 December 2002 by \$750 relating to the comparative year ended 31 December 2001.
6. In its annual financial statements for the year ended 31 December 2002, the enterprise discloses that an adjustment to the carrying amount of identifiable assets and liabilities acquired was made during 2002, because a valuation study of the tangible assets acquired became available. The fact that the fair value of property, plant and equipment assets at the date of acquisition would have been increased by \$20,000 with a corresponding decrease in goodwill is disclosed. The enterprise also discloses that if the adjusted fair values had been applied from the date of the acquisition, net income for the comparative year ended 31 December 2001 would have been decreased by depreciation of \$1,000 and increased by a decrease in goodwill amortisation of \$250, and that these effects have been included in the financial statements for the year ended 31 December 2002.

Example 2

7. This example assumes an adjustment which is in the reverse direction of Example 1. The adjustment to identifiable assets and liabilities is instead a \$20,000 decrease to the amount initially allocated to property, plant and equipment assets having a remaining useful life of 5 years at 30 September 2001, the date of acquisition. Assume also that the enterprise determines that the recoverable amount of additional goodwill is only \$17,000 at 31 December 2001.
8. The carrying amount of property, plant and equipment assets is reduced by \$19,000, representing the decrease in fair value of the \$20,000 less \$1,000 in depreciation expense recognised through 31 December 2001.

9. The enterprise determines the adjusted carrying amount of goodwill relating to the \$20,000 increase would be \$19,750, after taking into consideration \$250 in amortisation from the date of the acquisition through 31 December 2001. The enterprise recognises only \$17,000 in goodwill as that is the maximum amount of the 19,750 increase that is recoverable.
10. The difference of \$2,000 between the decrease in the fixed assets of \$19,000 and the increase in goodwill of \$17,000 is recognised as expense in the year ended 31 December 2002. The \$1,000 decrease in the depreciation expense relating to property, plant and equipment and an increase in goodwill amortisation of \$250 have the net effect of increasing net profit for the year ended 31 December 2002 by \$750 relating to the prior comparative period. Net profit for this period is also decreased by an impairment loss of \$2,750.
11. In its annual financial statements for the year ended 31 December 2002, the enterprise discloses that an adjustment to the carrying amount of identifiable assets and liabilities acquired was made during 2002 as a valuation study of the tangible assets acquired became available. The fact that the fair value of property, plant and equipment assets at the date of acquisition had been decreased by \$20,000 with a corresponding increase in goodwill is disclosed. The enterprise also discloses that if the adjusted fair values had been applied from the date of the acquisition, net income for the comparative year ended 31 December 2001 would have been decreased by an impairment loss of \$2,750 and by additional goodwill amortisation of \$250, and increased by a reduction to depreciation expense of \$1,000, and that these effects have been included in the financial statements for the year ended 31 December 2002.