Exposure Draft

ED 3 BUSINESS COMBINATIONS

Comments to be received by 4 April 2003

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All replies will be put on the public record unless confidentiality is requested by the commentator. 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.uk** or addressed to:

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INVITATION TO COMMENT

The International Accounting Standards Board invites comments on any aspect of this Exposure Draft of its proposed IFRS *Business Combinations*. It would particularly welcome answers to the questions set out below. Comments are most helpful if they indicate the specific paragraph or group of paragraphs to which they relate, contain a clear rationale and, where applicable, provide a suggestion for alternative wording.

Comments should be submitted in writing so as to be received no later than **4 April 2003**.

Until an IFRS based on this Exposure Draft becomes effective, IAS 22 *Business Combinations* remains effective.

Question 1 – Scope

The Exposure Draft proposes:

(a) to exclude from the scope of the IFRS business combinations in which separate entities or operations of entities are brought together to form a joint venture, and business combinations involving entities under common control (see proposed paragraphs 2 and 3 and paragraphs BC9-BC11 of the Basis for Conclusions).

Are these scope exclusions appropriate? If not, why not?

(b) to include in the IFRS a definition of business combinations involving entities under common control, and additional guidance on identifying such transactions (see proposed paragraphs 9-12 and Appendix A, and paragraphs BC12-BC15 of the Basis for Conclusions).

Are the definition and additional guidance helpful in identifying transactions within the scope exclusion? If not, what additional guidance would you suggest, and why?

Question 2 – Method of accounting for business combinations

The Exposure Draft proposes to eliminate the use of the pooling of interests method and require all business combinations within its scope to be accounted for by applying the purchase method (see proposed paragraphs 13-15 and paragraphs BC18-BC35 of the Basis for Conclusions).

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Is this appropriate? If not, why not? If you believe the pooling of interests method should be applied to a particular class of transactions, what criteria should be used to distinguish those transactions from other business combinations, and why?

Question 3 – Reverse acquisitions

Under IAS 22 *Business Combinations*, a business combination is accounted for as a reverse acquisition when an entity (the legal parent) obtains ownership of the equity of another entity (the legal subsidiary) but, as part of the exchange transaction, issues enough voting equity as consideration for control of the combined entity to pass to the owners of the legal subsidiary. In such circumstances, the legal subsidiary is deemed to be the acquirer. The Exposure Draft:

(a) proposes to modify the circumstances in which a business combination could be regarded as a reverse acquisition by clarifying that for all business combinations effected through an exchange of equity interests, the acquirer is the combining entity that has the power to govern the financial and operating policies of the other entity (or entities) so as to obtain benefits from its (or their) activities. As a result, a reverse acquisition occurs when the legal subsidiary has the power to govern the financial and operating policies of the legal parent so as to obtain benefits from its activities (see proposed paragraph 21 and paragraphs BC37-BC41 of the Basis for Conclusions).

    Is this an appropriate description of the circumstances in which a business combination should be accounted for as a reverse acquisition? If not, under what circumstances, if any, should a business combination be accounted for as a reverse acquisition?

(b) proposes additional guidance on the accounting for reverse acquisitions (see proposed paragraphs B1-B14 of Appendix B).

    Is this additional guidance appropriate? If not, why not? Should any additional guidance be included? If so, what specific guidance should be added?

Question 4 – Identifying the acquirer when a new entity is formed to effect a business combination

The Exposure Draft proposes that when a new entity is formed to issue equity instruments to effect a business combination, one of the combining entities that existed before the combination should be adjudged the acquirer on the evidence

available (see proposed paragraph 22 and paragraphs BC42-BC46 of the Basis for Conclusions).

Is this appropriate? If not, why not?

Question 5 – Provisions for terminating or reducing the activities of the acquiree

Under IAS 22, an acquirer must recognise as part of allocating the cost of a business combination a provision for terminating or reducing the activities of the acquiree (a 'restructuring provision') that was not a liability of the acquiree at the acquisition date, provided the acquirer has satisfied specified criteria. The Exposure Draft proposes that an acquirer should recognise a restructuring provision as part of allocating the cost of a business combination only when the acquiree has, at the acquisition date, an existing liability for restructuring recognised in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* (see proposed paragraph 40 and paragraphs BC55-BC66 of the Basis for Conclusions).

Is this appropriate? If not, what criteria should an acquirer be required to satisfy to recognise a restructuring provision that was not a liability of the acquiree as part of allocating the cost of a combination, and why?

Question 6 – Contingent liabilities

The Exposure Draft proposes that an acquirer should recognise separately the acquiree's contingent liabilities at the acquisition date as part of allocating the cost of a business combination, provided their fair values can be measured reliably (see proposed paragraphs 36 and 45 and paragraphs BC80-BC85 of the Basis for Conclusions).

Is this appropriate? If not, why not?

Question 7 – Measuring the identifiable assets acquired and liabilities and contingent liabilities assumed

IAS 22 includes a benchmark and an allowed alternative treatment for the initial measurement of the identifiable net assets acquired in a business combination, and therefore for the initial measurement of any minority interests. The Exposure Draft proposes requiring the acquiree's identifiable assets, liabilities and contingent liabilities recognised as part of allocating the cost to be measured initially by the acquirer at their fair values at the acquisition date. Therefore, any minority interest in the acquiree will be stated at the minority's proportion of the net fair values of those items. This proposal is consistent with the allowed

alternative treatment in IAS 22 (see proposed paragraphs 35 and 39 and paragraphs BC88-BC95 of the Basis for Conclusions).

Is this appropriate? If not, how should the acquiree's identifiable assets, liabilities and contingent liabilities recognised as part of allocating the cost of a business combination be measured when there is a minority interest in the acquiree, and why?

Question 8 – Goodwill

The Exposure Draft proposes that goodwill acquired in a business combination should be recognised as an asset and should not be amortised. Instead, it should be accounted for after initial recognition at cost less any accumulated impairment losses (see proposed paragraphs 50-54 and paragraphs BC96-BC108 of the Basis for Conclusions).

Do you agree that goodwill acquired in a business combination should be recognised as an asset? If not, how should it be accounted for initially, and why? Should goodwill be accounted for after initial recognition at cost less any accumulated impairment losses? If not, how should it be accounted for after initial recognition, and why?

Question 9 – Excess over the cost of a business combination of the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities

In some business combinations, the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities recognised as part of allocating the cost of the combination exceeds that cost. The Exposure Draft proposes that when such an excess exists, the acquirer should:

(a) reassess the identification and measurement of the acquiree's identifiable assets, liabilities and contingent liabilities and the measurement of the cost of the combination; and

(b) recognise immediately in profit or loss any excess remaining after that reassessment.

(See proposed paragraphs 55 and 56 and paragraphs BC109-BC120 of the Basis for Conclusions.)

Is this treatment appropriate? If not, how should any such excess be accounted for, and why?

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Question 10 – Completing the initial accounting for a business combination and subsequent adjustments to that accounting

The Exposure Draft proposes that:

(a) if the initial accounting for a business combination can be determined only provisionally by the end of the reporting period in which the combination occurs because either the fair values to be assigned to the acquiree's identifiable assets, liabilities or contingent liabilities or the cost of the combination can be determined only provisionally, the acquirer should account for the combination using those provisional values. Any adjustment to those values as a result of completing the initial accounting is to be recognised within twelve months of the acquisition date (see proposed paragraphs 60 and 61 and paragraphs BC123-BC126 of the Basis for Conclusions).

    Is twelve months from the acquisition date sufficient time for completing the accounting for a business combination? If not, what period would be sufficient, and why?

(b) with some exceptions carried forward as an interim measure from IAS 22, adjustments to the initial accounting for a business combination after that accounting is complete should be recognised only to correct an error (see proposed paragraphs 62 and 63 and paragraphs BC127-BC132 of the Basis for Conclusions).

    Is this appropriate? If not, under what other circumstances should the initial accounting be amended after it is complete, and why?

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[Draft] International Financial Reporting Standard X *Business Combinations* ([draft] IFRS X) is set out in paragraphs 1-84 and Appendices A and B. All the paragraphs have equal authority. Paragraphs in **bold type** state the main principles. Terms defined in Appendix A are in *italics* the first time they appear in the [draft] Standard. Definitions of other terms are given in the Glossary for International Financial Reporting Standards. [Draft] IFRS X 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.* These provide a basis for selecting and applying accounting policies in the absence of explicit guidance.

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INTRODUCTION

Reasons for issuing the [draft] IFRS

I1 IAS 22 *Business Combinations* permitted business combinations to be accounted for using one of two methods: the pooling of interests method or the purchase method. Although IAS 22 restricted the use of the pooling of interests method to business combinations classified as unitings of interests, analysts and other users of financial statements indicated that permitting two methods of accounting for substantially similar transactions impaired the comparability of financial statements. Others argued that requiring more than one method of accounting for such transactions created incentives for structuring those transactions to achieve a desired accounting result, particularly given that the two methods produce quite different results.

I2 These factors, combined with the prohibition of the pooling of interests method in Australia, Canada and the United States, prompted the International Accounting Standards Board to examine whether, given that few combinations were understood to be accounted for under IAS 22 using the pooling of interests method, it would be advantageous for international standards to come into line with those in Australia and North America by also prohibiting the method.

I3 Accounting for business combinations varied across jurisdictions in other respects as well. These included the accounting for goodwill and intangible assets acquired in a business combination, the treatment of any excess of the acquirer's interest in the fair values of identifiable net assets acquired over the cost of the business combination, and the recognition of liabilities for terminating or reducing the activities of an acquiree.

I4 Furthermore, IAS 22 contained an option in respect of how the purchase method could be applied: the identifiable assets acquired and liabilities assumed could be measured initially using either a benchmark treatment or an allowed alternative treatment. The benchmark treatment resulted in the identifiable assets acquired and liabilities assumed being measured initially at a combination of fair values (to the extent of the acquirer's ownership interest) and pre-acquisition carrying amounts (to the extent of any minority interest). The allowed alternative treatment resulted in the identifiable assets acquired and liabilities assumed being measured initially at their fair values as at the date of acquisition. The Board believes that permitting similar transactions to be accounted for in

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dissimilar ways impairs the usefulness of the information provided to users of financial reports, because both comparability and reliability are diminished.

I5 Therefore, this [draft] IFRS has been issued in an effort to improve the quality of, and seek international convergence on, the accounting for business combinations, including:

(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;

(d) the treatment of any excess of the acquirer's interest in the fair values 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.

Main features of the [draft] IFRS

I6 This [draft] IFRS:

(a) requires all business combinations within its scope to be accounted for by applying the purchase method.

(b) requires an acquirer to be identified for every business combination within its scope. The acquirer is the combining entity that obtains control of the other combining entities or operations.

(c) requires an acquirer to measure the cost of a business combination as the aggregate of: the fair values, at the date of exchange, of assets given, liabilities incurred, and equity instruments issued by the acquirer, in exchange for control of the acquiree; plus any costs directly attributable to the combination.

(d) requires an acquirer to recognise separately at the acquisition date, the acquiree's identifiable assets, liabilities and contingent liabilities that satisfy the following recognition criteria at that date, regardless of whether they had been previously recognised in the acquiree's financial statements:

(i) in the case of an asset other than an intangible asset, it is probable that any associated future economic benefits will flow to the acquirer, and its fair value can be measured reliably;

(ii) in the case of a liability other than a contingent liability, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation, and its fair value can be measured reliably;

(iii) it is an intangible asset, as defined in IAS 38 *Intangible Assets* (revised 200X), and it is not an assembled workforce; and

(iv) in the case of a contingent liability, its fair value can be measured reliably.

(e) requires the identifiable assets, liabilities and contingent liabilities that satisfy the above recognition criteria to be measured initially by the acquirer at their fair values at the acquisition date, irrespective of the extent of any minority interest.

(f) requires goodwill acquired in a business combination to be recognised by the acquirer as an asset from the acquisition date, initially measured as the excess of the cost of the business combination over the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities recognised in accordance with (d) above.

(g) prohibits the amortisation of goodwill acquired in a business combination and instead requires the goodwill to be tested for impairment annually, or more frequently if events or changes in circumstances indicate that the asset might be impaired, in accordance with IAS 36 *Impairment of Assets* (revised 200X).

(h) requires the acquirer 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 if the acquirer's interest in the net fair value of the items recognised in accordance with (d) above exceeds the cost of the combination. Any excess remaining after that reassessment must be recognised by the acquirer immediately in profit or loss.

(i) requires disclosure of information that enables users of an entity's financial statements to evaluate the nature and/or financial effect of:

(i) business combinations that occurred during the reporting period;

(ii) business combinations that occurred after the balance sheet date but before the financial statements are authorised for issue; and

(iii) certain business combinations that occurred in previous reporting periods.

(j) requires disclosure of information that enables users of an entity's financial statements to evaluate changes in the carrying amount of goodwill during the reporting period.

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[DRAFT] INTERNATIONAL FINANCIAL REPORTING STANDARD IFRS X

Business Combinations

OBJECTIVE

1 The objective of this [draft] IFRS is to specify the financial reporting by an entity when it combines with one or more other entities or operations.

SCOPE

2 Except as described in paragraph 3, entities shall apply this [draft] IFRS when accounting for *business combinations*.

3 This [draft] IFRS does not apply to:

(a) business combinations in which separate entities or operations of entities are brought together to form a *joint venture*; or

(b) *business combinations involving entities (or operations of entities) under common control.*

Identifying a business combination

4 A business combination is the bringing together of separate entities or operations of entities into one *reporting entity*. It may be structured in a variety of ways for legal, taxation or other reasons. It may involve the purchase by an entity of the equity of another entity, the purchase of all the net assets of another entity, the assumption of the liabilities of another entity, or the purchase of some of the net assets of another entity that together form one or more operations. It may be effected by the issue of equity instruments, the transfer of cash, cash equivalents or other assets, or a combination thereof. The transaction may be between the shareholders of the combining entities or between one entity and the shareholders of another entity. It may involve the establishment of a new entity to *control* the combining entities or net assets transferred, or the restructuring of one or more of the combining entities.

5 A business combination may result in a parent-subsidiary relationship in which the acquirer is the *parent* and the acquiree a *subsidiary* of the acquirer. In such circumstances, the acquirer applies this [draft] IFRS in its consolidated financial statements. It includes its interest in the

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acquiree in its separate financial statements as an investment in a subsidiary (see [draft] IAS 27 *Consolidated and Separate Financial Statements*).

6 A business combination may involve the purchase of the net assets, including any *goodwill*, of another entity rather than the purchase of the equity of the other entity. Such a combination does not result in a parent-subsidiary relationship.

7 Included within the definition of a business combination, and therefore the scope of this [draft] IFRS, are business combinations in which one entity obtains control of another entity but for which the date of obtaining control (the *acquisition date*) does not coincide with the date or dates of acquiring an ownership interest (the date or dates of exchange). This situation may arise, for example, when an investee enters into share buy-back arrangements with some of its investors and, as a result, control over the investee changes.

8 This IFRS does not deal with the accounting by venturers for interests in joint ventures (see IAS 31 *Financial Reporting of Interests in Joint Ventures*).

Business combinations involving entities under common control

9 A business combination involving entities (or operations of entities) under common control is a business combination in which all of the combining entities (or operations of entities) are ultimately controlled by the same party or parties both before and after the business combination, and that control is not transitory.

10 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.

11 An entity can 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 financial reporting requirements under 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.

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12 The extent of *minority 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 of the group under [draft] IAS 27 is not relevant to determining whether a combination involves entities under common control.

METHOD OF ACCOUNTING

13 All business combinations within the scope of this [draft] IFRS shall be accounted for by applying the purchase method.

14 The result of nearly all business combinations is that one entity, the acquirer, obtains control of one or more other entities or operations, the acquiree.

15 The purchase method views a business combination from the perspective of the combining entity that is identified as the acquirer; the acquirer purchases net assets and recognises the assets acquired and liabilities and *contingent liabilities* assumed, including those not previously recognised by the acquiree. The measurement of the acquirer's assets and liabilities is not affected by the transaction, nor are any additional assets or liabilities of the acquirer recognised, because they are not the subjects of the transaction.

APPLICATION OF THE PURCHASE METHOD

16 The purchase method involves the following steps:

(a) identifying an acquirer;

(b) measuring the cost of the business combination; and

(c) allocating, at the acquisition date, the cost of the business combination to the assets acquired and liabilities and contingent liabilities assumed.

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Identifying the acquirer

17 An acquirer shall be identified for all business combinations within the scope of this [draft] IFRS. The acquirer is the combining entity that obtains control of the other combining entities or operations.

18 Because the purchase method views a business combination from the acquirer's perspective, it assumes that one of the parties to the transaction can be identified as the acquirer.

19 Control is the power to govern the financial and operating policies of an entity or operation so as to obtain benefits from its activities. A combining entity shall be presumed to have obtained control of another combining entity when it acquires more than one-half of that other entity's voting rights, unless it can be demonstrated that such ownership does not constitute control. Even if one of the combining entities does not acquire more than one-half of the voting rights of another combining entity, it might have obtained control of that other entity if, as a result of the combination, it obtains:

(a) power over more than one-half of the voting rights of the other entity by virtue of an agreement with other investors; or

(b) power to govern the financial and operating policies of the other entity under a statute or an agreement; or

(c) power to appoint or remove the majority of the members of the board of directors or equivalent governing body of the other entity; or

(d) power to cast the majority of votes at meetings of the board of directors or equivalent governing body of the other entity.

20 Although sometimes it may be difficult to identify an acquirer, there are usually indications that one exists. For example:

(a) if the *fair value* of one of the combining entities is significantly greater than that of the other combining entity, the entity with the greater fair value is likely to be the acquirer;

(b) if the business combination is effected through an exchange of voting ordinary equity instruments for cash or other assets, the entity giving up cash or other assets is likely to be the acquirer; and

(c) 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 so to dominate is likely to be the acquirer.

21 In a business combination effected through an exchange of equity interests, the entity that issues the equity interests is normally the acquirer. However, all pertinent facts and circumstances shall be considered to determine which of the combining entities has the power to govern the financial and operating policies of the other entity (or entities) so as to obtain benefits from its (or their) activities. In some business combinations, commonly referred to as reverse acquisitions, the acquirer is the entity whose equity interests have been acquired and the issuing entity is the acquiree. This is the case when, for example, a private operating entity arranges to have itself 'acquired' by a non-operating or dormant public entity as a means of obtaining a stock exchange listing. Although legally the issuing non-operating public entity is regarded as the parent and the operating entity is regarded as the subsidiary, the legal subsidiary is the acquirer with the power to govern the financial and operating policies of the legal parent so as to obtain benefits from its activities. Commonly the acquirer is the larger entity; however, the facts and circumstances surrounding a combination sometimes indicate that a smaller entity acquires a larger entity. Guidance on the accounting for reverse acquisitions is provided in paragraphs B1-B14 of Appendix B.

22 When a new entity is formed to issue equity instruments to effect a business combination, one of the combining entities that existed before the combination shall be adjudged the acquirer on the evidence available.

Cost of a business combination

23 The acquirer shall measure the cost of a business combination as the aggregate of:

(a) the fair values, at the *date of exchange*, of assets given, liabilities incurred, and equity instruments issued by the acquirer, in exchange for control of the acquiree; plus

(b) any costs directly attributable to the business combination.

24 The 'acquisition date' is the date on which the acquirer effectively obtains control of the acquiree. When this is achieved through a single exchange transaction, the 'date of exchange' coincides with the acquisition date. However, a business combination may involve more than one exchange transaction, for example when it is achieved in stages by successive

share purchases. When this occurs:

(a) the cost of the combination is the aggregate cost of the individual transactions; and

(b) the 'date of exchange' is the date of each exchange transaction (ie the date that each individual investment is recognised in the financial statements of the acquirer), whereas the 'acquisition date' is the date on which the acquirer obtains control of the acquiree.

25 Assets given and liabilities incurred by the acquirer in exchange for control over the acquiree are required under paragraph 23 to be measured at their fair values at the date of exchange. Therefore, when settlement of all or any part of the cost of a business combination is deferred, the fair value of that deferred component shall be determined by discounting the amounts payable to their present value at the date of exchange, taking into account any premium or discount likely to be incurred in settlement.

26 The published price at the date of exchange of a quoted equity instrument provides the best evidence of the instrument's fair value and shall be used, except in rare circumstances. Other evidence and valuation methods shall be considered only in the rare circumstance when it can be demonstrated that the published price at the date of exchange is an unreliable indicator of fair value, and that the other evidence and valuation methods provide a more reliable measure of the equity instrument's fair value. The published price at the date of exchange is an unreliable indicator only when it has been affected by the thinness of the market. If the published price at the date of exchange is an unreliable indicator or if a published price does not exist for equity instruments issued as part of the cost of a business combination, the fair value of those instruments could, for example, be estimated by reference to their proportional interest in the fair value of the acquirer or by reference to the proportional interest in the fair value of the acquiree obtained, whichever is the more clearly evident. The fair value at the date of exchange of monetary assets given to equity holders of the acquiree as an alternative to equity instruments may also provide evidence of the total fair value given by the acquirer in exchange for control of the acquiree. In any event, all aspects of the combination, including significant factors influencing the negotiations, shall be considered. Further guidance on determining the fair value of equity instruments is provided in [draft] IAS 39 *Financial Instruments: Recognition and Measurement*.

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27 The cost of a business combination includes liabilities incurred by the acquirer in exchange for control of the acquiree. Future losses or other costs expected to be incurred as a result of a combination are not liabilities incurred by the acquirer in exchange for control of the acquiree, and shall not, therefore, be included as part of the cost of the combination.

28 The cost of a business combination includes any costs directly attributable to the combination, such as professional fees paid to accountants, legal advisers, valuers and other consultants to effect the combination. General administrative costs, including the costs of maintaining an acquisitions department, and other costs that cannot be directly attributed to the particular combination being accounted for are not included in the cost of the combination: they are recognised as an expense when incurred.

29 The costs of arranging and issuing financial liabilities are an integral part of the liability issue transaction, even when the liabilities are issued to effect a business combination, rather than costs directly attributable to the combination. Therefore, entities shall not include such costs in the cost of a business combination. In accordance with [draft] IAS 39, such costs shall be included in the initial measurement of the liability.

30 Similarly, the costs of issuing equity instruments are an integral part of the equity issue transaction, even when the equity instruments are issued to effect a business combination, rather than costs directly attributable to the combination. Therefore, entities shall not include such costs in the cost of a business combination. In accordance with [draft] IAS 32 *Financial Instruments: Disclosure and Presentation*, such costs reduce the proceeds from the equity issue.

Adjustments to the cost of a business combination contingent on future events

31 When a business combination agreement provides for an adjustment to the cost of the combination contingent on future events, the acquirer shall include the amount of that adjustment in the cost of the combination at the acquisition date if the adjustment is *probable* and can be measured reliably.

32 A business combination agreement may allow for adjustments to the cost of the combination contingent on one or more future events. The adjustment might, for example, be contingent on a specified level of

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income being maintained or achieved in future periods, or on the market price of the securities issued being maintained. It is usually possible to estimate the amount of any such adjustment at the time of initially accounting for the combination without impairing the reliability of the information, even though some uncertainty exists. If the future events do not occur or the estimate needs to be revised, the cost of the business combination shall be adjusted accordingly.

33 However, when a business combination agreement provides for such an adjustment, that adjustment is not included in the cost of the combination at the time of initially accounting for the combination if it either is not probable or cannot be measured reliably. If that adjustment subsequently becomes probable and can be measured reliably, the additional consideration shall be treated as an adjustment to the cost of the combination.

34 In some circumstances, the acquirer may be required to make a subsequent payment to the seller as compensation for a reduction in the value of the assets given, equity instruments issued, or liabilities incurred by the acquirer in exchange for control of the acquiree. This is the case, for example, when the acquirer has guaranteed the market price of equity or debt instruments issued as part of the cost of the business combination and is required to issue additional equity or debt instruments to restore the originally determined cost. In such cases, no increase in the cost of the business combination is recognised. In the case of equity instruments, the fair value of the additional payment is offset by an equal reduction in the value attributed to the instruments initially issued. In the case of debt instruments, the additional payment is regarded as a reduction in the premium or an increase in the discount on the initial issue.

Allocating the cost of a business combination to the assets acquired and liabilities and contingent liabilities assumed

35 The acquirer shall, at the acquisition date, allocate the cost of a business combination by recognising the acquiree's identifiable assets, liabilities and contingent liabilities that satisfy the recognition criteria in paragraph 36 at their fair values at that date. Any difference between the cost of the business combination and the acquirer's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities so recognised shall be accounted for in accordance with paragraphs 50-56.

36 The acquirer shall recognise separately the acquiree's identifiable assets, liabilities and contingent liabilities at the acquisition date only if they satisfy the following criteria at that date:

(a) in the case of an asset other than an *intangible asset*, it is probable that any associated future economic benefits will flow to the acquirer, and its fair value can be measured reliably;

(b) in the case of a liability other than a contingent liability, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation, and its fair value can be measured reliably;

(c) it is an intangible asset as defined in IAS 38 *Intangible Assets* (revised 200X), including an in-process research and development project that meets that definition, and it is not an assembled workforce; and

(d) in the case of a contingent liability, its fair value can be measured reliably.

37 The acquirer's income statement shall incorporate the acquiree's profits and losses after the acquisition date by including the acquiree's income and expenses based on the cost of the business combination to the acquirer. For example, the depreciation expense included after the acquisition date in the acquirer's income statement that relates to the acquiree's depreciable assets shall be based on the fair values of those depreciable assets at the acquisition date, ie their cost to the acquirer.

38 Application of the purchase method starts from the acquisition date, which is the date on which the acquirer effectively obtains control of the acquiree. Because control is the power to govern the financial and operating policies of an entity or operation so as to obtain benefits from its activities, it is not necessary for a transaction to be closed or finalised at law before the acquirer effectively obtains control. All pertinent facts and circumstances surrounding a business combination shall be considered in assessing when the acquirer has effectively obtained control.

39 Because the acquirer recognises the acquiree's identifiable assets, liabilities and contingent liabilities that satisfy the recognition criteria in paragraph 36 at their fair values at the acquisition date, any minority interest in the acquiree is stated at the minority's proportion of the net fair values of those items. Guidance on determining the fair values of the acquiree's identifiable assets, liabilities and contingent liabilities for the

purpose of allocating the cost of a business combination is provided in paragraphs B15 and B16 of Appendix B.

Acquiree's identifiable assets and liabilities

40 In accordance with paragraph 35, only the identifiable assets, liabilities and contingent liabilities of the acquiree that existed at the acquisition date and satisfy the recognition criteria in paragraph 36 are recognised separately by the acquirer as part of allocating the cost of the combination. Therefore:

(a) the acquirer shall recognise liabilities for terminating or reducing the activities of the acquiree as part of allocating the cost of the combination only when the acquiree has, at the acquisition date, an existing liability for restructuring recognised in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*; and

(b) the acquirer, when allocating the cost of the combination, shall not recognise liabilities for future losses or other costs expected to be incurred as a result of the business combination.

41 A payment that an entity is contractually required to make to, for example, its employees or suppliers in the event it is acquired in a business combination is a present obligation of that entity that is regarded as a contingent liability until it becomes probable that a business combination will occur. The contractual obligation is recognised as a liability by that entity under IAS 37 when a business combination becomes probable and the liability can be measured reliably. Therefore, when the business combination occurs, that liability of the acquiree is recognised by the acquirer as part of allocating the cost of the combination.

42 The acquiree's identifiable assets and liabilities that are recognised under paragraph 35 might include assets and liabilities not previously recognised in the acquiree's financial statements. This might occur because they did not qualify for recognition before the acquisition. For example, a tax benefit arising from the acquiree's tax losses that was not recognised by the acquiree before the business combination qualifies for recognition as an identifiable asset under paragraph 35 if it is probable that the acquirer will have future taxable profits against which the unrecognised tax benefit can be applied.

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Acquiree's identifiable intangible assets

43 Under paragraph 36, the acquirer recognises separately an intangible asset of the acquiree at the acquisition date only if it meets the definition of an intangible asset in IAS 38 (revised 200X) and is not an assembled workforce. A non-monetary asset without physical substance must be identifiable to meet the definition of an intangible asset and thus be recognised by the acquirer separately from goodwill. In accordance with IAS 38 (revised 200X), an asset meets the identifiability criterion in the definition of an intangible asset only if it:

(a) 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; or

(b) is separable, ie 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.

44 The acquirer shall not recognise an assembled workforce separately as part of allocating the cost of a business combination, irrespective of whether that workforce meets the definition of an intangible asset.

Acquiree's contingent liabilities

45 Under paragraph 36, the acquirer recognises separately a contingent liability of the acquiree as part of allocating the cost of a business combination only if its fair value can be measured reliably. If its fair value cannot be measured reliably:

(a) there is a resulting impact on the amount recognised as goodwill or accounted for in accordance with paragraph 55; and

(b) the acquirer shall disclose the information about that contingent liability required to be disclosed under IAS 37.

Guidance on determining the fair value of a contingent liability is provided in paragraph B15(l) of Appendix B.

46 After their initial recognition, the acquirer shall measure contingent liabilities that are recognised separately in accordance with paragraph 35 at their fair values, with changes in fair value recognised in profit or loss.

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47 The acquirer shall evaluate changes after initial recognition in the fair value of a contingent liability recognised separately in accordance with paragraph 35 to determine whether any part of a value change is attributable to errors in the initial measurement of the contingent liability. This will be the case when information on which a subsequent fair value measurement is based:

(a) differs from that on which the initial measurement was based; and

(b) was available at the time of the initial measurement and could reasonably be expected to have been obtained and taken into account in that measurement.

Errors in the initial measurement of a contingent liability recognised separately in accordance with paragraph 35 include the effects of mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts, and fraud. Changes after initial recognition in the fair value of a contingent liability that are attributable to errors in its initial measurement shall be accounted for as described in paragraphs 62 and 63.

48 In accordance with paragraphs 71 and 72, the acquirer is required to disclose separately the amount and an explanation of any change in fair value recognised in profit or loss under paragraph 46 if that change is of such size, nature or incidence that disclosure is relevant to an understanding of the combined entity's financial performance.

49 Contingent liabilities recognised separately by the acquirer as part of allocating the cost of a business combination are excluded from the scope of IAS 37 [as proposed to be amended by this Exposure Draft]. However, the acquirer shall disclose for those contingent liabilities the information required to be disclosed under IAS 37 for each class of provision.

Goodwill

50 The acquirer shall, at the acquisition date:

(a) recognise goodwill acquired in a business combination as an asset; and

(b) initially measure that goodwill at its cost, being the excess of the cost of the business combination over the acquirer's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities recognised in accordance with paragraph 35.

51 Goodwill acquired 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.

52 To the extent that the acquiree's identifiable assets, liabilities or contingent liabilities do not satisfy the criteria in paragraph 36 for separate recognition at the acquisition date, there is a resulting impact on the amount recognised as goodwill (or accounted for in accordance with paragraph 55). This is because goodwill is measured as the residual cost of the business combination after recognising the acquiree's identifiable assets, liabilities and contingent liabilities.

53 After initial recognition, the acquirer shall measure goodwill acquired in a business combination at cost less any accumulated impairment losses.

54 Goodwill acquired in a business combination shall not be amortised. Instead, the acquirer shall test it for impairment annually, or more frequently if events or changes in circumstances indicate that it might be impaired, in accordance with IAS 36 *Impairment of Assets* (revised 200X).

Excess of acquirer's interest in the net fair value of acquiree's identifiable assets, liabilities and contingent liabilities over cost

55 If the acquirer's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities recognised under paragraph 35 exceeds the cost of the business combination, the acquirer shall:

(a) reassess the identification and measurement of the acquiree's identifiable assets, liabilities and contingent liabilities and the measurement of the cost of the combination; and

(b) recognise immediately in profit or loss any excess remaining after that reassessment.

56 A gain recognised under paragraph 55 could comprise one or more of the following components:

(a) errors in measuring the fair value of either the cost of the combination or the acquiree's identifiable assets, liabilities or

contingent liabilities. Possible future costs arising in respect of the acquiree that have not been reflected correctly in the fair value of the acquiree's identifiable assets, liabilities or contingent liabilities are a potential cause of such errors.

(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. For example, the guidance on determining the fair values of the acquiree's identifiable assets and liabilities in Appendix B requires the amount assigned to tax assets and liabilities to be undiscounted.

(c) a bargain purchase.

Business combination achieved in stages

57 A business combination may involve more than one exchange transaction, for example when it occurs in stages by successive share purchases. If so, each exchange transaction shall be treated separately by the acquirer, using the cost of the transaction and fair value information at the date of each exchange transaction, to determine the amount of 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 percentage interest in the fair values of the acquiree's identifiable assets, liabilities and contingent liabilities at each step.

58 When a business combination involves more than one exchange transaction, the fair values of the acquiree's identifiable assets, liabilities and contingent liabilities may be different at the date of each exchange transaction. Because:

(a) the acquiree's identifiable assets, liabilities and contingent liabilities are notionally restated to their fair values at the date of each exchange transaction to determine the amount of any goodwill associated with each transaction; and

(b) the acquiree's identifiable assets, liabilities and contingent liabilities must then be recognised by the acquirer at their fair values at the acquisition date,

any adjustment to those fair values relating to previously held interests of the acquirer is a revaluation and shall be accounted for as such. However, because this revaluation arises on the initial recognition by the acquirer of the acquiree's assets, liabilities and contingent liabilities, it does not signify that the acquirer has elected to apply an accounting

policy of revaluing those items after initial recognition under, for example, [draft] IAS 16 *Property, Plant and Equipment*.

59 Before qualifying as a business combination, a transaction may qualify as an investment in an associate and be accounted for under [draft] IAS 28 *Accounting for Investments in Associates* using the equity method. If so, the fair values of the investee's identifiable net assets at the date of each earlier exchange transaction will have been determined previously in order for the equity method to be applied to the investment.

Initial accounting determined on a provisional basis

60 The initial accounting for a business combination involves identifying and determining the fair values to be assigned to the acquiree's identifiable assets, liabilities and contingent liabilities and the cost of the combination.

61 If the initial accounting for a business combination can be determined only provisionally by the end of the reporting period in which the combination is effected because either the fair values to be assigned to the acquiree's identifiable assets, liabilities or contingent liabilities or the cost of the combination can be determined only provisionally, the acquirer shall account for the combination using those provisional values. The acquirer shall recognise any adjustments to those provisional values as a result of completing the initial accounting within twelve months of the acquisition date.

Adjustments after the initial accounting is complete

62 Except as outlined in paragraphs 32, 33 and 64, adjustments to the initial accounting for a business combination after that initial accounting is complete shall be recognised only to correct an error in accordance with [draft] IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. Adjustments to the initial accounting for a business combination after that accounting has been completed shall not be recognised for the effect of changes in accounting estimates. In accordance with IAS 8, the effect of a change in an accounting estimate shall be recognised prospectively.

63 [Draft] IAS 8 requires an entity to account for an error correction retrospectively, and to present financial statements as if the error had never occurred by correcting the comparative information for the prior period(s) in which the error occurred. Therefore, the carrying amount of an identifiable asset, liability or contingent liability of the acquiree that is

recognised or adjusted as a result of an error correction shall be calculated as if its fair value or adjusted fair value at the acquisition date had been recognised from that date. Goodwill or any gain recognised in a prior period under paragraph 55 shall be adjusted retrospectively by an amount equal to the fair value at the acquisition date (or the adjustment to the fair value at the acquisition date) of the identifiable asset, liability or contingent liability being recognised (or adjusted).

Recognition of deferred tax assets after the initial accounting is complete

64 If the potential benefit of the acquiree's income tax loss carry-forwards or other deferred tax assets did not satisfy the criteria in paragraph 36 for separate recognition when initially accounting for a business combination but is subsequently realised, the acquirer shall recognise that benefit as income under IAS 12 *Income Taxes*. 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) recognise the reduction in the carrying amount of the goodwill as an expense.

However, this procedure shall not result in the creation of an excess as described in paragraph 55, nor shall it increase the amount of any gain previously recognised in accordance with paragraph 55.

DISCLOSURE

65 An acquirer shall disclose information that enables users of its financial statements to evaluate the nature and financial effect of business combinations that were effected:

(a) during the reporting period.

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

66 To give effect to the principle in paragraph 65(a), the acquirer shall disclose the following information for each business combination that was effected during the reporting period:

(a) the names and descriptions of the combining entities or operations.

(b) the acquisition date.

(c) details of any operations the entity has decided to dispose of as a result of the combination.

(d) the percentage of voting equity instruments acquired.

(e) the cost of the combination and a description of the components of that cost, including any costs directly attributable to the combination. When equity instruments are issued or issuable as part of the cost, the following shall also be disclosed:

(i) the number of equity instruments issued or issuable; and

(ii) the fair value of those instruments and the basis for determining that fair value. If a published price does not exist for the instruments at the date of exchange, the significant assumptions used to determine fair value shall be disclosed. If a published price exists at the date of exchange but has not been used as the basis for determining the cost of the combination, that fact shall be disclosed together with: the reasons the published price has not been used; the method and significant assumptions used to attribute a value to the equity instruments; and the aggregate amount of the difference between the value attributed to, and the published price of, the equity instruments.

(f) the amounts recognised at the acquisition date for each class of the acquiree's assets, liabilities and contingent liabilities, and the carrying amounts of each of those classes, determined in accordance with IFRSs, immediately before the combination.

(g) the amount of any excess recognised in profit or loss in accordance with paragraph 55, and the line item in the income statement in which the excess is recognised.

(h) a description of the factors that contributed to a cost that results in the recognition of goodwill, or a description of the nature of any excess recognised in profit or loss in accordance with paragraph 55.

(i) the amount of the acquiree's profit or loss since the acquisition date included in the acquirer's profit or loss for the period.

67 The information required to be disclosed under paragraph 66 shall be disclosed in aggregate for business combinations effected during the reporting period that are individually immaterial.

68 If the initial accounting for a business combination that was effected during the reporting period has been determined only provisionally as

described in paragraph 61, that fact shall also be disclosed together with an explanation of why this is the case.

69 To give effect to the principle in paragraph 65(a), the acquirer shall also disclose the following information, unless such disclosure would involve undue cost and effort:

(a) the revenue of the combined entity for the period as though the acquisition date for all business combinations effected during the reporting period had been the beginning of that period.

(b) the profit or loss of the combined entity for the period as though the acquisition date for all business combinations effected during the reporting period had been the beginning of that period.

If disclosure of this information would involve undue cost and effort, that fact shall be disclosed.

70 To give effect to the principle in paragraph 65(b), the acquirer shall disclose the information required to be disclosed under paragraph 66 for each business combination occurring after the balance sheet date but before the financial statements are authorised for issue, unless such disclosure would involve undue cost and effort. If disclosure of any of that information would involve undue cost and effort, that fact shall be disclosed.

71 An acquirer shall disclose information that enables users of its financial statements to evaluate the financial effects of gains, losses, error corrections and other adjustments recognised in the current period that relate to business combinations that were effected in the current or in previous reporting periods.

72 To give effect to the principle in paragraph 71, the acquirer shall disclose the following information:

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

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

(ii) is of such size, nature or incidence that disclosure is relevant to an understanding of the combined entity's financial performance.

(b) if the initial accounting for a business combination that was effected in the immediately preceding reporting period was determined only provisionally at the end of that period, the amounts and explanations of the adjustments to the provisional values recognised during the current reporting period.

(c) the information about error corrections required to be disclosed under [draft] IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* for any of the acquiree's identifiable assets, liabilities or contingent liabilities, or changes in the values assigned to those items, that the acquirer recognises during the current reporting period in accordance with paragraphs 62 and 63.

73 An entity shall disclose information that enables users of its financial statements to evaluate changes in the carrying amount of goodwill during the reporting period.

74 To give effect to the principle in paragraph 73, the entity 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 period;

(b) additional goodwill recognised during the period;

(c) adjustments resulting from the subsequent recognition of deferred tax assets during the period in accordance with paragraph 64;

(d) goodwill derecognised during the period on the disposal of the operation to which it relates;

(e) impairment losses recognised during the period in accordance with IAS 36 *Impairment of Assets* (revised 200X);

(f) net exchange differences arising during the period;

(g) any other changes in the carrying amount during the period; and

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

75 The entity discloses information about the recoverable amount and impairment of goodwill in accordance with IAS 36 (revised 200X) in addition to the information required to be disclosed under paragraph 74(e).

76 If in any situation the information required to be disclosed by this [draft] IFRS does not completely satisfy the objectives set out in paragraphs 65, 71 and 73, the entity shall disclose such additional information as is necessary to meet those objectives.

TRANSITIONAL PROVISIONS AND EFFECTIVE DATE

77 Except as provided in paragraph 78, this [draft] IFRS shall apply to the accounting for business combinations for which the *agreement date* is on or after [date the IFRS is issued]. This [draft] IFRS shall also apply to the accounting for:

(a) goodwill arising from a business combination for which the agreement date is on or after [date the IFRS is issued]; or

(b) 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 a business combination for which the agreement date is on or after [date the IFRS is issued].

78 This [draft] IFRS shall not apply to the accounting for the following business combinations until guidance on the application of the purchase method to those transactions has been issued by the IASB:

(a) combinations involving two or more *mutual entities*; and

(b) combinations in which separate entities or operations of entities are brought together to form a reporting entity by contract only without the obtaining of an ownership interest (for example, combinations in which separate entities are brought together by contract only to form a dual listed corporation).

Previously recognised goodwill

79 This [draft] IFRS shall apply on a prospective basis, from the beginning of the first annual reporting period beginning on or after [date the IFRS is issued], to goodwill acquired in a business combination for which the agreement date was before [date the IFRS is issued]. Therefore, an entity shall:

(a) from the beginning of the first annual reporting period beginning on or after [date the IFRS is issued], discontinue amortising goodwill acquired in a business combination for which the agreement date was before [date the IFRS is issued];

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(b) at the beginning of the first annual reporting period beginning on or after [date the IFRS is issued], eliminate the carrying amount of the related accumulated amortisation with a corresponding decrease in goodwill; and

(c) from the beginning of the first annual reporting period beginning on or after [date the IFRS is issued], test the goodwill for impairment in accordance with IAS 36 *Impairment of Assets* (revised 200X).

Previously recognised negative goodwill

80 The carrying amount of negative goodwill at the beginning of the first annual reporting period beginning on or after [date the IFRS is issued] that arose from a business combination for which the agreement date was before [date the IFRS is issued] shall be derecognised at the beginning of that reporting period, with a corresponding adjustment to the opening balance of retained earnings.

Previously recognised intangible assets

81 The carrying amount of an intangible asset, including an in-process research and development project, acquired in a business combination for which the agreement date was before [date the IFRS is issued] shall be reclassified as goodwill at the beginning of the first annual reporting period beginning on or after [date the IFRS is issued], if that intangible asset:

(a) is an assembled workforce; or

(b) does not, at the beginning of the first annual reporting period beginning on or after [date the IFRS is issued], meet the identifiability criterion in IAS 38 *Intangible Assets* (revised 200X) for identification as an intangible asset.

Equity accounted investments

82 For investments accounted for by applying the equity method and acquired on or after [date the IFRS is issued], this [draft] IFRS shall be applied in the accounting for:

(a) any acquired goodwill included in the carrying amount of that investment. Therefore, amortisation of that notional goodwill shall not be included in the determination of the entity's share of the investee's profits or losses.

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(b) any excess included in the carrying amount of the investment of the entity's interest in the net fair value of the investee's identifiable assets, liabilities and contingent liabilities over the cost of the investment. Therefore, an entity shall include that excess as income in the determination of the entity's share of the investee's profits or losses in the period in which the investment is acquired.

83 For investments accounted for by applying the equity method and acquired before [date the IFRS is issued]:

(a) this [draft] IFRS shall be applied on a prospective basis, from the beginning of the first annual reporting period beginning on or after [date the IFRS is issued], to any acquired goodwill included in the carrying amount of that investment. Therefore, an entity shall, from the beginning of the first annual reporting period beginning on or after [date the IFRS is issued], discontinue including the amortisation of that goodwill in the determination of the entity's share of the investee's profits or losses.

(b) an entity shall derecognise any negative goodwill included in the carrying amount of that investment at the beginning of the first annual reporting period beginning on or after [date the IFRS is issued], with a corresponding adjustment to the opening balance of retained earnings.

Early application

84 Entities are encouraged to apply the requirements of this [draft] IFRS before the effective dates outlined in paragraphs 77 and 79-83. However, if an entity elects to apply this [draft] IFRS before those effective dates, it shall also apply IAS 36 (revised 200X) and IAS 38 (revised 200X) at the same time.

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Appendix A
Defined terms

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

acquisition date — The date on which the acquirer effectively obtains **control** of the acquiree.

agreement date — 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.

business combination — The bringing together of separate entities or operations of entities into one **reporting entity**.

business combination involving entities (or operations of entities) under common control — A **business combination** in which all of the combining entities (or operations of entities) ultimately are **controlled** by the same party or parties both before and after the combination, and that **control** is not transitory.

contingent liability — Contingent liability has the meaning given to it in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, ie:

(a) a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or

(b) a present obligation that arises from past events but is not recognised because:

(i) it is not **probable** that an outflow of resources embodying economic benefits will be required to settle the obligation; or

(ii) the amount of the obligation cannot be measured with sufficient reliability.

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control — The power to govern the financial and operating policies of an entity or operation so as to obtain benefits from its activities.

date of exchange — When a **business combination** is achieved through a single exchange transaction, the date of exchange is the **acquisition date**. When a **business combination** involves more than one exchange transaction, for example when it is achieved in stages by successive share purchases, the date of exchange is the date that each individual investment is recognised in the financial statements of the acquirer.

fair value — The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

goodwill — Future economic benefits arising from assets that are not capable of being individually identified and separately recognised.

intangible asset — Intangible asset has the meaning given to it in IAS 38 *Intangible Assets* (revised 200X), ie an identifiable non-monetary asset without physical substance.

joint venture — Joint venture has the meaning given to it in IAS 31 *Financial Reporting of Interests in Joint Ventures*, ie a contractual arrangement whereby two or more parties undertake an economic activity which is subject to joint control.

minority interest — That portion of the profit or loss and net assets of a subsidiary attributable to equity interests that are not owned, directly or indirectly through **subsidiaries**, by the **parent**.

mutual entity — An entity other than an investor-owned entity, such as a mutual insurance company or a mutual cooperative entity, that provides lower costs or other economic benefits directly and proportionately to its policyholders or participants.

parent — An entity that has one or more **subsidiaries**.

probable — More likely than not.

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reporting entity — An entity for which there are users who rely on the entity's general purpose financial statements for information that will be useful to them for making decisions about the allocation of resources. A reporting entity can be a single entity or a group comprising a **parent** and all of its **subsidiaries**.

subsidiary — An entity, including an unincorporated entity such as a partnership, that is **controlled** by another entity (known as the **parent**).

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Appendix B
Application Supplement

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

Reverse acquisitions

B1 As noted in paragraph 21 of the [draft] IFRS, in some business combinations, commonly referred to as reverse acquisitions, the acquirer is the entity whose equity interests have been acquired and the issuing entity is the acquiree. This is the case when, for example, a private operating entity arranges to have itself 'acquired' by a non-operating or dormant public entity as a means of obtaining a stock exchange listing. Although legally the issuing non-operating public entity is regarded as the parent and the operating entity is regarded as the subsidiary, the legal subsidiary is the acquirer with the power to govern the financial and operating policies of the legal parent so as to obtain benefits from its activities.

B2 An entity shall apply the guidance in paragraphs B3-B14 when accounting for a reverse acquisition.

B3 Reverse acquisition accounting determines the allocation of the cost of the business combination as at the acquisition date and does not apply to transactions after the combination.

Cost of the business combination

B4 When equity instruments are issued as part of the cost of the business combination, paragraph 23 of this [draft] IFRS requires the cost of the combination to include the fair value of those equity instruments at the date of exchange. Paragraph 26 notes that, in the absence of a reliable published price, the fair value of the equity instruments can be estimated by reference to the fair value of the acquirer or the fair value of the acquiree, whichever is more clearly evident.

B5 In a reverse acquisition, the cost of the business combination is deemed to have been incurred by the legal subsidiary (ie the acquirer for accounting purposes) in the form of equity instruments issued to the owners of the legal parent (ie the acquiree for accounting purposes). If the published price of the equity instruments of the legal subsidiary is used to determine the cost of the combination, a calculation shall be

made to determine the number of equity instruments the legal subsidiary would have had to issue to provide the same percentage ownership interest of the combined entity to the owners of the legal parent as they have in the combined entity as a result of the reverse acquisition. The fair value of the number of equity instruments so calculated shall be used as the cost of the combination.

B6 If the fair value of the equity instruments of the legal subsidiary is not otherwise clearly evident, the total fair value of all the issued equity instruments of the legal parent before the business combination shall be used as the basis for determining the cost of the combination.

Preparation and presentation of consolidated financial statements

B7 Consolidated financial statements prepared following a reverse acquisition shall be 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 accounting 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 shall be recognised and measured in those consolidated financial statements at their pre-combination carrying amounts.

(b) the accumulated profit or loss and other equity balances recognised in those consolidated financial statements shall be the accumulated profit or loss and other equity balances of the legal subsidiary immediately before the business combination.

(c) the amount recognised as issued equity instruments in those consolidated financial statements shall be determined by adding to the issued equity of the legal subsidiary immediately before the business combination the cost of the combination determined as described in paragraphs B4-B6. However, the equity structure appearing in those consolidated financial statements (ie the number and type of equity instruments issued) shall reflect the equity structure of the legal parent, including the equity instruments issued by the legal parent to effect the combination.

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

B8 Consolidated financial statements prepared following a reverse acquisition shall reflect the fair values of the assets, liabilities and contingent liabilities of the legal parent (ie the acquiree for accounting purposes). Therefore, the cost of the business combination shall be allocated by measuring the identifiable assets, liabilities and contingent liabilities of the legal parent that satisfy the recognition criteria in paragraph 36 at their fair values at the acquisition date. Any excess of the cost of the combination over the acquirer's interest in the net fair value of those items shall be accounted for in accordance with paragraphs 50-54. Any excess of the acquirer's interest in the net fair value of those items over the cost of the combination shall be accounted for in accordance with paragraph 55.

Minority interest

B9 In some reverse acquisitions, some of the owners of the legal subsidiary do not exchange their equity instruments for equity instruments of the legal parent. Although the entity in which those owners hold equity instruments (the legal subsidiary) acquired another entity (the legal parent), those owners shall be treated as a minority interest in the consolidated financial statements prepared following the reverse acquisition. This is because the owners of the legal subsidiary that do not exchange their equity instruments for equity instruments 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, all of the owners of the legal parent, notwithstanding that the legal parent is regarded as the acquiree, have an interest in the results and net assets of the combined entity.

B10 Because the assets and liabilities of the legal subsidiary are recognised and measured in the consolidated financial statements at their pre-combination carrying amounts, the minority interest shall reflect the minority shareholders' proportionate interest in the pre-combination carrying amounts of the legal subsidiary's net assets.

Earnings per share

B11 As noted in paragraph B7(c), the equity structure appearing in the consolidated financial statements prepared following a reverse acquisition reflects the equity structure of the legal parent, including the equity instruments issued by the legal parent to effect the business combination.

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B12 For the purpose of calculating the weighted average number of ordinary shares outstanding (the denominator) during the annual reporting period in which the reverse acquisition occurs:

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

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

B13 The basic earnings per share disclosed for each comparative period 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.

B14 The calculations outlined in paragraphs B12 and B13 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 annual reporting period in which the reverse acquisition occurred to the acquisition date. The calculation of earnings per share shall be appropriately adjusted to take into account the effect of a change in the number of the legal subsidiary's issued ordinary shares during those periods.

Allocating the cost of a business combination

B15 This [draft] 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:

(a) for marketable securities the acquirer shall use current market values.

(b) for non-marketable securities the acquirer shall use estimated values that take into consideration features such as price-earnings ratios, dividend yields and expected growth rates of comparable securities of entities with similar characteristics.

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(c) for receivables, beneficial contracts and other identifiable assets the acquirer shall use the present values of the amounts to be received, determined at appropriate current interest rates, less allowances for uncollectability and collection costs, if necessary. However, discounting is not required for short-term receivables, beneficial contracts and other identifiable assets when the difference between the nominal and discounted amounts is not material.

(d) for inventories of:

(i) finished goods and merchandise the acquirer shall use selling prices less the sum of (1) the costs of disposal and (2) a reasonable profit allowance for the selling effort of the acquirer based on profit for similar finished goods and merchandise;

(ii) work in progress the acquirer shall use selling prices of finished goods less the sum of (1) costs to complete, (2) costs of disposal and (3) a reasonable profit allowance for the completing and selling effort based on profit for similar finished goods; and

(iii) raw materials the acquirer shall use current replacement costs.

(e) for land and buildings the acquirer shall use market values.

(f) for plant and equipment the acquirer shall use market values, normally determined by appraisal. When there is no evidence of market values because of the specialised nature of the plant and equipment or because the items are rarely sold, except as part of a continuing business, they are valued at their depreciated replacement cost.

(g) for intangible assets the acquirer shall determine fair value:

(i) by reference to an active market as defined in IAS 38 *Intangible Assets* (revised 200X); or

(ii) if no active market exists, on a basis that reflects the amounts the acquirer would have paid for the assets in arm's length transactions between knowledgeable willing parties, based on the best information available (see IAS 38 (revised 200X) for further guidance on determining the fair values of intangible assets acquired in business combinations).

(h) for net employee benefit assets or liabilities for defined benefit plans the acquirer shall use the present value of the defined benefit obligation less the fair value of any plan assets. However, an asset is recognised only to the extent that it is probable that it will be available to the acquirer in the form of refunds from the plan or a reduction in future contributions.

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(i) for tax assets and liabilities the acquirer shall use the amount of the tax benefit arising from tax losses or the taxes payable in respect of the net profit or loss, assessed from the perspective of the combined entity. The tax asset or liability is determined after allowing for the tax effect of restating identifiable assets, liabilities and contingent liabilities to their fair values and is not discounted.

(j) for accounts and notes payable, long-term debt, liabilities, accruals and other claims payable the acquirer shall use the present values of amounts to be disbursed in meeting the liabilities determined at appropriate current interest rates. However, discounting is not required for short-term liabilities when the difference between the nominal and discounted amounts is not material.

(k) for onerous contracts and other identifiable liabilities of the acquiree the acquirer shall use the present values of amounts to be disbursed in meeting the obligations determined at appropriate current interest rates.

(l) for contingent liabilities of the acquiree the acquirer shall use the amounts that a third party would charge to assume those contingent liabilities. Such an amount shall reflect all expectations about possible cash flows and not the single most likely or the expected maximum or minimum cash flow.

B16 Some of the above guidance requires fair values to be estimated using discounting. If the guidance for a particular item does not refer to the use of discounting, discounting may be used in estimating the fair value of that item.

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