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New Accounting Standards for Mergers and Consolidations (Summary)

Major Practical Impact

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Legal and Tax Research Dept
Kazuhiro Yoshii

Summary

- On 26 December, 2008, the Accounting Standards Board of Japan (ASBJ) published the following new accounting standards and application guidance.

- The new standards and application guidance include elimination of the pooling-of-interest method. They also contain revisions likely to have a by no means insignificant influence on accounting practice for business combinations and consolidations, etc., including the charging of intangible assets and recognition of in-process R&D as assets at the time of the combination, and the revaluation of current price at the point of gaining control in a step acquisition.

- Furthermore, to bring the methods used for stating profits and losses into convergence with IFRSs(International Financial Reporting Standards) and US accounting standards, net income before deduction of minority interests will be presented [as a line item] above net income for the period.

- The new standards and Application Guidance will be applied to business combinations, etc. from 1 April, 2010 (Early application is a possibility).

Publication for New Standards

On 26 December, 2008, the Accounting Standards Board of Japan (ASBJ) published the following accounting standards and application guidance (English titles of documents are unofficial translations).

- "Accounting Standards for Business Combinations" (Business Combination Accounting Standards)
- "Accounting Standards for Consolidated Financial Statements" (Consolidated Accounting Standards)
- "Partial amendments to 'Accounting Standards Relating to R&D Expenses, etc.'" (Amendments to R&D Expenses Accounting Standards)
- "Revised Accounting Standards for Business Divestitures" (Business Divestiture Accounting Standards)
- "Revised Accounting Standards for the Equity Method" (Equity Method Accounting Standards)
- "Revised Guidance for Accounting Standards for Business Combinations and Accounting Standards for Business Divestitures" (Application Guidance)

In order for Japanese accounting standards to be recognized as equivalent in the EU, where International Financial Reporting Standards (IFRSs) have been adopted, the ASBJ reached agreement with the International Accounting Standards Board (IASB), making a joint announcement in August 2007. Based on this “Tokyo Agreement,” the ASBJ is conducting short-term convergence projects to be completed within 2008. The newly-announced accounting standard and application guidance are part of this process, and constitute a revamp of accounting procedures for business combinations and consolidations in Japan.

The particulars of the revisions are outlined in the chart on the following page.

Features of the New Standards

The new standards include elimination of the pooling-of-interest method. Note, however, that there are only a small number of actual instances of the pooling-of-interest method being applied, so its elimination will only have a limited influence.

In contrast, revisions such as the handling of intangible assets and the recognition of in-process R&D as assets will have a greater influence on accounting practice. With the revisions, the values of these assets will need to be valued at the point of the business combination.

Other revisions will also have a significant influence, including the posting of negative goodwill as a one-off income item, the uniform application of the overall fair value approach, the revaluation of fair value at the point of acquiring control and the translation of foreign currency-denominated goodwill at the period-end exchange rate.

A new balance sheet item of “net income before deduction of minority interests” is introduced for the purpose of reducing the disparity with disclosure standards applying to Western companies.

Business Combination Items Covered by Short-term Convergence Projects

Item		Revision	Current standard
(1) Pooling-of-interest method		Eliminate the pooling-of-interest method and use only the purchase method (excluding joint ventures and intra-group business mergers)	- In principle, use the purchase method - Pooling-of-interest method may be used in a merger of equals[1], etc.
(2) Price determination date for business combinations		Calculations based on the current price on the combination date (or divestiture date)	Calculations based on the share price for a reasonable period before the date when the main conditions for the business combination are announced
(3) Intangible assets	Identifiable intangible assets	- If an acquired asset includes intangible assets that are identifiable (capable of being disposed of separately)[2], such assets must be recognized in principle - Legal rights[3] are included in this category[4]	The acquiring company can allocate a portion of the acquisition price to intangible assets
	In-process R&D	- In a business combination, intermediate results of R&D, to the extent that they are identifiable, must be recognized as intangible assets - When the R&D is complete[5] and the useful life has commenced, such assets must be amortized over the useful life	If the acquiring company allocates a portion of the acquisition price to R&D expenses, etc., this must be charged immediately at the point of such allocation
(4) Negative goodwill		After conducting a review to identify and determine assets and liabilities, any remaining amount is recorded as income (in principle, extraordinary income) in the operating year in which the negative goodwill arose	Amortization over an appropriate period not exceeding 20 years
(5) Minority interests	Determination method	Uniform application of overall fair value approach	Either the overall current value approach or the separate fair value approach can be selected
	Category in income statement	- Presented as “net income before deduction of minority interests” (pretax net income adjusted for corporation tax, etc.) - This figure is adjusted for minority interests to give the net income figure	Pretax net income is presented, then adjusted for corporation tax, etc. and minority interests to give the net income figure
(6) Step acquisitions		Portions acquired in the past are revalued at the fair value at the point of acquiring control, and the difference is recorded as income or loss on Consolidated Financial Statements	Recorded at the fair value at the point each partial acquisition is made, with no revaluation of portions acquired in the past
(7) Translation of foreign currency-denominated goodwill		Goodwill for foreign subsidiaries is translated at the exchange rate on the closing date	Goodwill for foreign subsidiaries is translated at the exchange rate on the acquisition date

Source: Compiled by DIR.

Notes: 1) To be classified as a merger of equals, three conditions must all be met: (1) The acquisition price is paid in stocks with voting rights, (2) the ratio of voting rights after the merger is in the range 45:55-55:45, and (3) there are no other controlling relationships. Regarding (3), if the conversion ratio for the merging companies’ stocks (the merger ratio) diverges from a conversion ratio calculated based on each of the companies’ stock prices by more than a certain amount, and if a large premium is paid, the merger is deemed not to meet the conditions for criteria (3). This means that application of the pooling-of-interest method is only recognized for mergers between companies with similar market capitalizations.

2) “Capable of being disposed of separately” means that the asset is capable of being sold, independent of company or business, regardless of whether or not the acquiring company has any intention of making such a sale.

3) “Legal rights” indicates rights such as intellectual property rights based on specific legislation, such as patents, utility rights, trademarks, registered designs, copyright, integrated circuit layout designs, trade names, trade secrets, and new plant varieties

4) The category also includes software, client lists, technology not protected by patents, databases, etc. capable of being sold separately.

5) The decision as to whether R&D is complete would be left to the company’s discretion.

Timing of Application

The new Business Combination Accounting Standards, Amendments to R&D Expenses Accounting Standards, Business Divestiture Accounting Standards and Application Guidance will be applied to business combinations and divestitures implemented on or after 1 April, 2010. The new standards can be applied for business combinations and business divestitures first executed during a fiscal year that begins on or after 1 April 2009.

The Consolidated Accounting Standards will be applied to accounting procedures and financial statement notes concerning business combinations and divestitures implemented on or after 1 April, 2010, with other items that relate to consolidated financial statements applied to statements for consolidated financial years commencing on or after 1 April, 2010. The new standards can be applied for the accounting treatment and notes for business combinations and business divestitures first executed during a consolidated fiscal year that begins on or after 1 April 2009. For other matters connected with consolidated financial statements, the new standards can be applied from the beginning of a consolidated fiscal year that begins on or after 1 April 2009.

Equity Method Accounting Standards will be applied to accounting procedures relating to investment in non-consolidated subsidiaries and affiliate companies implemented on or after 1 April, 2010. The new standards can be applied for investment in non-consolidated subsidiaries and affiliate companies first executed during a fiscal year that begins on and after 1 April 2009.

If the new standards are applied early, then the accounting standards listed on Page 1 must be applied entirely.

Next Step (Phase 2)

The ASBJ is considering the next step (Phase 2) with respect to accounting standards for business combinations and consolidations.

Under Japanese accounting standards, the goodwill that arises from a business combination (such as a merger) for which the purchase method is applied is amortized over a useful life of no more than 20 years. Additionally, if impairment arises, the impairment loss is recognized.

In contrast, under US accounting standards and International Financial Reporting Standards (IFRS), goodwill may not be amortized and companies must determine annually whether impairment has arisen and recognize any impairment losses when they arise.

Furthermore, in Japan, consolidated financial statements employ the “parent-company approach” under which they are prepared for the shareholders of the parent company, and minority interests are not treated as equity. By contrast, under US standards and IFRS, consolidated financial statements are seen as the financial statements of the entire business group. Therefore the “economic unit approach” is employed. Based on this approach, the financial statements reflect the interests of all of the companies, not just the parent company, so the minority interests are treated as equity. This results in certain differences, such as the following examples.

In Japan, when the shares of a subsidiary are transferred, the profit or loss associated with the transfer is booked as a transaction gain or loss. By contrast, under US standards and IFRS, no profit or loss is recorded on the transfer because the reclassification from parent-company interest to minority interest that accompanies the transfer of subsidiary shares is treated as a capital transaction.

In Japan, when recording consolidated-basis goodwill, only the portion of goodwill corresponding to the parent-company interest (the “acquisition goodwill”) is recorded. Under US standards and IFRS, the goodwill corresponding to not only the parent-company interest, but also to minority interests (the “entire goodwill”) is recorded. Under IFRS, however, minority interests are recognized based on the fair value of the net assets, rather than the market value (share price) of the acquired company at the time of the acquisition. Using this method, ultimately only the goodwill corresponding to the parent-company interest (the “acquisition goodwill”) is recorded.

In Phase 2, the ASBJ will review the differences noted above. From July to September 2009 it plans to sort out the issues to be addressed, after which it will release an exposure draft for the new accounting standards in 2010.

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