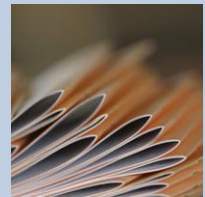


Canadian GAAP - IFRS Comparison Series

Issue # 11 – Business Combinations



Both IFRS and Canadian GAAP are principle based frameworks, and from a conceptual standpoint, many of the general principles are the same. However, the application of those general principles in IFRS can be significantly different from Canadian GAAP. Therefore, to understand the magnitude of the differences between IFRS and Canadian GAAP, it is essential to look beyond the general principles and look at the detailed guidance provided in the standards. This is our eleventh issue in a series of publications, which will provide detailed information on the key differences between IFRS and Canadian GAAP.

In this issue, consolidation and business combinations will be presented, with focus on differences related to:

- Key definitions and scope;
- Measurement of a business combination;
- Cost of a business combination;
- Acquisitions achieved in stages (step acquisition);
- Reverse takeover transactions; and
- IFRS 1 first time adoption exemptions.

The differences presented will focus on differences between the recently revised International Standards related to business combinations and the currently effective Canadian standards. In January 2009 the Canadian Accounting Standards Board issued new guidance for business combinations which is substantially converged with IFRS. The revised Canadian standards are effective for years beginning on or after January 1, 2011, with early adoption permitted. It is recommended that Canadian entities adopt these new standards in 2010 to avoid restatement of comparative numbers on adoption of IFRS in 2011.

This issue will not address differences related to determining which entities are controlled and are required to be consolidated, including Special Purpose Entities. These topics will be covered in a future issue.

Be advised that this publication is a guide to the differences between Canadian GAAP and IFRS and is not meant to be a comprehensive manual. Please contact a BDO Dunwoody representative for specific details and information.



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References

IFRS: IFRS 3 (Revised 2008), Business Combinations, IAS 27 (Revised 2008), Consolidated and Separate Financial Statements.

Canadian GAAP: Section 1581, Business Combinations, Section 1590, Subsidiaries, Section 1600, Consolidated Financial Statements, Section 3840, Related Party Transactions, EIC 10 – Reverse Takeover Accounting, EIC 14 - Adjustments To The Purchase Equation Subsequent To The Acquisition Date, EIC 94 – Accounting for Corporation Transaction Costs, EIC 114 - Liability Recognition For Costs Incurred On Purchase Business Combinations, EIC 119 - The Date Of Acquisition In A Business Combination, EIC 124 – Definition Of A Business, EIC 125 - Determination Of The Measurement Date For The Market Price Of Acquirer Securities Issued In A Business Combination, EIC 140 - Accounting For Operating Leases Acquired In Either An Asset Acquisition Or A Business Combination, EIC 154 - Accounting For Pre-Existing Relationships Between The Parties Of A Business Combination.

Key Definitions and Scope

Both Canadian GAAP and IFRS define a business combination as a transaction or other event in which an acquirer obtains control over one or more businesses. Both sets of standards also define the date of acquisition as the date which control is transferred.

It is important to understand the differences in the key definitions related to business combinations under Canadian GAAP and IFRS. Some of the slight differences in definitions may give rise to vast differences in accounting treatment.

Canadian GAAP	IFRS
<p>A business is a self-sustaining integrated set of activities and assets conducted and managed for the purpose of providing a return to investors. A business consists of:</p> <ul style="list-style-type: none">(a) Inputs;(b) Processes applied to those inputs; and(c) Resulting outputs that are used to generate revenues. <p>For a transferred set of activities and assets to be a business, it must contain all of the inputs and processes necessary for it to continue to conduct normal operations after the transferred set is separated from the transferor, which includes the ability to sustain a revenue stream by providing its outputs to customers.</p>	<p>Under IFRS, a business is defined as an operation that is capable of being conducted and managed for the purpose of providing a return to investors by way of dividends, lower costs, or other economic benefits.</p> <p>This means that a number of transactions that were previously dealt with as asset acquisitions will be treated as business combinations under IFRS. For example, an entity in its development stage can meet the definition of a business.</p>
<p>The transitional provisions of Section 1581 essentially provides a scope limitation for business combinations between two or more co-operative enterprises. For these transactions, the pooling of interests method may be used.</p>	<p>There is no scope limitation for co-operative enterprises. The pooling of interests method of accounting is prohibited.</p>
<p>Under Canadian GAAP, control is not specifically cited as a determinant of the acquirer. Rather, specific factors are identified such as:</p> <ul style="list-style-type: none">– The entity that transfers the cash or other	<p>Under IFRS, the acquirer is the entity that obtains control of the acquiree. The definition of control is provided in IAS 27. If a business combination has occurred but applying the guidance in IAS 27</p>

<p>assets or incurs the liabilities;</p> <ul style="list-style-type: none"> - The entity that issues its equity interests; - The relative voting rights in the combined entity after the business combination; - The existence of a large non-controlling interest in the combined entity if no other owner(s) holds the largest non-controlling voting interest in the combined entity; - The composition of the governing body of the combined entity; - The composition of the senior management of the combined entity; - The terms of exchange of equity interests; - The relative size of the entity after combination; and - The entity that initiated the combination. 	<p>does not clearly indicate which of the combining entities is the acquirer, the same factors which are identified in Canadian GAAP are considered to determine the acquirer.</p>
<p>The acquisition date is the date on which the acquirer obtains control of the acquiree.</p> <p>The date of acquisition is either:</p> <ol style="list-style-type: none"> (a) The date on which the net assets or equity interests are received and the consideration is given; or (b) The date of a written agreement, or a later date designated therein, that provides that control of the acquired enterprise is effectively transferred to the acquirer on that date, subject only to those conditions required to protect the interests of the parties involved. 	<p>The acquisition date is the date on which the acquirer obtains control of the acquiree.</p> <p>This is generally the date that the acquirer legally transfers the consideration, acquires the assets and assumes the liabilities of the acquiree. It could also be an earlier date if the acquirer obtains control earlier than the closing date. This is consistent with Canadian GAAP.</p>
<p>Under Canadian GAAP, common control / related party transactions are accounted for in accordance with Section 3840 – Related Party Transactions. For transactions required to be accounted for at carrying value, “continuity of interest” accounting is used. However if the transaction meets the requirements to be recorded at exchange amount, the transaction is accounted for a business combination in accordance with Section 1581.</p>	<p>Common control transactions are outside of the scope of IFRS 3 Revised. Entities can make an accounting policy choice to account for such transactions. Once an accounting policy choice is made, the treatment should continue to be applied consistently going forward.</p>

Accounting Treatment of a Business Combination

The accounting for a business combination is where the key differences arise between current Canadian GAAP and the revised IFRS 3. The differences that will be discussed in the following analysis focus on the measurement of a business combination, the consideration in a business combination and the treatment of other acquisition costs. This section will conclude with a discussion on the impact on the non-controlling interest (NCI) as a result of these other factors.

Measurement of a Business Combination	
Canadian GAAP	IFRS
<p>Under Canadian GAAP, when an acquirer purchases less than 100% of an acquiree, the assets and liabilities are adjusted by a fair value increment only to the extent of the acquirer's percentage ownership of the acquiree.</p>	<p>Under IFRS, when an acquirer purchases less than 100% of an acquiree, the full fair value of identifiable assets acquired and liabilities assumed is recognized.</p>
<p>Under Canadian GAAP, there are no exceptions to the measurement principle. Specific guidance is provided on assigning amounts to certain assets acquired and liabilities assumed. Measurement guidance is provided on the following topics:</p> <ul style="list-style-type: none"> • Inventories; • Plant and Equipment; • Accrued benefit assets / liabilities for defined benefit plans for employee future benefits; and • Income Taxes. 	<p>Under IFRS there limited exceptions to the measurement principle for specific types of identifiable assets and liabilities. These exceptions include:</p> <ul style="list-style-type: none"> • Contingent liabilities; • Indemnification Assets; • Reacquired Rights; • Income Taxes—follow IAS 12 <i>Income Taxes</i>; • Employee Benefits – follow <u>IAS 19</u> Employee Benefits; • Share Based Payments – follow IFRS 2 Share Based Payments; and • Assets Held for Sale – follow <u>IFRS 5</u> Non-current Assets Held for Sale and Discontinued Operations. <p>A contingent liability assumed in a business combination shall be recognized at the acquisition date, if it is a present obligation that arises from past events and its fair value can be measured reliably. This is contrary to the guidance in <u>IAS 37</u> – Provisions, Contingent Liabilities, and Contingent Assets, since the acquirer recognizes a contingent liability assumed in a business combination at the acquisition date <i>even</i> if it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation.</p> <p>An indemnification asset is recognized as an asset and measured using the same measurement basis as the related contingent</p>

	<p>liability subject to the need for a valuation allowance for uncollectible amounts. For an indemnification asset measured at fair value, the effects of uncertainty about future cash flows because of collectability considerations are included in the fair value measure and a separate valuation allowance is not necessary. There is no specific guidance in Canadian GAAP on indemnification assets.</p> <p>For reacquired rights, the acquirer shall measure the value of a reacquired right recognized as an intangible asset on the basis of the remaining contractual term of the related contract. Canadian GAAP provides limited guidance on reacquired rights with the only guidance being specific the reacquisition of troubled franchises by the franchisor.</p>
<p>Under Canadian GAAP, the criteria to recognize intangible assets apart from goodwill are the same as IFRS.</p> <p>An intangible asset should be recognized apart from goodwill when:</p> <p>(a) The asset results from contractual or other legal rights (regardless of whether those rights are transferable or separable from the acquired enterprise or from other rights and obligations); or</p> <p>(b) The asset is capable of being separated or divided from the acquired enterprise and sold, transferred, licensed, rented, or exchanged (regardless of whether there is an intent to do so).</p> <p>If neither of these criterion are met, then the intangible asset should be included in the amount recognized as goodwill.</p>	<p>Under IFRS, intangible assets are recognized apart from goodwill when the intangible asset meets either the separability criterion or the contractual-legal criterion. An intangible asset that meets the contractual-legal criterion even if the asset is not transferable or separable from the acquiree or from other rights and obligations. This is consistent with Canadian GAAP.</p>
<p>Under Canadian GAAP goodwill is measured as the difference between the cost of acquisition and the acquirer's interest in the net fair value of the assets acquired and liabilities assumed at the date of acquisition.</p> <p>In the case of negative goodwill, the excess of the cost of acquisition is first deducted proportionately from the purchase price allocated to certain non-monetary assets until their carrying value has been 'grinded down' to zero. Any remaining excess is recognized as a gain in the income statement.</p>	<p>Under IFRS, goodwill is measured as the difference between:</p> <p>(a) The aggregate of:</p> <ul style="list-style-type: none"> - The acquisition-date fair value of the consideration transferred; - The amount of any <u>NCI</u>; - In a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously-held equity interest in the acquiree; and <p>(b) The net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed.</p>

	<p>If the difference between (a) and (b) is negative, this is termed a bargain purchase. When a bargain purchase arises, an acquirer must reassess whether it has correctly identified and measured all of the components of the business combination. If it truly is a bargain purchase the goodwill is reduced to zero and any gain remaining is recognized in the income statement.</p>
<p>Under Canadian GAAP, the timeframe for adjustments to the purchase equation subsequent to the acquisition date is consistent with the 12-month window provided in IFRS. However, Canadian GAAP does allow for a window beyond 12 months in very unusual circumstances. Such adjustments do not require retrospective application with restatement of comparative figures, unless the adjustment is for the correction of an error.</p>	<p>Adjustments to the measurement of the business combination can be made within the measurement period, which cannot exceed 12 months from the date of acquisition. Adjustments are limited to better knowledge about facts and circumstances that existed at the acquisition date. Such adjustments are made retrospectively and comparative information is revised.</p> <p>Adjustments that are made based on conditions that exist after the acquisition date should be regarded as subsequent transactions that are not part of the business combination and should be treated separately.</p>
<p>Under Canadian GAAP, the non-controlling interest is calculated as the portion of ownership interest of the carrying amount of net assets of the acquiree that are not acquired by the acquiree.</p>	<p>Under IFRS, the non-controlling interest is measured using either:</p> <ul style="list-style-type: none"> - The fair value of the non-controlling interest; or - The proportionate interest of the fair value of net identifiable assets of the entity acquired.
Cost of Acquisition in a Business Combination	
Canadian GAAP	IFRS
<p>Under Canadian GAAP, consideration in a business combination is the aggregate of the fair value of the assets obtained, liabilities assumed, and equity interests issued.</p>	<p>Under IFRS, consideration in a business combination includes: the fair value of the assets obtained, liabilities assumed, equity interests issued and any contingent consideration.</p>
<p>The fair value of any equity securities issued by the acquirer is determined by the market price for a reasonable period before and after the terms of the acquisition are agreed to and announced.</p>	<p>The fair value of any equity securities issued by the acquirer is determined by the market prices at the date of acquisition.</p>
<p>In Canadian GAAP, there are very strict criteria for recognizing contingent consideration at the acquisition date.</p> <p>Contingent consideration is recognized only when the amount can be reasonably estimated at the date of acquisition and the outcome of the contingency can be determined beyond reasonable doubt. When the amount of contingent consideration cannot be reasonably</p>	<p>Under IFRS 3 (Revised 2008), contingent consideration is recognized as part of the consideration transferred at fair value. There is no requirement for the contingent consideration to meet the probability and reliably measurable criteria.</p> <p>Subsequent changes in the amount of contingent consideration are accounted for as follows:</p>

<p>estimated or the outcome of the contingency cannot be determined without reasonable doubt, details of the contingency should be disclosed. Neither a liability nor outstanding equity instruments are recognized until the contingency is resolved and consideration is issued or becomes issuable.</p> <p>Subsequent changes in the amount of contingent consideration are recognized as an adjustment to goodwill.</p>	<p>(a) Contingent consideration classified as equity shall not be remeasured and its subsequent settlement shall be accounted for within equity.</p> <p>(b) Contingent consideration classified as an asset or a liability that:</p> <p>(i) Is a financial instrument and is within the scope of IAS 39 Financial Instruments: Recognition and Measurement shall be measured at fair value, with any resulting gain or loss recognized either in profit or loss or in other comprehensive income appropriately. (See Canadian GAAP – IFRS Comparison Series - Issue 4 – Financial Instruments); and</p> <p>(ii) Is not within the scope of IAS 39 shall be accounted for in accordance with other IFRSs as appropriate.</p>
<p>Under Canadian GAAP, the cost of the purchase includes the direct costs of the business combination.</p>	<p>Under IFRS, transaction costs of the business combination are expensed as incurred.</p>
<p>Step Acquisitions</p>	
<p>Under Canadian GAAP, when a stage acquisition is done, the carrying amount of the previously held equity interest in the acquiree is not remeasured to fair value and no gain or loss is recognized when control is obtained. Instead, for each step acquisition, assets and liabilities are adjusted to reflect the additional proportionate amount of the fair value acquired at that date.</p>	<p>Under IFRS, where the acquirer has a pre-existing equity interest in the entity acquired if the acquirer increases its equity interest sufficiently to achieve control, it must remeasure its previously-held equity interest in the acquiree at acquisition-date fair value and recognize any resulting gain or loss in the income statement.</p> <p>In prior reporting periods, the acquirer may have recognized changes in the value of its equity interest in the acquiree in other comprehensive income. If so, the amount that was recognized in other comprehensive income shall be recognized on the same basis as would be required if the acquirer had disposed directly of the previously held equity interest.</p> <p>Once control is obtained, as long as control is not lost all changes to ownership interests are treated as transactions among equity holders and reported within equity. Goodwill does not arise on any increase, and no gain or loss is recognized on any decrease.</p>
<p>Reverse Takeover Transactions</p>	
<p>EIC 10 - Reverse Takeover Accounting, addresses 6 issues related to reverse takeover transactions. It also provides guidance for</p>	<p>The application guidance found in Appendix B of IFRS 3 (Revised 2008) addresses reverse takeover transactions. IFRS 3 Revised does not</p>

<p>situations that do not meet the definition of a business combination.</p> <p>The cost of the purchase in a reverse takeover should be measured in accordance with Section 1581. However, there is specific guidance provided on the determination of the fair value of the shares when the quoted market prices of the shares of the legal subsidiary is not indicative of the fair value of the shares the legal subsidiary would have had to issue or if the fair value is not otherwise reliably measurable or if there is a thin or inactive market for its shares.</p>	<p>provide guidance on situations that do not meet the definition of a business combination.</p> <p>The cost of the purchase in a reverse takeover transaction should apply the measurement principles of IFRS 3 Revised. There is no guidance under IFRS on measurement if the quoted market prices of the shares of the legal subsidiary is not indicative of the fair value of the shares the legal subsidiary would have had to issue or if the fair value is not otherwise reliably measurable. There is also no guidance under IFRS on measurement when the legal parent has a thin or inactive market for its shares.</p>
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First Time Adoption

IFRS 1 provides specific optional exemptions that an entity may elect to use when first adopting IFRS. One of these exemptions is for business combinations. For many Canadian entities that have completed acquisitions since inception electing to apply this exemption may save a lot of time, costs and resources. Under this exemption a first time adopter may account for transactions prior to the date of transition that meets IFRS 3 Revised definition, in three ways:

- i) Retrospectively restate all business combinations since inception in accordance with IFRS 3; or
- ii) Elect to retrospectively restate all business combinations after a particular date in accordance with IFRS 3; or
- iii) Elect not to retrospectively restate any business combinations (i.e. prospective application of IFRS 3 Revised).

This exemption is also available for past acquisitions of investments in Associates and interests in Joint Ventures and is very relevant for Canadian entities. For many Canadian publicly accountable entities, retrospective application of IFRS 3 for past business combinations may be difficult, or even impossible, given the historical information currently available. Therefore, some Canadian entities will only be able to elect to prospectively account for the past business combinations. The remaining entities need to consider whether they have enough information necessary to apply IFRS 3 at the date of a business combination, or all subsequent business combinations, with sufficient reliability.

An entity that elects not to fully retrospectively adopt IFRS 3, but rather elects to restate all business combinations after a particular date, is also required to apply IAS 36 - Impairment of Assets (IAS 36) and IAS 38 – Intangible Assets (IAS 38) from that date, regardless of whether there is any indication of impairment.

For more information on IFRS 1 Exemptions for First Time Adopters, please refer to our publication *IFRS 1 – In a Canadian Context*.

Conclusion

The principles related to business combination under current Canadian GAAP and IFRS have some fundamental differences.

If you require further guidance on business combinations under IFRS or any other IFRS information or reference sources, please contact your local BDO Dunwoody LLP office or visit www.bdo.ca/ifrs.