IFRS 3 Business Combinations
Joint control or only if control?

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Kristiansand, 12 June 2012

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Agenda

- Introduction – interplay between IFRS 3 and IFRS 11
- IFRS 3
    - Recap of requirements
- IFRS 11
    - Joint control vs control
- Interplay between IFRS 3 and IFRS 11 - recent IFRIC considerations

Introduction – interplay between IFRS 3 and IFRS 11

Introduction
Why focus on this?

- Asset acquisition
  - Allocate the purchase price to the acquired assets on the basis of their relative fair values at the date of the purchase
  - Difference between the carrying amount and its tax base will not cause recognition of deferred tax liability under IFRS (IAS 12.15)
- The difference between asset acquisition and business combination
  - Goodwill will only arise from business combinations
  - Difference between the carrying amount and its tax base will cause recognition of deferred tax liability for business combinations
  - Assets and liabilities are recognised at fair value in a business combination, while they are allocated a book value on the basis of their relative fair value in an asset acquisition

Introduction
Why focus on this?

IFRS 3 – *Business Combinations*
Recap of requirements

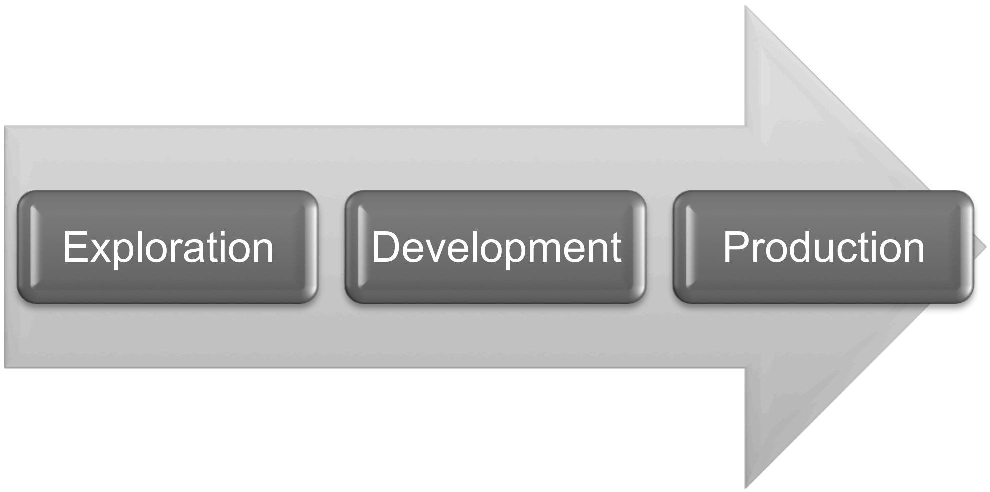
Business Combinations

Business combination

- A transaction or other event in which an acquirer obtains **control** of one or more businesses. Transactions sometimes referred to as 'true mergers' or 'mergers of equals' are also business combinations as that term is used in this IFRS.

Business

- An integrated set of activities and assets that is **capable** of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants



Business Combinations

- Authoritative guidance: IFRS 3 *Business Combinations*
- Definition of a business combination
  - A transaction or other event in which an acquirer obtains **control** of one or more **businesses**
- Control
  - IFRS 10 *Consolidated financial statements* has introduced new definition of control
  - Change from “power to govern financial and operating policies” to “current ability to direct the activities”
    - Broadens scope
  - Need to possess 3 essential elements:
    - Power
    - Exposure, or rights, to variable returns
    - Ability to use power to affect returns

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New definition of control (IFRS 10)

An investor has power over an investee when the investor has existing rights that give it the current ability to direct the activities that significantly affect the investee's returns.

Identifying activities

Activities

Identifying which activities of the investee are considered "relevant activities" i.e., those activities of the investee that significantly affect the investee's returns

Examples of relevant activities could include:

- Determining operating policies
- Making capital decisions
- Appointing KMP or key service providers
- Management of underlying investments

Evaluating power

Power

Determine which party, if any, has power ("current ability to direct" those activities).

Power arises from those rights which may include:

- Voting rights
- Potential voting rights (e.g., options or convertible instruments)
- Rights to appoint key personnel
- Decision making rights within a management contract
- Removal "kick-out" rights

Assessing returns

Returns

Assess whether the investor is exposed, or has rights, to variable returns from its involvement. Returns could be positive or negative or both.

Examples of returns include:

- Dividends
- Remuneration
- Returns that are not available to other interest holders

Understand purpose and design of arrangement

Definition of a business

- Definition of a business
  - An integrated set of activities and assets that is **capable** of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants
  - A business consists of inputs **and** processes applied to those inputs that have the **ability to create** outputs.
    - Although businesses usually have outputs, outputs are not required for an integrated set to qualify as a business
- Definition of a business considered to now be broader

Definition of a business

- To qualify as a business as an integrated set of activities and assets:
  - Only needs to be 'capable' of being run as a business
  - Does not need all of the inputs and processes that the seller used, i.e., it does not need to be self-sustaining
  - Is not required to have any outputs and does not have to have started planned principal operations
  - But do need inputs AND processes

Challenges for E&P companies

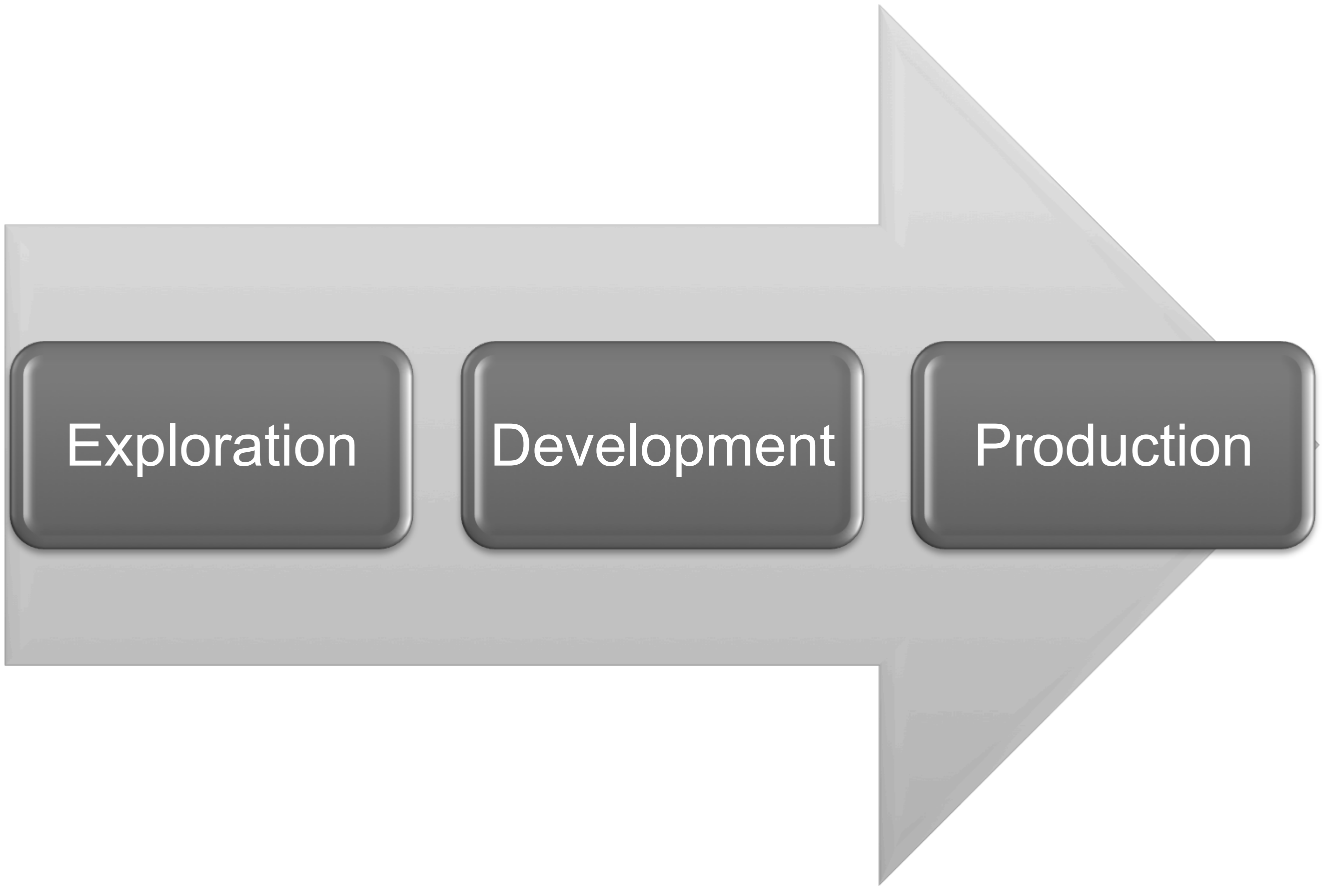
- Determining when an integrated set of activities and assets = business is very complex – what does “capable” mean and when is this criterion met?
  - Exploration stage only
  - Fields under development
  - Producing field

Definition of a business

Examples:

- E&P Co A acquires an exploration interest from E&P Co B, on which it intends to perform exploration activities to determine if reserves exist. The exploration interest is an unproven property and there have been no exploration activities performed
  - Business vs asset?
- E&P Co A acquires a property similar to that in Example 1 above, except that oil and gas production activities are in place. The target's employees are not part of the transferred set. E&P Co A will take over the operations by using its own employees
  - Business vs asset?
- Requires significant management judgement

Definition of a business



IFRS 11 – Joint arrangements

Joint arrangements – IFRS 11
Core principles

Does the contractual arrangement give all the parties, or a group of the parties, **control** over the arrangement collectively?

No → Outside the scope of IFRS 11 (not a Joint Arrangement … as defined)

Yes ↓

Do decisions about the **relevant activities** require the **unanimous consent** of all the parties, or a group of the parties, that collectively control the arrangement (i.e. **joint control**)?

No → Outside the scope of IFRS 11 (not a Joint Arrangement … as defined)

Yes ↓

Joint Arrangement

Focus on nature of arrangement instead of form

Joint arrangements – IFRS 11 (cont'd)
Joint control – unanimous consent

	Example 1	Example 2	Example 3
Requirement re. relevant activities	75% vote	75% vote	Majority vote
Party A	50%	50%	35%
Party B	30%	25%	35%
Party C	20%	25%	n/a
Other	n/a	n/a	Widely dispersed
Conclusion	Even though A can block any decision, A does not control the arrangement, because A needs B to agree = **joint control** between A and B.	**No control (or joint control)** because multiple combinations could be used to reach agreement	**No control (or joint control)** because multiple combinations could be used to reach agreement

IFRIC issue – interplay between IFRS 3 and IFRS 11

Interplay between IFRS 3 and IFRS 11
Current situation – policy choice....

”Joint control” under IAS 31 (and IFRS 11) is strong enough to qualify as ”control” under IFRS 3

”Joint control” under IAS 31 (and IFRS 11) does not qualify as ”control” under IFRS 3

Interplay between IFRS 3 and IFRS 11
IFRIC update – accounting for joint operations

- Issue taken to IFRIC - Does IFRS 3 *Business combinations* apply to acquisition of an interest in a joint operation (JO)?
- IFRIC agreed – not "directly" in IFRS 3 because don't have **control** over whole business only have **joint control**
- So how do you account for such an acquisition?
  - Fair value – analogise to IFRS 3 (but must apply all relevant parts)
  - Relative fair value – treat like an asset acquisition
  - Combination approach – only apply IFRS 3 to recognise goodwill (no others parts of IFRS 3 applied)
- IFRIC rejected combination approach – don't like "cherry picking" aspect of this
- IFRIC unanimously "preferred" IFRS 3 by analogy

Interplay between IFRS 3 and IFRS 11 (cont'd)
IFRIC update – accounting for joint operations (cont'd)

January 2012 IFRIC meeting

- Staff paper stated following
  - Most of IFRS 3 guidance on business combinations and other standards applies (with some modifications)
    - Transaction costs must be expensed
    - Assets & liabilities booked at fair valued
    - Deferred tax to be recognised
    - Goodwill recognised (where appropriate)
    - BUT no non-controlling interest recognised
  - Only small amount of additional guidance for issues that have not so far been explicitly addressed and that are specific to interests in joint operations needs to be developed
  - Guidance to be developed should demonstrate how the existing guidance on business combination in IFRS 3 and other standards is applied

Interplay between IFRS 3 and IFRS 11 (cont’d)
IFRIC update – accounting for joint operations (cont’d)

January 2012 IFRIC meeting – update (cont’d)

- Staff paper (continued)
  - Best format to demonstrate this is an **IFRIC Interpretation**
  - Not in scope:
    - Loss of joint control (either joint control to control; or joint control to significant influence or financial asset)
- Majority of IFRIC members believed interpretation NOT the best way to go, believed IFRS 11 should be amended or additional guidance added
- IMPACT:
  - Business vs asset assessment will need to be completed for more transactions
  - Different balances will be recognised and at different amounts

Interplay between IFRS 3 and IFRS 11 (cont'd)
IFRIC update – accounting for joint operations (cont'd)

March 2012 IFRIC meeting - update

- Staff paper proposed amendment to IFRS 11 & provided illustration to show how guidance would work (but proposed not to include in standard – IFRIC disagreed and asked staff to include example in IFRS 11
- Options for levels of guidance to be provided in IFRS 11
  a) Illustrative approach
  b) Specific references approach
  c) General reference approach
- Staff recommended approach c)
  - Proposed an amendment to IFRS 11 which contained minimal guidance and only addressed the principle that IFRS 3 applies, with specific guidance only in the areas where diversity exists - IFRIC agreed but suggested drafting changes and to include the reference to IFRS 3 in the body of the standard, not in the Application Guidance

Interplay between IFRS 3 and IFRS 11 (cont'd)
IFRIC update – accounting for joint operations (cont'd)

March 2012 IFRIC meeting - update (cont'd)

- Transition – recommended prospective application – IFRIC agreed
- **Next steps**: The draft amendments to IFRS 11 will be presented to the Board at a future meeting for its approval

Interplay between IFRS 3 and IFRS 11 (cont'd)
IFRIC update – accounting for joint operations (cont'd)

So what about step acquisitions?

Joint control to joint control
- Layer by layer
  (no step accounting)

Joint control to control
- Unclear…
  (not in scope)

Interplay between IFRS 3 and IFRS 11 (cont'd)
IFRIC update – accounting for joint operations (cont'd)

September 2011	November 2011	March 2012
Majority recognizes goodwill, but by analogous treatment to IFRS 3. **IFRIC staff** believes IFRS 3 should be applied in full **IFRIC Board** Clearly disagrees – do more (and better) work….	**IFRIC Board** Changed position	**IFRIC decision** Buying a share of a business is a business combination IFRS 11 will be changed Prospective application No step acquisition (joint control to joint control)

Thank you!
Questions?

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