NEWSLETTER – FEBRUARY 2009

***Revised* Business Combinations Financial Reporting Standards**

- Effective for accounting periods beginning on or after 1 July 2009
- More valuations may be required when accounting for combinations
- Must revalue previously acquired equity interests to fair value when control is achieved
- Contingent consideration is recognised and measured at fair value at the acquisition date
- Minority interests now called non-controlling interests ("NCI")
- Choice to measure NCI at time control is achieved at share of net assets or at fair value
- Choice of measurement of NCI will effect the goodwill recognised
- Losses must be allocated to NCI even if results in a debit balance
- Transaction costs are to be expensed and not added to the cost of the investment
- Profit or loss on partial disposal of subsidiary is recorded as movement within shareholders' equity

It has been a considerable challenge for both preparers and auditors of financial statements moving from Statements of Standard Accounting Practice to Hong Kong Financial Reporting Standards ("HKFRS"). In order to assist and encourage National Standard setters to make the transition to IFRS, the International Accounting Standards Board promised a four year "stable" IFRS framework period from 2005 to 2008. This stable period is nearly over and for accounting periods ending on or after 31 December 2009, there are a number of new and revised IFRS/HKFRS which will require consideration as to their application. This newsletter considers the recent changes which have been made to the financial reporting standards for Business Combinations.

Revised Accounting for Business Combinations – HKFRS 3 and HKAS 27

HKFRS 3 (revised) and HKAS 27 (revised) are mandatory for business combinations occurring in accounting periods commencing on or after 1 July 2009. However, the new standards can be early adopted for annual reporting periods beginning on or after 30 June 2007.

For step acquisitions, there is now a requirement to remeasure previously acquired interests to fair value at the time when control is achieved. Acquisition accounting is applied only at the date that control is achieved. For example, the carrying value of an associate which is equity accounted must be revalued to fair value before the business combination goodwill calculation is carried out. The profit or loss on remeasurement of the associate to fair value is recognised in the income statement. Once control is achieved, all other increases and decreases in ownership interests are treated as transactions among equity holders and are reported within equity.

Contingent consideration (e.g. earnout payments) payable in a business combination is measured at fair value and included within the cost of the combination on acquisition. Changes to the consideration payable are recorded within profit or loss unless the reason for the change provides additional information on factors that existed at acquisition, in which case the adjustment must be added to goodwill.

At acquisition, there is an option to measure any non-controlling interest (the new term for minority interest) in the company acquired either at fair value or at the NCI's proportionate share of net assets. A choice is available, on an acquisition-by-acquisition basis, to measure such non-controlling interests either at their proportionate interest in the net identifiable assets of the acquiree (which is the previous IFRS 3 requirement) or at fair value (which is a new option and is mandatory under US GAAP). The choice of method has a consequential effect on the balancing amount recognised as goodwill.

The revised standards require that a NCI should be allocated its share of a subsidiary's income even if this results in the NCI having a deficit balance. The old standards only allowed for the minority interest to show a negative balance if there was a binding obligation on the minority interest to make good any losses in the subsidiary.

The cost of an acquisition generally only includes the consideration paid to the vendor and therefore excludes all other acquisition-related costs (such as advisory, legal and accounting fees) which must be expensed. HKFRS 3 (revised) clarifies that an entity must classify and designate all contractual arrangements at the acquisition date as if it had acquired those contractual relationships outside of the business combination. Reassessing assets and liabilities is particularly relevant - consideration will be required as to how financial instruments are classified, whether embedded derivatives exist (which the acquiree may not have previously recognised) and whether hedge accounting performed by the acquiree will continue to be highly effective for the acquirer.

For a partial disposal of a subsidiary where control is maintained, any resulting gain or loss on disposal must be recorded within shareholders' equity. The previous standards were silent on this and therefore allowed a choice as to whether the gain or loss was reported in the income statement or within reserves.

HKFRS 3 (revised) and HKAS 27 (revised) are complex and the full text of the standards must be read in order to obtain a complete understanding of the requirements. Should you wish to discuss the standards please call your usual Moore Stephens contact partner and/or Michael Pyburn and Erik Tang in the Technical Department.

905 Silvercord, Tower 2, 30 Canton Road, Tsimshatsui, Kowloon, Hong Kong. Tel: (852) 2375 3180 Fax: (852) 2375 3828
E-mail: ms@ms.com.hk Website: http://www.ms.com.hk