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Accounting Alert

A Focus On Topical Financial Reporting and Accounting Issues

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In this issue

Focusing on what **matters**

Welcome to the year-end edition of Accounting Alert. The Institute has issued plenty of reading to keep us entertained over the year-end break in the form of three new financial reporting standards for Business Combinations.

Out with the old ...

SSAP-8 Accounting for Business Combinations, which has been with us in its revised form since 1990 has been replaced.

And in with the new ...

The three new accounting standards are FRS-36: Accounting for Acquisitions Resulting in Combinations of Entities or Operations, FRS-37: Consolidating Investments in Subsidiaries and FRS-38: Accounting for Investments in Associates. The requirements of the three new standards are similar to those of SSAP-8, but contain more guidance and examples. They also clarify areas on which SSAP-8 was silent.

Key changes include:

- the prohibition of the pooling of interests method of accounting for consolidations
- the requirement to apply the step acquisition method to all material interests acquired to determine goodwill
- a structured approach to determining whether control exists and the requirement to demonstrate both a power and a benefit element to that control
- the requirement for equity accounted earnings to be recorded “above the line” in operating surplus; and
- a number of new disclosure requirements.

When?

All three standards are applicable for periods ending on or after 31 December 2002.

More on FRS 36 and FRS 37

Scope

These standards are applicable to all acquisitions of operations whether an ownership interest in an entity is acquired (eg shares in a company) or the assets and liabilities of a business are acquired directly. The only exception to this is where the transaction arises from an “intra-group reconstruction”. An intra-group reconstruction is a transfer of operations or interests between entities which are in the same reporting group (eg a transfer of control of a company or operations between wholly-owned subsidiaries of a particular investor). A key point to note is that effectively the transfer must take place within a group that is reporting in New Zealand to meet the definition.

... the pooling of interests method of accounting for business combinations currently available under SSAP-8 in certain circumstances has been prohibited.

Pooling of interests method prohibited

FRS-36 mandates the use of the **purchase method** of accounting for acquisitions. This means that the pooling of interests method of accounting for business combinations currently permissible under SSAP-8 in certain circumstances has been prohibited. Australia and the United States have also recently prohibited the pooling method. All the identifiable assets and liabilities of the acquired operation or entity must be recognised at their fair values at the date of acquisition and all changes to these assets and liabilities arising after the date of acquisition are recognised as part of the post acquisition financial performance of the group.

Fair values

FRS-36 outlines the appropriate methods for establishing fair values for various assets and liabilities and there are some changes from the guidance in SSAP-8. Where valuations are determined based on expected cash flows these are required to be discounted. Identifiable intangible assets are valued by reference to an active market or if there isn't an active market, by reference to other market based evidence (eg a discounted cash flow analysis). If there is no active market, the value placed on an identifiable intangible asset is limited to an amount that does not give rise to or increase discount on acquisition. Tax assets and liabilities are required to be determined after adjusting for the tax effect of fair value adjustments.

Provisions for terminating or reducing activities

Only liabilities which were the liabilities of the investee at the time of acquisition are permitted to be recognised. Provisions for future losses and expenses or costs cannot be recognised in contrast to SSAP-8. However, FRS-36 does permit an exception to this rule. A provision for terminating or reducing activities of the investee or operation acquired may be recognised if the investor has:

(a) at or before the date of acquisition, developed the main features of a plan that effectively relates to costs for redundancies; closing facilities; eliminating product lines; or terminating onerous contracts;

(b) announced the main features of the plan at or before the date of acquisition; and

(c) by the earlier of three months after that date of acquisition or the date when the financial statements are approved, developed those main features into a detailed formal plan similar to that required under FRS-15.

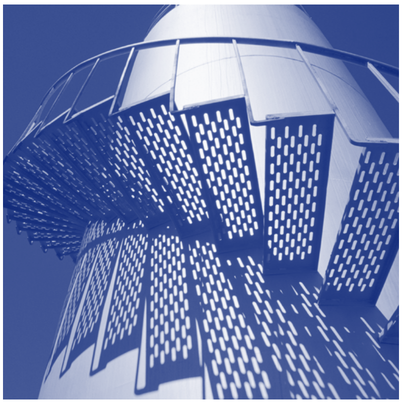
Any provision recognised must cover only the costs of the items listed in (a) above and the costs must only relate to the investee not the investor. Any subsequent adjustments to the provision must be against goodwill not revenue or expense and the goodwill amortisation must be adjusted accordingly.

Goodwill

FRS-36 requires goodwill to be amortised over its useful life on a systematic basis and the period must not exceed 20 years. The use of a method other than the straight line method must be justified. The useful life and method must be reviewed at each reporting date. The carrying value must also be reviewed for impairment at each reporting date and losses must be recognised immediately. Any reversal of losses previously recognised are only permitted if the loss was caused by a specific external event of an exceptional nature and subsequent external events occurred that reverse the effect of that event.

Discount on acquisition

The treatment of discount arising on acquisition is consistent with SSAP-8. ED-83 had proposed to follow the corresponding international standard, however FRS-36 requires that the fair values of identifiable non-monetary assets be reduced proportionately for the amount of the discount. If the discount exceeds the fair values of the non-monetary assets then it is recognised as revenue.



Step acquisition procedures must be adopted for additional purchases even after control is achieved, under FRS-37.

Subsequent changes in fair values

When further information comes available to assist in the determination of identifiable assets and liabilities or in estimating the fair values of those assets and liabilities, changes must be recognised and adjusted against goodwill if the adjustment is made by end of the first annual accounting period commencing after acquisition. The adjustment should be from the date of acquisition and take into account any amortisation or depreciation etc that would have been charged.

Step acquisitions leading to control

FRS-36 requires that goodwill arising from each acquisition of a material interest must be calculated. (A number of immaterial acquisitions may be aggregated.) The fair values at the date of each acquisition must be used unless it is impracticable in which case the fair values must be estimated using the relationship between the carrying values and the fair values at the time control is obtained.

The investor's share of the increase in the fair values of the assets of the investee must be recognised to the extent the increase is attributable to interests previously held (either in the statement of financial performance or the statement of movements in equity according to the nature of the change).

Any minority interest must be recognised at the minority's proportion of the fair values at the acquisition date.

Step acquisitions after control

The assets and liabilities of the subsidiary must be re-valued to fair values at the date of the further acquisition. ED-84 had proposed to adopt the entity concept of consolidation and to account for step acquisitions after control had been obtained as transactions in the equity of the group without further recognition of fair values or goodwill. This proposal was rejected by the majority of submissions on the exposure draft and so FRS-37 adopts the current step-by-step treatment.

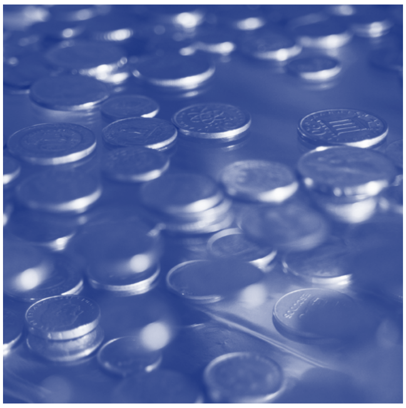
Cost of acquisition

Consistent with the recently released FRS-3 on property, plant and equipment, where there is a deferred settlement arrangement, the cost of acquisition must be recognised at the discounted amount. Where there is an element of donation or subsidy to an acquisition, the cost is recorded at the fair value and the donation or subsidy is recognised as revenue. (Donations or subsidies must be distinguished from "bargain purchases" which would give rise to a discount on acquisition.) Where a portion of the purchase consideration is contingent on the future performance of the operation subsequent to its acquisition, a reasonable estimate of the fair value of the amounts expected to be payable in the future is included in the cost of acquisition. Any adjustments are made to goodwill until the final amounts are determined.

Identification of subsidiaries

FRS-37 requires investors to prepare consolidated financial statements where an investor has one or more subsidiaries and it has an amended definition of "control" to help clarify which entities are subsidiaries. The standard contains a substantial amount of guidance on determining when one entity controls another and on the nature of control itself.

FRS-37 requires that in order to demonstrate that an investor has control over another entity it must have both the capacity to determine the financing and operating policies of the second entity (the power element), and an entitlement to a significant level of current or future ownership benefits (the benefit element). Control must be of an ownership form. This suggests that the adoption of FRS-37 may give rise to fewer situations where control, as defined, exists. However, this is offset to some extent in that the power and benefit elements are broader than those under SSAP-8.



The requirement for both the power and benefit elements to exist to evidence control will effectively exclude risks-only relationships which may have been captured formerly under SSAP-8.

FRS-37 adopts a structured approach to determining whether or not control exists. It lists seven circumstances, each of which establish a rebuttable presumption that control exists (eg a unilateral power to appoint or remove a majority of the members of the Board). In order to rebut the presumption that control exists there must be clear evidence that the entity does not have control (usually because the other rebuttable presumptions apply to another entity which has control). Where the rebuttable presumptions do not apply, the investor is also required to assess a number of other indicators of powers and benefits which are listed in FRS-37 in order to determine whether in fact the investor does have control.

There are two limited exceptions to the requirement to demonstrate the power element. The first covers "autopilot" entities where the policies have been predetermined by the investor or its agent for the investor's benefit and so there is no ongoing power element. FRS-37 considers that there is no need for a power element because the party to which the ownership benefits will accrue (ie the investor) has been irreversibly specified and therefore control accrues to the investor in such circumstances.

The second is where the determination of the financing and operating policies is unable to materially impact the level of potential ownership benefits that arise. An example of this is a special purpose entity (SPE) established to securitise a mortgage portfolio where the activities of the SPE are effectively limited to the securitisation activities. Any party able to determine the policies of the entity will be unable to materially influence the net surplus or deficit. FRS-37 therefore considers that control arises in favour of the party that is entitled to the ownership benefits and notes that typically entities having financial assets securitised through an SPE in this manner will have control over the SPE.

The requirement for both the power and benefit elements to exist to evidence control will effectively exclude risks-only relationships which may have been captured formerly under SSAP-8.

Consolidated financial statements - exceptions

A parent is required to present consolidated financial statements unless a statute expressly exempts it from the requirement. An investor is required to consolidate all subsidiaries except where at the date control is obtained, the parent is obliged to relinquish control within one year or it has entered into a binding arrangement within three months of the date control is obtained to do so. Where an entity meets the definition of a subsidiary under legislation (eg the Companies Act 1993) but is not subject to control by the investor as defined by FRS-37, it must not be consolidated.

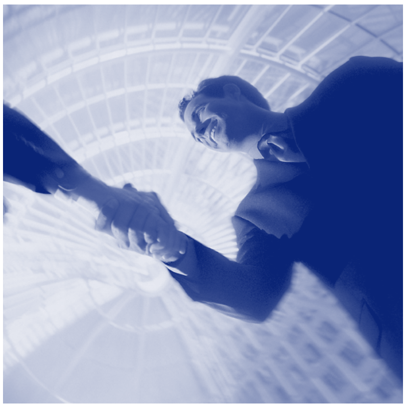
Reporting dates/ accounting policies

The difference between the reporting dates of the parent and the subsidiaries must not exceed three months except in rare circumstances. Adjustments must be made for the effects of significant transactions or other events that occur during the period of difference if they would otherwise have been included in the group financial statements had the reporting dates been the same.

Subsidiary accounting policies must be aligned with the group policies on consolidation.

Disclosures

There are a number of new disclosures particularly surrounding adjustments to goodwill or discount on acquisition. Discount on acquisition must also be separately disclosed and details of the application of the discount. Where fair values or the purchase consideration can only be estimated on a provisional basis then this must be disclosed together with the reasons. Acquisitions subsequent to balance date must also be disclosed together with details of the goodwill or discount and the impact on the group statement of financial position of the acquisition. Details of entities where the investor owns less (more) than 50% and which have (have not) been consolidated must be



Goodwill must be calculated by determining the fair values of the identifiable assets and liabilities of the associate but it is not separately recognised as it was under SSAP-8.

disclosed together with explanations as to why control does (doesn't) exist. Where a parent has had one or more subsidiaries during the period but none at balance date, it is required to disclose in its own financial statements some of the disclosures which would otherwise have been required in the group financial statements if they were prepared.

Transitional provisions

Comparative figures are not required for new disclosures. Retrospective application to acquisitions prior to the application of FRS-36 and FRS-37 are not permitted. However, if a subsidiary was not previously consolidated and would now be required to be consolidated under FRS-37, then the fair values and resulting goodwill or discount must be determined as if FRS-36 had been applicable at the time of acquisition. Where an entity had previously been consolidated but would not now be consolidated under FRS-37, then the net carrying value of the assets would be reclassified to the carrying value of the investment. Details of those entities now included or excluded from the consolidated financial statements as a result of FRS-37 becoming applicable are required to be disclosed together with the aggregate net increases or decreases in the group assets, liabilities and equity as a result. The Crown is not required to comply with the requirements of FRS-37 for a further two years.

More on FRS-38: Accounting for Investments in Associates

FRS-38 is similar to SSAP-8 in accounting for associates however there are a few key changes.

Scope

FRS-38 requires all entities with one or more associates to apply the equity method in the group financial statements. If the investor does not have subsidiaries and does not prepare group financial statements then it must apply the method in either its own financial statements or in a separate set of financial statements. If the investor is exempted from preparing group financial statements under statute then FRS-38 also exempts it from applying the equity method to associates.

The only exceptions from applying the equity method are where at the date significant influence is obtained, the investor is obligated to relinquish significant influence within one year or has entered into a binding arrangement within three months (or by balance date if earlier) to do so. Where market value accounting is applied and is expressly permitted or required under another financial reporting standard (eg for life insurers under FRS-34: Life Insurance Business) then the investor is not required to adopt the equity method.

The definition of "ownership interest" has changed to exclude any interests in the equity of an associate held by the investor indirectly through other associates. This is to line up with the definition in FRS-37. This will result in the equity method being applied only to investments in associates that are held directly by the investor or held indirectly by the investor through its subsidiaries.

Goodwill

Goodwill must be calculated by determining the fair values of the identifiable assets and liabilities of the associate but it is not separately recognised as it was under SSAP-8.

If the investment was acquired in tranches and significant influence was not obtained until after the first acquisition, then the step acquisition method referred to above under FRS-36 is required to be adopted for material acquisitions to determine the goodwill (immaterial acquisitions may be grouped and treated as a single material acquisition).

Seasons Greetings and best wishes for a Happy and Prosperous 2002 from Deloitte Touche Tohmatsu.

FRS-38 has a similar concession to FRS-36 if it is impractical to determine the fair values at an earlier acquisition date. The investment must also be accounted for as if the investment had always been an associate from the initial acquisition. (eg if two tranches of 10% and 15% were purchased then the equity method would be applied to the first 10% investment from the time of its acquisition to the time significant influence was obtained on the purchase of the second 15% after which time 25% would be equity accounted).

Recognition of equity earnings

SSAP-8 requires that equity accounted earnings are displayed after operating surplus after tax and that dividends received from associates are included in the operating surplus before tax. FRS-38 removes this distinction between realised and unrealised earnings by requiring the investor's share of the associate's earnings to be recognised as a single amount in operating surplus before tax. Any dividends received will be deducted from the investment in the associate. This means that any financing costs associated with the investment will effectively be matched with the equity earnings.

Reporting dates

FRS-38 has similar requirements to FRS-37 in relation to reporting dates. FRS-38 does not restrict the use of un-audited associate financial statements as SSAP-8 did, however the investor would need to assess the reliability of measurement prior to using such information.

Impairment

The carrying value of the investment in the associate must be assessed and written down in the group financial statements if it exceeds its recoverable amount.

Disclosures

A number of new disclosures are required including details of the aggregate amount of all liabilities of associates for which the investor is jointly and severally liable and of the investor's share of contingent assets and contingent liabilities and amounts committed for future capital expenditure. The carrying amount of the investment in each significant associate is also required to be disclosed.

Transitional provisions

Comparative figures are not required for new disclosures. Retrospective application to acquisitions prior to the application of FRS-38 is not permitted. However, if an associate was not previously equity accounted and would now be required to be equity accounted under FRS-38, then the fair values and resulting goodwill or discount and equity accounted earnings must be determined as if FRS-38 had been applicable from the date of acquisition. Any adjustment would be recognised as an adjustment against opening equity. Any goodwill separately disclosed must be reclassified to investment in associates.

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