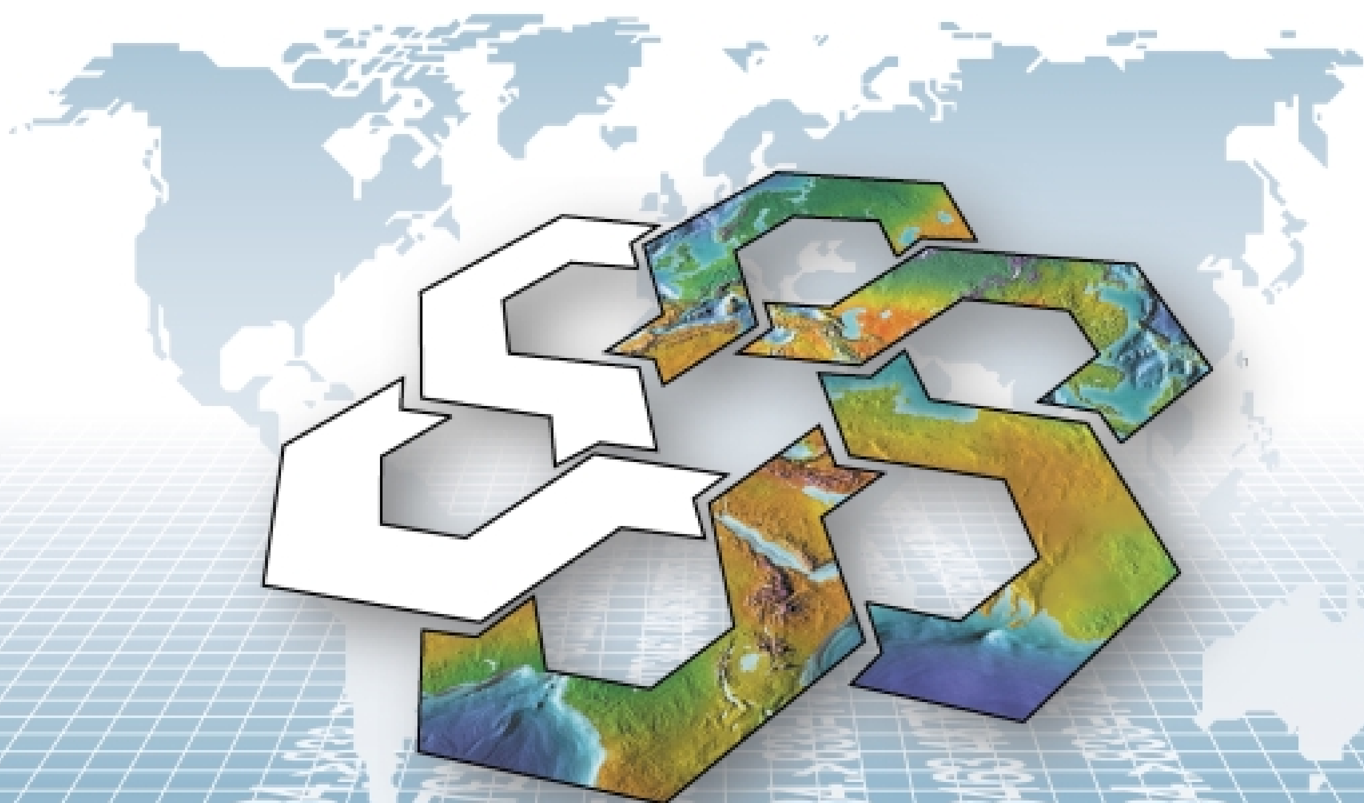
June 2005

EXPOSURE DRAFT OF PROPOSED

Amendments to

IFRS 3 Business Combinations

Comments to be received by 28 October 2005



International Accounting Standards Board®

Exposure Draft of Proposed

AMENDMENTS TO IFRS 3
BUSINESS COMBINATIONS

Comments to be received by 28 October 2005

This Exposure Draft of Proposed Amendments to IFRS 3 *Business Combinations* is published by the International Accounting Standards Board (IASB) for comment only. The proposals may be modified in the light of the comments received before being issued as an International Financial Reporting Standard (IFRS). Comments on the draft IFRS and its accompanying documents (see separate booklet) should be submitted in writing so as to be received by **28 October 2005**.

All responses will be put on the public record unless the respondent requests confidentiality. However, such requests will not normally be granted unless supported by good reason, such as commercial confidence. If commentators respond by fax or email, it would be helpful if they could also send a hard copy of their response by post. Comments should preferably be sent by email to: **CommentLetters@iasb.org** or addressed to:

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Note: Appendix B is not used in this publication. In the equivalent FASB Exposure Draft, Appendix B contains the FASB's Background Information and Basis for Conclusions. The IASB's Basis for Conclusions is not integral to the proposed IFRS and is presented in a separate booklet.

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INVITATION TO COMMENT

The International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) invite comments on all matters in the Exposure Draft, particularly on the questions set out below. Comments are most helpful if they:

(a) comment on the questions as stated

(b) indicate the specific paragraph or paragraphs to which the comments relate

(c) contain a clear rationale

(d) include any alternative the boards should consider.

Respondents need not comment on all of the questions presented and are encouraged to comment on additional issues.

Respondents should submit one comment letter to either the IASB or the FASB. The boards will share and consider jointly all comment letters received. Respondents must submit comments in writing by **28 October 2005**.

Until a final IFRS based on the Exposure Draft becomes effective, IFRS 3 *Business Combinations* remains effective.

Question 1—Objective, definition and scope

The proposed objective of the Exposure Draft is:

> …that all business combinations be accounted for by applying the acquisition method. A business combination is a transaction or other event in which an acquirer obtains control of one or more businesses (the acquiree). In accordance with the acquisition method, the acquirer measures and recognises the acquiree, as a whole, and the assets acquired and liabilities assumed at their fair values as of the acquisition date. [paragraph 1]

The objective provides the basic elements of the acquisition method of accounting for a business combination (formerly called the purchase method) by describing:

(a) what is to be measured and recognised. An acquiring entity would measure and recognise the acquired business at its fair value, regardless of the percentage of the equity interests of the acquiree it holds at the acquisition date. That objective also provides the foundation for determining whether specific assets acquired or liabilities assumed are part of an acquiree and would be accounted for as part of the business combination.

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(b) when to measure and recognise the acquiree. Recognition and measurement of a business combination would be as of the acquisition date, which is the date the acquirer obtains control of the acquiree.

(c) the measurement attribute as fair value, rather than as cost accumulation and allocation. The acquiree and the assets acquired and liabilities assumed would be measured at fair value as of the acquisition date, with limited exceptions. Consequently, the consideration transferred in exchange for the acquiree, including contingent consideration, would also be measured at fair value as of the acquisition date.

The objective and definition of a business combination would apply to all business combinations in the scope of the proposed IFRS, including business combinations:

(a) involving only mutual entities

(b) achieved by contract alone

(c) achieved in stages (commonly called step acquisitions)

(d) in which the acquirer holds less than 100 per cent of the equity interests in the acquiree at the acquisition date.

(See paragraphs 52-58 and paragraphs BC42-BC46 of the Basis for Conclusions.)

Question 1—Are the objective and the definition of a business combination appropriate for accounting for all business combinations? If not, for which business combinations are they not appropriate, why would you make an exception, and what alternative do you suggest?

Question 2—Definition of a business

The Exposure Draft proposes to define a *business* as follows:

> A business is an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing either:
>
> (1) a return to investors, or
>
> (2) dividends, lower costs, or other economic benefits directly and proportionately to owners, members, or participants. [paragraph 3(d)]

Paragraphs A2-A7 of Appendix A provide additional guidance for applying this definition. The proposed IFRS would amend the definition of a business in IFRS 3. (See paragraphs BC34-BC41.)

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Question 2—Are the definition of a business and the additional guidance appropriate and sufficient for determining whether the assets acquired and the liabilities assumed constitute a business? If not, how would you propose to modify or clarify the definition or additional guidance?

Questions 3-7—Measuring the fair value of the acquiree

The Exposure Draft proposes that in a business combination that is an exchange of equal values, the acquirer should measure and recognise 100 per cent of the fair value of the acquiree as of the acquisition date. This applies even in business combinations in which the acquirer holds less than 100 per cent of the equity interests in the acquiree at that date. In those business combinations, the acquirer would measure and recognise the non-controlling interest as the sum of the non-controlling interest's proportional interest in the acquisition-date values of the identifiable assets acquired and liabilities assumed plus the goodwill attributable to the non-controlling interest. (See paragraphs 19, 58 and BC52-BC54.)

Question 3—In a business combination in which the acquirer holds less than 100 per cent of the equity interests of the acquiree at the acquisition date, is it appropriate to recognise 100 per cent of the acquisition-date fair value of the acquiree, including 100 per cent of the values of identifiable assets acquired, liabilities assumed and goodwill, which would include the goodwill attributable to the non-controlling interest? If not, what alternative do you propose and why?

The Exposure Draft proposes that a business combination is usually an arm's length transaction in which knowledgeable, unrelated willing parties are presumed to exchange equal values. In such transactions, the fair value of the consideration transferred by the acquirer on the acquisition date is the best evidence of the fair value of the acquirer's interest in the acquiree, in the absence of evidence to the contrary. Accordingly, in most business combinations, the fair value of the consideration transferred by the acquirer would be used as the basis for measuring the acquisition-date fair value of the acquirer's interest in the acquiree. However, in some business combinations, either no consideration is transferred on the acquisition date or the evidence indicates that the consideration transferred is not the best basis for measuring the acquisition-date fair value of the acquirer's interest in the acquiree. In those business combinations, the acquirer would measure the acquisition-date fair value of its interest in the acquiree and the acquisition-date fair value of the acquiree using other valuation techniques. (See paragraphs 19, 20 and A8-A26, Appendix E and paragraphs BC52-BC89.)

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Question 4—Do paragraphs A8-A26 in conjunction with Appendix E provide sufficient guidance for measuring the fair value of an acquiree? If not, what additional guidance is needed?

The Exposure Draft proposes a presumption that the best evidence of the fair value of the acquirer's interest in the acquiree would be the fair values of all items of consideration transferred by the acquirer in exchange for that interest measured as of the acquisition date, including:

(a) contingent consideration;

(b) equity interests issued by the acquirer; and

(c) any non-controlling equity investment in the acquiree that the acquirer owned immediately before the acquisition date.

(See paragraphs 20-25 and BC55-BC58.)

Question 5—Is the acquisition-date fair value of the consideration transferred in exchange for the acquirer's interest in the acquiree the best evidence of the fair value of that interest? If not, which forms of consideration should be measured on a date other than the acquisition date, when should they be measured, and why?

The Exposure Draft proposes that after initial recognition, contingent consideration classified as:

(a) equity would not be remeasured.

(b) liabilities would be remeasured with changes in fair value recognised in profit or loss unless those liabilities are in the scope of IAS 39 *Financial Instruments: Recognition and Measurement* or [draft] IAS 37 *Non-financial Liabilities.* Those liabilities would be accounted for after the acquisition date in accordance with those IFRSs.

(See paragraphs 26 and BC64-BC89.)

Question 6—Is the accounting for contingent consideration after the acquisition date appropriate? If not, what alternative do you propose and why?

The Exposure Draft proposes that the costs that the acquirer incurs in connection with a business combination (also called acquisition-related costs) should be excluded from the measurement of the consideration transferred for the acquiree because those costs are not part of the fair value of the acquiree and are not assets. Such costs include finder's fees; advisory, legal, accounting, valuation and other professional or consulting fees; the cost of issuing debt and equity instruments; and general administrative costs, including the costs of maintaining an internal acquisitions department. The acquirer would account for those costs

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separately from the business combination accounting. (See paragraphs 27 and BC84-BC89.)

Question 7—Do you agree that the costs that the acquirer incurs in connection with a business combination are not assets and should be excluded from the measurement of the consideration transferred for the acquiree? If not, why?

Questions 8 and 9—Measuring and recognising the assets acquired and the liabilities assumed

The Exposure Draft proposes that an acquirer measure and recognise as of the acquisition date the fair value of the assets acquired and liabilities assumed as part of the business combination, with limited exceptions. (See paragraphs 28-41 and BC111-BC116.) That requirement would result in the following significant changes to accounting for business combinations:

(a) Receivables (including loans) acquired in a business combination would be measured at fair value. Therefore, the acquirer would not recognise a separate valuation allowance for uncollectible amounts as of the acquisition date.

(b) An identifiable asset or liability (contingency) would be measured and recognised at fair value at the acquisition date even if the amount of the future economic benefits embodied in the asset or required to settle the liability are contingent (or conditional) on the occurrence or non-occurrence of one or more uncertain future events. After initial recognition, such an asset would be accounted for in accordance with IAS 38 *Intangible Assets* or IAS 39 *Financial Instruments: Recognition and Measurement,* as appropriate, and such a liability would be accounted for in accordance with [draft] IAS 37 or other IFRSs as appropriate.

Question 8—Do you believe that these proposed changes to the accounting for business combinations are appropriate? If not, which changes do you believe are inappropriate, why, and what alternatives do you propose?

The Exposure Draft proposes limited exceptions to the fair value measurement principle. Therefore, some assets acquired and liabilities assumed (for example, those related to deferred taxes, assets held for sale, or employee benefits) would continue to be measured and recognised in accordance with other IFRSs rather than at fair value. (See paragraphs 42-51 and BC117-BC150.)

Question 9—Do you believe that these exceptions to the fair value measurement principle are appropriate? Are there any exceptions you would eliminate or add? If so, which ones and why?

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Questions 10-12—Additional guidance for applying the acquisition method to particular types of business combinations

The Exposure Draft proposes that, for the purposes of applying the acquisition method, the fair value of the consideration transferred by the acquirer would include the fair value of the acquirer's non-controlling equity investment in the acquiree at acquisition date that the acquirer owned immediately before the acquisition date. Accordingly, in a business combination achieved in stages (step acquisition) the acquirer would remeasure its non-controlling equity investment in the acquiree at fair value as of the acquisition date and recognise any gain or loss in profit or loss. If, before the business combination, the acquirer recognised changes in the value of its non-controlling equity investment directly in equity (for example, the investment was designated as available for sale), the amount that was recognised directly in equity would be reclassified and included in the calculation of any gain or loss as of the acquisition date. (See paragraphs 55, 56 and BC151-BC153.)

Question 10—Is it appropriate for the acquirer to recognise in profit or loss any gain or loss on previously acquired non-controlling equity investments on the date it obtains control of the acquiree? If not, what alternative do you propose and why?

The Exposure Draft proposes that in a business combination in which the consideration transferred for the acquirer's interest in the acquiree is less than the fair value of that interest (referred to as a bargain purchase) any excess of the fair value of the acquirer's interest in the acquiree over the fair value of the consideration transferred for that interest would reduce goodwill until the goodwill related to that business combination is reduced to zero, and any remaining excess would be recognised in profit or loss on the acquisition date. (See paragraphs 59-61 and paragraphs BC164-BC177.) However, the proposed IFRS would not permit the acquirer to recognise a loss at the acquisition date if the acquirer is able to determine that a portion of the consideration transferred represents an overpayment for the acquiree. The boards acknowledge that an acquirer might overpay to acquire a business, but they concluded that it is not possible to measure such an overpayment reliably at the acquisition date. (See paragraph BC178.)

Question 11—Do you agree with the proposed accounting for business combinations in which the consideration transferred for the acquirer's interest in the acquiree is less than the fair value of that interest? If not, what alternative do you propose and why?

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Question 12—Do you believe that there are circumstances in which the amount of an overpayment could be measured reliably at the acquisition date? If so, in what circumstances?

Question 13—Measurement period

The Exposure Draft proposes that an acquirer should recognise adjustments made during the measurement period to the provisional values of the assets acquired and liabilities assumed as if the accounting for the business combination had been completed at the acquisition date. Thus, comparative information for prior periods presented in financial statements would be adjusted, including any change in depreciation, amortisation or other profit or loss effect recognised as a result of completing the initial accounting. (See paragraphs 62-68 and BC161-BC163.)

Question 13—Do you agree that comparative information for prior periods presented in financial statements should be adjusted for the effects of measurement period adjustments? If not, what alternative do you propose and why?

Question 14—Assessing what is part of the exchange for the acquiree

The Exposure Draft proposes that an acquirer assess whether any portion of the transaction price (payments or other arrangements) and any assets acquired or liabilities assumed or incurred are not part of the exchange for the acquiree. Only the consideration transferred by the acquirer and the assets acquired or liabilities assumed or incurred that are part of the exchange for the acquiree would be included in the business combination accounting. (See paragraphs 69, 70, A87-A109 and BC154-BC160.)

Question 14—Do you believe that the guidance provided is sufficient for making the assessment of whether any portion of the transaction price or any assets acquired and liabilities assumed or incurred are not part of the exchange for the acquiree? If not, what other guidance is needed?

Question 15—Disclosures

The Exposure Draft proposes broad disclosure objectives that are intended to ensure that users of financial statements are provided with adequate information to enable them to evaluate the nature and financial effects of business combinations. Those objectives are supplemented by specific minimum disclosure requirements. In most instances, the objectives would be met by the minimum disclosure requirements that follow each of the broad objectives.

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However, in some circumstances, an acquirer might be required to disclose additional information necessary to meet the disclosure objectives. (See paragraphs 71-81 and BC200-BC203.)

Question 15—Do you agree with the disclosure objectives and the minimum disclosure requirements? If not, how would you propose amending the objectives or what disclosure requirements would you propose adding or deleting, and why?

Questions 16-18—The IASB's and the FASB's convergence decisions

The Exposure Draft is the result of the boards' projects to improve the accounting for business combinations. The first phase of those projects led to the issue of IFRS 3 and FASB Statement No. 141. In 2002, the FASB and the IASB agreed to reconsider jointly their guidance for applying the purchase method of accounting, which the Exposure Draft calls the acquisition method, for business combinations. An objective of the joint effort is to develop a common and comprehensive standard for the accounting for business combinations that could be used for both domestic and cross-border financial reporting. Although the boards reached the same conclusions on the fundamental issues addressed in the Exposure Draft, they reached different conclusions on a few limited matters. Therefore, the IASB's version and the FASB's version of the Exposure Draft provide different guidance on those limited matters. A comparison, by paragraph, of the different guidance provided by each board accompanies the draft IFRS. Most of the differences arise because each board decided to provide business combinations guidance that is consistent with its other standards. Even though those differences are candidates for future convergence projects, the boards do not plan to eliminate those differences before final standards on business combinations are issued.

The joint Exposure Draft proposes to resolve a difference between IFRS 3 and SFAS 141 relating to the criteria for recognising an intangible asset separately from goodwill. Both boards concluded that an intangible asset must be identifiable (arising from contractual-legal rights or separable) to be recognised separately from goodwill. In its deliberations that led to SFAS 141, the FASB concluded that, when acquired in a business combination, all intangible assets (except for an assembled workforce) that are identifiable can be measured with sufficient reliability to warrant recognition separately from goodwill. In addition to the identifiability criterion, IFRS 3 and IAS 38 required that an intangible asset acquired in a business combination be reliably measurable to be recognised separately from goodwill. Paragraphs 35-41 of IAS 38 provide guidance for determining whether an intangible asset acquired in a business combination is reliably measurable. IAS 38 presumes that the fair value of an intangible asset with a finite useful life can be measured reliably. Therefore, a difference between

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IFRS 3 and SFAS 141 would arise only if the intangible asset has an indefinite life. The IASB decided to converge with the FASB in the Exposure Draft by:

(a) eliminating the requirement that an intangible asset be reliably measurable to be recognised separately from goodwill; and

(b) precluding the recognition of an assembled workforce acquired in a business combination as an intangible asset separately from goodwill.

(See paragraphs 40 and BC100-BC102.)

Question 16—Do you believe that an intangible asset that is identifiable can always be measured with sufficient reliability to be recognised separately from goodwill? If not, why? Do you have any examples of an intangible asset that arises from legal or contractual rights and has both of the following characteristics:

(a) the intangible asset cannot be sold, transferred, licensed, rented, or exchanged individually or in combination with a related contract, asset, or liability; and

(b) cash flows that the intangible asset generates are inextricably linked with the cash flows that the business generates as a whole?

For the joint Exposure Draft, the boards considered the provisions of IAS 12 *Income Taxes* and FASB Statement No. 109 *Accounting for Income Taxes*, relating to an acquirer's deferred tax benefits that become recognisable because of a business combination. IAS 12 requires the acquirer to recognise separately from the business combination accounting any changes in its deferred tax assets that become recognisable because of the business combination. Such changes are recognised in post-combination profit or loss, or equity. On the other hand, SFAS 109 requires any recognition of an acquirer's deferred tax benefits (through the reduction of the acquirer's valuation allowance) that results from a business combination to be accounted for as part of the business combination, generally as a reduction of goodwill. The FASB decided to amend SFAS 109 to require the recognition of any changes in the acquirer's deferred tax benefits (through a change in the acquirer's previously recognised valuation allowance) as a transaction separately from the business combination. As amended, SFAS 109 would require such changes in deferred tax benefits to be recognised either in income from continuing operations in the period of the combination or directly to contributed capital, depending on the circumstances. Both boards decided to require disclosure of the amount of such acquisition-date changes in the acquirer's deferred tax benefits in the notes to the financial statements. (See paragraphs D4 and BC119-BC129.)

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Question 17—Do you agree that any changes in an acquirer's deferred tax benefits that become recognisable because of the business combination are not part of the fair value of the acquiree and should be accounted for separately from the business combination? If not, why?

The boards reconsidered disclosure requirements in IFRS 3 and SFAS 141 for the purposes of convergence. For some of the disclosures, the boards decided to converge. However, divergence continues to exist for some disclosures as described in the accompanying note *Differences between the Exposure Drafts published by the IASB and the FASB*. The boards concluded that some of this divergence stems from differences that are broader than the Business Combinations project.

Question 18—Do you believe it is appropriate for the IASB and the FASB to retain those disclosure differences? If not, which of the differences should be eliminated, if any, and how should this be achieved?

Question 19—Style of the Exposure Draft

The Exposure Draft was prepared in a style similar to the style used by the IASB in its standards in which paragraphs in **bold type** state the main principles. All paragraphs have equal authority.

Question 19—Do you find the bold type-plain type style of the Exposure Draft helpful? If not, why? Are there any paragraphs you believe should be in bold type, but are in plain type, or vice versa?

Public round-table meetings

The boards plan to hold public round-table meetings with constituents to discuss issues related to the Exposure Draft and the proposed amendments to IAS 27 *Consolidated and Separate Financial Statements*. The round-table meetings are scheduled to be held on 27 October 2005 in Norwalk, Connecticut, and on 9 November 2005 in London, England.

The boards would like those who participate in the meetings to be drawn from a wide variety of constituencies, including investors, preparers of financial statements, auditors, valuation experts, analysts and others.

If you wish to participate in the round-table meetings, you must notify the boards by 15 September 2005 by sending an email to ateixeira@iasb.org. You must specify the location of the round-table meeting that you would prefer to attend. Each round-table meeting can accommodate only a limited number of participants. The boards may not be able to accommodate all requests to participate. You will be notified about whether you were selected to participate by 30 September 2005.

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[Draft] International Financial Reporting Standard 3 *Business Combinations* (revised 200X) ([draft] IFRS 3) is set out in paragraphs 1-88 and Appendices A and C-E. All the paragraphs have equal authority. Paragraphs in **bold type** state the main principles. Terms defined in paragraph 3 are underlined the first time they appear in the [draft] IFRS. [Draft] IFRS 3 should be read in the context of its objective and the basis for conclusions, the *Preface to International Financial Reporting Standards* and the *Framework for the Preparation and Presentation of Financial Statements*. IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

Note: The IASB and FASB have aligned the paragraph numbering in their Exposure Drafts. Where one Exposure Draft does not use a paragraph number used by the other, this is identified as '*Not used*'.

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INTRODUCTION

IN1 A business combination is a transaction or other event in which an acquirer obtains control of one or more businesses (the acquiree). The objective of this [draft] IFRS is that all business combinations be accounted for by applying the acquisition method. In accordance with the acquisition method, the acquirer measures and recognises the acquiree, as a whole, and the assets acquired and liabilities assumed at their fair values as of the acquisition date.

IN2 This [draft] IFRS replaces IFRS 3 *Business Combinations* (as issued in 2004). This [draft] IFRS is to be applied at the same time as [draft] IAS 27 *Consolidated and Separate Financial Statements* (as revised in 200X) and [draft] IAS 37 *Non-financial Liabilities.*

Background

IN3 This [draft] IFRS is issued as part of a joint effort by the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) (referred to as the boards) to improve financial reporting while promoting the international convergence of accounting standards. The boards believe that developing a common set of high quality financial accounting standards improves the comparability of financial information around the world and simplifies the accounting for entities that issue financial statements in accordance with international accounting standards and US generally accepted accounting principles or reconcile from one set of standards to the other.

IN4 The boards each decided to address the financial accounting for business combinations in two phases. The IASB and the FASB deliberated the first phase separately. The FASB concluded the first phase in June 2001 by issuing Statement No. 141 *Business Combinations.* The IASB concluded the first phase in March 2004 by issuing IFRS 3 *Business Combinations.* The boards' primary conclusion in the first phase was that virtually all business combinations are acquisitions. Accordingly, the boards decided to require the use of one method of accounting for business combinations—the purchase method (called the *acquisition method* in this [draft] IFRS).

IN5 The second phase of the project addresses the guidance for applying the acquisition method. The IASB and the FASB began deliberating the second phase of their projects at about the same time. The boards decided that a significant improvement could be made to financial reporting if they had similar standards for accounting for business

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combinations. Thus, they decided to conduct the second phase of the project as a joint effort with the objective of reaching the same conclusions.

Reasons for issuing this [draft] IFRS

IN6 This [draft] IFRS seeks to improve financial reporting by requiring the acquisition method to be applied to more business combinations, including those involving only mutual entities and those achieved by contract alone. The boards believe that applying a single method of accounting to all business combinations will result in more comparable and transparent financial statements.

IN7 This [draft] IFRS requires an acquirer to recognise an acquired business at its fair value at the acquisition date rather than at its cost. It also requires the acquirer to measure and recognise the individual assets acquired and liabilities assumed at their fair values at the acquisition date, with limited exceptions. The boards concluded that requiring the recognition of the acquiree and the assets acquired and liabilities assumed at fair value as of the acquisition date improves the relevance and reliability of financial information. This is true even in business combinations in which the acquirer obtains control of a business by acquiring less than 100 per cent of the equity interests in the acquiree or in business combinations achieved in stages (step acquisitions). Relevance and reliability are characteristics that make financial information more useful to users.

Main features of this [draft] IFRS

IN8 This [draft] IFRS retains the fundamental requirements in the previous version of IFRS 3 for the acquisition method of accounting to be used for all business combinations and for an acquirer to be identified for every business combination. Additionally, this [draft] IFRS requires:

(a) the acquirer to measure the fair value of the acquiree, as a whole, as of the acquisition date.

(b) for the purposes of applying the acquisition method, the consideration transferred by the acquirer in exchange for the acquiree to be measured at its fair value as of the acquisition date calculated as the sum of:

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(i) the assets transferred by the acquirer, liabilities incurred by the acquirer, and equity interests issued by the acquirer, including contingent consideration, and

(ii) any non-controlling equity investment in the acquiree owned by the acquirer immediately before the acquisition date.

(c) the acquirer to assess whether any portion of the transaction price paid and any assets acquired or liabilities assumed or incurred are not part of the exchange for the acquiree. Only the consideration transferred or the assets acquired or liabilities assumed or incurred that are part of the exchange for the acquiree are to be accounted for as part of the business combination accounting.

(d) the acquirer to account for acquisition-related costs incurred in connection with the business combination separately from the business combination (generally as expenses).

(e) the acquirer to measure and recognise the acquisition-date fair value of the assets acquired and liabilities assumed as part of the business combination, with limited exceptions. Those exceptions are:

(i) goodwill is to be measured and recognised as the excess of the fair value of the acquiree, as a whole, over the net amount of the recognised identifiable assets acquired and liabilities assumed. If the acquirer owns less than 100 per cent of the equity interests in the acquiree at the acquisition date, goodwill attributable to the non-controlling interest is recognised.

(ii) non-current assets (or disposal group) classified as held for sale, deferred tax assets or liabilities, and assets or liabilities related to the acquiree's employee benefit plans are measured in accordance with other IFRSs.

(iii) if the acquiree is a lessee to an operating lease, no asset or related liability is recognised if the lease is at market terms.

(f) the acquirer to recognise separately from goodwill an acquiree's intangible assets that meet the definition of an intangible asset in IAS 38 *Intangible Assets* and are identifiable (ie arise from contractual-legal rights or are separable).

(g) *Not used.*

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(h) in a business combination in which the acquisition-date fair value of the acquirer's interest in the acquiree exceeds the fair value of the consideration transferred for that interest (referred to as a bargain purchase), the acquirer to account for that excess by reducing goodwill until the goodwill related to that business combination is reduced to zero and then by recognising any remaining excess in profit or loss.

(i) the acquirer to recognise any adjustments made during the measurement period to the provisional values of the assets acquired and liabilities assumed as if the accounting for the business combination had been completed at the acquisition date. Thus, comparative information for prior periods presented in financial statements is to be adjusted.

Significant changes to IFRS 3

IN9 The main changes between this [draft] IFRS and the previous version of IFRS 3 are described below.

Scope

(a) The requirements of this [draft] IFRS are applicable to business combinations involving only mutual entities and business combinations achieved by contract alone.

Definition of a business combination

(b) This [draft] IFRS amends the definition of a *business combination* provided in the previous version of IFRS 3. This [draft] IFRS defines a business combination as 'a transaction or other event in which an acquirer obtains control of one or more businesses'.

Definition of a business

(c) This [draft] IFRS provides a definition of a *business* and additional guidance for identifying when a group of assets constitutes a business. This [draft] IFRS amends the definition provided in the previous version of IFRS 3.

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Measuring the fair value of the acquiree

(d) This [draft] IFRS requires business combinations to be measured and recognised as of the acquisition date at the fair value of the acquiree, even if the business combination is achieved in stages or if less than 100 per cent of the equity interests in the acquiree are owned at the acquisition date. The previous version of IFRS 3 required a business combination to be measured and recognised on the basis of the accumulated cost of the combination.

(e) This [draft] IFRS requires the costs the acquirer incurs in connection with the business combination to be accounted for separately from the business combination accounting. The previous version of IFRS 3 required direct costs of the business combination to be included in the cost of the acquiree.

(f) This [draft] IFRS requires all items of consideration transferred by the acquirer to be measured and recognised at fair value at the acquisition date. Therefore, this [draft] IFRS requires the acquirer to recognise contingent consideration arrangements at fair value as of the acquisition date. Subsequent changes in the fair value of contingent consideration classified as liabilities are recognised in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*, IAS 37 or other IFRSs, as appropriate.

(g) This [draft] IFRS requires the acquirer in a business combination in which the acquisition-date fair value of the acquirer's interest in the acquiree exceeds the fair value of the consideration transferred for that interest (referred to as a bargain purchase) to account for that excess by first reducing the goodwill related to that business combination to zero, and then by recognising any excess in income. The previous version of IFRS 3 required the excess of the acquirer's interest in the net fair values of the acquiree's assets and liabilities over cost to be recognised immediately in profit or loss.

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Measuring and recognising the assets acquired and the liabilities assumed

(h) This [draft] IFRS requires the assets acquired and liabilities assumed to be measured and recognised at their fair values as of the acquisition date, with limited exceptions. The previous version of IFRS 3 required the cost of an acquisition to be allocated to the individual assets acquired and liabilities assumed based on their estimated fair values. However, it also provided guidance for measuring some assets and liabilities that was inconsistent with fair value measurement objectives. Thus, those assets or liabilities may not have been recognised at fair value as of the acquisition date in accordance with that version of IFRS 3.

(i) This [draft] IFRS requires an identifiable asset or liability to be measured and recognised at fair value at the acquisition date even if the amount of the future economic benefits embodied in the asset or required to settle the liability are contingent (or conditional) on the occurrence or non-occurrence of one or more uncertain future events. The previous version of IFRS 3 required the recognition of contingent liabilities at fair value as of the acquisition date.

(j) *Not used.*

(k) This [draft] IFRS requires the acquirer in business combinations in which the acquirer holds less than 100 per cent of the equity interests in the acquiree at the acquisition date to recognise the identifiable assets and liabilities at the full amount of their fair values, with limited exceptions, and goodwill as the difference between the fair value of the acquiree, as a whole, and the fair value of the identifiable assets acquired and liabilities assumed. The previous version of IFRS 3 required the identifiable assets acquired and liabilities assumed to be recognised at fair value but goodwill to be recognised as the difference between the cost of the interest acquired and the acquirer's proportional interest in the fair value of the identifiable assets acquired and liabilities assumed. If the business combination was achieved in stages, IFRS 3 previously required goodwill to be determined by a step-by-step comparison of the cost of the individual investments with the acquirer's interest in the fair values of the identifiable assets acquired and liabilities assumed at each step.

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(l) Acquisitions of additional non-controlling equity interests after the business combination are not permitted to be accounted for using the acquisition method. In accordance with [draft] IAS 27 (as revised in 200X), acquisitions (or disposals) of non-controlling equity interests after the business combination are accounted for as equity transactions.

(m) The acquirer is required to recognise separately from goodwill an acquiree's intangible assets if they meet the definition of an intangible asset in IAS 38 *Intangible Assets*. The previous version of IFRS 3 required the recognition of intangible assets separately from goodwill only if they met the IAS 38 definition and were reliably measurable. For the purposes of this [draft] IFRS, an assembled workforce is not to be recognised as an intangible asset separately from goodwill.

(n) *Not used.*

Benefits and costs

IN10 The boards have striven to issue a [draft] IFRS with common requirements that will fill a significant need and for which the costs imposed to apply it, as compared with other alternatives, are justified in relation to the overall benefits of the resulting information. The boards concluded that this [draft] IFRS will, for the reasons previously noted, make several improvements to financial reporting that would benefit investors, creditors, and other users of financial statements.

IN11 The boards sought to reduce the costs of applying this [draft] IFRS. This [draft] IFRS (a) requires particular assets and liabilities (for example, those related to deferred taxes, assets held for sale, and employee benefits) to continue to be measured and recognised in accordance with existing IFRSs rather than at fair value and (b) requires its provisions to be applied prospectively rather than retrospectively. The boards acknowledge that those two steps may diminish some benefits of improved reporting provided by this [draft] IFRS. However, they concluded that the complexities and related costs that would result from imposing a fair value measurement requirement at this time to all assets acquired and liabilities assumed in a business combination and requiring retrospective application of the provisions of this [draft] IFRS are not justified.

IN12 In addition, improving the consistency of the procedures used in accounting for business combinations, including international consistency, should help alleviate concerns that an entity's competitive

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position as a potential bidder is affected by differences in accounting for business combinations. Consistency in the accounting procedures can also reduce the costs to prepare financial statements, especially for entities with global operations. Moreover, such consistency also will enhance comparability of information among entities, which can lead to a better understanding of the resulting financial information and reduce the costs to users of analysing that information.

Effective date

IN13 This [draft] IFRS applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual period beginning on or after 1 January 2007. Earlier application is encouraged. However, this [draft] IFRS is to be applied only at the beginning of an annual period that begins on or after the date on which this [draft] IFRS was issued. If this [draft] IFRS is applied before its effective date, that fact is to be disclosed and [draft] IAS 27 (as revised in 200X) and [draft] IAS 37 (as revised in 200X) is/are to be applied at the same time.

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[DRAFT] INTERNATIONAL FINANCIAL REPORTING STANDARD 3

Business Combinations

OBJECTIVE

1 This [draft] IFRS requires that all business combinations be accounted for by applying the acquisition method. A business combination is a transaction or other event in which an acquirer obtains control of one or more businesses (the acquiree). In accordance with the acquisition method, the acquirer measures and recognises the acquiree, as a whole, and the assets acquired and liabilities assumed at their fair values as of the acquisition date.

SCOPE

2 An entity shall apply this [draft] IFRS when accounting for business combinations. However, this [draft] IFRS does not apply to:

(a) formations of joint ventures

(b) combinations involving only entities or businesses under common control (see paragraphs C6-C10 of Appendix C).

(c) *Not used.*

KEY TERMS

3 The following terms are used with specific meanings and are integral to understanding and applying this [draft] IFRS.

(a) The acquiree is the business or businesses the acquirer obtains control of in a business combination.

(b) The acquirer is the entity that obtains control of the acquiree.

(c) The acquisition date is the date the acquirer obtains control of the acquiree.

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(d) A business is an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing either:

(1) a return to investors, or

(2) dividends, lower costs, or other economic benefits directly and proportionately to owners, members or participants.

(e) A business combination is a transaction or other event in which an acquirer obtains control of one or more businesses.

(f) Control is defined in [draft] IAS 27 *Consolidated and Separate Financial Statements*.

(g) Contingencies is used with the same meaning as in [draft] IAS 37 *Non-financial Liabilities.*

(h) For the purposes of this [draft] IFRS, the term equity interests is used broadly to mean ownership interests of investor-owned entities and owner, member, or participant interests of mutual entities.

(i) For the purposes of this [draft] IFRS, fair value is the price at which an asset or liability could be exchanged in a current transaction between knowledgeable, unrelated willing parties.*

(j) Goodwill is the future economic benefits arising from assets that are not individually identified and separately recognised.

(k) An asset is identifiable if it either:

(1) is separable, that is, capable of being separated or divided from the entity and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, asset, or liability, regardless of whether the entity intends to do so; or

(2) Arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

* The definition of fair value is based on the definition in the FASB's Proposed Statement *Fair Value Measurements*. The FASB plans to issue a final Statement on fair value measurements in the fourth quarter of 2005. The definition of fair value may change in that final Statement.

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(l) Impracticable is defined in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors.*

(m) A mutual entity is an entity other than an investor-owned entity that provides dividends, lower costs, or other economic benefits directly and proportionately to its owners, members, or participants.

(n) For the purposes of this [draft] IFRS, the term owners is used broadly to include holders of equity interests of investor-owned entities and owners, members, or participants of mutual entities.

(o) Non-controlling interest is used with the same meaning as in [draft] IAS 27 (revised 200X).

IDENTIFYING A BUSINESS COMBINATION

4 **A business combination is a transaction or other event in which an acquirer obtains control of one or more businesses.**

5 A transaction or other event is accounted for as a business combination only if the assets acquired and liabilities assumed constitute a business (an acquiree). Paragraphs A2-A7 of Appendix A provide guidance for identifying whether the assets acquired and liabilities assumed constitute a business. If the assets acquired and liabilities assumed do not constitute a business, the acquirer shall account for the transaction as an asset acquisition. The accounting for an asset acquisition is set out in paragraphs C3-C5.

6 In a business combination, an acquirer might:

(a) acquire the equity interests of a business.

(b) acquire some or all of an entity's assets (net assets) that constitute a business.

(c) assume some or all of the liabilities of an acquiree.

An acquirer might obtain control of an acquiree:

(d) by transferring cash, cash equivalents, or other assets (including net assets that constitute a business).

(e) by issuing equity interests.

(f) by providing more than one type of consideration.

(g) by contract alone (see paragraph 54).

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(h) without transferring any consideration.

(i) without a transaction involving the acquirer. One example is a business combination that occurs when an entity (the acquiree) repurchases its own shares and, as a result, an existing investor (the acquirer) obtains control of that entity. Another example is a business combination that occurs when an acquirer obtains control of an acquiree through the lapse of minority veto rights that previously kept the acquirer from controlling the acquiree even though the acquirer held the majority voting interest in the acquiree.

7 A business combination may be structured in a variety of ways for legal, taxation, or other reasons. Accordingly, this [draft] IFRS applies equally to business combinations in which:

(a) one or more businesses are merged with or become subsidiaries of an acquirer.

(b) one entity transfers net assets or its owners transfer their equity interests to another entity or the owners of another entity.

(c) all entities transfer net assets or the owners of those entities transfer their equity interests to a newly formed entity (some of which are referred to as roll-up or put-together transactions).

All those transactions are business combinations regardless of:

(d) whether the acquiree is incorporated.

(e) the form of consideration transferred in exchange for the acquiree.

(f) whether a group of former owners of one of the combining entities retains or receives a majority of the voting rights of the combined entity.

THE ACQUISITION METHOD

8 All business combinations shall be accounted for by applying the acquisition method.

9 The acquisition method has four steps:

(a) identifying the acquirer

(b) determining the acquisition date

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(c) measuring the fair value of the acquiree

(d) measuring and recognising the assets acquired and the liabilities assumed.

Identifying the acquirer

10 An acquirer shall be identified for all business combinations.

11 The guidance in [draft] IAS 27 (revised 200X) shall be used to identify the acquirer, which is the entity that obtains control of the acquiree. If an acquirer cannot be determined solely on the basis of the guidance in [draft] IAS 27 paragraphs 12-16 shall be considered in making that determination.

12 The form of the consideration transferred may provide evidence about which entity is the acquirer. For example:

(a) in a business combination effected solely through the transfer of cash or other assets or by incurring liabilities, the entity that transfers the cash or other assets or incurs the liabilities is likely to be the acquirer.

(b) in a business combination effected through an exchange of cash or other assets for voting equity interests, the entity that gives up the cash or other assets is likely to be the acquirer.

(c) in a business combination effected through an exchange of equity interests, the entity that issues the equity interests is normally the acquirer. However, in some business combinations, commonly called reverse acquisitions, the issuing entity is the acquiree. Paragraphs A111-A136 provide guidance for accounting for reverse acquisitions. Commonly in an exchange of equity interests, the acquirer is the larger entity; however, the facts and circumstances surrounding a combination sometimes indicate that a smaller entity acquires a larger entity. Therefore, in identifying the acquirer in a business combination effected through an exchange of equity interests, all pertinent facts and circumstances shall be considered, in particular:

(1) *the relative voting rights in the combined entity after the business combination*—All else being equal, the acquirer is the combining entity whose owners as a group retained or received the largest portion of the voting rights in the combined entity. In determining which group of owners retained or received the largest portion of the voting rights,

consideration shall be given to the existence of any unusual or special voting arrangements and options, warrants, or convertible securities.

(2) *the existence of a large minority voting interest in the combined entity when no other owner or organised group of owners has a significant voting interest*—All else being equal, the acquirer is the combining entity whose single owner or organised group of owners holds the largest minority voting interest in the combined entity.

(3) *the composition of the governing body of the combined entity*—All else being equal, the acquirer is the combining entity whose owners or governing body has the ability to elect or appoint a voting majority of the governing body of the combined entity.

(4) *the terms of the exchange of equity interests*—All else being equal, the acquirer is the combining entity that pays a premium over the pre-combination market value of the equity securities of the other combining entity or entities.

13 If the fair value of one of the combining entities is significantly greater than that of the other combining entity or entities, the entity with the greatest fair value is likely to be the acquirer.

14 If the business combination results in the management of one of the combining entities being able to dominate the selection of the management team of the resulting combined entity, the entity whose management is able to dominate is likely to be the acquirer.

15 In a business combination involving more than two entities, determining the acquirer shall include a consideration of, among other things, which of the combining entities initiated the combination and whether the assets, revenues, or profit or loss of one of the combining entities significantly exceeds those of the others.

16 If a new entity is formed to issue equity interests to effect a business combination, one of the combining entities that existed before the business combination shall be identified as the acquirer based on the evidence available. The guidance in paragraphs 11-15 shall be used to identify the acquirer.

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Determining the acquisition date

17 The acquisition date is the date the acquirer obtains control of the acquiree.

18 The acquirer generally obtains control of the acquiree on the closing date, which is the date that the acquirer transfers the consideration, acquires the assets, and assumes the liabilities of the acquiree. In some cases, the acquisition date may precede the closing date of the business combination or the date the business combination is finalised in law. All pertinent facts and circumstances surrounding a business combination shall be considered in assessing when the acquirer has obtained control of the acquiree. For example, the acquisition date may precede the closing date if a written agreement provides that the acquirer obtains control of the acquiree on a date before the closing date.

Measuring the fair value of the acquiree

19 The acquirer shall measure the fair value of the acquiree, as a whole, as of the acquisition date.

20 Business combinations are usually arm's length exchange transactions in which knowledgeable, unrelated willing parties exchange equal values. Therefore, in the absence of evidence to the contrary, the exchange price (referred to in this [draft] IFRS as the consideration transferred) paid by the acquirer on the acquisition date is presumed to be the best evidence of the acquisition-date fair value of the acquirer's interest in the acquiree. In some business combinations, either no consideration is transferred on the acquisition date or the evidence indicates that the consideration transferred is not the best basis for measuring the acquisition-date fair value of the acquirer's interest in the acquiree. In those business combinations, the acquirer should measure the acquisition-date fair value of its interest in the acquiree using other valuation techniques. Paragraphs A8-A26 provide additional guidance for performing the fair value measurement described in this paragraph.

Consideration transferred

21 For the purposes of applying the acquisition method, the fair value of the consideration transferred in exchange for the acquirer's interest in the acquiree is calculated as the sum of:

(a) the acquisition-date fair values of the assets transferred by the

acquirer, liabilities assumed or incurred by the acquirer, and equity interests issued by the acquirer. Examples include cash, other assets, contingent consideration (see paragraph 25), a business or a subsidiary of the acquirer, common or preferred equity instruments, options, warrants, and member interests of mutual entities; and

(b) the acquisition-date fair value of any non-controlling equity investment in the acquiree that the acquirer owned immediately before the acquisition date (see paragraph 56).

22 The consideration transferred may include assets or liabilities of the acquirer that have carrying amounts that differ from their fair values at the acquisition date (for example, non-monetary assets or a business of the acquirer). In that case, the acquirer shall remeasure those transferred assets or liabilities to their fair values as of the acquisition date and recognise any gains or losses in profit or loss. However, if those assets or liabilities are transferred to the acquiree and, therefore, remain within the combined entity after the business combination, the acquirer shall eliminate any gains or losses on those transferred assets or liabilities in the consolidated financial statements.

23 If the information necessary to measure the fair value of some or all of the consideration transferred is not available at the acquisition date, the measurement period guidance in paragraphs 62-68 applies.

24 The acquirer shall assess whether any portion of the transaction price includes payments or other arrangements that are not consideration transferred in exchange for the acquiree. Paragraphs 69 and 70 provide guidance for making that assessment. Only the consideration transferred in exchange for the acquiree shall be accounted for as part of the business combination.

Contingent consideration

25 As described in paragraph 21(a), the fair value of the consideration transferred in exchange for the acquiree includes the acquisition-date fair value of any obligations of the acquirer to transfer additional assets or equity interests if specified future events occur or conditions are met (commonly called contingent consideration). For example, the acquirer may agree to transfer additional equity interests, cash, or other assets to the former owners of the acquiree after the acquisition date if the acquiree meets specified financial or non-financial targets in the future. The acquirer shall measure and recognise the fair value of such contingent consideration as of the acquisition date and shall classify that

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obligation as either a liability or equity on the basis of other IFRSs. An arrangement to transfer additional assets or equity interests if specified events or conditions occur may be incorporated in an acquirer's share-based payment awards exchanged for awards held by the acquiree's employees. The acquirer shall measure the portion of such awards included in consideration transferred for the acquiree in accordance with paragraphs A102-A109.

26 After initial recognition, the acquirer shall account for changes in the fair value of contingent consideration that do not qualify as measurement period adjustments (see paragraphs 62-68) as follows:

(a) contingent consideration classified as equity shall not be remeasured.

(b) contingent consideration classified as liabilities that:

(1) are financial instruments and within the scope of IAS 39 *Financial Instruments: Recognition and Measurement,* shall be accounted for in accordance with that IFRS.

(2) are non-financial liabilities that include a contingency shall be accounted for in accordance with [draft] IAS 37, or other IFRSs as appropriate.

Costs incurred in connection with a business combination

27 Costs the acquirer incurs in connection with a business combination (also called acquisition-related costs) are not part of the consideration transferred in exchange for the acquiree. For example, such costs include finder's fees, advisory, legal, accounting, valuation, other professional or consulting fees, general administrative costs, including the costs of maintaining an internal acquisitions department, and costs of registering and issuing debt and equity securities. The acquirer shall not include such costs in the measure of the fair value of the acquiree or the assets acquired or liabilities assumed as part of the business combination. The acquirer shall account for acquisition-related costs, separately from the business combination, in accordance with other IFRSs.

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Measuring and recognising the assets acquired and the liabilities assumed

28 **The acquirer shall measure and recognise as of the acquisition date the assets acquired and liabilities assumed as part of the business combination. Except as provided in paragraphs 42-51, the identifiable assets acquired and liabilities assumed shall be measured at fair value and recognised separately from goodwill.**

29 As part of the business combination accounting, the acquirer recognises assets acquired or liabilities assumed that are part of the exchange for the acquiree and meet the definition of assets and liabilities in the *Framework for the Preparation and Presentation of Financial Statements*. The assets and liabilities the acquirer recognises as part of the business combination may include assets and liabilities the acquiree had not recognised previously in its financial statements. For example, the acquirer often recognises the acquired identifiable intangible assets that were internally developed by the acquiree and did not meet the criteria for recognition in the acquiree's financial statements. The acquirer does not recognise any assets or liabilities other than the assets acquired or the liabilities assumed as part of the business combination.

30 A business combination does not affect the measurement of the acquirer's assets and liabilities, except for those assets or liabilities that are not recognised at fair value by the acquirer before the business combination and are part of the consideration transferred in exchange for the acquiree (see paragraph 22).

31 If the information necessary to measure the fair value of some or all of the assets acquired or liabilities assumed is not available at the acquisition date, the measurement period guidance in paragraphs 62-68 applies.

32 The acquirer shall assess whether any of the assets acquired or liabilities assumed or incurred are not part of the exchange for the acquiree (that is, not included in the business combination accounting). Paragraphs 69 and 70 provide guidance for making that assessment.

Guidance for measuring and recognising particular assets acquired and liabilities assumed

33 Paragraphs 34-41 provide guidance for measuring and recognising particular assets acquired and liabilities assumed at fair value as of the acquisition date.

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Valuation allowances

34 The acquirer shall not recognise a separate valuation allowance as of the acquisition date for assets required to be recognised at fair value in accordance with this [draft] IFRS. For example, an acquirer would recognise receivables (including loans) acquired in a business combination at fair value as of the acquisition date and would not recognise a separate valuation allowance for uncollectible receivables at that date. Uncertainty about collections and future cash flows is included in the fair value measure.

Contingencies

35 The acquirer shall recognise, separately from goodwill, the acquisition-date fair value of an identifiable asset acquired or liability assumed as part of the business combination even if the amount of the future economic benefits embodied in the asset or required to settle the liability are contingent (or conditional) on the occurrence or non-occurrence of one or more uncertain future events. Such an asset or liability is called a contingency in this [draft] IFRS.

36 After initial recognition, the acquirer shall account for such assets in accordance with IAS 38 *Intangible Assets* or IAS 39, as appropriate, and such liabilities in accordance with [draft] IAS 37 or other IFRSs, as appropriate.

Liabilities associated with restructuring or exit activities

37 The acquirer shall recognise, separately from goodwill, the acquisition-date fair value of liabilities for restructuring or exit activities acquired in a business combination only if they meet the recognition criteria in [draft] IAS 37 as of the acquisition date. Costs associated with restructuring or exit activities that do not meet the recognition criteria in [draft] IAS 37 as of the acquisition date are not liabilities at the acquisition date and, therefore, are recognised separately from the business combination, generally as post-combination expenses of the combined entity when incurred. For example, costs the acquirer expects to incur in the future pursuant to its plan (a) to exit an activity of an acquiree, (b) to involuntarily terminate the employment of an acquiree's employees, or (c) to relocate employees of an acquiree are not assumed liabilities of the acquiree and, therefore, are not accounted for as part of the business combination.

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Leases

38 In accordance with IAS 17 *Leases*, a lease of the acquiree (regardless of whether the acquiree is the lessee or lessor) retains the lease classification determined by the acquiree at the lease inception, unless the provisions of a lease are modified as a result of the business combination in a way that would require the acquirer to consider the revised agreement a new lease agreement in accordance with paragraph 13 of IAS 17. In that circumstance, the acquirer would classify the new lease according to the criteria set out in IAS 17 on the basis of the conditions of the modified lease.

39 The acquirer shall account for the acquiree's operating leases in which the acquiree is the lessee in accordance with paragraph 47. For all other leases, the acquirer shall measure and recognise separately the asset and any related liability embodied in a lease at their acquisition-date fair values. After initial recognition, assets and liabilities related to leases shall be accounted for in accordance with IAS 17.

Intangible assets

40 The acquirer shall recognise, separately from goodwill, the acquisition-date fair value of intangible assets acquired in a business combination that meet the definition of an intangible asset in IAS 38. For the purposes of this [draft] IFRS, an assembled workforce shall not be recognised as an intangible asset separately from goodwill. Paragraphs A27-A61 provide additional guidance about measuring and recognising intangible assets acquired in a business combination.

41 As part of a business combination, an acquirer may reacquire a right that it had previously granted to the acquiree to use the acquirer's recognised or unrecognised intangible assets (such as a right to use the acquirer's trade name under a franchise agreement or a right to use the acquirer's technology under a technology licensing agreement). Such a right is an identifiable intangible asset that shall be recognised separately from goodwill as part of the business combination accounting. If the contract giving rise to the reacquired right includes pricing terms that are favourable or unfavourable when compared with pricing for current market transactions for the same or similar items, the acquirer shall recognise a settlement gain or loss. Paragraph A92 provides guidance for measuring that settlement gain or loss. After initial recognition, reacquired rights shall be amortised over the remaining contractual period of the pre-combination contract that granted those rights.

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Assets acquired and liabilities assumed that are not recognised at fair value as of the acquisition date

42 The following assets acquired and liabilities assumed shall be measured and recognised as of the acquisition date as follows.

Assets held for sale

43 The acquirer shall measure and recognise, separately from goodwill, an acquired non-current asset (or disposal group) that is classified as held for sale as of the acquisition date in accordance with paragraphs 7-11 of IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations.*

Deferred taxes

44 The acquirer shall measure and recognise, separately from goodwill, a deferred tax asset or liability in accordance with IAS 12 *Income Taxes* as amended by paragraph D4 of this [draft] IFRS.

45 IAS 12, as amended by this [draft] IFRS, sets out the subsequent accounting for deferred tax assets (including unrecognised deferred tax assets) and liabilities that were acquired in a business combination.

46 The acquirer shall account for the potential tax effects of (a) temporary differences and carry-forwards of an acquiree that exist at the acquisition date and (b) income tax uncertainties related to the acquisition (for example, an uncertainty related to the tax basis of an acquired asset that ultimately will be agreed to by the taxing authority or positions taken in prior tax returns of the acquiree) in accordance with the provisions of IAS 12, as amended.

Operating leases

47 If the acquiree is the lessee to an operating lease, the acquirer shall not recognise separately the asset and related liability embodied in the lease. If the acquiree is the lessor to an operating lease, the acquirer shall measure and recognise the asset subject to the operating lease at its acquisition-date fair value in accordance with paragraph 39. The acquirer shall also assess whether each of the acquiree's operating leases are at market terms as of the acquisition date, regardless of whether the

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acquiree is the lessee or lessor. If an operating lease is not at market terms as of the acquisition date, the acquirer shall recognise:

(a) an intangible asset if the terms of the operating lease are favourable relative to market terms.

(b) a liability if the terms of the operating lease are unfavourable relative to market terms.

Employee benefit plans

48 The acquirer shall measure and recognise, separately from goodwill, any asset or liability related to the acquiree's employee benefit plans that is within the scope of IAS 19 *Employee Benefits* in accordance with paragraph 108 of that standard.

Goodwill

49 Except as provided by paragraph 61, the acquirer shall measure and recognise goodwill as of the acquisition date as the excess of the fair value of the acquiree, as a whole, over the net amount of the recognised identifiable assets acquired and liabilities assumed. This requirement applies even if the acquirer owns less than 100 per cent of the equity interests in the acquiree at the acquisition date (that is, even if a non-controlling interest in the acquiree exists at the acquisition date).

50 The amount recognised as goodwill includes synergies and other benefits that are expected from combining the activities of the acquirer and acquiree. Because goodwill is measured as a residual, the amount recognised as goodwill also includes (a) intangible assets that do not meet the criteria in paragraph 40 for recognition separately from goodwill and (b) any difference between the fair values of the assets acquired and liabilities assumed and the amount recognised in accordance with paragraphs 42-48.

51 After initial recognition, the acquirer shall measure goodwill at the amount recognised as of the acquisition date less any accumulated impairment losses. Goodwill shall not be amortised. The acquirer shall test goodwill for impairment in accordance with IAS 36 *Impairment of Assets* as amended by paragraph D10 of this [draft] IFRS.

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Additional guidance for applying the acquisition method to particular types of business combinations

52 Paragraphs 53-61 provide additional guidance for applying the acquisition method to the following types of business combinations:

(a) business combinations involving only mutual entities

(b) business combinations achieved by contract alone

(c) business combinations achieved in stages

(d) business combinations in which the acquirer holds less than 100 per cent of the equity interests in the acquiree at the acquisition date

(e) business combinations in which the consideration transferred for the acquirer's interest in the acquiree is less than the fair value of that interest.

Business combinations involving only mutual entities

53 In a business combination involving only mutual entities in which the only consideration exchanged is the member interests of the acquiree for the member interests of the acquirer (or the member interests of the newly combined entity), the amount equal to the fair value of the acquiree shall be recognised as a direct addition to capital or equity, not retained earnings.

Business combinations achieved by contract alone

54 In rare circumstances, an acquirer (a) obtains control of an acquiree by contract, (b) transfers no consideration for control of the acquiree or for the net assets of the acquiree, and (c) obtains no equity interests in the acquiree, either on the acquisition date or previously. An example of such a business combination is one in which two businesses are brought together to form a dual listed corporation. This type of business combination is referred to in this [draft] IFRS as a business combination achieved by contract alone. In such a business combination, the fair value of the acquiree shall be attributed to the non-controlling interests of the acquiree (that is, the equity holders of the acquiree) in the consolidated financial statements of the acquirer.

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Business combinations achieved in stages

55 A business combination in which an acquirer holds a non-controlling equity investment in the acquiree immediately before obtaining control of that acquiree is a business combination achieved in stages. This type of business combination is also commonly called a step acquisition.

56 As described in paragraph 21(b), for the purposes of applying the acquisition method, the fair value of the consideration transferred by the acquirer includes the acquisition-date fair value of any non-controlling equity investment in the acquiree that the acquirer owned immediately before the acquisition date. In a business combination achieved in stages, the acquirer shall remeasure its non-controlling equity investment in the acquiree at fair value as of the acquisition date and recognise any gain or loss in profit or loss. If, before the business combination, the acquirer recognised changes in the value of its non-controlling equity investment directly in equity (for example, the investment was designated as available for sale), the amount that was recognised directly in equity shall be reclassified and included in the calculation of any gain or loss as of the acquisition date.

57 Once an acquirer has obtained control of an acquiree, subsequent acquisitions (or dispositions) of any non-controlling interests in the acquiree shall be accounted for as equity transactions in accordance with [draft] IAS 27.

Business combinations in which the acquirer holds less than 100 per cent of the equity interests in the acquiree at the acquisition date

58 In a business combination in which the acquirer holds less than 100 per cent of the equity interests in the acquiree at the acquisition date, the acquirer shall:

(a) recognise identifiable assets acquired and liabilities assumed at their acquisition date values measured in accordance with paragraphs 28-48.

(b) recognise goodwill at the amount measured in accordance with paragraph 49.

(c) allocate the amount of goodwill determined in accordance with paragraph 49 to the acquirer and the non-controlling interest. Paragraphs A62 and A63 provide additional guidance for

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allocating goodwill between the acquirer and the non-controlling interest.

(d) measure and recognise the non-controlling interest as the sum of the non-controlling interest's proportional interest in the identifiable assets acquired and liabilities assumed plus the non-controlling interest's share of goodwill, if any.

Business combinations in which the consideration transferred for the acquirer's interest in the acquiree is less than the fair value of that interest

59 In rare circumstances, the acquisition-date fair value of the acquirer's interest in the acquiree exceeds the fair value of the consideration transferred for that interest (as might be the case, for example, in a business combination that is a forced sale in which the seller is acting under compulsion). This type of business combination is referred to in this [draft] IFRS as a bargain purchase. However, this type of business combination may occur also because of the requirements in paragraphs 43-48 to measure and recognise particular assets acquired or liabilities assumed in accordance with other [draft] IFRSs rather than at fair value.

60 If the fair value of the acquirer's interest in the acquiree is initially determined to exceed the fair value of the consideration transferred for that interest, the acquirer shall assess whether it has correctly identified all assets acquired and liabilities assumed and shall review the procedures used to measure and remeasure, if necessary, all of the following:

(a) the acquisition-date fair value of the acquiree

(b) the acquisition-date fair value of the acquirer's interest in the acquiree

(c) the acquisition-date fair value of the consideration transferred

(d) the acquisition-date values of the identifiable assets acquired and liabilities assumed recognised in accordance with the requirements of this [draft] IFRS.

The objective of this review is to ensure that appropriate consideration has been given to all available information in performing the measurements.

61 If, after performing any remeasurements required by paragraph 60, the fair value of the acquirer's interest in the acquiree still exceeds the fair value of the consideration transferred for that interest, the acquirer shall account for that excess by reducing the amount of goodwill that

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otherwise would be recognised in accordance with paragraph 49. If the goodwill related to that business combination is reduced to zero, any remaining excess shall be recognised as a gain attributable to the acquirer on the acquisition date. Paragraphs A64-A70 provide additional guidance and examples for applying this requirement.

Measurement period

62 **The measurement period is the period after the acquisition date during which the acquirer may adjust the provisional amounts recognised at the acquisition date in accounting for a business combination. The measurement period provides the acquirer a reasonable time to obtain the information necessary to identify and measure the following:**

- **(a) the acquisition-date fair value of the acquiree**
- **(b) the acquisition-date fair value of the acquirer's interest in the acquiree**
- **(c) the acquisition-date fair value of the consideration transferred for the acquiree**
- **(d) the acquisition-date values of the assets acquired and liabilities assumed recognised in accordance with the requirements of this [draft] IFRS.**

63 If any of those measurements can be determined only provisionally by the end of the reporting period in which the business combination occurs, the acquirer shall report those provisional amounts in its financial statements.

64 During the measurement period, the acquirer shall adjust the provisional amounts recognised at the acquisition date to reflect any new information obtained about facts and circumstances that existed as of the acquisition date and, if known, would have affected the measurement of the amounts recognised as of that date. During the measurement period, the acquirer also shall recognise additional assets or liabilities if new information is obtained about facts and circumstances that existed as of the acquisition date and, if known, would have resulted in the recognition of those assets and liabilities as of that date.

65 The measurement period ends as soon as the acquirer receives the necessary information about facts and circumstances that existed as of the acquisition date or learns that the information is not obtainable. However, the measurement period shall not exceed one year from the acquisition date.

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66 Generally, adjustments to the provisional amounts recognised for identifiable assets and liabilities during the measurement period are recognised through an offsetting adjustment to goodwill. However, the offsetting adjustment (or part of the offsetting adjustment) may be to an asset or liability other than goodwill. For example, assume that an acquirer's contingent consideration obligation is directly related to the value of an acquired intangible asset and, during the measurement period, the acquirer obtains new information about the fair value of that intangible asset as of the acquisition date. In this case, the adjustment to the provisional amount recognised for that asset may be offset (or partially offset) by a corresponding adjustment to the provisional amount recognised for the contingent consideration liability.

67 The acquirer shall recognise any adjustments to the provisional values during the measurement period as if the accounting for the business combination had been completed at the acquisition date. Thus, comparative information for prior periods presented in financial statements shall be adjusted, including any change in depreciation, amortisation, or other profit or loss effect recognised as a result of completing the initial accounting. Paragraphs A71-A86 provide additional guidance and illustrative examples for applying the measurement period requirements.

68 After the end of the measurement period, the accounting for a business combination shall be restated only to correct an error in accordance with IAS 8.

Assessing what is part of the exchange for the acquiree

69 The acquirer shall assess whether any portion of the transaction price (payments or other arrangements) and any assets acquired or liabilities assumed or incurred are not part of the exchange for the acquiree. Only the consideration transferred and the assets acquired or liabilities assumed or incurred that are part of the exchange for the acquiree shall be included in the business combination accounting. Any portion of the transaction price or any assets acquired or liabilities assumed or incurred that are not part of the exchange for the acquiree shall be accounted for separately from the business combination.

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70 Examples of payments or other arrangements that are not part of the exchange for the acquiree include:

(a) payments that effectively settle pre-existing relationships between the acquirer and acquiree (see paragraphs A91-A97).

(b) payments to compensate employees or former owners of the acquiree for future services (see paragraphs A98-A101).

(c) payments to reimburse the acquiree or its former owners for paying the acquirer's costs incurred in connection with the business combination.

Paragraphs A87-A109 provide guidance for assessing whether a portion of the transaction price and any assets and liabilities are not part of the exchange for the acquiree.

DISCLOSURES

71 The acquirer shall disclose information that enables users of its financial statements to evaluate the nature and financial effect of business combinations that occur:

(a) during the reporting period; and

(b) after the balance sheet date but before the financial statements are authorised for issue.

72 To meet the objective in paragraph 71, the acquirer shall disclose the following information for each material business combination that occurs during the reporting period:

(a) the name and a description of the acquiree.

(b) the acquisition date.

(c) the percentage of voting equity instruments acquired.

(d) the primary reasons for the business combination, including a description of the factors that contributed to the recognition of goodwill.

(e) the acquisition-date fair value of the acquiree and the basis for measuring that value.

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(f) the acquisition-date fair value of the consideration transferred, including the fair value of each major class of consideration, such as:

(1) cash

(2 other tangible or intangible assets, including a business or subsidiary of the acquirer

(3 contingent consideration

(4) debt instruments

(5) equity or member interests of the acquirer, including the number of instruments or interests issued or issuable, and the method of determining the fair value of those instruments or interests

(6 the acquirer's previously acquired non-controlling equity investment in the acquiree in a business combination achieved in stages.

(g) the amounts recognised as of the acquisition date for each major class of assets acquired and liabilities assumed in the form of a condensed balance sheet (see paragraph A110).

(h) the maximum potential amount of future payments (undiscounted) the acquirer could be required to make under the terms of the acquisition agreement. If there is no limitation on the maximum potential amount of future payments, that fact shall be disclosed.

(i) in a business combination in which the consideration transferred for the acquiree is less than fair value, the amount of any gain recognised in accordance with paragraph 61, the line item in the income statement in which the gain is recognised, and a description of the reasons why the acquirer was able to achieve a gain.

(j) in a business combination achieved in stages, the amount of any gain or loss recognised in accordance with paragraph 56 and the line item in the income statement in which that gain or loss is recognised.

(k) in a business combination in which the acquirer and acquiree have a pre-existing relationship:

(1) the nature of the pre-existing relationship.

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(2) the measurement of the settlement amount of the pre-existing relationship, if any, and the valuation method used to determine the settlement amount.

(3) the amount of any settlement gain or loss recognised and the line item in the income statement in which that gain or loss is recognised.

(l) the amount of costs incurred in connection with the business combination, the amount recognised as an expense and the line item or items in the income statement in which those expenses are recognised.

73 The acquirer also shall disclose the information required by:

(a) paragraphs 72(e)-(l) in aggregate for individually immaterial business combinations that are material collectively.

(b) paragraph 72 if a material business combination is completed after the balance sheet date but before the financial statements are authorised for issue unless disclosure of any of the information is impracticable. If disclosure of any of the information required by paragraph 72 is impracticable, that fact and the reasons shall be disclosed.

74 An acquirer shall also disclose the following information for each material business combination that occurs during the reporting period or in the aggregate for individually immaterial business combinations that are material collectively and occur during the reporting period:

(a) the amounts of revenue and profit or loss of the acquiree since the acquisition date that are included in the consolidated income statement for the reporting period.

(b) the following information:

(1) the revenue and profit or loss of the combined entity for the current reporting period as though the acquisition date for all business combinations that occurred during the year had been as of the beginning of the annual reporting period.

(2) *Not used.*

If disclosure of any of the information required by this paragraph is impracticable, that fact and the reasons shall be disclosed.

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75 The acquirer shall disclose information that enables users of its financial statements to evaluate the financial effects of adjustments recognised in the current reporting period relating to business combinations that were effected in the current or previous reporting periods.

76 To meet the objective in paragraph 75, the acquirer shall disclose the following information for each material business combination or in the aggregate for individually immaterial business combinations that are material collectively:

(a) if the amounts recognised in the financial statements for the business combination have been determined only provisionally:

(1) the reasons why the initial accounting for the business combination is not complete.

(2) the assets acquired or the liabilities assumed for which the measurement period is still open.

(3) the nature and amount of any measurement period adjustments recognised during the reporting period.

(b) a reconciliation of the beginning and ending balances of liabilities for contingent consideration and contingencies that are required to be remeasured to fair value after initial recognition in accordance with paragraphs 26(b)(2) and 36, showing separately the changes in fair value during the reporting period and amounts paid or otherwise settled in accordance with IAS 37 and IAS 39.

(c) a description of the discrete event or circumstance that occurred after the acquisition date that resulted in deferred tax assets acquired as part of the business combination being recognised as income within 12 months after the acquisition date (see paragraph 86).

(d) the amount and an explanation of any gain or loss recognised in the current reporting period that both:

(1) relates to the identifiable assets acquired or liabilities assumed in a business combination that was effected in the current or a previous reporting period, and

(2) is of such a size, nature, or incidence that disclosure is relevant to understanding the combined entity's financial statements.

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77 The acquirer shall disclose information that enables users of its financial statements to evaluate changes in the carrying amount of goodwill during the reporting period.

78 To meet the objective in paragraph 77, if the total amount of goodwill is significant in relation to the fair value of the acquiree, the acquirer shall disclose the following information for each material business combination that occurs during the reporting period:

(a) the total amount of goodwill and the amount that is expected to be deductible for tax purposes.

(b) *Not used.*

79 The acquirer also shall disclose the information required by paragraph 78:

(a) in aggregate for individually immaterial business combinations that are material collectively.

(b) if a material business combination is completed after the balance sheet date but before the financial statements are authorised for issue unless such disclosure is impracticable. If disclosure of any of the information required by paragraph 78 is impracticable, that fact and the reasons shall be disclosed.

80 The acquirer shall disclose a reconciliation of the carrying amount of goodwill at the beginning and end of the reporting period, showing separately:

(a) the gross amount and accumulated impairment losses at the beginning of the reporting period.

(b) additional goodwill recognised during the reporting period, except goodwill included in a disposal group that, on acquisition, meets the criteria to be classified as held for sale in accordance with IFRS 5.

(c) adjustments resulting from the subsequent recognition of deferred tax assets during the reporting period in accordance with paragraph 86.

(d) goodwill included in a disposal group classified as held for sale in accordance with IFRS 5 and goodwill derecognised during the reporting period without having previously been included in a disposal group classified as held for sale.

(e) impairment losses recognised during the reporting period in accordance with IAS 36. (IAS 36 requires disclosure of

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information about the recoverable amount and impairment of goodwill in addition to this requirement.)

(f) net exchange differences arising during the reporting period in accordance with IAS 21 *The Effects of Changes in Foreign Exchange Rates*.

(g) any other changes in the carrying amount during the reporting period.

(h) the gross amount and accumulated impairment losses at the end of the reporting period.

81 If the specific disclosures required by this and other IFRSs do not meet the objectives set out in paragraphs 71, 75, or 77, the acquirer shall disclose any additional information necessary to meet those objectives.

EFFECTIVE DATE AND TRANSITION

82 This [draft] IFRS shall apply prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual period beginning on or after 1 January 2007. Earlier application is encouraged. However, this [draft] IFRS shall be applied only at the beginning of an annual period that begins on or after this [draft] IFRS is issued. If this [draft] IFRS is applied before the effective date, that fact shall be disclosed and [draft] IAS 27 (revised 200X) and [draft] IAS 37 (revised 200X) shall be applied at the same time.

83 Except as provided in paragraphs 86 and 87, assets and liabilities that arose from business combinations whose acquisition dates preceded the application of this [draft] IFRS shall not be adjusted upon application of this [draft] IFRS.

84 Entities that have not applied IAS 36 and IAS 38 shall apply those [draft] IFRSs at the same time as they apply this IFRS.

85 Entities, such as mutual entities, that have not applied IFRS 3 and have had one or more business combinations that were accounted for using the purchase method shall apply the transitional provisions in paragraphs C11 and C12.

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Subsequent recognition of acquired deferred tax benefits

86 For the recognition of deferred tax assets acquired in a business combination in which the acquisition date was before this [draft] IFRS is applied:

(a) the acquirer shall apply the requirements of paragraph 68 of IAS 12, as amended by paragraph D4 of this [draft] IFRS, prospectively. Therefore, an acquirer shall not adjust the accounting for prior business combinations if tax benefits failed to satisfy the criteria for separate recognition as of the acquisition date and are recognised after the acquisition date, unless the rebuttable presumption in paragraph 68 of IAS 12 applies.

(b) the acquirer shall credit tax benefits recognised more than one year after the acquisition date to profit or loss or, if IAS 12 so requires, to equity.

Previously recognised contingent liabilities

87 Any contingent liability recognised relating to a business combination for which the acquisition date was before this [draft] IFRS is applied shall be assessed to determine whether it satisfies the definition of a liability (see [draft] IAS 37 (revised 200X)). If not, any recognised amount shall be derecognised with an offsetting adjustment to any goodwill that arose from that business combination. The adjustment to goodwill is limited to the lesser of the carrying amount of goodwill or the amount originally recognised at the acquisition date for the contingent liability. Any remaining recognised amount (that is, any balance in excess of the carrying amount of goodwill that arose in that business combination and any changes in the measurement of the contingent liability after the acquisition date) shall be derecognised as an adjustment to the opening balance of retained earnings.

WITHDRAWAL OF OTHER PRONOUNCEMENTS

88 This [draft] IFRS supersedes IFRS 3 (as issued in 2004).

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Appendix A

Application guidance

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Appendix A

Application guidance

This appendix is an integral part of the [draft] IFRS.

INTRODUCTION

A1 This appendix discusses generalised situations and provides examples that incorporate simplified assumptions to illustrate how to apply some of the provisions of this [draft] IFRS.

Definition of a business (application of paragraph 3(d))

A2 A *business* is defined as an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing either (a) a return to investors or (b) dividends, lower costs, or other economic benefits directly and proportionately to owners, members, or participants (paragraph 3(d)). 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. The three elements of a business are defined as follows:

(a) *Input*: Any economic resource that creates or has the ability to create outputs when one or more processes are applied to it. Examples include long-lived assets (including intangible assets or rights to use long-lived assets), intellectual property, ability to obtain access to necessary materials or rights, and employees.

(b) *Process*: Any system, standard, protocol, convention or rule that when applied to an input, or inputs, creates or has the ability to create outputs. Examples include strategic management processes, operational processes, and resource management processes. These processes typically are documented; however, an organised workforce having the necessary skills and experience following rules and conventions may provide the necessary processes that are capable of being applied to inputs to create outputs. (Accounting, billing, payroll, and other administrative systems typically are not processes that are used to create outputs.)

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(c) *Output*: The result of inputs and processes applied to those inputs that provide or have the ability to provide a return to investors or dividends, lower costs, or other economic benefits directly and proportionately to owners, members or participants.

A3 To be capable of being conducted and managed for the purposes defined, an integrated set of activities and assets requires two essential elements—inputs and processes applied to those inputs, which together are or will be used to create outputs. However, a business need not include all of the inputs or processes that the seller used in operating that business if a willing party is capable of acquiring the business and continuing to produce outputs, for example, by integrating the business with its own inputs and processes. Paragraph E4 of Appendix E states that willing parties are 'presumed to be marketplace participants representing unrelated buyers and sellers that are (a) knowledgeable, having a common level of understanding about factors relevant to the asset or liability and the transaction, and (b) willing and able to transact in the same market(s), having the legal and financial ability to do so.'

A4 The nature of the elements of a business varies by industry and by the structure of an entity's operations (activities), including the entity's stage of development. Established businesses often have many, and different, kinds of inputs, processes, and outputs, whereas new businesses often have few inputs and processes, and sometimes only a single output (product). Nearly all businesses also have liabilities, but a business need not have any liabilities.

A5 An integrated set of activities and assets in the development stage may not have outputs. In that case, other factors should be assessed to determine whether the set is a business. Those factors would include whether the set:

(a) has begun planned principal activities;

(b) has employees, intellectual property, and other inputs and processes that could be applied to those inputs;

(c) is pursuing a plan to produce outputs; or

(d) has the ability to obtain access to customers that will purchase the outputs.

A6 The determination of whether a particular set of assets and activities is a business should be based on whether the integrated set is capable of being conducted and managed as a business by a willing acquirer. Thus, in evaluating whether a particular set is a business, it is not relevant

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whether a seller operated the set as a business or whether the acquirer intends to operate the set as a business.

A7 If goodwill is present in a particular set of assets and activities then in the absence of evidence to the contrary the set shall be presumed to be a business. However, a business need not have goodwill.

Measuring the fair value of the acquiree (application of paragraphs 19–27)

A8 As noted in paragraph 19, the acquirer is required to measure the fair value of the acquiree, as a whole, as of the acquisition date. The objective of measuring the fair value of the acquiree is to estimate the price at which 100 per cent of the acquiree could be exchanged in a current transaction between knowledgeable, unrelated willing parties when neither party is acting under compulsion.

Measuring the fair value of the acquiree using the consideration transferred

A9 In the absence of evidence to the contrary, the acquisition-date fair value of the consideration transferred is presumed to be the best basis for measuring the fair value of the acquirer's interest in the acquiree on that date.

A10 In a business combination between willing parties in which the acquirer purchases 100 per cent of the equity interests or net assets that constitute a business (an acquiree), the fair value of the consideration transferred usually is more clearly evident and reliably measurable than the fair value of the acquiree in the absence of evidence to the contrary. Therefore, the acquirer usually should use the acquisition-date fair value of the consideration transferred in exchange for the acquiree to measure the fair value of the acquiree on that date.

A11 If the acquirer purchases less than 100 per cent of the equity interests of an acquiree on the acquisition date (either in a single transaction or in multiple transactions), the acquisition-date fair value of the consideration transferred is usually the best basis for measuring the fair value of the acquirer's interest in the acquiree on that date. However, the consideration transferred by itself is most likely not to be representative of the fair value of the acquiree as a whole. The following examples illustrate how the fair value of consideration transferred for less than 100 per cent

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of the equity interests of an acquiree, together with other available information, might be used to estimate the fair value of the acquiree as a whole.

Example 1
Acquisition of less than 100 per cent of the equity interests of an acquiree

A12 Acquirer Company (AC) offers to purchase all of the 10 million outstanding shares of Target Company (TC) for CU10.00 per share, provided that at least 80 per cent of TC's shares are tendered. Shares of TC are publicly traded and widely dispersed. On the acquisition date, 90 per cent of TC's shares are tendered and acquired by AC for CU90 million. In the week before the announcement of the offer, TC's shares were trading at CU8.85–CU9.15 per share. During the first week after the acquisition date, the remaining 1 million outstanding shares of TC continue to trade with significantly lower volume and greater volatility (at prices ranging from CU8.50 to CU13.00 per share).

A13 In this example, the consideration transferred by AC for 90 per cent of the equity interests of TC is determined to be the best basis for estimating the fair value of TC as CU100 million (10 million shares × CU10.00). First, there is no evidence to suggest that the price of CU10.00 per share exchanged for the 90 per cent interest is not representative of the price that knowledgeable, unrelated willing parties would pay at the acquisition date in exchange for a 100 per cent ownership interest in TC. In fact, AC offered to pay CU10.00 for all of the outstanding shares. Second, because the shares were widely dispersed, there is no evidence that it would be necessary to pay an amount other than CU10.00 per share to obtain 100 per cent of the shares.

Example 2
Acquisition of less than 100 per cent of the equity interests of an acquiree in a business combination achieved in stages

A14 Assume the same facts as in paragraph A12, except that AC owns 100,000 shares (1 per cent) of TC that it originally purchased at CU8.50 per share. The shares are classified as available-for-sale securities and carried at fair value. For the reasons described in paragraph A13, the amount paid (CU10.00 per share) to obtain a 90 per cent interest (an additional 8.9 million shares) continues to be the best basis for measuring the fair value of TC as CU100 million. However, consistently

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with the provisions of paragraph 56, AC recognises a gain of CU150,000 [(CU10.00–CU8.50) × 100,000 shares] on its original 1 per cent non-controlling equity investment in profit or loss. The carrying amount of CU1 million for that 1 per cent investment, like the CU89 million investment for the 8.9 million shares acquired, is eliminated in consolidation.

Example 3
Acquisition of less than 100 per cent of the equity interests of an acquiree with evidence of a control premium

A15 Assume that a single Founding Shareholder (FS) owns 60 per cent of TC's shares, and the remaining 40 per cent of TC's 10 million shares are widely dispersed and have been publicly trading in the CU9.85–CU10.15 range. Also assume that FS desires to sell its controlling 60 per cent interest in TC, and, on the basis of its knowledge of the industry, FS identifies AC as the highest bidder if FS was interested in making TC available for sale to all potential buyers. Following private negotiations, AC buys all of FS's holdings in TC for CU81 million (CU13.50 per share), a premium of about CU3.50 per share over the market price of the publicly traded non-controlling shares on the acquisition date. During the first week following the acquisition, the non-controlling shares of TC traded in a range of CU8.50–CU13.00. AC willingly paid a premium over the market price of the publicly traded shares on the basis of its assessment that:

(a) TC, as a whole, would be worth between CU110 million and CU130 million to other marketplace participants (based on market comparisons of companies similar to TC and its best estimate as to the likely synergies that those marketplace participants might be able to achieve).

(b) AC can extract synergies similar to those of other marketplace participants, as well as generate additional savings by making proprietary technology available to TC.

A16 At issue is whether the consideration transferred by AC for the less than 100 per cent equity interest, by itself, can be presumed to provide the best basis for measuring the fair value of TC (ie the fair value that knowledgeable, unrelated willing parties would exchange for a 100 per cent equity interest in TC).

A17 In this example, AC has information that suggests that CU135 million is not necessarily representative of the amount that other knowledgeable, unrelated willing parties would pay for TC as a whole. Moreover, the

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market prices for the non-controlling shares at the acquisition date (CU9.85–CU10.15 per share) and during the first week following the acquisition (CU8.50–CU13.00) suggest that CU13.50 per share is not representative of the fair value of TC, as a whole. In this case, the fair value of TC may be estimated on a preliminary basis to be CU121 million based on (a) the CU81 million paid for the controlling 60 per cent interest plus CU40 million for the value of the non-controlling shares (4 million × CU10.00) and (b) the fact that CU121 million falls within the CU110 million–CU130 million range used in AC's preliminary assessments of the value of TC. However, before AC concludes that CU121 million is its best estimate of the fair value of TC, consistently with the objective of measuring the fair value for 100 per cent of the equity interests in the acquiree and with the guidance in Appendix E, AC should refine its initial estimate of fair value using other relevant valuation techniques, as appropriate. Thus, AC might refine its preliminary assessment of the fair value of TC using, for example, the market and income approaches discussed in paragraphs A20–A23.

Measuring the fair value of the acquiree using valuation techniques

A18 In some circumstances, the measurement of the fair value of the acquiree should not be based on the consideration transferred. These circumstances include the following:

(a) The acquirer does not transfer any consideration on the acquisition date (for example, a business combination in which an entity (the acquiree) repurchases its own shares and, as a result, an existing investor (the acquirer) obtains control of that entity).

(b) There is evidence that the transaction is not an exchange of equal values by willing parties (for example, a business combination in which the seller is acting under duress).

(c) The fair value of the total consideration transferred is not more reliably measurable than the fair value of the acquiree (for example, a business combination in which two private business entities or two mutual entities combine through an exchange of equity or member interests and the fair value of the acquiree is more clearly evident and, thus, more reliably measurable than the fair value of the equity or member interests transferred by the acquirer).

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A19 When the measurement of the fair value of the acquiree is not based on the consideration transferred, that measurement should be based on observable prices for a business that is similar to the acquiree, if such information is available. Otherwise, fair value should be estimated using multiple techniques that are relevant and for which reliable data are available. The results of the multiple techniques would then be evaluated considering the relevance and reliability of the inputs used to estimate the fair value of the acquiree. The techniques applied and evaluated might be the market approach, the income approach, or several variations of each on the basis of the relevance of the approach and the extent of the available data.

Market approach

A20 In applying the market approach, the basic steps are (a) define and assess the available marketplace data (and adjust, if necessary) to derive one or more valuation ratios and (b) apply the appropriate valuation ratios to the acquiree. As applied to measuring the fair value of a business for the purposes of applying this [draft] IFRS, the market approach typically is based on prices of publicly traded equity shares or prices in other business combinations involving comparable businesses for which the terms of the arrangements are disclosed. Identifying comparable businesses requires judgements about the degree to which operational, market, financial and non-financial factors are similar between the acquiree and comparable businesses. Factors to be considered in making this assessment might include products and services (operational factors); markets served, competitors, and position within the industry (market factors); capital structure and historical and forecast financial performance (financial factors); and the depth of management, the expertise of personnel, and the maturity of the business (non-financial factors). Other factors might be considered, depending on the nature of the business being valued.

A21 Ideally, marketplace data are based on other entities within the same industry. In the absence of that information, marketplace data might be based on economically similar businesses. Thus, the degree of comparability between other businesses and the acquiree varies and it may be necessary to adjust the valuation ratios to reflect differences. Such adjustments should be consistent with the objective of measuring fair value.

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Income approach

A22 In applying an income approach, the basic steps involve estimating the value of future cash flows or other income-related valuation measures such as residual income profit or loss. Paragraph E6(b) summarises key aspects of the income approach and states:

> The income approach uses valuation techniques to convert future amounts (for example, cash flows or earnings) to a single present amount (discounted). The estimate of fair value is based on the value indicated by marketplace expectations about those future amounts.

A23 Appendix A of IAS 36 discusses the use of present value techniques to estimate value in use. If an entity estimates fair value using such present value techniques, inputs should be consistent with the objective of measuring fair value rather than value in use.

Special considerations in applying the market and income approaches to mutual entities

A24 When two mutual entities combine, the fair value of the acquiree may be more reliably measurable than the fair value of member interests transferred by the acquirer. In a business combination involving only mutual entities in which the only consideration is an exchange of the acquirer's member interests for the acquiree's member interests, the fair value of the acquiree and the fair value of the member interests exchanged as consideration are presumed to be equal.

A25 Mutual entities, although similar in many ways to other businesses, have distinct characteristics that arise primarily because the members of a mutual entity are both customers and owners. Members of mutual entities generally expect to receive benefits for their membership, often in the form of reduced fees charged for goods and services or patronage dividends. The portion of patronage dividends allocated to each member is often based on the amount of business the member did with the mutual entity during the year.

A26 A fair value measurement of a mutual entity should include the assumptions that marketplace participants would make about future member benefits as well as any other relevant assumptions marketplace participants would make about the mutual entity. For example, in determining the fair value of a mutual entity, an estimated cash flow model may be used. In that case, the cash flows should be based on the

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expected cash flows of the mutual entity, which are likely to include adjustments for member benefits, such as the cost of reduced fees charged for goods and services.

INTANGIBLE ASSETS (APPLICATION OF PARAGRAPHS 40 AND 41)

Research and development assets

A27 An acquirer recognises and measures the acquisition-date fair value of all identifiable intangible assets acquired in a business combination that are used in research and development activities. After initial recognition, the provisions of IAS 38 *Intangible Assets* apply.

Recognition of intangible assets separately from goodwill

A28 In accordance with paragraph 40, the acquirer recognises separately from goodwill the acquisition-date fair value of intangible assets acquired in a business combination that meet the definition of an intangible asset in IAS 38, which requires the asset to be identifiable. An intangible asset is identifiable if it arises from contractual or other legal rights (the contractual-legal criterion) or is separable (separability criterion). Intangible assets that meet the contractual-legal criterion are identifiable even if the asset is not transferable or separable from the acquiree or from other rights and obligations. For example:

(a) An acquiree leases a manufacturing facility under an operating lease that has terms that are favourable relative to market prices. The lease terms explicitly prohibit transfer of the lease (through either sale or sublease). The amount by which the lease terms are favourable relative to market prices is an intangible asset that meets the contractual-legal criterion for recognition separately from goodwill, even though the lease contract cannot be sold or otherwise transferred.

(b) An acquiree owns and operates a nuclear power plant. The licence to operate that power plant is an intangible asset that meets the contractual-legal criterion for recognition separately from goodwill, even if it cannot be sold or transferred apart from the acquired power plant. An acquirer may recognise the fair

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value of the operating licence and the fair value of the power plant as a single asset for financial reporting purposes if the useful lives of those assets are similar.

(c) An acquiree owns a technology patent. It has licensed that patent to others for their exclusive use outside the United States in exchange for which the acquired business receives a specified percentage of future non-US revenue. Both the technology patent and the related licence agreement meet the contractual-legal criterion for recognition separately from goodwill even if selling or exchanging the patent and the related licence agreement apart from one another would not be practical.

A29 The separability criterion means that the acquired intangible asset is capable of being separated or divided from the acquiree and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, asset, or liability. Exchange transactions provide evidence that an intangible asset is separable from the acquiree and might provide information that can be used to estimate its fair value. An acquired intangible asset meets the separability criterion if there is evidence of exchange transactions for that type of asset or an asset of a similar type (even if those exchange transactions are infrequent and regardless of whether the acquirer is involved in them). For example, customer and subscriber lists are frequently licensed and thus meet the separability criterion. Even if an acquiree believes its customer lists have different characteristics from other customer lists, the fact that customer lists are frequently licensed generally means that the acquired customer list meets the separability criterion.

A30 An intangible asset that meets the separability criterion should be recognised separately from goodwill even if the acquirer does not intend to sell, license, or otherwise exchange that asset. The separability criterion is met because the asset is capable of being separated from the acquiree or combined entity and sold, transferred, licensed, rented or otherwise exchanged for something else of value. For example, because an acquired customer list is generally capable of being licensed, it meets the separability criterion regardless of whether the acquirer intends to license it.

A31 An intangible asset that is not separable from the acquiree or combined entity individually meets the separability criterion if it is separable in combination with a related contract, asset or liability. For example:

(a) Deposit liabilities and related depositor relationship intangible assets are exchanged in observable exchange transactions.

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Therefore, the depositor relationship intangible asset should be recognised separately from goodwill.

(b) An acquiree owns a registered trademark, a related secret formula, and unpatented technical expertise used to manufacture the trademarked product. To transfer ownership of a trademark, the owner is also required to transfer everything else necessary for the new owner to produce a product or service indistinguishable from that produced by the former owner. Because the unpatented technical expertise must be separated from the acquiree or combined entity and sold if the related trademark is sold, it meets the separability criterion.

A32 An acquirer subsumes into goodwill the value of any acquired intangible asset that is not identifiable as of the acquisition date. For example, an acquirer may attribute value to the potential contracts the acquiree is negotiating with prospective new customers at the acquisition date. Because those potential contracts are not identifiable intangible assets at the acquisition date, they are not recognised separately from goodwill. The value of those contracts should not be reclassified from goodwill for events that occur after the acquisition date. However, the acquirer should assess the facts and circumstances surrounding events occurring shortly after the acquisition to determine whether a separately recognisable intangible asset existed at the acquisition date.

A33 After initial recognition, intangible assets acquired in a business combination are accounted for in accordance with the provisions of IAS 38. However, as described in paragraph 3 of IAS 38, the accounting for some acquired intangible assets after initial recognition is prescribed by other IFRSs.

A34 The identifiability criterion is used to determine whether an intangible asset should be recognised separately from goodwill. It does not provide guidance for measuring the fair value of an intangible asset. That criterion does not restrict the assumptions used in estimating the fair value of an intangible asset. For example, assumptions that marketplace participants would consider, such as expectations of future contract renewals, are considered in arriving at a fair value measurement even though those renewals do not meet the identifiability criterion.

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Examples of intangible assets that are identifiable

A35 The following are examples of identifiable intangible assets acquired in a business combination. Some of the examples may have characteristics of assets other than intangible assets. Accordingly, those assets should be accounted for on the basis of their substance. These examples are not intended to be all-inclusive.

A36 Intangible assets designated with the symbol # are those that arise from contractual or other legal rights. Those designated with the symbol * do not arise from contractual or other legal rights, but are separable. Intangible assets designated with the symbol # might also be separable; however, separability is not a necessary condition for the asset to meet the contractual-legal criterion.

Marketing-related intangible assets

A37 Marketing-related intangible assets are those assets that are primarily used in the marketing or promotion of products or services. Examples of marketing-related intangible assets are:

(a) trademarks, trade names, service marks, collective marks, certification marks #

(b) trade dress (unique colour, shape, or package design) #

(c) newspaper mastheads #

(d) Internet domain names #

(e) non-competition agreements #.

Trademarks, trade names, service marks, collective marks, and certification marks

A38 Trademarks are words, names, symbols, or other devices used in trade to indicate the source of a product and to distinguish it from the products of others. A service mark identifies and distinguishes the source of a service rather than a product. Collective marks are used to identify the goods or services of members of a group. Certification marks are used to certify the geographical origin or other characteristics of a good or service.

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A39 Trademarks, trade names, service marks, collective marks, and certification marks may be protected legally through registration with governmental agencies, continuous use in commerce, or by other means. Provided it is protected legally through registration or other means, a trademark or other mark acquired in a business combination is an intangible asset that meets the contractual-legal criterion. Otherwise, a trademark or other mark acquired in a business combination can be recognised separately from goodwill provided the separability criterion is met, which would normally be the case.

A40 The terms brand and brand name are often used as synonyms for trademarks and other marks. However, the former are general marketing terms that are typically used to refer to a group of complementary assets such as a trademark (or service mark) and its related trade name, formulas, recipes, and technological expertise. An entity is not precluded from recognising, as a single asset apart from goodwill, a group of complementary intangible assets commonly referred to as a brand if the assets that make up that group have similar useful lives.

Internet domain names #

A41 An Internet domain name is a unique alphanumeric name that is used to identify a particular numeric Internet address. Registration of a domain name creates an association between that name and a designated computer on the Internet for the period of the registration. Those registrations are renewable. A registered domain name acquired in a business combination meets the contractual-legal criterion.

Customer-related intangible assets

A42 Examples of customer-related intangible assets are:

(a) customer lists *

(b) order or production backlog #

(c) customer contracts and related customer relationships #

(d) non-contractual customer relationships *.

Customer lists *

A43 A customer list consists of information about customers, such as their names and contact information. A customer list also may be in the form of a database that includes other information about the customers, such

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as their order histories and demographic information. A customer list does not generally arise from contractual or other legal rights. However, customer lists are frequently leased or exchanged. Therefore, a customer list acquired in a business combination normally meets the separability criterion. However, a customer list acquired in a business combination would not meet the separability criterion if the terms of confidentiality or other agreements prohibit an entity from selling, leasing or otherwise exchanging information about its customers.

Order or production backlog #

A44 An order or production backlog arises from contracts such as purchase or sales orders. An order or production backlog acquired in a business combination meets the contractual-legal criterion, even if the purchase or sales orders are cancellable.

Customer contracts and the related customer relationships #

A45 If an entity establishes relationships with its customers through contracts, those customer relationships arise from contractual rights. Therefore, customer contracts and the related customer relationships acquired in a business combination meet the contractual-legal criterion. This will be the case even if confidentiality or other contractual terms prohibit the sale or transfer of a contract separately from the acquiree.

A46 A customer contract intangible asset and the related customer relationship intangible asset may represent two distinct intangible assets. Both the useful lives and the pattern in which the economic benefits of the two assets are consumed may differ.

A47 A customer relationship exists between an entity and its customer if (a) the entity has information about the customer and has regular contact with the customer and (b) the customer has the ability to make direct contact with the entity. Customer relationships meet the contractual-legal criterion when an entity has a practice of establishing contracts with its customers, regardless of whether a contract exists at the acquisition date. Customer relationships also may arise through means other than contracts, such as through regular contact by sales or service representatives. As noted in paragraph A44, an order or a production backlog arises from contracts such as purchase or sales orders, and therefore is also regarded as a contractual right. Consequently, if an entity has customer relationships with its customers through these types of contracts, the customer relationships also arise from contractual rights and, therefore, meet the contractual-legal criterion.

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Non-contractual customer relationships *

A48 If a customer relationship acquired in a business combination does not arise from a contract, the relationship may be separable. Exchange transactions for the same asset or a similar asset provide evidence of separability of a non-contractual customer relationship and might also provide information about exchange prices that should be considered when estimating fair value.

Examples illustrating customer contract and customer relationship intangible assets acquired in a business combination

A49 The following examples illustrate the recognition of customer contract and customer relationship intangible assets acquired in a business combination.

(a) AC acquires TC in a business combination on 31 December 20X5. TC has a five-year agreement to supply goods to Customer. Both TC and AC believe that Customer will renew the supply agreement at the end of the current contract. The supply agreement is not separable. The supply agreement, whether cancellable or not, meets the contractual-legal criterion. Additionally, because TC establishes its relationship with Customer through a contract, the customer relationship with Customer meets the contractual-legal criterion. In determining the fair value of the customer relationship, AC considers assumptions such as the expected renewal of the supply agreement.

(b) AC acquires TC in a business combination on 31 December 20X5. TC manufactures goods in two distinct lines of business: sporting goods and electronics. Customer purchases both sporting goods and electronics from TC. TC has a contract with Customer to be its exclusive provider of sporting goods. However, there is no contract for the supply of electronics to Customer. Both TC and AC believe only one overall customer relationship exists between TC and Customer.

The contract to be Customer's exclusive supplier of sporting goods, whether cancellable or not, meets the contractual-legal criterion. Additionally, because TC establishes its relationship with Customer through a contract, the customer relationship with Customer meets the contractual-legal criterion. Because there is only one customer relationship with Customer, the fair value of

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that relationship incorporates assumptions regarding TC’s relationship with Customer related to both sporting goods and electronics. However, if both AC and TC believe there were separate customer relationships with Customer—one for sporting goods and another for electronics—the customer relationship with respect to electronics would be assessed by AC to determine whether it meets the separability criterion for identification as an intangible asset.

(c) AC acquires TC in a business combination on 31 December 20X5. TC does business with its customers solely through purchase and sales orders. At 31 December 20X5, TC has a backlog of customer purchase orders from 60 per cent of its customers, all of whom are recurring customers. The other 40 per cent of TC's customers also are recurring customers. However, as of 31 December 20X5, TC does not have any open purchase orders or other contracts with those customers.

The purchase orders from 60 per cent of TC's customers, whether cancellable or not, meet the contractual-legal criterion. Additionally, because TC has established its relationship with 60 per cent of its customers through contracts, those customer relationships meet the contractual-legal criterion. Because TC has a practice of establishing contracts with the remaining 40 per cent of its customers, its relationship with those customers also arises through contractual rights and, therefore, meets the contractual-legal criterion, even though TC does not have contracts with those customers at 31 December 20X5.

(d) AC acquires TC, an insurer, in a business combination on 31 December 20X5. TC has a portfolio of one-year motor insurance contracts that are cancellable by policyholders. Annual renewal rates are reasonably predictable. Because TC establishes its relationships with policyholders through insurance contracts, the customer relationship with policyholders meets the contractual-legal criterion. In determining the fair value of the customer relationship intangible asset, AC considers estimates of renewals and cross-selling. IAS 36 *Impairment of Assets* and IAS 38 *Intangible Assets* apply to the customer relationship intangible asset.

In determining the fair value of the liability relating to the portfolio of insurance contracts, AC considers estimates of cancellations by policyholders. IFRS 4 *Insurance Contracts* permits, but does

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not require, an expanded presentation that splits the fair value of acquired insurance contracts into two components:

(1) a liability measured in accordance with the insurer's accounting policies for insurance contracts that it issues; and

(2) an intangible asset, representing the fair value of the contractual rights and obligations acquired, to the extent that the liability does not reflect that fair value. This intangible asset is excluded from the scope of IAS 36 and IAS 38. After the business combination, AC is required to measure that intangible asset on a basis consistent with the measurement of the related insurance liability.

Artistic-related intangible assets

A50 Examples of artistic-related intangible assets are:

(a) plays, operas, ballets #

(b) books, magazines, newspapers, other literary works #

(c) musical works such as compositions, song lyrics, advertising jingles #

(d) pictures, photographs #

(e) video and audiovisual material, including motion pictures or films, music videos, television programmes #.

A51 Artistic-related assets acquired in a business combination meet the identifiability criterion if they arise from contractual or legal rights such as those provided by copyright. Copyrights can be transferred either in whole through assignments or in part through licensing agreements. In determining the fair value of an intangible asset protected by copyright, an entity considers the existence of any assignments or licences of the acquired copyrights. An acquirer is not precluded from recognising a copyright intangible asset and any related assignments or licence agreements as a single asset, provided they have similar useful lives.

Contract-based intangible assets

A52 Contract-based intangible assets represent the value of rights that arise from contractual arrangements. Customer contracts are one particular type of contract-based intangible asset. If the terms of a contract give rise to a liability (which might be the case if the terms of an operating lease or

customer contract are unfavourable relative to market prices), that liability is recognised as a liability assumed. Examples of contract-based intangible assets are:

(a) licensing, royalty, standstill agreements #

(b) advertising, construction, management, service or supply contracts #

(c) lease agreements (whether the acquiree is the lessee or lessor) #

(d) construction permits #

(e) franchise agreements #

(f) operating and broadcast rights #

(g) servicing contracts such as mortgage servicing contracts #

(h) employment contracts #.

Servicing contracts such as mortgage servicing contracts #

A53 Contracts to service financial assets are one type of contract-based intangible asset. Although servicing is inherent in all financial assets, it becomes a distinct asset by one of the following:

(a) when contractually separated from the underlying financial asset by sale or securitisation of the assets with servicing retained; or

(b) through the separate purchase and assumption of the servicing.

A54 If mortgage loans, credit card receivables, or other financial assets are acquired in a business combination with servicing retained, the inherent servicing rights are not a separate intangible asset because the fair value of those servicing rights is included in the measurement of the fair value of the acquired financial asset.

Employment contracts #

A55 Employment contracts that are beneficial contracts from the perspective of the employer are one type of contract-based intangible asset because the pricing of those contracts is favourable relative to market prices.

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Technology-based intangible assets

A56 Examples of technology-based intangible assets are:

(a) patented technology #

(b) computer software and mask works #

(c) unpatented technology *

(d) databases, including title plants *

(e) trade secrets, such as secret formulas, processes, recipes #.

Computer software and mask works #

A57 If computer software and program formats acquired in a business combination are protected legally, such as by patent or copyright, they meet the contractual-legal criterion for identification as intangible assets.

A58 Mask works are software permanently stored on a read-only memory chip as a series of stencils or integrated circuitry. Mask works may have legal protection. Mask works with legal protection that are acquired in a business combination meet the contractual-legal criterion for identification as intangible assets.

Databases, including title plants *

A59 Databases are collections of information, often stored in electronic form (such as on computer disks or files). A database that includes original works of authorship may be entitled to copyright protection. If a database acquired in a business combination is protected by copyright, it meets the contractual-legal criterion. However, a database typically includes information created as a consequence of an entity's normal operations, such as customer lists, or specialised information such as scientific data or credit information. Databases that are not protected by copyright can be, and often are, exchanged, licensed or leased to others in their entirety or in part. Therefore, even if the future economic benefits from a database do not arise from legal rights, a database acquired in a business combination meets the separability criterion.

A60 Title plants constitute a historical record of all matters affecting title to parcels of land in a particular geographical area. Title plant assets are bought and sold in exchange transactions (either in whole or in part) or are licensed. Therefore, title plant assets acquired in a business combination meet the separability criterion.

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Trade secrets such as secret formulas, processes, recipes #

A61 A trade secret is 'information, including a formula, pattern, recipe, compilation, program, device, method, technique, or process that (1) derives independent economic value, actual or potential, from not being generally known and (2) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.[*] If the future economic benefits from a trade secret acquired in a business combination are legally protected, that asset meets the contractual-legal criterion. Otherwise, trade secrets acquired in a business combination are identifiable only if the separability criterion is met, which is likely to be the case.

INITIAL CALCULATION AND ALLOCATION OF GOODWILL IN A BUSINESS COMBINATION IN WHICH THE ACQUIRER HOLDS LESS THAN 100 PER CENT OF THE EQUITY INTERESTS IN AN ACQUIREE AT THE ACQUISITION DATE (APPLICATION OF PARAGRAPH 58)

A62 In accordance with paragraph 58, in a business combination in which the acquirer holds less than 100 per cent of the equity interests in the acquiree at the acquisition date, the acquirer allocates the amount of goodwill determined in accordance with paragraph 49 to the acquirer and the non-controlling interests. The amount of goodwill allocated to the acquirer shall be measured as the difference between the acquisition-date fair value of the acquirer's equity interest in the acquiree and the acquirer's share in the acquisition-date fair value of the separately recognised assets acquired and liabilities assumed. The remainder of the goodwill shall be allocated to the non-controlling interests. The goodwill allocated to the acquirer shall not exceed the total goodwill calculated in accordance with paragraph 49. The acquisition-date fair value of the acquirer's equity interest in the acquiree includes the fair value of any equity interests the acquirer owned immediately before the acquisition date. The following example illustrates those requirements.

[*] Melvin, Simensky, and Lanning Bryer, *The New Role of Intellectual Property in Commercial Transactions* (New York: John Wiley & Sons, 1998), page 293.

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Example 4
Initial calculation and allocation of goodwill to the acquirer and non-controlling interests in the acquiree

A63 On 1 January 20X5, AC acquires 80 per cent of the equity interests in TC for CU160. There is no evidence to suggest that this transaction is not an exchange of equal values. Therefore, the consideration transferred of CU160 is presumed to be the fair value of the 80 per cent interest acquired by AC. Through valuation techniques, the fair value of TC as a whole is determined to be CU195. As of the acquisition date, the fair value of the separately recognisable identifiable assets acquired is CU210 and the fair value of the liabilities assumed is CU60. On the basis of those facts, the amount of goodwill is measured as follows:

	CU
Fair value of TC	195
Less: net amount of the fair values of the separately recognised identifiable assets acquired and liabilities assumed [CU210 – CU60]	(150)
Goodwill	45

As described in paragraph A62, the amount of goodwill allocated to AC and to the non-controlling interests of TC is calculated as follows:

	CU
Fair value of AC's 80 per cent interest in TC	160
Less: AC's share of the fair value of the identifiable net assets acquired (80 per cent × [CU210 – CU60])	(120)
Goodwill allocated to AC	40
Goodwill allocated to the non-controlling interests in TC [CU45 – CU40]	5

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BUSINESS COMBINATIONS IN WHICH THE CONSIDERATION TRANSFERRED FOR THE ACQUIRER'S INTEREST IN THE ACQUIREE IS LESS THAN THE FAIR VALUE OF THAT INTEREST (APPLICATION OF PARAGRAPHS 59–61)

Example 5

Business combinations in which the consideration transferred for 100 per cent of the equity interests in the acquiree is less than the fair value

A64 On 1 January 20X5, AC acquires 100 per cent of the equity interests of TC in exchange for AC's shares with a value of CU190. Because of a regulatory requirement, the former owner of TC did not have sufficient time to market TC to multiple potential buyers. The management of AC initially measures the acquisition-date fair value of the separately recognisable identifiable assets acquired at CU250 and the fair value of the liabilities assumed at CU50. Management of AC estimates the fair value of TC as between CU215 and CU230. Because the fair value of TC exceeds the fair value of the consideration transferred, AC reviews the procedures it used to identify and measure the assets acquired and liabilities assumed and to measure the fair values of both the consideration transferred and TC on the acquisition date and decides that they were appropriate. Nonetheless, management of AC also engages an independent valuation firm to review its estimates. That firm, using multiple valuation techniques, determines that the fair value of TC as a whole is CU225 because of economies of scale that any likely acquirer could achieve in TC's operations. On the basis of those facts, the amount of goodwill and the gain on the bargain purchase are measured as follows:

	CU
Fair value of TC	225
Less: net amount of the fair values of the separately recognised identifiable assets acquired and liabilities assumed [CU250 – CU50]	(200)
Goodwill that tentatively would be recognised under paragraph 49	25

continued...

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Fair value of TC	225
Less: fair value of the consideration transferred for TC	(190)
Excess of the fair value of TC over the fair value of the consideration transferred for TC	35
Less: reduction of tentative goodwill (to zero)	(25)
Adjusted 'gain' on bargain purchase for any excess remaining after reducing goodwill to zero	10

A65 Alternatively, because the fair value of the consideration transferred for TC of CU190 is less than the fair value of the separately recognised identifiable assets acquired and liabilities assumed of CU200 [CU250 – CU50], the amount of the gain may be calculated as follows:

	CU
Fair value of the consideration transferred for TC	190
Less: net amount of the fair values of the separately recognised identifiable assets acquired and liabilities assumed [CU250 – CU50]	(200)
Gain on bargain purchase	10

A66 AC would record its acquisition of TC in its consolidated financial statements as follows:

Identifiable assets acquired (at fair value)	CU250	
Goodwill	0	
Liabilities assumed (at fair value)		CU50
Equity (for issue of shares of AC)		190
Gain on the bargain purchase		10

Example 6
Business combinations in which the consideration transferred for less than 100 per cent of the equity interests in the acquiree is less than the fair value

A67 Consider the same facts as in the previous example, except that AC acquires 80 per cent of the equity interests in TC for CU152 in AC's shares. If the goodwill measured in accordance with paragraph 49 is reduced to zero, any remaining excess is recognised as a gain attributable

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to the acquirer on the acquisition date. No gain is attributable to the non-controlling interest. On the basis of those facts, the amount of goodwill and the gain on bargain purchase are measured as follows:

	TC, as a whole	AC's interest	Non-controlling interest
	CU	CU	CU
Fair value of TC (and related 80 per cent controlling and 20 per cent non-controlling interests)	225	180	45
Less: net amount of the fair values of the separately recognised identifiable assets acquired and liabilities assumed [CU250 – CU50]	(200)	(160)	(40)
Goodwill that tentatively would be recognised under paragraph 49 (and tentative allocations)*	25	20	5
Fair value of AC's 80 per cent interest in TC [CU225 × 0.80]		180	
Less: fair value of the consideration transferred for AC's interest		(152)	
Excess of the fair value of AC's interest in TC over the consideration exchanged for that interest		28	
Less: Adjustment to reduce goodwill that tentatively would have been recognised under paragraph 49 [CU25 × 0.80]		(20)	
Adjusted 'gain' for the 80 per cent interest acquired in a bargain purchase after reducing goodwill to zero		8	

* In a business combination in which the consideration transferred for a less than 100 per cent equity interest in the acquiree is less than the fair value of that interest, goodwill measured in accordance with paragraph 49 is allocable to the acquirer and non-controlling interests based on their relative equity interests since presumably the acquirer did not pay a control premium to obtain its interest.

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A68 In this case, goodwill of CU25 that otherwise would be attributable to AC and the non-controlling interest is reduced to zero.

A69 Alternatively, because the fair value of the consideration transferred for AC's 80 per cent interest in TC of CU152 is less than the fair value of AC's 80 per cent interest in the separately recognised identifiable assets acquired and liabilities assumed of CU160 [(CU250 – CU50) × 0.80], the amount of the gain on AC's purchase of the 80 per cent interest may be calculated as follows:

	CU
Fair value of the consideration transferred for AC's 80 per cent interest in TC	152
Less: net amount of the fair values of the separately recognised identifiable assets acquired and liabilities assumed [(CU250 – CU50) × 0.8]	(160)
Gain on bargain purchase of 80 per cent interest	8

A70 AC would record its acquisition of TC in its consolidated financial statements as follows:

Identifiable assets acquired (at fair value)	CU250	
Goodwill	0	
Liabilities assumed (at fair value)		CU50
Equity (for issue of shares of AC)		152
Gain on the bargain purchase		8
Equity—non-controlling interest [(CU250 – CU50) × 0.20]		40

MEASUREMENT PERIOD (APPLICATION OF PARAGRAPHS 62–68 AND 76(a))

A71 During the measurement period, the acquirer adjusts the provisional amounts recognised at the acquisition date or recognises additional assets or liabilities to reflect any new information obtained about facts and circumstances that existed as of the acquisition date and, if known, would have affected the measurement or recognition of the amounts as of that

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date. Some factors to consider in determining whether new information should result in a measurement period adjustment to the provisional amounts recognised are:

(a) *The timing of the receipt of subsequent information.* Generally, new information that is obtained shortly after the acquisition date is more likely to reflect circumstances that existed at the acquisition date.

(b) *The type of subsequent information.* An actual exchange with a third party generally provides the best evidence of fair value.

(c) *The size of the adjustment and the ability to identify the reason for the adjustment.* Significant gains and losses that do not have identifiable causes and that are recognised shortly after the acquisition date may be an indication of circumstances that existed at the acquisition date.

Example 7
Lawsuit

A72 AC acquires TC on 31 December 20X5. One of the liabilities assumed in the business combination is a liability for a lawsuit against TC. At the acquisition date, AC initially measures the fair value of the liability on the basis of the information obtained during the due diligence procedures and recognises a provisional fair value for the liability of CU95,000. Within the measurement period, AC discovers information about the lawsuit against TC. AC determines that the information relates to facts that existed as of the acquisition date, and AC revises its fair value measure of the liability as of the acquisition date to CU80,000.

A73 In this example, the adjustment to the fair value of the liability (CU15,000 reduction) would be accounted for as part of completing the initial accounting in the business combination because the new information (a) is obtained within the measurement period and (b) relates to facts and circumstances that existed as of the acquisition date. The adjustment would result in an offsetting adjustment to goodwill.

A74 In contrast, instead assume that a lawsuit is settled late in the measurement period for an amount that is different from the initial estimate. After assessing all of the facts and circumstances causing the difference, AC determines there is no new information about facts that existed at the acquisition date. In that case, the difference would not be

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an adjustment to the initial accounting for the business combination, but instead would be recognised as an adjustment to profit or loss of the post-combination period.

Example 8
Disposal of an asset during the measurement period

A75 AC acquires TC on 15 September 20X5. AC measures and recognises a provisional fair value of CU1,000 for TC's specialised (non-wasting) Asset A. AC also seeks an independent appraisal of the fair value of Asset A. On 15 December 20X5 AC sells Asset A to Third Party Co. for CU1,750. The sale provides information about the fair value of Asset A. Depending on the circumstances, the adjustment or adjustments to the provisional fair value of Asset A (CU750 increase) would be accounted for as part of completing the initial accounting for the business combination, as current-period income or, perhaps, partly as each. That determination would depend on whether the sale at CU1,750 is indicative of the fair value that existed at the acquisition date or indicative of an increase in value that resulted from events and circumstances that occurred after the acquisition date.

A76 In this example, also assume that before agreeing to sell Asset A to Third Party Co., AC receives the independent appraisal indicating a fair value of Asset A of CU1,500 as of the acquisition date. In these circumstances, AC would adjust the fair value of Asset A to the appraised value of CU1,500 as of the acquisition date. The CU500 adjustment to Asset A would result in an offsetting adjustment to goodwill. The incremental CU250 would be recognised as a gain on the sale of Asset A.

Consideration transferred and contingent consideration

A77 The measurement period guidance also applies to the consideration transferred, including contingent consideration. The objective of the measurement period in relation to the consideration transferred is the same, ie allow the acquirer a reasonable time to obtain the information necessary to measure the items of consideration transferred on the basis of facts and circumstances that existed at the acquisition date. Subsequent changes in the fair value of consideration transferred, especially contingent consideration, usually result from events and changes in circumstances that occur after the acquisition date and, therefore, should not be recognised as measurement period adjustments.

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Example 9
Contingent payout based on future earnings

A78 AC acquires TC on 31 December 20X5 for cash and contingent consideration. The contingent consideration arrangement provides that if TC's 20X6 earnings exceed CU100,000, TC's former owners will receive CU10,000 on 31 March 20X7.

A79 At the acquisition date, AC had obtained information about the historical profitability of TC and projected its future cash flows and profitability on the basis of AC's assessment of economic conditions, TC's prospects, and its plans for TC. On the basis of that information, AC recognises a provisional fair value of its liability for the contingent consideration of CU3,700. Three months after the acquisition, TC unexpectedly obtains a profitable contract from a new customer, and first quarter 20X6 earnings are substantially greater than AC's projections for TC as of the acquisition date. AC determines that the fair value of its liability is now CU7,000.

A80 In this example, the increase in the liability for the contingent consideration should be recognised in profit or loss in the first quarter 20X6. AC had the information necessary to measure the liability as of the acquisition date on the basis of the circumstances that existed at that time. In this case, the change in projections (and the increased likelihood of the contingent consideration payment) is identifiable with an event that occurred after the acquisition date.

Example 10
Contingent payout based on the outcome of a lawsuit

A81 AC acquires TC on 31 December 20X5 for cash and contingent consideration. The fair value of the contingent consideration liability depends on assessments about the outcome of a lawsuit against TC that AC assumes in the combination. The values of the liabilities for the lawsuit and for the contingent consideration are directly related. A decrease in the fair value of the liability for the lawsuit leads to an equal increase in the fair value of the liability for the contingent consideration. However, if the lawsuit results in a judgement or settlement of CU200,000 or more, TC's former owners will receive no additional consideration.

A82 At the acquisition date, AC measures and recognises a provisional fair value of the liability for the lawsuit at CU95,000 and a provisional fair value of the liability for the contingent consideration at CU3,000 on the basis of the information obtained during the due diligence procedures. After the

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acquisition date and during the measurement period, AC discovers information in the records about the lawsuit that relates to facts that existed as of the acquisition date. On the basis of that information, AC revises its estimates of the fair value of the liability for the lawsuit to CU93,000 and the fair value of the liability for the contingent consideration to CU5,000.

A83 In this example, the adjustments to the liabilities should be accounted for as part of completing the initial accounting for the business combination because the new information was (a) obtained during the measurement period and (b) related to facts and circumstances that existed as of the acquisition date. The adjustments equally affect the fair values of the contingent consideration and the liability for the lawsuit. Therefore, in this example the offsetting adjustments result in no change to the amount recognised for goodwill.

Example 11
Illustration of paragraphs 64 and 76(a)—incomplete appraisal

A84 AC acquires TC on 30 September 20X5. AC seeks an independent appraisal for an item of property, plant and equipment acquired in the combination. However, the appraisal was not completed by the time AC completed its 20X5 annual financial statements. AC recognised in its 20X5 annual financial statements a provisional fair value for the asset of CU30,000. The item of property, plant, and equipment had a remaining useful life at the acquisition date of five years. Four months after the acquisition date, AC received the independent appraisal, which estimated the asset's fair value at the acquisition date at CU40,000.

A85 As described in paragraph 64, AC is required to recognise any adjustments to provisional values as a result of completing the initial accounting for the business combination as if the initial accounting for the business combination had been completed at the acquisition date. In its 20X6 financial statements, AC presents a current period balance sheet and a two-year comparative income statement. Therefore, in the 20X6 financial statements, an adjustment is made to the opening carrying amount of the item of property, plant and equipment. That adjustment is measured as the fair value adjustment at the acquisition date of CU10,000 less the additional depreciation that would have been recognised had the asset's fair value at the acquisition date been recognised from that date (CU500 for three months' depreciation).

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The carrying amount of goodwill also is adjusted for the reduction in value at the acquisition date of CU10,000, and the 20X5 comparative information is adjusted to include additional depreciation of CU500.

A86 In accordance with paragraph 76(a), AC discloses:

(a) in its 20X5 financial statements, that the initial accounting for the business combination has not been completed, and explains why this is the case.

(b) in its 20X6 financial statements, the amounts and explanations of the adjustments to the provisional values recognised during the current reporting period. Therefore, AC discloses that the fair value of the item of property, plant and equipment at the acquisition date has been increased by CU10,000 with a corresponding decrease in goodwill. The 20X5 comparative information is adjusted to include additional depreciation of CU500.

ASSESSING WHAT IS PART OF THE EXCHANGE FOR THE ACQUIREE (APPLICATION OF PARAGRAPHS 69 AND 70)

A87 In accordance with paragraph 69, the acquirer assesses whether any portion of the transaction price and any assets acquired or liabilities assumed or incurred are not part of the exchange for the acquiree. Because only the consideration transferred and the assets acquired or liabilities assumed or incurred that are part of the exchange for the acquiree are included in the business combination accounting any portion that is not part of the exchange for the acquiree is accounted for separately from the business combination.

A88 Judgement is required to determine whether a portion of the transaction price paid, or the assets acquired and liabilities assumed or incurred, are part of the exchange for the acquiree. A transaction or event arranged primarily for the economic benefit of the acquirer or the combined entity is not part of the exchange for the acquiree and is accounted for separately from the business combination. One arranged primarily for the benefit of the acquiree or its former owners generally is part of the exchange and is included in the business combination accounting. The acquirer should consider the following factors, which are neither mutually exclusive nor individually conclusive, to determine whether a

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transaction or event is arranged primarily for the economic benefit of the acquirer or combined entity, rather than for the acquiree or its former owners.

(a) *The reasons for the transaction or event*—Understanding the reasons why the parties to the combination (the acquirer, the acquiree, and their owners, directors, managers, and their agents) entered into a particular transaction or arrangement may provide insight into whether it should be accounted for as part of the exchange for the acquiree. For example, if a transaction is arranged primarily for the economic benefit of the acquirer or combined entity with little or no benefit received by the acquiree or its former owners, that portion of the transaction price paid (and any related assets or liabilities) is unlikely to be part of the exchange for the acquiree and would be accounted for separately from the business combination.

(b) *Who initiated the transaction or event*—Understanding who initiated the transaction or event may also provide insight into whether it should be accounted for as part of the exchange for the acquiree. For example, a transaction or other event that is initiated by the acquirer may be entered into for the purpose of providing future economic benefits to the acquirer or combined entity with little or no benefit received by the acquiree or its former owners. On the other hand, a transaction or arrangement initiated by the owners of the acquiree is unlikely to be for the benefit of the acquirer or combined entity.

(c) *The timing of the transaction or event*—The timing of the transaction or event may also provide insight into whether it should be accounted for as part of the exchange for the acquiree. For example, a transaction between the acquirer and the acquiree that takes place during the negotiations of the terms of a business combination may be entered into in contemplation of the business combination for the purpose of providing future economic benefits to the acquirer or combined entity with little or no benefit received by the acquiree or its former owners.

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Example 12
Regulatory asset acquired that is included in the business combination accounting

A89 To induce the acquisition of WB (Weak Bank) by SB (Strong Bank), as a condition of the combination between WB and SB, a regulatory authority agrees to provide financial assistance in the form of cash, a receivable, or guarantees. That assistance is transferred to SB (the combined entity) upon the closing of the combination agreement. The regulatory authority, as part of its mission and public purpose, has an interest in supporting the soundness of financial institutions, which includes protecting the interests of the depositors of WB. From the perspective of the regulatory body, the assistance provided to induce WB and SB to combine is in the furtherance of its mission.

A90 In this case, the transaction was not arranged primarily to achieve economic benefits favourable to the acquirer or combined entity. If SB did not receive the financial assistance, it might not have acquired WB or would have paid less to acquire WB (presumably by an amount equal to the financial assistance). Thus, SB is indifferent whether it pays less to acquire WB or if it pays more to acquire WB and also receives the financial assistance. Thus, that assistance would be an asset acquired at the acquisition date that is recognised as part of accounting for the business combination. The portion of the consideration transferred for the financial assistance is also accounted for as part of the business combination accounting even though it is transferred to the former owners of WB not to the regulator that provided it.

Effective settlement of pre-existing relationships between the acquirer and acquiree in a business combination

A91 The acquirer and acquiree may have a relationship that existed before the business combination was contemplated. For the purposes of this [draft] IFRS, those relationships are called *pre-existing relationships*. A pre-existing relationship between the acquirer and acquiree may be contractual (for example, vendor and customer or licensor and licensee), or non-contractual (for example, plaintiff and defendant).

A92 In general, the effective settlement of a pre-existing relationship between the acquirer and acquiree should be accounted for in the same way whether it is settled as part of a business combination or separately from

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a business combination. Therefore, if the business combination results in the effective settlement of a pre-existing relationship, the acquirer recognises a gain or loss and measures it as follows:

(a) a non-contractual pre-existing relationship (such as a lawsuit) should be measured at fair value.

(b) A contractual pre-existing relationship should be measured as the lesser of the following:

(1) the amount by which the contract is favourable or unfavourable from the perspective of the acquirer when compared with pricing for current market transactions for the same or similar items.

(2) any stated settlement provisions in the contract available to the counterparty to whom the contract is unfavourable.

To the extent that (2) is less than (1), the difference should be included as part of the business combination accounting. Also, an unfavourable contract is not necessarily a loss contract for the acquirer.

A93 A pre-existing relationship may be a contract between the acquirer and the acquiree in which the acquirer had previously granted to the acquiree the right to use the acquirer's recognised or unrecognised intangible assets (for example, a right to use the acquirer's trade name under a franchise agreement). In that case, paragraph 41 requires the acquirer to recognise an intangible asset for that right separately from goodwill as part of the business combination accounting. However, if the contract includes terms that are favourable or unfavourable when compared with pricing for current market transactions for the same or similar items, the acquirer should recognise a gain or loss separately from the business combination for the effective settlement of the contract. The gain or loss is measured in accordance with paragraph A92.

Example 13
Effective settlement of a supply contract as a result of a business combination

A94 AC purchases electronic components from TC under a five-year supply contract at fixed rates. Currently, the fixed rates are higher than rates at which AC could purchase similar electronic components from another supplier. The supply contract includes provisions that AC can terminate the contract before the end of the initial five-year term only by paying a

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CU6 million penalty. With three years remaining under the supply contract, AC pays CU50 million to acquire TC, which is the fair value of TC based on what other marketplace participants would be willing to pay.

A95 Included in the total fair value of TC is CU8 million related to the fair value of the supply contract with AC. The CU8 million represents a CU3 million component that is 'at-market' because the pricing is comparable to pricing for current market transactions for the same or similar items (selling effort, customer relationships, and so forth) and a CU5 million component for pricing that is unfavourable to AC. TC has no other identifiable assets or liabilities related to the supply contract, and AC has not recognised any assets or liabilities related to the supply contract before the business combination.

A96 In this example, AC recognises separately from the business combination a settlement loss of CU5 million (the lesser of the stated settlement amount and the amount by which the contract is unfavourable to the acquirer).

Example 14
Effective settlement of a contract between the acquirer and acquiree in which the acquirer had recognised a liability before the business combination

A97 The amount recognised by AC as a gain or loss for the effective settlement of the pre-existing relationship will be affected if AC had previously recognised an amount in its financial statements related to that pre-existing relationship. Assume the same facts as in Example 13 except that before the business combination AC had recognised a CU6 million liability on the supply contract. AC recognises a CU1 million settlement gain on that contract at the acquisition date (the CU5 million measured loss on the contract less the CU6 million loss previously recognised) in profit or loss.

Arrangements to pay for employee services

A98 Judgement is often required to determine whether arrangements to pay for employee services (compensation arrangements) should be accounted for as part of the exchange for the acquiree or separately from the business combination. To assist in that determination, it is important to understand whether the transaction includes payments or other arrangements for the economic benefit of the acquirer or combined entity

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with little or no benefit received by the acquiree or its former owners. To the extent that it is, that portion of the transaction price (and any related liabilities) should be accounted for separately from the business combination. As described in paragraph A88, understanding the reasons for the arrangement, who initiated the arrangement, and when the arrangement was entered into may also assist in determining whether the arrangement should be accounted for as part of the business combination accounting or separately.

A99 If it is not clear whether an arrangement to pay for employee services should be accounted for as part of the exchange for the acquiree or separately from the business combination, the following indicators also should be considered:

(a) *Continuing employment*—If future payments are automatically forfeited if employment ends, the arrangement may be compensation for post-combination services that will benefit the combined entity and should be accounted for separately from the business combination. In contrast, if future payments are not affected by employment termination, the arrangement may be part of the consideration transferred for the acquiree.

(b) *Duration of continuing employment*—An employment agreement with an employment period coinciding with or longer than the future payment period may indicate that the arrangement is compensation for post-combination services that will benefit the combined entity and should be accounted for separately from the business combination accounting.

(c) *Level of payment*—Reduced payments to owners who do not become employees may indicate that the incremental payments to selling owners who become employees are payments for post-combination services that will benefit the combined entity and should be accounted for separately from the business combination accounting. In contrast, payments in excess of reasonable levels paid to employees with similar responsibilities may indicate that the payment is part of the consideration transferred for the acquiree.

(d) *Formula for determining consideration*—Contingent payments that are based on multiples of future earnings, future cash flows, or other similar performance measures may indicate that the formula is intended to verify the fair value of the acquiree and, therefore, should be accounted for as part of the business combination. In contrast, contingent payments based on

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percentages of earnings may indicate a profit-sharing arrangement that should be accounted for separately from the business combination.

Example 15
Arrangement that is part of the exchange for the acquiree

A100 TC appointed a candidate as its new CEO under a ten-year contract. The contract required TC to pay the candidate CU5 million if TC is acquired before (a) the contract expires or (b) the termination of CEO's employment for specified causes within the control of TC. AC acquires TC eight years later. CEO remained an employee of TC through the acquisition date and, thus, will receive the additional payment under the existing contract.

A101 AC is required to assess whether a portion of the consideration transferred and the related liability incurred—required payment of CU5 million—is part of the exchange for the acquiree that should be included in the business combination accounting. The employment agreement was entered into by TC to secure the employment of CEO and by CEO to secure payment and security. The employment agreement was also entered into before the negotiations of the combination began. Thus, there is no reason to believe that the agreement was arranged primarily to achieve economic benefits for AC. Therefore, the consideration transferred and the related liability for the payment to CEO should be regarded as part of the exchange for the acquiree and included in the business combination accounting.

Acquirer share-based payment awards exchanged for awards held by the employees of the acquiree

A102 In a business combination, an acquirer may exchange its share-based payment awards (replacement awards) for awards held by employees of the acquiree. If the acquirer is obligated to replace the acquiree's awards, all or a portion of the acquirer's replacement awards shall be included in the measurement of the consideration transferred by the acquirer in the business combination, as explained in the following paragraph.

A103 For the purpose of determining the portion of a replacement award that is part of the consideration exchanged for the acquiree, the share-based payment awards made by the acquirer and acquiree shall be measured using the fair value-based measurement method of IFRS 2 *Share-based*

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Payment. The portion of the replacement award that is part of the consideration transferred in exchange for the acquiree shall be determined as follows:

(a) On the acquisition date, the acquirer recognises an expense in post-combination profit or loss for any excess of (1) the fair value-based measure of the acquirer's replacement award over (2) the fair value-based measure of the replaced acquiree awards.

(b) The remaining fair value-based measure of the acquirer's replacement award is the amount that remains after deducting the excess, if any, recognised in post-combination profit or loss under (a). Of this amount, the portion attributable to past services is regarded as part of the consideration transferred in exchange for the acquiree. The portion, if any, attributable to future services is not part of the consideration transferred and is an expense to be recognised in post-combination profit or loss. The guidance in (c) and (d) shall be followed to determine the portion of the remaining fair value-based measure of the replacement award attributable to past and future services. Depending on the circumstances, the acquirer recognises the replacement award as a liability or an equity instrument, as required in accordance with IFRS 2.

(c) Of the remaining fair value-based measure of the replacement award, the portion attributable to past services is equal to the remaining fair value-based measure of the replacement award (or settlement) multiplied by the ratio of the portion of the vesting period completed to the total vesting period. (The amount, if any, to be recognised in post-combination profit or loss is the remaining fair value-based measure of the replacement award (or settlement) multiplied by the ratio of the future vesting period to the total vesting period.)

(d) The vesting period is the period during which all the specified vesting conditions are to be satisfied. Vesting conditions are defined in IFRS 2.

A104 The following examples illustrate the application of these provisions in circumstances in which AC makes replacement awards of CU100 (fair value-based measure) at the acquisition date for TC awards of CU100 (fair value-based measure) at the acquisition date. Because the fair value-based measure of replacement awards equals the fair value-based measure of the replaced awards, there is no excess value

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recognised as acquisition date expense in accordance with paragraph A103(a). Therefore, in accordance with paragraph A103(b), the remaining fair value-based measure of the replacement awards is (CU100).

Example 16
Acquirer replacement awards, for which no services are required after the acquisition date, are exchanged for awards of the acquiree, for which the required services were rendered before the acquisition date

A105 AC exchanges replacement awards for which no services are required after the acquisition of TC for share-based payment awards of TC, for which the required services were rendered before the business combination. When originally granted, the share-based payment awards of TC had a vesting period of four years. The required services were rendered before the business combination. Because no future service is required for AC's replacement award, the AC replacement award represents part of the consideration transferred by AC in the business combination. Thus, 100 per cent of the award is regarded as equity interest in the acquiree, and the CU100 replacement award is included as part of the consideration transferred by AC.

Example 17
Acquirer replacement awards, for which services are required after the acquisition date, are exchanged for awards of the acquiree, for which the required services were rendered before the acquisition date

A106 AC exchanges replacement awards that require three years of future service for share-based payment awards of TC, for which the vesting period was completed before the business combination. When originally granted, the share-based payment awards of TC had a vesting period of four years. Because the original vesting period was completed, the TC awards represent an equity interest. However, because the replacement awards require three years of future services, a portion of the replacement award is to be recognised in post-combination profit or loss in accordance with paragraph A103(b). In this case, the total vesting period is seven years—the vesting period of the original award and the vesting period of the replacement award. The portion attributable to past services is equal to the remaining fair value-based measure of the replacement

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award (CU100) multiplied by the ratio of the past vesting period (four years) to the total vesting period (seven years). Thus, CU57 would be attributable to the past services and CU43 to the future services.

Example 18
Acquirer replacement awards, for which services are required after the acquisition date, are exchanged for awards of the acquiree, for which the vesting period was not completed before the acquisition date

A107 AC exchanges replacement awards that require one year of future service for share-based payment awards of TC, for which the vesting period was not completed before the business combination. When originally granted, the awards of TC had a vesting period of four years. As of the acquisition date the TC employees had rendered a total of two years' service; thus, two years of service after the acquisition date would be required. Because all required service has not been rendered, the TC awards represent an equity interest in part (50 per cent, two of the required four years of service rendered as of the acquisition date).

A108 The replacement awards require only one year of future service. Thus, because two years of service have been rendered, the total vesting period is three years. Normally, the portion attributable to past services would be equal to the remaining fair value of the replacement award (CU100) multiplied by the ratio of the past vesting period (two years) to the total vesting period (three years). Thus, CU67 would be attributable to the past services (and therefore would be part of the consideration transferred for the acquiree) and CU33 to the future services. However, in accordance with paragraph A103(b), because the amount of the acquirer's replacement award attributable to past services (CU67) exceeds the amount of the replaced acquirer's awards attributable to those services (CU50, or CU100 × 2/4 years), the excess (CU17) is not part of the consideration transferred. Rather, that excess is an expense to be recognised in post-combination financial statements. Thus, CU50 would be attributable to past services (and included as part of the consideration transferred for the acquiree) and CU50 to future services.

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Example 19
Acquirer replacement awards, for which no services are required after the acquisition date, are exchanged for awards of the acquiree, for which the vesting period was not completed before the acquisition date

A109 Assume the same facts as in the previous example except that AC exchanges replacement awards that require no service after the business combination. Like the previous example, the portion that could be attributable to past services cannot exceed the amount of the replaced TC awards attributable to those services. Thus, CU50 (which is calculated as CU100 × 2/4 years) is attributable to the past services and is part of the consideration transferred for the acquiree, and CU50 is an expense to be recognised in post-combination financial statements. Because this replacement award has no vesting period associated with it, the entire CU50 would be recognised as an expense immediately.

ILLUSTRATION OF DISCLOSURE REQUIREMENTS (APPLICATION OF PARAGRAPHS 71 AND 72)

A110 The following example of some of the disclosure requirements of this [draft] IFRS is presented for illustrative purposes only and, therefore, may not be representative of actual transactions.

Footnote X: acquisitions

On 30 June 20X2 Alpha acquired 100 per cent of the outstanding common shares of Beta. Beta is a provider of data networking products and services in Canada and Mexico. As a result of the acquisition, Alpha is expected to be the leading provider of data networking products and services in those markets. It also expects to reduce costs through economies of scale.

The fair value of Beta on 30 June 20X2 was CU9,400, determined on the basis of the consideration paid. Alpha's consideration included CU6,000 of cash, 100,000 ordinary shares valued at CU2,400, and a contingent future payment arrangement with a fair value of CU1,000 at the acquisition date. The fair value of the 100,000 ordinary shares issued was determined on the basis of the closing market price of Alpha's ordinary shares at the acquisition date. The future payment arrangement is contingent on the levels of revenue that Omega, an unconsolidated

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equity investment owned by Beta, achieves over the 12-month period following the acquisition. The maximum potential undiscounted amount of all future payments that Alpha could be required to make under the future payment arrangement is CU2,000.

Alpha incurred CU500 of third-party expenses related to the acquisition of Beta. Those expenses are included in the selling, general, and administrative expenses in Alpha's consolidated statement of income.

The following table summarises the estimated fair values of the assets acquired and liabilities assumed at the acquisition date.

At 30 June 20X2

	CU
Current assets	2,400
Property, plant and equipment	1,500
Intangible assets subject to amortisation	2,500
Intangible assets not subject to amortisation	2,400
Goodwill	2,200
Total assets acquired	11,000
Current liabilities	(1,100)
Non-current debt	(500)
Total liabilities assumed	(1,600)
Net assets acquired	9,400

REVERSE ACQUISITIONS (APPLICATION OF PARAGRAPH 12(c))

A112 In some business combinations, commonly called *reverse acquisitions*, the acquirer is the entity whose equity interests have been acquired and the issuing entity is the acquiree. For example, a private entity might initiate a combination and arrange to have itself 'acquired' by a smaller public entity as a means of obtaining a stock exchange listing. Although the public entity that issues equity interests is regarded as the legal parent and the private entity is regarded as the legal subsidiary, the private entity that initiated and arranged the combination is the acquirer if it is determined to have obtained control of the public entity in accordance with the requirements of paragraphs 11–16. Therefore, for financial reporting purposes in a reverse acquisition, the legal parent is the acquiree and the legal subsidiary is the acquirer.

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A112 The requirement in this [draft] IFRS for an acquirer to measure and recognise the fair value of the acquiree and the values of the assets acquired and liabilities assumed on the acquisition date applies to reverse acquisition accounting. In a reverse acquisition, the legal subsidiary is the acquirer that measures and recognises the legal parent, which is the acquiree. Paragraphs A113–A136 provide guidance for applying the acquisition method to reverse acquisitions.

Fair value of the acquiree

A113 In accordance with paragraph 20 of this [draft] IFRS, the acquisition-date fair value of the consideration transferred by the acquirer is presumed to be the best basis for measuring the fair value of the acquirer's interest in the acquiree on that date, in the absence of evidence to the contrary. If the consideration transferred by the acquirer is not the best evidence of the fair value of the acquiree, the acquirer should use other valuation techniques to measure directly the fair value of the acquiree (see paragraphs A18–A26). When equity interests are issued as part of the consideration transferred in a business combination, the fair value of those equity interests is measured as of the acquisition date.

A114 In a reverse acquisition, the consideration is deemed to have been transferred by the legal subsidiary (ie the acquirer for financial reporting purposes) in the form of equity interests issued to the owners of the legal parent (ie the acquiree for financial reporting purposes). If the fair value of the equity interests of the legal subsidiary (acquirer) is used to determine the fair value of the consideration transferred for the acquiree, a method of calculating the fair value of the consideration is to determine the number of equity interests the legal subsidiary (acquirer) would have had to issue to provide the same percentage equity interest of the combined entity to the owners of the legal parent (acquiree) as they have in the combined entity as a result of the reverse acquisition. The fair value of the number of equity interests so calculated can be used as the fair value of consideration transferred for the acquiree in the combination.

A115 If the fair value of the consideration transferred by the acquirer (ie the fair value of the equity interests of the legal subsidiary) is not the best basis for measuring the fair value of the acquiree (legal parent), the acquirer should use other valuation techniques. In a reverse acquisition, the fair value of the issued equity interests of the legal parent (acquiree) as of the acquisition date, based on prices of the legal parent's publicly traded equity shares, may provide the best basis for measuring the fair value of the legal parent (acquiree).

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Preparation and presentation of consolidated financial statements

A116 Consolidated financial statements prepared following a reverse acquisition are issued under the name of the legal parent, but described in the notes as a continuation of the financial statements of the legal subsidiary (ie the acquirer for financial reporting purposes). Because such consolidated financial statements represent a continuation of the financial statements of the legal subsidiary:

(a) the assets and liabilities of the legal subsidiary (acquirer) are measured and recognised in those consolidated financial statements at their pre-combination carrying amounts.

(b) the retained earnings and other equity balances recognised in those consolidated financial statements are the retained earnings and other equity balances of the legal subsidiary (acquirer) immediately before the business combination.

(c) the amount recognised as issued equity interests in those consolidated financial statements shall be determined by adding the issued equity of the legal subsidiary (acquirer) immediately before the business combination to the fair value of the legal parent (acquiree) determined in accordance with paragraphs A113–A115. However, the equity structure appearing in those consolidated financial statements (ie the number and type of equity interests issued) reflects the equity structure of the legal parent (acquiree), including the equity interests issued by the legal parent to effect the combination.

(d) comparative information presented in those consolidated financial statements is that of the legal subsidiary (acquirer).

A117 Reverse acquisition accounting applies only in the consolidated financial statements, and not in the separate financial statements. Therefore, in the legal parent's separate financial statements, if any, the investment in the legal subsidiary is accounted for in accordance with the requirements in IAS 27 *Consolidated and Separate Financial Statements*, on accounting for investments in an investor's separate financial statements.

A118 Consolidated financial statements prepared following a reverse acquisition reflect the values measured in accordance with this [draft] IFRS for the assets and liabilities of the legal parent (ie the acquiree for

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financial reporting purposes). Therefore, the fair value of the assets and liabilities of the legal parent are recognised in accordance with paragraphs 28–51 of this [draft] IFRS.

Non-controlling interest

A119 In a reverse acquisition, some of the owners of the legal subsidiary (acquirer) may not exchange their equity interests for equity interests of the legal parent (acquiree). Although the entity in which those owners hold equity interests (the legal subsidiary) acquired another entity (the legal parent), those owners are treated as a non-controlling interest in the consolidated financial statements prepared after the reverse acquisition. This is because the owners of the legal subsidiary that do not exchange their equity interests for equity interests of the legal parent have an interest only in the results and net assets of the legal subsidiary, and not in the results and net assets of the combined entity. Conversely, the owners of the legal parent, notwithstanding that the legal parent is the acquiree for financial reporting purposes, have an interest in the results and net assets of the combined entity.

A120 Because the assets and liabilities of the legal subsidiary are measured and recognised in the consolidated financial statements at their pre-combination carrying amounts, the non-controlling interest reflects the non-controlling shareholders' proportionate interest in the pre-combination carrying amounts of the legal subsidiary's net assets. This is unique to a reverse acquisition.

Earnings per share

A121 As noted in paragraph A116(c), the equity structure appearing in the consolidated financial statements prepared following a reverse acquisition reflects the equity structure of the legal parent (acquiree), including the equity interests issued by the legal parent to effect the business combination.

A122 For the purpose of calculating the weighted average number of ordinary shares outstanding (the denominator) during the period in which the reverse acquisition occurs:

(a) the number of ordinary shares outstanding from the beginning of that period to the acquisition date shall be deemed to be the number of ordinary shares issued by the legal parent (acquiree) to the owners of the legal subsidiary (acquirer); and

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(b) the number of ordinary shares outstanding from the acquisition date to the end of that period shall be the actual number of ordinary shares of the legal parent (acquiree) outstanding during that period.

A123 The basic earnings per share disclosed for each comparative period before the acquisition date that is presented in the consolidated financial statements following a reverse acquisition shall be calculated by dividing the profit or loss of the legal subsidiary attributable to ordinary shareholders in each of those periods by the number of ordinary shares issued by the legal parent to the owners of the legal subsidiary in the reverse acquisition.

A124 The calculations outlined in paragraphs A132 and A133 assume that there were no changes in the number of the legal subsidiary's issued ordinary shares during the comparative periods and during the period from the beginning of the period in which the reverse acquisition occurred to the acquisition date. The calculation of earnings per share shall be adjusted appropriately to take into account the effect of a change in the number of the legal subsidiary's issued ordinary shares during those periods.

Example 20
Reverse acquisition

A125 This example illustrates the accounting for a reverse acquisition in which Entity A, the entity issuing equity instruments and, therefore, the legal parent, is acquired in a reverse acquisition by Entity B, the legal subsidiary, on 30 September 20X6. This example ignores the accounting for any income tax effects.

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A126 The following are the balance sheets of Entity A and Entity B immediately before the business combination:

	Entity A (legal parent, acquiree)	Entity B (legal subsidiary, acquirer)
	CU	CU
Current assets	500	700
Non-current assets	1,300	3,000
Total assets	1,800	3,700
Current liabilities	300	600
Non-current liabilities	400	1,100
Total liabilities	700	1,700
Owners' equity		
Retained earnings	800	1,400
Issued equity		
100 ordinary shares	300	–
60 ordinary shares	–	600
Total owners' equity	1,100	2,000
Total liabilities and owners' equity	1,800	3,700

A127 The following is other information used in this example:

(a) On 30 September 20X6 Entity A issues 2½ shares in exchange for each ordinary share of Entity B. All of Entity B's shareholders exchange their shares in Entity B. Therefore, Entity A issues 150 ordinary shares in exchange for all 60 ordinary shares of Entity B.

(b) The fair value of each ordinary share of Entity B at 30 September 20X6 is CU40. The quoted market price of Entity A's ordinary shares at that date is CU16.

(c) The fair values of Entity A's identifiable assets and liabilities at 30 September 20X6 are the same as their carrying amounts, except that the fair value of Entity A's non-current assets at 30 September 20X6 is CU1,500.

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Calculating the fair value of the acquiree

A128 As a result of the issue of 150 ordinary shares by Entity A (legal parent, acquiree), Entity B's shareholders own 60 per cent of the issued shares of the combined entity (ie 150 of 250 issued shares). The remaining 40 per cent are owned by Entity A's shareholders. If the business combination had taken the form of Entity B issuing additional ordinary shares to Entity A's shareholders in exchange for their ordinary shares in Entity A, Entity B would have had to issue 40 shares for the ratio of ownership interest in the combined entity to be the same. Entity B's shareholders would then own 60 of the 100 issued shares of Entity B and, therefore, 60 per cent of the combined entity. As a result, the fair value of the consideration transferred by Entity B and the fair value of the Entity A is CU1,600 (ie 40 shares each with a fair value of CU40). If the fair value of the consideration transferred by Entity B is determined not to be the best evidence of the fair value of Entity A, then other valuation techniques should be used to measure the fair value of Entity A directly. The fair value of Entity A could be measured directly on the basis of the fair value of Entity A's shares outstanding.

Measuring goodwill

A129 Goodwill is measured as the excess of the fair value of the acquiree, Entity A, over the net amount of Entity A's recognised identifiable assets and liabilities. Therefore, goodwill is measured as follows:

	CU	CU
Fair value of Entity A (legal parent, acquiree)		1,600
Net recognised values of Entity A's identifiable assets and liabilities		
Current assets	500	
Non-current assets	1,500	
Current liabilities	(300)	
Non-current liabilities	(400)	(1,300)
Goodwill		300

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Consolidated balance sheet at 30 September 20X6

A130 The following is the consolidated balance sheet immediately after the business combination:

	CU
Current assets [CU700 + CU500]	1,200
Non-current assets [CU3,000 + CU1,500]	4,500
Goodwill	300
Total assets	6,000
Current liabilities [CU600 + CU300]	900
Non-current liabilities [CU1,100 + CU400]	1,500
Total liabilities	2,400
Owners' equity	
Retained earnings	1,400
Issued equity	
250 ordinary shares [CU600 + CU1,600]	2,200
Total owners' equity	3,600
Total liabilities and owners' equity	6,000

A131 In accordance with paragraph A116(c), the amount recognised as issued equity interests in the consolidated financial statements (CU2,200) is determined by adding the issued equity of the legal subsidiary immediately before the business combination (CU600) and the fair value of the legal parent (acquiree) measured in accordance with paragraphs A113–A115 (CU1,600). However, the equity structure appearing in the consolidated financial statements (ie the number and type of equity interests issued) must reflect the equity structure of the legal parent, including the equity interests issued by the legal parent to effect the combination.

Earnings per share

A132 Assume that Entity B's profit for the annual period ended 31 December 20X5 was CU600, and that the consolidated profit for the annual period ended 31 December 20X6 is CU800. Assume also that there was no change in the number of ordinary shares issued by Entity B during the

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annual period ended 31 December 20X5, and during the period from 1 January 20X6 to the date of the reverse acquisition on 30 September 20X6. Earnings per share for the annual period ended 31 December 20X6 is calculated as follows:

Number of shares deemed to be outstanding for the period from 1 January 20X6 to the acquisition date (ie the number of ordinary shares issued by Entity A (legal parent, acquiree) in the reverse acquisition)	150
Number of shares outstanding from the acquisition date to 31 December 20X6	250
Weighted average number of ordinary shares outstanding [(150 × 9 ÷12) + (250 × 3 ÷12)]	175
Earnings per share [800 ÷ 175]	CU4.57

A133 Restated earnings per share for the annual period ended 31 December 20X5 is CU4.00 (ie the profit of Entity B of 600 divided by the number of ordinary shares issued by Entity A in the reverse acquisition).

Non-controlling interest

A134 Assume the same facts as above, except that only 56 of Entity B's 60 ordinary shares are exchanged. Because Entity A issues 2½ shares in exchange for each ordinary share of Entity B, Entity A issues only 140 (rather than 150) shares. As a result, Entity B's shareholders own 58.3 per cent of the issued shares of the combined entity (ie 140 shares of 240 issued shares). The fair value of the consideration transferred for Entity A, the acquiree, is calculated by assuming that the combination had taken place in the form of Entity B issuing additional ordinary shares to the shareholders of Entity A in exchange for their ordinary shares in Entity A. In calculating the number of shares that would have to be issued by Entity B, the non-controlling interest is ignored. The majority shareholders own 56 shares of Entity B. For this to represent a 58.3 per cent equity interest, Entity B would have had to issue an additional 40 shares. The majority shareholders would then own 56 of the 96 issued shares of Entity B and, therefore, 58.3 per cent of the combined entity. As a result, the fair value of the consideration transferred for Entity A, the acquiree, is CU1,600 (ie 40 shares each with a fair value of CU40). This is the same amount as when all 60 of Entity B's ordinary shares are tendered for exchange. The fair value of Entity A, the acquiree, does not change if some of Entity B's shareholders do not participate in the exchange.

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A135 The non-controlling interest is represented by the four shares of the total 60 shares of Entity B that are not exchanged for shares of Entity A. Therefore, the non-controlling interest is 6.7 per cent. The non-controlling interest reflects the non-controlling shareholders' proportionate interests in the pre-combination carrying amounts of the net assets of Entity B, the legal subsidiary. Therefore, the consolidated balance sheet is adjusted to show a non-controlling interest of 6.7 per cent of the pre-combination carrying amounts of Entity B's net assets (ie CU134 or 6.7 per cent of CU2,000).

A136 The consolidated balance sheet at 30 September 20X6, reflecting the non-controlling interest, is as follows:

	CU
Current assets [CU700 + CU500]	1,200
Non-current assets [CU3,000 + CU1,500]	4,500
Goodwill	300
Total assets	6,000
Current liabilities [CU600 + CU300]	900
Non-current liabilities [CU1,100 + CU400]	1,500
Total liabilities	2,400
Owners' equity	
Retained earnings [CU1,400 × 93.3 per cent]	1,306
Issued equity	
240 ordinary shares [CU560 + CU1,600]	2,160
Non-controlling interest	134
Total owners' equity	3,600
Total liabilities and owners' equity	6,000

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Appendix C

Guidance on accounting for asset acquisitions, and on identifying business combinations between entities under common control, and transitional provisions for business combinations involving only mutual entities or by contract alone.

This appendix is an integral part of the [draft] IFRS.

Introduction

C1 This appendix provides guidance on three matters:

(a) asset acquisitions,

(b) identifying business combinations between entities under common control, and

(c) transitional provisions for business combinations involving only mutual entities or by contract alone without obtaining any equity interests.

[The source of the guidance is given in square brackets.]

C2 The guidance in this appendix was deliberated by the IASB, but not jointly with the FASB. The FASB's [draft proposed] SFAS 141(R) includes an appendix of continuing authoritative guidance; however, that guidance has been carried forward by the FASB from other sources. Therefore, the guidance provided in the FASB's appendix is not the same as the guidance provided in this appendix.

Accounting for asset acquisitions

C3 As noted in paragraph 5 a transaction or event is accounted for as a business combination only if the assets acquired and liabilities assumed constitute a business (an acquiree). If the assets acquired and liabilities assumed do not constitute a business, the acquirer shall account for the transaction as an asset acquisition. The accounting for an asset acquisition is described below in paragraphs C4 and C5. [Source: IFRS 3, paragraph 4]

C4 The acquirer shall:

(a) identify the individual identifiable assets acquired and liabilities assumed, including those assets that meet the definition of, and

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recognition criteria for, intangible assets in IAS 38 *Intangible Assets*.

(b) allocate the cost of the group to the individual identifiable assets and liabilities based on their relative fair values at the date of purchase. Such a transaction or event does not give rise to goodwill.

(c) recognise the identifiable assets acquired and liabilities assumed.

C5 Intangible assets acquired in an asset acquisition shall be recognised in accordance with the requirements of IAS 38.

Business combinations involving entities under common control

C6 Consistently with the previous version of IFRS 3, the provisions of this [draft] IFRS do not apply to combinations involving entities under common control.

C7 A business combination involving entities or businesses under common control is a business combination in which all of the combining entities or businesses are ultimately controlled by the same party or parties both before and after the business combination, and that control is not transitory. [Source: IFRS 3, paragraph 10]

C8 A group of individuals shall be regarded as controlling an entity when, as a result of contractual arrangements, they collectively have the power to govern its financial and operating policies so as to obtain benefits from its activities. Therefore, a business combination is outside the scope of this [draft] IFRS when the same group of individuals has, as a result of contractual arrangements, ultimate collective power to govern the financial and operating policies of each of the combining entities so as to obtain benefits from their activities, and that ultimate collective power is not transitory. [Source: IFRS 3, paragraph 11]

C9 An entity may be controlled by an individual or by a group of individuals acting together under a contractual arrangement, and that individual or group of individuals may not be subject to the financial reporting requirements of IFRSs. Therefore, it is not necessary for combining entities to be included as part of the same consolidated financial statements for a business combination to be regarded as one involving entities under common control. [Source: IFRS 3, paragraph 12]

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C10 The extent of non-controlling interests in each of the combining entities before and after the business combination is not relevant to determining whether the combination involves entities under common control. Similarly, the fact that one of the combining entities is a subsidiary that has been excluded from the consolidated financial statements is not relevant to determining whether a combination involves entities under common control. [Source: IFRS 3, paragraph 13]

Transitional provisions for business combinations involving only mutual entities or by contract alone without obtaining any equity interests

C11 Paragraph 82 provides that it applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual period beginning on or after 1 January 2007. Earlier application is encouraged. However, this [draft] IFRS shall be applied only when an annual period begins on or after this [draft] IFRS was issued. If this [draft] IFRS is applied before its effective date, that fact shall be disclosed and [draft] IAS 27 and [draft] IAS 37 are to be applied at the same time.

C12 The requirement to apply this [draft] IFRS prospectively has the following effect for a business combination involving only mutual entities or by contract alone (see paragraph 54) if the acquisition date for that business combination is before the beginning of the first annual period beginning on or after 1 January 2007:

(a) Classification

An entity shall continue to classify the prior business combination in accordance with the entity's previous accounting policies for such combinations.

(b) Previously recognised goodwill

At the beginning of the first annual period beginning on or after 1 January 2007 the carrying amount of goodwill arising from the prior business combination shall be its carrying amount at that date in accordance with the entity's previous accounting policies, after eliminating the carrying amount of any accumulated amortisation of that goodwill with a corresponding decrease in goodwill. No other adjustments shall be made to the carrying amount of goodwill.

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(c) Goodwill previously recognised as a deduction from equity

If the entity's previous accounting policies resulted in goodwill arising from the prior business combination being recognised as a deduction from equity, the entity shall not recognise that goodwill as an asset at the beginning of the first annual period beginning on or after 1 January 2007. Furthermore, the entity shall not recognise any part of that goodwill in profit or loss when it disposes of all or part of the business to which that goodwill relates or when a cash-generating unit to which the goodwill relates becomes impaired.

(d) Subsequent accounting for goodwill

From the beginning of the first annual period beginning on or after 1 January 2007 an entity shall discontinue amortising goodwill arising from the prior business combination and shall test goodwill for impairment in accordance with IAS 36.

(e) Previously recognised negative goodwill

An entity that accounted for the prior business combination by applying the purchase method may have recognised a deferred credit for an excess of its interest in the net fair value of the acquiree's identifiable assets and liabilities over the cost of that interest (sometimes called negative goodwill). If so, the entity shall derecognise the carrying amount of that deferred credit at the beginning of the first annual period beginning on or after 1 January 2007 with a corresponding adjustment to the opening balance of retained earnings at that date.

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Appendix D
Amendments to other IFRSs

The amendments in this [draft] Appendix shall be applied for annual periods beginning on or after [1 January 2007]. If an entity applies this [draft] IFRS for an earlier period, these amendments shall be applied for that earlier period. Amended paragraphs are shown with new text underlined and deleted text struck through.

D1 In International Financial Reporting Standards (including International Accounting Standards and Interpretations) applicable at [1 January 2007]:

(a) references to 'the purchase method' are amended to 'the acquisition method'.

(b) references to 'identifiable assets, liabilities and contingent liabilities' are amended to 'identifiable assets and liabilities'.

(c) references to 'each identifiable asset, liability and contingent liability' are amended to 'each identifiable asset and liability'.

(d) references to 'goodwill acquired in a business combination' are amended to 'goodwill arising in a business combination'.

(e) references to 'acquired goodwill' are amended to 'goodwill arising in a business combination'.

D2 IFRS 1 *First-time Adoption of International Financial Reporting Standards* is amended as described below.

In Appendix B, paragraphs B1 and B2(g)(ii) are deleted.

In Appendix B, paragraph B2(g) is amended as follows:

(g) The carrying amount of goodwill in the opening IFRS balance sheet shall be its carrying amount under previous GAAP at the date of transition to IFRSs, after the following ~~three~~two adjustments:

D3 In IFRS 2 *Share-based Payment*, paragraph 5 is amended as follows:

5 As noted in paragraph 2, this IFRS applies to share-based payment transactions in which an entity acquires or receives goods or services. Goods include~~s~~ inventories, consumables, property, plant and equipment, intangible assets and other non-financial assets. However, an entity shall not apply this IFRS to transactions in which the entity acquires goods as part of the

net assets acquired in a business combination to which IFRS 3 *Business Combinations* applies. Hence, equity instruments issued in a business combination in exchange for control of the acquiree are not within the scope of this IFRS. However, equity instruments granted to employees of the acquiree in their capacity as employees (eg in return for continued service) are within the scope of this IFRS. Similarly, the cancellation, replacement or other modification of *share-based payment arrangements* because of a business combination or other equity restructuring shall be accounted for in accordance with this IFRS. IFRS 3 provides guidance on determining whether equity instruments issued in a business combination are part of the consideration transferred in exchange for control of the acquiree (and therefore within the scope of IFRS 3) or are in return for continued service to be recognised in the post-combination period (and therefore within the scope of this IFRS).

D4 IAS 12 *Income Taxes* is amended as described below.

The Objective is amended as follows:

Objective

…

This Standard requires an entity to account for the tax consequences of transactions and other events in the same way that it accounts for the transactions and other events themselves. Thus, for transactions and other events recognised in profit or loss, any related tax effects are also recognised in profit or loss. For transactions and other events recognised directly in equity, any related tax effects are also recognised directly in equity. Similarly, the recognition of deferred tax assets and liabilities in a business combination affects the amount of goodwill arising in that business combination ~~or the amount of any excess of the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities over the cost of the combination~~.

…

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Paragraphs 18, 19, 21, 22 and 26 are amended as follows:

18 Temporary differences also arise when:

(a) ~~the cost of a business combination is allocated by recognising~~ the identifiable assets acquired and liabilities assumed in a business combination are recognised at their fair values in accordance with IFRS 3 *Business Combinations*, but no equivalent adjustment is made for tax purposes (see paragraph 19);

Business combinations

19 ~~The cost of a business combination is allocated by recognising~~ With limited exceptions, the identifiable assets acquired and liabilities assumed in a business combination are recognised at their fair values at the acquisition date. Temporary differences arise when the tax bases of the identifiable assets acquired and liabilities assumed are not affected by the business combination or are affected differently. For example, when the carrying amount of an asset is increased to fair value but the tax base of the asset remains at cost to the previous owner, a taxable temporary difference arises which results in a deferred tax liability. The resulting deferred tax liability affects goodwill (see paragraph 66).

Goodwill

21 Goodwill arising in a business combination is measured as the excess of the fair value of the acquiree, as a whole, over the net amount of the recognised identifiable assets acquired and liabilities assumed~~cost of the combination over the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities~~. Many taxation authorities do not allow reductions in the carrying amount of goodwill as a deductible expense in determining taxable profit. Moreover, in such jurisdictions, the cost of goodwill is often not deductible when a subsidiary disposes of its underlying business. In such jurisdictions, goodwill has a tax base of nil. Any difference between the carrying amount of goodwill and its tax base of nil is a taxable temporary difference. However, this Standard does not permit the recognition of the resulting deferred tax liability

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because goodwill is measured as a residual and the recognition of the deferred tax liability would increase the carrying amount of goodwill.

Initial recognition of an asset or liability

22 A temporary difference may arise on initial recognition of an asset or liability, for example if part or all of the cost of an asset will not be deductible for tax purposes. The method of accounting for such a temporary difference depends on the nature of the transaction which led to the initial recognition of the asset:

(a) in a business combination, an entity recognises any deferred tax liability or asset and this affects the amount of goodwill ~~or the amount of any excess over the cost of the combination of the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities~~ (see paragraph 19);

...

26 The following are examples of deductible temporary differences that result in deferred tax assets:

…

(c) ~~the cost of a business combination is allocated by recognising~~ with limited exceptions, the identifiable assets acquired and liabilities assumed in a business combination are recognised at their fair values at the acquisition date. When a liability assumed is recognised at the acquisition date but the related costs are not deducted in determining taxable profits until a later period, a deductible temporary difference arises which results in a deferred tax asset. A deferred tax asset also arises when the fair value of an identifiable asset acquired is less than its tax base. In both cases, the resulting deferred tax asset affects goodwill (see paragraph 66); and

…

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After paragraph 31 a heading and a new paragraph 32 are added as follows:

Goodwill

32 If the carrying amount of goodwill arising in a business combination is less than its tax base, the difference gives rise to a deferred tax asset. The deferred tax asset arising from the initial recognition of goodwill should be recognised as part of the accounting for a business combination to the extent that it is probable that taxable profit will be available against which the deductible temporary difference could be utilised.

Paragraphs 66-68 are amended as follows:

Deferred tax arising from a business combination

66 As explained in paragraphs 19 and 26(c), temporary differences may arise in a business combination. In accordance with IFRS 3 *Business Combinations*, an entity recognises any resulting deferred tax assets (to the extent that they meet the recognition criteria in paragraph 24) or deferred tax liabilities as identifiable assets and liabilities at the acquisition date. Consequently, those deferred tax assets and deferred tax liabilities affect goodwill ~~or the amount of any excess of the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities over the cost of the combination.~~ However, in accordance with paragraph 15(a), an entity does not recognise deferred tax liabilities arising from the initial recognition of goodwill.

67 As a result of a business combination, the probability of realising a deferred tax asset of the acquirer could change. A~~a~~n acquirer may consider it probable that it will recover its own deferred tax asset that was not recognised before the business combination. For example, the acquirer may be able to utilise the benefit of its unused tax losses against the future taxable profit of the acquiree. Alternatively, as a result of the business combination it may no longer be probable that future taxable profit will allow the deferred tax asset to be recovered. In such cases, the acquirer recognises a change in the deferred tax asset in the period of the business combination~~deferred tax asset~~, but does not include it as part of the accounting for the business combination.~~, and therefore~~ Therefore, the acquirer does not take it into account in

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~~determining~~ measuring ~~the~~ goodwill on consolidation~~or the amount of any excess of the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities over the cost of the combination.~~

68 ~~If t~~The potential benefit of the acquiree's income tax loss carryforwards or other deferred tax assets ~~did~~ may not satisfy the criteria ~~in IFRS 3~~ for separate recognition when a business combination is initially accounted for but ~~is~~ may be ~~subsequently~~ realised subsequently.~~, the acquirer shall recognise the resulting deferred tax income in profit or loss. In addition, the acquirer shall:~~

- ~~(a) reduce the carrying amount of goodwill to the amount that would have been recognised if the deferred tax asset had been recognised as an identifiable asset from the acquisition date; and~~
- ~~(b) recognises the reduction in the carrying amount of goodwill as an expense.~~

~~However, this procedure shall not result in the creation of an excess of the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities over the cost of the combination, nor shall it increase the amount previously recognised for any such excess.~~ There is a rebuttable presumption that acquired deferred tax benefits recognised within one year after the acquisition date are an adjustment to any deferred tax benefits recognised at that date and will be applied to reduce the carrying amount of any goodwill related to that acquisition. If the carrying amount of that goodwill is zero, any remaining deferred tax benefits will be credited to profit or loss or, if this Standard so requires, to equity. The rebuttable presumption is overcome if the recognition of the tax benefits results from a discrete event that occurred after the acquisition date. If the rebuttable presumption is overcome, or if those tax benefits are recognised more than one year after the acquisition date, they shall be credited to profit or loss or, if this Standard so requires, to equity.

The example following paragraph 68 is deleted.

Paragraph 81 is amended as follows:

81 The following shall also be disclosed separately:

…

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(h) in respect of discontinued operations, the tax expense relating to:

(i) the gain or loss on discontinuance; and

(ii) the profit or loss from the ordinary activities of the discontinued operation for the period, together with the corresponding amounts for each prior period presented; ~~and~~

(i) the amount of income tax consequences of dividends to shareholders of the entity that were proposed or declared before the financial statements were authorised for issue, but are not recognised as a liability in the financial statements~~.~~;

(j) if the probability of realising the acquirer's deferred tax asset changes as a result of a business combination (see paragraph 67), the amount of the resulting change in the deferred tax asset at the acquisition date; and

(k) a description of the event or change in circumstances that has resulted in deferred tax benefits acquired in a business combination being recognised.

Paragraphs 92 and 93 are added as follows:

92 Paragraph 68 shall be applied prospectively from the effective date of IFRS 3 *Business Combinations* (as revised in 200X) to the recognition of deferred tax assets acquired in business combinations, including business combinations effected before IFRS 3 (revised) is applied.

93 Therefore, entities shall not adjust the accounting for prior business combinations if tax benefits failed to satisfy the criteria for separate recognition as of the acquisition date and are recognised after the acquisition date, unless the rebuttable presumption in paragraph 68 applies. Tax benefits recognised more than one year after the acquisition date shall be credited to profit or loss or, if this Standard so requires, to equity.

In Appendix A, paragraph 12 of section A is amended as follows:

12 The carrying amount of an asset is increased to fair value in a business combination and no equivalent adjustment is made for tax purposes. *(Note that on initial recognition, the resulting deferred tax liability increases goodwill, if any ~~or decreases the amount of any excess of the acquirer's interest in the net fair value~~*

~~of the acquiree's identifiable assets, liabilities and contingent liabilities over the cost of the combination~~. See paragraph 66 of the Standard).

In Appendix A, paragraph 9 of section B is amended as follows:

Business combinations and consolidation

9 A liability is recognised at its fair value in a business combination, but none of the related expense is deducted in determining taxable profit until a later period. *(Note that the resulting deferred tax asset decreases goodwill, if any ~~or increases the amount of any excess of the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities over the cost of the combination~~. See paragraph 66 of the Standard).*

In Appendix B, Example 3 is amended as follows:

Example 3 - Business combinations

…

	~~Cost of~~ Values recognised at acquisition	*Tax base*	*Temporary differences*
Property, plant and equipment	270	155	115
Accounts receivable	210	210	–
Inventory	174	124	50
Retirement benefit obligations	(30)	–	(30)
Accounts payable	(120)	(120)	–
Fair value of the identifiable assets acquired and liabilities assumed, excluding deferred tax	504	369	135

...

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D5 In IAS 19 *Employee Benefits*, paragraph 108 is amended as follows:

Business combinations

108 In a business combination, an entity ~~recognises~~ measures assets and liabilities arising from post-employment benefits at the present value of the obligation less the fair value of any plan assets (see IFRS 3 *Business Combinations*). The present value of the obligation includes all of the following, even if the acquiree had not yet recognised them at the acquisition date:

(a) actuarial gains and losses that arose before the acquisition date (whether or not they fell inside the 10% 'corridor');

(b) past service cost that arose from benefit changes, or the introduction of a plan, before the acquisition date; and

(c) amounts that, under the transitional provisions of paragraph 155(b), the acquiree had not recognised.

D6 In IAS 28 *Investments in Associates*, paragraph 23 is amended as follows:

23 An investment in an associate is accounted for using the equity method from the date on which it becomes an associate. On acquisition of the investment any difference between the cost of the investment and the investor's share of the net fair value of the associate's identifiable assets~~,~~ and liabilities ~~and contingent liabilities~~ is accounted for in accordance with IFRS 3 *Business Combinations*. Therefore:

(a) goodwill relating to an associate is included in the carrying amount of the investment. However, amortisation of that goodwill is not permitted and is therefore not included in the determination of the investor's share of the associate's profits or losses.

(b) any excess of the investor's share of the net fair value of the associate's identifiable assets~~,~~ and liabilities ~~and contingent liabilities~~ over the cost of the investment is ~~excluded from the carrying amount of the investment and is instead~~ included as income in the determination of the investor's share of the associate's profit or loss in the period in which the investment is acquired.

…

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D7 In IAS 32 *Financial Instruments: Disclosure and Presentation*, paragraph 4(c) is deleted.

D8 In IAS 33 *Earnings per Share*, paragraph 22 is amended as follows:

22 Ordinary shares issued as part of the ~~cost of~~consideration transferred in a business combination are included in the weighted average number of shares from the acquisition date. This is because the acquirer incorporates into its income statement the acquiree's profits and losses from that date.

D9 In IAS 34 *Interim Financial Reporting*, paragraph 16(i) is amended as follows:

…

(i) the effect of changes in the composition of the entity during the interim period, including business combinations, acquisition or disposal of subsidiaries and long-term investments, restructurings, and discontinued operations. In the case of business combinations, the entity shall disclose the information required to be disclosed ~~under~~ by ~~paragraphs 66-73 of~~ IFRS 3 *Business Combinations*; and

…

D10 IAS 36 *Impairment of Assets* is amended as described below.

In paragraph 6, the definition of the agreement date is deleted.

Paragraph 81 is amended as follows:

81 Goodwill ~~acquired~~ arising in a business combination represents ~~a payment made by an acquirer in anticipation of~~ assets that provide future economic benefits ~~from assets that~~ but are not capable of being individually identified and separately recognised. Goodwill does not generate cash flows independently of other assets or groups of assets, and often contributes to the cash flows of multiple cash-generating units. Goodwill sometimes cannot be allocated on a non-arbitrary basis to individual cash-generating units, but only to groups of cash-generating units. As a result, the lowest level within the entity at which the goodwill is monitored for internal management purposes sometimes comprises a number of cash-generating units to which the goodwill relates, but to which it cannot be allocated.

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References in paragraphs 83-99 to a cash-generating unit to which goodwill is allocated should be read as references also to a group of cash-generating units to which goodwill is allocated.

After paragraph 90 the heading and paragraphs 91-95 are deleted. Those paragraphs are reproduced, with minor changes, as paragraphs C1-C5 in a new appendix (Appendix C). Appendix C also includes new paragraphs C6-C12. The appendix is inserted, as follows, with the changes highlighted being the differences between paragraphs 91-95 of IAS 36 and paragraphs C1-C5:

Appendix C

This appendix is an integral part of the Standard. It provides guidance on goodwill impairment testing for cash-generating units with goodwill and non-controlling interests.

Impairment testing cash-generating units with goodwill and non-controlling interests

Before [draft] IFRS 3 (as revised in 200X) is applied, the following guidance is relevant when performing a goodwill impairment test for cash-generating units with non-controlling interests.

C1 In accordance with IFRS 3, goodwill recognised in a business combination represents the goodwill acquired by a parent based on the parent's ownership interest, rather than the amount of goodwill controlled by the parent as a result of the business combination. Therefore, goodwill attributable to a ~~minority~~non-controlling interest is not recognised in the parent's consolidated financial statements. Accordingly, if there is a ~~minority~~non-controlling interest in a cash-generating unit to which goodwill has been allocated, the carrying amount of that unit comprises:

(a) both the parent's interest and the ~~minority~~non-controlling interest in the identifiable net assets of the unit; and

(b) the parent's interest in goodwill.

However, part of the recoverable amount of the cash-generating unit determined in accordance with this Standard is attributable to the ~~minority~~non-controlling interest in goodwill.

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C2 Consequently, for the purpose of impairment testing a ~~non-whooly-owned~~ cash-generating unit with goodwill that is not wholly-owned, the carrying amount of that unit is notionally adjusted, before being compared with its recoverable amount. This is accomplished by grossing up the carrying amount of goodwill allocated to the unit to include the goodwill attributable to the ~~minority~~non-controlling interest. This notionally adjusted carrying amount is then compared with the recoverable amount of the unit to determine whether the cash-generating unit is impaired. If it is, the entity allocates the impairment loss in accordance with paragraph 104 first to reduce the carrying amount of goodwill allocated to the unit.

C3 However, because goodwill is recognised only to the extent of the parent's ownership interest, any impairment loss relating to the goodwill is apportioned between that attributable to the parent and that attributable to the ~~minority~~non-controlling interest, with only the former being recognised as a goodwill impairment loss.

C4 If the total impairment loss relating to goodwill is less than the amount by which the notionally adjusted carrying amount of the cash-generating unit exceeds its recoverable amount, paragraph 104 requires the remaining excess to be allocated to reduce the other assets of the unit pro rata on the basis of the carrying amount of each asset in the unit.

C5 Illustrative Example 7 illustrates the impairment testing of a ~~non-whooly-owned~~ cash-generating unit with goodwill that is not wholly-owned.

After [draft] IFRS 3 (as revised in 200X) is applied, the following guidance is relevant when performing a goodwill impairment test for cash-generating units with non-controlling interests.

C6 In accordance with [draft] IFRS 3 (revised), the acquirer measures and recognises goodwill as of the acquisition date as the excess of the fair value of the acquiree, as a whole, over the net amount of the recognised identifiable assets acquired and liabilities assumed. This requirement applies even if the acquirer owns less than 100 per cent of the equity interests in the acquiree at the acquisition date (ie even if a non-controlling interest in the acquiree exists then).

C7 In accordance with [draft] IFRS 3 (revised), the acquirer allocates the carrying amount of goodwill as of the acquisition date between the acquirer and the non-controlling interest, if any.

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The carrying amount of goodwill allocated to the acquirer is the difference as of that date between the fair value of the acquirer's equity interest in the acquiree and the acquirer's share in the fair value of the separately recognised assets acquired and liabilities assumed. The rest of the goodwill is allocated to the non-controlling interests.

C8 In a cash-generating unit that includes a partially-owned subsidiary or is a stand-alone partially-owned subsidiary, goodwill impairment losses are allocated between the controlling and non-controlling interests pro rata using the relative carrying values of goodwill.

C9 If the partially-owned subsidiary is itself a cash-generating unit, the impairment loss is allocated to the controlling and non-controlling interests on the basis of the relative carrying values of goodwill allocated to them.

C10 If the partially-owned subsidiary is part of a larger cash-generating unit, goodwill impairment losses are allocated first to the components of the cash-generating unit and then to the controlling and non-controlling interests of the partially-owned subsidiary. The portion of the impairment loss allocated to the subsidiary is determined by multiplying the goodwill impairment loss for the unit by the carrying value of the goodwill assigned to that subsidiary, divided by the carrying value of the goodwill assigned to the cash-generating unit as a whole. The amount of the impairment loss allocated to the partially-owned subsidiary is then allocated to the controlling and non-controlling interests on the basis of the relative carrying values of goodwill allocated to those interests.

C11 If the total impairment loss relating to goodwill is less than the amount by which the carrying amount of the cash-generating unit exceeds its recoverable amount, paragraph 104 of IAS 36 requires the remaining excess to be allocated to reduce the other assets of the unit pro rata on the basis of the carrying amount of each asset in the unit.

C12 Illustrative Example 7A illustrates the impairment testing of a cash-generating unit with goodwill that is not wholly-owned.

Paragraph 138 is deleted.

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Paragraph 139 is amended as follows:

139 ~~Otherwise, a~~An entity shall apply this Standard:

(a) to goodwill and intangible assets acquired in business combinations for which the agreement date is on or after 31 March 2004; and

(b) to all other assets prospectively from the beginning of the first annual period beginning on or after 31 March 2004.

The agreement date for a business combination is the date that a substantive agreement between the combining parties is reached and, in the case of publicly listed entities, announced to the public. In the case of a hostile takeover, the earliest date that a substantive agreement between the combining parties is reached is the date that a sufficient number of the acquiree's owners have accepted the acquirer's offer for the acquirer to obtain control of the acquiree.

In the Illustrative Examples, the heading of Example 7 is amended as follows:

Example 7 - Impairment testing cash-generating units with goodwill and ~~minority~~non-controlling interests

(applicable to business combinations effected before [draft] IFRS 3 (revised 200X) is applied)

In the Illustrative Examples, paragraph IE65 of Example 7 is amended as follows.

IE65 A portion of Y's recoverable amount of CU1,000 is attributable to the unrecognised ~~minority~~non-controlling interest in goodwill. Therefore, in accordance with paragraph ~~92~~C2 of Appendix C of IAS 36, the carrying amount of Y must be notionally adjusted to include goodwill attributable to the ~~minority~~non-controlling interest, before being compared with the recoverable amount of CU1,000.

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In the Illustrative Examples, a new Example 7A is added as follows:

Example 7A - Impairment testing cash-generating units with goodwill and non-controlling interests

(applicable to business combinations effected after [draft] IFRS 3 (revised 200X) is applied)

In this example, tax effects are ignored.

Background

IE68A Entity X acquires an 80 per cent ownership interest in Entity Y for CU1,650 on 1 January 20X3. There is no evidence that this transaction is not an exchange of equal values. Therefore, the consideration transferred of CU1,650 is presumed to be the fair value of the 80 per cent interest. The fair value of Y is CU2,000. At 1 January 20X3, Y's identifiable net assets have a fair value of CU1,500.

IE68B Therefore, X recognises in its consolidated financial statements Y's identifiable net assets at their fair value of CU1,500.

X also recognises in its consolidated financial statements goodwill of CU500, measured as the excess of the fair value of Y, as a whole, of CU2,000 over the net amount of the recognised identifiable assets acquired and liabilities assumed of CU1,500.

The amount of goodwill attributable to the controlling interest and to the non-controlling interests in Y is calculated as follows:

	CU
Fair value of X's 80 per cent interest in Y	1,650
Less: X's share of the fair value of the identifiable net assets acquired (80 per cent × CU1,500)	(1,200)
Goodwill allocated to X	450
Goodwill allocated to the non-controlling interests in Y [CU500 - CU450]	50

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Therefore, the fair value of Y is attributed to X and the non-controlling interest at the acquisition date as follows:

	Total	*Attributable to X*	*Attributable to the non-controlling interest*
	CU	CU	CU
Identifiable net assets	1,500	1,200	300
Goodwill	500	450	50
Total	2,000	1,650	350

IE68C The assets of Y together are the smallest group of assets that generate cash inflows that are largely independent of the cash inflows from other assets or groups of assets. Therefore Y is a cash-generating unit. Because this cash-generating unit includes goodwill within its carrying amount, it must be tested for impairment annually, or more frequently if there is an indication that it may be impaired (see paragraph 90 of IAS 36).

IE68D At the end of 20X3, X determines that the recoverable amount of cash-generating unit Y is CU1,650. X uses straight-line depreciation over a 10-year life for Y's identifiable assets and anticipates no residual value.

Allocating impairment loss between the parent and non-controlling interest

Schedule 1. Testing Y for impairment at the end of 20X3

End of 20X3	*Goodwill*	*Identifiable net assets*	*Total*
	CU	CU	CU
Gross carrying amount	500	1,500	2,000
Accumulated depreciation	-	(150)	(150)
Carrying amount	500	1,350	1,850
Recoverable amount			1,650
Impairment loss			200

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IE68E In accordance with paragraph 104 of IAS 36, the impairment loss of CU200 is allocated to the assets in the unit by first reducing the carrying amount of goodwill to zero.

IE68F Therefore, the full amount of impairment loss of CU200 for the unit is allocated to the goodwill. In accordance with paragraph C9 of Appendix C of IAS 36, if the partially-owned subsidiary is itself a cash-generating unit, the goodwill impairment loss is allocated to the controlling and non-controlling interests on the basis of the relative carrying values of goodwill allocated to them.

Schedule 2. Allocating goodwill impairment loss to X and the non-controlling interest.

	Total amount	Attributable to X	Attributable to non-controlling interest
Goodwill before impairment loss	CU500	CU450	CU50
Percentage of the total	100%	90%	10%
Impairment loss	(CU200)	(CU180)	(CU20)
Goodwill after being reduced for impairment loss	CU300	CU270	CU30

D11 IAS 38 *Intangible Assets* is amended as follows:

In paragraph 8, the definition of the agreement date is deleted.

Paragraphs 11, 25 and 33 are amended as follows:

11 The definition of an intangible asset requires an intangible asset to be identifiable to distinguish it from goodwill. Goodwill ~~acquired~~ arising in a business combination represents ~~a payment made by the acquirer in anticipation of~~ future economic benefits from assets that are not capable of being individually identified and separately recognised. The future economic benefits may result from synergy between the identifiable assets acquired or from assets that, individually, do not qualify for recognition in the financial statements ~~but for which the acquirer is prepared to make a payment in the business combination~~.

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25 Normally, the price an entity pays to acquire separately an intangible asset reflects expectations about the probability that the expected future economic benefits embodied in the asset will flow to the entity. In other words, there will be an inflow of economic benefits, even if there could be uncertainty about the timing and the amount of the inflow ~~the effect of probability is reflected in the cost of the asset~~. Therefore, the probability recognition criterion in paragraph 21(a) is always considered to be satisfied for separately acquired intangible assets.

33 In accordance with IFRS 3 *Business Combinations*, if an intangible asset is acquired in a business combination, the cost of that intangible asset is its fair value at the acquisition date. ~~The fair value of an intangible asset reflects market expectations about the probability that the future economic benefits embodied in the asset will flow to the entity. In other words, the effect of probability is reflected in the fair value measurement of the intangible asset.~~ An intangible asset acquired in a business combination embodies an entity's unconditional right to future economic benefits. ~~Therefore~~Thus, the probability recognition criterion in paragraph 21(a) is always considered to be satisfied for intangible assets acquired in business combinations. Any uncertainty will relate to the timing and amount of the inflow.

Paragraphs 33A and 33B are inserted as follows:

33A A non-monetary asset without physical substance must be identifiable to meet the definition of an intangible asset. As outlined in paragraph 12, this will be the case when the asset is separable or arises from contractual or other legal rights. With one possible exception discussed in paragraph 33B, sufficient information should always exist to measure reliably the fair value of an asset that has an underlying contractual or legal basis or is capable of being separated from the entity.

33B As discussed in paragraph 15, an entity usually has insufficient control over the expected future economic benefits arising from a team of skilled staff and from training to conclude that these items meet the definition of an intangible asset. However, even in the unlikely event that an entity could demonstrate:

(a) control over the future economic benefits arising from an assembled workforce acquired in a business combination; and

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(b) that the workforce meets one of the criteria in paragraph 12 for identifiability,

it is highly unlikely that the fair value of that workforce and the related intellectual capital could be measured with sufficient reliability. Accordingly, [draft] IFRS 3 (revised) prohibits an acquirer from recognising an assembled workforce as an asset separately from goodwill.

Paragraphs 34 and 35 are amended as follows:

34 Therefore, in accordance with this Standard and [draft] IFRS 3 (revised), an acquirer recognises at the acquisition date separately from goodwill an intangible asset of the acquiree (other than an assembled workforce) ~~if the asset's fair value can be measured reliably~~, irrespective of whether the asset had been recognised by the acquiree before the business combination. This means that the acquirer recognises as an asset separately from goodwill an in-process research and development project of the acquiree if the project meets the definition of an intangible asset ~~and its fair value can be measured reliably~~. An acquiree's in-process research and development project meets the definition of an intangible asset when it:

(a) meets the definition of an asset; and

(b) is identifiable, ie is separable or arises from contractual or other legal rights.

Measuring the fair value of an intangible asset acquired in a business combination

35 With the exception of an assembled workforce, sufficient information always exists to measure reliably the fair value of an asset that has an underlying contractual or legal basis or is capable of being separated from the entity. ~~The fair value of intangible assets acquired in business combinations can normally be measured with sufficient reliability to be recognised separately from goodwill.~~ When, for the estimates used to measure an intangible asset's fair value, there is a range of possible outcomes with different probabilities, that uncertainty enters into the measurement of the asset's fair value~~, rather than demonstrates an inability to measure fair value reliably. If an intangible asset~~

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~~acquired in a business combination has a finite useful life, there is a rebuttable presumption that its fair value can be measured reliably~~.

Paragraphs 38-41 are deleted.

Paragraphs 68 and 69 are amended as follows:

68 Expenditure on an intangible item shall be recognised as an expense when it is incurred unless:

(a) it forms part of the cost of an intangible asset that meets the recognition criteria (see paragraphs 18-67); or

(b) the item is acquired in a business combination and cannot be recognised as an intangible asset. If this is the case, this expenditure (included in the ~~cost of~~ consideration transferred in the business combination) shall form part of the ~~amount attributed to~~goodwill at the acquisition date (see IFRS 3 *Business Combinations*).

69 In some cases, expenditure is incurred to provide future economic benefits to an entity, but no intangible asset or other asset is acquired or created that can be recognised. In these cases, the expenditure is recognised as an expense when it is incurred. For example, except when it forms part of the ~~cost of~~assets acquired in a business combination, expenditure on research is recognised as an expense when it is incurred (see paragraph 54). Other examples of expenditure that is recognised as an expense when it is incurred include:

…

Paragraph 129 is deleted.

Paragraph 130 is amended as follows:

130 ~~Otherwise, a~~An entity shall apply this Standard:

(a) to the accounting for intangible assets acquired in business combinations for which the agreement date is on or after 31 March 2004; and

(b) to the accounting for all other intangible assets prospectively from the beginning of the first annual period beginning on or after 31 March 2004. Thus, the entity shall not adjust the carrying amount of intangible assets recognised at that date. However, the entity shall, at that date, apply this Standard to reassess the useful

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lives of such intangible assets. If, as a result of that reassessment, the entity changes its assessment of the useful life of an asset, that change shall be accounted for as a change in an accounting estimate in accordance with IAS 8.

The agreement date for a business combination is the date that a substantive agreement between the combining parties is reached and, in the case of publicly listed entities, announced to the public. In the case of a hostile takeover, the earliest date that a substantive agreement between the combining parties is reached is the date that a sufficient number of the acquiree's owners have accepted the acquirer's offer for the acquirer to obtain control of the acquiree.

D12 In IAS 39 *Financial Instruments: Recognition and Measurement*, paragraph 2(f) is deleted.

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Appendix E

Fair Value Measurements

This appendix is an integral part of the [draft] IFRS.

E1 This appendix provides guidance on how to measure fair value when accounting for a business combination. It shall be applied to all fair value measurements required by this [draft] IFRS, including the fair values of the acquiree, the financial and non-financial identifiable assets acquired and liabilities assumed, and the consideration transferred. [The guidance in this Appendix is based on the FASB's Proposed Statement of Financial Accounting Standards *Fair Value Measurements.* The FASB plans to issue a final Statement on Fair Value Measurements in the fourth quarter of 2005. This guidance may change as a consequence of that final Statement.]

Definition of fair value

E2 For the purposes of this [draft] IFRS, fair value is the price at which an asset or liability could be exchanged in a current transaction between knowledgeable, unrelated, willing parties.

E3 The objective of a fair value measurement is to estimate an exchange price for the asset or liability being measured in the absence of an actual transaction for that asset or liability.* Thus, the estimate is determined by reference to a current hypothetical transaction between willing parties.

E4 Willing parties are presumed to be marketplace participants representing unrelated buyers and sellers that are:

(a) knowledgeable, having a common level of understanding about factors relevant to the asset or liability and the transaction: and

(b) willing and able to transact in the same market(s), having the legal and financial ability to do so.

* For a liability, the estimate of fair value shall consider the effect of the liability's credit standing so that the estimate reflects the amount that would be observed in an exchange between willing parties of the same credit quality.

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E5 Fair value presumes the absence of compulsion (duress). Accordingly, the amount that forms the basis for the estimate is the price that would be observed in a transaction other than a forced liquidation transaction or distress sale. In all cases, that price shall be estimated without regard to an entity's current intention to enter into such a transaction.

Valuation techniques

E6 Valuation techniques consistent with the market approach, income approach and cost approach shall be considered for all estimates of fair value. However, for estimates of fair value that are developed using quoted prices in active markets (an application of the market approach), the results of other valuation techniques may not provide significant additional information (paragraphs E12-E22). Key aspects of those approaches are summarised below:

(a) The market approach requires observable prices and other information generated by actual transactions involving identical, similar or otherwise comparable assets or liabilities (including businesses). The estimate of fair value is based on the value indicated by those transactions. For example, paragraph 41 of IAS 38 refers to the use of valuation techniques consistent with the market approach in determining the fair value of an intangible asset.

(b) The income approach uses valuation techniques to convert future amounts (for example, cash flows or profit or loss) to a single present amount (discounted). The estimate of fair value is based on the value indicated by marketplace expectations about those future amounts.

(c) For an asset, the cost approach considers the amount that would currently be required to replace its service capacity (often referred to as current replacement cost). The estimate of fair value considers the cost to acquire a substitute asset of comparable utility, adjusted for obsolescence. Obsolescence encompasses physical depreciation, functional obsolescence and economic obsolescence and is broader than depreciation for financial reporting purposes (an allocation of historical cost) or tax purposes (based on specified service lives).

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E7 Valuation techniques used to estimate fair value shall be consistently applied. A change in the valuation technique(s) used is appropriate only if the change results in a more reliable estimate of fair value, for example as new markets develop or as new and improved valuation techniques become available.

Market inputs

E8 Market inputs refer to the assumptions and data that marketplace participants would use in their estimates of fair value. Valuation techniques used to estimate fair value shall emphasise market inputs, including those derived from active markets, whether using the market approach, income approach, or cost approach.

E9 In an active market, such as the Brussels Stock Exchange (Bourse), quoted prices that represent actual (observable) transactions are readily and regularly available; *readily available* means that pricing information is currently accessible and *regularly available* means that transactions occur with sufficient frequency to provide pricing information on an ongoing basis. In determining whether a market is active, the emphasis is on the level of activity for a particular asset or liability.

E10 Markets in which assets and liabilities are exchanged vary in structure and level of activity. Examples of such markets include the following:

(a) Exchange market—An exchange market provides high visibility and order to the trading of financial instruments. Typically, closing prices are readily and regularly available. In an exchange market, multiple identical exchange units are traded. An example of such a market is the London Stock Exchange.

(b) Dealer market—In a dealer market, dealers stand ready to trade (either buy or sell for their own account), thereby providing liquidity by using their capital to hold an inventory of the items for which they make a market. Typically, bid and asked prices are more readily and regularly available than closing prices. In a dealer market, multiple identical exchange units are traded. 'Over-the-counter' markets (where prices are publicly reported by, for example, the International Securities Market Association in Europe or US National Association of Securities Dealers Automated Quotations systems or the US National Quotation Bureau in the United States) are dealer markets. For example, the market for US Treasury securities is a dealer market. Dealer

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markets also exist for other assets and liabilities, such as financial instruments, commodities and physical assets (for example, certain used equipment).

(c) Brokered market—In a brokered market, brokers attempt to match buyers with sellers but do not stand ready to trade for their own account. In other words, brokers do not use their own capital to hold an inventory of the items for which they make a market. The broker knows the prices bid and asked by the respective parties, but each party is typically unaware of another party's price requirements. Prices of completed transactions are sometimes available. Brokered markets include electronic communication networks (ECNs), in which buy and sell orders are matched, and commercial and residential real estate markets.

(d) Principal-to-principal market—Principal-to-principal transactions, both originations and resales, are negotiated independently with no intermediary. Little information about those transactions may be released publicly.

E11 Market inputs shall be determined on the basis of information that is timely, originated from sources independent of the entity and used by marketplace participants in making pricing decisions. Examples of market inputs that may be used, directly or indirectly as a basis for deriving other relevant inputs, include the following:

(a) quoted prices, whether quoted in terms of completed transaction prices, bid and asked prices, or rates, adjusted as appropriate. The fair value hierarchy (paragraphs E12-E24) specifies whether and, if so, when adjustments to those prices are appropriate.

(b) information about interest rates, yield curve, volatility, prepayment speeds, default rates, loss severity, credit risk, liquidity and foreign exchange rates.

(c) specific and broad credit data and other relevant statistics (industry and other), including a current published index.

Fair value hierarchy

E12 The fair value hierarchy groups into three broad categories (levels) the inputs that should be used to estimate fair value. The hierarchy gives the highest priority to market inputs that reflect quoted prices in active markets for identical assets and liabilities (whether such prices are quoted

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in terms of completed transaction prices, bid and asked prices, or rates) and the lowest priority to entity inputs developed on the basis of an entity's own internal estimates and assumptions.

Level 1 estimates

E13 Fair value shall be estimated using quoted prices for identical assets or liabilities in active reference markets whenever that information is available. Quoted prices used for a Level 1 estimate shall not be adjusted.

E14 For an identical asset or liability, the Level 1 reference market is the active market to which an entity has immediate access (in many cases, the principal trading market for the asset or liability being measured). *Immediate access* means that an entity could exchange the asset or liability in its current condition at the quoted price in that market within a period that is usual and customary for transactions involving such assets or liabilities. If the entity has immediate access to multiple active markets with different prices, the Level 1 reference market is the most advantageous market, ie the market with the price that maximises (or minimises) the net amount that would be received (or incurred) in a current transaction for an asset (or liability). For the purposes of determining the most advantageous market, costs to transact in the respective markets shall be considered. However, the price used to estimate fair value, ie the price in the most advantageous market, shall not be adjusted for those costs. Transaction costs shall be accounted for in accordance with the provisions of other applicable pronouncements, generally in the period incurred.

E15 In an active dealer market where bid and asked prices are more readily and regularly available than closing prices, fair value shall be estimated using bid prices for long positions (assets) and asked prices for short positions (liabilities). For offsetting positions, mid-market prices shall be used for the matched portion. Bid and asked prices shall be used for the net open position, as appropriate.

E16 In some cases in which significant events (for example, principal-to-principal or brokered trades or significant announcements) occur after the close of the market but before the end of the reporting period, the closing price in that market might not be representative of fair value. An entity shall establish and apply consistently a policy for determining how those events affect estimates of fair value.

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Level 2 estimates

E17 If quoted prices for identical assets or liabilities in active markets are not available, fair value shall be estimated using quoted prices for similar assets or liabilities in active markets, adjusted as appropriate for differences, whenever that information is available.

E18 For a Level 2 estimate, the price effect of the differences must be determinable objectively. For example, an observed price of securitised receivables can be used as a basis for estimating the fair value of unsecuritised receivables of the same type, but only if the price effect of the securitisation (the price effect of the liquidity, security, and other benefits added by securitisation) is determinable objectively. Otherwise, the estimate is a Level 3 estimate.

Level 3 estimates

E19 If quoted prices for identical or similar assets or liabilities in active markets are not available, or if differences between similar assets or liabilities are not determinable objectively, fair value shall be estimated using multiple valuation techniques consistent with the market approach, income approach, and cost approach whenever the information necessary to apply those multiple techniques is available without undue cost and effort.

E20 Level 3 estimates require judgement in the selection and application of valuation techniques and relevant inputs. Only multiple valuation techniques that are applicable or relevant in the circumstances shall be used. If multiple valuation techniques are used, the results of those techniques (ie the respective indications of fair value) shall be evaluated, considering the relevance and reliability of the inputs used. If information necessary to apply multiple valuation techniques is not available without undue cost and effort, the valuation technique that best approximates what an exchange price would be in the circumstances shall be used.

E21 Valuation techniques used for Level 3 estimates shall emphasise market inputs, including quoted prices generated by actual (observable) market transactions, adjusted as appropriate (see paragraph E11). The reasons for adjustments to quoted prices will vary. Examples include the following:

(a) A price might not be sufficiently current for a Level 1 or Level 2 estimate (stale price). In determining whether a price is stale, an entity shall consider the timing of the actual transaction, the frequency of other similar transactions, changes in credit conditions, interest rates, and other market conditions during the intervening period and other relevant factors.

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(b) The price effect of differences between similar assets (liabilities) might not be sufficiently determinable for a Level 2 estimate.

(c) A price might be quoted in terms of bid and asked prices in a less active market (where the spread between the bid and asked prices is relatively wide).

(d) The underlying transaction might not be representative of a marketplace transaction. That could be the case if, for example, the transaction:

   (i) occurred under duress (in a forced liquidation transaction or distress sale);

   (ii) was between related parties; or

   (iii) was part of a series of other simultaneous planned or recent transactions between the parties and would have occurred at a different price if not for those other transactions.

(e) Contractual terms might affect the total transaction price (for example, contingent consideration).

(f) A price might need to be adjusted for differences in the unit of account, condition, or location.

Level 3 estimates with significant entity inputs

E22 In some cases, market inputs might not be available without undue cost and effort, requiring the use of significant entity inputs derived from an entity's own internal estimates and assumptions. In those cases, valuation techniques that rely on significant entity inputs may be used for Level 3 estimates, but only as a practical expedient (the fair value measurement objective remains the same).

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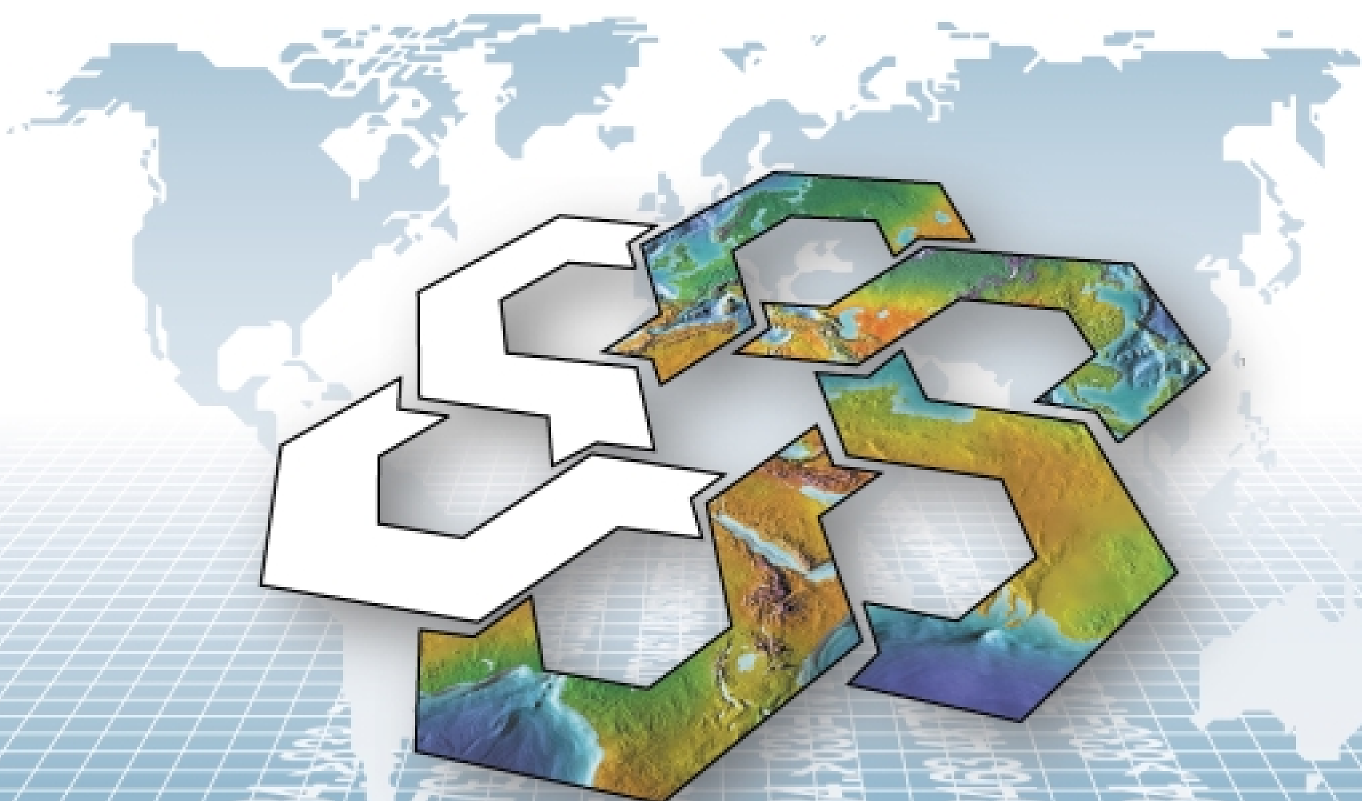
June 2005

BASIS FOR CONCLUSIONS ON EXPOSURE DRAFT OF PROPOSED

Amendments to

IFRS 3 Business Combinations

Comments to be received by 28 October 2005



International Accounting Standards Board®

Basis for Conclusions on
Exposure Draft

PROPOSED AMENDMENTS TO
IFRS 3 BUSINESS COMBINATIONS

Comments to be received by 28 October 2005

This Basis for Conclusions accompanies the draft International Financial Reporting Standard (IFRS) set out in the Exposure Draft of Proposed Amendments to IFRS 3 *Business Combinations* (see separate booklet). Comments on the draft IFRS and its accompanying documents should be submitted in writing so as to be received by **28 October 2005**.

All responses will be put on the public record unless the respondent requests confidentiality. However, such requests will not normally be granted unless supported by good reason, such as commercial confidence. If commentators respond by fax or email, it would be helpful if they could also send a hard copy of their response by post. Comments should preferably be sent by email to: **CommentLetters@iasb.org** or addressed to:

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Differences between the Exposure Drafts published by the IASB and the FASB

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Basis for Conclusions on Proposed Amendments to IFRS 3 *Business Combinations*

This Basis for Conclusions accompanies, but is not part of, the draft IFRS.

INTRODUCTION

BC1 This Basis for Conclusions summarises the International Accounting Standards Board's considerations in reaching the conclusions in the Exposure Draft of Proposed Amendments to IFRS 3 *Business Combinations*. It includes the reasons why the Board accepted particular approaches and rejected others. Individual Board members gave greater weight to some factors than to others. The considerations and conclusions of the US Financial Accounting Standards Board (FASB) on the issues addressed jointly by the FASB and the IASB, which are similar in most but not all respects, are summarised in the Background Information and Basis for Conclusions on proposed Statement No. 141(R) *Business Combinations* (SFAS 141(R)).

BC2 The draft revised IFRS 3 is published by the Board as part of its project on business combinations. The Board added the project to its initial agenda in July 2001. The objective of the project is to improve the quality of, and achieve international convergence on, the accounting for business combinations.

BC3 The project on business combinations is being undertaken in stages. The first phase resulted in the Board issuing simultaneously the current version of IFRS 3 and revised versions of IAS 36 *Impairment of Assets* and IAS 38 *Intangible Assets*. In developing IFRS 3 the Board carried forward without reconsideration some of the requirements in the predecessor standard IAS 22 *Business Combinations*. The Board's primary focus in that process was on:

(a) the method of accounting for business combinations;

(b) the initial measurement of the identifiable assets acquired and liabilities and contingent liabilities assumed in a business combination;

(c) the recognition of liabilities for terminating or reducing the activities of an acquiree;

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(d) the treatment of any excess of the acquirer's interest in the fair value of identifiable net assets acquired in a business combination over the cost of the combination; and

(e) the accounting for goodwill and intangible assets acquired in a business combination.

BC4 The second phase is being conducted as a joint project with the FASB. It involves a broad reconsideration of the requirements in IFRSs and US generally accepted accounting principles (US GAAP) on applying the purchase method (which the draft revised IFRS 3 refers to as the acquisition method). An objective of the second phase of the project is to reconsider existing guidance on the application of the acquisition method in order to improve the completeness, relevance, and comparability of financial information about business combinations that is provided in financial statements. Another objective of this phase is to achieve convergence of IFRSs and US GAAP on how the acquisition method is applied.

BC5 The second phase also addresses how the acquisition method should be applied to business combinations involving only mutual entities and to combinations achieved by contract alone. A business combination achieved by contract alone includes combinations in which separate entities are brought together by contract to form a dual listed corporation.

BC6 The IASB and FASB deliberated concurrently on each of the fundamental issues in the second phase of the project. They reached the same conclusions on all of those issues. The application of some requirements of the draft revised IFRS 3 and the proposed SFAS 141(R) may differ, however, because of differences in:

(a) other accounting standards to which the draft revised IFRS 3 and proposed SFAS 141(R) refer. For example, recognition and measurement requirements for some assets acquired and liabilities assumed refer to existing standards rather than fair value measures. The proposed revision of IFRS 3 requires a deferred tax asset or liability to be recognised in accordance with IAS 12 *Income Taxes*. The proposed FASB SFAS 141(R) requires a deferred tax asset or liability to be recognised in accordance with FASB Statement No. 109 *Accounting for Income Taxes* (SFAS 109).

(b) disclosure practices between the IASB and the FASB. For example, the FASB requires additional disclosures and unaudited supplementary information, although these are limited to

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public entities. The IASB has no similar requirements for unaudited information and does not distinguish between public and non-public entities.

(c) transition provisions for changes to past accounting practices that previously differed under IFRSs and US GAAP.

The substantive differences that remain are described in the note *Differences between the Exposure Drafts published by the IASB and the FASB* on page 70.

BC7 The second phase has resulted in the Board publishing simultaneously the draft revised IFRS, which proposes to replace IFRS 3, together with an Exposure Draft of Proposed Amendments to IAS 27 *Consolidated and Separate Financial Statements* and an Exposure Draft of Proposed Amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* (to be retitled *Non-financial Liabilities*). The Board's intention in developing the proposed amendments to IAS 27 is to reflect only those changes related to its decisions in the second phase of the Business Combinations project, and not to reconsider all of the requirements in IAS 27. The changes proposed to IAS 27 deal primarily with the accounting for increases and decreases in ownership interests in subsidiaries after control is obtained and the accounting for the loss of control of subsidiaries. Similarly, the Board's intention in developing the proposed amendments to IAS 37 is not to reconsider all of the requirements in IAS 37. Some of those proposed changes arise from the second phase of the Business Combinations project, with the remainder arising from the Board's Short-term Convergence project. The changes arising from the second phase of the Business Combinations project result from the Board's reconsideration of the treatment in a business combination of the contingencies of an acquiree. The changes arising from the Short-term Convergence project are focused on narrowing the differences between IFRSs and US GAAP in the timing of the recognition of liabilities for costs associated with restructurings.

BC8 The draft revised IFRS 3 proposes to carry forward without reconsideration some conclusions reached in the development of IFRS 3. They include the requirements to use the acquisition method of accounting and to identify an acquirer for all business combinations. They also include the notion of 'identifiability' for recognising an intangible asset separately from goodwill. Thus, the sections of the Basis for Conclusions in the current IFRS 3 related to those matters remain relevant. However, because the Board did not redeliberate and is not seeking comments on those conclusions, this Basis for Conclusions does not repeat those sections.

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BC9 The Board will consider the following issues as part of future phases of its project on business combinations:

(a) the accounting for business combinations in which separate entities or businesses are brought together to form a joint venture, including possible applications of 'fresh start' accounting.

(b) the accounting for business combinations involving entities under common control.

A single accounting standard

BC10 In July 2004 the FASB and the IASB agreed to develop jointly a single standard on accounting for business combinations that could be used for both cross-border and domestic financial reporting. The boards decided that financial reporting would be improved if they had similar standards for accounting for business combinations.

BC11 Originally, the boards did not plan to reconsider jointly all of the issues addressed in their separate phase I projects on which they had reached similar, but not identical, decisions. However, having decided to develop a single standard on accounting for business combinations, the boards agreed that reaching a converged position on most aspects of the single standard was of primary importance. Therefore, the boards focused their efforts on eliminating points of divergence that were identified in the process of drafting the single standard. These included agreeing on converged definitions of a business combination and goodwill, and guidance on identifying the acquirer.

BC12 The draft revised IFRS 3 and draft SFAS 141(R) incorporate the decisions reached in the joint project. They also incorporate the guidance from the existing business combinations standards, which reflects the decisions made in the separate first phases of the Business Combinations project. The boards expect that their guidance in this single standard will differ only to the extent there are differences in application resulting from the factors identified in paragraph BC6.

FUNDAMENTAL PRINCIPLES UNDERLYING THE DRAFT REVISED IFRS 3

BC13 As noted in paragraph BC8, the draft revised IFRS 3 proposes to carry forward without reconsideration the primary provisions of IFRS 3 including its requirement for all business combinations to be accounted for by

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applying the acquisition method. The Board did, however, examine inconsistencies that have resulted from the application of the acquisition method.

BC14 Under the acquisition method in IFRS 3 a business combination is recognised at its cost. That cost is measured by the acquirer as the aggregate of the fair values, at the date of exchange, of assets given, liabilities incurred or assumed, and equity interests issued by the acquirer, in exchange for control over the acquiree plus any costs directly attributable to the business combination. The cost is then allocated among the individual identifiable assets and liabilities of the acquiree on the basis of their fair values.

BC15 In a business combination in which the acquirer obtains control of a 100 per cent interest in the acquiree, in a single transaction, the acquirer recognises in its consolidated financial statements all of the goodwill at the date of acquisition. In a business combination in which the acquirer obtains control of less than all of the equity interest of the acquiree, the acquirer recognises all of the acquiree's identifiable assets and liabilities at their full fair values but only its portion of the goodwill.

BC16 Furthermore, IFRS 3 requires that for a business combination achieved in stages each exchange transaction is treated separately by the acquirer, using the cost and fair value information at the date of each exchange transaction, to measure any goodwill associated with that transaction. This results in a step-by-step comparison of the cost of the individual investments with the acquirer's interest in the fair values of the acquiree's identifiable assets and liabilities at each step. As a result, goodwill is a mixture of some current exchange prices and some carry-forward book values for each earlier purchase. Therefore, the amount of goodwill recognised in a business combination achieved in stages and in a business combination achieved in a single transaction will not be the same.

BC17 The Board believes these inconsistencies result in information that is not as complete or as useful as it would be without them. Obtaining control over an acquired entity makes the acquirer accountable for all of the acquiree's assets and liabilities—not just those that are identifiable and not just its proportionate share of those assets and liabilities. Therefore, the Board decided that the measurement objective in accounting for business combinations should be the fair value of the acquiree on the acquisition date rather than the costs incurred in a business combination. Moreover, the Board concluded that the same measurement principle—measuring the business at its fair value—should apply whether the acquiree is acquired in an exchange transaction or through other means.

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BC18 The Board believes that the principles underlying IFRSs should strive to reflect the underlying economics of transactions and events. The Board therefore concluded that financial reporting and the relevance of information about business combinations could be improved significantly by developing fundamental principles that focus on the underlying economic circumstances that exist when a business is acquired and applying them consistently. The Board decided that the following fundamental principles should be applied in accounting for all business combinations:

(a) *The acquirer obtains control of the acquiree at the acquisition date and thereby becomes responsible and accountable for all of the acquiree's assets, liabilities and activities, regardless of the percentage of its ownership in the acquiree*. The Board concluded that obtaining control of a business is an event that should result in remeasurement regardless of how control is obtained. Thus, to provide information that is both relevant and reliable, the acquirer's accounting for those assets, liabilities and activities begins at the acquisition date and, if the acquirer held a non-controlling equity investment in the acquired entity, its accounting for that interest as an investment should cease.

(b) *The total amount to be recognised for the acquiree should be the fair value of the acquiree as a whole*. The Board concluded that this faithfully and consistently reflects the underlying economic value of the business acquired, regardless of the ownership interest in the acquiree at the acquisition date or whether control was achieved in stages (involving two or more purchases of ownership interests in the acquiree) or whether a purchase occurred on the acquisition date.

(c) *Business combinations generally are exchange transactions in which knowledgeable, unrelated willing parties are presumed to exchange equal values*. The Board concluded that, in the absence of evidence to the contrary, the consideration transferred by the acquirer on the acquisition date is presumed to be the best evidence of the fair value of its interest in the acquiree at that date. If the consideration transferred is not the best evidence of the acquisition-date fair value of the acquirer's interest in the acquiree, the acquirer should measure that fair value directly using valuation techniques.

(d) *The identifiable assets acquired and liabilities assumed in a business combination should be recognised at their fair values on the date control is obtained*. The Board concluded that this

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faithfully reflects the underlying economic circumstances at that date.

The draft revised IFRS 3 reflects, where possible, the Board's application of these fundamental principles in accounting for all business combinations. The Board decided that it was necessary, in some circumstances, to depart from the principles. For example, the proposed IFRS requires some assets and liabilities to be measured in accordance with another standard. The exceptions are discussed in paragraphs BC117-BC150.

BC19 The Board also concluded that the full amount of goodwill will be recognised in a business combination, rather than goodwill only to the extent of the acquirer's interest in the acquiree. This is consistent with recognising the full amount of the net identifiable assets acquired.

BC20 The Board concluded that, by focusing on the principles in paragraph BC18, the draft revised IFRS 3 will, if adopted, lead to significant improvements in financial reporting without imposing undue costs. In particular, the Board believes that the emphasis on accounting for business combinations at the acquisition date (rather than on a basis of accumulating costs) is consistent with its commitment to develop standards that result in similar transactions and circumstances being accounted for in a similar way.

BC21 In considering the benefits and costs of any new standard, the Board is mindful that its standards should emphasis fundamental principles and strive to avoid exceptions, particularly those that add undue complexities and costs. The Board concluded that the draft IFRS's focus on the principles in paragraph BC18 accomplishes that objective. It also believes that the exceptions to those principles have been appropriately limited to those that are necessary, at this time, and minimise disruptions to the continuity of reporting practice.

BC22 The following sections discuss the Board's decisions with respect to the application of the principles to specific aspects of accounting for business combinations.

DEFINITION OF A BUSINESS COMBINATION

BC23 Initially the Board did not plan to reconsider the definition of a business combination in this phase of the Business Combinations project. However, as discussed above, the decision to develop a single standard on accounting for business combinations prompted the Board to reconsider it, given that it was an area of divergence for the boards.

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BC24 The FASB decided, in this project, to define a business combination as a transaction or other event in which an acquirer obtains control over one or more businesses. This is broader than the definition in FASB Statement No. 141 *Business Combinations* (SFAS 141) because it includes all events and transactions that result in one entity obtaining control of a business, regardless of the form of the transaction. It includes, for example, obtaining control through the lapse of minority veto rights without a purchase of the net assets or equity interests of the acquiree.

BC25 A business combination is defined in IFRS 3 as the bringing together of separate entities or businesses into one reporting entity. The Board observed that this definition could be read to include circumstances in which there may not be an economic event or transaction that triggers a business combination. Consequently, there may not be a change in an economic entity per se. Rather, a business combination could take place when entities or businesses are brought into one reporting entity.* This could occur when, for example, an individual decides to prepare combined financial statements for all or some of the entities that he or she controls. The Board concluded that the definition of a business combination in IFRS 3 is too broad and that a business combination should be described in terms of an economic event rather than in terms of consolidation accounting. The Board decided that the FASB's proposed definition meets this condition.

BC26 However, the Board observed that the FASB definition focuses on control being the factor that triggers a business combination. In developing IFRS 3 the Board concluded that the definition of a business combination should be broad enough to encompass all transactions or other events in which separate entities or businesses are brought together into one reporting entity, regardless of the form of the transaction. The Board intended its definition of a business combination to be broader than transactions in which one entity obtains control of another (or others). For example, the definition in IFRS 3 includes formations of joint ventures and any other 'bringing together' that does not involve one entity obtaining control of another. As noted in paragraph BC39 of IFRS 3, at that time the Board:

> …decided that it should not, in the first phase of its project, rule out the possibility of a business combination occurring (other than a combination involving the formation of a joint venture) in which one of the combining

* Paragraph 8 of the *Framework* states that it is concerned with the financial statements of reporting entities, and that a reporting entity is 'an entity for which there are users who rely on the financial statements as their major source of financial information about the entity'.

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> entities does not obtain control of the other combining entity or entities (often referred to as a 'true merger' or 'merger of equals').

BC27 Although the definition was intended to be broad, IFRS 3 then excluded formations of joint ventures from its scope. The Board agreed that it will consider formations of joint ventures as part of future phases of its project on business combinations.

BC28 Furthermore, IFRS 3, like SFAS 141, requires a single method to be applied in accounting for all business combinations in its scope—the acquisition method. Paragraph BC39 of the Basis for Conclusions on IFRS 3 notes:

> After considering all the information and arguments put before it, including case studies drawn from situations encountered in practice, the Board concluded that most business combinations result in one entity obtaining control of another entity (or entities) or business(es), and therefore that an acquirer could be identified for most combinations.

BC29 As a result, the FASB's proposed definition and the IFRS 3 definition in conjunction with the scope exclusion for joint ventures would result in the same transactions or events being accounted for as business combinations using the acquisition method.

BC30 In developing SFAS 141 the FASB also considered the accounting for true mergers or mergers of equals and concluded that all business combinations result in one entity obtaining control of another; that is, true mergers are very rare. Paragraph 42 of the Basis for Conclusions on SFAS 141 states:

> The [FASB] Board concluded that 'true mergers' or 'mergers of equals' are nonexistent or so rare as to be virtually nonexistent, and many respondents agreed. Other respondents stated that even if a true merger or merger of equals did occur, it would be so rare that a separate accounting treatment is not warranted. They also stated that developing the criteria necessary to identify those transactions simply would be a continuation of the same problems and potential for abuse evidenced by Opinion 16….The [FASB] Board further observed that respondents and other constituents were unable to suggest an unambiguous and nonarbitrary boundary for distinguishing true mergers or mergers of equals from other two-party business combinations and concluded that developing such an operational boundary would not be feasible. Moreover, even if those mergers could feasibly be distinguished from other combinations, the [FASB] Board concluded that it does not follow that such combinations should be accounted for on a carry-over basis. If they were to be accounted for using a method other than the purchase method, the [FASB] Board believes that a better method would be the fresh-start method.

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BC31 The IASB agreed with the FASB's conclusion that true mergers, if they exist, would be very rare. The Board observed that almost all business combinations portrayed as mergers of equals by the combining entities resulted in one of the parties undoubtedly obtaining control over the other combining entity after the combination. Therefore, the Board agreed with the FASB's conclusion that virtually all business combinations result in one entity obtaining control of another entity (or entities) or business(es). As a result, the Board decided to adopt the FASB's definition of a business combination.

BC32 Even though the new definition focuses on control, all business combinations included in the scope of IFRS 3 are within the scope of the draft revised IFRS 3. Like IFRS 3 and SFAS 141, the proposed IFRS will continue to require the acquisition method to be applied to those rare combinations, if any, for which one of the combining entities does not obtain control of the other combining entity. However, the Board noted that it is committed to exploring in a future phase of its Business Combinations project whether the 'fresh start' method might be applied to these combinations.

BC33 As noted in paragraph BC4, the Board decided to replace the term 'purchase method' that was previously used to describe the method of accounting for business combinations with the term 'acquisition method'. The Board concluded that 'acquisition method' better describes circumstances in which an acquirer obtains control of a business through means other than a purchase of its net assets or equity interests. In other words, a business combination could occur in the absence of a purchase.

DEFINITION OF A BUSINESS

BC34 IFRS 3 precludes accounting for a transaction as a business combination if the entity or entities over which the acquirer obtains control does not constitute a business. This provision is carried forward into the draft revised IFRS 3.

BC35 Before IFRS 3 was issued, IFRSs did not include a definition of a business. In response to suggestions from respondents to the Exposure Draft ED 3 *Business Combinations*, IFRS 3 includes guidance on identifying when an entity or a group of assets or net assets constitutes a business.

BC36 The IASB and the FASB decided to develop a converged definition of a business and related guidance. As a starting point, the boards considered the definition of a business and the related guidance in the

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US Emerging Issues Task Force (EITF) Issue 98-3 *Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business.* When the Board issued IFRS 3, it decided to adopt the definition of a business, and limited guidance, on the basis of conclusions reached in the joint discussions by the boards to that date. Paragraphs BC12-BC15 of the Basis for Conclusions on IFRS 3 discuss those conclusions.

BC37 The draft revised IFRS 3 proposes changes to the definition and guidance in IFRS 3 on the basis of joint decisions of the boards. Specifically, the proposed IFRS includes a modification to the definition of a business to clarify that an integrated set of activities and assets does not need to be conducted and managed for the purpose specified in the definition, as long as it is capable of being conducted and managed for those purposes. In other words, the acquired set is assessed as it exists at the acquisition date rather than how it was used by the seller or how it might be used by the buyer. This change is intended to clarify that a business need not include all of the inputs or processes that the seller used in operating that business if a willing acquirer is capable of operating the business, for example, by integrating the business with its own inputs and processes.

BC38 The Board concluded that the presumption in the definition in IFRS 3 that when goodwill is present in a transferred set of activities and assets, the transferred set is presumed to be a business is, in essence, guidance about determining whether a group of assets constitutes a business. That presumption has been moved to the application guidance in Appendix A of the draft IFRS.

BC39 The proposed application guidance also clarifies the meanings of the terms 'inputs', 'processes' and 'outputs'. It clarifies that inputs and the processes applied to those inputs are essential to a business and that even though the resulting outputs are normally present they need not be. Therefore, an integrated set of assets could qualify as a business if the integrated set of activities and assets is capable of being conducted and managed for the purpose of providing either a return to investors or dividends, lower costs or other economic benefits to owners, members or participants.

BC40 The Board concluded that it should clarify when a group of assets, or net assets, constitutes a business because the accounting differs. Specifically:

(a) in the accounting for an acquisition of a group of assets, or net assets, that does not constitute a business, the objective is to recognise those assets at cost. That cost is allocated to the

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individual assets acquired and liabilities assumed on the basis of their relative fair values at the date of the acquisition.

(b) no goodwill is recognised.

(c) the cost of the assets can include related transaction costs.

(d) intangible assets acquired in an asset acquisition are recognised in accordance with the requirements of IAS 38 *Intangible Assets,* rather than the requirements of the draft IFRS.

BC41 The Board discussed whether the principles in the draft revised IFRS 3 should also apply to acquisitions of all asset groups, avoiding the need to distinguish between groups of assets that are businesses and groups that are not. The Board concluded that, conceptually, acquisitions of all groups of assets should be accounted for in the same way and therefore the guidance in the draft revised IFRS 3 is appropriate for all asset acquisition transactions. Although the Board expressed a preference for expanding the scope of the proposed revised IFRS 3 to acquisitions of asset groups it noted that further research and deliberations of additional issues would be required. The Board decided not to extend the scope to acquisitions of all asset groups because to do so would delay implementation of the proposals.

SCOPE

BC42 The draft revised IFRS 3, like IFRS 3, excludes from its scope the formation of a joint venture and combinations involving businesses under common control. The Board will consider the accounting for these business combinations as part of the future phases of its Business Combinations project. The Board will also consider whether and, if so, when to apply 'fresh start' accounting in the absence of a change in control.

BC43 The FASB draft SFAS 141(R) also excludes from its scope business combinations between not-for-profit organisations or acquisitions of for-profit businesses by not-for-profit organisations. The Board concluded that a similar scope exclusion is not necessary for the proposed IFRS because IFRSs, generally, do not address not-for-profit activities in the private sector, public sector or government.

BC44 The draft revised IFRS 3 removes the scope exclusion in IFRS 3 for business combinations:

(a) involving only mutual entities; and

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(b) achieved by contract alone, without the acquirer purchasing or otherwise obtaining any of the acquiree's net assets or equity interests.

BC45 Originally, business combinations involving only mutual entities or achieved by contract alone were not included in the second phase of the Business Combinations project. The Board intended to deal with these transactions as part of future phases of the project. However, in 2004 the Board added these transactions to the scope of the joint project.

BC46 The Board's considerations in reaching its conclusion that business combinations involving only mutual entities and combinations achieved by contract alone should be accounted for using the acquisition method are outlined in paragraphs BC179-BC199.

METHODS OF ACCOUNTING FOR BUSINESS COMBINATIONS

BC47 In IFRS 3, the Board adopted a single-method approach for accounting for business combinations that is fundamentally different from the approaches that existed under the predecessor standard IAS 22. The single-method approach required by IFRS 3 reflects the Board's conclusion that virtually all business combinations are acquisitions. The draft revised IFRS 3 carries forward that conclusion.

BC48 Paragraphs BC37–BC55 of IFRS 3 discuss the basis for that conclusion, including the reasons for requiring the acquisition method and rejecting the pooling of interests method.

APPLICATION OF THE ACQUISITION METHOD

BC49 Paragraph 9 of the draft revised IFRS 3 identifies four basic steps in applying the acquisition method of accounting for a business combination. They are:

(a) identifying the acquirer;

(b) determining the acquisition date;

(c) measuring the fair value of the acquiree; and

(d) measuring and recognising the individual assets acquired and the liabilities assumed.

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Identifying the acquirer

BC50 Paragraph 10 of the draft IFRS carries forward without reconsideration the requirement in IFRS 3 that an acquirer is to be identified in every business combination. Paragraphs BC56–BC66 of IFRS 3 discuss the related considerations and deliberations that led to the Board's conclusions and guidance in IFRS 3.

BC51 IFRS 3 and SFAS 141 include similar, but not identical, guidance for identifying the acquirer. However, because the guidance is worded differently, the boards were concerned that differences in identifying the acquirer could arise. The boards decided to develop common guidance for identifying the acquirer. The intention of the boards is to confirm and clarify their guidance but not to change its substance.

Measuring the fair value of the acquiree

BC52 Paragraph 19 of the draft revised IFRS 3 requires the acquirer in a business combination to measure 'the fair value of the acquiree, as a whole, as of the acquisition date'. Like IFRS 3, the draft IFRS reflects the belief of the Board that, as a general principle, exchange transactions should be accounted for at the fair values of the items exchanged.

BC53 The Board observed in paragraph BC44 of IFRS 3 that because the exchange transaction is assumed to result from arm's length bargaining between independent parties, the values exchanged are presumed to be equal. The draft revised IFRS 3 carries forward this fundamental conclusion. The Board agreed that measurement of the values exchanged could be based on the fair value of the consideration given or the fair value of the net assets acquired, whichever is more reliably measurable.

BC54 To help reduce the costs of implementing the proposed IFRS, and to promote greater consistency in the techniques used in measuring the fair value of an acquiree, the Board decided that the draft revised IFRS 3 should provide guidance for applying its fair value measurement principle.

Using the fair value of consideration to measure the fair value of the acquiree

BC55 To facilitate the implementation of the proposed IFRS, the Board concluded that it should:

(a) include the presumption that the consideration transferred by the acquirer for its interest in the acquiree generally provides the best basis for measuring that interest; and

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(b) provide guidance illustrating how the fair value of the consideration transferred for less than 100 per cent of the equity interests of an acquiree, together with other available information, might be used to estimate the fair value of the acquiree as a whole.

BC56 The Board has agreed that business combinations, generally, are exchange transactions in which knowledgeable, unrelated willing parties are presumed to exchange equal values. Thus, in the absence of evidence to the contrary it can be presumed that the fair value of the consideration transferred is representative of the fair value of the acquirer's interest in the business. The Board also believes that evidence of the fair value of consideration transferred by the acquirer is equally if not more reliably measurable than the fair value of the acquiree and generally is more readily available to the acquirer or obtainable at a lower cost. The Board acknowledges that some entities, generally those with active acquisition programmes, may have valuation professionals on their staffs with the expertise and ability to measure reliably the fair value of a potential acquiree at relatively low cost. Nonetheless, the Board believes that presuming that the fair value of consideration transferred by the acquirer is a reliable measure, in the absence of evidence to the contrary, is a reasonable way to mitigate the costs to the many entities that do not have these internal resources.

BC57 The Board also believes that emphasis on use of the consideration transferred as an appropriate basis for determining the fair value of the business as a whole will avoid or minimise:

(a) unproductive disputes in practice about whether the consideration transferred or another valuation technique provides the best evidence and basis for estimating the fair value of the business in those circumstances in which both measurement techniques provide sufficiently reliable estimates.

(b) incremental costs, for example, to verify independently valuations of the business that were performed by the acquirer as part of its due diligence but are not necessarily audited.

BC58 The Board also concluded that in acquisitions of less than 100 per cent of the equity interests of the acquiree, it is often appropriate for the acquirer to measure the fair value of the acquiree as a whole on the basis of the consideration transferred for its interest. This indirect measurement of the fair value of the acquiree as a whole is more likely to be appropriate as the proportion of the interest being acquired increases. Acquisitions exceeding 80 per cent of the ownership interests in an acquiree are common in the US, for example. The Board acknowledges, however, that an acquirer may obtain control of an acquiree through a transaction

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involving a relatively small percentage of the acquiree's equity interest or, in some cases, through an event that results in control without purchasing any equity interests. Accordingly, the draft revised IFRS 3 acknowledges that in those circumstances measuring the fair value of the acquiree may require the use of other techniques.

Using other valuation techniques to measure the fair value of the acquiree

BC59 The draft revised IFRS 3 notes that in some business combinations, either no consideration is transferred or the evidence indicates that consideration transferred is not the best basis for measuring the acquisition-date fair value of the acquirer's interest in the acquiree. In those business combinations, the acquirer should measure the acquisition-date fair value of its interest in the acquiree using other valuation techniques. The presumption and guidance which emphasises the use of the consideration transferred by the acquirer is not intended to override the requirement to measure and recognise the fair value of the acquiree as a whole at the acquisition date.

BC60 In circumstances in which consideration is difficult to measure, the acquiring entity is likely to incur costs to determine the fair value of the acquiree as a whole and an incremental cost to have that measure verified independently. The Board observed that in many of those circumstances entities will already have incurred these costs as part of their due diligence procedures. For example, an acquisition of a privately held business by another privately held entity is often accomplished by an exchange of equity shares that do not have observable market prices. For the purposes of determining the exchange ratio those entities generally engage advisers and valuation experts to assist them in valuing the acquiree as well as the equity transferred by the acquirer in exchange for the shares of the acquiree. Similarly, a combination involving only mutual entities is often accomplished by an exchange of member interests of the acquirer for all of the member interests of the acquiree. In many, but not necessarily all, of those cases the directors and managers of the entities also assess the relative fair values of the combining entities to ensure that the exchange of member interests is equitable to the members of both entities.

BC61 The Board believes that the incremental measurement costs that the revised IFRS 3 might impose are justified. The Board reached that conclusion on the basis of its assessment of overall improvements in financial information. Those improvements include the increased relevance and understandability of information resulting from measuring

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all businesses acquired as a whole at their acquisition-date fair value, which is consistent with reflecting the change in economic circumstances that occurs at that date.

BC62 The Board also concluded that the proposed IFRS should provide guidance on how to measure the fair value of the acquiree using valuation techniques. This decision is consistent with the objective of providing broadly applicable measurement guidance. Paragraphs A18–A23 and Appendix E of the draft revised IFRS 3 provide that guidance.

BC63 The Board was concerned that some acquirers of mutual entities might neglect to consider relevant assumptions that marketplace participants would make about future member benefits when measuring fair value of the entity. For example, an entity acquiring a co-operative entity should consider the value of the member discounts in its determination of fair value. Accordingly, the Board decided to include guidance (paragraphs A24–A26) that discusses special considerations when measuring the fair value of mutual entities.

Measuring specific items and determining whether they are part of the consideration transferred for the acquiree

BC64 Paragraphs BC65-BC89 summarise the Board's considerations and decisions related to issues raised about (a) the components of consideration that are often transferred by acquirers and can be more difficult to measure, and (b) whether costs incurred by acquirers in connection with an acquisition are part of the consideration transferred for the acquiree. Paragraphs BC154-BC160 summarise the Board's considerations related to determining which assets acquired and liabilities assumed in connection with a business combination are part of the exchange for the acquiree.

Measurement date for equity securities

BC65 The draft revised IFRS 3 carries forward the requirement in IFRS 3 that equity interests issued by the acquirer as consideration in a business combination should be measured at the acquisition date. The boards diverged on this matter, with the FASB measuring equity interests issued by the acquirer as consideration in a business combination at the agreement date.

BC66 The IASB and the FASB considered the agreement date and acquisition date models in their deliberations. Both boards observed that there are valid conceptual arguments for measuring equity interests at the

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agreement date or the acquisition date. However, the boards concluded that reaching a converged answer on the measurement date was of primary importance. The FASB agreed to change, to require that equity interests issued by an acquirer as consideration in a business combination should be measured at their fair value at the acquisition date. As a consequence all consideration transferred by an acquirer is to be measured at its acquisition-date fair value.

Contingent consideration

BC67 IFRS 3 requires equity instruments issued and liabilities incurred by the acquirer in exchange for control of the acquiree to be measured at fair value. An exception to this principle is a requirement relating to the acquirer's obligation for contingent consideration. That requirement, which was carried forward into IFRS 3 from IAS 22 without reconsideration, takes a cost accumulation approach to accounting for contingent consideration. The Board decided to reconsider this treatment in developing the draft revised IFRS 3.

BC68 Under IFRS 3, when a business combination agreement provides for an adjustment to the consideration that is contingent on future events, the acquirer includes that adjustment in the measurement of consideration at the acquisition date only if it is probable and can be measured reliably. If the required level of probability or reliability for recognition occurs only after the acquisition date the additional consideration is treated as an adjustment to the accounting for the business combination and to goodwill at that later date. Therefore, unlike other forms of consideration, an obligation for contingent consideration is not measured at its fair value at the acquisition date and its remeasurement results in an adjustment to the business combination accounting. The Board concluded that this approach ignores the fact that the acquirer's agreement to make contingent payments is the obligating event in a business combination transaction.

BC69 Contingent consideration arrangements are used by buyers and sellers to reach an agreement by sharing specified economic risks related to uncertainties about future outcomes. Differences in the views of the buyer and seller about those uncertainties can be reconciled by their agreeing to share the risks in ways that result in additional payments to the seller for favourable future outcomes and no, or lower, payments for unfavourable outcomes.

BC70 The Board concluded that by not recognising, at the acquisition date, the acquirer's obligation for contingent payments, the economic

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consideration exchanged at that date would not be fairly represented. The Board decided that obligations for contingent consideration should be measured and recognised at fair value at the acquisition date.

BC71 The Board considered arguments that it might be difficult to measure the fair value of the contingent obligation at the acquisition date. The Board acknowledges that measuring the fair value of some contingent payments may be difficult, but it concluded that to delay recognition of, or otherwise ignore, assets or liabilities that are difficult to measure would cause financial reporting to be incomplete. The Board concluded that excluding an obligation related to a contingent payment diminishes the usefulness of financial reporting and fails to represent faithfully the economics of the business combination transaction.

BC72 The Board noted that most contingent consideration arrangements are financial instruments. It concluded that classifying obligations for contingent consideration as either an equity instrument or as a financial liability in accordance with IAS 32 *Financial Instruments: Disclosure and Presentation* would improve transparency in reporting these financial instruments. Accordingly, the Board decided to remove a scope exception in paragraph 4(c) of IAS 32. As a consequence, if a contingent consideration arrangement is a financial instrument it should be classified as a financial liability, a financial asset or an equity instrument in accordance with IAS 32.

BC73 The Board also noted that some contingent consideration arrangements require the acquirer to deliver its equity securities if specified future events occur. Application of IAS 32 to those arrangements means that obligations for contingent payments classified as equity will not be remeasured after the acquisition date.

BC74 The Board observed that obligations for contingent consideration classified as a financial liability would often meet the definition of a derivative. The Board noted that many contingent consideration arrangements are similar or identical to contracts that are otherwise subject to the requirements in IAS 39 *Financial Instruments: Recognition and Measurement*.

BC75 To improve transparency in reporting these instruments, the Board concluded that all contingent consideration contracts that meet the definition of a financial instrument should be subject to the requirements of IAS 39. Therefore, it decided to eliminate the exception in paragraph 2(g) of IAS 39 that excluded contingent consideration in a business combination from its scope. Thus, under IAS 39, liabilities for contingent

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consideration that meet the definition of a derivative would be remeasured, after the acquisition date, at fair value with changes in fair value recognised in accordance with IAS 39.

BC76 The Board also considered whether changes in the measurement of liabilities for contingent consideration should be reflected as an adjustment to the consideration transferred and, normally, goodwill. The Board noted that the measurement objective of a business combination is to recognise the fair value of the acquiree on the acquisition date and that measuring contingent consideration at its fair value, at that date, is consistent with that objective. The Board acknowledges that a conclusive determination of the fair value of any liability for contingent consideration may not be practicable, in the limited circumstances in which particular information is not available at the acquisition date. As discussed in paragraphs BC161-BC163, in those circumstances the draft revised IFRS 3 provides for the provisional measurement of the fair value of assets acquired or liabilities assumed and consideration transferred, including obligations for contingent payments. The provisional values are adjusted for changes that are determined during the measurement period (after the acquisition date) as if the accounting for the business combination had been completed at the acquisition date.

BC77 Moreover, the Board concluded that subsequent changes in the fair value of a liability for contingent consideration do not affect the acquisition-date fair value of the consideration transferred for the acquiree. Rather, the Board believes that those subsequent changes in value are, generally, more likely to be related to post-combination events and changes in circumstances related to the combined entity.*

BC78 The Board also considered arguments that the approach it had adopted will result in:

(a) the recognition of gains in the income statement when the specified milestone or event requiring the contingent payment is not met. For example, the acquirer would record a gain on the reversal of the liability if an earnings target in an earnout arrangement is not achieved.

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* The Board also acknowledges, however, that some changes in fair value might result from events and circumstances that may relate to a pre-combination period, but the extent of the change is indistinguishable from that part related to the post-combination period. The Board concluded that, in those limited circumstances, the benefits in information that might result from making such fine distinctions in practice would not justify the costs that such a requirement would impose.

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(b) the recognition of losses in the income statement for subsequent changes in the fair value of liabilities for contingent consideration that some believe are directly attributable to changes in the fair value of the business acquired and, thus, should be capitalised as part of the acquired entity.

BC79 The Board accepts that recognising the fair value of a liability for contingent payments is likely to result in a gain if smaller or no payments are required or in a loss if greater payments are required. The Board believes that this is a consequence of entities entering into contingent consideration arrangements in which the underlying in the arrangement relates to future changes in the fair value of a specified asset or liability or net income of the acquiree after the acquisition date.*

Share-based compensation replacement awards of the acquirer

BC80 Paragraphs A109-A116 provide guidance for circumstances in which an acquirer is obligated to exchange its share-based payment awards for those of an acquiree. The Board decided that the draft revised IFRS 3 should provide implementation guidance for those transactions because:

(a) difficulties could arise in judging the extent to which replacement awards are for past services (and, therefore, part of the consideration for the business) or future services (and, therefore, not part of the consideration for the business).

(b) the proposed IFRS and IFRS 2 are new Standards and, therefore, implementation difficulties could be encountered in practice.

* The Board observed that liabilities for contingent payments may be related to contingencies surrounding an outcome for a particular asset or other liability. In those cases, the effects on income of changes in estimates of the fair value related to the liability for the contingent payment may be offset by changes in the fair value of the asset or other liability. Assume, for example, that after an acquisition the combined entity reaches a very favourable settlement of pending litigation of the acquiree for which it had a contingent consideration arrangement. If the combined entity is required to make a contingent payment to the seller of the acquiree of an amount greater than the carrying amount (fair value) of the liability to the seller, the effect of the increase in that liability and charge to income may be offset in part by the reduction to the liability to the litigation claimant and the credit to income resulting from that favourable settlement. Similarly, assume the acquirer is not required to make a contingent payment to the seller because an acquired research and development project failed to materialise into a viable product. In that case, the gain resulting from the elimination of the liability may be offset, in whole or in part, by an impairment charge for the asset acquired.

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BC81 The Board believes that the guidance in the draft revised IFRS 3 is consistent with the objective that the measure of the consideration transferred should include those payments that are in exchange for the business and exclude those payments that are not. Payments for future services that former owners, officers and employees may provide to the acquirer are not payments for the business acquired.

BC82 The Board also acknowledges that although the guidance in the proposed IFRS is consistent with the FASB's basic guidance, some details are different. The boards arrived at different conclusions on how replacement of vested awards granted by the acquiree with non-vested acquirer awards should be allocated between the consideration transferred in the business combination and compensation expense.

BC83 The FASB concluded that the requisite service period of awards issued by the acquirer should be taken into consideration reflecting any explicit, implicit and derived service periods. In contrast, the Board concluded that the entire period of service rendered before the business combination should be taken into account to determine the allocation between compensation expenses and consideration. The *requisite service period* will often, but not always, result in the same total service period. The boards decided to accept this divergence at this time because it stems from differences in their other standards, and is a matter outside the scope of the joint project on business combinations.

Costs incurred in connection with a business combination

BC84 The Board considered whether costs that an acquirer incurs in connection with a business combination are part of the consideration transferred in exchange for the acquiree. Those costs (commonly called acquisition-related costs) can include the costs of services of lawyers, investment bankers, accountants, and other third parties and the issue costs of debt or equity instruments used to effect the combination.

BC85 The Board concluded that acquisition-related costs are not part of the fair value exchange between the buyer and seller for the business. Rather, they are separate transactions in which the buyer makes payments in exchange for services rendered. The Board observed that these costs, whether for services performed by external parties or internal staff of the acquirer, generally do not represent assets of the acquirer, because they are consumed as the services are rendered.

BC86 Thus, the draft revised IFRS 3 specifies that the acquirer must account for acquisition-related costs separately from the business combination. Under IFRS 3, the cost of an acquired entity includes direct costs incurred

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for an acquisition of a business but excludes indirect costs. Indirect costs can include recurring internal costs such as maintaining an acquisitions department and, although those costs can be attributable to a successful acquisition, they are recognised as an expense as incurred. Furthermore, direct costs incurred in unsuccessful negotiations are also recognised as an expense as incurred. The changes proposed resolve these inconsistencies.

BC87 The Board considered the argument that acquisition-related costs, including costs of due diligence, are an unavoidable cost of the investment in a business. As with other investments, the acquirer intends to recover these costs through the post-acquisition operations of the business and considers these costs in determining the amount it is willing to pay for the acquiree. On this basis it could be argued that acquisition-related costs should be capitalised as part of the total investment in the business. The Board did not agree with this argument. The Board was not persuaded that the seller of a business is willing to accept less than fair value as consideration for its business merely because a particular buyer may incur more (or less) acquisition-related costs than other potential buyers for that business. The Board concluded that the intention of a buyer, including how acquisition-related costs are expected to be recovered, is distinct from fair value measurement of the acquiree.

BC88 The Board acknowledges, that under some IFRSs, direct acquisition-related costs would be included as part of the carrying amount of the asset acquired. The Board also acknowledges that the treatment of acquisition-related costs should be similar for acquisitions of an individual asset, a group of assets and a business. However, as noted in paragraph BC41, the Board decided not to extend the scope of the draft revised IFRS 3 to acquisitions of all asset groups. The Board accepts that, at this time, recognising as an expense acquisition-related costs differs from some accepted practices that allow direct acquisition-related costs to be included in the cost of an acquired asset. The Board concluded, however, that the proposed IFRS will improve financial reporting by eliminating inconsistencies in accounting for acquisition-related costs in connection with a business combination.

BC89 The Board also considered arguments that, if acquirers can no longer capitalise acquisition-related costs as part of the cost of the business acquired, they may attempt to avoid recognising those costs as expenses. For example, a buyer might ask a seller to make payments to the service providers on its behalf. To facilitate the negotiations the seller might agree to make those payments, provided the agreed price includes an amount sufficient to reimburse the seller for payments it made on the

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buyer's behalf. If the disguised reimbursements were treated as part of the consideration for the business those expenses might not be recognised by the acquirer. Rather, the amount recognised for goodwill could be overstated. To mitigate these concerns, the Board decided to clarify in the draft revised IFRS 3 that the portion of any payments to an acquiree (or its former owners) in connection with a business combination that are payments for goods or services that are not part of the acquired business should be assigned to those goods or services and accounted for as if separately acquired. As discussed in paragraphs BC154-BC160, the Board also decided that the proposed IFRS should require an assessment to determine whether any portion of the amounts transferred by the acquirer are not part of the consideration transferred in exchange for the acquiree.

Measuring and recognising the assets acquired and the liabilities assumed

BC90 Paragraphs BC91-BC102 discuss the Board's considerations in concluding that the probability and reliability of measurement recognition criteria need not be included in the draft IFRS. Paragraphs BC103-BC110 discuss the Board's proposals for application of the fair value measurement principle for the recognition of assets acquired and liabilities assumed.

Recognition criteria

BC91 IFRS 3 requires the acquiree's identifiable assets and liabilities to be recognised separately if they can be measured reliably and if it is probable that any related future economic benefits will flow to, or resources embodying economic benefits will flow from, the acquirer. For the reasons explained in paragraphs BC92-BC97, the Board decided not to include the probability and reliability of measurement recognition criteria in the proposed IFRS.

Probability recognition criterion

BC92 IFRS 3 specifies that an acquirer should recognise the acquiree's identifiable assets (other than intangible assets) and liabilities only if it is probable that the asset or liability will result in an inflow or outflow of economic benefits. The draft revised IFRS 3 does not contain this probability recognition criterion and hence proposes that the acquirer

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should recognise identifiable assets acquired and liabilities assumed regardless of the degree of probability of an inflow or outflow of economic benefits.

BC93 The concept of probability is used in the recognition criteria in the *Framework* to refer to the degree of uncertainty that the future economic benefits associated with the asset or liability will flow to or from the entity.

BC94 As discussed in paragraphs BC115 and BC116 (and more fully in paragraphs BC35-BC47 of the Basis for Conclusions on the accompanying proposed amendments to IAS 37), during the development of the draft revised IFRS 3 the Board reconsidered items previously described in IAS 37 as contingent assets and contingent liabilities. The Board observed that by analysing the rights or obligations in such items into conditional and unconditional rights or obligations, it is possible to address better the question of whether the entity has an asset or a liability at the acquisition date. As a result, the Board concluded that many items previously described as contingent assets or contingent liabilities meet the definition of asset or liability in the *Framework*, because they contain unconditional rights or obligations as well as conditional rights or obligations.

BC95 The Board observed that when the unconditional right in an asset (or unconditional obligation in a liability) is identified, the question to be addressed is what is the inflow (or outflow) of economic benefits relating to the unconditional right (or unconditional obligation) rather than the conditional right (or conditional obligation).

BC96 The Board noted that the *Framework* articulates the probability recognition criterion in terms of a flow of economic benefits rather than just direct cash flows. It concluded that, if an entity has an unconditional obligation, it is certain that there will be an outflow of economic benefits from the entity, even if there is uncertainty about the timing and the amount of the outflow of benefits associated with the conditional obligation. Hence, when the *Framework*'s probability recognition criterion is applied to the liability (ie unconditional obligation), it is satisfied. The Board's arguments apply equally to unconditional rights. Thus, if an entity has an unconditional right, it is certain that there will be an inflow of economic benefits and again the probability recognition criterion is satisfied.

BC97 The Board therefore decided that inclusion of the probability criterion in the draft revised IFRS 3 is unnecessary because in all cases an unconditional right or obligation satisfies the criterion. In addition, the Board proposed consequential amendments to IAS 38 *Intangible Assets* (paragraphs 25 and 33) to clarify the reason for the Board's conclusion

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that the probability recognition criterion is always considered to be satisfied for intangible assets that are acquired separately or in a business combination. Specifically, the Board stated that an intangible asset acquired separately or in a business combination embodies an entity's unconditional right to future economic benefits. The uncertainty is about the timing and the amount of the inflow.

Reliability of measurement recognition criterion

BC98 IFRS 3 states that any asset acquired or liability assumed in a business combination must be able to be measured reliably to be recognised. The Board decided not to include an equivalent statement in the draft revised IFRS 3 because it is a criterion for recognition in the *Framework*.

BC99 The Board reconsidered the reliability of measurement criterion for intangible assets and decided to remove it. This is because the Board concluded that sufficient information should exist to measure reliably the fair value of an intangible asset, as discussed in paragraphs BC100-BC102.

Reliability of measurement of intangible assets

BC100 IFRS 3 requires an intangible asset acquired in a business combination to be able to be measured reliably for it to be recognised separately from goodwill. SFAS 141 does not have a similar requirement. Therefore, the Board reconsidered whether to retain the reliability of measurement criterion for intangible assets.

BC101 When IFRS 3 was developed, the Board noted that the fair value of intangible assets acquired in a business combination can normally be measured with sufficient reliability to be recognised separately from goodwill. When there is a range of possible outcomes with different probabilities, that uncertainty enters into the measurement of the asset's fair value rather than demonstrating an inability to measure fair value reliably. IAS 38 includes a rebuttable presumption that the fair value of a intangible asset with a finite useful life acquired in a business combination can be measured reliably. The Board concluded that it might not always be possible to measure reliably the fair value of an asset that has an underlying contractual or legal basis and, therefore, decided to retain the reliability of measurement criterion. However, IAS 38 provides that the only circumstances in which it might not be possible to measure reliably the fair value of an intangible asset acquired in a business combination are

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when the intangible asset arises from legal or other contractual rights and either:

(a) is not separable; or

(b) is separable, but there is no history or evidence of exchange transactions for the same or similar assets, and otherwise estimating fair value would be dependent on immeasurable variables.

BC102 In developing this draft IFRS, the Board noted that the divergence between its own conclusions and the FASB's results in a difference in classification of assets as indefinite-lived intangible assets rather than as goodwill. The Board agreed with the FASB that the usefulness of financial statements would be enhanced if intangible assets acquired in a business combination were distinguished from goodwill. The Board concluded that an estimate of fair value and the separate recognition of intangible assets, rather than subsuming them in goodwill, provides better information to the users of financial statements, even though a significant degree of judgement could be involved in determining that fair value. Reliability of measurement is a criterion for recognition in the *Framework*. For these reasons, and for the sake of convergence, the Board decided to propose consequential amendments to IAS 38 (paragraphs 33A-35) to remove the reliability of measurement criterion for intangible assets acquired in a business combination.

Fair value recognition and measurement principle

BC103 The Board considered the process required by IFRS 3 to allocate amounts to assets acquired and liabilities assumed in a business combination. That process requires the acquirer to measure initially the assets and liabilities recognised at their fair values at the acquisition date. Therefore, any minority interest in the acquiree is stated at the minority's proportion of the net fair value of those assets and liabilities. IFRS 3 also requires the excess of the cost of the business combination over the acquirer's interest in the net fair value of the identifiable assets and liabilities to be recognised as goodwill.

BC104 That allocation is based on the estimated fair values of the assets and liabilities at the acquisition date. When it issued IFRS 3, the Board carried forward, without reconsideration, the general guidance in IAS 22 for allocating amounts to assets acquired and liabilities assumed. As a result, paragraph B16 of IFRS 3 states:

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> This IFRS requires an acquirer to recognise the acquiree's identifiable assets, liabilities and contingent liabilities that satisfy the relevant recognition criteria at their fair values at the acquisition date. For the purpose of allocating the cost of a business combination, the acquirer shall treat the following measures as fair values:…

BC105 The Board acknowledged at that time that some of the guidance for allocating the cost of the business combination conflicted with the general principle of recognising at fair value assets acquired and liabilities assumed, and observed in paragraph BC153 of IFRS 3:

> …although conceptually any guidance on determining the values to be assigned by the acquirer to the acquiree's identifiable net assets should be consistent with a fair value measurement objective, this is not currently the case under IFRSs.
>
> ….it is reconsidering as part of the second phase of its Business Combinations project those requirements in IFRSs that result in the acquirer initially recognising identifiable net assets acquired at amounts that are not fair values but are treated as though they are fair values for the purpose of allocating the cost of the combination.

BC106 The Board decided to include guidance for measuring fair value in the form of a hierarchy (referred to as the fair value hierarchy), which is contained in Appendix E. The Board noted that including the fair value hierarchy and related guidance in the proposed IFRS will improve the relevance and comparability of information provided about the assets acquired and liabilities assumed in a business combination. However, for cost/benefit reasons, the Board decided that the revised IFRS 3 should provide exceptions to the application of the fair value measurement and recognition principles. More specifically, the Board decided that the proposed IFRS should:

(a) require some assets and liabilities to continue to be measured in accordance with existing IFRSs and goodwill to continue to be measured as a residual.*

(b) clarify that separate recognition of assets and liabilities is not required for the offsetting executory rights and obligations for an acquiree's operating leases.

* Assets and liabilities that are to be measured in accordance with other IFRSs rather than at their fair values include: (a) assets (disposal group) that qualify as assets held for sale, (b) deferred tax assets and liabilities, and (c) employee benefit obligations. Under the draft revised IFRS 3 goodwill would be measured as the excess of the fair value of the business acquired over the net amount of the fair values of the recognised identifiable assets acquired and liabilities assumed.

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BC107 During the course of this joint project, the FASB added a fair value measurements project to its agenda. The objective of that project is to develop a Statement that defines fair value and establishes a framework for applying the fair value measurement objective in US GAAP. The project focuses on 'how' to measure fair value, not 'what' to measure at fair value. In June 2004 the FASB published the Exposure Draft of Proposed SFAS *Fair Value Measurements*. That Exposure Draft incorporates the fair value hierarchy developed initially by the boards in the second phase of the Business Combinations project. The FASB's draft SFAS 141 (R) refers to that Exposure Draft for fair value guidance.

BC108 To ensure consistent application of the hierarchy to business combinations in IFRSs and US GAAP, the Board decided to include parts of the FASB's *Fair Value Measurements* Exposure Draft in the draft revised IFRS 3. The sections are designed to help users apply the fair value hierarchy and include the definition of fair value and additional guidance about 'willing', 'knowledgeable' and 'unrelated parties', the guidance on valuation techniques and market inputs and the definition of an active market.

BC109 The exposure period for the Proposed SFAS *Fair Value Measurements* has ended and the FASB has begun redeliberating fair value measurement issues. It plans to issue the final Statement on *Fair Value Measurements* in the near future. The FASB's Website includes updated information about the status of the FASB's decisions.

BC110 The Board intends to redeliberate any issues that emerge from the FASB's final Statement *Fair Value Measurements* and, where appropriate, amend the fair value guidance in Appendix E before issuing the proposed IFRS on business combinations.

Guidance for assets acquired and liabilities assumed

BC111 Paragraphs BC112-BC116 set out the Board's conclusions on the application of the fair value measurement principle to assets acquired and liabilities assumed.

Valuation allowances

BC112 IFRS 3 provides that, in determining the fair value of receivables, the acquirer should use the present values of the amounts to be received, determined at appropriate current interest rates, less allowances for uncollectibility and collection costs, if necessary.

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BC113 In developing the draft revised IFRS 3, the Board noted that in determining the fair value of receivables any uncertainties about the collectibility of receivables should affect their fair value. If receivables are assigned an amount equal to their fair value, there will be no need to recognise separately an allowance for uncollectibility and collection costs.

BC114 Therefore, using an acquiree's carrying basis and including collection costs is inconsistent with the fair value measurement principles in the draft IFRS. The Board concluded that the acquirer should not recognise a separate valuation allowance for uncollectible amounts in its initial measure of the acquisition-date fair value of an acquiree's receivables. Any uncertainty about collections and future cash flows is included in the fair value measure.

Contingencies

BC115 The draft revised IFRS 3 requires the acquirer to measure and recognise at the acquisition date the assets acquired and liabilities assumed as part of the business combination even if the amount of the future economic benefits embodied in the asset or required to settle the liability are contingent (or conditional) on the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

BC116 This requirement is consistent with the Board's proposed amendments to IAS 37 relating to contingencies. The Board proposes eliminating the terms 'contingent asset' and 'contingent liability'. Instead of using the word 'contingent' to refer to uncertainty about whether a liability exists, the Board proposes to use it to refer to one or more uncertain future events, the occurrence or non-occurrence of which affects the amount of the future economic benefits embodied in an asset or required to settle a liability. The Board's amendments to IAS 37 clarify that many items previously described as contingent assets or contingent liabilities satisfy the *Framework*'s definition of an asset or a liability. Therefore, such items are recognised in a business combination.

Exceptions to the fair value measurement principle

BC117 The Board decided to allow exceptions to the application of the fair value measurement principle, primarily because of cost/benefit or practicability concerns. The exceptions, and the reasons for allowing each, are described in paragraphs BC118-BC150.

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Assets (disposal group) held for sale

BC118 The Board decided that non-current assets (or a disposal group) acquired in a business combination that qualify as held for sale, in accordance with IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*, should be measured at fair value less costs to sell in accordance with that IFRS. The Board was concerned that a requirement in the draft revised IFRS 3 to measure those assets at fair value at their acquisition date would lead to the immediate recognition of a loss. Applying IFRS 5 would require expected costs to sell to be recognised immediately as an expense. The Board concluded that reporting a loss in relation to those costs would not present fairly the activities of the acquirer during that period. Accordingly, the proposed IFRS requires these qualifying assets to be measured on initial recognition at fair value less costs to sell and that after initial recognition IFRS 5 will apply.

Deferred tax assets and liabilities

BC119 The draft revised IFRS 3 requires deferred tax assets and liabilities to be measured and recognised in accordance with IAS 12 *Income Taxes,* as proposed to be amended, rather than at their acquisition-date fair values. Under IAS 12, deferred tax assets and liabilities generally are to be measured and recognised at the current period undiscounted settlement amounts. The Board decided not to require deferred tax assets and liabilities acquired in a business combination to be measured at fair value because it observed that:

(a) if those assets and liabilities were measured at their acquisition-date fair values, without any change in the underlying economic circumstances, their subsequent measurement under IAS 12 would result in post-combination gains or losses in the period immediately following the acquisition. The Board concluded that this would not faithfully represent the results of the post-combination period, and would be inconsistent with the notion that a business combination that is a fair value exchange should not give rise to the immediate recognition of post-combination gains or losses.

(b) to measure those assets and liabilities at their acquisition-date fair values and overcome the problem noted in (a) would require a comprehensive consideration of whether and how to modify the requirements of IAS 12 for the subsequent measurement of deferred tax assets or liabilities acquired in a business combination. The Board concluded that the complexities of IAS 12, and the

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difficulties that tracking deferred tax assets acquired and liabilities assumed in a business combination would create, do not warrant a comprehensive reconsideration of IAS 12 as part of this joint project.

BC120 The Board decided, however, to address three income tax accounting issues in connection with business combinations. They are the acquirer's accounting for (a) a change in the probability of realising the acquirer's deferred tax asset as a result of a business combination, (b) deferred tax benefits acquired in a business combination that did not satisfy the criteria for separate recognition when a business combination was initially accounted for, but are subsequently realised, and (c) tax benefits arising from tax-deductible goodwill in excess of financial reporting goodwill.

BC121 The Board considered the first issue because there is a difference between the requirements of IAS 12 and those of SFAS 109. At present, under SFAS 109, effects of changes in the probability of realising the acquirer's deferred tax asset are included as part of the business combination accounting. IAS 12 currently provides that:

> As a result of a business combination, an acquirer may consider it probable that it will recover its own deferred tax asset that was not recognised before the business combination. For example, the acquirer may be able to utilise the benefit of its unused tax losses against the future taxable profit of the acquiree. In such cases, the acquirer recognises a deferred tax asset, but does not include it as part of the accounting for the business combination, and therefore does not take it into account in determining the goodwill ...

BC122 The Board confirmed that any changes in the acquirer's deferred tax asset that result from a change in the acquirer's circumstances upon a business combination should be accounted for as a separate event and, thus, excluded from the business combination accounting. The Board concluded that this is consistent with the requirements in paragraphs 66 and 67 of the draft revised IFRS 3 relating to the assessment of whether other assets and liabilities are part of the business combination. The business combination model focuses on measuring and recognising the fair value of the acquiree and the Board believes that the acquirer's deferred tax asset is an attribute of the *acquirer* rather than the *acquiree*. This decision results in the retention of the guidance in paragraph 67 of IAS 12. The FASB agreed to converge with the Board on this issue.

BC123 The Board also considered the situation when, as a result of the business combination, it may no longer be probable that sufficient taxable profit will be available to allow the benefit of part or all of the acquirer's deferred tax asset to be utilised. The Board concluded that an acquirer should reduce

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the carrying amount of a deferred tax asset to the extent that it is no longer probable that it will be realised. The reduction should also not be part of the accounting for the business combination.

BC124 As a result, the acquirer would recognise the effect of a change in the probability of realising the deferred tax asset in profit or loss or, if IAS 12 so requires, in equity in the period of the business combination. The Board considered this issue because of its commitment to convergence with the FASB. Under SFAS 109 effects of changes in the probability of realising the acquirer's deferred tax asset are included as part of the business combination. The FASB decided to converge with the Board on this issue.

BC125 The Board believes that the change in the measurement of deferred tax that is the consequence of a business combination is information useful to investors. Accordingly, it decided to amend IAS 12 to require disclosure of that change.

BC126 The second issue relates to deferred tax benefits acquired in a business combination that did not satisfy the criteria for separate recognition when a business combination was accounted for initially, but are subsequently realised. Under IFRS 3, the acquirer recognises that benefit and reduces the carrying amount of goodwill to the amount that would have been recognised if the deferred tax asset had been recognised as an identifiable asset at the acquisition date.

BC127 In developing the draft revised IFRS 3, the Board concluded that goodwill should not be reduced for the subsequent recognition of deferred tax benefits acquired in a business combination. The change in the value of deferred tax benefits is likely to be a consequence of events occurring after the acquisition. Therefore, the effect of these events should not be part of the accounting for the business combination. The Board concluded that this decision is consistent with accounting for other assets acquired and liabilities assumed. Any changes in those assets and liabilities that occur as a result of events and circumstances that arise after the acquisition are not accounted for as adjustments to the initial accounting for a business combination.

BC128 However, the Board decided that if acquired deferred tax benefits are recognised within one year after the acquisition date they are more likely to be a result of a more thorough assessment of the probability of realising deferred tax benefits acquired in a business combination than a subsequent event. Therefore, the Board decided to propose an amendment to IAS 12 introducing a rebuttable presumption that acquired deferred tax benefits recognised within one year of the acquisition date should be applied to reduce the carrying amount of any goodwill related

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to that acquisition. If the carrying amount of that goodwill is zero, the remaining deferred tax benefits are credited to profit or loss or, if IAS 12 requires, to equity.

BC129 The third issue relates to circumstances in which the carrying amount of goodwill arising in a business combination is less than its tax base. Under IAS 12 this difference gives rise to a deferred tax asset. The Board decided to clarify in IAS 12 that the deferred tax asset arising from the initial recognition of goodwill should be recognised as part of the accounting for a business combination to the extent that it is probable that taxable profit will be available against which the deductible temporary difference could be utilised.

Operating leases

BC130 The Board considered whether to require the recognition of the acquiree's rights related to its operating leases in which the acquiree is the lessee separately from its obligations. This would require, for example, recognition of an asset for an acquiree's rights to use assets according to the lease agreement, including related renewal options and other rights, and a liability for its obligations to make lease payments. Under IAS 17 *Leases*, these rights and obligations are not recognised as assets and liabilities. The Board concluded that, because it is not prepared at this time to address how the asset and the liability for an operating lease would be accounted for after the acquisition date, consistency in lease accounting should take primacy over consistency in the application of the fair value measurement requirement in the draft revised IFRS 3. Therefore, the asset and the liability arising from an operating lease would not be recognised on a gross basis.

BC131 The Board clarified that an acquirer should recognise, as part of the combination, an intangible asset or a liability for the favourable or unfavourable portion of an operating lease if an acquired operating lease is not at market terms (regardless of whether the acquiree is the lessee or lessor).

Employee benefit obligations

BC132 The Board decided that assets and liabilities arising from post-employment benefits assumed in a business combination that are within the scope of IAS 19 *Employee Benefits* should be measured in accordance with that standard rather than at fair value.

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BC133 The Board concluded that if, at this time, it required employee benefit obligations assumed in a business combination to be measured at their acquisition-date fair values it also would need either to reconsider comprehensively the relevant standards for those employee benefits or, at a minimum, to determine whether accommodations would be required for their subsequent measurement following the acquisition date, or both. At this time, the Board does not have an active project plan or the resources for such an undertaking. Thus, in view of the complexities in accounting for employee benefit obligations under IAS 19*,* the Board decided that those benefits should be measured in accordance with that standard.

Goodwill

BC134 The draft revised IFRS 3 carries forward the requirement from IFRS 3 to measure goodwill as a residual and recognise it as an asset. In developing IFRS 3, the Board concluded that direct measurement of goodwill would not be feasible. Paragraphs BC129-BC135 of IFRS 3 explain the Board's reasons for that conclusion. The Board did not reconsider that conclusion as part of the second phase of the Business Combinations project.

BC135 As noted in paragraph BC15 above, the Board considered a present inconsistency in accounting for acquisitions in which less than all of the equity interest is acquired and, therefore, only a partial interest in goodwill is recognised. This is referred to as the purchased goodwill method. The Board considered whether information provided by the full goodwill method is relevant. The Board observed that paragraph 26 of the *Framework* states that 'to be useful, information must be relevant to the decision-making needs of users. Information has the quality of relevance when it influences the economic decisions of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations.' The *Framework* also describes the purpose of consolidated financial statements as follows:

> The economic decisions that are taken by users of financial statements require an evaluation of the ability of an entity to generate cash and cash equivalents and of the timing and certainty of their generation. ….. Users are better able to evaluate this ability to generate cash and cash equivalents if they are provided with information that focuses on the financial position, performance and changes in financial position of an entity. [Paragraph 15]
>
> The financial position of an entity is affected by the economic resources *it controls*, its financial structure, its liquidity and solvency, and its capacity to adapt to changes in the environment in which it operates. Information

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> about the *economic resources controlled* by the entity and its capacity in the past to modify these resources is useful in predicting the ability of the entity to generate cash and cash equivalents in the future. [Paragraph 16; emphasis added.]

BC136 Therefore, under the *Framework*, the objective of consolidated financial statements is to provide information about the economic resources controlled by the parent. The Board believes that an entity's financial statements provide users with more useful information about the entity's financial position when they include all of the assets under its control, regardless of the extent of ownership interests held.

BC137 The Board had already concluded while developing IFRS 3 that goodwill meets the definition of an asset. Therefore, the assets under the control of a parent should include all of the goodwill of an acquiree, not just the parent's proportionate share.

BC138 Thus, the Board concluded that the full goodwill method is consistent with the concept that control over another entity makes the controlling entity accountable for all of that other entity's assets and liabilities. The Board believes that the full goodwill method is relevant because it is consistent with the control and completeness concepts underlying the preparation of consolidated financial statements.

Measurement

BC139 The draft revised IFRS 3 requires goodwill to be measured as the amount by which the fair value of the acquiree as a whole exceeds the net amount of the fair values of the identifiable assets acquired and liabilities assumed.

BC140 The Board considered whether application difficulties could arise in measuring goodwill, but concluded that calculating full goodwill is not itself difficult. Rather, any difficulties associated with its calculation could stem from problems entities might encounter in measuring either (a) the fair value of the acquiree (or consideration transferred that is used to determine that fair value) or (b) the fair values of the identifiable assets acquired and liabilities assumed as part of the business combination.

BC141 The Board had observed in developing IFRS 3 that goodwill measured as a residual could include overpayments by the acquirer and errors in measuring and recognising the fair value of the identifiable assets acquired and liabilities assumed, or a requirement in a standard to measure those identifiable items at an amount that is not fair value. However, the Board concluded in IFRS 3 that goodwill is likely to consist

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primarily of core goodwill at the acquisition date, and that recognising it as an asset is more representationally faithful than recognising it as an expense.

BC142 Paragraphs BC52-BC63 above provide a fuller discussion of the Board's considerations relating to measuring the fair value of the acquiree as a whole. The Board concluded that the fair value of the acquiree could be measured on the basis of the fair value of the consideration given or measured directly by using valuation techniques. The Board also decided to provide additional guidance for estimating the fair value of the acquiree as a whole (paragraphs A9-A17).

BC143 The Board considered concerns that circumstances surrounding a particular business combination might not provide strong evidence of the fair value of the acquiree as a whole. A particular situation considered was when an acquirer obtains control but the consideration given to obtain control of the acquiree is for much less than a 100 per cent ownership interest in the acquiree. Examples of such circumstances could include:

(a) an associate buys back some or all of its equity instruments held by other unrelated equity-holders, resulting in the entity obtaining control of the former associate.

(b) an entity has an ownership interest in an associate and acquires a small additional holding sufficient to give it control of that entity.

BC144 The measurement difficulties may be more challenging in circumstances in which there is no consideration exchanged on the date control is obtained, such as those described in example (a) above. The amount of the consideration paid in example (b) would provide evidence of a market-based transaction on the date control is obtained. Although the consideration paid is for a partial ownership interest, it can provide useful evidence for estimating the fair value of the acquiree as a whole.

BC145 The Board observed that the purchased goodwill method can have the same measurement difficulties that arise under the full goodwill method. For example, similar measurement difficulties arise if a business combination is effected via a share-for-share exchange between two privately held entities or as described in paragraph BC143(a).

BC146 Furthermore, one could argue that similar measurement difficulties might arise when testing goodwill for impairment. Goodwill impairment tests rely on the measurement of the recoverable amount of a cash-generating unit, to which goodwill is allocated. If, as one could argue, it would be burdensome to measure the fair value of the acquiree when the transaction is, for example, an acquisition of a 60 per cent

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controlling-ownership interest, it could be difficult to justify adopting an 'impairment only' approach for goodwill after initial recognition given that the recoverable amount of a cash-generating unit must be calculated in the absence of transaction-based evidence.

BC147 The Board observed that multiple valuation techniques are available and are used in practice, and that the use of multiple techniques provides a way of increasing the reliability of the resulting fair value measure. Therefore, the draft IFRS provides that if either no consideration is transferred on the acquisition date or the evidence indicates that the consideration transferred is not the best basis for measuring the acquisition-date fair value of the acquirer's interest in the acquiree, the acquirer should measure the acquisition-date fair value of its interest using other valuation techniques.

BC148 Thus, the draft revised IFRS 3 eliminates the past practice of omitting the portion of goodwill related to the non-controlling interests in subsidiaries. Because that is a change to present practice, the Board decided to provide guidance that illustrates how goodwill is to be measured and allocated between the controlling and non-controlling interests in an acquiree that is not wholly-owned (paragraphs A66 and A67).

Allocation of goodwill between the controlling and non-controlling interests

BC149 The Board considered three alternatives for allocating goodwill between the controlling and non-controlling interests in an acquisition of a less than wholly-owned acquiree. They are:

(a) allocate a portion of goodwill to the controlling interest on the basis of the difference between the fair value of the ownership interest acquired (which includes any previous investment held in the acquiree) and the acquirer's share of the fair value of the net identifiable assets acquired, and allocate the remaining portion to the non-controlling interests.

(b) allocate goodwill to the controlling and non-controlling interests on the basis of their relative ownership interests in the fair value of the acquiree.

(c) allocate a portion of goodwill first to a reporting unit of the controlling interest that is expected to benefit from synergies of the combination, and then allocate the remainder to the controlling and non-controlling interests on the basis of their relative ownership interests in the fair value of the acquiree.

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BC150 The Board decided that goodwill should be allocated on the basis of the first of those alternatives. Thus, as noted in paragraph A66, the amount of goodwill allocated to the acquirer (controlling interest) is to be measured as the difference between the acquisition-date fair value of the acquirer's equity interest in the acquiree and the acquirer's share in the acquisition-date fair value of the separately recognised assets acquired and liabilities assumed. The remainder is to be allocated to the non-controlling interests. The Board noted that each alternative has merits. It concluded that the first alternative reflects best the assumption that any premium paid by the acquirer for control rights that is included in the full amount of goodwill should be allocated to the acquirer's interests, and not to the non-controlling interest. The second alternative would be simple to apply, but would result in a portion of goodwill related to any control premium being allocated to the non-controlling interest. The third alternative would allocate goodwill to the reporting units on the basis of expected benefits but the Board concluded that this approach is likely to be more difficult and costly to apply.

RECOGNISING GAINS OR LOSSES ON NON-CONTROLLING EQUITY INVESTMENTS

BC151 Paragraph 53 of the draft revised IFRS 3 requires, in a business combination achieved in stages, an acquirer to remeasure its non-controlling equity investment at its acquisition-date fair value and to recognise any unrealised gains or losses in income. This decision reflects the Board's conclusion that gaining control of a business is an event that should trigger remeasurement. Specifically, a change from holding a non-controlling investment in an entity to obtaining control of that entity is a significant change in the nature of the economic circumstances surrounding the investment. That change warrants a change in the classification and measurement of the investment. The Board observed that when control of the underlying entity is obtained the acquirer is no longer the owner of a non-controlling investment asset in that entity. As in present practice, the acquirer ceases accounting for an investment asset and begins reporting the underlying assets, liabilities, and results of operations of the acquiree as part of its consolidated results. In effect, the acquirer exchanges its status as an owner of an investment asset for a controlling interest in all of the underlying assets and liabilities of that acquiree.

BC152 Paragraph 21(b) of the draft revised IFRS 3 also provides that, for the purposes of measuring the initial fair value of the acquiree as a whole, the fair value of any non-controlling equity investment is regarded as part of

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the fair value of the consideration transferred. The Board noted that measuring the investment asset at its fair value at the acquisition date—when investment accounting ceases—is consistent with the concept that when one asset is exchanged for another asset the transaction is accounted for on the basis of the fair values of the assets involved (paragraph BC52).

BC153 The Board acknowledges concerns about allowing what some perceive to be an opportunity for gain recognition around the changes in status from investment to subsidiary. The Board notes that remeasurement could also result in recognising a loss. Moreover, the Board disagreed with characterising the resulting gain or loss as arising from a purchase. Rather, under the mixed attribute accounting model that exists today, economic gains and losses are recognised as they occur for some, but not all, financial instruments. If a non-controlling equity interest in an entity is not measured at its fair value, the recognition of a gain or loss at the acquisition date is merely a consequence of the delayed recognition of the economic gain or loss that is present in that financial instrument. However, if an investment asset is measured at fair value under IFRSs, the gain or loss would be recognised as it occurs, and remeasurement would result in no further gain or loss.* The Board decided to require disclosure of the gain or loss on remeasurement of any previously held non-controlling equity interest.

DETERMINING THAT ASSETS ACQUIRED AND LIABILITIES ASSUMED ARE PART OF THE EXCHANGE FOR THE ACQUIREE

BC154 The Board decided that, to improve consistency, the draft revised IFRS 3 should provide guidance for applying its measurement and recognition principle.

BC155 The Board decided to provide application guidance to help address concerns expressed about the difficulty of determining whether the consideration is for the acquiree. Parties involved directly in the negotiations of an impending business combination could take on the characteristics of related parties. As a result, they may be willing to enter

* Paragraph 53 requires that if the acquirer recognised changes in the value of its non-controlling equity investment, before the business combination, directly in equity (for example, the investment was classified as available for sale), the amount that was recognised directly in equity must be reclassified and included in the calculation of any gain or loss as of the acquisition date.

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into other agreements or include conditions as part of the business combination agreement that are designed primarily to achieve favourable post-combination reporting outcomes. Because of those concerns the Board decided to develop an overall principle that should be considered when assessing a particular transaction or arrangement entered into by the parties to the combination.

BC156 The Board concluded that if a transaction or arrangement is designed primarily for the economic benefit of the acquirer or the combined entity (rather than the acquiree or its former owners), that transaction or arrangement is not part of the exchange for the acquiree. Accordingly, those transactions or arrangements should be accounted for separately from the business combination. The Board acknowledges that judgement may be required to determine whether a portion of the transaction price paid, or the assets acquired and liabilities assumed, are not part of the exchange for the acquiree. Accordingly, the Board decided to include guidance in the draft revised IFRS 3 on factors to be considered in applying the general principle when assessing a business combination. Paragraph A92 of the proposed IFRS identifies those factors as the reason, initiating party and timing of the transaction or event. The Board believes that, although those factors are neither mutually exclusive nor individually conclusive, they can be helpful in considering whether a transaction or event is arranged primarily for the economic benefit of the acquirer or combined entity. Paragraph A92 expands on those factors and paragraphs A93–A116 provide illustrative examples.

BC157 The guidance emphasises that assets acquired or liabilities assumed that are recognised as part of the business combination must be part of the exchange. Paragraph 66 of the draft revised IFRS 3 requires the acquirer to assess whether any portion of the transaction price paid and any assets acquired or liabilities assumed are not part of the exchange for the acquiree. Any portion of the transaction price paid or any assets acquired or liabilities assumed that are not part of the exchange are accounted for separately from the business combination.

BC158 An objective of that assessment is to distinguish consideration that an acquirer transfers for the acquiree from other payments made in connection with the business combination that are for other assets or purposes. To assist in meeting that objective, paragraph 67 of the draft revised IFRS 3 includes three examples of payments or other arrangements that are not part of the exchange for the acquiree; Appendix A provides additional implementation guidance.

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BC159 The first example in paragraph 67 is the exclusion of payments that effectively settle pre-existing relationships between the acquirer and acquiree. The example is directed at ensuring that assets and liabilities related to pre-existing relationships between the parties that are not transferred to, or assumed by, the acquirer are excluded from the accounting for the business combination. To illustrate, suppose a potential acquiree had a receivable for an unresolved claim against the potential acquirer and that the acquirer and the acquiree's owner agree to settle that claim as part of an agreement to sell the acquiree to the acquirer. The Board concluded that if the acquirer makes a lump-sum payment to the seller-owner, part of that payment is to settle the claim and is not part of the consideration transferred to acquire the business. Thus, the portion of the payment that relates to the claim settlement should be excluded from the accounting for the business combination and accounted for separately. In effect, the acquiree relinquished its claim (receivable) against the acquirer by transferring it (as a dividend) to the acquiree's owner. Thus, at the acquisition date the acquiree has no receivable to be acquired as part of the combination and the acquirer would account for its settlement payment separately.

BC160 The second and third examples are also directed at illustrating cases in which payments that are not part of the consideration transferred for the acquiree should be excluded from the business combination accounting. Paragraph BC89 also discusses the Board's considerations surrounding the third example—payments to reimburse the acquiree or its former owners for paying the acquirer's costs incurred in connection with the business combination.

MEASUREMENT PERIOD

BC161 In developing IFRS 3, the Board observed that normally it is not possible for an acquirer to obtain before the acquisition date all of the information necessary for the acquirer to complete the initial accounting for a business combination immediately after the acquisition date. Therefore, the Board concluded that IFRS 3 should allow an acquirer some period after the acquisition date to finalise the accounting and adjust any provisional amounts to their subsequently determined acquisition-date fair values. The draft revised IFRS 3 carries forward the provisions from IFRS 3 in paragraphs 59-65, and refers to this period as the measurement period. Those paragraphs also provide guidance to be applied during the measurement period.

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BC162 The Board decided to place constraints on the period of time for which it is deemed reasonable to be seeking necessary information and concluded that a maximum period of one year is reasonable.

BC163 The Board acknowledges that many contingencies and similar matters may not be settled within one year. It observes, however, that the objective of the measurement period is to provide time to obtain the information necessary to measure the acquisition-date fair value of the item. The objective is not to determine the ultimate settlement amount of a contingency or other item. Uncertainties about future cash flows are part of the measure of the fair value of an asset or liability.

BUSINESS COMBINATIONS IN WHICH THE CONSIDERATION TRANSFERRED FOR THE ACQUIRER'S INTEREST IN THE ACQUIREE IS LESS THAN THE FAIR VALUE OF THAT INTEREST (BARGAIN PURCHASE)

BC164 Paragraphs 56–58 of the draft revised IFRS 3 set out the requirements for business combinations in which the fair value of the consideration transferred (paid) by the acquirer is less than the fair value of that interest in the acquiree. IFRS 3 refers to this difference as 'excess'. It is also commonly referred to as negative goodwill. However, bargain purchases have occurred and are likely to continue to occur. They include a forced liquidation or distress sale (for example, death of a founder or key manager) in which owners need to sell a business and are acting under compulsion to sell at less than fair value.

BC165 In developing IFRS 3, the Board concluded that an excess should rarely exist if the valuations inherent in the accounting for a business combination are properly performed and all of the acquiree's identifiable liabilities and contingent liabilities have been properly identified and recognised. Therefore, when an excess exists, the acquirer is required to reassess the identification and measurement of the acquiree's identifiable assets, liabilities and contingent liabilities and the measurement of the cost of the business combination.

BC166 The draft revised IFRS 3 carries forward from IFRS 3 a requirement to reassess the identification and measurement of the acquiree's identifiable assets and liabilities and the measurement of the consideration paid. In addition, the proposed IFRS requires remeasurement of the acquisition-date fair value of the acquiree and the acquirer's interest in that acquiree.

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BC167 The Board affirmed that the objective of that requirement is to ensure that appropriate consideration has been given to all available information in identifying the items to be measured and recognised and in determining their fair values. The Board believes that such remeasurement checks will mitigate, if not eliminate, undetected errors that might have existed in the initial measurements.

BC168 The Board observed in IFRS 3 that any excess remaining after the reassessment could comprise one or more of the following components:

(a) errors that remain, notwithstanding the reassessment, in recognising or measuring the fair value of either the cost of the combination or the acquiree's identifiable assets, liabilities or contingent liabilities.

(b) a requirement in an accounting standard to measure identifiable net assets acquired at an amount that is not fair value, but is treated as though it is fair value for the purpose of allocating the cost of the combination.

(c) a bargain purchase. This might occur, for instance, when the seller of a business wishes to exit from that business for other than economic reasons and is prepared to accept less than its fair value as consideration.

BC169 The Board acknowledges that negative goodwill remains a possibility because the draft revised IFRS 3 continues to require that some assets acquired and liabilities assumed should be measured at other than their acquisition-date fair value. The Board observes, however, that the requirements in the proposed IFRS address most shortcomings that may previously have led to negative goodwill being reported that did not have the economic substance of a bargain purchase. For example, before IFRS 3 was issued, a liability accompanied by a contingent liability of an acquiree might not have been recognised at the acquisition date at all. The omission of such liabilities would result in an overstatement of the identifiable net assets acquired and, thus, an equivalent understatement of goodwill. If the omitted liability exceeded the actual goodwill in the acquiree, negative goodwill would result. Similarly, a liability for contingent payment arrangements (for example, earnouts) might not have been recognised at the acquisition date, which, in some cases, could lead to understating the consideration paid and creating the appearance of a bargain purchase. The proposed IFRS reduces the possible errors further by requiring the measurement and recognition of substantially all liabilities at their fair values at the acquisition date.

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BC170 Other changes in the draft revised IFRS 3 may also reduce the instances of negative goodwill. When it issued IFRS 3, the Board acknowledged that some of the guidance for allocating the cost of the business combination conflicted with the general principle of recognising assets acquired and liabilities assumed at their fair value. The additional guidance in the proposed IFRS on the fair value hierarchy should help to reduce measurement errors that have, in the past, led to negative goodwill.

BC171 The Board believes that most business combinations are exchange transactions in which each party receives and sacrifices equal value. The Board concluded that the consideration transferred by the acquirer is presumed to be the best evidence of the acquisition-date fair value of the acquirer's interest in the acquiree and should be used as a basis for measuring the fair value of the acquiree. Moreover, the Board noted that a fair value estimate is determined by reference to willing marketplace participants representing unrelated buyers and sellers that are knowledgeable and have a common level of understanding about factors relevant to the business and the transaction, and are willing and able to transact in the same market(s) and have the legal and financial ability to do so. The Board is not aware of any compelling reason to believe that, in the absence of duress, a seller of a business would willingly and knowingly sell a business for less than its fair value. Thus, the Board concluded that applying the proposed fair value measurement requirements will mitigate concerns that negative goodwill might result and be misinterpreted as indicating a bargain purchase.

BC172 However, as discussed above, a business combination in which the fair value of the consideration transferred (paid) by the acquirer is less than the fair value of the interest in the acquiree could be a true bargain purchase. The Board believes that bargain purchases are not common.

BC173 The Board decided that because a bargain purchase is unlike a business combination in which willing parties exchange assets (net assets) of equal values, the presumption in paragraph 20 of the draft revised IFRS 3 would not apply to those transactions. That is to say, the Board concluded that the presumption in the proposed IFRS that the amount paid by the acquirer is the best evidence of the acquisition-date fair value of the acquirer's interest and its related measurement guidance are not appropriate for circumstances in which the seller of the business is known to be acting under compulsion. The Board also concluded, however, that the objectives and other principles (paragraph BC18) underlying the proposed IFRS are relevant and apply to a bargain purchase.

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BC174 The Board also observes that, unlike a typical acquisition of an acquiree, an economic gain is inherent in a bargain purchase. Specifically, the acquirer is better off at the acquisition date by the amount by which the fair value of the acquiree exceeds the fair value of the consideration paid. The Board believes that, in concept, that gain should be recognised by the acquirer at the acquisition date, but decided to place limits on the recognition of gains on a bargain purchase. The Board acknowledges that although the reasons for a forced liquidation or distress sale are often apparent, clear evidence does not always exist. This could occur, for example, if a seller uses a closed (private) process for the sale to maintain its negotiating position rather than reveal the main reason for the sale. The Board also concluded that, because these transactions are expected to be rare, the appearance of a bargain purchase without evidence of the underlying reasons would raise concerns in practice about the existence of measurement errors.

BC175 The Board acknowledges that the remeasurement checks discussed above may be insufficient to eliminate its concern about measurement bias. Therefore, the Board decided to address its concern by limiting the gain that can be recognised. Thus, the draft revised IFRS 3 provides that if, after performing the remeasurements required, the fair value of the acquirer's interest in the acquiree still exceeds the fair value of the consideration transferred, the acquirer must account for that excess by reducing goodwill related to that business combination. If goodwill is reduced to zero any remaining excess must be recognised as a gain allocable to the acquirer on the acquisition date. The proposed IFRS also requires disclosure of the amount of any gain recognised and a description of the reasons why the acquirer was able to achieve a gain.

BC176 The primary objective of the limitation on gain recognition is to mitigate the potential for inappropriate gain recognition through measurement errors, particularly those that might result from unintended measurement bias. The objective of the disclosure requirement is to provide information that enables users of an acquirer's financial statements to evaluate the nature and financial effect of business combinations that take place during the period. The Board understands from professional analysts and others that disclosing information about revenues, expenses, gains and losses resulting from atypical events and circumstances, such as gains on a bargain purchase transaction, is particularly important for analysing an entity's performance and developing trend information to assess an entity's prospects for generating future earnings and cash flows. The Board also noted that the limitation and disclosure requirements may also help to alleviate concerns about intentional measurement bias, although that is not their primary objective.

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BC177 The Board recognises concerns that placing limits on gain recognition is not consistent with the fair value measurement principles in the draft revised IFRS 3 and could lead to misrepresenting bargain purchases that are free of measurement errors. In concept, a gain should be recognised without the proposed limitations in those cases in which there is persuasive evidence (such as duress on a seller) that the transaction is a bargain purchase. The Board acknowledges, however, that to apply this distinction could lead to other difficulties in practice. The Board concluded that placing a limit on the gain permitted to be recognised is a practical way to address the problems and concerns raised about measurement errors.

ACQUISITIONS AT MORE THAN THE FAIR VALUE OF THE INTEREST IN THE ACQUIREE (OVERPAYMENTS)

BC178 The Board considered whether the draft revised IFRS 3 should include requirements for accounting for a business combination in which the acquirer pays an amount that is more than the fair value of its interest in the acquiree. The Board observed that this circumstance indicates that the business combination is not an exchange of equal values. However, the Board observed that although an overpayment by the acquirer is a theoretical possibility, it believes that in practice, if it occurs, it will not be detectable or known at the acquisition date. That is to say, the Board is not aware of instances in which a buyer knowingly overpays a seller to acquire a business or is otherwise compelled to make such an overpayment. Rather, the Board believes that an acquirer's overpayment, although rare, occurs unknowingly and generally as a result of misinformation at the acquisition date. Thus, the Board concluded that in practice it might not be possible to identify and measure reliably an overpayment at the acquisition date. The Board concluded that the accounting for overpayments is best addressed through subsequent impairment testing when evidence of a potential overpayment first arises.

COMBINATIONS BETWEEN MUTUAL ENTITIES AND ACHIEVED BY CONTRACT ALONE

BC179 As noted in paragraph BC45, issues relating to business combinations between mutual entities and combinations achieved by contract alone were not included in the original scope of the second phase of the project. The Board intended to deal with such business combinations as part of

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future phases of the project. However, the Board decided to address the accounting for such combinations as part of this joint project. The reason is that the FASB decided that decisions in the joint project should also apply to business combinations involving mutual entities and achieved by contract alone and, therefore, the scope of a single standard on business combinations became a convergence issue.

Combinations between mutual entities

BC180 The FASB considered issues relating to business combinations between mutual entities as part of its separate *Combinations Between Mutual Enterprises* project, a joint project with the Accounting Standards Board of the Canadian Institute of Chartered Accountants (CICA). The objective of that project was to develop guidance on the accounting for combinations between two or more mutual entities. In that project, the FASB and CICA identified the circumstances particular to mutual entities that may require additional guidance. That approach presumed that a future FASB Statement arising from the second phase of the Business Combinations project should apply to combinations between mutual entities, unless the economic conditions or other circumstances of the combination were found to be so different as to warrant a different accounting treatment or further guidance. The FASB decided that the unique attributes of mutual entities were not sufficient to justify an accounting treatment different from that provided for other entities. Therefore, the FASB decided that the joint project decisions should apply to combinations of mutual entities.

BC181 Like the FASB, the Board also considered whether its decisions in this draft IFRS should apply to business combinations between mutual entities by focusing on characteristics that distinguish mutual entities and combinations between mutual entities from other business entities. The Board's focus was on whether such unique circumstances would justify a different accounting treatment.

BC182 The Board noted that mutual entities have many characteristics in common with other business entities and some distinguishing characteristics. However, the Board observed that the economic motivations for combinations between mutual entities, such as to provide constituents with a broader range of, or access to, services and cost savings through economies of scale, are similar to those for combinations between other business entities. In particular:

(a) although mutual entities generally do not have shareholders in the traditional sense of investor-owners, they are in effect 'owned' by

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their members and are in business to serve their members or other stakeholders. Like other businesses, mutual entities strive to provide their members with a financial return or benefits. However, a mutual entity generally does that by focusing on providing its members with its products and services at lower prices. For example, in the case of credit unions, the benefit may be a lower interest rate on a borrowing than might be obtainable through an investor-owned financial institution. In a wholesale buying co-operative, the benefit might be realised in lower net costs, after consideration of patronage dividends.

(b) interests of members of a mutual entity generally are not transferable like other ownership interests. However, they usually include a right to share in the net assets of the mutual entity in the event of its liquidation or conversion.

(c) a higher percentage of combinations among mutual entities occur without an exchange of cash or other readily measurable consideration. However, that circumstance is not unique to mutual entities. Business combinations without an exchange of cash or other readily measurable consideration also take place between other entities, particularly combinations of private entities.

BC183 The Board considered whether differences between the ownership structures of mutual entities (such as mutual insurance companies or mutual co-operative entities) and those of investor-owned entities may give rise to complications in applying the acquisition method to business combinations between mutual entities. The ownership structures of mutual entities vary from a single class of membership shares issued at par value, to more complex structures including various classes of membership and investment shares. The Board observed that this complexity results in some difficult questions when determining the classification as liability or equity of members' and participants' interests in a mutual entity. However, the Board noted that the issue of classification of those interests is not an issue for the Business Combinations project. To the extent that members' and participants' interests meet the definition of a liability in IAS 32, the fair value of that liability assumed should be recognised in accounting for a business combination involving mutual entities.

BC184 The Board then considered whether mutual entities should be required to apply the proposed IFRS to such transactions, focusing its discussion on three issues that might arise in applying the acquisition method to those transactions. The first was the suggestion that the acquisition method is not appropriate for all combinations between mutual entities. The second

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was the proposition that it might be difficult to identify the acquirer. The third was the concern that such transactions normally do not involve the payment of any readily measurable consideration.

Method of accounting

BC185 As part of the first phase of the Business Combinations project, the Board published an Exposure Draft of Proposed Amendments to IFRS 3 *Business Combinations – Combinations by Contract Alone or Involving Mutual Entities*. The Exposure Draft proposed an interim approach for accounting for these business combinations until the Board considered these issues as part of its second phase of the project.* The Exposure Draft suggested that the acquisition method should be used in accounting for these business combinations.

BC186 In response to the Exposure Draft, some representatives of mutual entities expressed a concern about requiring all combinations of mutual entities to be accounted for as acquisitions. Several respondents suggested that prohibiting the pooling of interests method would discourage combinations between entities affected by the proposals and reduce the amount of capital flowing into their industries. This is because the acquisition method may give the incorrect impression that one entity has become dominant over the other. They suggested, for example, that the requirement to identify an acquirer could prevent mergers of neighbouring mutual entities when both the fact and appearance of a merger of equals are of paramount importance to their directors, members and communities.

BC187 Some respondents to the Exposure Draft noted that the acquisition method may impede combinations because of particular laws and regulatory requirements. For example, some regulatory agencies currently evaluate the financial soundness of credit unions on the basis of their accumulated retained earnings measured by generally accepted accounting principles rather than their total equity capitalisation. Under the pooling of interests method the recognised amount of the retained earnings of each of the combining credit unions is carried forward and, thus, becomes the aggregate retained earnings of the combined entity. Under the acquisition method only the retained earnings of the acquirer are carried forward in the combined entity. Accordingly, credit unions will have a reduced net worth ratio after a combination, which may be below

* In the light of respondents' comments, the Board decided not to proceed with the proposals in the Exposure Draft primarily for reasons of timing and impending consideration of these issues in the second phase of this project.

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regulatory requirements. This will discourage healthy credit unions from merging with weaker ones (and would indirectly lead to higher failure rates). The implication drawn by respondents was that the pooling of interests method should be retained for public policy reasons.

BC188 The Board affirmed its conclusion in IFRS 3 that there are no circumstances in which the pooling of interests method provides information superior to that provided by the acquisition method. Paragraph 36 of the *Framework* states that to be reliable, the information contained in financial statements must be neutral, and should not influence the making of a decision or judgement in order to achieve a predetermined result or outcome. In this context, neutrality means that accounting standards should neither encourage nor discourage business combinations but, rather, provide information about those combinations that is representationally faithful and even-handed. The Board concluded that eliminating the pooling of interests method and requiring a single method of accounting for all business combinations is consistent with this goal. The Board also concluded that regulatory concerns are not a sufficient reason to grant combinations of mutual entities special treatment vis-à-vis allowing them to apply the pooling of interests method.

BC189 The Board also observed that it concluded in the first phase of its Business Combinations project that applying the acquisition method to combinations involving two or more mutual entities results in providing the users of financial statements with information that is superior to, and more representationally faithful than, the information that would be provided by applying the pooling of interests method to such combinations. Therefore, the Board concluded that the acquisition method should be used in accounting for such combinations.

BC190 However, the Board agrees with respondents that for business combinations in which one of the combining entities does not obtain control of the other combining entity (assuming such transactions exist), the fresh start method is likely to be more representationally faithful than the acquisition method. But this would be the case irrespective of whether the transaction involves mutual entities, is by contract alone, or involves (for example) the formation of a new entity to issue equity interests to effect the merger of two or more other businesses. As discussed in paragraph BC32, the Board is committed to exploring the fresh start method in the future.

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Identifying the acquirer

BC191 On the second issue, the Board affirmed its conclusion in IFRS 3 that even though it could be difficult to identify an acquirer in some rare circumstances, exceptions to applying the acquisition method should not be permitted. The Board acknowledged that difficulties may arise in identifying the acquirer in combinations of two virtually equal mutual entities. However, it also observed that those difficulties also arise in combinations of two virtually equal investor-owned entities and, thus, are not unique to combinations of mutual entities. The Board concluded that in no circumstances does the pooling of interests method provide superior information to that provided by the acquisition method, even if identifying the acquirer is problematic.

BC192 Additionally, the Board concluded that the IFRS 3 indicators for identifying the acquirer in a business combination are applicable to combinations of investor-owned entities and mutual entities and that no additional indicators are needed to identify the acquirer in combinations between mutual entities. As a result, the Board affirmed that the provision in IFRS 3 that requires an acquirer to be identified applies to all business combinations, including those between mutual entities.

No payment of any reliably measurable consideration

BC193 The Board considered the concern that one of the difficulties in applying the acquisition method to such business combinations is that the transactions normally do not involve the payment of cash or any other readily measurable consideration. However, the Board observed that the objective of accounting for a business combination is to determine and recognise the fair value of the business acquired. Although the fair value of the consideration given is, generally, more clearly evident than the fair value of the business acquired, this is not always the case. In some circumstances, the fair value of the consideration given by the acquirer does not provide the best basis for measuring the fair value of the business acquired.

BC194 The Board decided that, in such circumstances, the fair value of the acquiree should be measured directly using valuation techniques. The Board noted that business combinations without an exchange of cash or other readily measurable consideration also take place between other types of entity. Therefore, although a higher percentage of combinations among mutual entities take place without an exchange of cash or other readily measurable consideration, that circumstance is not unique to mutual entities. The Board concluded that the acquisition

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method can and should be applied in accounting for business combinations that do not involve the payment of reliably measurable consideration.

BC195 In considering the application of the acquisition method to mutual entities, the Board considered the accounting and reporting for an acquisition in which an acquirer issues equity shares or member interests as consideration in exchange for the equity shares or member interests of an acquiree. The Board observed that in a business combination between two investor-owned entities, if the acquirer issues equity shares as consideration for all of the equity shares of an acquiree, the fair value of the acquiree (its equity or net assets) is recognised as an addition to the equity of the acquirer. Thus, the equity (net assets) of the combined entity is increased from the acquisition of the acquiree (and the fair value of its net assets), but retained earnings of the acquirer are unaffected.

BC196 Some representatives of mutual entities suggested that a similar acquisition of a mutual entity should be allowed to be recognised as an increase in the retained earnings of the acquirer (combined entity) as had been the practice under the pooling method of accounting. The Board rejected that view. The Board believes that business combinations between two investor-owned entities are economically similar to those between two mutual entities in which the acquirer issues member interests for all the member interests of the acquiree. Thus, the Board concluded that those similar transactions should be accounted for on a similar basis. Therefore, paragraph 50 of the draft revised IFRS 3 clarifies that in a business combination involving only mutual entities in which the only consideration exchanged is the member interests of the acquiree for the member interests of the acquirer (or the member interests of the newly combined entity), the amount equal to the fair value of the acquiree must be recognised as a direct addition to capital or equity, not retained earnings.

BC197 As a result of these deliberations, the Board concluded that its decisions in the second phase of the Business Combinations project have addressed the difficulties in applying the acquisition method to business combinations involving two or more mutual entities. Therefore, the Board concluded that the proposed IFRS should provide that such business combinations should be accounted for in accordance with its requirements. The Board also concluded that combinations between mutual entities are economically similar to combinations between other business entities and that there is no need to issue separate application guidance for those business combinations.

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Combinations achieved by contract alone

BC198 The Board also concluded that business combinations achieved by contract alone should be included in the scope of the draft revised IFRS 3 and accounted for in accordance with its provisions. The current practice in the US is that such combinations are accounted for in accordance with SFAS 141. Therefore, they are accounted for by applying the SFAS 141 version of the acquisition method.*

BC199 The Board notes that difficulties may arise in applying the acquisition method to combinations achieved by contract alone. In particular, such business combinations normally do not involve the payment of any readily measurable consideration and in rare circumstances it might be difficult to identify the acquirer. However, as for combinations between mutual entities and for the reasons discussed above, the Board concluded that the acquisition method can and should be applied in accounting for such business combinations. The Board concluded that in a business combination achieved by contract:

(a) difficulties in identifying the acquirer are not a sufficient reason to justify a different accounting treatment, and no further guidance is necessary for identifying the acquirer for combinations by contract.

(b) determining the fair value of the acquiree and calculating the related goodwill should be consistent with decisions reached in the second phase of the project.

DISCLOSURES

BC200 The draft revised IFRS 3 carries forward those disclosure requirements from IFRS 3 that remain relevant, eliminates those that do not, and modifies those that are affected by changes in the measurement or recognition requirements it proposes. Paragraphs BC170-BC178 of IFRS 3 discuss the Board's considerations and decisions that led to the

* Under US GAAP EITF 97-2 *Application of FASB Statement No. 94 and APB Opinion No. 16 to Physician Practice Management Entities and Certain Other Entities with Contractual Management Arrangements* deals with combinations by contract. Although EITF 97-2 applies only to physician practice management entities and some other entities with contractual management arrangements, EITF 97-2 is applied more widely by analogy. EITF 97-2 requires the execution of such a management agreement to be accounted for as a business combination.

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disclosures required by that IFRS. Because the Board is not redeliberating, or seeking comments on, those conclusions they are not repeated in this Basis for Conclusions.

BC201 Changes from the IFRS 3 requirements include amended disclosures relating to the change from the cost-allocation method to the fair value measurement principle. Some of these disclosures are modified to retain the information but reflect the change in measurement basis. For example, IFRS 3 requires disclosure of the cost of the combination and a description of the components of that cost. The draft revised IFRS 3 requires disclosure of the acquisition-date fair value of the consideration transferred, including the fair value of each major class of consideration. The Board also concluded that the following additional disclosures are necessary under the fair value measurement principle:

(a) the acquisition-date fair value of the acquiree and the basis for measuring that value.

(b) the amount of acquisition-related costs that are recognised as an expense, and the income statement line item in which that expense is recognised.

(c) in a business combination achieved in stages, the fair value of the acquirer's previously acquired non-controlling equity investment in the acquiree and the amount of any gain or loss recognised in accordance with paragraph 53, and the line item in the income statement in which that gain or loss is recognised.

BC202 The following are among the disclosure requirements that the Board decided to add to meet its disclosure objectives in IFRS 3:

(a) the maximum potential amount of future payments (undiscounted) the acquirer could be required to make under the terms of the acquisition agreement.

(b) in a business combination in which the acquirer and acquiree have a pre-existing relationship:

    (i) the nature of the pre-existing relationship

    (ii) the measurement of the settlement amount of the pre-existing relationship, if any, and the valuation method used to determine the settlement amount

    (iii) the amount of any settlement gain or loss recognised and the line item in the income statement in which that gain or loss is recognised.

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(c) the amount of revenue of the acquiree since the acquisition date included in the consolidated income statement for the period. The Board concluded that information about post-combination revenues of an acquired business allows users to distinguish acquired revenues from those generated by the acquirer itself.

(d) if the amounts recognised in the financial statement for the business combination have been determined only provisionally, the assets acquired or the liabilities assumed for which the measurement period is still open. This disclosure provides information about items of assets and liabilities for which the acquirer continues to seek information relating to their fair values.

(e) a description of an event or change in circumstances that has resulted in deferred tax benefits acquired in a business combination being recognised.

(f) the total amount of goodwill and the amount that is expected to be deductible for tax purposes.

BC203 The Board decided not to require in the draft IFRS the following disclosures currently required by IFRS 3:

(a) the carrying amounts for each class of the acquiree's assets and liabilities, determined in accordance with IFRSs, immediately before the combination. The Board concluded that providing this disclosure could often involve significant costs that do not justify the benefits that users receive from this information.

(b) a description of each intangible asset that was not recognised separately from goodwill and an explanation of why the intangible asset's fair value could not be measured reliably. This disclosure is unnecessary because the Board concluded that the fair value of intangible assets acquired in a business combination that are identifiable can always be measured reliably.

EFFECTIVE DATE AND TRANSITION

BC204 The Board decided that the provisions of the draft revised IFRS 3 should apply prospectively and that the proposed amendments to IAS 27 and IAS 37 should be applied at the same time. Prospective application of the draft revised IFRS 3 is consistent with IFRS 3. The Board acknowledges that, like IFRS 3, the proposed IFRS could be made effective immediately when issued, or shortly after. However, the Board's preference is that the proposed IFRS should be applied at the same time as the proposed

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revisions of IAS 27 and IAS 37 and that they should all be effective as of the beginning of an entity's annual period. The Board regards the proposed revisions in IAS 27, which address the subsequent accounting for an acquiree in consolidated financial statements, as related to provisions in the draft revised IFRS 3 that address the initial accounting for an acquiree at the acquisition date. Furthermore, the proposed changes in IAS 37 are concerned with the treatment in a business combination of the contingencies of an acquiree. The Board believes that linking the timing of the changes in accounting required by these IFRSs will minimise disruption to practice, to the benefit of both preparers and users of financial statements.

BC205 At the time the Exposure Drafts for the draft revised IFRS 3 and of the proposed amendments to IAS 27 and IAS 37 were published, the Board estimated that the resulting IFRSs would become effective no later than for annual periods beginning on or after 1 January 2007. The Board believes that a period of approximately 3–6 months after they are issued is desirable to provide sufficient time for entities to analyse, interpret, and prepare to implement those Standards. It allows sufficient time for countries to enact enabling legislation. It also allows time to co-ordinate the effective dates with the standards being issued by the FASB. The Board also decided to encourage early application of the proposed IFRS 3, as long as the revisions proposed for IAS 27 and IAS 37 are applied at the same time.

Effective date and transition for combinations between mutual entities or by contract alone

BC206 IFRS 3 excludes from its scope combinations between mutual entities and those achieved by contract alone. In developing IFRS 3 the Board decided that these combinations should be excluded from its scope until the Board issued interpretative guidance for the application of the acquisition method to those transactions. The draft revised IFRS 3 provides that interpretative guidance. The effective date for combinations between mutual entities is the same as the effective date for all other entities applying the proposed IFRS.

BC207 For the reasons outlined in paragraph BC180 of IFRS 3 the Board concluded that the transitional provisions for combinations involving mutual entities or those achieved by contract alone should be prospective. Given that these combinations are not currently within the scope of IFRS 3, they may be accounted for differently from what IFRS 3 requires. The transitional provisions currently in IFRS 3 take into

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consideration and properly reflect that entities may have used a range of alternatives in accounting for combinations in the past. The Board concluded that the transitional provisions for these combinations should incorporate the transitional provisions currently in IFRS 3 for other business combinations. In addition, the Board concluded that the transitional provisions should provide that an entity should continue to classify prior combinations in accordance with its previous accounting for such combinations. This is consistent with the prospective approach. Those provisions are contained in paragraphs C11 and C12 of Appendix C of the draft revised IFRS 3.

Previously recognised contingent liabilities

BC208 As discussed in paragraphs BC115 and BC116, the Board, in its amendments to IAS 37, proposes eliminating the term 'contingent liability' and highlighting that many items previously described as contingent liabilities satisfy the *Framework*'s definition of a liability. Accordingly, the Board decided that any recognised contingent liability that relates to a business combination for which the acquisition date was before the draft revised IFRS 3 is applied should be assessed to determine whether it satisfies the definition of a liability. If it does not, the Board concluded that it should be derecognised with a corresponding adjustment to goodwill arising from that business combination. The Board observed that continuing to recognise such contingent liabilities would be inconsistent with the principle that only those identifiable items that satisfy the definition of an asset or liability in the *Framework* should be recognised.

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Alternative Views

AV1 Five Board members have alternative views on some aspects of the draft revised IFRS 3. Their reasons are discussed in paragraphs AV2-AV20.

Goodwill

AV2 Five Board members disagree with the use of the full goodwill method in the revised IFRS 3, as explained in paragraphs BC134-BC150. This involves the recognition of not only the purchased goodwill attributable to the acquirer as a result of the acquisition transaction, but also the goodwill attributable to the non-controlling interest in the subsidiary. This method treats goodwill as an asset that can be identified separately and measured at fair value, like any other asset of the subsidiary.

AV3 The full goodwill method is based upon the assumption that in a business combination all assets of the acquiree, including goodwill, should be accounted for on a similar basis. The five Board members note that goodwill is different from other assets, because it is a component of the value of the business as a whole, rather than having a separate existence. Thus, under the full goodwill method, it has to be measured as the difference between the value of the acquired business as a whole and the sum of the separately measurable assets. The total goodwill of the acquiree then has to be apportioned between the controlling and non-controlling interests.

AV4 The process of measuring goodwill is therefore extremely difficult. The residual nature of its measurement means that it captures measurement errors in other assets, and sometimes non-recognition of those assets. Moreover, the total value of the acquired business is an extremely subjective measure, based upon the acquirer's judgement of the potential returns that it will generate. These returns will depend upon the synergies that the acquirer expects to achieve with its own business. Thus they are entity-specific to the particular acquirer and there will not be an observable fair value in the marketplace, especially when the acquisition is combined with restructuring.

AV5 Not only is the total value of the acquired business difficult to measure, but so is the allocation of the goodwill between the parent and the subsidiary. Some synergies will benefit the parent entity rather than, or in addition to, the subsidiary. Thus, the allocation of the goodwill between the parent

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and the subsidiary is also problematic, and this adds to the difficulty of measuring the goodwill attributable to the non-controlling interest in the subsidiary.

AV6 The 'parent-only' approach to goodwill in IFRS 3 avoids this difficulty by measuring goodwill as the difference between the fair value of the consideration paid by the parent for the subsidiary and its share of the fair value of the identifiable net assets of the subsidiary. Thus, purchased goodwill is the amount implicit in the acquisition transaction and excludes any goodwill attributable to non-controlling interests. This method gives rise to more reliable measurement, because it is based on the purchase consideration, which can usually be reliably measured, and it reflects faithfully the acquisition transaction, to which the non-controlling interests were not a party.

AV7 This 'parent-only' approach is, in the view of the five Board members, preferable to the full goodwill approach now proposed. The latter involves estimating a highly subjective measurement of the total fair value of the subsidiary (including the non-controlling interest). This would involve the extremely difficult process of stripping out the synergies attributable to the parent entity. It would also involve identifying and measuring the other elements of the 'control premium' that are included in the consideration paid by the acquirer. The likely existence of a control premium on acquisition means that it is inappropriate simply to value the acquired business by grossing up the consideration paid by the acquirer for a proportion of the business. Thus, the measurement of the goodwill attributable to the non-controlling interest is likely to be extremely unreliable or even misleading, and it is doubtful if it will confer any informational benefit on users of financial statements.

Recognising gains or losses on non-controlling equity investments

AV8 Three Board members disagree with the proposed treatment (in the proposed amendments to IAS 27) of changes in controlling interests in subsidiaries after control is established (paragraphs BC151-BC153). They believe that it is important that the consequences of such changes for the shareholders of the parent entity should be reported clearly in the income statement, as is permitted by current IFRSs.

AV9 The proposed revision of IAS 27 adopts the economic entity view of the consolidated accounts. This treats all equity interests in the group as being homogeneous, so that transactions between controlling and non-controlling interests are regarded as mere transfers within the total

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equity interest and no gain or loss should be recognised on such transactions. The three Board members observe that the non-controlling interests represent equity claims that are restricted to particular subsidiaries, whereas the controlling interests are affected by the performance of the entire group. The consolidated financial statements should therefore report performance from the perspective of the controlling interest (a parent entity perspective) in addition to the wider perspective provided by the economic entity approach.

AV10 The parent entity perspective implies the recognition of gains or losses on transactions by the parent entity in the equity of a subsidiary which is controlled both before and after the transaction. If, as these Board members would prefer, the full goodwill method were not used, the acquisition of additional equity in a subsidiary would give rise to the recognition of additional purchased goodwill, measured as the excess of the purchase consideration over the book value of the separately identified assets in the subsidiary attributable to the additional interest acquired. On reducing the equity stake in a subsidiary, without loss of control, a gain or loss attributable to the controlling interest would be recognised. This would be measured as the difference between the consideration received and the proportion of the book value of the subsidiary's assets (including purchased goodwill) attributable to the holding disposed of. This would provide the controlling interest with the relevant information about the gains and losses arising on the partial disposal of holdings in subsidiaries. It would also improve the reporting of gains and losses arising on disposals of subsidiaries that are made in stages.

AV11 Two of these Board members also disagree with the requirement in paragraph 56 that:

> In a business combination achieved in stages, the acquirer shall remeasure its non-controlling equity investment in the acquiree at fair value as of the acquisition date and recognise any gains or losses in profit or loss. If, before the business combination, the acquirer recognised changes in the value of its non-controlling equity investment directly in equity (for example, the investment was designated as available for sale) the amount that was recognised directly in equity shall be reclassified and included in the calculation of any gain or loss as of the acquisition date.

AV12 Although these Board members agree that the acquisition of a controlling interest is an event that requires remeasurement of the investment to its fair value, they disagree that it results in derecognition of the investment. The acquirer has obtained rights to direct the use of the underlying net assets of acquiree as a result of the purchase of an additional investment that achieves a controlling interest. It has not disposed of the original

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investment, and it is therefore inappropriate to reclassify past gains or losses on that investment to profit or loss, as would be done if they were realised by disposal.

AV13 These Board members would recognise the gain or loss on remeasurement of the non-controlling interest directly in equity, in the manner required by paragraph 55(b) of IAS 39 for available-for-sale financial assets.

Definition of a business combination

AV14 Two Board members disagree with the decision to revise the definition of a business combination, as explained in paragraphs BC23-BC33. By emphasising the acquisition of one entity by another, the new definition is narrower than that in IFRS 3 which used the term 'bringing together' rather than 'acquirer obtains control', thus allowing the definition to embrace mergers as well as acquisitions. They believe that the definition in IFRS 3, which is wider than that proposed in the revised IFRS 3, should be retained. In their view, paragraph BC32 is inconsistent with the new definition because it advocates applying the acquisition method to true mergers that do not now meet the definition of a business combination.

Combinations between mutual entities

AV15 One Board member disagrees with the decision to bring combinations of mutual entities and those achieved by contract alone within the scope of the proposed IFRS, as explained in paragraphs BC42-BC46 and BC179-BC199.

AV16 In this member's view, combinations of mutual entities have characteristics that are more likely to have the characteristics of true mergers rather than acquisitions (as summarised in paragraph BC184), and they are also likely to have characteristics, such as lack of measurable financial consideration (which will apply particularly when combinations are achieved by contract alone), that make acquisition accounting difficult to implement reliably. Therefore, it would be better to defer changes in accounting for combinations of such entities until more appropriate methods, such as fresh start accounting (paragraph BC190), have been explored properly.

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AV17 The Board member supports the alternative view of the FASB Board member who also has concerns about the proposed accounting for mutual entities. Those views are contained in paragraph B212 of the FASB's Background Information and Basis for Conclusions.

Costs incurred in connection with a business combination

AV18 Two Board members also disagree that acquisition-related costs are not part of the consideration transferred in exchange for the acquiree and should be recognised as an expense as incurred (paragraphs BC84-BC89). Recognising acquisition-related costs as expenses is inconsistent with accounting for purchases of assets, including investments in associated companies, whereby the direct costs form part of the carrying amount of the assets acquired, on initial recognition. It also fails to reflect the economic substance of the acquisition transaction. In order for a transaction to be justified economically, the acquirer must expect that the fair value of what is acquired is equal to, or exceeds, the total cost of acquisition (the purchase consideration plus the associated costs).

Recognition criteria

AV19 One Board member also disagrees with the decision to remove the reliable measurement recognition criterion for intangible assets acquired in a business combination (paragraph BC99). It is acknowledged that reliability of measurement is 'a criterion for recognition in the *Framework*' (paragraph BC98). Its absence from the draft revised IFRS 3 is supported by the claim that 'separate recognition of intangible assets, rather than subsuming them in goodwill, provides better information to users of financial statements, even though a significant degree of judgement could be involved in determining that fair value' (paragraph BC102). This statement is unsupported by evidence, and overriding the *Framework* in this way creates the possibility of serious inconsistencies in the reliability of different components of financial statements. This is particularly the case because, once the reliability criterion is removed, there is no limit to the unreliability of measurements which may be reported for separate intangible assets acquired in a business combination.

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AV20 The draft revised IFRS 3 acknowledges only one example in which measurement is sufficiently unreliable to justify non-recognition—the case of an assembled workforce. The Board member does not believe this is the only possible example of measurement unreliability that should preclude separate recognition. Indeed, the responses to ED 3, the Exposure Draft that preceded IFRS 3, suggested that in many cases the measurement of acquired intangible assets is extremely unreliable.

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Differences between the Exposure Drafts published by the IASB and the FASB

INTRODUCTION

This note accompanies, but is not part of, the draft IFRS.

N1 The accompanying Exposure Draft is the result of the IASB's and the FASB's projects to improve accounting and reporting for business combinations. The first phase of those projects led to IFRS 3 *Business Combinations* and FASB Statement No. 141 *Business Combinations.* In 2002, the IASB and the FASB agreed to reconsider jointly their guidance for applying the purchase method (now called the acquisition method) of accounting for business combinations. The objective of the joint effort is to develop a common and comprehensive standard for the accounting for business combinations that could be used for both domestic and international financial reporting. Although the boards reached the same conclusions on the fundamental issues addressed in the accompanying Exposure Draft, they reached different conclusions on a few limited matters.

N2 On those matters on which the boards reached different conclusions, each board has set out its own guidance in its version of the Exposure Draft. This note identifies and compares those paragraphs in which the IASB and the FASB have proposed substantively different guidance. This note does not identify non-substantive differences such as differences in terminology: *profit or loss* (IASB) and *income* (FASB). Nor does it identify differences in references to IASB or FASB guidance. For example, the IASB's version of the Exposure Draft refers to IAS 19 *Employee Benefits,* whereas the FASB's version refers to FASB Statement No. 87 *Employers' Accounting for Pensions.*

N3 Most of the differences identified in this note arise because of the boards' decisions to produce guidance for accounting for business combinations that is consistent with other existing IFRSs or FASB standards. Even though those differences are candidates for future convergence projects, the boards do not plan to eliminate them before the proposed standards on business combinations are issued.

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Paragraph reference	**IASB's guidance**	**FASB's guidance**
Paragraph 2(c)—Scope exception for not-for-profit organisations	Paragraph 2(c) is not used because the IASB does not provide guidance for not-for-profit organisations. Therefore, this scope exception is not necessary for the IASB.	Paragraph 2(c) specifies that this Statement does not apply to combinations between not-for-profit organisations or the acquisition of a for-profit business by a not-for-profit organisation. The FASB plans to issue a separate Exposure Draft that addresses business combinations between not-for-profit organisations.
Paragraph 11—Identification of the primary beneficiary as the acquirer	N/A—The IASB does not have guidance for primary beneficiaries because it does not have consolidation guidance equivalent to FASB Interpretation No. 46 (revised December 2003) *Consolidation of Variable Interest Entities*.	The last two sentences of paragraph 11 state that for the purposes of this Statement, the primary beneficiary of a variable interest entity is always the acquirer. The determination of what party, if any, is the primary beneficiary of a variable interest entity is made solely in accordance with Interpretation 46(R), not based on the guidance in paragraphs 12–16.

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Paragraph reference	IASB's guidance	FASB's guidance
Paragraphs 35, 36 and 87 — Contingencies	**Contingencies** Paragraph 35 requires the acquirer to recognise, separately from goodwill, the acquisition-date fair value of an identifiable asset or liability even if the amount of the future economic benefits embodied in the asset or required to settle the liability is contingent (or conditional) on the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity. Although the IASB and the FASB use different words to describe the accounting for contingencies acquired in a business combination, the guidance is expected to result in the identification and recognition of the same assets and liabilities at the same amounts.	**Contingencies that meet the definition of assets or liabilities** Paragraph 35 requires the acquirer to recognise separately from goodwill the acquisition-date fair value of assets and liabilities arising from contingencies that were acquired or assumed as part of the business combination. Therefore, the acquirer recognises as of the acquisition date an asset or a liability for a contingency even if that contingency does not meet the recognition criteria in SFAS 5. Although the IASB and the FASB use different words in these paragraphs, the guidance is expected to result in the identification and recognition of the same assets and liabilities and at the same amounts.
	After initial recognition, paragraph 36 requires the acquirer to account for such assets in accordance with IAS 38 *Intangible Assets* or IAS 39 *Financial Instruments: Recognition and Measurement,* as appropriate, and such liabilities in accordance with [draft] IAS 37 *Non-financial Liabilities* or other IFRSs, as appropriate.	After initial recognition, paragraph 36 requires contingencies to be accounted for in accordance with applicable generally accepted accounting principles, except for contingencies that would be accounted for in accordance with SFAS 5 if they were acquired or incurred in an event other than a business combination. Those contingencies should continue to be measured at fair value with changes in fair value recognised in income in each reporting period.
	Paragraph 87 provides transition from the existing IFRS 3 requirement for previously recognised contingent liabilities.	N/A – FASB did not have similar guidance in Statement 141.

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Paragraph reference	IASB's guidance	FASB's guidance
Paragraph 74—Disclosures of the effects of a business combination	The disclosures required by paragraph 74 apply to all acquirers.	The disclosures required by paragraph 74 apply only to acquirers that are *public business enterprises*, as described in paragraph 9 of FASB Statement No. 131 *Disclosures about Segments of an Enterprise and Related Information.*
	Paragraph 74(b)(1) requires disclosure of the revenue and profit or loss of the combined entity *for the current period* as though the acquisition date for all business combinations that occurred during the year had been as of the beginning of the annual reporting period. Paragraph 74(b)(2) is not used because the IASB does not require this disclosure for the comparable prior period.	Paragraph 74(b) requires disclosure of the following *supplemental pro forma* information: (1) The *results of operations** of the combined entity for the current period as though the acquisition date for all business combinations that occurred during the year had been as of the beginning of the annual reporting period. (2) If comparative financial statements are presented, the *results of operations* of the combined entity for the comparable prior period as though the acquisition date for all business combinations that occurred during the current year had occurred as of the beginning of the comparable prior fiscal year.

* For this disclosure, *results of operations* means revenue, income before extraordinary items and the cumulative effect of accounting changes, net income, and earnings per share. In determining the pro forma amounts, income taxes, interest expense, preferred share dividends and depreciation and amortisation of assets shall be adjusted to the accounting base recognised for each in recording the combination. Pro forma information related to results of operations of periods before the combination shall be limited to the results of operations for the immediately preceding period. Disclosure also shall be made of the nature and amount of any material, nonrecurring items included in the reported pro forma results of operations.

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Paragraph reference	**IASB's guidance**	**FASB's guidance**
Paragraph 76(d)—Disclosures of the financial effects of adjustments to the amounts recognised in a business combination	Paragraph 76(d) requires the acquirer to disclose the amount and an explanation of any gain or loss recognised in the current period that (1) relates to the identifiable assets acquired or liabilities assumed in a business combination that was effected in the current or the previous annual period and (2) is of such a size, nature, or incidence that disclosure is relevant to understanding the combined entity's financial statements.	N/A—FASB does not require this disclosure.
Paragraph 78(b)—Goodwill by reportable segment	The disclosure in paragraph 78(b) is not required by the IASB. Paragraph 134 of IAS 36 *Impairment of Assets* requires an entity to disclose the aggregate carrying amount of goodwill allocated to each cash-generating unit (group of units) for which the carrying amount of goodwill allocated to that unit (group of units) is significant in comparison with the entity's total carrying amount of goodwill. This information is not required to be disclosed for each material business combination that occurs during the period or in the aggregate for individually immaterial business combinations that are material collectively and occur during the period.	Paragraph 78(b) requires that the acquirer disclose *for each material business combination that occurs during the period or in the aggregate for individually immaterial business combinations that are material collectively and that occur during the period*, the amount of goodwill by reportable segment, if the combined entity is required to disclose segment information in accordance with SFAS 131, unless such disclosure is impracticable. Like IAS 36, paragraph 45 of FASB Statement No. 142 *Goodwill and Other Intangible Assets* requires disclosure of this information in aggregate by each reportable segment, not for each material business combination that occurs during the period or in the aggregate for individually immaterial business combinations that are material collectively and that occur during the period.

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Paragraph reference	IASB's guidance	FASB's guidance
Paragraph 80—Goodwill reconciliation	Paragraph 80 requires an acquirer to provide a goodwill reconciliation and provides a detailed list of items that should be shown separately.	Paragraph 80 requires an acquirer to provide a goodwill reconciliation in accordance with the requirements of SFAS 142. SFAS 142 requires a goodwill reconciliation; however, the requirement is less detailed than that required by the IASB. This Exposure Draft would amend the requirement in SFAS 142 to converge with the level of detail in the reconciliation required by the IASB.
Paragraph A49(d)—Customer contract intangible assets	IFRS 4 *Insurance Contracts* permits, but does not require, an expanded presentation that splits the fair value of acquired insurance contracts into two components: (a) a liability measured in accordance with the insurer's accounting policies for insurance contracts that it issues and (b) an intangible asset, representing the fair value of the contractual rights and obligations acquired, to the extent that the liability does not reflect that fair value.	Paragraph D13 amends FASB Statement No. 60 *Accounting and Reporting by Insurance Enterprises* to *require* the expanded presentation permitted by IFRS 4.
Footnote to paragraph A52(i)—Contract-based intangible assets	N/A	The footnote to paragraph A52(i) codifies FASB Staff Positions FAS 141-1 and 142-1, "Interaction of FASB Statements No. 141 *Business Combinations,* and No. 142, *Goodwill and Other Intangible Assets,* and EITF Issue No. 04-2, 'Whether Mineral Rights Are Tangible or Intangible Assets." The footnote to paragraph A56(i) incorporates the guidance in FSP 141-1. Also, the amendment that removes the parenthetical that reads "such as mineral rights to depleting assets" from paragraph 11 of SFAS 142 is carried forward in Appendix D of this Exposure Draft.

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Paragraph reference	IASB's guidance	FASB's guidance
Paragraph A102-A109—Replacement share-based payment awards	Both the IASB and the FASB require that if the acquirer is obligated to replace the acquiree's awards, all or a portion of the acquirer's replacement awards are included in the measurement of the consideration transferred by the acquirer. However, the amount included in the measurement of the consideration transferred by the acquirer is calculated consistently with the requirements of IFRS 2 *Share-based Payment*. The portion attributable to past services, which is included in the measurement of the consideration transferred, is equal to the remaining fair value based measure of the replacement award (or settlement) multiplied by *the ratio of the portion of the vesting period completed to the total vesting period*. (The amount, if any, to be recognised in post-combination profit or loss is the remaining fair value based measure of the replacement award (or settlement) multiplied by the ratio of the future vesting period to the total vesting period.) The vesting period is the period during which all the specified vesting conditions are to be satisfied. Vesting conditions are defined in IFRS 2. Paragraphs A104-A109 illustrate the IASB's requirements.	Both the IASB and the FASB require that if the acquirer is obligated to replace the acquiree's awards, all or a portion of the acquirer's replacement awards are included in the measurement of the consideration transferred by the acquirer. However, the amount included in the measurement of the consideration transferred by the acquirer is calculated consistently with the requirements of FASB Statement No. 123 (revised 2004) *Share-Based Payment*. The portion attributable to past services, which is included in the measurement of the consideration transferred, is equal to the remaining fair value based measure of the replacement award (or settlement) multiplied by *the ratio of the past service period to the total service period* (that is, the period that begins with the service inception date for the award of the acquiree and ends with the service completion date for the replacement award). The past service period ends and the future service period begins on the acquisition date. (The amount, if any, which represents compensation expense to be recognised in postcombination consolidated net income is the remaining fair value based measure of the replacement award (or settlement) multiplied by the ratio of the future service period to the total service period.)

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Paragraph reference	IASB's guidance	FASB's guidance
		The requisite service period of awards issued by the acquirer shall reflect any explicit, implicit, and derived service periods (consistent with the requirements of SFAS 123(R)). Paragraphs A104-A109 illustrate the FASB's requirements.
Appendix B—Background information and basis for conclusions / Basis for Conclusions	The Basis for Conclusions provides the background for the IASB's project and the IASB's basis for its conclusions, which is the same as or similar to the FASB's in many respects, but not all. The Basis for Conclusions is not integral to the draft proposed standard and, accordingly, the IASB does not have an Appendix B.	Appendix B provides the background for the FASB's project and the FASB's basis for its conclusions, which is the same as or similar to the IASB's in many respects, but not all.
Appendix C—Continuing authoritative guidance	Appendix C contains guidance and transition provisions that have been carried forward or adapted from IASB sources. The boards did not deliberate jointly or reach convergence on the continuing authoritative guidance. Therefore, the IASB's Appendix C differs from the FASB's Appendix C.	Appendix C contains guidance and transition provisions that have been carried forward or adapted from FASB sources. The boards did not deliberate jointly or reach convergence on the continuing authoritative guidance. Therefore, the FASB's Appendix C differs from the IASB's Appendix C.
Appendix D—Amendments	Appendix D contains the amendments to IFRSs that would result from the proposed IFRS.	Appendix D contains the amendments to FASB standards that would result from the proposed Statement.
Appendix E—Fair value measurement / Related literature analysis	The IASB's Appendix E provides guidance for measuring fair value. The FASB did not provide fair value measurement guidance in this appendix because the FASB's Exposure Draft refers to the FASB Exposure Draft *Fair Value Measurements,* which was published on 23 June 2004. That Exposure Draft provides the guidance that the IASB provides in Appendix E.	The FASB's Appendix E addresses the impact of this Exposure Draft on authoritative accounting literature included in categories (b), (c), and (d) in the GAAP hierarchy and the relationship between this Exposure Draft and related SEC literature. The IASB provides all authoritative guidance for entities under its jurisdiction and, therefore, does not need an equivalent appendix.

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Table of Concordance

This table shows how the contents of IFRS 3 and the Exposure Draft correspond. Paragraphs are treated as corresponding if they address broadly the same matter even though the guidance may differ.

IFRS 3 paragraph	Exposure Draft paragraph	IFRS 3 paragraph	Exposure Draft paragraph
1	1	32-35	25, 26
2	2	36-44	None
3	2(a)-(c)	45-46	40, 41
4	4	47-50	37
5	5	51-53	49, 50
6	6	54-55	51
7	7	57	59-61
8	None	58-60	55-57
9	None	61-64	62-68
10	C7	65	46
11	C8	66	71
12	C9	67	72
13	C10	68	73(a)
14	8	69	74
15	None	70	74
16	9	71	73(b)
17	10	72	75
18	None	73	76
19	None	74	77
20	13, 14	75	80
21	12	76	80(e)
22	16	77	81
23	15	78-85	82-87
24	19	86-87	88
25	17	Appendix A	3
26	28	IE (A)	A37-A41
27	Appendix E	IE (B)	A42-A49
28	28	IE (C)	A50, A51
29-31	27	IE (D)	A52-A55

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IE (E)	A56-A61	Example 5	Example 20
Example 1	A49(a)	Example 6	None
Example 2	A49(b)	Example 7	Example 11
Example 3	A49(c)	Example 8	None
Example 4	A49(d)	Example 9	None

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