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including International Accounting Standards (IASs™) and Interpretations as at 31 March 2004

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IASCF Publications Department, 30 Cannon Street, London EC4M 6XH, United Kingdom.

Telephone: +44 (0)20 7332 2730 Fax: +44 (0)20 7332 7249 Email: publications@iasb.org
Internet: http://www.iasb.org

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International Financial Reporting Standard 3

Business Combinations

This version includes amendments resulting from new and amended IFRSs issued up to 31 March 2004. The section "Changes in this Edition" at the front of this volume provides the application dates of these new and amended IFRSs and also identifies those current IFRSs that are not included in this volume.

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International Financial Reporting Standard 3 *Business Combinations* (IFRS 3) is set out in paragraphs 1-87 and Appendices A-C. 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 Standard. Definitions of other terms are given in the Glossary for International Financial Reporting Standards. 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.

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INTRODUCTION

IN1 International Financial Reporting Standard 3 *Business Combinations* (IFRS 3) replaces IAS 22 *Business Combinations*. The IFRS also replaces the following Interpretations:

- SIC-9 *Business Combinations—Classification either as Acquisitions or Unitings of Interests*
- SIC-22 *Business Combinations—Subsequent Adjustment of Fair Values and Goodwill Initially Reported*
- SIC-28 *Business Combinations—"Date of Exchange" and Fair Value of Equity Instruments*.

Reasons for issuing the IFRS

IN2 IAS 22 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.

IN3 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 in accordance with IAS 22 using the pooling of interests method, it would be advantageous for international standards to converge with those in Australia and North America by also prohibiting the method.

IN4 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.

IN5 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 dissimilar ways impairs the usefulness of the information provided to users of financial statements, because both comparability and reliability are diminished.

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IN6 Therefore, this IFRS has been issued 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 IFRS

IN7 This 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 businesses.

(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 or assumed, 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; and

  (iii) in the case of an intangible asset or 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.

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(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*.

(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 financial effect of:

  (i) business combinations that were effected during the period;

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

  (iii) some business combinations that were effected in previous 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 period.

Changes from previous requirements

IN8 The main changes from IAS 22 are described below.

Method of accounting

IN9 This IFRS requires all business combinations within its scope to be accounted for using the purchase method. IAS 22 permitted business combinations to be accounted for using one of two methods: the pooling of interests method for combinations classified as unitings of interests and the purchase method for combinations classified as acquisitions.

Recognising the identifiable assets acquired and liabilities and contingent liabilities assumed

IN10 This IFRS changes the requirements in IAS 22 for separately recognising as part of allocating the cost of a business combination:

(a) liabilities for terminating or reducing the activities of the acquiree; and

(b) contingent liabilities of the acquiree.

This IFRS also clarifies the criteria for separately recognising intangible assets of the acquiree as part of allocating the cost of a combination.

IN11 This IFRS requires an acquirer to 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*. IAS 22 required an acquirer to recognise as part of allocating the cost of a business combination a provision for terminating or reducing the activities of the acquiree that was not a liability of the acquiree at the acquisition date, provided the acquirer satisfied specified criteria.

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IN12 This IFRS requires an acquirer to recognise separately the acquiree's contingent liabilities (as defined in IAS 37) at the acquisition date as part of allocating the cost of a business combination, provided their fair values can be measured reliably. Such contingent liabilities were, in accordance with IAS 22, subsumed within the amount recognised as goodwill or negative goodwill.

IN13 IAS 22 required an intangible asset to be recognised if, and only if, it was probable that the future economic benefits attributable to the asset would flow to the entity, and its cost could be measured reliably. The probability recognition criterion is not included in this IFRS because it is always considered to be satisfied for intangible assets acquired in business combinations. Additionally, this IFRS includes guidance clarifying that the fair value of an intangible asset acquired in a business combination can normally be measured with sufficient reliability to qualify for recognition separately from goodwill. If an intangible asset acquired in a business combination has a finite useful life, there is a rebuttable presumption that its fair value can be measured reliably.

Measuring the identifiable assets acquired and liabilities and contingent liabilities assumed

IN14 IAS 22 included 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. This IFRS requires the acquiree's identifiable assets, liabilities and contingent liabilities recognised as part of allocating the cost of the combination to be measured initially by the acquirer 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 values of those items. This is consistent with IAS 22's allowed alternative treatment.

Subsequent accounting for goodwill

IN15 This IFRS requires goodwill acquired in a business combination to be measured after initial recognition at cost less any accumulated impairment losses. Therefore, the goodwill is not amortised and instead must be tested for impairment annually, or more frequently if events or changes in circumstances indicate that it might be impaired. IAS 22 required acquired goodwill to be systematically amortised over its useful life, and included a rebuttable presumption that its useful life could not exceed twenty years from initial recognition.

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

IN16 This IFRS 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 combination if, at the acquisition date, the acquirer's interest in the net fair value of those items exceeds the cost of the combination. Any excess remaining after that reassessment must be recognised by the acquirer immediately in profit or loss. In accordance with IAS 22, any excess of the acquirer's interest in the net fair value of the identifiable assets and liabilities acquired over the cost of the acquisition was accounted for as negative goodwill as follows:

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(a) to the extent that it related to expectations of future losses and expenses identified in the acquirer's acquisition plan, it was required to be carried forward and recognised as income in the same period in which the future losses and expenses were recognised.

(b) to the extent that it did not relate to expectations of future losses and expenses identified in the acquirer's acquisition plan, it was required to be recognised as income as follows:

    (i) for the amount of negative goodwill not exceeding the aggregate fair value of acquired identifiable non-monetary assets, on a systematic basis over the remaining weighted average useful life of the identifiable depreciable assets.

    (ii) for any remaining excess, immediately.

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International Financial Reporting Standard 3

Business Combinations

OBJECTIVE

1 The objective of this IFRS is to specify the financial reporting by an entity when it undertakes a *business combination*. In particular, it specifies that all business combinations should be accounted for by applying the purchase method. Therefore, the acquirer recognises the acquiree's identifiable assets, liabilities and *contingent liabilities* at their *fair values* at the *acquisition date*, and also recognises *goodwill*, which is subsequently tested for impairment rather than amortised.

SCOPE

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

3 This IFRS does not apply to:

(a) business combinations in which separate entities or *businesses* are brought together to form a *joint venture*.

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

(c) business combinations involving two or more *mutual entities*.

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

Identifying a business combination

4 A business combination is the bringing together of separate entities or businesses into one reporting entity. The result of nearly all business combinations is that one entity, the acquirer, obtains *control* of one or more other businesses, the acquiree. If an entity obtains control of one or more other entities that are not businesses, the bringing together of those entities is not a business combination. When an entity acquires a group of assets or net assets that does not constitute a business, it shall allocate the cost of the group between the individual identifiable assets and liabilities in the group based on their relative fair values at the date of acquisition.

5 A business combination 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 businesses. 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.

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6 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 IFRS in its consolidated financial statements. It includes its interest in the acquiree in any separate financial statements it issues as an investment in a subsidiary (see IAS 27 *Consolidated and Separate Financial Statements*).

7 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.

8 Included within the definition of a business combination, and therefore the scope of this IFRS, are business combinations in which one entity obtains control of another entity but for which the date of obtaining control (ie the acquisition date) does not coincide with the date or dates of acquiring an ownership interest (ie 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 of the investee changes.

9 This IFRS does not specify the accounting by venturers for interests in joint ventures (see IAS 31 *Interests in Joint Ventures*).

Business combinations involving entities under common control

10 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.

11 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 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.

12 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 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.

13 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 in accordance with IAS 27 is not relevant to determining whether a combination involves entities under common control.

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METHOD OF ACCOUNTING

14 All business combinations shall be accounted for by applying the purchase method.

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 as a result of the transaction, because they are not the subjects of the transaction.

APPLICATION OF THE PURCHASE METHOD

16 Applying 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.

Identifying the acquirer

17 An acquirer shall be identified for all business combinations. The acquirer is the combining entity that obtains control of the other combining entities or businesses.

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 business 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.

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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 might be the case when, for example, a private entity arranges to have itself 'acquired' by a smaller public entity as a means of obtaining a stock exchange listing. Although legally the issuing public entity is regarded as the parent and the private entity is regarded as the subsidiary, the legal subsidiary is the acquirer if it has 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-B15 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 identified as the acquirer on the basis of the evidence available.

23 Similarly, when a business combination involves more than two combining entities, one of the combining entities that existed before the combination shall be identified as the acquirer on the basis of the evidence available. Determining the acquirer in such cases shall include a consideration of, amongst other things, which of the combining entities initiated the combination and whether the assets or revenues of one of the combining entities significantly exceed those of the others.

Cost of a business combination

24 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 or assumed, and equity instruments issued by the acquirer, in exchange for control of the acquiree; plus

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

25 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.

26 Assets given and liabilities incurred or assumed by the acquirer in exchange for control of the acquiree are required by paragraph 24 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.

27 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 circumstances when the acquirer can demonstrate 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 by the acquirer, 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 set out in IAS 39 *Financial Instruments: Recognition and Measurement*.

28 The cost of a business combination includes liabilities incurred or assumed 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 or assumed by the acquirer in exchange for control of the acquiree, and are not, therefore, included as part of the cost of the combination.

29 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.

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30 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 IAS 39, such costs shall be included in the initial measurement of the liability.

31 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 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

32 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.

33 A business combination agreement may allow for adjustments to the cost of the combination that are contingent on one or more future events. The adjustment might, for example, be contingent on a specified level of profit being maintained or achieved in future periods, or on the market price of the instruments 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.

34 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.

35 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 or assumed by the acquirer in exchange for control of the acquiree. This is the case, for example, when the acquirer guarantees 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.

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

36 **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 37 at their fair values at that date, except for non-current assets (or disposal groups) that are classified as held for sale in accordance with IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*, which shall be recognised at fair value less costs to sell. 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 51-57.**

37 **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) in the case of an intangible asset or a contingent liability, its fair value can be measured reliably.**

38 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, 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.

39 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 business 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 obtains control. All pertinent facts and circumstances surrounding a business combination shall be considered in assessing when the acquirer has obtained control.

40 Because the acquirer recognises the acquiree's identifiable assets, liabilities and contingent liabilities that satisfy the recognition criteria in paragraph 37 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 value of those items. Paragraphs B16 and B17 of Appendix B provide 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.

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Acquiree's identifiable assets and liabilities

41 In accordance with paragraph 36, the acquirer recognises separately as part of allocating the cost of the combination only the identifiable assets, liabilities and contingent liabilities of the acquiree that existed at the acquisition date and satisfy the recognition criteria in paragraph 37. 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.

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

43 However, an acquiree's restructuring plan whose execution is conditional upon its being acquired in a business combination is not, immediately before the business combination, a present obligation of the acquiree. Nor is it a contingent liability of the acquiree immediately before the combination because it is not a possible obligation arising from a past event 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 acquiree. Therefore, an acquirer shall not recognise a liability for such restructuring plans as part of allocating the cost of the combination.

44 The identifiable assets and liabilities that are recognised in accordance with paragraph 36 include all of the acquiree's assets and liabilities that the acquirer purchases or assumes, including all of its financial assets and financial liabilities. They might also include assets and liabilities not previously recognised in the acquiree's financial statements, eg 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 in accordance with paragraph 36 if it is probable that the acquirer will have future taxable profits against which the unrecognised tax benefit can be applied.

Acquiree's intangible assets

45 In accordance with paragraph 37, 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 *Intangible Assets* and its fair value can be measured reliably. 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. IAS 38 provides guidance on determining whether the fair value of an intangible asset acquired in a business combination can be measured reliably.

46 A non-monetary asset without physical substance must be identifiable to meet the definition of an intangible asset. In accordance with IAS 38, an asset meets the identifiability criterion in the definition of an intangible asset only if it:

(a) 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; or

(b) 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.

Acquiree's contingent liabilities

47 Paragraph 37 specifies that 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 effect on the amount recognised as goodwill or accounted for in accordance with paragraph 56; and

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

Paragraph B16(l) of Appendix B provides guidance on determining the fair value of a contingent liability.

48 After their initial recognition, the acquirer shall measure contingent liabilities that are recognised separately in accordance with paragraph 36 at the higher of:

(a) the amount that would be recognised in accordance with IAS 37, and

(b) the amount initially recognised less, when appropriate, cumulative amortisation recognised in accordance with IAS 18 *Revenue*.

49 The requirement in paragraph 48 does not apply to contracts accounted for in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*. However, loan commitments excluded from the scope of IAS 39 that are not commitments to provide loans at below-market interest rates are accounted for as contingent liabilities of the acquiree if, at the acquisition date, it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation or if the amount of the obligation cannot be measured with sufficient reliability. Such a loan commitment is, in accordance with paragraph 37, recognised separately as part of allocating the cost of a combination only if its fair value can be measured reliably.

50 Contingent liabilities recognised separately as part of allocating the cost of a business combination are excluded from the scope of IAS 37. However, the acquirer shall disclose for those contingent liabilities the information required to be disclosed by IAS 37 for each class of provision.

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Goodwill

51 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 36.

52 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.

53 To the extent that the acquiree's identifiable assets, liabilities or contingent liabilities do not satisfy the criteria in paragraph 37 for separate recognition at the acquisition date, there is a resulting effect on the amount recognised as goodwill (or accounted for in accordance with paragraph 56). 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.

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

55 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*.

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

56 If the acquirer's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities recognised in accordance with paragraph 36 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.

57 A gain recognised in accordance with paragraph 56 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 in

Appendix B on determining the fair values of the acquiree's identifiable assets and liabilities requires the amount assigned to tax assets and liabilities to be undiscounted.

(c) a bargain purchase.

Business combination achieved in stages

58 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 interest in the fair values of the acquiree's identifiable assets, liabilities and contingent liabilities at each step.

59 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 in accordance with, for example, IAS 16 *Property, Plant and Equipment*.

60 Before qualifying as a business combination, a transaction may qualify as an investment in an associate and be accounted for in accordance with IAS 28 *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 applying the equity method to the investment.

Initial accounting determined provisionally

61 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.

62 If the initial accounting for a business combination can be determined only provisionally by the end of the 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:

(a) within twelve months of the acquisition date; and

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(b) from the acquisition date. Therefore:

(i) the carrying amount of an identifiable asset, liability or contingent liability that is recognised or adjusted as a result of completing the initial accounting shall be calculated as if its fair value at the acquisition date had been recognised from that date.

(ii) goodwill or any gain recognised in accordance with paragraph 56 shall be adjusted from the acquisition date by an amount equal to the adjustment to the fair value at the acquisition date of the identifiable asset, liability or contingent liability being recognised or adjusted.

(iii) comparative information presented for the periods before the initial accounting for the combination is complete shall be presented as if the initial accounting had been completed from the acquisition date. This includes any additional depreciation, amortisation or other profit or loss effect recognised as a result of completing the initial accounting.

Adjustments after the initial accounting is complete

63 Except as outlined in paragraphs 33, 34 and 65, 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 IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. Adjustments to the initial accounting for a business combination after that accounting is complete shall not be recognised for the effect of changes in estimates. In accordance with IAS 8, the effect of a change in estimates shall be recognised in the current and future periods.

64 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 restating 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 in accordance with paragraph 56 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

65 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 37 for separate recognition when a business combination is initially accounted for but is subsequently realised, the acquirer shall recognise that benefit as income in accordance with 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 56, nor shall it increase the amount of any gain previously recognised in accordance with paragraph 56.

DISCLOSURE

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

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

- (a) the names and descriptions of the combining entities or businesses.
- (b) the acquisition date.
- (c) the percentage of voting equity instruments acquired.
- (d) 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 was not used as the basis for determining the cost of the combination, that fact shall be disclosed together with: the reasons the published price was not 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.
- (e) details of any operations the entity has decided to dispose of as a result of the combination.
- (f) the amounts recognised at the acquisition date for each class of the acquiree's assets, liabilities and contingent liabilities, and, unless disclosure would be impracticable, the carrying amounts of each of those classes, determined in accordance with IFRSs, immediately before the combination. If such disclosure would be impracticable, that fact shall be disclosed, together with an explanation of why this is the case.
- (g) the amount of any excess recognised in profit or loss in accordance with paragraph 56, 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—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—or a description of the nature of any excess recognised in profit or loss in accordance with paragraph 56.
- (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, unless disclosure would be impracticable. If such disclosure would be impracticable, that fact shall be disclosed, together with an explanation of why this is the case.

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

69 If the initial accounting for a business combination that was effected during the period was determined only provisionally as described in paragraph 62, that fact shall also be disclosed together with an explanation of why this is the case.

70 To give effect to the principle in paragraph 66(a), the acquirer shall disclose the following information, unless such disclosure would be impracticable:

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

If disclosure of this information would be impracticable, that fact shall be disclosed, together with an explanation of why this is the case.

71 To give effect to the principle in paragraph 66(b), the acquirer shall disclose the information required by paragraph 67 for each business combination effected after the balance sheet date but before the financial statements are authorised for issue, unless such disclosure would be impracticable. If disclosure of any of that information would be impracticable, that fact shall be disclosed, together with an explanation of why this is the case.

72 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 periods.

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

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

(c) the information about error corrections required to be disclosed by IAS 8 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 period in accordance with paragraphs 63 and 64.

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

75 To give effect to the principle in paragraph 74, the entity shall disclose a reconciliation of the carrying amount of goodwill at the beginning and end of the period, showing separately:

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

(b) additional goodwill recognised during the 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 period in accordance with paragraph 65;

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

(e) impairment losses recognised during the period in accordance with IAS 36;

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

(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.

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

77 If in any situation the information required to be disclosed by this IFRS does not satisfy the objectives set out in paragraphs 66, 72 and 74, the entity shall disclose such additional information as is necessary to meet those objectives.

TRANSITIONAL PROVISIONS AND EFFECTIVE DATE

78 Except as provided in paragraph 85, this IFRS shall apply to the accounting for business combinations for which the *agreement date* is on or after 31 March 2004. This IFRS shall also apply to the accounting for:

(a) goodwill arising from a business combination for which the agreement date is on or after 31 March 2004; 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 31 March 2004.

Previously recognised goodwill

79 An entity shall apply this IFRS prospectively, from the beginning of the first annual period beginning on or after 31 March 2004, to goodwill acquired in a business combination for which the agreement date was before 31 March 2004, and to goodwill arising from an interest in a jointly controlled entity obtained before 31 March 2004 and accounted for by applying proportionate consolidation. Therefore, an entity shall:

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(a) from the beginning of the first annual period beginning on or after 31 March 2004, discontinue amortising such goodwill;

(b) at the beginning of the first annual period beginning on or after 31 March 2004, eliminate the carrying amount of the related accumulated amortisation with a corresponding decrease in goodwill; and

(c) from the beginning of the first annual period beginning on or after 31 March 2004, test the goodwill for impairment in accordance with IAS 36 (as revised in 2004).

80 If an entity previously recognised goodwill as a deduction from equity, it shall not recognise 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.

Previously recognised negative goodwill

81 The carrying amount of negative goodwill at the beginning of the first annual period beginning on or after 31 March 2004 that arose from either

(a) a business combination for which the agreement date was before 31 March 2004 or

(b) an interest in a jointly controlled entity obtained before 31 March 2004 and accounted for by applying proportionate consolidation

shall be derecognised at the beginning of that period, with a corresponding adjustment to the opening balance of retained earnings.

Previously recognised intangible assets

82 The carrying amount of an item classified as an intangible asset that either

(a) was acquired in a business combination for which the agreement date was before 31 March 2004 or

(b) arises from an interest in a jointly controlled entity obtained before 31 March 2004 and accounted for by applying proportionate consolidation

shall be reclassified as goodwill at the beginning of the first annual period beginning on or after 31 March 2004, if that intangible asset does not at that date meet the identifiability criterion in IAS 38 (as revised in 2004).

Equity accounted investments

83 For investments accounted for by applying the equity method and acquired on or after 31 March 2004, an entity shall apply this IFRS 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.

(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.

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84 For investments accounted for by applying the equity method and acquired before 31 March 2004:

(a) an entity shall apply this IFRS on a prospective basis, from the beginning of the first annual period beginning on or after 31 March 2004, to any acquired goodwill included in the carrying amount of that investment. Therefore, an entity shall, from that date, 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 period beginning on or after 31 March 2004, with a corresponding adjustment to the opening balance of retained earnings.

Limited retrospective application

85 An entity is permitted to apply the requirements of this IFRS to goodwill existing at or acquired after, and to business combinations occurring from, any date before the effective dates outlined in paragraphs 78-84, provided:

(a) the valuations and other information needed to apply the IFRS to past business combinations were obtained at the time those combinations were initially accounted for; and

(b) the entity also applies IAS 36 (as revised in 2004) and IAS 38 (as revised in 2004) prospectively from that same date, and the valuations and other information needed to apply those Standards from that date were previously obtained by the entity so that there is no need to determine estimates that would need to have been made at a prior date.

WITHDRAWAL OF OTHER PRONOUNCEMENTS

86 This IFRS supersedes IAS 22 *Business Combinations* (as issued in 1998).

87 This IFRS supersedes the following Interpretations:

(a) SIC-9 *Business Combinations—Classification either as Acquisitions or Unitings of Interests*;

(b) SIC-22 *Business Combinations—Subsequent Adjustment of Fair Values and Goodwill Initially Reported*; and

(c) SIC-28 *Business Combinations—"Date of Exchange" and Fair Value of Equity Instruments*.

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Appendix A
Defined terms

This appendix is an integral part of the 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	An integrated set of activities and assets conducted and managed for the purpose of providing: (a) a return to investors; or (b) lower costs or other economic benefits directly and proportionately to policyholders or participants. A business generally consists of inputs, processes applied to those inputs, and resulting outputs that are, or will be, used to generate revenues. If **goodwill** is present in a transferred set of activities and assets, the transferred set shall be presumed to be a business.
business combination	The bringing together of separate entities or **businesses** into one **reporting entity**.
business combination involving entities or businesses under common control	A **business combination** in which all of the combining entities or **businesses** 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.
control	The power to govern the financial and operating policies of an entity or **business** so as to obtain benefits from its activities.

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date of exchange	When a **business combination** is achieved in 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*, ie an identifiable non-monetary asset without physical substance.
joint venture	Joint venture has the meaning given to it in IAS 31 *Interests in Joint Ventures*, ie a contractual arrangement whereby two or more parties undertake an economic activity that 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.
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 IFRS.

Reverse acquisitions

B1 As noted in paragraph 21, 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 might be the case when, for example, a private entity arranges to have itself 'acquired' by a smaller public entity as a means of obtaining a stock exchange listing. Although legally the issuing public entity is regarded as the parent and the private entity is regarded as the subsidiary, the legal subsidiary is the acquirer if it has 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-B15 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 24 requires the cost of the combination to include the fair value of those equity instruments at the date of exchange. Paragraph 27 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 retained earnings and other equity balances recognised in those consolidated financial statements shall be the retained earnings 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 Reverse acquisition accounting applies only in the consolidated 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.

B9 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 37 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 51-55. 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 56.

Minority interest

B10 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 after 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.

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B11 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

B12 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.

B13 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 to the owners of the legal subsidiary; and

(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 outstanding during that period.

B14 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.

B15 The calculations outlined in paragraphs B13 and B14 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 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

B16 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:

(a) for financial instruments traded in an active market the acquirer shall use current market values.

(b) for financial instruments not traded in an active market the acquirer shall use estimated values that take into consideration features such as price-earnings ratios, dividend yields and expected growth rates of comparable instruments of entities with similar characteristics.

(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 uncollectibility 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. If there is no market-based evidence of fair value because of the specialised nature of the item of plant and equipment and the item is rarely sold, except as part of a continuing business, an acquirer may need to estimate fair value using an income or a depreciated replacement cost approach.

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

(i) by reference to an active market as defined in IAS 38 *Intangible Assets*; 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 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 it will be available to the acquirer in the form of refunds from the plan or a reduction in future contributions.

(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 profit or loss in accordance with IAS 12 *Income Taxes*, 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 settling 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 settling the obligations determined at appropriate current interest rates.

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(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.

B17 Some of the above guidance requires fair values to be estimated using present value techniques. If the guidance for a particular item does not refer to the use of present value techniques, such techniques may be used in estimating the fair value of that item.

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Appendix C
Amendments to other IFRSs

The amendments in this appendix shall be applied to the accounting for business combinations for which the agreement date is on or after 31 March 2004, and to the accounting for any goodwill and intangible assets acquired in those business combinations. In all other respects, these amendments shall be applied for annual periods beginning on or after 31 March 2004.

However, if an entity elects in accordance with paragraph 85 to apply IFRS 3 from any date before the effective dates outlined in paragraphs 78-84, it shall also apply these amendments prospectively from that same date.

* * * * *

The amendments contained in this appendix when this IFRS was issued in 2004 have been incorporated into the relevant pronouncements published in this volume.

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Approval of IFRS 3 by the Board

International Financial Reporting Standard 3 *Business Combinations* was approved for issue by twelve of the fourteen members of the International Accounting Standards Board. Professor Whittington and Mr Yamada dissented. Their dissenting opinions are set out after the Basis for Conclusions on IFRS 3.

Sir David Tweedie	Chairman
Thomas E Jones	Vice-Chairman
Mary E Barth	
Hans-Georg Bruns	
Anthony T Cope	
Robert P Garnett	
Gilbert Gélard	
James J Leisenring	
Warren J McGregor	
Patricia L O'Malley	
Harry K Schmid	
John T Smith	
Geoffrey Whittington	
Tatsumi Yamada	

Basis for Conclusions

on

IFRS 3 Business Combinations

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Basis for Conclusions on IFRS 3 Business Combinations

This Basis for Conclusions accompanies, but is not part of, IFRS 3.

INTRODUCTION

BC1 This Basis for Conclusions summarises the Board's considerations in reaching the conclusions in IFRS 3 *Business Combinations*. Individual Board members gave greater weight to some factors than to others.

BC2 IAS 22 *Business Combinations* (revised in 1998) specified the accounting for business combinations. In 2001 the Board began a project to review IAS 22 as part of its initial agenda, with the objective of improving the quality of, and seeking international convergence on, the accounting for business combinations. The Board's project on business combinations has two phases. As part of the first phase, the Board published in December 2002 ED 3 *Business Combinations*, together with an Exposure Draft of proposed related amendments to IAS 38 *Intangible Assets* and IAS 36 *Impairment of Assets*, with a comment deadline of 4 April 2003. The Board received 136 comment letters.

BC3 The first phase resulted in the Board issuing simultaneously the IFRS and revised versions of IAS 36 and IAS 38. The Board's intention in developing the IFRS as part of the first phase of the project was not to reconsider all of the requirements in IAS 22. Instead, the Board's primary focus 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;

(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 Therefore, a number of the requirements in the IFRS were carried forward from IAS 22 without reconsideration by the Board. This Basis for Conclusions identifies those requirements but does not discuss them in detail.

BC5 The second phase of the Business Combinations project includes consideration of:

(a) issues arising in respect of the application of the purchase method, including its application to:

   (i) business combinations involving two or more mutual entities; and

   (ii) business combinations in which separate entities are brought together to form a reporting entity by contract alone without the obtaining of an ownership interest. This includes combinations in which separate entities are brought together by contract to form a dual listed corporation.

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(b) the accounting for business combinations in which separate entities or businesses are brought together to form a joint venture, including possible applications for 'fresh start' accounting.

(c) the accounting for business combinations involving entities under common control.

DEFINITION OF A BUSINESS COMBINATION

BC6 A business combination is defined in the IFRS as "the bringing together of separate entities or businesses into one reporting entity".

BC7 The Board concluded that the definition of a business combination should be broad enough to encompass all transactions that meet the business combination definition in IAS 22, ie all transactions or other events in which separate entities or businesses are brought together into one economic entity, regardless of the form of the transaction. In developing ED 3 and the ensuing IFRS, the Board considered the following description contained in the US Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 141 *Business Combinations* (SFAS 141):

> … a business combination occurs when an entity acquires net assets that constitute a business or acquires equity interests of one or more other entities and obtains control over that entity or entities. (paragraph 9)

BC8 The Board was concerned whether the above description would, in fact, encompass all transactions or other events in which separate entities or businesses are brought together into one economic entity. That concern stemmed from the use of the term 'acquires' in the above description, and its implication that a business combination is always the result of one entity acquiring control of one or more other entities or businesses, ie that all business combinations are acquisitions. The Board concluded that it should not rule out the possibility of some transaction or other event occurring or being structured in which separate entities or businesses are brought together into one economic entity, but without one of the combining entities acquiring control of the other combining entities or businesses. Therefore, the Board decided to develop a more general definition.

BC9 Given the Board's desire for the definition to encompass all transactions or other events that are, in substance, business combinations, regardless of their form, the Board decided to retain the IAS 22 definition, but with two modifications. The first was to remove the reference in that definition to the form that IAS 22 asserts a business combination might take (ie a uniting of interests or an acquisition). The second was to replace the reference to 'economic entity' with 'reporting entity' for consistency with the IASB's *Framework for the Preparation and Presentation of Financial Statements*. Paragraph 8 of the *Framework* states that it is concerned with the financial statements of reporting enterprises, and that a reporting enterprise is "an enterprise for which there are users who rely on the financial statements as their major source of financial information about the enterprise." The definition of reporting entity in the IFRS also clarifies that a reporting entity can be a single entity or a group comprising a parent and all of its subsidiaries.

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Definition of a business

BC10 ED 3 proposed to define a business combination as "the bringing together of separate entities or operations of entities into one reporting entity". Many respondents to ED 3 asked for additional guidance on identifying when an entity or a group of assets or net assets comprises an operation and when, therefore, the acquisition of an entity or a group of assets or net assets should be accounted for in accordance with the IFRS. As a result:

(a) references in ED 3 to 'operations' have been replaced in the IFRS with 'businesses'.

(b) 'business' has been defined in the IFRS (Appendix A) as follows:

> An integrated set of activities and assets conducted and managed for the purpose of providing:
>
> (a) a return to investors; or
>
> (b) lower costs or other economic benefits directly and proportionately to policyholders or participants.
>
> A business generally consists of inputs, processes applied to those inputs, and resulting outputs that are, or will be, used to generate revenues. If goodwill is present in a transferred set of activities and assets, the transferred set shall be presumed to be a business.

(c) additional guidance has been included in the IFRS to clarify that if an entity obtains control over one or more other entities that are not businesses, the bringing together of those entities is not a business combination. When a group of assets that does not constitute a business is acquired, the cost of the group of assets should be allocated between the individual identifiable assets in the group based on their relative fair values.

Replacing 'operations' with 'businesses'

BC11 As noted above, ED 3 proposed to define a business combination as "the bringing together of separate entities or operations of entities into one reporting entity". The Board observed that the definition of a discontinuing operation in IAS 35 *Discontinuing Operations* incorporates a definition of an operation for the purpose of applying the requirements in IAS 35. Similarly, the IFRS arising from ED 4 *Disposal of Non-current Assets and Presentation of Discontinued Operations* will include a definition of an operation to ensure its consistent application. The Board decided that it should eliminate any possible connection between the IFRS and the notion of an operation embedded in any current or future Standard on discontinuing operations. Therefore, the Board decided to replace references to operations in ED 3 with businesses, and to include in the IFRS guidance on identifying when an entity or a group of assets or net assets constitutes a business.

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Defining a business

BC12 Given its objective of seeking international convergence on the accounting for business combinations, the Board considered as its starting point the definition of a business and the related guidance in the US Emerging Issues Task Force (EITF) Consensus 98-3 *Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business*. For the reasons discussed in paragraphs BC13-BC15, the Board decided to proceed with a definition of a business that differs from the EITF's definition in the following ways:

(a) the IFRS definition does not require a business to be self-sustaining;

(b) the IFRS definition does not include a presumption that a transferred set of activities and assets in the development stage that has not commenced planned principal operations cannot be a business;

(c) the IFRS definition includes a presumption that a transferred set of activities and assets is a business when that transferred set includes goodwill; and

(d) the IFRS definition can also be applied in assessing whether an integrated set of activities and assets of a mutual entity is a business.

BC13 A transferred set of activities and assets must be self-sustaining to meet the EITF's definition of a business. The Board concluded that such a requirement is too narrow because it excludes some transferred sets of activities and assets that include goodwill (ie future economic benefits arising from assets that are not capable of being individually identified and separately recognised) and are, in substance, businesses. For example, the EITF's definition excludes from business combination accounting transactions in which one entity (the acquirer) acquires a business (the acquiree) with the intention of completely integrating the acquiree with its existing operations, but without taking over the acquiree's systems and senior management. Indeed, not taking over the existing systems and senior management may be a major part of the synergistic cost savings the acquirer is striving to achieve through the business combination. The Board concluded that an acquirer's decision not to retain all of the employees and not to acquire systems does not mean the net assets it acquired are not a business.

BC14 EITF 98-3 includes the presumption that if a transferred set of activities and assets is in the development stage and has not commenced planned principal operations, the set cannot be a business. The Board observed that a development stage entity might often include significant resources in the nature of goodwill. Those resources might arise, for example, from employment contracts with development engineers, a new technology nearing the final stage of development, the work performed to develop markets and customers or protocols and systems. The Board concluded that it would be more representationally faithful to account for the acquisition of such a transferred set as a business combination, thereby recognising any goodwill as a separate asset rather than having the value attributable to that goodwill subsumed within the carrying amounts of the other assets in the transferred set. Therefore, the Board decided not to include a similar presumption in the IFRS. The Board further concluded that to be representationally faithful, *any* transferred set of assets that includes goodwill should be accounted for as a business combination. Therefore, the Board decided that the definition of a business should include a presumption that if a transferred set of activities and assets includes goodwill, the transferred set should be presumed to be a business.

BC15 The EITF's definition states that the set of assets must be managed for the purpose of "providing a return to investors". The Board agreed that this would preclude sets of activities and assets of mutual entities from being regarded as businesses when those sets are, in substance, businesses. This is because a mutual entity is defined in the IFRS as "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." The Board decided that:

(a) the definition of a business should be able to be applied in assessing whether an integrated set of activities and assets of a mutual entity is a business; and

(b) therefore, a business should be defined in the IFRS as an integrated set of activities and assets conducted and managed for the purpose of providing a return to investors *or* lower costs or other economic benefits directly and proportionately to policyholders or participants.

SCOPE

Scope exclusions (paragraphs 2 and 3)

BC16 The IFRS does not apply to:

(a) business combinations in which separate entities or businesses are brought together to form a joint venture.

(b) business combinations involving entities or businesses under common control.

(c) business combinations involving two or more mutual entities.

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

IAS 22 similarly did not deal with the formation of joint ventures or transactions among enterprises under common control. However, IAS 22 included within its scope combinations involving two or more mutual entities, and combinations in which separate entities or businesses are brought together to form a reporting entity by contract alone without the obtaining of an ownership interest.

Business combinations involving the formation of a joint venture

BC17 Although the treatment by venturers of interests in joint ventures is addressed in IAS 31 *Interests in Joint Ventures*, the Board has not yet considered the accounting by a joint venture upon its formation. The issues involved relate to broader 'new basis' issues that the Board intends to address as part of the second phase of its Business Combinations project.

BC18 However, in developing ED 3 and the IFRS, the Board considered whether it should amend the definition of joint control in IAS 31. The Board decided to consider this issue because it was concerned that its decision to eliminate the pooling of interests method (see paragraphs BC37-BC55) would create incentives for business

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combinations to be structured to meet the definition of a joint venture. A joint venture is defined in IAS 31 as “a contractual arrangement whereby two or more parties undertake an economic activity that is subject to joint control.” Joint control was defined as “the contractually agreed sharing of control over an economic activity.”

BC19 The Board considered as a starting point the following definition proposed in the 1999 G4+1 discussion paper *Reporting Interests in Joint Ventures and Similar Arrangements*:

> Joint control over an enterprise exists when no one party alone has the power to control its strategic operating, investing, and financing decisions, but two or more parties together can do so, and each of the parties sharing control (joint venturers) must consent.

BC20 In developing ED 3, the Board decided that the definition of joint control should be more closely aligned with the definition proposed by the G4+1. ED 3 proposed amending the definition of joint control as follows:

> ***Joint control ~~is the contractually agreed sharing of control~~ over an economic activity exists only when the financial and operating decisions relating to the activity require the unanimous consent of the parties sharing control (the venturers).***

BC21 Many respondents to ED 3 suggested that, unlike the definition proposed by the G4+1, the above definition would result in a joint venture existing only when unanimous consent is required for all, rather than just strategic, financial and operating decisions. They recommended that the Board retain the former definition of joint control in IAS 31, pending a comprehensive review of that Standard.

BC22 The Board agreed with the respondents’ concerns that requiring unanimous consent on all financial and operating decisions would narrow by too far the types of arrangements meeting the definition of a joint venture. However, the Board remained concerned that the former definition of joint control could result in the requirement to apply the purchase method being circumvented when a business combination involves the owners of multiple businesses (for example, multiple medical practices) agreeing to combine their businesses into a new entity (sometimes referred to as roll-up transactions). In such circumstances, the owners of the combining businesses could avoid the requirement to apply the purchase method by contractually agreeing that all the essential strategic operating, investing, and financing decisions require the consent of a majority of the owners. The Board concluded that in the absence of a contractual agreement requiring unanimous consent to strategic operating, investing and financing decisions of the parties sharing control, such transactions should be accounted for by applying the purchase method.

BC23 As a result, the Board decided to amend the definition of joint control as follows:

> ***Joint control is the contractually agreed sharing of control over an economic activity, and exists only when the strategic financial and operating decisions relating to the activity require the unanimous consent of the parties sharing control (the venturers).***

Business combinations involving entities under common control (paragraphs 10-13)

BC24 Because the first phase of the project primarily dealt with the issues identified in paragraph BC3, the Board also decided to defer until the second phase of the project consideration of the accounting for business combinations involving entities or businesses under common control.

BC25 The former Standing Interpretations Committee (SIC) received numerous requests to clarify the types of transactions that were within the IAS 22 scope exclusion for transactions among enterprises under common control. The SIC concluded that, in the absence of authoritative guidance, the identification of transactions within the scope exclusion was likely to receive divergent or unacceptable treatment. Therefore, the SIC agreed in December 2000 to add this issue to its agenda. The SIC had not, however, completed its deliberations by the time the Board began the first phase of its Business Combinations project. In developing ED 3 and the IFRS the Board reached the same view as the SIC and agreed that the IFRS replacing IAS 22 should include authoritative guidance on this issue.

BC26 Because the IFRS addresses the accounting for business combinations and not other transactions, the Board concluded that the nature of the scope exclusion would be better expressed as 'business combinations involving entities or businesses under common control' rather than 'transactions among enterprises under common control'.

BC27 The IFRS defines a business combination involving entities or businesses under common control as a business combination in which all of the combining entities or businesses ultimately are controlled by the same party or parties both before and after the combination, and that control is not transitory. In arriving at this definition, and the related guidance in paragraphs 10-13, the Board first considered the meaning of common control. The Board noted that control is defined in IFRSs as the power to govern the financial and operating policies of an entity or business so as to obtain benefits from its activities. This definition requires consideration of direct and indirect relationships and is not limited to control by another entity; control can, for example, rest with an individual or a group of individuals acting collectively under contractual arrangements. In addition, the definition of control means that control of an entity can exist irrespective of the extent of minority interest in that entity. The Board also noted that the ordinary meaning of 'common' is a similarity shared by two or more things. Therefore, the Board concluded that entities or businesses are under common control when the same party or parties have the power to govern the financial and operating policies of those entities or businesses so as to obtain benefits from their activities. The Board further concluded that for a business combination to involve entities or businesses under common control, the combining entities or businesses would need to be controlled by the same party or parties both before and after the combination.

BC28 The Board noted the concern expressed by some that business combinations between parties acting at arm's length could be structured through the use of 'grooming' transactions so that, for a brief period immediately before the combination, the combining entities or businesses are under common control. In this way, it might be possible for combinations that would otherwise be accounted for in accordance with the IFRS using the purchase method to be accounted for using some other method. Thus, the Board decided that for a business combination to be excluded

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from the scope of the IFRS as one involving entities or businesses under common control, the combining entities or businesses should be controlled by the same party or parties both before and after the combination, and that control should not be transitory.

Combinations involving mutual entities or the bringing together of separate entities to form a reporting entity by contract alone

BC29 The Board decided to exclude from the scope of the IFRS the following business combinations:

(a) combinations involving two or more mutual entities.

(b) combinations in which separate entities are brought together to form a reporting entity by contract alone without the obtaining of an ownership interest. This includes combinations in which separate entities are brought together by contract to form a dual listed corporation.

BC30 ED 3 did not propose to exclude such transactions from the scope of the IFRS, but instead proposed to delay the application of the IFRS to the accounting for such transactions until the Board issues guidance on the application of the purchase method to those transactions. In developing ED 3, the Board observed that differences between the ownership structures of mutual entities (such as mutual insurance companies or mutual cooperative entities) and those of investor-owned entities give rise to complications in applying the purchase method to business combinations involving two or more mutual entities. Similarly, the Board noted that complications arise in applying the purchase method to combinations involving the formation of a reporting entity by contract alone without the obtaining of an ownership interest. The Board decided to propose in ED 3 that until those issues are resolved as part of the second phase of the Business Combinations project, the accounting for such transactions should continue to be dealt with by IAS 22.

BC31 During its redeliberations, the Board observed that continuing to apply IAS 22 to such transactions would result in them being classified either as unitings of interests or as acquisitions. If such a transaction were classified as a uniting of interests, it would be required by IAS 22 to be accounted for by applying the pooling of interests method. The Board decided that this would not be consistent with its conclusion that there are no circumstances in which the pooling of interests method provides information superior to that provided by the purchase method (see paragraphs BC50-BC53). The Board also observed that if such a transaction were classified as an acquisition, it would be required by IAS 22 to be accounted for by applying the purchase method, but a different version of the purchase method from that contained in the IFRS. The Board considered it troublesome that two versions of the purchase method might co-exist for a period of time, particularly given that the two versions might produce quite different results. For example, unlike the IFRS, IAS 22 would require goodwill amortisation and permit restructuring plans that do not meet the definition of a liability to be recognised as a provision as part of allocating the cost of the combination.

BC32 The Board then considered whether entities should be required to apply the IFRS to such transactions, focusing its discussion on two issues that might arise in applying the purchase method to those transactions. The first was the proposition that it might be difficult to identify the acquirer. The second was the concern that such transactions normally do not involve the payment of any readily measurable consideration. Thus, difficulties would arise in estimating the cost of the business combination and any goodwill acquired in the combination.

BC33 On the first issue, the Board reaffirmed its conclusion outlined in paragraphs BC54 and BC55.

BC34 On the second issue, the Board decided that until it develops as part of the second phase of its Business Combinations project guidance on applying the purchase method to such transactions, the IFRS should include such transactions within its scope. However, the IFRS should require the aggregate fair value of the acquiree's identifiable assets, liabilities and contingent liabilities to be treated as the deemed cost of the business combination. Therefore, until guidance is developed as part of the second phase of the Business Combinations project on estimating the fair value of an acquiree when the combination does not involve readily measurable consideration, no goodwill would arise in the accounting for such transactions. The Board decided, however, that it would not be appropriate to incorporate this interim solution into the IFRS without first exposing it for public comment. Therefore, given the Board's desire to issue the IFRS before the end of March 2004, the Board decided:

(a) to proceed with publishing the IFRS before the end of March 2004, but to exclude such transactions from its scope.

(b) to publish at about the same time as the IFRS an exposure draft proposing a limited amendment to the IFRS whereby such transactions would be included within the scope of the IFRS, but with the aggregate fair value of the acquiree's identifiable assets, liabilities and contingent liabilities being treated as the deemed cost of the combination.

Scope inclusions (paragraph 8)

BC35 The Board concluded that, because the first phase of the project dealt primarily with the issues identified in paragraph BC3, the IFRS should apply to the same transactions as IAS 22. The Board observed that the definition of a business combination in IAS 22, and therefore the scope of IAS 22, included combinations in which one entity obtains control of another, but for which the date of obtaining control (the acquisition date) does not coincide with the date of acquiring an ownership interest (the date of exchange). This might occur, for example, when an investee enters into share buy-back arrangements with some of its investors and, as a result of those arrangements, control of the investee changes.

BC36 However, the Board noted that some constituents might not have appreciated this implication of IAS 22's scope. Accordingly, the Board decided that the IFRS should explicitly state that such transactions are within its scope.

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METHOD OF ACCOUNTING (paragraph 14)

BC37 ED 3 proposed, and the IFRS requires, all business combinations within its scope to be accounted for using the purchase method. IAS 22 permitted business combinations to be accounted for using one of two methods: the pooling of interests method for combinations classified as unitings of interests and the purchase method for combinations classified as acquisitions.

BC38 Although IAS 22 tightly restricted the scope of business combinations that could be accounted for using the pooling of interests method, analysts and other users of financial statements indicated that permitting two methods of accounting for business combinations impaired the comparability of financial statements. Others indicated that requiring more than one method of accounting for substantially similar transactions created incentives for structuring transactions to achieve a desired accounting result, particularly given that the two methods produce substantially different results. These factors, combined with the prohibition of the pooling of interests method in Australia, Canada and the United States, prompted the Board to examine whether, given that few combinations were understood to be accounted for in accordance with IAS 22 using the pooling of interests method, it would be advantageous for international standards to converge with those in Australia and North America by also prohibiting the method.

BC39 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. However, 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 entities does not obtain control of the other combining entity or entities (often referred to as a 'true merger' or 'merger of equals').

BC40 Therefore, the Board focused first on the appropriate method of accounting for business combinations in which one entity obtains control of another entity or business. Next it considered the method of accounting that should be applied to those business combinations within the scope of the IFRS for which one of the combining entities does not obtain control of the other combining entity (or entities), assuming such transactions exist.

BC41 For the reasons discussed in paragraphs BC44-BC46, the Board concluded that the purchase method is the appropriate method of accounting for business combinations in which one entity obtains control of another entity (or entities) or business(es).

BC42 As discussed in paragraphs BC47-BC49, the Board concluded that the IFRS arising from the first phase of the project should also require the purchase method to be applied to those combinations within its scope for which one of the combining entities does not obtain control of the other combining entity. The Board acknowledged, however, that a case might be made for using the 'fresh start' method to account for such business combinations. The fresh start method derives from the view that a new entity emerges as a result of such a business combination. Therefore, a case can be made that the assets and liabilities of each of the combining entities, including assets and liabilities not previously recognised, should be recognised by the new entity at their fair values. However, the Board observed that to the best of its knowledge the

fresh start method is not currently applied in any jurisdiction in accounting for business combinations, and that one of the primary aims of the first phase of the project is to seek international convergence on the method(s) of accounting for combinations. Therefore, the Board committed itself to exploring in a future phase of its Business Combinations project whether the fresh start method might be applied to some combinations. The Board noted, however, that business combinations to which the fresh start method might be applied would not necessarily be all of those that would be classified by IAS 22 as unitings of interests and accounted for by applying the pooling of interests method. Consequently, the pooling of interests method in IAS 22 could not simply be replaced with the fresh start method.

BC43 Most of the respondents to ED 3 supported the proposal to eliminate the pooling of interests method and require all business combinations to be accounted for by applying the purchase method, pending the Board's future consideration of whether the fresh start method might be applied to some combinations.

Business combinations in which one of the combining entities obtains control

BC44 The Board concluded that the purchase method is the only appropriate method of accounting for business combinations in which one entity obtains control of one or more other entities or businesses. The purchase method views a combination from the perspective of the combining entity that is the acquirer (ie the combining entity that obtains control of the other combining entities or businesses). The acquirer purchases net assets and recognises in its financial statements the assets acquired and liabilities and contingent liabilities assumed, including those not previously recognised by the acquiree. The nature of the consideration exchanged does not affect the recognition or measurement of the assets acquired and liabilities and contingent liabilities assumed. 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 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 as a result of the transaction, because they are not involved in the transaction. Therefore, the purchase method faithfully represents the underlying economics of business combinations in which one entity obtains control of another entity or business.

BC45 The *Framework* notes that one of the objectives of financial statements is to show the accountability of management for the resources entrusted to it. Because the purchase method recognises the values exchanged in a business combination, it provides users of an entity's financial statements with more useful information for assessing the investment made by management and the subsequent performance of that investment. In addition, by recognising at their fair values all of the assets acquired and liabilities and contingent liabilities assumed, the purchase method impounds information from the current transaction about the expected future cash flows associated with the assets acquired and liabilities and contingent liabilities assumed, thereby providing greater predictive value.

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BC46 The Board considered the assertion that identifying the fair values of assets acquired and liabilities and contingent liabilities assumed in such business combinations is too costly or too difficult, particularly when the assets and liabilities are not traded regularly. The Board concluded that the benefits of obtaining more useful financial information by applying the purchase method outweigh the costs to obtain fair values, and that an understanding by the acquirer of the fair values of the assets acquired and the liabilities and contingent liabilities assumed would be necessary to arrive at an acceptable exchange value for the combination. Therefore, any additional costs or difficulties associated with recognising those assets, liabilities and contingent liabilities at their fair values are unlikely to be significant.

Business combinations in which none of the combining entities obtains control

BC47 As noted above, the Board decided that it should not, in the first phase of its Business Combinations project, rule out the possibility of a combination occurring (other than a combination involving the formation of a joint venture) in which one of the combining entities does not obtain control of the other combining entity or entities. Such combinations are sometimes referred to as 'true mergers' or 'mergers of equals'.

BC48 The Board concluded that even if 'true mergers' exist and were to be accounted for using a method other than the purchase method, suitable non-arbitrary and unambiguous criteria would be needed to distinguish those transactions from business combinations in which one entity obtains control of another entity (or entities). The Board observed that such criteria do not exist at present and, based on the history of the pooling of interests method, would be likely to take considerable time, and be extremely difficult, to develop. The Board also noted that:

(a) one of its primary aims in the first phase of the project is to seek international convergence on the method(s) of accounting for business combinations.

(b) permitting more than one method of accounting for combinations would create incentives for structuring transactions to achieve a desired accounting result, particularly given that the different methods (ie the purchase method and the pooling of interests method) produce significantly different accounting results.

(c) true mergers, assuming they exist, are likely to be rare.

(d) it does not follow that the pooling of interests method is the appropriate method of accounting for true mergers, assuming they exist. For the reasons outlined in paragraphs BC50-BC53, the Board concluded that in no circumstances does the pooling of interests method provide information superior to that provided by the purchase method, and that if true mergers were to be accounted for using a method other than the purchase method, the 'fresh start' method was likely to be more appropriate than the pooling of interests method.

BC49 Therefore, the Board concluded that the IFRS arising from the first phase of the project should require all business combinations to be accounted for by applying the purchase method. However, as discussed in paragraph BC42, the Board committed itself to exploring in a future phase of its Business Combinations project whether the 'fresh start' method might be applied to some combinations.

Reasons for rejecting the pooling of interests method

BC50 IAS 22 permitted business combinations to be accounted for using one of two methods: the pooling of interests method or the purchase method. These methods were not regarded as alternatives for the same form of business combination either in IAS 22 or the equivalent accounting standards in other jurisdictions that permitted the use of the two methods. Rather, each method applied to a specific form of business combination: the purchase method to those that were acquisitions (ie business combinations in which one entity obtains control of another entity or business), and the pooling of interests method to those that were 'true mergers' or 'unitings of interest'. Standard-setters disagree about the precise meaning of the term 'true merger'. However, the Board's deliberations on applying the pooling of interests method to true mergers focused on combinations in which one of the combining entities does not obtain control of the other combining entity or entities. The Board concluded that the pooling of interests method should not be applied to such transactions because in no circumstances does it provide information superior to that provided by the purchase method.

BC51 Use of the pooling of interests method was limited to business combinations in which equity was the predominant form of consideration. Assets and liabilities of the combining entities were carried forward at their pre-combination book values, and no additional assets or liabilities were recognised as a result of the combination. The Board considered the assertion that the pooling of interests method is appropriate for true mergers because, in such transactions, ownership interests are completely or substantially continued, no new equity is invested and no assets are distributed, post-combination ownership interests are proportional to those before the combination, and the intention is to have a uniting of commercial strategies. The Board rejected these arguments, noting that although a combination effected by an exchange of equity instruments results in the continuation of ownership interests, those interests *change* as a result of the combination. The owners of the combining entities have, as a result of the combination, a residual interest in the net assets of the combined entity. The information provided by applying the pooling of interests method would fail to reflect this and would therefore lack relevance. Because the assets and liabilities of all the combining entities would be recognised at their pre-combination book values rather than at their fair values at the date of the combination, users of the combined entity's financial statements would be unable to assess reasonably the nature, timing and extent of future cash flows expected to arise from the combined entity as a result of a combination. Furthermore, the Board does not accept that the nature of the consideration tendered (equity interests in the case of true mergers) should dictate how the assets and liabilities of the combining entities are recognised.

BC52 The Board also considered the assertion that the pooling of interests method properly portrays true mergers as a transaction between the owners of the combining entities rather than between the combining entities. The Board rejected this assertion, noting that business combinations are initiated by, and take place as a result of, a transaction between the entities themselves. It is the entities, and not their owners, that engage in the negotiations necessary to carry out the combination, although obviously the owners must eventually participate in and approve the transaction.

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BC53 The *Framework* notes that one of the objectives of financial statements is to show the accountability of management for the resources entrusted to it. The Board observed that the pooling of interests method is an exception to the general principle that exchange transactions are accounted for at the fair values of the items exchanged. Because it ignores the values exchanged in the business combination, the information provided by applying the pooling of interests method does not hold management accountable for the investment made and its subsequent performance.

Business combinations in which it is difficult to identify an acquirer

BC54 The Board observed that in some business combinations, domestic legal, taxation or economic factors can make it extremely difficult to identify an acquirer. This can occur, for example, when entities of similar sizes or capitalisations come together through industry restructurings, with existing managements and staff retained and integrated. The Board considered arguments about whether such factors could make it impossible to identify an acquirer in a business combination and, if so, whether the pooling of interests method should be permitted in such circumstances. The Board also considered whether applying the purchase method to combinations for which identifying the acquirer is difficult could result in an arbitrary selection of an acquirer and therefore be detrimental to the comparability of accounting information. As part of its deliberations, the Board considered case studies that related to situations encountered in practice.

BC55 Whilst acknowledging that it could be difficult to identify an acquirer in some rare circumstances, the Board did not agree that exceptions to applying the purchase method should be permitted. The Board concluded that in no circumstances does the pooling of interests method provide superior information to that provided by the purchase method, even if identifying the acquirer is problematic.

APPLICATION OF THE PURCHASE METHOD

Identifying an acquirer (paragraphs 17-23)

BC56 As proposed in ED 3, the IFRS carries forward from IAS 22 the principle that, in a business combination accounted for using the purchase method, the acquirer is the combining entity that obtains control of the other combining entities or businesses. In developing ED 3 and the IFRS, the Board observed that the use of the control concept as the basis for identifying the acquirer is consistent with the use of the control concept in IAS 27 *Consolidated and Separate Financial Statements* to define the boundaries of the reporting entity and provide the basis for establishing the existence of a parent-subsidiary relationship. The IFRS also carries forward the guidance in paragraphs 10 and 11 of IAS 22 on control and identifying an acquirer.

Identifying an acquirer in a business combination effected through an exchange of equity interests (paragraph 21)

BC57 In developing ED 3 and the IFRS, the Board decided not to carry forward paragraph 12 of IAS 22, which provided guidance on identifying which of the combining entities is the acquirer when one entity (say entity A) obtains ownership of the equity instruments of another entity (entity B) but, as part of the exchange transaction, issues

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enough of its own voting equity instruments as purchase consideration for control of the combined entity to pass to the owners of entity B. IAS 22 described such a situation as a reverse acquisition and required the entity whose owners control the combined entity to be treated as the acquirer. The Board observed that such an approach to identifying the acquirer presumed that for any business combination effected through an exchange of equity interests, the entity whose owners control the combined entity is always the entity with the power to govern the financial and operating policies of the other entity so as to obtain benefits from its activities. The Board observed that this is not always the case and that carrying forward such a presumption to the IFRS would in effect override the control concept for identifying the acquirer.

BC58 The Board noted that the control concept focuses on the relationship between two entities, in particular, whether one entity has the power to govern the financial and operating policies of another so as to obtain benefits from its activities. Therefore, the Board concluded that fundamental to identifying the acquirer in a business combination is a consideration of the relationship between the combining entities to determine which of them has, as a consequence of the combination, the power to govern the financial and operating policies of the other so as to obtain benefits from its activities. The Board concluded that this should be the case irrespective of the form of the purchase consideration.

BC59 The Board also observed that there might be instances in which the acquirer is the entity whose equity interests have been acquired and the issuing entity is the acquiree. This might occur, for example, when a private entity arranges to have itself 'acquired' by a smaller public entity through an exchange of equity interests as a means of obtaining a stock exchange listing and, as part of the agreement, the directors of the public entity resign and are replaced with directors appointed by the private entity and its former owners. The Board observed that in such circumstances, the private entity (ie the legal subsidiary) has the power to govern the financial and operating policies of the combined entity so as to obtain benefits from its activities. Therefore, treating the legal subsidiary as the acquirer in such circumstances is consistent with applying the control concept for identifying the acquirer.

BC60 As a result, the Board concluded that the IFRS should require the acquirer in a business combination effected through an issue of equity interests to be identified on the basis of a consideration of all pertinent facts and circumstances, including but not limited to the relative ownership interests of the owners of the combining entities, to determine which of those entities has the power to govern the financial and operating policies of the other so as to obtain benefits from its activities. Respondents to ED 3 generally supported this conclusion.

BC61 The Board also considered the assertion that, although consistent with the control concept, treating the legal subsidiary as the acquirer in the circumstances described in paragraph BC59 produces an accounting result that:

(a) is difficult for users to understand; and

(b) provides less relevant information than would be the case if the legal parent (ie the entity providing the consideration) were treated as the acquirer.

The Board concluded that treating the legal parent as the acquirer in such circumstances places the form of the transaction over its substance, thereby providing less useful information than is provided using the control concept to identify

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the acquirer. Therefore, the Board concluded that the IFRS should not include any departures from the control concept to identify an acquirer.

Identifying an acquirer when a new entity is formed to effect a business combination (paragraphs 22 and 23)

BC62 ED 3 proposed, and the IFRS requires, 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 identified as the acquirer on the basis of the evidence available. In deciding to include this requirement in the IFRS, the Board identified two approaches to the purchase method that had been applied in various jurisdictions. The first approach viewed business combinations from the perspective of one of the combining entities that existed before the combination, ie the acquirer must be one of the combining entities that existed before the combination and therefore cannot be a new entity formed to issue equity instruments to effect a combination. The second approach viewed business combinations from the perspective of the entity, which could be a newly formed entity, providing the consideration, ie the acquirer must be the entity providing the consideration. The Board noted that whereas some jurisdictions had interpreted IAS 22 as requiring the acquirer to be identified as one of the combining entities that existed before the combination, other jurisdictions had interpreted IAS 22 as requiring the entity, which could be a newly formed entity, providing the purchase consideration to be treated as the acquirer.

BC63 The Board observed that if a new entity is formed to issue equity instruments to effect a business combination between, for example, two other entities, viewing the combination from the perspective of the entity providing the consideration would result in the newly formed entity applying the purchase method to each of the two other combining entities. This would, in effect, produce a business combination accounted for as a fresh start. The Board noted that this would potentially provide users of the financial statements with more relevant information than an approach in which one of the pre-existing combining entities must be treated as the acquirer.

BC64 The Board also noted that some of the issues that arise under an approach in which one of the pre-existing combining entities must be treated as the acquirer do not arise if the entity providing the purchase consideration is treated as the acquirer. For example, treating one of several combining entities as the acquirer when those separate entities are brought together to form a new consolidated group might require one of those pre-existing entities to be arbitrarily selected as the acquirer. The Board agreed that the usefulness of the information provided in such circumstances is questionable. If the entity providing the purchase consideration is treated as the acquirer, that entity would be regarded as having obtained control of each of the pre-existing combining entities and would therefore apply the purchase method to each of the combining entities.

BC65 The Board also considered the assertion that treating as the acquirer a new entity formed to issue equity instruments to effect a business combination places the form of the transaction over its substance, because the new entity may have no economic substance. The formation of such entities is often related to legal, tax or other business considerations that do not affect the identification of the acquirer. For example, a combination between two entities that is structured so that one entity directs the formation of a new entity to issue equity instruments to the owners of both

of the combining entities is, in substance, no different from a transaction in which one of the combining entities directly acquires the other. Therefore, the transaction should be accounted for in the same way as a transaction in which one of the combining entities directly acquires the other. Those supporting this approach argue that to do otherwise would impair the usefulness of the information provided to users about the combination, because both comparability and reliability (which rests on the notions of accounting for the substance of transactions and representational faithfulness, ie that similar transactions are accounted for in the same way) are diminished.

BC66 In developing ED 3 and the IFRS, the Board concluded that the users of an entity's financial statements are provided with more useful information about a business combination when that information represents faithfully the transaction it purports to represent. Therefore, the Board concluded that the IFRS should adopt the approach in which a business combination is viewed from the perspective of one of the combining entities that existed before the combination. In other words, the acquirer must be one of the combining entities that existed before the combination and therefore cannot be a new entity formed to issue equity instruments to effect a combination.

Cost of a business combination (paragraphs 24-35)

BC67 As proposed in ED 3, the IFRS carries forward from IAS 22, without reconsideration, the principle that the cost of a business combination should be 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 instruments issued by the acquirer, in exchange for control over the acquiree; plus any costs directly attributable to the business combination. The IFRS also incorporates, without reconsideration:

(a) the requirements of SIC-28 *Business Combinations—"Date of Exchange" and Fair Value of Equity Instruments* on the distinction between the date of exchange and the acquisition date, and, with one amendment (see paragraph BC69), measuring the fair value of equity instruments issued as part of the cost of a business combination;

(b) the requirement previously in paragraph 23 of IAS 22 on the treatment of the cost of a business combination when settlement of all or any part of that cost is deferred; and

(c) the requirements previously in paragraphs 65-70 of IAS 22 on adjustments to the cost of a business combination.

The Board is reconsidering these requirements as part of the second phase of its project.

BC68 The Basis for Conclusions on SIC-28 provided information on how the former Standing Interpretations Committee reached its consensus on the issues in (a) above (ie the distinction between the date of exchange and the acquisition date, and measuring the fair value of equity instruments issued as part of the cost of a combination). That Basis for Conclusions stated the following:

> …when an acquisition is achieved in stages, the distinction between the date of acquisition and the date of the exchange transaction is important. When an acquisition is achieved in one exchange transaction there is no distinction between the date of exchange and the date of acquisition. Sub-paragraph 100(a) of the Framework indicates that when assets are recorded at their historical cost, the assets are recorded at the fair

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> value of the purchase consideration given to acquire them at the time of their acquisition. Therefore, when a business is acquired in one exchange transaction (i.e., not in stages), the fair value of the purchase consideration given is determined when control … of the net assets and operations of the acquiree is effectively transferred to the acquirer. When a business is acquired in stages (e.g., successive share purchases), the fair value of the purchase consideration given at each stage is determined when each individual investment is recognised in the financial statements of the acquirer.
>
> …marketable securities issued by the acquirer are measured at their fair value, which is their market price as at the date of the exchange transaction, provided that undue fluctuations or the narrowness of the market do not make the market price an unreliable indicator. Under IAS 39, an investment in an equity instrument is measured at its fair value, except in specified circumstances. Equity instruments have only one fair value in a market. IAS 39 … indicates that the existence of published price quotations in an active market is normally the best evidence of fair value. Therefore, estimates of premiums for large, and discounts for small, blocks of equity instruments issued in comparison to that exchanged in observable transactions are not considered. When the published price of a quoted equity instrument on the date of an exchange is determined to be an unreliable indicator of its fair value, the information necessary to reliably estimate the effect of the undue fluctuation or market narrowness at that date is unlikely to be available due to the many factors that affect prices. Consequently, other evidence and valuation methods for determining fair value are considered only in the rare circumstance when it can be demonstrated that the published price is an unreliable indicator and that the other evidence and valuation methods provide a more reliable estimate of the equity instrument's fair value at the date of exchange.

BC69 SIC-28 stated that the published price of an equity instrument issued as part of the cost of a business combination is an unreliable indicator of fair value only when it has been affected by an undue price fluctuation or a narrowness of the market. The Board is of the view that the only circumstance in which the published price of an equity instrument is an unreliable indicator of its fair value is when the published price has been affected by the thinness of the market. Therefore, the Board decided to amend accordingly the requirements of SIC-28 included in the IFRS.

BC70 As proposed in ED 3, the IFRS includes additional guidance clarifying that future losses or other costs expected to be incurred as a result of a business combination cannot be included as part of the cost of the combination. The Board observed that those future losses or other costs do not satisfy the definition of a liability and therefore are not liabilities incurred by the acquirer in exchange for control over the acquiree, nor liabilities of the acquiree assumed by the acquirer. In the Board's view, future losses or other costs expected to be incurred as a result of a business combination should not have been included as part of the 'cost of acquisition' in accordance with IAS 22, but the Board noted that this was not stated explicitly in IAS 22. The IFRS states explicitly that this is the case to ensure that future losses or other costs expected to be incurred as a result of a business combination are treated consistently by all entities.

Costs directly attributable to the business combination (paragraphs 29-31)

BC71 Paragraph 25 of IAS 22 indicated that direct costs relating to an acquisition include the costs of registering and issuing equity instruments, and professional fees paid to accountants, legal advisers, valuers and other consultants to effect the acquisition. The Board noted that treating the costs of registering and issuing equity instruments as costs directly attributable to a business combination is inconsistent with the

treatment of such costs in the jurisdictions of its partner standard-setters. It is also inconsistent with the conclusion reached by the G4+1 group of standard-setters at its meeting in August 1998, namely that transaction costs arising on the issue of equity instruments are an integral part of the equity issue transaction and should be recognised directly in equity as a reduction of the proceeds of the equity instruments. The Board observed that treating the transaction costs as a reduction of the proceeds of the equity instruments issued is consistent with the treatment of such costs in accordance with IAS 32 *Financial Instruments: Disclosure and Presentation* in circumstances involving the issue of equity instruments other than to effect a business combination.

BC72 Therefore, the Board concluded that the IFRS should not carry forward the requirement in IAS 22 for the costs of registering and issuing equity instruments to be treated as costs directly attributable to a business combination.

BC73 As part of the first phase of the project, the Board considered issues raised by constituents as part of the Improvements project that related to IAS 22. One of the issues raised was whether the costs of arranging financial liabilities for the purpose of acquisition financing are costs directly attributable to the acquisition and therefore part of the cost of acquisition. Consistently with its conclusions about the costs of registering and issuing equity instruments, the Board concluded that the costs of arranging and issuing financial liabilities are an integral part of the liability and, in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*, should be included in the initial measurement of the liability rather than as part of the costs directly attributable to a business combination.

Allocating the cost of a business combination (paragraphs 36-60)

Recognising the identifiable assets acquired and liabilities and contingent liabilities assumed (paragraphs 36-50)

BC74 With the exception of the separate recognition of an acquiree's intangible assets, the IFRS carries forward the general principle previously in paragraphs 19 and 26-28 of IAS 22. That principle required an acquirer to recognise separately, from the acquisition date, the acquiree's identifiable assets and liabilities at that date that can be measured reliably and for which it is probable that any associated future economic benefits will flow to, or resources embodying economic benefits will flow from, the acquirer. The IFRS also carries forward:

(a) the requirement previously in paragraph 19 of IAS 22 for the acquirer's income statement to incorporate the acquiree's profits and losses from the acquisition date;

(b) the guidance previously in paragraph 20 of IAS 22 on determining the acquisition date; and

(c) the prohibition previously in paragraph 29 of IAS 22 on recognising as part of allocating the cost of a business combination provisions for future losses or other costs expected to be incurred as a result of the combination.

BC75 However, the IFRS changes the requirements previously in IAS 22 on separately recognising the following items as part of allocating the cost of a combination:

(a) provisions for terminating or reducing the activities of the acquiree; and

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(b) contingent liabilities of the acquiree.

The IFRS also clarifies the criteria for separately recognising intangible assets of the acquiree as part of allocating the cost of a combination, and includes guidance on the treatment of payments that an entity is contractually required to make if it is acquired in a business combination.

Provisions for terminating or reducing the activities of the acquiree

BC76 IAS 22 contained one exception to the general principle that an acquirer should recognise separately, from the acquisition date, only those liabilities of the acquiree that existed at the acquisition date and satisfy the recognition criteria. The exception related to provisions for terminating or reducing the activities of the acquiree that were not liabilities of the acquiree at the acquisition date. Paragraph 31 of IAS 22 required the acquirer to recognise as part of allocating the cost of a 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 had satisfied the following criteria:

(a) at or before the acquisition date it had developed the main features of a plan that involved terminating or reducing the activities of the acquiree and related to:

  (i) compensating employees of the acquiree for terminating their employment;

  (ii) closing the facilities of the acquiree;

  (iii) eliminating product lines of the acquiree; or

  (iv) terminating contracts of the acquiree that had become onerous because the acquirer had communicated to the other party, at or before the acquisition date, that the contract would be terminated;

(b) raised a valid expectation in those affected by the plan that the plan will be implemented by announcing, at or before the acquisition date, the plan's main features; and

(c) by the earlier of three months after the acquisition date and the date when the annual financial statements are authorised for issued, developed those main features into a detailed formal plan.

BC77 The general criteria for identifying and recognising restructuring provisions are in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. IAS 37 states that a constructive obligation to restructure (and therefore a liability) arises only when the entity has developed a detailed formal plan for the restructuring and either raised a valid expectation in those affected that it will carry out the restructuring by publicly announcing details of the plan or begun implementing the plan. Such a liability is required to be recognised in accordance with IAS 37 when it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation, and a reliable estimate can be made of the amount of the obligation.

BC78 The Board observed that the requirement in IAS 22 for the acquirer to recognise a restructuring provision that was not a liability of the acquiree at the acquisition date provided specified criteria were met leads to different accounting, depending on whether a plan to restructure arose in connection with, or in the absence of, a business combination. The Board agreed that it should not, as part of its Business

Combinations project, reconsider the general requirements in IAS 37 on the identification and recognition of restructuring provisions, but that it should consider whether the differences in accounting should be carried forward in the IFRS arising from the first phase of that project.

BC79 In developing ED 3 and the IFRS, the Board considered the view that a restructuring provision that was not a liability of the acquiree at the date of acquisition should nonetheless be recognised by the acquirer as part of allocating the cost of the combination if the decision to terminate or reduce the activities of the acquiree is communicated at or before the acquisition date to those likely to be affected and, within a limited time after the acquisition date, a detailed formal plan for the restructuring is developed. Those supporting this view, including some respondents to ED 3, argued that:

(a) the estimated cost of terminating or reducing the activities of the acquiree would have influenced the price paid by the acquirer for the acquiree and therefore should be taken into account in measuring goodwill; and

(b) the acquirer is committed to the costs of terminating or reducing the activities of the acquiree as a result of the business combination: in other words, the combination is the past event that gives rise to a present obligation to terminate or reduce the activities of the acquiree.

BC80 The Board rejected these arguments, noting that the price paid by the acquirer would also be influenced by future losses and other 'unavoidable' costs that relate to the future conduct of the business, such as costs of investing in new systems. Such costs are not recognised as liabilities as part of allocating the cost of the business combination because they do not represent liabilities or contingent liabilities of the acquiree at the acquisition date, although the expected future outflows may affect the value of existing recognised assets. The Board also agreed that it is inconsistent to argue that when a business combination gives rise to 'unavoidable' restructuring costs, the combination is a past event giving rise to a present obligation, but to prohibit recognition of a liability for other 'unavoidable' costs to be incurred as a result of the combination as part of allocating the cost.

BC81 The Board also noted the assertion that the necessary condition for the existence of a constructive obligation for restructuring is the creation of a valid expectation in those affected that it will carry out the restructuring by beginning implementation or by a sufficiently specific announcement. As a result, some argue that satisfying the criteria previously in paragraph 31 of IAS 22 is sufficient to establish the existence, at the acquisition date, of a liability for terminating or reducing the activities of the acquiree. Based on the *Framework*, a liability for terminating or reducing the activities of the acquiree does not exist at the acquisition date unless at that date there is a present obligation (legal or constructive) for the costs of terminating or reducing the acquiree's activities arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits. Based on the conclusions reached in IAS 37, this will be the case only when, before the acquisition date, firm contracts for the restructuring have been entered into, or a detailed formal plan for the restructuring has been developed, and a valid expectation has been raised in those affected (either by a public announcement of the main features of the plan or by the start of its implementation) that the restructuring will be carried out. The Board decided that any reconsideration of the necessary conditions that must be

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satisfied for a constructive obligation for restructuring to exist should be part of a future project on IAS 37, and not part of the Business Combinations project, because it relates to broader issues associated with the existence of obligations for restructurings generally.

BC82 The Board concluded that if the criteria previously in paragraph 31 of IAS 22 for the recognition of a restructuring provision were carried forward, similar items would be accounted for in dissimilar ways because the timing of the recognition of restructuring provisions would differ, depending on whether a plan to restructure arises in connection with, or in the absence of, a business combination. The Board agreed that this would impair the usefulness of the information provided to users about an entity's plans to restructure, because both comparability and reliability would be diminished.

BC83 The Board considered the concern expressed by some that removing the exception in IAS 22 would simply open the way to accounting that achieves the same result by other means. For example, the acquiree, on the instructions of the acquirer, might enter into obligations to restructure the business before the formal transfer of control. The Board considered the suggestions that to overcome the potential for entities to structure business combinations so as to achieve a desired outcome, the IFRS should require either of the following:

(a) prohibiting restructuring provisions that *are* recognised liabilities of the acquiree at the acquisition date from being recognised as part of allocating the cost of the combination (and therefore from the determination of goodwill or any excess of the acquirer's interest in the net fair value of the acquiree's identifiable net assets over the cost of the combination). Under such an approach, the acquiree's existing liability would be excluded from the acquiree's pre-combination net assets and instead treated as arising after the combination.

(b) continuing to permit recognition of restructuring provisions that are not liabilities of the acquiree at the acquisition date as part of allocating the cost of the combination provided that, within a limited time after the combination, the decision to terminate or reduce the activities of the acquiree is communicated to those likely to be affected, and a detailed formal plan for the restructuring is developed.

BC84 The Board observed that for the acquirer to have, in effect, the 'free choice' to recognise a liability as part of allocating the cost of the business combination requires such a level of cooperation between the acquirer and acquiree that the acquiree, on the instructions of the acquirer, would enter into obligations to restructure the business before the formal transfer of control. The Board concluded that possible cooperation between parties to a combination does not provide sufficient justification for departing from the *Framework* and treating post-combination liabilities as arising before the combination or pre-combination liabilities as arising after the combination.

BC85 Moreover, if the acquirer can compel the acquiree to incur obligations, then it is likely that the acquirer already controls the acquiree, given that control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. If, alternatively, the acquirer suggests that negotiations cannot proceed until the acquiree arranges, for example, to restructure its workforce, and the acquiree

takes the steps necessary to satisfy the recognition criteria for restructuring provisions in IAS 37, then those obligations are pre-combination obligations of the acquiree and, in the Board's view, should be recognised as part of allocating the cost of the combination.

BC86 The Board considered the assertion that another way in which an acquirer could achieve the same result as that previously achieved for restructuring provisions under IAS 22 would be for the acquirer to recognise the restructuring provision either as part of the cost of the business combination, ie as a liability incurred by the acquirer in exchange for control of the acquiree, or as a contingent liability of the acquiree.* The Board noted that a provision for restructuring the acquiree could be recognised by the acquirer, and therefore included as part of the cost of the combination, only if the criteria in IAS 37 for recognising a restructuring provision are satisfied. In other words, the acquirer, at or before the acquisition date, must have developed a detailed formal plan for the restructuring and raised a valid expectation in those affected that it will carry out the restructuring by publicly announcing the main features of the plan or beginning its implementation. These criteria are not the same as the criteria previously in IAS 22 for recognising restructuring provisions as part of allocating the cost of a combination. Therefore, the Board disagreed that an acquirer can recognise a provision for restructuring the acquiree as part of the cost of the combination to achieve virtually the same result as that previously available under IAS 22.

BC87 Consequently, the Board concluded that liabilities for terminating or reducing the activities of the acquiree should be recognised by the acquirer as part of allocating the cost of the business combination only when the acquiree has, at the acquisition date, an existing liability for restructuring recognised in accordance with IAS 37. A majority of respondents to ED 3 supported this conclusion.

Intangible assets

BC88 The IFRS requires an acquirer to recognise separately at the acquisition date an intangible asset of the acquiree, but only when it meets the definition of an intangible asset in IAS 38 *Intangible Assets* and its fair value can be measured reliably. A non-monetary asset without physical substance must be identifiable to meet the definition of an intangible asset. In accordance with IAS 38, an asset meets the identifiability criterion in the definition of an intangible asset only if it arises from contractual or other legal rights or is separable. Previously IAS 22 required an acquirer to recognise any identifiable asset of the acquiree separately from goodwill at the acquisition date if it was probable that any associated future economic benefits would flow to the acquirer and the asset could be measured reliably. The previous version of IAS 38 clarified that the definition of an intangible asset required an intangible asset to be identifiable to distinguish it from goodwill. However, it did not define 'identifiability', but stated that an intangible asset could be distinguished from goodwill if the asset was separable, though separability was not a necessary condition for identifiability. Therefore, previously under international standards, to be recognised separately from goodwill an intangible asset would have to be identifiable and reliably measurable, and it would have to be probable that any associated future economic benefits would flow to the acquirer.

* See paragraphs BC107-BC110 for a discussion of this latter point.

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BC89 Changes during 2001 to the requirements in Canadian and United States standards on the separate recognition of intangible assets acquired in a business combination prompted the Board to consider whether it also should explore this issue as part of the first phase of its Business Combinations project. The Board observed that intangible assets comprise an increasing proportion of the assets of many entities, and that intangible assets acquired in a business combination were often included in the amount recognised as goodwill, despite the previous requirements in IAS 22 and the previous version of IAS 38 that they should be recognised separately from goodwill. The Board also agreed with the conclusion reached in IAS 22 and by the Canadian and US standard-setters that the usefulness of financial statements would be enhanced if intangible assets acquired in a business combination were distinguished from goodwill. Therefore, the Board concluded that IAS 38 and the IFRS arising from the first phase of the project should provide a definitive basis for identifying and recognising intangible assets acquired in a business combination separately from goodwill.

BC90 The Board focused its deliberations first on intangible assets, other than in-process research and development projects, acquired in a business combination. Paragraphs BC91-BC103 outline those deliberations. The Board then considered whether the criteria for recognising those intangible assets separately from goodwill should also be applied to in-process research and development projects acquired in a business combination, and concluded that they should. The Board's reasons for reaching this conclusion are outlined in paragraphs BC104-BC106.

BC91 In revising IAS 38 and developing the IFRS, the Board affirmed the view contained in the previous version of IAS 38 that identifiability is the characteristic that conceptually distinguishes other intangible assets from goodwill. The Board concluded that to provide a definitive basis for identifying and recognising intangible assets separately from goodwill, the concept of identifiability needed to be articulated more clearly.

BC92 Consistently with the guidance in the previous version of IAS 38, the Board concluded that an intangible asset can be distinguished from goodwill if it is separable, ie capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged. Therefore, in the context of intangible assets, separability signifies identifiability, and intangible assets with that characteristic that are acquired in a business combination should be recognised as assets separately from goodwill.

BC93 However, again consistently with the guidance in the previous version of IAS 38, the Board concluded that separability is not the only indication of identifiability. The Board observed that, in contrast to goodwill, the values of many intangible assets arise from rights conveyed legally by contract or statute. In the case of acquired goodwill, its value arises from the collection of assembled assets that make up an acquired entity or the value created by assembling a collection of assets through a business combination, such as the synergies that are expected to result from combining two or more entities or businesses. The Board also observed that, although many intangible assets are both separable and arise from contractual-legal rights, some contractual-legal rights establish property interests that are not readily separable from the entity as a whole. For example, under the laws of some jurisdictions some licences granted to an entity are not transferable except by sale of the entity as a whole. The Board

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concluded that the fact that an intangible asset arises from contractual or other legal rights is a characteristic that distinguishes it from goodwill. Therefore, intangible assets with that characteristic that are acquired in a business combination should be recognised as assets separately from goodwill.

BC94 As outlined in paragraph BC88, the previous Standards required an intangible asset acquired in a business combination and determined to be identifiable also to satisfy the following recognition criteria to be recognised as an asset separately from goodwill:

(a) it must be probable that any associated future economic benefits will flow to the acquirer; and

(b) it must be reliably measurable.

BC95 ED 3 and the Exposure Draft of Proposed Amendments to IAS 38 proposed that the above recognition criteria would, with the exception of an assembled workforce, always be satisfied for an intangible asset acquired in a business combination. Therefore, those criteria were not included in ED 3. ED 3 proposed requiring an acquirer to recognise separately at the acquisition date all of the acquiree's intangible assets as defined in IAS 38, other than an assembled workforce. After considering respondents' comments, the Board decided:

(a) to proceed with the proposal that the probability recognition criterion is always considered to be satisfied for intangible assets acquired in a business combination.

(b) not to proceed with the proposal that, with the exception of an assembled workforce, sufficient information should always exist to measure reliably the fair value of an intangible asset acquired in a business combination.

BC96 In developing ED 3 and the IFRS, the Board observed that the fair value of an intangible asset reflects market expectations about the probability that the future economic benefits associated with the intangible asset will flow to the acquirer. In other words, the effect of probability is reflected in the fair value measurement of an intangible asset. The Board concluded that, given its decision to require the acquirer to recognise the acquiree's intangible assets satisfying the relevant criteria at their fair values as part of allocating the cost of a business combination, the probability recognition criterion need not be included in the IFRS. The Board observed that this highlights a general inconsistency between the recognition criteria for assets and liabilities in the *Framework* (which states that an item meeting the definition of an element should be recognised only if it is probable that any future economic benefits associated with the item will flow to or from the entity, and the item can be measured reliably) and the fair value measurements required in, for example, a business combination. However, the Board concluded that the role of probability as a criterion for recognition in the *Framework* should be considered more generally as part of a forthcoming Concepts project.

BC97 In developing ED 3 and the IAS 38 Exposure Draft, the Board had concluded that, except for an assembled workforce, sufficient information could reasonably be expected to 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. Respondents generally disagreed with this conclusion, arguing that:

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(a) it might not always be possible 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.

(b) a similar presumption does not exist in IFRSs for identifiable tangible assets acquired in a business combination. Indeed, the Board decided when developing the IFRS to carry forward from IAS 22 the general principle that an acquirer should recognise separately from goodwill the acquiree's identifiable tangible assets, but only provided they can be measured reliably.

BC98 Additionally, as part of its consultative process, the Board conducted field visits and round-table discussions during the comment period for the Exposure Draft.* Field visit and round-table participants were asked a series of questions aimed at improving the Board's understanding of whether there might exist non-monetary assets without physical substance that are separable or arise from legal or other contractual rights, but for which there may *not* be sufficient information to measure fair value reliably.

BC99 The field visit and round-table participants provided numerous examples of intangible assets they had acquired in recent business combinations whose fair values might not be reliably measurable. For example, one participant acquired water acquisition rights as part of a business combination. The rights are extremely valuable to many manufacturers operating in the same jurisdiction as the participant—the manufacturers cannot acquire water and, in many cases, cannot operate their plants without them. Local authorities grant the rights at little or no cost, but in limited numbers, for fixed periods (normally 10 years), and renewal is certain at little or no cost. The rights cannot be sold other than as part of the sale of a business as a whole, therefore there exists no secondary market in the rights. If a manufacturer hands the rights back to the local authority, it is prohibited from reapplying. The participant argued that it could not value these rights separately from its businesses (and therefore from the goodwill), because the businesses would cease to exist without the rights.

BC100 After considering respondents' comments and the experiences of field visit and round-table participants, the Board concluded that, in some instances, there might not be sufficient information to measure reliably the fair value of an intangible asset separately from goodwill, notwithstanding that the asset is 'identifiable'. The Board observed that the intangible assets whose fair values respondents and field visit and round-table participants could not measure reliably arose either:

(a) from legal or other contractual rights and are not separable (ie could be transferred only as part of the sale of a business as a whole); or

(b) from legal or other contractual rights and are 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

* The field visits were conducted from early December 2002 to early April 2003, and involved IASB members and staff in meetings with 41 companies in Australia, France, Germany, Japan, South Africa, Switzerland and the United Kingdom. IASB members and staff also took part in a series of round-table discussions with auditors, preparers, accounting standard-setters and regulators in Canada and the United States on implementation issues encountered by North American companies during first-time application of US Statements of Financial Accounting Standards 141 *Business Combinations* and 142 *Goodwill and Other Intangible Assets*, and the equivalent Canadian Handbook Sections, which were issued in June 2001.

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liability), 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 variables whose effect is not measurable.

BC101 Nevertheless, the Board remained of the view that the usefulness of financial statements would be enhanced if intangible assets acquired in a business combination were distinguished from goodwill, particularly given the Board's decision to regard goodwill as an indefinite-lived asset that is not amortised. The Board also remained concerned that failing the reliability of measurement recognition criterion might be inappropriately used by entities as a basis for not recognising intangible assets separately from goodwill. For example, IAS 22 and the previous version of IAS 38 required an acquirer to recognise an intangible asset of the acquiree separately from goodwill at the acquisition date if it was probable that any associated future economic benefits would flow to the acquirer and the asset's fair value could be measured reliably. The Board observed when developing ED 3 that although intangible assets constitute an increasing proportion of the assets of many entities, those acquired in business combinations were often included in the amount recognised as goodwill, despite the requirements in IAS 22 and the previous version of IAS 38 that they should be recognised separately from goodwill.

BC102 Therefore, although the Board decided not to proceed with the proposal that, with the exception of an assembled workforce, sufficient information should always exist to measure reliably the fair value of an intangible asset acquired in a business combination, the Board also decided:

(a) to clarify in IAS 38 that the fair value of an intangible asset acquired in a business combination can normally be measured with sufficient reliability for it 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.

(b) to include in IAS 38 a rebuttable presumption that the fair value of a finite-lived intangible asset acquired in a business combination can be measured reliably.

(c) to clarify in IAS 38 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 when the intangible asset arises from legal or other contractual rights and it either (i) is not separable or (ii) 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 variables whose effect is not measurable.

(d) to include in the IFRS a requirement for entities to disclose a description of each asset that meets the definition of an intangible asset and was acquired in a business combination during the period but was not recognised separately from goodwill, and an explanation of why its fair value could not be measured reliably.

BC103 Some respondents and field visit participants suggested that it might also not be possible to measure reliably the fair value of an intangible asset when it is separable, but only together with a related contract, asset or liability (ie it is not individually separable), there is no history of exchange transactions for the same or similar assets on a stand-alone basis, and, because the related items produce jointly the same cash

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flows, the fair value of each could be estimated only by arbitrarily allocating those cash flows between the two items. The Board disagreed that such circumstances provide a basis for subsuming the value of the intangible asset within the carrying amount of goodwill. Although some intangible assets are so closely related to other identifiable assets or liabilities that they are usually sold as a ‘package’, it would still be possible to measure reliably the fair value of that ‘package’. Therefore, the Board decided to include the following clarifications in IAS 38:

(a) when an intangible asset acquired in a business combination is separable but only together with a related tangible or intangible asset, the acquirer recognises the group of assets as a single asset separately from goodwill if the individual fair values of the assets in the group are not reliably measurable.

(b) similarly, an acquirer recognises as a single asset a group of complementary intangible assets constituting a brand if the individual fair values of the complementary assets are not reliably measurable. If the individual fair values of the complementary assets are reliably measurable, the acquirer may recognise them as a single asset separately from goodwill, provided the individual assets have similar useful lives.

BC104 As noted in paragraph BC90, the Board also considered whether the criteria for recognising intangible assets separately from goodwill should also be applied to in-process research and development projects acquired in a business combination, and concluded that they should. In reaching this conclusion, the Board observed that the criteria in IAS 22 and the previous version of IAS 38 for recognising an intangible asset acquired in a business combination separately from goodwill applied to all intangible assets, including in-process research and development projects. Therefore, the effect of those Standards was that any intangible item acquired in a business combination was recognised as an asset separately from goodwill when it was identifiable and could be measured reliably, and it was probable that any associated future economic benefits would flow to the acquirer. If those criteria were not satisfied, the expenditure on that item, which was included in the cost of the combination, was attributed to goodwill.

BC105 The Board could see no conceptual justification for changing the approach in IAS 22 and the previous version of IAS 38 of using the same criteria for all intangible assets acquired in a business combination when assessing whether those assets should be recognised separately from goodwill. The Board concluded that adopting different criteria would impair the usefulness of the information provided to users about the assets acquired in a combination, because both comparability and reliability would be diminished.

BC106 Some respondents to ED 3 and the IAS 38 Exposure Draft expressed concern that applying the same criteria to all intangible assets acquired in a business combination to assess whether they should be recognised separately from goodwill results in treating some in-process research and development projects acquired in business combinations differently from similar projects started internally. The Board acknowledged this point. However, it concluded that this does not provide a basis for subsuming those acquired intangible assets within goodwill. Rather, it highlights a need to reconsider the view taken in IAS 38 that an intangible asset can never exist in

respect of an in-process research project and can exist in respect of an in-process development project only once all of the criteria for deferral in IAS 38 have been satisfied. The Board concluded that such a reconsideration is outside the scope of its Business Combinations project.

Contingent liabilities

BC107 ED 3 proposed, and the IFRS requires, an acquirer to recognise separately the acquiree's contingent liabilities (as defined in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*) at the acquisition date as part of allocating the cost of a business combination, provided their fair values can be measured reliably. In reaching its decision to include this requirement in the IFRS, the Board observed that provisions for terminating or reducing the activities of an acquiree that were previously recognised in accordance with paragraph 31 of IAS 22 as part of allocating the cost of a combination (but which the IFRS prohibits from being so recognised; see paragraphs BC76-BC87) are not contingent liabilities of the acquiree. A contingent liability is defined in IAS 37 as (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 either because it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation or because the amount of the obligation cannot be measured with sufficient reliability. In the case of provisions for terminating or reducing the activities of an acquiree that were previously recognised in accordance with paragraph 31 of IAS 22, there is no present obligation, nor is there a possible obligation arising from a past event 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.

BC108 However, some respondents to ED 3 suggested that the acquiree and acquirer could agree for the acquiree to take the steps necessary to satisfy the recognition criteria for restructuring provisions in IAS 37, but to make the execution of the plan conditional on the acquiree being acquired in a business combination. This could circumvent the prohibition in the IFRS on recognising restructuring provisions as part of allocating the cost of a combination. Unlike the circumstances contemplated by the Board in paragraph BC85, if the business combination does not take place the acquiree is under no obligation to proceed with the plan. Respondents suggested that, in such circumstances, it might be possible to argue that the restructuring plan is, before the business combination, either one of the following:

(a) a possible obligation of the acquiree 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. Therefore, the acquirer could recognise it as a contingent liability of the acquiree when allocating the cost of the combination.

(b) a present obligation of the acquiree that is regarded as a contingent liability until it becomes probable that a business combination will occur. This obligation could then be recognised as a liability by the acquiree, in accordance with IAS 37, when a business combination becomes probable and the liability can be measured reliably. Respondents suggested that this would be consistent with paragraph 41 of ED 3 (with slightly revised wording, that paragraph is now paragraph 42 of the IFRS), which stated that "A payment that an entity is contractually required to make to, for example, its employees or suppliers in the

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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 take place. 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 is effected, that liability of the acquiree is recognised by the acquirer as part of allocating the cost of the combination."

BC109 The Board disagreed that a restructuring plan whose execution is conditional on a business combination is either (a) a possible obligation of the acquiree that, before the business combination, meets part (a) of the definition of a contingent liability, or (b) a present obligation of the acquiree that is regarded as a contingent liability until it becomes probable that a business combination will take place. This is because:

(a) a possible obligation meets the definition of a contingent liability only when it satisfies all of the following criteria:

(i) it arises from past events;

(ii) its existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events; and

(iii) the uncertain future event(s) is (are) not wholly within the control of the entity.

The Board concluded that a restructuring plan whose execution is conditional on a business combination, although meeting the criteria in (i) and (ii) above, fails to meet the criterion in (iii). This is because the uncertain future event (ie being acquired in a business combination) is generally within the acquiree's control.

(b) the acquiree has not, before the business combination, established a present obligation. In accordance with paragraph 72 of IAS 37, a constructive obligation to restructure arises only when an entity has:

(i) a detailed formal plan for the restructuring; and

(ii) raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it.

The Board concluded that if execution of the plan is conditional on the acquiree being acquired in a business combination, then the criterion in (ii) has not been satisfied. Even if the main features of the plan were announced to those that would be affected by it, the 'valid expectation' would be conditional on the entity being acquired in a business combination—a possibility that is not provided for in the wording of paragraph 72 of IAS 37.

BC110 Therefore, to avoid any confusion or possibility of circumventing the Board's intention in relation to the treatment of restructuring provisions, the Board decided to clarify in paragraph 43 of the IFRS that an acquiree's restructuring plan whose execution is conditional upon it being acquired in a business combination is not, immediately before the business combination, a present obligation of the acquiree, nor is it a contingent liability of the acquiree. Therefore, an acquirer shall not recognise such restructuring plans as part of allocating the cost of the combination.

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BC111 In developing ED 3 and the IFRS, the Board observed that although a contingent liability of the acquiree is not recognised by the acquiree before the business combination, that contingent liability has a fair value, the amount of which reflects market expectations about any uncertainty surrounding the possibility that an outflow of resources embodying economic benefits will be required to settle the possible or present obligation. As a result, the existence of contingent liabilities of the acquiree has the effect of depressing the price that an acquirer is prepared to pay for the acquiree, ie the acquirer has, in effect, been paid to assume an obligation in the form of a reduced purchase price for the acquiree.

BC112 The Board observed that this highlights an inconsistency between the recognition criteria applying to liabilities and contingent liabilities in IAS 37 and the *Framework* (both of which permit liability recognition only when it is probable that an outflow of resources embodying economic benefits will be required to settle a present obligation) and the fair value measurement of the cost of a business combination. Indeed, the probability recognition criterion applying to liabilities in IAS 37 and the *Framework* is fundamentally inconsistent with any fair value or expected value basis of measurement because expectations about the probability that an outflow of resources embodying economic benefits will be required to settle a possible or present obligation will be reflected in the measurement of that possible or present obligation. However, the Board agreed that the role of probability in the *Framework* should be considered more generally as part of a forthcoming Concepts project.

BC113 The Board also observed that the principles in IAS 37 had been developed largely for provisions that are generated internally, not obligations that the entity has been paid to assume. This is not dissimilar from situations in which assets are recognised as a result of the business combination, even though they would not be recognised had they been generated internally. For example, some internally generated intangible assets are not permitted to be recognised by an entity, but would be recognised by an acquirer as part of allocating the cost of acquiring that entity.

BC114 In developing ED 3 the Board proposed that a contingent liability recognised as part of allocating the cost of a business combination should be excluded from the scope of IAS 37 and measured after initial recognition at fair value with changes in fair value recognised in profit or loss until settled or the uncertain future event described in the definition of a contingent liability is resolved. While considering respondents' comments on this issue, the Board noted that measuring such contingent liabilities after initial recognition at fair value would be inconsistent with the conclusions it reached on the accounting for financial guarantees and commitments to provide loans at below-market interest rates when revising IAS 39 *Financial Instruments: Recognition and Measurement*.

BC115 The Board decided to amend the proposal in ED 3 for consistency with IAS 39. Therefore, the IFRS requires contingent liabilities recognised as part of allocating the cost of a combination to be measured after their initial recognition at the higher of:

(a) the amount that would be recognised in accordance with IAS 37, and

(b) the amount initially recognised less, when appropriate, cumulative amortisation recognised in accordance with IAS 18 *Revenue*.

The Board observed that not specifying the subsequent accounting might result in some or all of these contingent liabilities inappropriately being derecognised immediately after the combination.

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BC116 To avoid any confusion over the interaction between IAS 39 and the above requirement, the Board also decided to clarify in the IFRS that:

(a) the above requirement does not apply to contracts accounted for in accordance with IAS 39.

(b) loan commitments excluded from the scope of IAS 39 that are not commitments to provide loans at below-market interest rates are accounted for as contingent liabilities of the acquiree if, at the acquisition date, it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation or if the amount of the obligation cannot be measured with sufficient reliability. Such a loan commitment is recognised separately as part of allocating the cost of a combination only if its fair value can be measured reliably.

BC117 The Board is considering as part of the second phase of its Business Combinations project whether items meeting the definition in IAS 37 of contingent assets should also be recognised separately as part of allocating the cost of a business combination. However, the Board decided that it was necessary to address contingent liabilities of the acquiree in the first phase of its project, given that it had agreed to reconsider the requirements in IAS 22 for the treatment of negative goodwill as part of that first phase. The Board observed that negative goodwill as determined in accordance with IAS 22 could have arisen as a result of, amongst other things, failure to recognise contingent liabilities of the acquiree that the acquirer had been paid to take on in the form of a reduced purchase price.

Contractual obligations of the acquiree for which payment is triggered by a business combination

BC118 The IFRS clarifies that a payment an acquiree is contractually required to make, for example, to its employees or suppliers in the event it is acquired in a business combination, would be recognised by the acquirer as part of allocating the cost of the combination. The Board agreed that before the business combination, such a contractual arrangement gives rise to a present obligation of the acquiree. That present obligation meets the IAS 37 definition of a contingent liability until it becomes probable that a business combination will take place. Once it becomes probable that a business combination will take place, the obligation should, in accordance with IAS 37, be recognised as a liability by the acquiree provided it can be measured reliably. Therefore, when the business combination is effected, the liability is recognised by the acquirer as part of allocating the cost of the combination.

BC119 The Board concluded that the treatment in IAS 22 of such obligations was ambiguous, and that the IFRS should therefore clarify their treatment.

BC120 However, as outlined in paragraphs BC108–BC110, the Board clarified that an acquiree's restructuring plan whose execution is conditional on the acquiree being acquired in a business combination is not, immediately before the business combination, a present obligation of the acquiree.

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Measuring the identifiable assets acquired and liabilities and contingent liabilities incurred or assumed (paragraphs 36 and 40)

BC121 IAS 22 included 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 Board agreed that permitting similar transactions to be accounted for in dissimilar ways impairs the usefulness of the information provided to users of financial reports, because both comparability and reliability are diminished. The Board concluded that the quality of Standards would be improved by omitting the option that existed in IAS 22 from the IFRS arising from the first phase of its Business Combinations project. ED 3 proposed, and the IFRS requires, the acquiree's identifiable assets, liabilities and contingent liabilities recognised as part of allocating the cost of the business combination 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 value of those items. Almost all of the respondents to ED 3 supported the proposal, which was consistent with the allowed alternative treatment in IAS 22.

BC122 Applying IAS 22's benchmark treatment, the acquirer would have initially measured each of the acquiree's identifiable assets and liabilities at the aggregate of:

(a) its fair value at the date of the exchange transaction, but only to the extent of the ownership interest obtained by the acquirer in the exchange transaction; and

(b) the minority's proportion of its pre-combination carrying amount.

BC123 In assessing IAS 22's benchmark treatment, the Board noted that the requirement in IAS 27 *Consolidated and Separate Financial Statements* to prepare consolidated financial statements is driven by the existence of a group. The objective of consolidated financial statements is to provide users with relevant and reliable financial information about the resources under the control of the parent entity so as to reflect that the related entities operate as a single economic entity. Therefore, under IAS 27 the consolidated financial statements for the group are intended to reflect the performance of that group and the resources under the control of the parent entity, irrespective of the extent of the ownership interest held. As a result, IAS 27 requires consolidation of all of the identifiable assets and liabilities of the controlled entity; a proportionate approach to the preparation of consolidated financial statements is not permitted. Accordingly, with the exception of goodwill arising on the acquisition of a subsidiary, 100 per cent of a subsidiary's assets and liabilities are included in the consolidated financial statements from the date on which the parent obtains control of that subsidiary, irrespective of the ownership interest held in the subsidiary.

BC124 The Board concluded that the mixed measurement reported in accordance with IAS 22's benchmark treatment was inconsistent with the consolidation approach in IAS 27 and with the objective of providing users with relevant and reliable financial information about the resources under the control of the parent entity.

BC125 The Board noted that the allowed alternative treatment provided users with information about the fair values at the acquisition date of the acquiree's identifiable assets and liabilities, together with any minority interest in those fair values. The Board concluded that this treatment was consistent with the consolidation approach adopted in IAS 27 and the objective of consolidated financial statements because the

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information it provided enabled users to better assess the cash-generating abilities of the identifiable net assets acquired in the business combination. The Board also noted that the allowed alternative treatment provided users of the group's consolidated financial statements with more useful information for assessing the accountability of management for the resources entrusted to it.

BC126 The Board considered the view that, notwithstanding the use in IAS 27 of control to define the boundaries of a group, the focus of consolidated financial statements remains the owners of the parent. On that basis, and because the cost of a business combination relates only to the percentage of the identifiable net assets acquired by the parent, those identifiable net assets should be measured at their fair values only to the extent of the parent's interest obtained in the exchange transaction. In other words, the minority's proportionate interest in the identifiable net assets acquired by the parent is not part of the exchange transaction and therefore should be stated on the basis of pre-combination carrying amounts. Those supporting this approach argue that it is consistent with the requirement in IAS 22 to recognise only the amount of goodwill acquired by the parent based on the parent's ownership interest, rather than the amount of goodwill controlled by the parent as a result of the combination.

BC127 However, the Board concluded that the use in IAS 27 of control to define the boundaries of a group remains fundamental to identifying the objective of consolidated financial statements, even if the intended focus of those statements were the owners of the parent. In a consolidation model whose intended focus is the owners of the parent but which uses control to define the boundaries of the group, the objective of the consolidated financial statements for that group would be to provide information to the owners of the parent about the resources under their control, irrespective of the extent of the ownership interest held by the parent in those resources. The Board concluded that information about the fair values at the acquisition date of the acquiree's identifiable assets, liabilities and contingent liabilities provides the owners of the parent with more useful information about the resources under their control than the mixed measurement reported under the benchmark treatment.

BC128 The Board nonetheless observed that the requirement in IAS 22 to recognise only the amount of goodwill acquired by the 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, is problematic. The Board saw this as a flaw in the way that IAS 22 interacted with IAS 27 rather than an indication that consolidated financial statements prepared in accordance with IAS 27 are intended to reflect only the resources attributable to owners of the parent on the basis of the ownership interests held by the parent. The Board concluded that if this were indeed the objective of consolidated financial statements, then a proportionate approach to consolidation for all of the assets acquired and liabilities assumed in a business combination would be the only approach to satisfy that objective. The Board is reconsidering the requirement to recognise only the amount of goodwill acquired by the parent on the basis of the parent's ownership interest as part of the second phase of its Business Combinations project.

Goodwill (paragraphs 51-55)

Initial recognition of goodwill as an asset

BC129 ED 3 proposed, and the IFRS requires, goodwill acquired in a business combination to be recognised by the acquirer as an asset and initially measured as the excess of the cost of the combination over the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities. Almost all of the respondents to ED 3 supported these proposals. Except for the effect on the measurement of acquired goodwill of recognising the acquiree's contingent liabilities (see paragraphs BC107-BC117), these requirements are consistent with the requirements previously in IAS 22. However, the Board decided that the IFRS should not confuse measurement techniques with concepts and therefore, unlike IAS 22, the IFRS defines goodwill in terms of its nature rather than its measurement. In particular, the IFRS defines goodwill as future economic benefits arising from assets that are not capable of being individually identified and separately recognised.

BC130 In developing ED 3 and the IFRS, the Board observed that when goodwill is measured as a residual, it could comprise the following components:

(a) the fair value of the 'going concern' element of the acquiree. The going concern element represents the ability of the acquiree to earn a higher rate of return on an assembled collection of net assets than would be expected from those net assets operating separately. That value stems from the synergies of the net assets of the acquiree, as well as from other benefits such as factors related to market imperfections, including the ability to earn monopoly profits and barriers to market entry.

(b) the fair value of the expected synergies and other benefits from combining the acquiree's net assets with those of the acquirer. Those synergies and other benefits are unique to each business combination, and different combinations produce different synergies and, hence, different values.

(c) overpayments by the acquirer.

(d) errors in measuring and recognising the fair value of either the cost of the business combination or the acquiree's identifiable assets, liabilities or contingent liabilities, or a requirement in an accounting standard to measure those identifiable items at an amount that is not fair value.

BC131 The Board observed that the third and fourth components conceptually are not part of goodwill and not assets, whereas the first and second components conceptually *are* part of goodwill. The Board described those first and second components as 'core goodwill', and focused its analysis first on whether core goodwill should be recognised as an asset.

BC132 An asset is defined in the *Framework* as a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity. Paragraph 53 of the *Framework* states that "The future economic benefit embodied in an asset is the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the enterprise." The Board concluded that core goodwill represents resources from which future economic benefits are expected to flow to the entity. In considering whether core goodwill represents a resource *controlled* by the entity, the Board considered the assertion that core goodwill arises, at least in part, through factors such as a well-trained workforce, loyal customers etc,

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and that these factors cannot be regarded as controlled by the entity because the workforce could leave and the customers go elsewhere. However, the Board concluded that in the case of core goodwill, control is provided by means of the acquirer's power to direct the policies and management of the acquiree. Therefore, the Board concluded that core goodwill meets the *Framework's* definition of an asset.

BC133 The Board then considered whether including the third and fourth components identified in paragraph BC130 in the measurement of acquired goodwill should prevent goodwill from being recognised by the acquirer as an asset. To the extent that acquired goodwill includes those components, it includes items that are not assets. Thus, including them in the asset described as goodwill would not be representationally faithful.

BC134 The Board observed that it would not be feasible to determine the amount attributable to each of the components of acquired goodwill. Although there might be problems with representational faithfulness in recognising all of the components as an asset labelled goodwill, there are corresponding problems with the alternative of recognising all of the components immediately as an expense. In other words, to the extent that the measurement of acquired goodwill includes core goodwill, recognising that asset as an expense is also not representationally faithful.

BC135 The Board concluded that goodwill acquired in a business combination and measured as a residual is likely to consist 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.

Subsequent accounting for goodwill

BC136 ED 3 proposed, and the IFRS requires, goodwill acquired in a business combination to be carried after initial recognition at cost less any accumulated impairment losses. Therefore, the goodwill is not permitted to be amortised and instead must be tested 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*. IAS 22 required acquired goodwill to be amortised on a systematic basis over the best estimate of its useful life. There was a rebuttable presumption that its useful life did not exceed twenty years from initial recognition. If that presumption was rebutted, acquired goodwill was required to be tested for impairment in accordance with the previous version of IAS 36 at least at each financial year-end, even if there was no indication that it was impaired.

BC137 In considering the appropriate accounting for acquired goodwill after its initial recognition, the Board examined the following three approaches:

(a) straight-line amortisation but with an impairment test whenever there is an indication that the goodwill might be impaired;

(b) non-amortisation but with an impairment test annually or more frequently if events or changes in circumstances indicate that the goodwill might be impaired; and

(c) permitting entities a choice between approaches (a) and (b).

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BC138 The Board concluded, and the respondents to ED 3 that expressed a clear view on this issue generally agreed, that entities should not be allowed a choice between approaches (a) and (b). Permitting such choices impairs the usefulness of the information provided to users of financial statements because both comparability and reliability are diminished.

BC139 The respondents to ED 3 that expressed a clear view on this issue generally supported approach (a). They put forward the following arguments in support of that approach:

(a) acquired goodwill is an asset that is consumed and replaced with internally generated goodwill. Amortisation therefore ensures that the acquired goodwill is recognised in profit or loss and no internally generated goodwill is recognised as an asset in its place, consistently with the general prohibition in IAS 38 on the recognition of internally generated goodwill.

(b) conceptually, amortisation is a method of allocating the cost of acquired goodwill over the periods it is consumed, and is consistent with the approach taken to other intangible and tangible fixed assets that do not have indefinite useful lives. Indeed, entities are required to determine the useful lives of items of property, plant and equipment, and allocate their depreciable amounts on a systematic basis over those useful lives. There is no conceptual reason for treating acquired goodwill differently.

(c) the useful life of acquired goodwill cannot be predicted with a satisfactory level of reliability, nor can the pattern in which that goodwill diminishes be known. However, systematic amortisation over an albeit arbitrary period provides an appropriate balance between conceptual soundness and operationality at an acceptable cost: it is the only practical solution to an intractable problem.

BC140 In considering these comments, the Board agreed that achieving an acceptable level of reliability in the form of representational faithfulness, while at the same time striking some balance between what is practicable, was the primary challenge it faced in deliberating the subsequent accounting for goodwill. The Board observed that the useful life of acquired goodwill and the pattern in which it diminishes generally are not possible to predict, yet its amortisation depends on such predictions. As a result, the amount amortised in any given period can at best be described as an arbitrary estimate of the consumption of acquired goodwill during that period. The Board acknowledged that if goodwill is an asset, in some sense it must be true that goodwill acquired in a business combination is being consumed and replaced by internally generated goodwill, provided that an entity is able to maintain the overall value of goodwill (by, for example, expending resources on advertising and customer service). However, consistently with the view it reached in developing ED 3, the Board remained doubtful about the usefulness of an amortisation charge that reflects the consumption of acquired goodwill, whilst the internally generated goodwill replacing it is not recognised. Therefore, the Board reaffirmed the conclusion it reached in developing ED 3 that straight-line amortisation of goodwill over an arbitrary period fails to provide useful information. The Board noted that both anecdotal and research evidence supports this view.

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BC141 In considering respondents' comments summarised in paragraph BC139(b), the Board noted that although the useful lives of both goodwill and tangible fixed assets are directly related to the period over which they are expected to generate net cash inflows for the entity, the expected physical utility to the entity of a tangible fixed asset places an upper limit on the asset's useful life. In other words, unlike goodwill, the useful life of a tangible fixed asset could never extend beyond the asset's expected physical utility to the entity.

BC142 The Board reaffirmed the view it reached in developing ED 3 that if a rigorous and operational impairment test could be devised, more useful information would be provided to users of an entity's financial statements under an approach in which goodwill is not amortised, but instead tested for impairment annually or more frequently if events or changes in circumstances indicate that the goodwill might be impaired. After considering respondents' comments to the Exposure Draft of Proposed Amendments to IAS 36 on the form that such an impairment test should take, the Board concluded that a sufficiently rigorous and operational impairment test could be devised. Its deliberations on the form that the impairment test should take are included in the Basis for Conclusions on IAS 36.

Excess of acquirer's interest in the net fair value of acquiree's identifiable assets, liabilities and contingent liabilities over cost (paragraphs 56 and 57)

BC143 In some business combinations, the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities exceeds the cost of the combination. That excess, commonly referred to as negative goodwill, is referred to below as the excess.

BC144 ED 3 proposed, and the IFRS requires, that if an excess exists, the acquirer should:

(a) first 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.

BC145 Respondents to ED 3 generally did not support the proposal to recognise immediately in profit or loss any excess remaining after the reassessment. Their objections were based on the following views:

(a) any such excess is likely to arise because of expectations of future losses and expenses.

(b) recognising the excess immediately in profit or loss would not be representationally faithful to the extent it arises because of measurement errors or because of 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) the proposal is inconsistent with historical cost accounting.

BC146 In considering respondents' comments, the Board agreed that most business combinations are exchange transactions in which each party receives and sacrifices equal value. As a result, the existence of an excess might indicate that:

(a) the values attributed to the acquiree's identifiable assets have been overstated;

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(b) identifiable liabilities and/or contingent liabilities of the acquiree have been omitted or the values attributed to those items have been understated; or

(c) the values assigned to the items comprising the cost of the business combination have been understated.

BC147 The Board reaffirmed its previous conclusions that an excess should rarely remain 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 such an excess exists, the acquirer should first 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.

BC148 The Board further observed 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.

BC149 The Board disagreed with the view that expectations of future losses and expenses could give rise to an excess. Although expectations of future losses and expenses have the effect of depressing the price that an acquirer is prepared to pay for the acquiree, the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities will be similarly affected. For example, assume the present value of the expected future cash flows of a business is 100 provided 20 is spent on restructuring the business, but only 30 if no restructuring is done. Assume also there is no goodwill in the business. Any acquirer would therefore be prepared to pay 80 to acquire the business, provided it too could generate the additional cash flows as a result of the restructuring. The fair value of the business is therefore 80. This amount is compared with the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities. The net fair value of those items is also 80 and not 100, because the costs of 20 needed to generate the value of 100 have not yet been incurred. In other words, expectations of future losses and expenses are reflected in the fair value of the acquiree's identifiable assets, liabilities and contingent liabilities. The Board observed that a possible cause of the errors referred to in paragraph BC148(a) is a failure to reflect correctly the fair value of the acquiree's identifiable assets, liabilities or contingent liabilities in their current location and condition, reflecting their current level of performance.

BC150 In developing ED 3 and the IFRS, the Board considered the appropriate treatment for an excess comprising the components identified in paragraph BC148 by assessing whether it should be recognised:

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(a) as a reduction in the values attributed to some of the acquiree's identifiable net assets (for example, by reducing proportionately the values attributed to the acquiree's identifiable assets without readily observable market prices);

(b) as a separate liability; or

(c) immediately in profit or loss.

Recognising the excess as a reduction in the values attributed to some net assets

BC151 The Board considered the view that recognising an excess by reducing the values attributed to the acquiree's identifiable net assets is appropriate because it is consistent with the historical cost accounting method, in that it does not recognise the total net assets acquired above the total cost of those assets. The Board rejected this view, noting that, to the extent the excess comprises the first and third components in paragraph BC148, the reduction in the values allocated to each of the acquiree's identifiable net assets would inevitably be arbitrary and, therefore, not representationally faithful. The resulting amount recognised for each item would not be cost, nor would it be fair value. Such an approach raises further issues in respect of the subsequent measurement of those items. For example, if the acquirer reduces proportionately the fair values attributed to the acquiree's identifiable assets without readily observable market prices, that reduction would be immediately reversed for any of those assets that are measured after initial recognition on a fair value basis.

BC152 To the extent the excess comprises the second component in paragraph BC148, reducing the values assigned to the acquiree's identifiable net assets that *are* required to be initially measured by the acquirer at their fair values also would not be representationally faithful.

BC153 The Board observed that 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. Allocating an excess comprising the second component in paragraph BC148 to those items that *are not* initially measured by the acquirer at their fair values would nonetheless result in those items being initially recognised by the acquirer at their fair values at the acquisition date. However, the Board decided that such an approach would not be appropriate at this time because:

(a) 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.

(b) it would raise further issues in respect of the subsequent measurement of those items similar to those identified in paragraph BC151. For example, measuring the acquiree's deferred tax assets at their fair values at the acquisition date would involve discounting the nominal tax benefits to their present values. This is inconsistent with IAS 12 *Income Taxes*, which requires deferred tax assets to be measured at nominal amounts. Therefore, the effect of the discounting would be immediately reversed by IAS 12.

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Recognising the excess as a separate liability

BC154 The Board observed that an excess comprising any of the components identified in paragraph BC148 does not meet the definition of a liability and that its recognition as such would not be representationally faithful. The Board also observed that recognition as a liability also raises the issue of when, if ever, the credit balance should be reduced.

Recognising the excess immediately in profit or loss

BC155 The Board concluded that the most representationally faithful treatment of that part of an excess arising from a bargain purchase is immediate recognition in profit or loss. The Board further concluded that separately identifying the amount of an excess that is attributable to each of the first and second components identified in paragraph BC148 is not feasible.

BC156 As a result, the Board concluded that:

(a) the most appropriate treatment for any excess remaining after the acquirer performs the necessary reassessments is immediate recognition in profit or loss; and

(b) for each business combination occurring during the reporting period, the acquirer should be required to disclose the amount and a description of the nature of any such excess.

Business combination achieved in stages (paragraphs 58-60)

BC157 The IFRS carries forward the requirements in paragraphs 36-38 of IAS 22 on the accounting for business combinations achieved in stages by, for example, successive share purchases. The Board will reconsider those requirements as part of the second phase of its Business Combinations project.

BC158 However, the Board received a large number of requests from its constituents for guidance on the practical application of paragraphs 36-38 of IAS 22. As a result, the Board:

(a) clarified in the IFRS that accounting for adjustments to the fair values of the acquiree's identifiable assets, liabilities and contingent liabilities as revaluations to the extent that they relate to the acquirer's previously held ownership interests does not signify that the acquirer has elected to apply an accounting policy of revaluing those items after initial recognition.

(b) developed an example illustrating the application of the requirements in paragraphs 58-60 of the IFRS. That example is included in the Illustrative Examples accompanying the IFRS.

Initial accounting determined provisionally (paragraphs 61-65)

BC159 The IFRS changes the requirements in paragraphs 71-74 of IAS 22 on the subsequent recognition of, or changes in the values assigned to, the acquiree's identifiable assets and liabilities. When the initial accounting for a business combination can be determined only provisionally by the end of the reporting period in which the combination occurs, ED 3 proposed, and IFRS 3 requires, the acquirer to account for the combination using those provisional values. This will be the case if

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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 by the acquirer by the end of the reporting period in which the combination occurs. The IFRS also requires:

(a) any adjustments to those provisional values as a result of completing the initial accounting to be recognised from the acquisition date and within twelve months of the acquisition date.

(b) with a few specified exceptions, adjustments to the initial accounting for a combination after that initial accounting is complete to be recognised only to correct an error in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. Therefore, the initial accounting for the combination cannot be amended for the effects of changes in accounting estimates after the combination.

BC160 In contrast, IAS 22 required:

(a) the acquiree's identifiable assets and liabilities that did not satisfy the criteria for separate recognition at the time of initially accounting for a business combination to be subsequently recognised by the acquirer when they satisfy those criteria; and

(b) the values assigned to the acquiree's identifiable assets and liabilities to be adjusted by the acquirer when additional evidence became available to assist with estimating the values of those items at the acquisition date.

In accordance with IAS 22, the acquirer recognised any such adjustment by adjusting the amount assigned to goodwill or negative goodwill, but only provided the adjustment was made by the end of the first annual reporting period that began after the business combination, and only to the extent the adjustment did not increase the carrying amount of goodwill above its recoverable amount. Otherwise, the adjustment was required to be recognised in profit or loss.

BC161 In developing ED 3 and the IFRS, the Board observed that one of the objectives of accounting for a business combination is for the acquirer to recognise all of the acquiree's identifiable assets, liabilities and contingent liabilities that existed and satisfied the criteria for separate recognition at the acquisition date at their fair values at that date. The Board concluded that the requirements in IAS 22 for subsequently recognising the acquiree's identifiable assets and liabilities could, in some instances, have resulted in a business combination being accounted for in a way that was inconsistent with this objective. This would have been the case if, for example, an asset of the acquiree that did not satisfy the criteria for recognition separately from goodwill at the time of initially accounting for the combination subsequently satisfied those criteria because of an event taking place after the acquisition date but before the end of the first annual reporting period beginning after the combination.

BC162 However, the Board also observed that normally it is not possible for an acquirer to obtain before the acquisition date all of the information necessary to achieve, immediately after the acquisition date, the objective described in paragraph BC161. Consequently, it is often not possible for an acquirer to finalise the accounting for the combination for some time thereafter. The Board therefore concluded that the IFRS should, without modifying the objective described in paragraph BC161, provide an acquirer with some period of time after the acquisition date to finalise the accounting

for a business combination. The Board also concluded that a maximum time period in which to finalise that accounting, although arbitrary, is necessary to prevent the accounting from being adjusted indefinitely. The Board concluded that a 12-month maximum period is reasonable.

BC163 Respondents to ED 3 generally supported the above approach. The minority that disagreed questioned whether a 12-month period for completing the initial accounting would be sufficient. However, there was no clear consensus amongst respondents as to what an appropriate alternative period might be, nor did the respondents clarify why their proposed alternatives might be any less arbitrary than that proposed by the Board in ED 3.

Adjustments after the initial accounting is complete (paragraphs 63-65)

BC164 The Board began its deliberations on when adjustments to the initial accounting for a business combination after that accounting is complete should be required by first considering the other circumstances in which IFRSs require or permit the accounting for a transaction to be retrospectively adjusted. In accordance with IAS 8, in the absence of a change in an accounting policy, an entity is required to adjust its financial statements retrospectively only to correct an error. The Board concluded that it would be inconsistent for the IFRS to require or permit retrospective adjustments to the accounting for a business combination other than to correct an error. Therefore, the Board decided that, with the three exceptions discussed in paragraphs BC165-BC169, the IFRS should require an acquirer to adjust the initial accounting for a combination after that accounting is complete only to correct an error in accordance with IAS 8. Almost all of the respondents to ED 3 supported such a requirement.

BC165 Two of the three exceptions to this requirement relate to adjustments to the cost of a business combination after the initial accounting for the combination is complete. Those exceptions are discussed in paragraphs BC166 and BC167. The third relates to the subsequent recognition by the acquirer of the acquiree's deferred tax assets that did not satisfy the criteria for separate recognition when initially accounting for the business combination. This exception is discussed in paragraphs BC168 and BC169.

Adjustments to the cost of a business combination after the initial accounting is complete

BC166 When a business combination agreement provides for an adjustment to the cost of the combination contingent on future events, paragraph 32 of the IFRS requires the amount of the adjustment to be included in the cost of the combination at the acquisition date if the adjustment is probable and can be measured reliably. In accordance with paragraph 33, if the amount of the adjustment is included in the cost of the combination at the time of initially accounting for the combination but the future events do not occur or the estimate needs to be revised, the cost of the combination must be adjusted accordingly. In accordance with paragraph 34, if the amount of the adjustment is *not* included in the cost of the combination at the time of initially accounting for the combination and the adjustment subsequently becomes probable and can be measured reliably, the cost of the combination must also be

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adjusted accordingly. The requirements in paragraphs 33 and 34 of the IFRS are two exceptions to the principle adopted by the Board that the initial accounting for a business combination should be adjusted after that accounting is complete only to correct an error.

BC167 As noted in paragraph BC67, the IFRS carries forward from IAS 22, without reconsideration, the requirements on adjustments to the cost of a business combination contingent on future events. The Board is reconsidering those requirements, and therefore the two related exceptions to the principle that the initial accounting for a business combination can be adjusted only to correct an error, as part of the second phase of its Business Combinations project.

Recognition of deferred tax assets after the initial accounting is complete (paragraph 65)

BC168 IAS 22 contained an exception to the requirements outlined in paragraph BC160 for the subsequent recognition of the acquiree's identifiable assets and liabilities. That exception arose because of the accounting required by IAS 22 when the potential benefit of the acquiree's income tax loss carry-forwards or other deferred tax assets not satisfying the criteria for separate recognition when the business combination was initially accounted for was subsequently realised.

BC169 Paragraph 65 of the IFRS carries forward from IAS 22, without reconsideration, the requirements for accounting for the subsequent realisation of such potential tax benefits. These requirements:

(a) are also an exception to the principle adopted by the Board that the initial accounting for a business combination should be adjusted after that accounting is complete only to correct an error; and

(b) are being reconsidered by the Board as part of the second phase of its Business Combinations project.

DISCLOSURE (paragraphs 66-77)

BC170 In line with the Board's aim of articulating in IFRSs the broad principles underpinning a required accounting treatment, the Board decided that the IFRS should state explicitly the objectives that the various disclosure requirements are intended to meet. To that end, the Board identified the following three disclosure objectives:

(a) to provide the users of an acquirer's financial statements with information that enables them to evaluate the nature and financial effect of business combinations that were effected during the reporting period or after the balance sheet date but before the financial statements are authorised for issue.

(b) to provide the users of an acquirer's financial statements with information that enables them 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 period or in previous periods.

(c) to provide the users of an acquirer's financial statements with information that enables them to evaluate changes in the carrying amount of goodwill during the period.

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BC171 The Board began its discussion of the disclosure requirements necessary to meet these objectives by assessing the disclosure requirements in SIC-28 *Business Combinations—"Date of Exchange" and Fair Value of Equity Instruments* and IAS 22. The Board concluded that information disclosed in accordance with SIC-28 about equity instruments issued as part of the cost of a business combination helps to meet the first of the three objectives outlined above. Therefore, the Board decided to carry forward to the IFRS the disclosure requirements in SIC-28.

BC172 The Board also concluded that information previously disclosed in accordance with IAS 22 about business combinations classified as acquisitions and goodwill helps to meet the objectives outlined above. Therefore, the Board decided to carry forward to the IFRS the related disclosure requirements in IAS 22, amended as necessary to reflect the Board's other decisions in this project. For example, IAS 22 required disclosure of the amount of any adjustment during the period to goodwill or negative goodwill resulting from subsequent identification or changes in value of the acquiree's identifiable assets and liabilities. In line with the Board's decision that an acquirer should, with specified exceptions, adjust the initial accounting for a combination after that accounting is complete only to correct an error (see paragraphs BC164-BC169), the IAS 22 disclosure requirement has been amended in the IFRS to require disclosure of information about error corrections required to be disclosed by IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

BC173 The Board then assessed whether any additional disclosure requirements should be included in the IFRS to ensure that the three disclosure objectives outlined in paragraph BC170 are met. Mindful of the aim to seek international convergence on the accounting for business combinations, the Board, in making its assessment, considered the disclosure requirements in the corresponding domestic standards of each of its partner standard-setters.

BC174 As a result, and after considering respondents' comments on ED 3, the Board identified, and decided to include in the IFRS, the following additional disclosure requirements that it concluded would help to meet the first of the three disclosure objectives outlined in paragraph BC170:

(a) for each business combination that was effected during the period:

  (i) the amounts recognised at the acquisition date for each class of the acquiree's assets, liabilities and contingent liabilities, and, unless disclosure would be impracticable, the carrying amounts of each of those classes, determined in accordance with IFRSs, immediately before the combination. If such disclosure would be impracticable, that fact must be disclosed, together with an explanation of why this is the case.

  (ii) a description of the factors that contributed to a cost that results in the recognition of goodwill—including 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—or a description of the nature of an excess (ie 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).

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   (iii) the amount of the acquiree's profit or loss since the acquisition date included in the acquirer's profit or loss for the period, unless disclosure would be impracticable. If such disclosure would be impracticable, that fact must be disclosed, together with an explanation of why this is the case.

(b) the information required to be disclosed for each business combination that was effected during the period in aggregate for business combinations that are individually immaterial.

(c) the revenue and profit or loss of the combined entity for the period as though the acquisition date for all business combinations that were effected during the period had been the beginning of that period, unless such disclosure would be impracticable.

BC175 The Board further decided that, to aid in meeting the second disclosure objective outlined in paragraph BC170, the IFRS should also require disclosure by the acquirer of the amount and an explanation of any gain or loss recognised in the current period that:

(a) 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 period; and

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

BC176 In relation to the third disclosure objective outlined in paragraph BC170, the Board concluded that the requirement to disclose a reconciliation of the carrying amount of goodwill at the beginning and end of the period should be amended to require separate disclosure of net exchange differences arising during the period.

BC177 After deciding on these additional disclosure requirements, the Board observed that there might be situations in which the information disclosed under the specific requirements does not completely satisfy the three disclosure objectives outlined in paragraph BC170. The Board therefore agreed that the IFRS should require disclosure in these situations of such additional information as is necessary to meet those objectives.

BC178 Paragraph 67 of the IFRS also requires that when equity instruments are issued or issuable as part of the cost of a business combination, the acquirer should disclose the number of equity instruments issued or issuable, the fair value of those instruments, and the basis for determining that fair value. The Board concluded that, although IAS 22 did not explicitly require disclosure of this information, it should have nonetheless been provided by the acquirer as part of disclosing the cost of acquisition and a description of the purchase consideration paid or contingently payable in accordance with paragraph 87(b) of IAS 22. The Board decided that to avoid the IFRS being inconsistently applied, the IFRS should explicitly require disclosure of this information.

TRANSITIONAL PROVISIONS AND EFFECTIVE DATE (paragraphs 78-85)

BC179 Except as discussed in paragraphs BC181-BC184, the IFRS applies to the accounting for business combinations for which the agreement date is on or after 31 March 2004 (ie the date the IFRS was issued), and to the accounting for any goodwill or excess arising from such a business combination.

BC180 The Board observed that requiring the IFRS to be applied retrospectively to all business combinations for which the agreement date is before the date the IFRS was issued might improve the comparability of financial information. However, such an approach would be problematic for the following reasons:

(a) it is likely to be impossible for many business combinations because the information needed may not exist or may no longer be obtainable.

(b) it requires the determination of estimates that would have been made at a prior date, and therefore raises problems in relation to the role of hindsight—in particular, whether the benefit of hindsight should be included or excluded from those estimates and, if excluded, how the effect of hindsight can be separated from the other factors existing at the date for which the estimates are required.

The Board concluded that the problems associated with applying the IFRS retrospectively, on balance, outweigh the benefit of improved comparability of financial information.

Limited retrospective application (paragraph 85)

BC181 The Board then considered whether retrospective application of the IFRS to business combinations for which the agreement date is before the date the IFRS is issued should nonetheless be permitted. In developing ED 3 the Board concluded that this would have the effect of providing preparers of financial statements with an option in respect of transitional provisions, thereby undermining both the comparability of financial information and the Board's efforts to eliminate options from IFRSs. Therefore, ED 3 proposed prohibiting retrospective application of the IFRS to combinations for which the agreement date is before the date the IFRS is issued.

BC182 Some respondents to ED 3 were concerned that prohibiting retrospective application of the IFRS to combinations for which the agreement date is before the date the IFRS is issued would not be consistent with the option provided to first-time adopters in IFRS 1 *First-time Adoption of International Financial Reporting Standards*. IFRS 1 permits a first-time adopter to restate a past business combination to comply with IFRSs, provided it also restates all later business combinations. In considering this issue, the Board observed the following:

(a) requiring the IFRS to be applied retrospectively to *all* past business combinations would be problematic for the reasons described in paragraph BC180.

(b) IFRS preparers that are also US registrants would have the necessary information to apply US Statements of Financial Accounting Standards 141 *Business Combinations* and 142 *Goodwill and Other Intangible Assets*, from the effective date of those Standards. The availability of that information would make application of the IFRS and the revised versions of IAS 36 and IAS 38 practicable from at least that same date.

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BC183 The Board noted that giving entities the option of applying the IFRS to past business combinations from any date before the IFRS's effective dates would impair the comparability of financial information. However, the Board also noted that the issue of any new or revised IFRS reflects its opinion that application of that IFRS will result in more useful information being provided to users about an entity's financial position, performance or cash flows. On that basis, a case exists for permitting, and indeed encouraging, entities to apply a new or revised IFRS before its effective date. The Board concluded that if it were practicable for an entity to apply the IFRS from any date before the IFRS's effective dates, users of the entity's financial statements would be provided with more useful information than was previously the case under IAS 22. The Board concluded that the benefit of providing users with more useful information about an entity's financial position and performance by allowing limited retrospective application of this IFRS outweighs the disadvantages of potentially diminished comparability.

BC184 Therefore, unlike the proposals in ED 3, the IFRS permits entities to apply the requirements of the IFRS from any date before the effective dates outlined in paragraphs 78-84 of the IFRS, provided:

(a) the valuations and other information needed to apply the IFRS to past business combinations were obtained at the time those combinations were initially accounted for; and

(b) the entity also applies the revised versions of IAS 36 and IAS 38 prospectively from that same date, and the valuations and other information needed to apply those Standards from that date were previously obtained by the entity so that there would be no need to determine estimates that would need to have been made at a prior date.

Previously recognised goodwill (paragraphs 79 and 80)

BC185 The requirement to apply the IFRS to the accounting for business combinations for which the agreement date is on or after the date the IFRS is issued (or from an earlier date if the entity elects to apply paragraph 85 of the IFRS) raises a number of additional issues. One is whether goodwill acquired in a business combination for which the agreement date was before the date the IFRS is first applied should continue to be accounted for after that date in accordance with the requirements in IAS 22 (ie amortised and impairment tested), or in accordance with the requirements in the IFRS (ie impairment tested only). A similar issue exists for negative goodwill arising from a business combination for which the agreement date was before the date the IFRS is first applied. This latter issue is discussed in paragraphs BC189-BC195.

BC186 Consistently with its earlier decision about the accounting for goodwill after initial recognition (see paragraphs BC136-BC142), the Board concluded that non-amortisation of goodwill in conjunction with testing for impairment is the most representationally faithful method of accounting for goodwill and therefore should be applied in all circumstances, including to goodwill acquired in a business combination for which the agreement date was before the date the IFRS is first applied. The Board also concluded that if amortisation of such goodwill were to continue after the date the IFRS is first applied, financial statements would suffer the same lack of comparability that persuaded the Board to reject a mixed approach to accounting for goodwill, ie allowing entities a choice between amortisation and impairment testing.

BC187 As a result, the Board concluded that the IFRS should be applied prospectively, from the beginning of the first annual period beginning on or after the date the IFRS is issued (or from an earlier date if the entity elects to apply paragraph 85 of the IFRS), to:

(a) goodwill acquired in a business combination for which the agreement date was before the date the IFRS is first applied; and

(b) goodwill arising from an interest in a jointly controlled entity obtained before the date the IFRS is first applied and accounted for by applying proportionate consolidation.

BC188 In response to comments received on ED 3, the IFRS also clarifies that if an entity previously recognised goodwill as a deduction from equity, it should not recognise that goodwill in profit or loss if it disposes of all or part of the business to which that goodwill relates or if a cash-generating unit to which the goodwill relates becomes impaired.

Previously recognised negative goodwill (paragraph 81)

BC189 The Board considered whether the carrying amount of negative goodwill arising from a business combination for which the agreement date was *before* the date the IFRS is issued (or from an earlier date if the entity elects to apply paragraph 85 of the IFRS) should:

(a) continue to be accounted for after the date the IFRS is first applied in accordance with the requirements in IAS 22, ie deferred and recognised in profit or loss in future periods by matching the excess against the related future losses and/or expenses; or

(b) be derecognised on the date the IFRS is first applied with a corresponding adjustment to the opening balance of retained earnings.

BC190 In considering this issue, the Board observed that IAS 22 did not permit an acquirer to recognise the acquiree's contingent liabilities at the acquisition date as part of allocating the cost of a business combination. The Board also observed that the application of IAS 22 in practice would probably have resulted in liabilities arising as a consequence of the combination that were not liabilities of the acquiree immediately before the combination being incorrectly recognised as part of allocating the cost of the combination. Therefore, the carrying amount of negative goodwill arising from a combination for which the agreement date was *before* the date the IFRS is first applied is likely to comprise one or more of the following components:

(a) unrecognised contingent liabilities of the acquiree at the acquisition date.

(b) errors in measuring the fair value of either the consideration paid or the identifiable net assets acquired. These measurement errors could, for example, relate to a failure properly to reflect expectations of future losses and expenses in the market value of the acquiree's identifiable net assets.

(c) a requirement in an accounting standard to measure identifiable net assets acquired at an amount that is not fair value.

(d) a bargain purchase.

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BC191 The Board concluded that with the exception of the acquiree's contingent liabilities, the above components do not satisfy the definition of a liability. Therefore, they should not continue to be recognised as deferred credits in the balance sheet after the date the IFRS is first applied.

BC192 The Board noted that, to the extent the carrying amount of negative goodwill on the date the IFRS is first applied comprises contingent liabilities of the acquiree at the acquisition date, those contingent liabilities may or may not have been resolved. If the contingent liability *has* been resolved, the related expense (if any) will have been recognised by the combined entity in profit or loss. The Board therefore concluded that any component of the carrying amount of negative goodwill that relates to contingent liabilities of the acquiree that have been resolved should be derecognised on the date the IFRS is first applied.

BC193 The Board observed that if a contingent liability included within the carrying amount of negative goodwill at the date the IFRS is first applied has not been resolved, the portion of the carrying amount attributable to that contingent liability might, in theory, be able to be isolated and carried forward as a liability after the date the IFRS is first applied. However, the Board agreed that isolating the contingent liability is likely to be extremely difficult in practice: the information needed may not exist or may no longer be obtainable. In addition, it requires the determination of estimates that would have been made at a prior date, and therefore raises problems in relation to the role of hindsight.

BC194 Furthermore, IAS 22 required negative goodwill to be deferred and recognised as income in future periods by matching the excess against the related future losses and/or expenses that were identified in the acquirer's plan for the acquisition and could be measured reliably. To the extent the negative goodwill did not relate to expectations of future losses and expenses that were identified in the acquirer's plan and could be measured reliably, an amount not exceeding the aggregate fair values of the identifiable non-monetary assets acquired was recognised as income on a systematic basis over the remaining weighted average useful life of the identifiable depreciable assets acquired. Any remaining negative goodwill was recognised as income immediately. Therefore, if the acquiree's unresolved contingent liability was not identified in the acquirer's plan for the acquisition, some or all of that contingent liability would have been recognised as income before the date the IFRS is first applied, adding an additional layer of complexity to trying to isolate the portion of the carrying amount attributable to the unresolved contingent liability.

BC195 On the basis of these arguments, the Board concluded that the IFRS should require derecognition of the full carrying amount of negative goodwill at the beginning of the first annual period beginning on or after the date the IFRS is issued (or at an earlier date if the entity elects to apply paragraph 85 of the IFRS), with a corresponding adjustment to the opening balance of retained earnings.

Previously recognised intangible assets (paragraph 82)

BC196 The IFRS clarifies the criteria for recognising intangible assets separately from goodwill. The Board therefore considered whether entities should be required to apply those criteria to reassess:

(a) the carrying amount of intangible assets acquired in business combinations for which the agreement date was before the date the IFRS is issued (or at an earlier date if the entity elects to apply paragraph 85 of the IFRS) and reclassify as goodwill any that do not meet the criteria for separate recognition; and

(b) the carrying amount of goodwill acquired in business combinations for which the agreement date was before the date the IFRS is issued (or at an earlier date if the entity elects to apply paragraph 85 of the IFRS) and reclassify as an identifiable intangible asset any component of the goodwill that meets the criteria for separate recognition.

BC197 The Board noted that determining whether a recognised intangible asset meets the criteria for recognition separately from goodwill would be fairly straightforward, and that requiring reclassification as goodwill if the criteria are not met would improve the comparability of financial statements. However, identifying and reclassifying intangible assets that meet those criteria but were previously subsumed in goodwill would be problematic for the same reasons that it would be problematic to require retrospective application of the requirements in the IFRS to all past business combinations.

BC198 As a result, the Board concluded that the IFRS should require the criteria for recognising intangible assets separately from goodwill to be applied only to reassess the carrying amounts of recognised intangible assets acquired in business combinations for which the agreement date was before the date the IFRS is issued (or at an earlier date if the entity elects to apply paragraph 85 of the IFRS). The IFRS should not require the criteria to be applied to reassess the carrying amount of goodwill acquired before the date the IFRS is first applied.

BC199 The Board noted that the transitional provisions in the previous version of IAS 38 *Intangible Assets* permitted, but did not require, retrospective reclassification of an intangible asset acquired in a business combination that was an acquisition and subsumed within goodwill but which satisfied the criteria in IAS 22 and the previous version of IAS 38 for recognition separately from goodwill. However, the Board observed that adopting such an approach in the IFRS would have the effect of providing preparers of financial statements with an option in respect of transitional provisions, thereby undermining both the comparability of financial information and the Board's efforts to eliminate options from IFRSs. The Board further observed that such an option was likely to act as an incentive to restate financial statements only if that restatement serves to benefit the entity in some way. Therefore, the Board decided that the IFRS should also not permit the option of applying the criteria for recognising intangible assets separately from goodwill to goodwill acquired before the date the IFRS is first applied.

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Equity accounted investments (paragraphs 83 and 84)

BC200 Consistently with its decision that the IFRS should apply to the accounting for business combinations for which the agreement date is on or after the date the IFRS is issued and any goodwill or excess arising from such combinations (or from an earlier date if the entity elects to apply paragraph 85 of the IFRS), the Board agreed that the IFRS should also apply to the accounting for any goodwill or excess included in the carrying amount of an equity accounted investment acquired on or after the date the IFRS is first applied. Therefore, if the carrying amount of the investment includes goodwill, amortisation of that notional goodwill should not be included in the determination of the investor's share of the investee's profit or loss. If the carrying amount of the investment includes an excess, the amount of that excess should be included as income in the determination of the investor's share of the investee's profit or loss in the period in which the investment is acquired.

BC201 However, as outlined in paragraph BC185, the requirement for the IFRS to be applied to the accounting for goodwill or any excess arising from business combinations for which the agreement date is on or after the date the IFRS is issued (or from an earlier date if the entity elects to apply paragraph 85 of the IFRS) raises a number of additional issues. One is whether goodwill acquired in a combination for which the agreement date was *before* the date the IFRS is first applied should be accounted for after that date in accordance with IAS 22 or the IFRS. Another is whether the carrying amount of negative goodwill arising from a combination for which the agreement date was *before* the date the IFRS is first applied should be accounted for after that date as a deferred credit in accordance with IAS 22 or derecognised.

BC202 Related to these issues are questions of whether, for equity accounted investments acquired *before* the date the IFRS is first applied, an investor should calculate its share of the investee's profit or loss *after* that date by:

(a) in the case of an investment that notionally includes goodwill within its carrying amount, continuing to include an adjustment for the amortisation of that goodwill; or

(b) in the case of an investment that notionally includes negative goodwill in its carrying amount, continuing to reflect the deferral and matching approach required by IAS 22 for that negative goodwill.

BC203 For the reasons the Board concluded that previously recognised goodwill should be accounted for after the date the IFRS is first applied by applying the requirements in the IFRS (see paragraphs BC186 and BC187), the Board also concluded that any goodwill included in the carrying amount of an equity accounted investment acquired *before* the date the IFRS is first applied should be accounted for after that date by applying the requirements in the IFRS. Therefore, amortisation of that notional goodwill should not be included in the determination of the investor's share of the investee's profit or loss.

BC204 Similarly, for the reasons the Board concluded that previously recognised negative goodwill should be derecognised (see paragraphs BC189-BC195), the Board also concluded that any negative goodwill included in the carrying amount of an equity accounted investment acquired *before* the date the IFRS is first applied should be derecognised at the date the IFRS is first applied, with a corresponding adjustment to the opening balance of retained earnings.

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Dissenting opinions on IFRS 3

Dissent of Geoffrey Whittington and Tatsumi Yamada

DO1 Professor Whittington and Mr Yamada dissent from the issue of this Standard.

DO2 Professor Whittington dissents on three grounds: first, the Board's decision to defer consideration of 'fresh start' accounting rather than implementing it immediately in place of pooling of interests accounting; second, the recognition criteria for intangible assets acquired and contingent liabilities assumed in a business combination; and third, the abolition of the amortisation of goodwill.

DO3 Mr Yamada dissents because he objects to the abolition of the amortisation of goodwill.

Fresh start accounting

DO4 Professor Whittington notes that fresh start accounting treats the business combination as creating a new entity. It therefore requires revaluation of all the assets of the combining entities (including, when the method is applied in its purest form, goodwill) at current value at the date of the combination. In effect, it applies the purchase method to both parties to the combination. It therefore provides, in Professor Whittington's view, an appropriate representation of the economic reality of a 'true merger' or 'uniting of interests' in which all parties to the combination are radically affected by the transaction. The fresh start approach is long established in the accounting literature and a version of it (the new entity method) was suggested in E22 (1981) *Accounting for Business Combinations*, the exposure draft that preceded IAS 22 (1983) *Accounting for Business Combinations*. Professor Whittington believes that further consideration of this method should not have been deferred.

DO5 Professor Whittington also believes that while IFRS 3 correctly acknowledges that true mergers may exist (see paragraphs BC40-BC42 and BC47), it may underestimate the range of business combinations that might be included in this category. In Professor Whittington's view, a 'true acquisition' may be characterised as being similar to an investment by the acquiring business, which may extend the business but does not radically affect the existing activities of the acquirer. A 'true merger' on the other hand leads to a radical change in the conduct of all existing activities. Between these two extremes is a range of business combinations that fall less easily into one category or the other. When the pooling of interests method was the alternative accounting treatment available for mergers (as in IAS 22), the radical differences between the outcome of applying that method and the purchase method led to the possibility of accounting arbitrage across the merger/acquisition boundary (as is suggested in paragraph BC48(b)). Professor Whittington believes that because the fresh start method is, in effect, an extension of the purchase method, the incentives for such arbitrage would probably be less were the fresh start method substituted for the pooling of interests method as the appropriate treatment for mergers.

DO6 Professor Whittington believes that IFRS 3 is correct in its prohibition of the pooling of interests method, because that method does not take account of the values arising from the business combination transaction. However, IFRS 3 is wrong to substitute the purchase method for the pooling of interests method, enforcing the identification

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of an acquirer even when this is acknowledged to be extremely difficult and may fail to capture the economic substance of the transaction, as in the case of the 'roll-up transactions' described in paragraph BC22. In such circumstances, the fresh start method should be permitted.

Recognition criteria for intangible assets acquired and contingent liabilities assumed in a business combination

DO7 Professor Whittington dissents from the recognition criteria in paragraph 37 insofar as they exempt intangible assets acquired and contingent liabilities assumed in a business combination from the requirement that the inflows or outflows of benefits will probably flow to the acquirer. The Board acknowledges in paragraphs BC96 and BC112 that this is inconsistent with the *Framework* and, in the case of contingent liabilities, with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. Professor Whittington believes that such a step should not be taken in advance of a full review of the recognition criteria in the *Framework*.

Abolition of goodwill amortisation

DO8 Professor Whittington and Mr Yamada observe that the amortisation of goodwill is a well-established and well-understood practice. The requirements of IAS 22, including the rebuttable presumption of a 20-year useful life and an impairment test, appear to have given rise to no obvious difficulties.

DO9 Professor Whittington and Mr Yamada believe that the benefits of amortisation are its simplicity, its transparency and its precise targeting of the acquired goodwill, as opposed to the internally generated goodwill of the acquiring entity or the subsequent internally generated goodwill. The result is that management is made accountable for its expenditure on goodwill.

DO10 Professor Whittington and Mr Yamada acknowledge that two valid criticisms are made of amortisation: it is arbitrary, although not necessarily more arbitrary than the amortisation of other assets, and there is little evidence it is of significant value to users, as indicated by empirical studies of its impact on share prices. However, Professor Whittington and Mr Yamada believe that the arbitrariness can be overcome to a large extent by the additional use of impairment tests (as was required by IAS 22), and that the lack of immediate impact of amortisation on share prices does not negate the benefits of accountability. Indeed, it can reasonably be argued that the measurement of goodwill is intrinsically unreliable, and that a transparent if somewhat arbitrary method, such as amortisation, is less likely to mislead the market than the impairment-only approach required in IFRS 3, which, in the view of Professor Whittington and Mr Yamada, purports to capture economic reality but fails to do so.

DO11 Professor Whittington and Mr Yamada also believe that the abolition of goodwill amortisation in favour of an impairment-only approach is inconsistent with the general principle that internally generated goodwill should not be recognised. They agree with the Board's analysis in paragraphs BC130 and BC131 regarding the components of 'core goodwill', and note that the Board correctly acknowledges in paragraph BC140 that core goodwill acquired in a business combination is consumed over time and replaced by internally generated goodwill, provided that an entity is able to maintain the overall value of goodwill. In other words, the acquired core goodwill has a limited useful life, notwithstanding that it might be difficult to determine that useful life otherwise than in an arbitrary manner. Professor Whittington and Mr Yamada

therefore believe that the amortisation of acquired goodwill over its useful life to reflect its consumption over that useful life is more representationally faithful than the impairment-only approach required by IFRS 3, even if the useful life and pattern of consumption can be determined only arbitrarily. The potential for arbitrariness does not provide sufficient grounds for ignoring the fact that the value of the acquired goodwill diminishes over its useful life as it is consumed. Thus, Professor Whittington and Mr Yamada are of the view that amortisation with regular impairment testing should be the required method of accounting for goodwill after its initial recognition. Professor Whittington and Mr Yamada note that the respondents to ED 3 that expressed a clear view on this issue generally supported straight-line amortisation (provided there is no evidence that an alternative pattern of amortisation is more representationally faithful) coupled with an impairment test whenever there is an indication that the goodwill might be impaired (see paragraph BC139). Professor Whittington and Mr Yamada agree with these respondents, and disagree with the Board's analysis of their comments (as set out in paragraphs BC140 and BC141).

DO12 Professor Whittington is additionally concerned that in rejecting amortisation, IFRS 3 puts its faith in a potentially unreliable impairment test that inevitably cannot separate out subsequent internally generated goodwill and has other weaknesses that require attention. Until greater experience of such tests has been accumulated, it cannot be established that they pass the cost/benefit test for the majority of entities affected. The costs of the impairment tests are likely to be high and the benefits may be diminished by their potential unreliability. Thus, amortisation supplemented by an impairment test (as was required by IAS 22) should be retained as the required method of accounting for goodwill. Professor Whittington is of the view that annual impairment tests without amortisation could be permitted as an alternative treatment when it is possible to rebut the presumption that goodwill has a determinable life. In such cases, impairment testing can be regarded as an alternative technique for achieving a similar objective to amortisation (measuring the consumption of goodwill), rather than being in direct conflict with the method previously required by IAS 22. This treatment of goodwill would also be consistent with the treatment of intangible assets. Neither method will achieve the objective of measuring the consumption of goodwill perfectly: accounting for goodwill is one of the most difficult problems in financial reporting, and the difficulty arises from the nature of goodwill.

DO13 Mr Yamada shares Professor Whittington's concern that, in rejecting amortisation, IFRS 3 puts its faith in a potentially unreliable impairment-only approach that inevitably cannot separate out subsequent internally generated goodwill and has other weaknesses that require attention. Mr Yamada views the impairment-only approach for goodwill as particularly unsatisfactory because of the failure of the impairment test in IAS 36 *Impairment of Assets* to eliminate the internally generated goodwill of the acquiring entity at the acquisition date and internally generated goodwill accruing after a business combination. He believes that including these items in the measure of goodwill will inappropriately provide 'cushions' against recognising impairment losses that have in fact occurred in respect of the acquired goodwill. Such 'cushions', combined with the abolition of the amortisation of acquired goodwill, will improperly result in an entity recognising internally generated goodwill as an asset, up to the amount initially recognised for the acquired goodwill. Mr Yamada acknowledges that many of the 'cushioning' problems existed, to a certain extent, under the previous approach in IAS 22 and IAS 36 *Impairment of Assets* of amortising goodwill in

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conjunction with regular impairment testing using the 'one-step' impairment test in the previous version of IAS 36. However, he believes that the previous approach provided more appropriate information because it ensured that the carrying amount of acquired goodwill was reduced to zero at the end of its useful life, even though there was a degree of arbitrariness in determining that useful life and the pattern of the acquired goodwill's consumption. The previous approach also ensured that, ultimately, no internally generated goodwill could be recognised. Under IFRS 3, if a business combination is so successful that the recoverable amount of a cash-generating unit to which goodwill has been allocated continues to exceed its carrying amount, the goodwill allocated to that unit will continue indefinitely to be recognised at its fair value at the acquisition date. Mr Yamada does not agree that this is a representationally faithful method of accounting for an asset that is consumed over time and replaced by internally generated goodwill. He believes that the previous approach provided a more transparent and representationally faithful method of accounting for acquired goodwill than the impairment-only approach required by IFRS 3.

DO14 Mr Yamada notes the Board's conclusion, as set out in paragraph BC142, that if a rigorous and operational impairment test could be devised, more useful information would be provided under an approach in which goodwill is not amortised, but instead tested for impairment annually or more frequently if events or changes in circumstances indicate that the goodwill might be impaired. Mr Yamada is of the view that the Board's decision to withdraw the 'two-step' impairment test for goodwill proposed in the Exposure Draft of Proposed Amendments to IAS 36, in favour of retaining the 'one-step' approach to measuring impairments of goodwill in the previous version of IAS 36 does not meet the requirement of 'a rigorous and operational impairment test'. He is also of the view that the requirement in paragraph 104(a) of IAS 36 for impairment losses to be allocated first to reduce the carrying amount of any goodwill allocated to a cash-generating unit is inconsistent with the view set out in paragraph BC132 that 'core goodwill' represents resources from which future economic benefits are expected to flow to the entity. This inconsistency strengthens Mr Yamada's view that the impairment-only approach is not a transparent and representationally faithful method of accounting for acquired goodwill. Nevertheless he welcomes the Board's decision to retain the 'one-step' approach to measuring impairments of goodwill because he believes that the requirements proposed in the Exposure Draft of Proposed Amendments to IAS 36 for measuring the implied value of goodwill were extremely complex, unduly burdensome, and would have resulted in a hypothetical measure unrelated to the acquired goodwill being tested for impairment.

DO15 With regard to intangible assets other than goodwill, Mr Yamada agrees with the Board's conclusion, as set out in paragraphs BC74 and BC75 of the Basis for Conclusions on IAS 38 *Intangible Assets*, that there are some such assets that have indefinite useful lives and that should not, therefore, be amortised. Mr Yamada believes that intangible assets with indefinite useful lives are fundamentally different in nature from goodwill. Therefore, although he disagrees with the abolition of amortisation of goodwill, he agrees with the abolition of amortisation of intangible assets with indefinite useful lives.

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DO16 Mr Yamada notes the concern expressed by some that amortising goodwill but not amortising intangible assets with indefinite useful lives increases the potential for intangible assets to be misclassified at the acquisition date. However, Mr Yamada agrees with the Board's conclusion, as set out in paragraph BC49 of the Basis for Conclusions on IAS 38, that adopting the separability and contractual or other legal rights criteria provides a reasonably definitive basis for separately identifying and recognising intangible assets acquired in a business combination. Therefore, differences between the subsequent treatment of goodwill and intangible assets with indefinite useful lives would not, in his view, increase the potential for intangible assets to be misclassified at the acquisition date.

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IFRS 3 Business Combinations

Illustrative Examples

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IFRS 3 Business Combinations
Illustrative Examples

These examples accompany, but are not part of, IFRS 3.

Examples of items acquired in a business combination that meet the definition of an intangible asset

The following guidance provides examples of items acquired in a business combination that meet the definition of an intangible asset and are therefore recognised under IFRS 3 *Business Combinations* separately from goodwill, provided that their fair values can be measured reliably. To meet the definition of an intangible asset a non-monetary asset without physical substance must be identifiable, ie it must arise from contractual or other legal rights or be separable.

The examples provided below are not intended to be an exhaustive list of items acquired in a business combination that meet the definition of an intangible asset. A non-monetary asset without physical substance acquired in a business combination might meet the identifiability criterion for identification as an intangible asset but not be included in this guidance.

Assets designated with the symbol # are those that meet the definition of an intangible asset because they arise from contractual or other legal rights. Assets designated with the symbol * do not arise from contractual or other legal rights, but meet the definition of an intangible asset because they are separable. Assets designated with the symbol # might also be separable; however, separability is not a necessary condition for an asset to meet the contractual-legal criterion.

A Marketing-related intangible assets

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

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.

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 meet the definition of an intangible asset provided the separability criterion is met, which would normally be the case.

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.

2 Internet domain names #

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

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period of the registration. Those registrations are renewable. A registered domain name acquired in a business combination is an intangible asset that meets the contractual-legal criterion.

3 Trade dress (unique colour, shape or package design) #

4 Newspaper mastheads #

5 Non-competition agreements #

B Customer-related intangible assets

1 Customer lists *

A customer list consists of information about customers, such as their name and contact information. A customer list may also be in the form of a database that includes other information about the customers such as their order history and demographic information. A customer list does not generally arise from contractual or other legal rights. However, customer lists are valuable and are frequently leased or exchanged. Therefore, a customer list acquired in a business combination normally meets the separability criterion for identification as an intangible asset. However, a customer list acquired in a business combination would not meet that criterion if the terms of confidentiality or other agreements prohibit an entity from selling, leasing or otherwise exchanging information about its customers.

2 Order or production backlog #

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 for identification as an intangible asset, even if the purchase or sales orders are cancellable.

3 Customer contracts and the related customer relationships #

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 for identification as intangible assets. This will be the case even if confidentiality or other contractual terms prohibit the sale or transfer of a contract separately from the acquired entity or business.

Customer relationships also meet the contractual-legal criterion for identification as intangible assets when an entity has a practice of establishing contracts with its customers, regardless of whether a contract exists at the date of acquisition.

As noted in B2, an order or a production backlog arises from contracts such as purchase or sales orders, and is therefore also considered 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 for identification as intangible assets.

4 Non-contractual customer relationships *

If a customer relationship acquired in a business combination does not arise from a contract, the relationship is an intangible asset if it meets the separability criterion. Exchange transactions for the same asset or a similar asset provide evidence of

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separability of a non-contractual customer relationship and might also provide information about exchange prices that should be considered when estimating fair value.

C Artistic-related intangible assets

Artistic-related assets acquired in a business combination meet the criteria for identification as intangible assets 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. An entity 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.

1 Plays, operas and ballets #

2 Books, magazines, newspapers and other literary works #

3 Musical works such as compositions, song lyrics and advertising jingles #

4 Pictures and photographs #

5 Video and audiovisual material, including films, music videos and television programmes #

D Contract-based intangible assets

1 Licensing, royalty and standstill agreements #

2 Advertising, construction, management, service or supply contracts #

3 Lease agreements #

4 Construction permits #

5 Franchise agreements #

6 Operating and broadcasting rights #

7 Use rights such as drilling, water, air, mineral, timber-cutting and route authorities #

8 Servicing contracts such as mortgage servicing contracts #

Contracts to service financial assets are one particular type of contract-based intangible asset. While servicing is inherent in all financial assets, it becomes a distinct asset (or liability):

(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.

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.

9 Employment contracts that are beneficial contracts from the perspective of the employer because the pricing of those contracts is below their current market value #

E Technology-based intangible assets

1 Patented technology #

2 Computer software and mask works #

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.

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 also meet the contractual-legal criterion for identification as intangible assets.

3 Unpatented technology *

4 Databases *

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 for identification as an intangible asset. 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 for identification as an intangible asset.

5 Trade secrets such as secret formulas, processes or recipes #

If the future economic benefits from a trade secret acquired in a business combination are legally protected, that asset meets the contractual-legal criterion for identification as an intangible asset. Otherwise, trade secrets acquired in a business combination meet the definition of an intangible asset only if the separability criterion is met, which is often likely to be the case.

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Customer relationship intangible assets acquired in a business combination

The following examples illustrate the recognition in accordance with IFRS 3 *Business Combinations* of customer relationship intangible assets acquired in a business combination.

Example 1

Background

Parent obtained control of Supplier in a business combination on 31 December 20X4. Supplier has a five-year agreement to supply goods to Buyer. Both Supplier and Parent believe that Buyer will renew the supply agreement at the end of the current contract. The supply agreement is not separable.

Analysis

The supply agreement (whether cancellable or not) meets the contractual-legal criterion for identification as an intangible asset, and therefore is recognised separately from goodwill, provided its fair value can be measured reliably. Additionally, because Supplier establishes its relationship with Buyer through a contract, the customer relationship with Buyer meets the contractual-legal criterion for identification as an intangible asset. Therefore, the customer relationship intangible asset is also recognised separately from goodwill provided its fair value can be measured reliably. In determining the fair value of the customer relationship, Parent considers assumptions such as the expected renewal of the supply agreement.

Example 2

Background

Parent obtained control of Subsidiary in a business combination on 31 December 20X4. Subsidiary manufactures goods in two distinct lines of business—sporting goods and electronics. Customer purchases from Subsidiary both sporting goods and electronics. Subsidiary 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 Subsidiary and Parent believe that there is only one overall customer relationship between Subsidiary and Customer.

Analysis

The contract to be Customer's exclusive supplier of sporting goods (whether cancellable or not) meets the contractual-legal criterion for identification as an intangible asset, and is therefore recognised separately from goodwill, provided its fair value can be measured reliably. Additionally, because Subsidiary establishes its relationship with Customer through a contract, the customer relationship with Customer meets the contractual-legal criterion for identification as an intangible asset. Therefore, the customer relationship intangible asset is also recognised separately from goodwill, provided its fair value can be measured reliably. Because there is only one customer relationship with Customer, the fair value of that relationship incorporates assumptions regarding Subsidiary's relationship with Customer related to both sporting goods and electronics.

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However, if both Parent and Subsidiary believed 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 Parent to determine whether it meets the separability criterion for identification as an intangible asset.

Example 3

Background

Entity A obtained control of Entity B in a business combination on 31 December 20X4. Entity B does business with its customers solely through purchase and sales orders. At 31 December 20X4, Entity B 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 Entity B's customers are also recurring customers. However, as of 31 December 20X4, Entity B does not have any open purchase orders or other contracts with those customers.

Analysis

The purchase orders from 60 per cent of Entity B's customers (whether cancellable or not) meet the contractual-legal criterion for identification as intangible assets, and are therefore recognised separately from goodwill, provided their fair values can be measured reliably. Additionally, because Entity B has established its relationship with 60 per cent of its customers through contracts, those customer relationships meet the contractual-legal criterion for identification as an intangible asset. Therefore, the customer relationship intangible asset is also recognised separately from goodwill provided its fair value can be measured reliably.

Because Entity B 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 for identification as an intangible asset. Entity A recognises this customer relationship separately from goodwill, provided its fair value can be measured reliably, even though Entity B does not have contracts with those customers at 31 December 20X4.

Example 4

Background

Parent obtained control of Insurer in a business combination on 31 December 20X4. Insurer has a portfolio of one-year motor insurance contracts that are cancellable by policyholders. A reasonably predictable number of policyholders renew their insurance contracts each year.

Analysis

Because Insurer establishes its relationships with policyholders through insurance contracts, the customer relationship with policyholders meets the contractual-legal criterion for identification as an intangible asset. Therefore, the customer relationship intangible asset is recognised separately from goodwill, provided its fair value can be measured reliably. In determining the fair value of the customer relationship intangible asset, Parent considers estimates of renewals and cross-selling. IAS 36 *Impairment of Assets* and IAS 38 *Intangible Assets* apply to the customer relationship intangible asset.

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In determining the fair value of the liability relating to the portfolio of insurance contracts, Parent considers estimates of cancellations by policyholders. 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. This intangible asset is excluded from the scope of IAS 36 and IAS 38. After the business combination, Parent is required to measure that intangible asset on a basis consistent with the measurement of the related insurance liability.

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Reverse acquisitions

The following example illustrates the application of the guidance on reverse acquisition accounting provided as an application supplement in paragraphs B1-B15 of Appendix B of IFRS 3 *Business Combinations*.

Example 5

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 20X1. The accounting for any income tax effects is ignored in this example:

Balance sheets of A and B immediately before the business combination

	A	B
	CU	CU
Current assets	500	700
Non-current assets	1,300	3,000
	1,800	3,700
Current liabilities	300	600
Non-current liabilities	400	1,100
	700	1,700
Owners' equity		
Retained earnings	800	1,400
Issued equity		
100 ordinary shares	300	
60 ordinary shares		600
	1,100	2,000
	1,800	3,700

Other information

(a) On 30 September 20X1, A issues 2½ shares in exchange for each ordinary share of B. All of B's shareholders exchange their shares in B. Therefore, A issues 150 ordinary shares in exchange for all 60 ordinary shares of B.

(b) The fair value of each ordinary share of B at 30 September 20X1 is CU40. The quoted market price of A's ordinary shares at that date is CU12.

(c) The fair values of A's identifiable assets and liabilities at 30 September 20X1 are the same as their carrying amounts, with the exception of non-current assets. The fair value of A's non-current assets at 30 September 20X1 is CU1,500.

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Calculating the cost of the business combination

As a result of the issue of 150 ordinary shares by A, B's shareholders own 60 per cent of the issued shares of the combined entity (ie 150 shares out of 250 issued shares). The remaining 40 per cent are owned by A's shareholders. If the business combination had taken place in the form of B issuing additional ordinary shares to A's shareholders in exchange for their ordinary shares in A, B would have had to issue 40 shares for the ratio of ownership interest in the combined entity to be the same. B's shareholders would then own 60 out of the 100 issued shares of B and therefore 60 per cent of the combined entity.

As a result, the cost of the business combination is CU1,600 (ie 40 shares each with a fair value of CU40).

Measuring goodwill

Goodwill is measured as the excess of the cost of the business combination over the net fair value of A's identifiable assets and liabilities. Therefore, goodwill is measured as follows:

	CU	CU
Cost of the business combination		1,600
Net fair value of 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 20X1

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

Earnings per share

Assume that B's profit for the annual period ending 31 December 20X0 was CU600, and that the consolidated profit for the annual period ending 31 December 20X1 is CU800. Assume also that there was no change in the number of ordinary shares issued by B during the annual period ending 31 December 20X0 and during the period from 1 January 20X1 to the date of the reverse acquisition (30 September 20X1).

Earnings per share for the annual period ending 31 December 20X1 is calculated as follows:

Number of shares deemed to be outstanding for the period from 1 January 20X1 to the acquisition date (ie the number of ordinary shares issued by A in the reverse acquisition)	150
Number of shares outstanding from the acquisition date to 31 December 20X1	250
Weighted average number of ordinary shares outstanding [(150 × 9/12) + (250 × 3/12)]	175
Earnings per share [800/175]	CU4.57

* In accordance with paragraph B7(c) of IFRS 3, the amount recognised as issued equity instruments in the consolidated financial statements is determined by adding to the issued equity of the legal subsidiary immediately before the business combination [CU600] the cost of the combination [CU1,600]. However, the equity structure appearing in the consolidated financial statements (ie the number and type of equity instruments issued) must reflect the equity structure of the legal parent, including the equity instruments issued by the legal parent to effect the combination.

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Restated earnings per share for the annual period ending 31 December 20X0 is 4.00 (ie the profit of B of 600 divided by the number of ordinary shares issued by A in the reverse acquisition).

Minority interest

In the above example, assume that only 56 of B's ordinary shares are tendered for exchange rather than all 60. Because A issues 2½ shares in exchange for each ordinary share of B, A issues only 140 (rather than 150) shares. As a result, B's shareholders own 58.3 per cent of the issued shares of the combined entity (ie 140 shares out of 240 issued shares).

The cost of the business combination is calculated by assuming that the combination had taken place in the form of B issuing additional ordinary shares to the shareholders of A in exchange for their ordinary shares in A. In calculating the number of shares that would have to be issued by B, the minority interest is ignored. The majority shareholders own 56 shares of B. For this to represent a 58.3 per cent ownership interest, B would have had to issue an additional 40 shares. The majority shareholders would then own 56 out of the 96 issued shares of B and therefore 58.3 per cent of the combined entity.

As a result, the cost of the business combination is CU1,600 (ie 40 shares each with a fair value of CU40). This is the same amount as when all 60 of B's ordinary shares are tendered for exchange. The cost of the combination does not change simply because some of B's shareholders do not participate in the exchange.

The minority interest is represented by the 4 shares of the total 60 shares of B that are not exchanged for shares of A. Therefore, the minority interest is 6.7 per cent. The minority interest reflects the minority shareholders' proportionate interest in the pre-combination carrying amounts of the net assets of the legal subsidiary. Therefore, the consolidated balance sheet is adjusted to show a minority interest of 6.7 per cent of the pre-combination carrying amounts of B's net assets (ie CU134 or 6.7 per cent of CU2,000).

The consolidated balance sheet at 30 September 20X1 reflecting the minority interest is as follows:

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

Business combination achieved in stages

The following example illustrates the application of the guidance on business combinations achieved in stages in paragraphs 58-60 of IFRS 3 *Business Combinations*. In particular, it deals with successive share purchases that result in an investee previously accounted for at fair value being included as a subsidiary in the consolidated financial statements.

Immediately following the example is a discussion of the outcome of applying the guidance in paragraphs 58-60 of IFRS 3 to the example assuming the investee had previously been accounted for at cost or by applying the equity method, rather than at fair value.

Example 6

Investor acquires a 20 per cent ownership interest in Investee (a service company) on 1 January 20X1 for CU3,500,000 cash. At that date, the fair value of Investee's identifiable assets is CU10,000,000, and the carrying amount of those assets is CU8,000,000. Investee has no liabilities or contingent liabilities at that date. The following shows Investee's balance sheet at 1 January 20X1 together with the fair values of the identifiable assets:

	Carrying amounts CU	Fair values CU
Cash and receivables	2,000,000	2,000,000
Land	6,000,000	8,000,000
	8,000,000	10,000,000
Issued equity: 1,000,000 ordinary shares	5,000,000	
Retained earnings	3,000,000	
	8,000,000	

During the year ended 31 December 20X1, Investee reports a profit of CU6,000,000 but does not pay any dividends. In addition, the fair value of Investee's land increases by CU3,000,000 to CU11,000,000. However, the amount recognised by Investee in respect of the land remains unchanged at CU6,000,000. The following shows Investee's balance sheet at 31 December 20X1 together with the fair values of the identifiable assets:

	Carrying amounts CU	Fair values CU
Cash and receivables	8,000,000	8,000,000
Land	6,000,000	11,000,000
	14,000,000	19,000,000
Issued equity: 1,000,000 ordinary shares	5,000,000	
Retained earnings	9,000,000	
	14,000,000	

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On 1 January 20X2, Investor acquires a further 60 per cent ownership interest in Investee for CU22,000,000 cash, thereby obtaining control. Before obtaining control, Investor does *not* have significant influence over Investee, and accounts for its initial 20 per cent investment at fair value with changes in value included in profit or loss. Investee's ordinary shares have a quoted market price at 31 December 20X1 of CU30 per share.*

Throughout the period 1 January 20X1 to 1 January 20X2, Investor's issued equity was CU30,000,000. Investor's only asset apart from its investment in Investee is cash.

Accounting for the initial investment before obtaining control

Investor's initial 20 per cent investment in Investee is measured at CU3,500,000. However, Investee's 1,000,000 ordinary shares have a quoted market price at 31 December 20X1 of CU30 per share. Therefore, the carrying amount of Investor's initial 20 per cent investment is remeasured in Investor's financial statements to CU6,000,000 at 31 December 20X1, with the CU2,500,000 increase recognised in profit or loss for the period. Therefore, Investor's balance sheet at 31 December 20X1, before the acquisition of the additional 60 per cent ownership interest, is as follows:

	CU
Cash	26,500,000
Investment in Investee	6,000,000
	32,500,000
Issued equity	30,000,000
Retained earnings	2,500,000
	32,500,000

Accounting for the business combination

Paragraph 25 of IFRS 3 states that when a business combination involves more than one exchange transaction, the cost of the combination is the aggregate cost of the individual transactions, with the cost of each individual transaction determined at the date of each exchange transaction (ie the date that each individual investment is recognised in the acquirer's financial statements). This means that for this example, the cost to Investor of the business combination is the aggregate of the cost of the initial 20 per cent ownership interest (CU3,500,000) plus the cost of the subsequent 60 per cent ownership interest (CU22,000,000), irrespective of the fact that the carrying amount of the initial 20 per cent interest has changed.

* Therefore, Investee's market capitalisation at 31 December 20X1 is CU30,000,000. However, Investor paid CU22,000,000 for the additional 60 per cent of the issued shares and control of Investee on 1 January 20X2. This indicates that Investor paid a significant premium for control of Investee.

In addition, and in accordance with paragraph 58 of IFRS 3, each transaction must be treated separately to determine the goodwill on that transaction, using cost and fair value information at the date of each exchange transaction. Therefore, Investor recognises the following amounts for goodwill in its consolidated financial statements:

For the 20% ownership interest costing CU3,500,000: goodwill = 3,500,000 – [20% × 10,000,000] =	CU1,500,000
For the 60% ownership interest costing CU22,000,000: goodwill = 22,000,000 – [60% × 19,000,000] =	CU10,600,000

The following shows Investor's consolidation worksheet (all amounts in CU) immediately after the acquisition of the additional 60 per cent ownership interest in Investee, together with consolidation adjustments and associated explanations:

	Investor	Investee	Consolidation Adjustments Dr	Consolidation Adjustments Cr	Consolidated	
Net Assets						
Cash and receivables	4,500	8,000			12,500	
Investment in Investee	28,000	-		2,500 (2) 3,500 (3) 22,000 (4)	-	
Land	-	6,000	5,000 (1)		11,000	See note (a)
Goodwill	-	-	1,500 (3) 10,600 (4)		12,100	See note (b)
	32,500	14,000			35,600	
Issued equity	30,000	5,000	1,000 (3) 3,000 (4) 1,000 (5)		30,000	See note (c)
Asset revaluation surplus	-	-	400 (3) 3,000 (4) 1,000 (5)	5,000 (1)	600	See note (d)
Retained earnings	2,500	9,000	2,500 (2) 600 (3) 5,400 (4) 1,800 (5)		1,200	See note (e)
Minority interest	-	-		3,800 (5)	3,800	See note (a)
	32,500	14,000			35,600	

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Consolidation Adjustments

		Dr	Cr
(1)	Land	5,000	
	Asset revaluation surplus		5,000
	To recognise Investee's identifiable assets at fair values at the acquisition date		
(2)	Retained earnings	2,500	
	Investment in Investee		2,500
	To restate the initial 20 per cent investment in Investee to cost		
(3)	Issued equity [20% × 5,000]	1,000	
	Asset revaluation surplus [20% × 2,000*]	400	
	Retained earnings [20% × 3,000]	600	
	Goodwill	1,500	
	Investment in Investee		3,500
	To recognise goodwill on the initial 20 per cent investment in Investee and record the elimination of that investment against associated equity balances		
(4)	Issued equity [60% × 5,000]	3,000	
	Asset revaluation surplus [60% × 5,000]	3,000	
	Retained earnings [60% × 9,000]	5,400	
	Goodwill	10,600	
	Investment in Investee		22,000
	To recognise goodwill on the subsequent 60 per cent investment in Investee and record elimination of that investment against associated equity balances		
(5)	Issued equity [20% × 5,000]	1,000	
	Asset revaluation surplus [20% × 5,000]	1,000	
	Retained earnings [20% × 9,000]	1,800	
	Minority interest (in issued equity)		1,000
	Minority interest (in asset revaluation surplus)		1,000
	Minority interest (in retained earnings)		1,800
	To recognise the minority interest in the Investee		

* The CU2,000,000 asset revaluation surplus represents the amount by which the fair value of Investee's land at the date of the first exchange transaction exceeds its carrying amount; the carrying amount of the land at the date Investor acquired the initial 20 per cent interest was CU6,000,000, but its fair value was CU8,000,000. In accordance with paragraph 58 of IFRS 3, each transaction must be treated separately for the purpose of determining the amount of goodwill on that transaction, using cost and fair value information at the date of each exchange transaction.

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Notes

The above consolidation adjustments result in:

(a) Investee's identifiable net assets being stated at their full fair values at the date Investor obtains control of Investee. This means that the 20 per cent minority interest in Investee also is stated at the minority's 20 per cent share of the fair values of Investee's identifiable net assets.

(b) goodwill being recognised from the acquisition date at an amount based on treating each exchange transaction separately and using cost and fair value information at the date of each exchange transaction.

(c) issued equity of CU30,000,000 comprising the issued equity of Investor of CU30,000,000.

(d) an asset revaluation surplus of CU600,000. This amount reflects that part of the increase in the fair value of Investee's identifiable net assets after the acquisition of the initial 20 per cent interest that is attributable to that initial 20 per cent interest [20% × CU3,000,000].

(e) a retained earnings balance of CU1,200,000. This amount reflects the changes in Investee's retained earnings after Investor acquired its initial 20 per cent interest that is attributable to that 20 per cent interest [20% × CU6,000,000].

Therefore, the effect of applying the requirements in IFRS 3 to business combinations involving successive share purchases for which the investment was previously accounted for at fair value with changes in value included in profit or loss is to cause:

- changes in the fair value of previously held ownership interests to be reversed (so that the carrying amounts of those ownership interests are restated to cost).
- changes in the investee's retained earnings and other equity balances after each exchange transaction to be included in the post-combination consolidated financial statements to the extent that they relate to the previously held ownership interests.

Applying IFRS 3 if the investee had previously been accounted for at cost or using the equity method

As discussed above, paragraph 25 of IFRS 3 requires the cost of a business combination involving more than one exchange transaction to be measured as the aggregate cost of the individual transactions, with the cost of each individual transaction determined at the date of each exchange transaction (ie the date that each individual investment is recognised in the acquirer's financial statements). Therefore, irrespective of whether the initial 20 per cent investment in Investee is accounted for at cost, by applying the equity method or at fair value, the cost to Investor of the combination is the aggregate of the cost of the initial 20 per cent ownership interest (CU3,500,000) plus the cost of the subsequent 60 per cent ownership interest (CU22,000,000).

In addition, and again irrespective of whether the initial 20 per cent investment in Investee is accounted for at cost, by applying the equity method or at fair value, each transaction must be treated separately for the purpose of determining the amount of goodwill on that transaction, using cost and fair value information at the date of each exchange transaction.

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Therefore, the effect of applying IFRS 3 to any business combination involving successive share purchases is to cause:

- any changes in the carrying amount of previously held ownership interests to be reversed (so that the carrying amounts of those ownership interests are restated to cost).
- changes in the investee's retained earnings and other equity balances after each exchange transaction to be included in the post-combination consolidated financial statements to the extent that they relate to the previously held ownership interests.

Consequently, the consolidated financial statements immediately after Investor acquires the additional 60 per cent ownership interest and obtains control of Investee would be the same irrespective of the method used to account for the initial 20 per cent investment in Investee before obtaining control.

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Changes in the values assigned to the acquiree's identifiable assets

Completing the initial accounting for a business combination

The following example illustrates the application of the guidance in paragraph 62 of IFRS 3 *Business Combinations* on completing the initial accounting for a business combination when the acquirer has, at the end of the first period after the combination, accounted for the combination using provisional values. This example does not address the accounting for any income tax effects arising from the adjustments.

IFRS 3 requires the acquirer to account for a business combination using provisional values 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. The acquirer is required to recognise any adjustments to those provisional values as a result of completing the initial accounting:

(a) within twelve months of the acquisition date; and

(b) from the acquisition date. Therefore:

  (i) the carrying amount of an identifiable asset, liability or contingent liability that is recognised or adjusted as a result of completing the initial accounting is calculated as if its fair value at the acquisition date had been recognised from that date.

  (ii) goodwill or any gain recognised in accordance with paragraph 56 is adjusted from the acquisition date by an amount equal to the adjustment to the fair value at the acquisition date of the identifiable asset, liability or contingent liability being recognised or adjusted.

  (iii) comparative information presented for the periods before the initial accounting for the combination is complete is presented as if the initial accounting had been completed from the acquisition date. This includes any additional depreciation, amortisation or other profit or loss effects recognised as a result of completing the initial accounting.

Example 7

An entity prepares financial statements for annual periods ending on 31 December and does not prepare interim financial statements. The entity was the acquirer in a business combination on 30 September 20X4. The entity sought an independent appraisal for an item of property, plant and equipment acquired in the combination. However, the appraisal was not finalised by the time the entity completed its 20X4 annual financial statements. The entity recognised in its 20X4 annual financial statements a provisional fair value for the asset of CU30,000, and a provisional value for acquired goodwill of CU100,000. 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, the entity received the independent appraisal, which estimated the asset's fair value at the acquisition date at CU40,000.

As outlined in paragraph 62 of IFRS 3, the acquirer is required to recognise any adjustments to provisional values as a result of completing the initial accounting from the acquisition date.

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Therefore, in the 20X5 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 to 31 December 20X4). The carrying amount of goodwill is also adjusted for the reduction in value at the acquisition date of CU10,000, and the 20X4 comparative information is restated to reflect this adjustment and to include additional depreciation of CU500 relating to the year ended 31 December 20X4.

In accordance with paragraph 69 of IFRS 3, the entity discloses in its 20X4 financial statements that the initial accounting for the business combination has been determined only provisionally, and explains why this is the case. In accordance with paragraph 73(b) of IFRS 3, the entity discloses in its 20X5 financial statements the amounts and explanations of the adjustments to the provisional values recognised during the current reporting period. Therefore, the entity 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; and
- the 20X4 comparative information is restated to reflect this adjustment and to include additional depreciation of CU500 relating to the year ended 31 December 20X4.

Error corrections

The following examples illustrate the application of the guidance in paragraphs 63 and 64 of IFRS 3 on the accounting for error corrections related to the initial accounting for a business combination. These examples do not address the accounting for any income tax effects arising from the adjustments.

With three exceptions,[*] IFRS 3 requires adjustments to be made to the initial accounting for a business combination after that initial accounting is complete only to correct an error in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. After that accounting is completed, adjustments cannot be recognised for the effect of changes in accounting estimates. In accordance with IAS 8, the effect of a change in an accounting estimate is recognised prospectively. IAS 8 provides guidance on distinguishing corrections of errors from changes in accounting estimates.

Example 8

An entity prepares financial statements for annual periods ending on 31 December and does not prepare interim financial statements. The entity was the acquirer in a business combination on 30 September 20X1. As part of the initial accounting for that combination, the entity recognised goodwill of CU100,000. The carrying amount of goodwill at 31 December 20X1 was CU100,000.

During 20X2, the entity becomes aware of an error relating to the amount initially allocated to property, plant and equipment assets acquired in the business combination. In particular, CU20,000 of the CU100,000 initially allocated to goodwill should be allocated to property, plant and equipment assets that had a remaining useful life at the acquisition date of five years.

[*] Two of the three exceptions relate to adjustments to the cost of a business combination after the initial accounting for the combination is complete. The third relates to the subsequent recognition by the acquirer of the acquiree's deferred tax assets that did not satisfy the criteria for separate recognition when initially accounting for the business combination.

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As outlined in paragraph 64 of IFRS 3, IAS 8 requires the correction of an error to be accounted for retrospectively, and for the financial statements to be presented as if the error had never occurred by correcting the error in the comparative information for the prior period(s) in which it occurred.

Therefore, in the 20X2 financial statements, an adjustment is made to the opening carrying amount of property, plant and equipment assets. That adjustment is measured as the fair value adjustment at the acquisition date of CU20,000 less the amount that would have been recognised as depreciation of the fair value adjustment (CU1,000 for three months' depreciation to 31 December 20X1). The carrying amount of goodwill is also adjusted for the reduction in value at the acquisition date of CU20,000, and the 20X1 comparative information is restated to reflect this adjustment and to include additional depreciation of CU1,000 relating to the year ended 31 December 20X1.

In accordance with IAS 8, the entity discloses in its 20X2 financial statements the nature of the error and that, as a result of correcting that error, an adjustment was made to the carrying amount of property, plant and equipment. The entity also discloses that:

- the fair value of property, plant and equipment assets at the acquisition date has been increased by CU20,000 with a corresponding decrease in goodwill; and
- the 20X1 comparative information is restated to reflect this adjustment and to include additional depreciation of CU1,000 relating to the year ended 31 December 20X1.

Example 9

This example assumes the same facts as in Example 8, except that the amount initially allocated to property, plant and equipment assets is decreased by CU20,000 to correct the error, rather than increased by CU20,000. This example also assumes that the entity determines that the recoverable amount of the additional goodwill is only CU17,000 at 31 December 20X1.

In the 20X2 financial statements, the opening carrying amount of property, plant and equipment assets is reduced by CU19,000, being the fair value adjustment at the acquisition date of CU20,000 less CU1,000 in depreciation expense recognised for the three-month period to 31 December 20X1. The carrying amount of goodwill is increased by CU17,000, being the increase in value at the acquisition date of CU20,000 less a CU3,000 impairment loss to reflect that the carrying amount of the adjustment exceeds its recoverable amount. The 20X1 comparative information is restated to reflect this adjustment and to exclude the CU1,000 depreciation and include the CU3,000 impairment loss.

In accordance with IAS 8, the entity discloses in its 20X2 financial statements the nature of the error and that, as a result of correcting that error, an adjustment was made to the carrying amount of property, plant and equipment. The entity also discloses that:

- the fair value of property, plant and equipment assets at the acquisition date has been decreased by CU20,000 with a corresponding increase in goodwill; and
- the 20X1 comparative information is restated to reflect this adjustment and to exclude CU1,000 depreciation recognised during the year ended 31 December 20X1 and include a CU3,000 impairment loss for goodwill relating to the year ended 31 December 20X1.

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