

Basis for Conclusions on  
Exposure Draft

**ED 3 BUSINESS  
COMBINATIONS**

*Comments to be received by 4 April 2003*

This Basis for Conclusions accompanies the proposed International Financial Reporting Standard (IFRS) set out in ED 3 *Business Combinations* (see separate booklet). Comments on the draft IFRS and its accompanying documents should be submitted in writing so as to be received by **4 April 2003**.

All replies will be put on the public record unless confidentiality is requested by the commentator. If commentators respond by fax or email, it would be helpful if they could also send a hard copy of their response by post. Comments should preferably be sent by email to: **CommentLetters@iasb.org.uk** or addressed to:

**Annette Kimmitt**  
**Senior Project Manager**  
**International Accounting Standards Board**  
**30 Cannon Street, London EC4M 6XH**  
**United Kingdom**  
**Fax: +44 (0)20 7246 6411**

Copyright © 2002 International Accounting Standards Committee Foundation

ISBN for this part: 1-904230-08-3

ISBN for complete publication (set of four parts): 1-904230-06-7

All rights reserved. Copies of the draft IFRS and its accompanying documents may be made for the purpose of preparing comments to be submitted to the IASB, provided such copies are for personal or intra-organisational use only and are not sold or disseminated and provided each copy acknowledges the International Accounting Standards Committee Foundation's copyright and sets out the IASB's address in full. Otherwise, no part of this publication may be translated, reprinted or reproduced or utilised in any form either in whole or in part or by any electronic, mechanical or other means, now known or hereafter invented, including photocopying and recording, or in any information storage and retrieval system, without permission in writing from the International Accounting Standards Committee Foundation.

The IASB logo/"Hexagon Device", "IAS", "IASB", "IASCF", "IASC", "IFRIC", "IFRS", "International Accounting Standards" and "International Financial Reporting Standards" are Trade Marks of the International Accounting Standards Committee Foundation and may not be used without the prior written approval of the IASCF.

**Additional copies of this publication may be obtained from:**  
**IASCF Publications Department,**  
**1st Floor, 30 Cannon Street, London EC4M 6XH, United Kingdom.**  
**Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7332 2749**  
**Email: [publications@iasb.org.uk](mailto:publications@iasb.org.uk) Web: [www.iasb.org.uk](http://www.iasb.org.uk)**

## Contents

### ED 3 Business Combinations

#### Basis for Conclusions

	Paragraphs
<b>INTRODUCTION</b>	<b>BC1-4</b>
<b>DEFINITION OF A BUSINESS COMBINATION</b>	<b>BC5-8</b>
<b>SCOPE</b>	<b>BC9-17</b>
<b>Scope exclusions</b>	<b>BC9-15</b>
Business combinations involving entities under common control	BC12-15
<b>Scope inclusions</b>	<b>BC16-17</b>
<b>METHOD OF ACCOUNTING</b>	<b>BC18-35</b>
<b>Business combinations in which one of the combining entities obtains control</b>	<b>BC24-26</b>
<b>Business combinations in which one of the combining entities does not obtain control</b>	<b>BC27-33</b>
Reasons for rejecting the pooling of interests method	BC30-33
<b>Business combinations in which it is difficult to identify an acquirer</b>	<b>BC34-35</b>
<b>APPLICATION OF THE PURCHASE METHOD</b>	<b>BC36-132</b>
<b>Identifying an acquirer</b>	<b>BC36-46</b>
Identifying an acquirer in a business combination effected through an exchange of equity interests	BC37-41
Identifying an acquirer when a new entity is formed to effect a business combination	BC42-46
<b>Cost of a business combination</b>	<b>BC47-52</b>
Costs directly attributable to the business combination	BC50-52
<b>Allocating the cost of a business combination</b>	<b>BC53-122</b>

Recognising the identifiable assets acquired and liabilities and contingent liabilities assumed	BC53-87
<i>Provisions for terminating or reducing the activities of the acquiree</i>	BC55-66
<i>Identifiable intangible assets</i>	BC67-79
<i>Contingent liabilities</i>	BC80-85
<i>Contractual obligations of the acquiree for which payment is triggered by a business combination</i>	BC86-87
Measuring the identifiable assets acquired and liabilities and contingent liabilities assumed	BC88-95
Goodwill	BC96-108
<i>Initial recognition of goodwill as an asset</i>	BC96-102
<i>Subsequent accounting for goodwill</i>	BC103-108
Excess of acquirer's interest in the net fair value of acquiree's identifiable assets, liabilities and contingent liabilities over cost	BC109-120
<i>Recognising the excess as a reduction in the values attributed to some net assets</i>	BC114-116
<i>Recognising the excess as a separate liability</i>	BC117
<i>Recognising the excess immediately in profit or loss</i>	BC118-120
Business combination achieved in stages	BC121-122
<b>Initial accounting determined on a provisional basis</b>	<b>BC123-132</b>
Adjustments after the initial accounting is complete	BC127-132
<i>Adjustments to the cost of a business combination after the initial accounting is complete</i>	BC129-130
<i>Recognition of deferred tax assets after the initial accounting is complete</i>	BC131-132
<b>DISCLOSURE</b>	<b>BC133-141</b>
<b>TRANSITIONAL PROVISIONS AND EFFECTIVE DATE</b>	<b>BC142-167</b>
<b>Exceptions to transitional provisions</b>	<b>BC145-146</b>

<b>Previously recognised goodwill</b>	<b>BC147-149</b>
<b>Previously recognised negative goodwill</b>	<b>BC150-156</b>
<b>Previously recognised intangible assets</b>	<b>BC157-160</b>
<b>Equity accounted investments</b>	<b>BC161-165</b>
<b>Early application</b>	<b>BC166-167</b>

**APPENDIX**

**ALTERNATIVE VIEWS ON ED 3 BUSINESS COMBINATIONS  
AND ASSOCIATED PROPOSED AMENDMENTS  
TO IAS 36 AND IAS 38**

**AV1-29**

*This Basis for Conclusions is not part of the draft IFRS.*

## INTRODUCTION

- BC1 This Basis for Conclusions summarises the Board's considerations in reaching the conclusions in draft IFRS X *Business Combinations*. Individual Board members gave greater weight to some factors than to others.
- BC2 The Board's project on business combinations has two phases. The first phase has resulted in the Board issuing the draft IFRS and draft revised Standards IAS 36 *Impairment of Assets* and IAS 38 *Intangible Assets*. The Board's intention in developing the draft IFRS as part of the first phase of the project was *not* to reconsider all of the requirements in IAS 22 *Business Combinations*. Instead, the Board's primary focus was on the following issues:
- (a) the method of accounting for business combinations;
  - (b) the accounting for goodwill and intangible assets acquired in a business combination;
  - (c) 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;
  - (d) the recognition of provisions for terminating or reducing the activities of an acquiree; and
  - (e) the initial measurement of the identifiable assets acquired and liabilities and contingent liabilities assumed in a business combination.
- BC3 Therefore, a number of the proposed requirements in the draft IFRS have been carried forward from IAS 22 without reconsideration by the Board. This Basis for Conclusions identifies those proposed requirements but does not discuss them in detail.
- BC4 The second phase of the Business Combinations project will include consideration of:
- (a) issues arising in respect of the application of the purchase method;

- (b) the accounting for business combinations in which separate entities or operations of entities are brought together to form a joint venture, including possible applications for 'fresh start' accounting; and
- (c) the accounting for business combinations involving entities under common control.

## DEFINITION OF A BUSINESS COMBINATION

- BC5 A business combination is defined in the draft IFRS as "the bringing together of separate entities or operations of entities into one reporting entity".
- BC6 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 events in which separate entities or operations of entities are brought together into one economic entity, regardless of the form of the transaction. The Board considered the following description contained in the US Financial Accounting Standards Board 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)
- BC7 The Board was concerned whether the above description would, in fact, encompass all transactions or events in which separate entities or operations of entities 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 another entity or operation, ie that all business combinations are acquisitions. The Board agreed that it should not rule out the possibility of some transaction or event occurring or being structured in which separate entities or operations are brought together into one economic entity, but without one of the combining entities acquiring control of the other combining entities or operations. Therefore, the Board decided to develop a more general definition.
- BC8 Given the Board's desire for the definition to encompass all transactions or events that are, in substance, business combinations, regardless of their form, the Board decided to retain the IAS 22 definition, but with two key modifications. The first was to remove the reference in that definition to the form that IAS 22 asserts a business combination might take

(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 draft IFRS also clarifies that a reporting entity can be a single entity or a group comprising a parent and all of its subsidiaries.

## SCOPE

### Scope exclusions (paragraphs 2 and 3)

BC9 The proposals in the draft IFRS do not apply to:

- (a) business combinations in which separate entities or operations of entities are brought together to form a joint venture; or
- (b) business combinations involving entities (or operations of entities) under common control.

IAS 22 similarly does not deal with the formation of joint ventures or transactions among enterprises under common control.

BC10 Although the treatment by venturers of interests in joint ventures is addressed in IAS 31 *Financial Reporting of 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, which the Board intends to address as part of the second phase of its Business Combinations project.

BC11 Similarly, because the first phase of the project primarily dealt with the issues identified in paragraph BC2, the Board also agreed to defer until the second phase of the project consideration of the accounting for business combinations involving entities (or operations of entities) under common control.

### Business combinations involving entities under common control (paragraphs 9-12)

BC12 The former Standing Interpretations Committee (SIC) received numerous requests to clarify the types of transactions that are 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. The Board reached the same view as the SIC and agreed that the IFRS replacing IAS 22 should include authoritative guidance on this point.

BC13 Because the proposals in the draft IFRS address 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 operations of entities) under common control' rather than 'transactions among enterprises under common control'.

BC14 The draft IFRS defines a business combination involving entities (or operations of entities) under common control as a business combination in which all of the combining entities (or operations of entities) ultimately are controlled by the same party or parties both before and after the combination, and that control is not transitory. In arriving at this definition, and the related guidance in paragraphs 9-12, 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 operation) 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. The Board concluded, therefore, that entities or operations are under common control when the same party or parties have the power to govern the financial and operating policies of those entities or operations so as to obtain benefits from their activities. The Board further concluded that for a business combination to involve entities or operations under common control, the combining entities or operations would need to be controlled by the same party or parties both before and after the combination.

BC15 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 operations are under common control. In this way, it might be possible for combinations that would otherwise be accounted for under the draft IFRS using the purchase method to be accounted for using some other method. The Board concluded that for a business combination to be excluded from the scope of the draft IFRS as one involving entities (or operations of entities) under common control, the combining entities or operations should be controlled by the same party or parties both before and after the combination, and that control should not be transitory.

### Scope inclusions (paragraph 7)

BC16 The Board concluded that, because the first phase of the project dealt primarily with the issues identified in paragraph BC2, the draft 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.

BC17 The Board noted, however, that some constituents might not have appreciated this implication of IAS 22's scope. Accordingly, the Board decided that the draft IFRS should explicitly clarify that such transactions are within its scope.

### METHOD OF ACCOUNTING (paragraph 13)

BC18 The draft IFRS proposes that all business combinations within its scope shall be accounted for using the purchase method. IAS 22 permits 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.

BC19 Although IAS 22 tightly restricts the scope of business combinations that can 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 impairs the comparability of financial statements. Others have indicated that requiring more than one method of accounting for substantially similar transactions creates incentives for structuring transactions to achieve a desired accounting result, particularly given that the two methods produce quite 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 are understood to be accounted for under IAS 22 using the pooling of interest method, it would be advantageous for international standards to come into line with those in Australia and North America by also prohibiting the method.

BC20 After carefully 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 operation(s), and that an acquirer could therefore be identified for most combinations. However, the Board agreed 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').

BC21 Therefore, the Board focused first on the appropriate method of accounting for business combinations in which one entity obtains control of another entity or operation. Next it considered the method of accounting that should be applied to those business combinations within the scope of the draft IFRS for which one of the combining entities does not obtain control of the other combining entity (or entities), assuming such transactions exist.

BC22 For the reasons discussed in paragraphs BC24-BC26, 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 operation(s).

BC23 As discussed in paragraphs BC27-BC29, 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 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. The Board observed, however, that the fresh start method is not currently applied in the 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 the future whether the fresh start method might be applied to some combinations.

### **Business combinations in which one of the combining entities obtains control**

BC24 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 operations. 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 operations); 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, 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 operation.

BC25 The IASB's *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.

BC26 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 one of the combining entities does not obtain control**

BC27 As noted above, the Board agreed 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'.

BC28 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 likely take a considerable amount of 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 currently being used (purchase method and pooling of interests method) produce quite different accounting results.

- (c) true mergers, assuming they exist, are likely to be relatively 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 BC30-BC33, the Board concluded that the pooling of interests method does not provide information superior to that provided by the purchase method in any circumstance, 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.

BC29 Therefore, the Board concluded that the IFRS arising from the first phase of the project should require all business combinations within its scope to be accounted for by applying the purchase method. However, as discussed in paragraph BC23, the Board committed itself to exploring in the future whether the 'fresh start' method might be applied to some combinations.

#### Reasons for rejecting the pooling of interests method

BC30 IAS 22 permits business combinations to be accounted for using one of two methods: the pooling of interests method or the purchase method. These methods are not regarded as alternatives for the same form of business combination either in IAS 22 or the equivalent accounting standards in other jurisdictions that permit the use of the two methods. Rather, each method applies to a specific form of business combination: the purchase method to those that are acquisitions (ie business combinations in which one entity obtains control of another entity or operation), and the pooling of interests method to those that are '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 it does not provide information superior to that provided by the purchase method in any circumstance.

- BC31 Use of the pooling of interests method has been limited to business combinations in which equity is the predominant form of consideration. Assets and liabilities of the combining entities are carried forward at their pre-combination book values, and no additional assets or liabilities are recognised as a result of the combination. The Board considered the assertion that the pooling of interest 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 going forward. 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 fails to reflect this and therefore lacks relevance. Because the assets and liabilities of all the combining entities are 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 are 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.
- BC32 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.
- BC33 The IASB's *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 fails

to hold management accountable for the investment made and its subsequent performance.

### **Business combinations in which it is difficult to identify an acquirer**

- BC34 The Board observed that in some business combinations, domestic legal, taxation or economic factors can work to 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 staffing retained and integrated. The Board considered detailed arguments as to 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 actual situations encountered in practice.
- BC35 Whilst acknowledging that it could be very difficult to identify an acquirer in some circumstances, the Board did not agree that exceptions to applying the purchase method should be permitted. The Board concluded that the pooling of interests method does not provide superior information to that provided by the purchase method in any circumstance, even if identifying the acquirer is problematic.

## **APPLICATION OF THE PURCHASE METHOD**

### **Identifying an acquirer (paragraphs 17-22)**

- BC36 The draft 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 operations. 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 [draft] 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 draft 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)**

- BC37 The Board decided not to carry forward paragraph 12 of IAS 22, which provides 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 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 describes such a situation as a reverse acquisition and requires 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 presumes 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 draft IFRS would in effect override the control concept for identifying the acquirer.
- BC38 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. The Board concluded, therefore, 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 agreed that this should be the case irrespective of the form of the purchase consideration.
- BC39 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 operating entity arranges to have itself 'acquired' by a non-operating or dormant 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 operating entity and its former owners. The Board observed that in such circumstances, the operating entity (ie the 'legal subsidiary') enjoys 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.

BC40 As a result, the Board concluded that the draft IFRS should require the acquirer in a business combination effected through an issue of equity interests to be identified based on a consideration of all pertinent facts and circumstances, and not just the relative ownership interests of the owners of the combining entities, to determine which of those entities enjoys the power to govern the financial and operating policies of the other so as to obtain benefits from its activities.

BC41 The Board then considered the assertion that, although consistent with the control concept, treating the legal subsidiary as the acquirer in the circumstances described in paragraph BC39 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 the acquirer. The Board agreed, therefore, that the draft 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 (paragraph 22)**

BC42 The draft IFRS proposes requiring 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 shall be adjudged the acquirer on the evidence available. In deciding to include this proposal in the draft IFRS, the Board identified two approaches to the purchase method currently being applied in various jurisdictions. The first approach views 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 views 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.

BC43 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 group's financial statements with more relevant information than an approach in which one of the pre-existing combining entities must be treated as the acquirer.

BC44 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 requires 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.

BC45 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. 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.

- BC46 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 agreed that the draft 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 cannot, therefore, be a new entity formed to issue equity instruments to effect a combination.

### Cost of a business combination (paragraphs 23-34)

- BC47 The draft 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, and equity instruments issued by the acquirer, in exchange for control over the acquiree; plus any costs directly attributable to the business combination. The draft 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 BC48), measuring the fair value of equity instruments issued as part of the cost of a business combination;
- (b) the requirement 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 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.

- BC48 The Board agreed to propose one amendment to the requirements of SIC-28 in the draft IFRS. SIC-28 states 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. The Board therefore agreed to amend accordingly the requirements of SIC-28 included in the draft IFRS.

- BC49 The draft 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 are not, therefore, liabilities incurred by the acquirer in exchange for control over the acquiree, nor liabilities of the acquiree assumed by the acquirer. The Board agreed that future losses or other costs expected to be incurred as a result of a business combination should not be included as part of the 'cost of acquisition' under IAS 22, but noted that this is not stated explicitly in IAS 22. The draft 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 applying the IFRS

### Costs directly attributable to the business combination (paragraphs 28-30)

- BC50 Paragraph 25 of IAS 22 indicates that direct costs relating to an acquisition include the costs of registering and issuing equity securities, 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 under [draft] IAS 32 *Financial Instruments: Disclosure and Presentation* in circumstances involving the issue of equity instruments other than to effect a business combination.

- BC51 Therefore, the Board agreed that the draft 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.
- BC52 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 [draft] 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 35-59)**

#### **Recognising the identifiable assets acquired and liabilities and contingent liabilities assumed (paragraphs 35-49)**

- BC53 With the exception of the separate recognition of an acquiree's intangible assets, the draft IFRS carries forward the general principle in paragraphs 19 and 26-28 of IAS 22 that an acquirer should 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 draft IFRS also carries forward:
- the requirement in paragraph 19 of IAS 22 for the acquirer's income statement to incorporate the acquiree's profits and losses from the acquisition date;
  - the guidance in paragraph 20 of IAS 22 on determining the acquisition date; and
  - the prohibition 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.

- BC54 However, the draft IFRS proposes changing the requirements in IAS 22 on separately recognising the acquiree's identifiable assets and liabilities for the following items:
- provisions for terminating or reducing the activities of the acquiree;
  - intangible assets of the acquiree; and
  - contingent liabilities of the acquiree.

The draft IFRS also 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**

- BC55 IAS 22 contains one exception to the general principle that an acquirer should recognise separately, at the acquisition date, only those liabilities of the acquiree that existed at the acquisition date and satisfy the recognition criteria. The exception relates to provisions for terminating or reducing the activities of the acquiree that were not liabilities of the acquiree at the acquisition date. Under paragraph 31 of IAS 22, the acquirer must recognise as part of allocating the cost of a business combination a provision for terminating or reducing the activities of the acquiree (a 'restructuring provision') that was not a liability of the acquiree at the acquisition date, provided the acquirer has satisfied specified criteria.
- BC56 The general criteria for identifying and recognising restructuring provisions are in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. Under IAS 37, 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 under 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.
- BC57 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 are met leads to different accounting depending on whether a plan to restructure arises 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.

BC58 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 argue 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.

BC59 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 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. The Board also agreed that it is inconsistent to argue that when a business combination gives rise to 'unavoidable' restructuring costs, that 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.

BC60 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 a sufficiently specific announcement. As a result, some argue that satisfying the criteria 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 IASB's *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 via a public announcement of the main features of the plan or 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 satisfied for a constructive obligation for restructuring to exist should form 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.

BC61 The Board concluded that if the criteria 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.

BC62 The Board considered the concern expressed by some that removing the exception currently 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 draft IFRS should propose either of the following:

- (a) prohibiting restructuring provisions that *are* 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.

BC63 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 collusion 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 collusion between parties to a combination does not provide sufficient justification for departing from the IASB's *Framework* and treating post-combination liabilities as arising before the combination or pre-combination liabilities as arising after the combination.

BC64 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.

BC65 The Board considered the assertion that another way in which an acquirer could achieve the same result as that 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

\* See paragraph BC80 for a discussion of this latter point.

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 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 available under IAS 22.

BC66 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.

#### Identifiable intangible assets

BC67 The draft IFRS proposes requiring an acquirer to recognise at the acquisition date the acquiree's intangible assets as defined in [draft] IAS 38 *Intangible Assets*, including in-process research and development projects that meet that definition, but excluding assembled workforces. A non-monetary asset without physical substance must be identifiable to meet the definition of an intangible asset and thus be recognised by the acquirer separately from goodwill. In accordance with [draft] 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. Under IAS 22, an acquirer must recognise any identifiable asset of the acquiree separately from goodwill at the acquisition date if it is probable that any associated future economic benefits will flow to the acquirer and the asset can be measured reliably. The current version of IAS 38 clarifies that the definition of an intangible asset requires that an intangible asset is identifiable to distinguish it clearly from goodwill. IAS 38 does not define 'identifiability', but states that an intangible asset can be distinguished clearly from goodwill if the asset is separable, but separability is not a necessary condition for identifiability. Therefore, under international standards, to be recognised separately from goodwill an intangible asset must be identifiable, it must be probable that any associated future economic benefits will flow to the acquirer, and it must be reliably measurable. Under existing international standards and the proposals in the draft IFRS, the items that might be recognised must first meet the definition of an asset.

- BC68 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 consider this issue as part of the first phase of its Business Combinations project. The Board observed that intangible assets make up an increasing proportion of the assets of many entities, and that intangible assets acquired in a business combination are often included in the amount recognised as goodwill, despite the requirements in IAS 22 and IAS 38 that they should be recognised separately from goodwill. The Board also agreed with the conclusion reached 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 agreed that the IFRS arising from the first phase of the project should provide a more definitive basis for identifying and recognising intangible assets acquired in a business combination separately from goodwill.
- BC69 The Board focused its deliberations first on intangible assets, other than in-process research and development projects, acquired in a business combination. Paragraphs BC70-BC76 outline those deliberations. The Board then considered whether the proposed 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 BC77-BC79.
- BC70 In developing the draft IFRS the Board affirmed the view contained in IAS 38 that identifiability is the characteristic that conceptually distinguishes other intangible assets from goodwill. The Board agreed that to provide a more definitive basis for identifying and recognising intangible assets separately from goodwill, the concept of identifiability would need to be articulated more clearly.
- BC71 Consistently with the guidance in IAS 38, the Board agreed that an intangible asset can be distinguished clearly 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.
- BC72 However, again consistently with the guidance in IAS 38, the Board agreed that separability is not the only sign 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 operations. 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 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.
- BC73 As outlined in paragraph BC67, an intangible asset acquired in a business combination and determined to be identifiable must, under existing Standards, also 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.
- BC74 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 draft IFRS. The Board agreed 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 it can be measured reliably) and the fair value measurements required in, for example, a business combination. However, the Board agreed that the role of probability in the *Framework* should be considered more generally as part of a later Concepts project.



- BC75 The Board also concluded that, except for an assembled workforce (see paragraph BC76), 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. In other words, the 'reliability of measurement' recognition criterion is subsumed within the contractual-legal and separability criteria for recognising intangible assets separately from goodwill. The Board observed that an asset that has an underlying contractual or legal basis is often associated with specific cash flow streams. The Board also observed that one way of demonstrating that an intangible asset is separable is to show that others have transferred or rented similar items as discrete units. If so, that previous behaviour suggests the availability of a price and a means to estimate fair value. The Board acknowledged that the fair value estimates for some intangible assets that meet the contractual-legal or separability criteria might lack the precision of the fair value measurements for other assets. However, the Board concluded that the financial information provided by recognising those intangible assets at their estimated fair values will be more useful than the information provided if those intangible assets are subsumed into goodwill on the basis of measurement difficulties.
- BC76 In the case of an assembled workforce of 'at-will' employees, the Board concluded that techniques to measure the fair value of that workforce and the related intellectual capital with sufficient reliability are not available at present. The Board observed that the technique often used to measure the fair value of an assembled workforce is replacement cost—the cost to hire and train a comparable assembled workforce. The Board believes that replacement cost is not a representationally faithful measurement of the fair value of the intellectual capital acquired in a business combination. It therefore decided that even if there are circumstances in which an assembled workforce acquired in a business combination could be viewed as meeting the contractual-legal or separability criteria, such intangibles should not be permitted to be recognised separately from goodwill.
- BC77 As noted in paragraph BC69, the Board also considered whether the proposed contractual-legal or separability 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 IAS 38 for recognising an intangible asset acquired in a business combination separately from goodwill apply to all intangible assets, including in-

- process research and development projects. Therefore, under existing international standards, any intangible item acquired in a business combination is recognised as an asset separately from goodwill when the item is identifiable and can be measured reliably, and it is probable that any associated future economic benefits will flow to the acquirer. If these criteria are not satisfied, the expenditure on the cost or value of that item, which is included in the cost of the combination, forms part of the amount attributed to goodwill.
- BC78 The Board could see no conceptual justification for changing the approach in IAS 22 and 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.
- BC79 The Board acknowledged 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 the treatment of some in-process research and development projects acquired in a business combination differing from the treatment of similar projects started internally. However, the Board 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 agreed that such a reconsideration is outside the scope of its Business Combinations project.

### Contingent liabilities

- BC80 The draft IFRS proposes requiring 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 proposal in the draft IFRS, the Board observed that provisions for terminating or reducing the activities of an acquiree that are recognised under paragraph 31 of IAS 22 as part of allocating the cost of a combination (but which the draft IFRS proposes to prohibit from being so

recognised; see paragraphs BC55-BC66) 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 are recognised under 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.

BC81 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.

BC82 The Board agreed 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. The Board agreed, however, that the role of probability in the *Framework* should be considered more generally as part of a later Concepts project.

BC83 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 in an ongoing entity, but would be recognised by an acquirer as part of allocating the cost of acquiring that entity.

BC84 The Board also decided 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 until settled or the uncertain future event described in the definition of a contingent liability is resolved. The Board observed that not doing so would result in some or all of these contingent liabilities inappropriately being derecognised immediately after the combination.

BC85 The Board is considering as part of the second phase of its Business Combinations project whether contingent assets of the acquiree 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 under IAS 22 could arise as a result of, amongst other things, failure to recognise contingent liabilities of the acquiree that the acquirer has 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**

BC86 The draft IFRS clarifies that a payment an acquiree is contractually required to make if 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 occur. Once it becomes probable that a business combination will occur, the obligation should, under IAS 37, be recognised as a liability by the acquiree provided it can be measured reliably. Therefore, when the

business combination occurs, the liability is recognised by the acquirer as part of allocating the cost of the combination.

BC87 The Board agreed that the treatment of such obligations under IAS 22 is ambiguous, and that the draft IFRS therefore should clarify their treatment.

**Measuring the identifiable assets acquired and liabilities and contingent liabilities assumed (paragraphs 35 and 39)**

BC88 IAS 22 includes a benchmark and an allowed alternative treatment for the initial measurement of the identifiable net assets acquired in a business combination, and therefore for the initial measurement of any minority interests. The 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 exists in IAS 22 from the IFRS arising from the first phase of its Business Combinations project. The draft IFRS proposes requiring 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 values of those items. This proposal is consistent with the allowed alternative treatment in IAS 22.

BC89 Under IAS 22's benchmark treatment, the acquirer must initially measure each of the acquiree's identifiable assets and liabilities at the aggregate of:

- (a) their 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 their pre-combination carrying amount.

BC90 In assessing IAS 22's benchmark treatment, the Board noted that the requirement in [draft] 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

[draft] 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, [draft] 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, 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.

BC91 The Board concluded that the 'mixed' measurement reported under IAS 22's benchmark treatment is inconsistent with the consolidation approach adopted in [draft] 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 so as to reflect that the related entities operate as a single economic entity.

BC92 The Board noted that the allowed alternative treatment provides 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 agreed that this treatment is consistent with the consolidation approach adopted in [draft] IAS 27 and the objective of consolidated financial statements because the information it provides enables 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 provides users of the group's consolidated financial statements with more useful information for assessing the accountability of management for the resources entrusted to it.

BC93 The Board considered the view that, notwithstanding the use in [draft] 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 proportion of the identifiable net assets acquired by the parent does not form 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.

BC94 However, the Board agreed that the use in [draft] 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 entity with more useful information about the resources under their control than the 'mixed' measurement reported under the benchmark treatment.

BC95 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 interacts with [draft] IAS 27 rather than an indication that consolidated financial statements prepared in accordance with [draft] IAS 27 are intended to reflect only the resources attributable to owners of the parent based on the ownership interests held by the parent. The Board agreed 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 based on the parent's ownership interest as part of the second phase of its Business Combinations project.

### Goodwill (paragraphs 50-54)

#### Initial recognition of goodwill as an asset

BC96 The draft IFRS proposes requiring 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. Except for the effect on the measurement of acquired goodwill of recognising the acquiree's contingent liabilities (see paragraphs BC80-BC85), these proposals are consistent with the requirements in IAS 22. However, the Board decided that the draft IFRS should not confuse measurement techniques with concepts and therefore, unlike IAS 22, the draft IFRS proposes defining goodwill in terms of its nature rather than its measurement. In particular, the draft IFRS proposes defining goodwill as future economic benefits arising from assets that are not capable of being individually identified and separately recognised.

BC97 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.

BC98 The Board agreed 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.

- BC99 An asset is defined in the IASB's *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 agreed 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, 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 agreed 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.
- BC100 The Board then considered whether including the third and fourth components identified in paragraph BC97 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.
- BC101 The Board agreed 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 those assets as an expense is also not representationally faithful.
- BC102 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 writing it off as an expense.

### Subsequent accounting for goodwill

- BC103 The draft IFRS proposes requiring 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 [draft] IAS 36 *Impairment of Assets*. IAS 22 requires acquired goodwill to be amortised on a systematic basis over the best estimate of its useful life. There is a rebuttable presumption that its useful life does not exceed twenty years from initial recognition. If that presumption is rebutted, acquired goodwill must be tested for impairment in accordance with the existing version of IAS 36 at least at each financial year-end, even if there is no indication that it is impaired.
- BC104 In considering the appropriate accounting for acquired goodwill after its initial recognition, the Board examined the following three approaches:
- straight-line amortisation but with an impairment test whenever there is an indication that the goodwill might be impaired;
  - 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
  - permitting entities a choice between approaches (a) and (b).
- BC105 The Board concluded 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.
- BC106 The Board noted the following arguments in support of approach (a):
- conceptually, amortisation is a method of allocating the cost of 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.
  - acquired goodwill is an asset that is consumed and replaced with internally generated goodwill. Amortisation therefore ensures that the acquired goodwill is written off and no internally generated goodwill is recognised in its place, consistently with the general prohibition on the recognition of internally generated goodwill.

- (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. Therefore, amortisation over an arbitrary period of time is the only practical solution to an intractable problem.

- BC107 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, the Board was 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 concluded 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.
- BC108 The Board agreed 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 deliberating the form that such an impairment test should take, the Board concluded that a 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 to [draft] 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 (paragraphs 55 and 56)**

- BC109 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 herein as the *excess*. 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:
- the values attributed to the acquiree's identifiable assets have been overstated;
  - identifiable liabilities and/or contingent liabilities of the acquiree have been omitted or the values attributed to those items have been understated; and/or
  - the values assigned to the items comprising the cost of the business combination have been understated.
- BC110 The Board agreed 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.
- BC111 The Board further agreed, and the draft IFRS proposes, that the acquirer should recognise any excess remaining after that reassessment immediately in profit or loss. As a first step in reaching this decision, the Board observed that any excess remaining after the reassessment could comprise one or more of the following components:
- 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.
  - 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.

BC112 IAS 22 adopts the view that negative goodwill could arise from expectations of future losses and expenses. The Board disagreed that such expectations 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. An acquirer would therefore be prepared to pay 80 to acquire the business. 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 BC111(a) is a failure to reflect correctly such expectations in the fair value of the acquiree's identifiable assets, liabilities or contingent liabilities.

BC113 The Board considered the appropriate treatment for an excess comprising the components identified in paragraph BC111 by assessing whether it should be recognised:

- (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

BC114 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, 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.

BC115 To the extent the excess comprises the second component, 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.

BC116 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 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 BC114. 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 under IAS 12.

#### Recognising the excess as a separate liability

- BC117 The Board agreed that an excess comprising any of the components identified in paragraph BC111 does not meet the definition of a liability and that its recognition as such would not be representationally faithful. The Board 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

- BC118 The Board agreed 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 BC111 is not feasible.
- BC119 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.
- BC120 The Board observed that the accounting for an excess proposed in the draft IFRS is consistent with the following working principle that the IASB and the US Financial Accounting Standards Board have agreed should underpin their joint project on issues related to the application of the purchase method (the joint project forms part of the second phase of the IASB's Business Combinations project):

The accounting for a business combination is based on the assumption that the transaction is an exchange of equal values; the total amount recognised should be measured at either the fair value of the consideration paid or the fair value of the net assets acquired, whichever is more clearly evident of the fair value of the transaction. The acquiring entity obtains control over the acquired entity and is therefore responsible for the assets and liabilities of the acquired entity. The identifiable assets acquired and liabilities assumed should be recognised on the date control is obtained, and measured at their fair values at that date. If the total fair value of the acquired business exceeds the sum of the fair values of the recognised identifiable assets acquired and liabilities assumed, that amount is the implied fair value of goodwill and should be recognised as an asset. If the total fair value of the acquired business is less than the sum of the fair values of the recognised identifiable assets acquired and liabilities assumed, that amount should be recognised as a gain in the income statement.

#### Business combination achieved in stages (paragraphs 57-59)

- BC121 The draft 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.
- BC122 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 has:
- (a) clarified in the draft IFRS that accounting for adjustments to the fair values of the acquiree's identifiable assets, liabilities and contingent liabilities as revaluations to the extent 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 57-59 of the draft IFRS. That example is included in *Draft Illustrative Examples, ED 3 Business Combinations*.

#### Initial accounting determined on a provisional basis (paragraphs 60-64)

- BC123 The draft IFRS proposes changing 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. The draft IFRS proposes that, 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, the acquirer should account for the combination using those provisional values. This will be the case if 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 draft IFRS also proposes that:

- (a) any adjustments to those provisional values as a result of completing the initial accounting should be recognised 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 should be recognised only to correct an error in accordance with [draft] 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.

BC124 In contrast, IAS 22 requires:

- (a) the acquiree's identifiable assets and liabilities that do 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 becomes available to assist with estimating the values of those items at the acquisition date.

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

BC125 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 satisfy 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 might, in some instances, result in a business combination being accounted for in a way that was inconsistent with this objective. This would be 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 satisfies 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.

BC126 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 BC125. 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 draft IFRS should, without modifying the objective described in paragraph BC125, 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 agreed that a 12-month maximum period is reasonable.

#### **Adjustments after the initial accounting is complete (paragraphs 62-64)**

BC127 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. Under [draft] 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 agreed that it would be inconsistent for the draft IFRS to require or permit retrospective adjustments to the accounting for a business combination other than to correct an error. The Board therefore agreed that, with the three exceptions discussed in paragraphs BC128-BC132, the draft 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 [draft] IAS 8.

BC128 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 BC129 and BC130. 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 BC131 and BC132.

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

BC129 When a business combination agreement provides for an adjustment to the cost of the combination contingent on future events, paragraph 31 of the draft IFRS proposes that the amount of the adjustment should be included in the cost of the combination at the acquisition date if the adjustment is probable and can be measured reliably. Under paragraph 32, 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. Under paragraph 33, 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 adjusted accordingly. The requirements proposed in paragraphs 32 and 33 of the draft IFRS are two exceptions to the principle agreed by the Board that the initial accounting for a business combination should be adjusted after that accounting is complete only to correct an error.

BC130 As noted in paragraph BC47, the draft 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 proposals in the draft IFRS on when the initial accounting for a business combination can be adjusted, as part of the second phase of its Business Combinations project.

**Recognition of deferred tax assets after the initial accounting is complete (paragraph 64)**

BC131 IAS 22 contains an exception to the requirements outlined in paragraph BC124 for the subsequent recognition of the acquiree's identifiable

assets and liabilities. That exception arises because of the accounting required under 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 initially accounting for the business combination is subsequently realised.

BC132 Paragraph 64 of the draft 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 agreed 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 65-76)**

BC133 In line with the Board's aim of articulating in IFRSs the broad principles underpinning a required accounting treatment, the Board decided that the draft 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 or in previous reporting 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 reporting period.

BC134 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 agreed

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 agreed to carry forward to the draft IFRS the disclosure requirements in SIC-28.

BC135 The Board also agreed that information disclosed in accordance with IAS 22 about business combinations classified as acquisitions and goodwill helps to meet the objectives outlined above. Therefore, the Board agreed to carry forward to the draft IFRS the related disclosure requirements in IAS 22, amended where necessary to reflect the Board's other decisions in this project. For example, IAS 22 requires disclosure of the amount of any adjustment during the reporting 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 BC127-BC132), the IAS 22 disclosure requirement has been amended in the draft IFRS to require disclosure of information about error corrections required to be disclosed under [draft] IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

BC136 The Board then assessed whether any additional disclosure requirements should be included in the draft IFRS to ensure that the three disclosure objectives outlined in paragraph BC133 are met. Mindful of the need to seek international convergence on the accounting for business combinations, the Board's assessment involved considering the disclosure requirements in the corresponding domestic standards of each of its partner standard-setters.

BC137 As a result, the Board identified, and agreed to include in the draft IFRS, the following additional disclosure requirements that it concluded would help to meet the first of the three disclosure objectives outlined in paragraph BC133:

- (a) for each business combination that was effected during the reporting period:
  - (i) the amounts recognised at the acquisition date for each class of the acquiree's assets, liabilities and contingent liabilities, and the carrying amounts of each of those classes immediately before the combination.

- (ii) a description of the factors that contributed to a cost that results in the recognition of goodwill, 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).
  - (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.
- (b) the information required to be disclosed for each business combination that was effected during the reporting 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 reporting period had been the beginning of that period, unless such disclosure would involve undue cost and effort.

BC138 The Board further agreed that, to aid in meeting the second disclosure objective outlined in paragraph BC133, the draft IFRS should also propose requiring disclosure by the acquirer of the amount and an explanation of any gain or loss recognised in the current reporting 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 reporting period; and
- (b) is of such size, nature or incidence that disclosure is relevant to an understanding of the combined entity's financial performance.

BC139 In relation to the third disclosure objective outlined in paragraph BC133, the Board agreed that the requirement to disclose a reconciliation of the carrying amount of goodwill at the beginning and end of the reporting period should be amended to require separate disclosure of net exchange differences arising during the period.

BC140 After agreeing to these additional disclosure requirements, Board members 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 BC133. The Board therefore agreed that the draft IFRS should propose requiring disclosure in these situations of such additional information as is necessary to meet those objectives.

BC141 Paragraph 66 of the draft IFRS also proposes 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 does not explicitly require disclosure of this information, it should nonetheless be provided by the acquirer as part of disclosing in accordance with paragraph 87(b) of IAS 22 the cost of acquisition and a description of the purchase consideration paid or contingently payable. The Board agreed that to avoid the IFRS being inconsistently applied, the draft IFRS should explicitly require disclosure of this information.

### **TRANSITIONAL PROVISIONS AND EFFECTIVE DATE (paragraphs 77-84)**

BC142 The draft IFRS proposes that, with two exceptions (see paragraphs BC145 and BC146), 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 to the accounting for any goodwill or excess arising from such a business combination.

BC143 The Board observed that requiring the IFRS to be applied retrospectively to business combinations for which the agreement date is before the date the IFRS is 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 impracticable for many business combinations because the information needed may not exist, may no longer be obtainable, or may be obtainable only if the entity bears undue cost and effort.
- (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.

BC144 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. The Board agreed 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. The Board further agreed 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. The Board concluded that the quality of financial reporting would not be improved if restatement occurs only when it serves to benefit an entity. Therefore, the Board decided that the draft IFRS should propose prohibiting retrospective application of the IFRS to combinations for which the agreement date is before the date the IFRS is issued.\*

### **Exceptions to transitional provisions (paragraph 78)**

BC145 The draft IFRS proposes delaying the application of the IFRS to the accounting for the following business combinations until such time as the Board issues guidance on the application of the purchase method to those transactions:

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

BC146 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 mean that some complications arise in applying the purchase method to business combinations involving two or more mutual entities. Similarly, the Board has noted that complications arise in applying the purchase method to combinations involving the formation of a reporting entity by

---

\* However, the draft IFRS proposes to encourage entities to apply the requirements of the IFRS before the effective dates outlined in paragraphs 77 and 79-83 of the draft IFRS, provided they also apply [draft] IAS 36 *Impairment of Assets* and [draft] IAS 38 *Intangible Assets* at the same time. See paragraphs BC166 and BC167.

contract only without the obtaining of an ownership interest. The Board is considering issues associated with the application of the purchase method to these transactions as part of the second phase of its Business Combinations project. Therefore, until those issues are resolved, the accounting for such transactions will continue to be dealt with by IAS 22.

### Previously recognised goodwill (paragraph 79)

- BC147 The proposal to require the IFRS to be applied to the accounting for business combinations for which the agreement date is on or after the date the IFRS is issued 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 issued should continue to be accounted for after the effective date of the IFRS in accordance with the requirements in IAS 22 (ie amortised and impairment tested), or in accordance with the requirements in the draft 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 issued. This latter issue is discussed in paragraphs BC150-BC156.
- BC148 Consistently with its earlier decision about the accounting for goodwill after initial recognition (see paragraphs BC103-BC108), 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 should therefore 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 issued. The Board also concluded that if amortisation of such goodwill were to continue after the effective date of the IFRS, 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.
- BC149 As a result, the Board agreed that the draft IFRS should propose requiring the IFRS to be applied prospectively, from the beginning of the first annual reporting period beginning on or after the date the IFRS is issued, to goodwill acquired in a business combination for which the agreement date was *before* the date the IFRS is issued.

### Previously recognised negative goodwill (paragraph 80)

- BC150 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 should:
- continue to be accounted for after the effective date of the IFRS 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
  - be derecognised on the effective date of the IFRS with a corresponding adjustment to the opening balance of retained earnings.
- BC151 In considering this issue, the Board observed that an acquirer is not permitted under IAS 22 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 has probably 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 issued is likely to comprise one or more of the following components:
- unrecognised contingent liabilities of the acquiree at the acquisition date.
  - 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 to properly reflect expectations of future losses and expenses in the market value of the acquiree's identifiable net assets.
  - a requirement in an accounting standard to measure identifiable net assets acquired at an amount that is not fair value.
  - a true bargain purchase.
- BC152 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 effective date of the IFRS.

- BC153 The Board noted that, to the extent the carrying amount of negative goodwill on the effective date of the IFRS comprises contingent liabilities of the acquiree at the acquisition date, those contingent liabilities may or may not be resolved by the effective date of the IFRS. If the contingent liability *has* been resolved by that date, 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 effective date of the IFRS.
- BC154 The Board observed that if a contingent liability included within the carrying amount of negative goodwill at the effective date of the IFRS 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 effective date of the IFRS. However, the Board agreed that isolating the contingent liability is likely to be extremely difficult in practice: the information needed may not exist, may no longer be obtainable, or may be obtainable only if the entity bears undue cost and effort. 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.
- BC155 Furthermore, IAS 22 requires 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 are identified in the acquirer’s plan for the acquisition and can be measured reliably. To the extent the negative goodwill does not relate to expectations of future losses and expenses that are identified in the acquirer’s plan and can be measured reliably, an amount not exceeding the aggregate fair values of the identifiable non-monetary assets acquired is recognised as income on a systematic basis over the remaining weighted average useful life of the identifiable depreciable assets acquired. Any remaining negative goodwill is 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 will have been recognised as income before the effective date of the IFRS, adding an additional layer of complexity to trying to isolate the portion of the carrying amount attributable to the unresolved contingent liability.
- BC156 On the basis of these arguments, the Board concluded that the draft IFRS should propose requiring derecognition of the full carrying amount

of negative goodwill at the beginning of the first annual reporting period beginning on or after the date the IFRS is issued, with a corresponding adjustment to the opening balance of retained earnings.

### Previously recognised intangible assets (paragraph 81)

- BC157 The draft IFRS proposes clarifying the criteria for recognising intangible assets separately from goodwill. The Board therefore considered whether entities should be required to apply those criteria to reassess:
- the carrying amount of intangible assets acquired in business combinations for which the agreement date was before the date the IFRS is issued and reclassify as goodwill any that do not meet the criteria for separate recognition; and
  - the carrying amount of goodwill acquired in business combinations for which the agreement date was before the date the IFRS is issued and reclassify as an identifiable intangible asset any component of the goodwill that meets the criteria for separate recognition.
- BC158 The Board noted that determining whether a recognised intangible asset meets the proposed 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 apply retrospectively the requirements in the draft IFRS to business combinations for which the agreement date was before the date the IFRS is issued. The main reasons are:
- it is likely to be impracticable in many cases because the information needed may not exist, may no longer be obtainable, or may be obtainable only if the entity bears undue cost and effort; and
  - 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.

- BC159 As a result, the Board agreed that the draft IFRS should propose requiring 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. The draft IFRS should not propose requiring the criteria to be applied to reassess the carrying amount of goodwill acquired in business combinations for which the agreement date was before the date the IFRS is issued.
- BC160 The Board noted that the current transitional provisions in IAS 38 *Intangible Assets* permit, but do not require, retrospective reclassification of an intangible asset acquired in a business combination that was an acquisition and subsumed within goodwill but which satisfies the criteria in IAS 22 and IAS 38 for recognition separately from goodwill. However, the Board agreed that adopting such an approach in the draft 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 agreed 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 draft IFRS should also not permit the option of applying the criteria for recognising intangible assets separately from goodwill to goodwill acquired in business combinations for which the agreement date was before the date the IFRS is issued.\*

### Equity accounted investments (paragraphs 82 and 83)

- BC161 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, 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 issued. Therefore, if the carrying amount of

---

\* However, the draft IFRS proposes to encourage entities to apply the requirements of the IFRS before the effective dates outlined in paragraphs 77 and 79-83 of the draft IFRS, provided they also apply [draft] IAS 36 *Impairment of Assets* and [draft] IAS 38 *Intangible Assets* at the same time. See paragraphs BC166 and BC167.

- 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.
- BC162 However, as outlined in paragraph BC147, the proposal to require 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 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 issued should be accounted for after the effective date of the IFRS 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 issued should be accounted for after the effective date of the IFRS as a deferred credit in accordance with IAS 22 or derecognised.
- BC163 Related to these issues are questions of whether, for equity accounted investments acquired *before* the date the IFRS is issued, an investor should calculate its share of the investee's profit or loss *after* the effective date of the IFRS by:
- 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
  - in the case of an investment that notionally includes negative goodwill in its carrying amount, continuing to reflect the deferral and matching approach required under IAS 22 for that negative goodwill.
- BC164 For the reasons the Board concluded that previously recognised goodwill should be accounted for after the effective date of the IFRS by applying the requirements in the draft IFRS (see paragraphs BC148 and BC149), the Board also concluded that any goodwill included in the carrying amount of an equity accounted investment acquired *before* the date the IFRS is issued should be accounted for after the effective date of the IFRS by applying the requirements in the draft 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.

BC165 Similarly, for the reasons the Board concluded that previously recognised negative goodwill should be derecognised (see paragraphs BC150-BC156), 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 issued should be derecognised at the beginning of the first annual reporting period beginning on or after the date the IFRS is issued, with a corresponding adjustment to the opening balance of retained earnings.

### Early application (paragraph 84)

BC166 The Board noted that the issue of any new or revised IFRS demonstrates 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. However, the Board also considered the assertion that permitting an IFRS to be applied before its effective date potentially diminishes comparability between entities in the period(s) leading up to that date, and has the effect of providing entities with an option.

BC167 The Board concluded that the benefit of providing users with more useful information about an entity's financial position and performance by permitting early application of this IFRS outweighs the disadvantages of potentially diminished comparability. Therefore, the draft IFRS proposes to encourage entities to apply the requirements of the draft IFRS before the effective dates outlined in paragraphs 77 and 79-83 of the draft IFRS, provided they also apply [draft] IAS 36 *Impairment of Assets* and [draft] IAS 38 *Intangible Assets* at the same time.

## Appendix

### Alternative views on ED 3 *Business Combinations* and associated proposed amendments to IAS 36 and IAS 38

AV1 Two Board members voted against the publication of ED 3 *Business Combinations* and the Exposure Draft of Proposed Amendments to IAS 36 *Impairment of Assets* and IAS 38 *Intangible Assets*. Their alternative views are set out below.

#### ALTERNATIVE VIEW OF THE FIRST BOARD MEMBER

- AV2 The first Board member voted against the publication of ED 3 and the Exposure Draft of Proposed Amendments to IAS 36 and IAS 38 on four grounds:
- the proposal in ED 3 to defer consideration of 'fresh start' accounting rather than implementing it immediately in place of the pooling of interests method;
  - the proposal in ED 3 to abolish the amortisation of goodwill;
  - the impairment test for goodwill proposed in the Exposure Draft of Proposed Amendments to IAS 36; and
  - the proposal in ED 3 and the Exposure Draft of Proposed Amendments to IAS 38 to recognise separately in a business combination some intangible assets that would not be so recognised if acquired in other circumstances.

#### Fresh start accounting as a means of reporting unitings of interests

AV3 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 the Board member'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 to such an extent that the post-combination entity cannot be represented as



a continuation of one of the parties, as is the perspective of the purchase method. The Board's proposals recognise the relevance of such an approach at the micro level in the impairment test being proposed for goodwill. For the purpose of that test, the current values of all the assets within a cash-generating unit are determined, without distinguishing between those derived from an acquirer or from an acquiree. 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*) as a possible alternative method of accounting for unitings of interests. The Board member believes that further consideration of this method should not be deferred to the second phase of the Business Combinations project, as ED 3 proposes.

- AV4 The Board member also believes that while ED 3 correctly acknowledges that true mergers may exist, it may underestimate the range of business combinations that might be included in this category. In the Board member'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. A 'true merger' on the other hand leads to a radical change in the conduct of existing activities as a result of the uniting of activities. Between these two extremes is a range of business combinations that fall less easily into one category or the other. If the pooling of interests method is the accounting treatment available for true mergers (as in IAS 22), the radical differences between the outcome of applying that method and the purchase method lead to the possibility of accounting arbitrage across the merger/acquisition boundary. The Board member 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 true mergers.
- AV5 The Board member believes that ED 3 is correct in its proposal to disallow the pooling of interests method, because that method does not take account of the values arising from the business combination transaction. However, the Board member believes that ED 3 is wrong to propose substituting the purchase method for the pooling of interests method to account for true mergers, enforcing the identification of an acquirer even when this is acknowledged to be extremely difficult. The Board member believes that applying the purchase method to true mergers may fail to capture the economic substance of the transaction

and that, in such circumstances, fresh start accounting should be required.

## Proposed abolition of goodwill amortisation

- AV6 The Board member observes that the amortisation of goodwill is a well-established and well-understood practice. The current requirements of IAS 22, including a rebuttable presumption of a 20-year useful life and an impairment test, appear to be giving rise to no obvious difficulties in practice.
- AV7 The Board member believes that the benefits of amortisation are 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.
- AV8 The Board member acknowledges that two valid criticisms are made of amortisation: that it is arbitrary and that there is little evidence it is of significant value to users, as indicated by empirical studies of its impact on share prices. However, the Board member believes that the arbitrariness can be overcome to a large extent by the additional use of impairment tests (as in 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, so that a transparent if somewhat arbitrary method, such as amortisation, is less likely to mislead the market than the impairment-only approach proposed in ED 3 and the Exposure Draft of Proposed Amendments to IAS 36, which, in the Board member's view, purports to capture economic reality but fails to do so.
- AV9 The Board member is concerned that, in rejecting amortisation, ED 3 puts its faith in a potentially unreliable and certainly complex impairment test that inevitably cannot separate out subsequent internally generated goodwill and has the other weaknesses discussed in paragraphs AV10-AV18. 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, the Board member is of the view that amortisation (as in IAS 22) should be retained as an allowed method of accounting for goodwill after its initial recognition. Annual impairment tests without amortisation could nonetheless be permitted as an alternative technique

for achieving the same objective as amortisation (measuring the consumption of goodwill) in situations in which the life of goodwill is difficult to assess and the annual impairment test is regarded by the reporting entity as a feasible and cost-effective method of measuring goodwill. 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.

### Proposed impairment test for goodwill

AV10 The Board member views three aspects of the proposed impairment test for goodwill as particularly unsatisfactory:

- (a) the failure to eliminate the internally generated goodwill of the acquiring entity at the acquisition date from the measure of goodwill's implied value;
- (b) the lack of a subsequent cash flow test; and
- (c) the complexity and inconsistency of the proposed two-stage test.

The inability to eliminate internally generated goodwill accruing after a business combination from the measure of goodwill's implied value is also a problem, providing another 'cushion' against the recognition of impairment losses. However, the Board member acknowledges that there is no obvious practical way of dealing with this problem within the framework of conventional impairment tests.

### Pre-existing internally generated goodwill

AV11 This is discussed in paragraphs C37-C40 of Appendix C, the Basis for Conclusions to the Exposure Draft of Proposed Amendments to IAS 36. It is acknowledged in the Basis for Conclusions that this does create a cushion against the recognition of impairment losses for acquired goodwill, within the proposed impairment test, but it is alleged in paragraph C38 that a requirement to remove the cushion would prove unworkable for entities that regularly reorganise or restructure their organisations. In the Board member's view, it is not clear that reorganisation and restructuring pose problems uniquely for the measurement and allocation of this element of goodwill: rather it would seem that they pose problems for all elements of goodwill and, if these problems are insurmountable, they threaten the feasibility of the proposed impairment test. This suggests that amortisation should be available as an alternative treatment for goodwill when the impairment test is

infeasible. When the test is feasible and appropriate, it should be applied in a rigorous manner, eliminating pre-existing internally generated goodwill.

AV12 The Board observes in conclusion (paragraph C40) that "the impairment test for goodwill would ensure that the carrying amount of acquired goodwill is recoverable from the future cash flows expected to be generated by goodwill". This is an affirmation that acquired goodwill is cushioned in the proposed impairment test by internally generated goodwill – both pre-existing and subsequently generated.

### Subsequent cash flow test

AV13 This is discussed in paragraphs C72-C75 of Appendix C, the Basis for Conclusions to the Exposure Draft of Proposed Amendments to IAS 36.

AV14 The Board's reasons for rejecting the subsequent cash flow test are given in paragraph C74(a)-(c). The preamble to paragraph C74 claims that the subsequent cash flow test is misdirected because excessive write-downs of goodwill may be a problem that should be prevented. However, such excessive write-downs would not be a consequence of the subsequent cash flow test, which requires only realistic write-downs (based on actual outcomes). If the statement in paragraph C74 is correct, this may point to another deficiency in the impairment testing process that requires a different remedy.

AV15 Paragraphs C74(a) and (b) in effect criticise the subsequent cash flow test because it does not result in a full current remeasurement of value in use – it merely substitutes the cash flows that actually occurred for those that were estimated at the time of the impairment test. The Board member believes that this test has a clear meaning and purpose. It provides a safeguard against over-optimism in the estimation of cash flows. If corrections of estimates of other elements, such as variations that have occurred in interest rates, were considered important and cost-effective in this context, they also could be incorporated in the recalculation performed under the test.

AV16 Paragraph C74(c) criticises the excessive burden that a subsequent cash flow test might impose. The extent of the burden depends, of course, upon the frequency with which the test is required to be applied, and it should be borne in mind that the disclosure requirements associated with the impairment test that are proposed in paragraph 134 of the draft IAS 36 could be reduced if the subsequent cash flow test were in place.

### The two-stage impairment test

- AV17 The proposed impairment test for goodwill has two stages: one in which the recoverable amount of a cash-generating unit is compared with the aggregate carrying amount of the assets in that unit, and one in which the carrying amount of goodwill is compared with its implied current value. This is inconsistent with the impairment test for other assets in IAS 36 and, more seriously, the two stages of the proposed test might contradict one another. In particular, the first stage might reveal no impairment of the unit and therefore goodwill would be regarded as not impaired, when the second stage would in fact reveal an impairment of goodwill. Paragraph C49 of Appendix C, the Basis for Conclusions to the Exposure Draft of Proposed Amendments to IAS 36, tries to address this problem by asserting that changes in the value of identifiable assets will be correlated with changes in the value of goodwill. The Board member notes that this assertion is unsupported by evidence.
- AV18 The one-step approach to testing goodwill for impairment in IAS 36 is rejected in paragraph C47 because “given the nature of goodwill and the fact that its non-amortisation increases the reliance that must be placed on impairment testing, a more rigorous impairment test is justified for goodwill than for other assets”. The Board member believes that given the existence of various ‘cushions’ against impairment, described above, it is questionable whether the proposed two-stage test achieves sufficient rigour to justify its complexity and cost. If the option of amortising goodwill were retained, a rigorous single-stage impairment test for goodwill might be proposed: entities that felt that this did not pass the cost-benefit test could then opt for the amortisation alternative.

### The recognition of intangible assets

- AV19 The proposals in ED 3 and the proposed amendments to IAS 38 suggest that the range of intangible assets recognised in the event of a business combination should be wider than that recognised in other circumstances. In particular, it is asserted in paragraph 30 of the draft IAS 38 that “sufficient information should always exist to measure reliably the fair value of an asset that has an underlying contractual or legal basis or is capable of being separated from the entity”.
- AV20 In the Board member’s view, this assertion wrongly equates identifiability with economic measurability. In many cases, it may be possible to identify contractual rights or separable assets whose separate fair value cannot be measured reliably. For example, the illustrative examples

accompanying ED 3 cite ‘trade dress’ as an intangible asset to be recognised separately from goodwill. Trade dress is uniquely associated with a particular business and, unless it has exceptional artistic merit in its own right, it is unlikely to have value if separated from the goodwill of that business.

- AV21 The Board member believes that research expenditure is another example of an item whose fair value may not be reliably measurable, even though the item is potentially marketable separately. The draft IAS 38 states (paragraph 47) that “in the research phase of an internal project, an entity cannot demonstrate that an intangible asset exists that will generate probable future economic benefits”. Obviously, if the research project is subsequently sold separately, that does provide a measurement of probable economic benefits. However, if the project is sold along with the rest of the business in a business combination transaction, this aggregate transaction does not help in the measurement of the research project separately from the other assets included in the transaction. Thus, the research project should not, in these circumstances, be reported separately from goodwill.

### ALTERNATIVE VIEW OF THE SECOND BOARD MEMBER

- AV22 The second Board member voted against the publication of ED 3 and the Exposure Draft of Proposed Amendments to IAS 36 and IAS 38 on two grounds:
- the proposal in ED 3 to abolish the amortisation of goodwill; and
  - the impairment test for goodwill proposed in the Exposure Draft of Proposed Amendments to IAS 36.

### Proposed abolition of goodwill amortisation

- AV23 The second Board member supports the comments and views of the first Board member outlined in paragraphs AV6-AV8. The second Board member also shares the first Board member’s concern that, in rejecting amortisation, ED 3 puts its faith in a potentially unreliable and certainly complex impairment test that inevitably cannot separate out subsequent internally generated goodwill and has the other weaknesses discussed in paragraphs AV25-AV29. 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.

AV24 However, the second Board member does not agree that annual impairment tests without amortisation should be permitted as an alternative to amortisation with regular impairment testing (as in IAS 22 and IAS 36). The second Board member believes that that the proposal in ED 3 to abolish the amortisation of goodwill and require an impairment-only approach is inconsistent with the general principle that internally generated goodwill should not be recognised. This Board member agrees with the Board's analysis in paragraphs BC97 and BC98 of the Basis for Conclusions to ED 3 regarding the components of 'core goodwill', and notes that the Board correctly acknowledges in paragraph BC107 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 other than in an arbitrary manner. The Board member therefore believes 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 proposed in ED 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, the Board member is of the view that amortisation with regular impairment testing (as in IAS 22 and IAS 36) should be the required method of accounting for goodwill after its initial recognition.

### Proposed impairment test for goodwill

AV25 The second Board member views two aspects of the proposed impairment test for goodwill as particularly unsatisfactory:

(a) the failure to eliminate the internally generated goodwill of the acquiring entity at the acquisition date from the measure of goodwill's implied value; and

(b) the complexity and inconsistency of the proposed two-stage test.

AV26 On the first point (ie the failure to eliminate the internally generated goodwill of the acquiring entity at the acquisition date from the measure of goodwill's implied value), the second Board member supports the

comments and views of the first Board member outlined in paragraphs AV11-AV12.

AV27 On the second point, although both Board members view as unsatisfactory the complexity and inconsistency of the proposed two-stage impairment test for goodwill, their concerns in relation to this issue differ. The second Board member believes that the requirements proposed in draft IAS 36 for measuring the implied value of goodwill are extremely complex, unduly burdensome, and result in a hypothetical measure that is unrelated to the acquired goodwill being tested for impairment. Indeed, the need to include additional and very detailed guidance on calculating the implied value of goodwill, such as the guidance on unrecognised value in paragraphs 87 and C33-C36 of draft IAS 36, is, in the Board member's view, indicative of serious problems with the approach being proposed by the Board for testing acquired goodwill for impairment.

AV28 As noted in paragraph AV27, the measure of goodwill's implied value proposed in draft IAS 36 will incorporate items that are unrelated to the acquired goodwill being tested for impairment. This includes pre-existing internally generated goodwill of the acquiring entity at the acquisition date, and internally generated goodwill accruing after a business combination. The second Board member believes that including these items in the measure of goodwill's implied value will inappropriately provide 'cushions' against recognising impairment losses that have in fact occurred in respect of the acquired goodwill. Such 'cushions', combined with the proposal in ED 3 to abolish 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. Put another way, 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. The second Board member 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.

AV29 In the second Board member's view, the defects described in paragraphs AV27 and AV28 of the proposed impairment test are unavoidable under the impairment-only approach to the accounting for acquired goodwill proposed in ED 3 and the Exposure Draft of Proposed Amendments to IAS 36. The Board member recognises that many of the 'cushioning' problems also arise under the current approach in IAS 22 and IAS 36 of

amortisation in conjunction with regular impairment testing using the one-step impairment test under IAS 36. Nevertheless, the Board member believes that such an approach should be retained. The Board member agrees with the arguments outlined in paragraph C46, Appendix C, the Basis for Conclusions to the Exposure Draft of Proposed Amendments to IAS 36, in support of retaining the one-step approach in IAS 36 for testing goodwill for impairment. This approach ensures that the carrying amount of acquired goodwill is reduced to zero at the end of its useful life, even though there is a degree of arbitrariness in determining that useful life and the pattern of the acquired goodwill's consumption. This approach also ensures that, ultimately, no internally generated goodwill can be recognised. It therefore provides a more transparent and representationally faithful method of accounting for acquired goodwill than the impairment-only approach being proposed in ED 3 and the Exposure Draft of Proposed Amendments to IAS 36.