HKFRS 3 (Revised) *Business Combinations*

HKICPA Standard Setting Department Staff Summary (April 2008)

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The HKICPA Standard Setting Department welcomes your comments and feedback, which should be sent to commentletters@hkicpa.org.hk.

Introduction

1. Hong Kong Financial Reporting Standard 3 *Business Combinations* (HKFRS 3 (Revised)) replaces HKFRS 3 *Business Combinations* (issued in 2004) as amended in 2005 and 2007. It is effective for annual periods beginning on or after 1 July 2009. Earlier application is permitted provided that HKAS 27 *Consolidated and Separate Financial Statements* (as revised in 2008) is applied at the same time.

Reasons for revising HKFRS 3

2. The objective of the Hong Kong Institute of Certified Public Accountants (HKICPA) in revising HKFRS 3 is to maintain international convergence arising from the revision of IFRS 3 *Business Combinations* by the International Accounting Standards Board (IASB).

   The revised IFRS 3 is part of a joint effort by the IASB and the US Financial Accounting Standards Board (FASB) to improve financial reporting while promoting the international convergence of accounting standards. The IASB and FASB decided to address the accounting for business combinations in two phases. The IASB and the FASB deliberated the first phase separately and the IASB concluded its first phase in March 2004 by issuing the previous version of IFRS 3 *Business Combinations*. The IASB's and FASB's primary conclusion in the first phase was that virtually all business combinations are acquisitions. Accordingly, the IASB and FASB decided to require the use of one method of accounting for business combinations—the acquisition method.

   The second phase of the project addressed the guidance for applying the acquisition method. The IASB and FASB decided that a significant improvement could be made to financial reporting if they had similar standards for accounting for business combinations. Thus, they decided to conduct the second phase of the project as a joint effort with the objective of reaching the same conclusions. The IASB and FASB concluded the second phase of the project by issuing IFRS 3 and FASB Statement No. 141 (revised 2007) *Business Combinations* and the related amendments to IAS 27 *Consolidated and Separate Financial Statements* and FASB Statement No. 160 *Noncontrolling Interests in Consolidated Financial Statements*.

Main features of HKFRS 3 (Revised)

3. The objective of HKFRS 3 is to enhance the relevance, reliability and comparability of the information that an entity provides in its financial statements about a business combination and its effects. It does that by establishing principles and requirements for how an acquirer:

   (a) recognises and measures in its financial statements the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree;

   (b) recognises and measures the goodwill acquired in the business combination or a gain from a bargain purchase; and

   (c) determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination.

Core principle

4. An acquirer of a business recognises the assets acquired and liabilities assumed at their acquisition-date fair values and discloses information that enables users to evaluate the nature and financial effects of the acquisition.

Applying the acquisition method

5. A business combination must be accounted for by applying the acquisition method, unless it is a combination involving entities or businesses under common control. One of the parties to a business combination can always be identified as the acquirer, being the entity that obtains control of the other business (the acquiree). Formations of a joint venture or the acquisition of an asset or a group of assets that does not constitute a business are not business combinations.

6. The HKFRS establishes principles for recognising and measuring the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree. Any classifications or designations made in recognising these items must be made in accordance with the contractual terms, economic conditions, acquirer's operating or accounting policies and other factors that exist at the acquisition date.

7. Each identifiable asset and liability is measured at its acquisition-date fair value. Any non-controlling interest in an acquiree is measured at fair value or as the non-controlling interest's proportionate share of the acquiree's net identifiable assets.

8. The HKFRS provides limited exceptions to these recognition and measurement principles:

   (a) Leases and insurance contracts are required to be classified on the basis of the contractual terms and other factors at the inception of the contract (or when the terms have changed) rather than on the basis of the factors that exist at the acquisition date.

   (b) Only those contingent liabilities assumed in a business combination that are a present obligation and can be measured reliably are recognised.

   (c) Some assets and liabilities are required to be recognised or measured in accordance with other HKFRSs, rather than at fair value. The assets and liabilities affected are those falling within the scope of HKAS 12 *Income Taxes*, HKAS 19 *Employee Benefits*, HKFRS 2 *Share-based Payment* and HKFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*.

   (d) There are special requirements for measuring a reacquired right.

   (e) Indemnification assets are recognised and measured on a basis that is consistent with the item that is subject to the indemnification, even if that measure is not fair value.

9. The HKFRS requires the acquirer, having recognised the identifiable assets, the liabilities and any non-controlling interests, to identify any difference between:

   (a) the aggregate of the consideration transferred, any non-controlling interest in the acquiree and, in a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree; and

   (b) the net identifiable assets acquired.

   The difference will, generally, be recognised as goodwill. If the acquirer has made a gain from a bargain purchase that gain is recognised in profit or loss.

10. The consideration transferred in a business combination (including any contingent consideration) is measured at fair value.

11. In general, an acquirer measures and accounts for assets acquired and liabilities assumed or incurred in a business combination after the business combination has been completed in accordance with other applicable HKFRSs. However, the HKFRS provides accounting requirements for reacquired rights, contingent liabilities, contingent consideration and indemnification assets.

Disclosure

12. The HKFRS requires the acquirer to disclose information that enables users of its financial statements to evaluate the nature and financial effect of business combinations that occurred during the current reporting period or after the reporting date but before the financial statements are authorised for issue. After a business

combination, the acquirer must disclose any adjustments recognised in the current reporting period that relate to business combinations that occurred in the current or previous reporting periods.

Main changes from previous requirements

13. The scope has been broadened to cover business combinations involving only mutual entities and business combinations achieved by contract alone.

14. The definitions of a business and a business combination have been amended and additional guidance has been added for identifying when a group of assets constitutes a business.

15. For each business combination, the acquirer must measure any non-controlling interest in the acquiree either at fair value or as the non-controlling interest's proportionate share of the acquiree's net identifiable assets. Previously, only the latter was permitted.

16. The requirements for how the acquirer makes any classifications, designations or assessments for the identifiable assets acquired and liabilities assumed in a business combination have been clarified.

17. The period during which changes to deferred tax benefits acquired in a business combination can be adjusted against goodwill has been limited to the measurement period (through a consequential amendment to HKAS 12 *Income Taxes*).

18. An acquirer is no longer permitted to recognise contingencies acquired in a business combination that do not meet the definition of a liability.

19. Costs the acquirer incurs in connection with the business combination must be accounted for separately from the business combination, which usually means that they are recognised as expenses (rather than included in goodwill).

20. Consideration transferred by the acquirer, including contingent consideration, must be measured and recognised at fair value at the acquisition date. Subsequent changes in the fair value of contingent consideration classified as liabilities are recognised in accordance with HKAS 39, HKAS 37 or other HKFRSs, as appropriate (rather than by adjusting goodwill). The disclosures required to be made in relation to contingent consideration have been enhanced.

21. Application guidance has been added in relation to when the acquirer is obliged to replace the acquiree's share-based payment awards; measuring indemnification assets; rights sold previously that are reacquired in a business combination; operating leases; and valuation allowances related to financial assets such as receivables and loans.

22. For business combinations achieved in stages, having the acquisition date as the single measurement date has been extended to include the measurement of goodwill. An acquirer must remeasure any equity interest it holds in the acquiree immediately before achieving control at its acquisition-date fair value and recognise the resulting gain or loss, if any, in profit or loss.

Other references on IFRS 3 (Revised)

1. Deloitte IAS Plus on IASB revises IFRS 3 and IAS 27

   http://www.iasplus.com/iasplus/0801buscomb.pdf

2. Deloitte publication on Business combinations and changes in ownership interests – A guide to the revised IFRS 3 and IAS 27

   http://www.iasplus.com/dttpubs/0807ifrs3guide.pdf

3. Ernst & Young IFRS Alert on Business Combinations and Consolidations – Revisions to IFRS 3 and IAS 27

   http://www.ey.com/Global/assets.nsf/International/IFRSAlert_23/$file/EY_IFRSAlert_Issue23.pdf

4. Ernst & Young publication on Business Combinations and Consolidated Financial Statements – How the changes will impact your business

   http://www.ey.com/Global/assets.nsf/UK/Business_Combinations_and_Consolidated_Financial_Statements_2008/$file/EY_Business_combinations_consol_financial_state.pdf

5. KPMG IFRS Briefing Sheet on Revised standard IFRS 3 *Business Combinations* (2008) and amended standard IAS 27 *Consolidated and Separate Financial Statements* (2008)

   http://www.kpmg.com.hk/en/virtual_library/Audit/IFRS_briefingsheet/IFRSBS0881.pdf

6. PricewaterhouseCoopers HKFRS News on Business Combinations Phase II: IFRS 3 and IAS 27 amendments

   http://www.pwchk.com/webmedia/doc/633365293855235500_hkfrs_news_jan2008.pdf

7. PricewaterhouseCoopers HKFRS News on Business Combinations Phase II – Frequently Asked Questions

   http://www.pwchk.com/webmedia/doc/633408290236419068_hkfrs_news_mar2008.pdf

8. PricewaterhouseCoopers publication on IFRS 3 (Revised): Impact on earnings – The crucial Q&A for decision-makers

   http://www.pwc.com/gx/eng/about/svcs/corporatereporting/IFRS3R.pdf

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