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ACCOUNTING NEWS

TEN WAYS TO MATERIALLY MISSTATE YOUR FINANCIAL STATEMENTS...

THE 'BLIND FREDDY' PROPOSITION CONTINUED - PART 6 – BUSINESS COMBINATIONS

This month we continue our 'Blind Freddy' series with a discussion on business combinations. There are potentially numerous issues that an accountant can get wrong when accounting for a business combination. These include:

- Incorrectly treating an asset acquisition as a business combination
- Incorrectly treating a business combination as an asset acquisition
- Incorrectly identifying the acquirer
- Incorrectly applying 'fresh start accounting'
- Not identifying embedded share-based payments or post acquisition service-based arrangements
- Not identifying all acquired intangible assets
- Incorrectly valuing acquired intangible assets
- Incorrectly valuing acquired inventory
- Incorrectly accounting for 'puttable minority interests'
- Incorrectly determining purchase consideration
- Incorrectly determining date on which control was achieved.

In this article we will specifically consider:

- Date of determining control
- Fair valuing inventory
- Allocating appropriate fair value to work in progress (WIP) and order backlogs
- Allocating appropriate fair value to intangibles acquired that you do not intend to use.

Date of determining control

A common mistake when determining the date on which control was achieved is incorrectly referring to the date from which profits flow to the purchaser vs. the date when control is actually achieved. This is best illustrated by an example:

Example 1:

In late 2010, Aggregator Ltd enters into talks to acquire Company X from Old Ltd.

Talks are progressing well and the target date for acquisition is 1 January 2011. Aggregator Ltd enters into a Memorandum of Understanding (MOU) on 30 November 2010 with Old Ltd to enter into good faith negotiations to acquire Company X, with a target acquisition date of 1 January 2011. The acquisition process includes Aggregator Ltd performing due diligence on Company X and Aggregator Ltd securing financing.

Talks proceed at a slower pace than anticipated and the purchase agreement is signed on 1 June 2011. The purchase price is based on Company X's 31 December 2010 balance sheet and states that all profits and revenues earned after 1 January 2011 will go to Aggregator Ltd. Purchase price is \$100m, revenue of Company X for the five months to 31 May 2011 is \$100m and profit is \$10m.

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In this month's newsletter, we continue our 'Blind Freddy' series looking at common things accountants get wrong when applying AASB 3 Business Combinations. We also look at an update on financial reporting obligations for charities, some recent updates to Accounting Standards, some proposed changes to accounting for biological assets and also accounting issues that have arisen out of the fixed carbon price mechanism.

Aggregator Ltd wants to consolidate Company X from 1 Jan 2011, recognising $100m of revenue and $10m of profit.

This proposed accounting is incorrect because the point consolidation commences is when control is achieved, which is 1 June 2011. Aggregator Ltd cannot recognise any revenue from Company X before that date. The $10 m profit is simply a purchase price adjustment and should be offset against the $100m consideration.

Fair valuing inventory

A basic requirement of AASB 3 is to fair value all assets and liabilities acquired in a business combination. This includes inventory. Thus, where inventory has appreciated over time (e.g. wine, timber, etc.) or has appreciated because of commodity price increases (e.g. gold, etc.), the fair value is very important.

The same principal applies when an acquirer acquires inventory as part of an acquisition of a manufacturer or a miner.

Example 2:

Gold Co Ltd acquires Small Co Ltd, a junior gold producer. Small Co Ltd has 1,000 oz of gold on hand, carried at its production cost of $700 per oz. Market price at date of acquisition is $1,700 per oz.

Gold Co Ltd fails to assign fair value to the inventory, and records the following entry when it subsequently sells the gold at $1,600 per oz:

Dr Cash	$1,600,000	
Cr Revenue		$1,600,000
Dr Cost of sales	$700,000	
Cr Inventory		$700,000

Net profit = $900,000

Correct accounting is:

Dr Cash	$1,600,000	
Cr Revenue		$1,600,000
Dr Cost of sales	$1,700,000	
Cr Inventory		$1,700,000

Net loss = $100,000

Example 3:

Big Manufacturer Ltd acquires Little Manufacturer Pty Ltd. Finished goods acquired is carried at cost of $10m. The expected wholesale price of these goods is $21m and fair value is $20m.

Big Manufacturer Ltd fails to assign fair value to the inventory, and records the following entry when is subsequently sells the finished goods:

Dr Cash	$21m	
Cr Revenue		$21m
Dr Cost of sales	$10m	
Cr Inventory		$10m

Net profit = $11m

Correct accounting is:

Dr Cash	$21m	
Cr Revenue		$21m
Dr Cost of sales	$20m	
Cr Inventory		$20m

Net profit = $1m

Allocating appropriate fair value to work in progress (WIP) and order backlogs

AASB 3 requires that all assets and liabilities acquired are measured at fair value. This includes WIP and order backlogs. As in the example in respect of inventory, this means that the fair value will include a significant amount of the anticipated gross profit on these contracts, with the subsequent profit recognised on the performance of the contractual obligations only being commensurate with the effort of satisfying the contract and the credit risk associated with the contract.

This situation is likely to give rise to material misstatements when buying entities with long term construction or service contracts.

Example 4:

Construction Ltd buys Small Builder Pty Ltd. Small Builder Pty Ltd is half way through a $100m construction project which is anticipated to make a 30 % gross profit. The fair value of this contract at date of the business combination is $10m.

Construction Ltd fails to fair value the contract and proposes the following entries for the completion of the contract:

Dr Cash	$50m	
Cr Revenue		$50m
Dr Cost of sales	$35m	
Cr WIP		$35m

Net profit = $15m (30% margin on $100m contract which was 50% complete at time of acquisition)

The correct accounting must also include the amortisation of the acquired contract as follows:

Dr Amortisation expense	$10m	
Cr Contract intangible		$10m

This has the effect of reducing the overall net profit by $10m.

Allocating appropriate fair value to intangibles acquired that you do not intend to use

When acquiring a business, it is very common that a purchaser acquires intangible assets that it does not require or intend to use. This is particularly common when acquiring brands that will be discontinued, or technology and intellectual property that will be abandoned. AASB 3 requires that all assets and liabilities acquired are measured at fair value and that the fair value is the value market participants would pay for the intangible, rather than specifically the fair value the acquirer assigns to the intangibles.

Example 5:

Big Pharma Ltd acquires Little Pharma Pty Ltd for $10m.

At the time of acquisition, Little Pharma Pty Ltd has four projects underway. The whole purpose of the acquisition of Little Pharma Pty Ltd by Big Pharma Ltd is to purchase Project A for further development and to abandon Projects B, C and D. Big Pharma Ltd allocates all of the purchase price of $10m to Project A.

The projects were valued in the market as:

PROJECT	FAIR VALUE ($M)
A	7
B	1.5
C	1
D	.05

Big Pharma Ltd should have assigned a fair value of $3m to the Projects B, C and D and then recognised an impairment loss on these projects as they would have no recoverable amount in future because Big Pharma Ltd intends to abandon these projects.

In next month's newsletter we will discuss failing to recognise a reverse acquisition, failing to properly apply derecognition requirements and pitfalls in capitalising items that fail the definition of an asset.

CHARITIES UPDATES

The Federal Government is driving a program of review and potential change in the not-for-profit sector, most of which is scheduled to apply from 1 July 2013. To date, Treasury has released a discussion paper on:

- The statutory definition of a charity
- Governance standards
- Fundraising regulation
- Financial reporting.

The new regulator, the Australian Charities and Not-for Profits Commission (ACNC) will oversee the administration of the not-for-profit sector, including access to the various taxation concessions.

The proposed reporting framework has three core pillars:

1. A proportional reporting system using a tiered system based on charity revenue and deductible gift recipient (DGR) status
2. A 'charity passport' that will facilitate access by government agencies to electronic information held by the ACNC regarding individual charities
3. The collection of information from charities using a fixed form which is aligned with Standard Business Reporting (SBR) and the Standard Chart of Accounts Taxonomies.

Entities wishing to register as a charity will be required to complete a registration form. Entities endorsed as a charity with the Australian Taxation Office as at the transition date will be automatically registered with the ACNC. The ACNC will be responsible for maintaining a register of 'registered' charities. It is proposed that the information gathered by the ACNC will facilitate determination by the regulator whether a charity is operating for its charitable purposes and whether there are sound financial and governance arrangements.

The proportional reporting system will be based on the following thresholds (which are based on those that apply to companies limited by guarantee under the Corporations Act):

TIER	THRESHOLD	REQUIREMENTS
Tier 1	• Charity with annual/ consolidated revenue of less than $250,000 and is not a DGR	Annual information statement, including: • Information about entity's purpose, activities and governance structure • Short-form financial information
Tier 2	• Charity with an annual/ consolidated revenue between $250,000 and $1 million and is not DGR	More detailed annual information statement
	• Charity with DGR status and annual/consolidated revenue under $1 million	Financial report reviewed by a registered company auditor
Tier 3	• Charity with annual/ consolidated revenue over $1 million	More detailed annual information statement Audited financial report

The proportional reporting system may result in some charities having a greater financial reporting burden. For example unincorporated and incorporated associations may currently have little or no reporting obligations whereas larger charities of this kind may, in future, be required to prepare a complete financial report and either have it audited or reviewed.

IASB RELEASES AMENDMENTS TO IFRS 1

The International Accounting Standards Board (IASB) last month issued amendments to IFRS 1 *First-time Adoption of International Financial Reporting Standards*. The changes relate to government loans received at below market interest rates and give first-time adopters of IFRSs relief from full retrospective restatement with respect to these loans in their opening balance sheets.

The amendments are mandatory for annual periods beginning on or after 1 January 2013 and early adoption is permitted, although not until these are adopted as Australian amendments by the Australian Accounting Standards Board (AASB).

IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* was amended in 2008 as part of the annual improvements project. The amendment clarified that the benefit of a government loan at a below-market interest rate is treated as a government grant and recognised and measured in accordance with IAS 39 *Financial Instruments: Recognition and Measurement* (i.e. at a discounted amount). Without this latest change to IFRS 1, entities with these types of loans would have been required to go back and retrospectively restate these loans at discounted amounts.

RDR UPDATE

The AASB recently released AASB 2012-1 *Amendments to Australian Accounting Standards – Fair Value Measurement – Reduced Disclosure Requirements* which expands the scope of the 'greyed out' paragraphs in the RDR versions of Accounting Standards as a result of issuing AASB 13 *Fair Value Measurement*.

So for example, where additional fair value disclosures are required in AASB 13 regarding the levels in the fair value hierarchy, AASB 2012-1 says that these are not required for general purpose financial statements prepared under Australian Accounting Standards – Reduced Disclosure Requirements.

The amendments apply to annual reporting periods beginning on or after 1 July 2013 and may be adopted early, provided that the following are also adopted early:

- Reduced disclosure requirements (i.e. AASB 1053)
- AASB 13 *Fair Value Measurement*
- AASB 2011-8 *Amendments to Australian Accounting Standards arising from AASB 13*.

AOSSG AND PROPOSED CHANGES TO ACCOUNTING FOR BIOLOGICAL ASSETS

The Asian-Oceanian Standard-Setters Group (AOSSG) met on 25 March 2012 in Kuala Lumpur. The informal meeting was attended by 15 member standard setters and representatives of the IASB.

AOSSG members and IASB representatives discussed current issues being deliberated by the IASB and emerging issues that are affecting the Asia-Oceania region. In addition, AOSSG members supported developing a proposal to establish an IFRS Centre of Excellence in a developing country within Asia-Oceania.

A major initiative being promoted by the AOSSG is a modification to IAS 41 (AASB 141) *Agriculture* for 'bearer assets' such as palm oil plantations, vineyards, orchards etc. The proposal argues that 'bearer assets' are, in substance, no different to a manufacturing facility and should be accounted for in a similar manner to property, plant and equipment, i.e. held at cost or revalued with the revalued amount going to equity.

FINANCIAL REPORTING IMPLICATIONS OF THE FIXED PRICE CARBON PRICE MECHANISM

The introduction of the proposed carbon pricing plan, contained within the Government's Climate Change Plan, has raised a number of interesting accounting issues which were discussed in a AASB staff paper, submitted to the 26 October 2011 meeting of the AASB. For more details refer to

http://www.aasb.gov.au/admin/file/content102/c3/Oct_2011_AP_5.2_Staff_paper_Possible_Financial_Reporting_Implications_Carbon_Tax.pdf

The proposed carbon pricing is:

- A fixed price phase operates between 1 July 2012 to 30 June 2015
- From 1 July 2012, emitters exceeding 25,000 tonnes of (CO_2-e) pay $23 per tonne of ($CO_2$-e)
- Price increases by 2.5 % per annum up to 2015.

The AASB staff paper specifically deals with accounting issues during the fixed pricing phase.

The paper recognises that the accounting issues for emitters is not in respect of the liabilities owing from the $23 per tonne charge, but rather the accounting for the permits, whether purchased or granted to emitters.

Accounting for permits

Whilst there is agreement that a permit represents an asset, there is uncertainty as to what type of asset, i.e.:

- Intangible asset
- Financial asset
- Statutory asset.

There is also significant debate as to how receipt of this permit should be accounted for, i.e.:

- Gross vs. net accounting
- Recognise in profit or loss
- Defer income statement impact until liability recognised.

Gross vs. net accounting

Net presentation

Some argue that the granting of free permits is the same as increasing the emissions threshold so that an entity only incurs a liability once it has reached this increased threshold. Consequently, a net presentation should be followed, i.e. only accounting for an entity's net carbon liability.

Gross presentation

The alternate view is that permits are separate assets and their use, including using them to settle an emission liability, is at the discretion of the entity. This view requires that a gross presentation be followed.

Where does the credit go?

If it is accepted that a permit is an asset, then the next question is 'What are the required entries when the asset is recognised, specifically, does the receipt of a free permit create an offsetting liability (obligation)?'

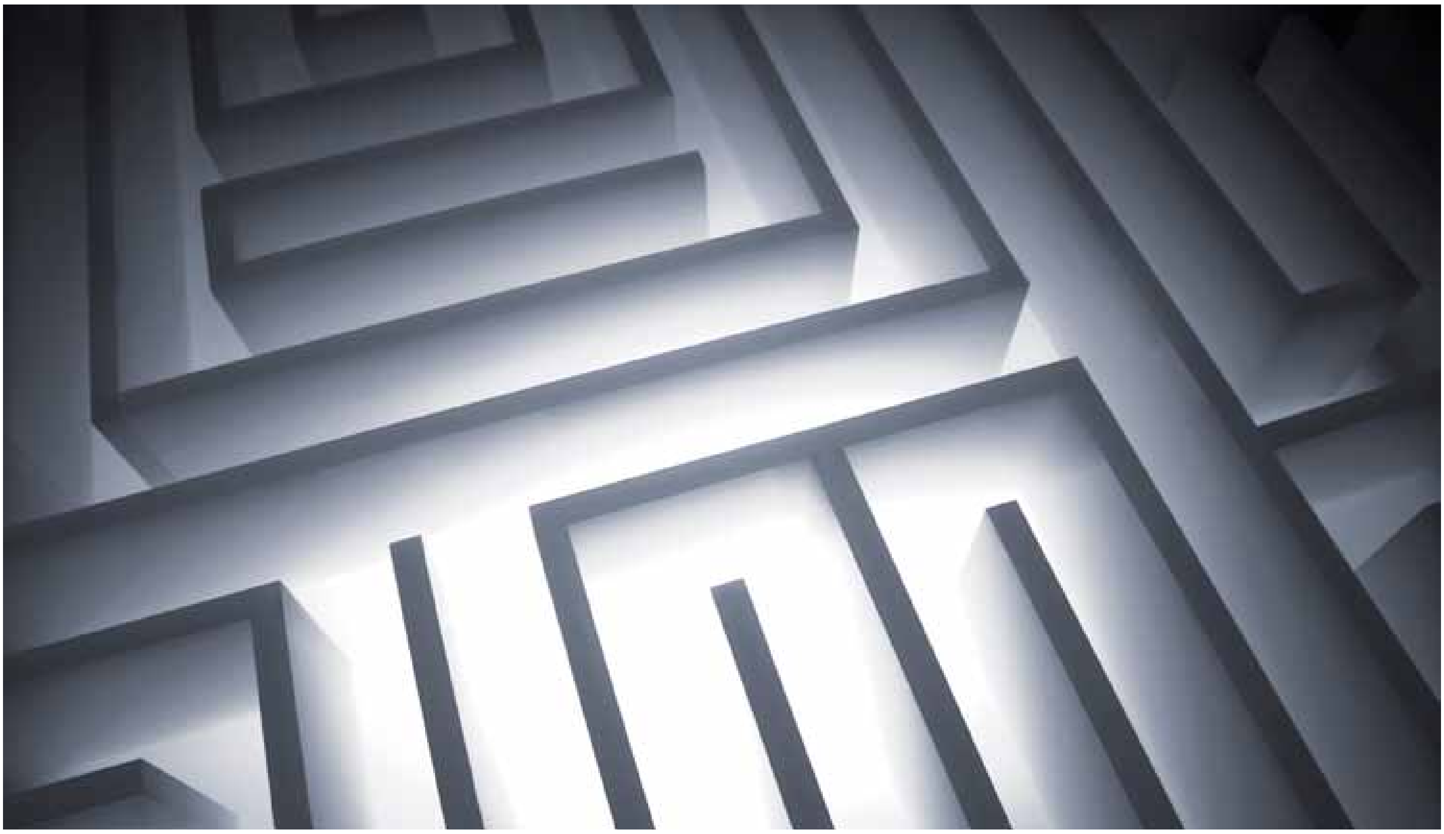
In this regard, the AASB staff paper puts forward three views:

- View A - No obligation (therefore credit to profit or loss)
- View B – Obligation to comply with scheme requirements and cannot avoid obligation through future actions (therefore credit to liabilities)
- View C – Analogy to AASB 141 *Agriculture*, i.e. recognise government grants that require an entity not to engage in a specific agricultural activity in profit or loss when conditions of grant have been met (recognise as a liability until conditions met, then recognise in profit or loss).

Opponents of View B argue that the outcome is within the control of the entity and that future events have a role in determining the obligating event, i.e. liability only arises when emissions have occurred.

The position put forward in View C is against the 'gross' presentation position and is more suited to the net presentation, whereby a liability only exists when the emitter has exceeded their allotted permits.

We will keep readers posted as to accounting developments in this area.



FAQs

Question one:
Group Ltd year end - 30 June 2012

Group Ltd has one subsidiary, Subsidiary Pty Ltd, which it has always consolidated in accordance with AASB 127 *Consolidated and Separate Financial Statements*.

Does Group Ltd, which prepares financial statements in accordance with Australian Accounting Standards, need to prepare consolidated financial statements if it disposes of its entire interest in Subsidiary Pty Ltd on 1 January 2012?

Answer one:
Yes. In our view, AASB 127, paragraph 9, requires a parent to prepare consolidated financial statements unless one of the four scope exemptions in paragraph 10 applies. The scope exemptions do not extend to an entity that disposes of its last subsidiary during the reporting period.

AASB 127, paragraph 26, also requires a parent entity to consolidate the income and expenses of a subsidiary up until the date when the parent ceases to control the subsidiary.

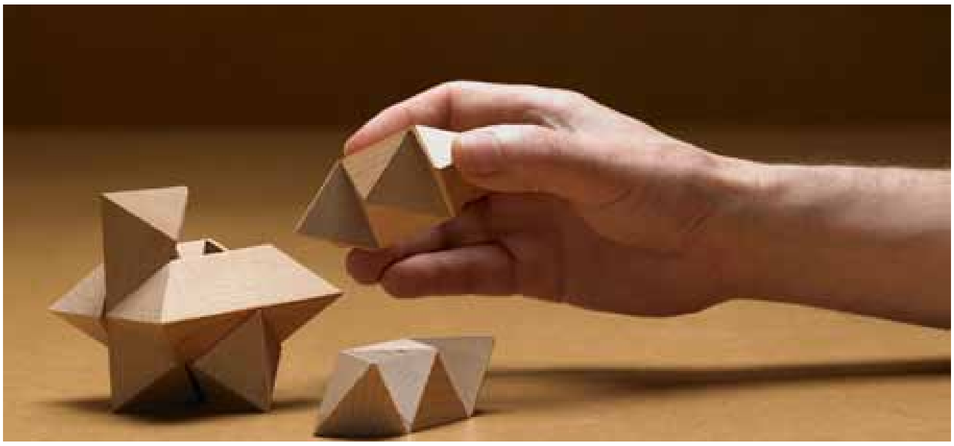
This is consistent with the proposals included in ED 224 *Transition Guidance (proposed amendments to AASB 10)* where the decision to prepare consolidated financial statements is made at the date of initial application (beginning of the relevant financial year).

Question two:
Big Co Ltd decides to sell off its investment in Old Co Pty Ltd during the reporting period and therefore classifies Old Co Pty Ltd's assets and liabilities in its consolidated financial statements as held for sale.

Old Co Pty Ltd has a loan owing to Big Co Ltd of $1.5m.

Should the intercompany loan be eliminated on consolidation?

Answer two:
Yes. It is our view that AASB 5 *Non-current Assets Held for Sale and Discontinued Operations* does not override the consolidation principles included in AASB 127 *Consolidated and Separate Financial Statements*. That is, AASB 127 is applied first, and then AASB 5 is applied to amounts included in the consolidated financial statements.



COMMENTS SOUGHT ON EXPOSURE DRAFTS

At BDO, we provide comments locally to the AASB and internationally to the IASB. We welcome any client comments. If you would like to provide any comments, please contact Wayne Basford.

DOCUMENT	PROPOSALS	COMMENTS DUE TO AASB BY	COMMENTS DUE TO IASB BY
ED 223 *Superannuation Entities*	Proposes to replace AAS 25 *Financial Reporting by Superannuation Plans*. Aligns the reporting requirements of superannuation entities with other entities applying Australian Accounting Standards.	30 April 2012	NA

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