

**IASB documents published to accompany**

**IFRS 3**

# Business Combinations

The text of the unaccompanied standard, IFRS 3, is contained in Part A of this edition. Its effective date when issued was 1 July 2009. The text of the Accompanying Guidance on IFRS 3 is contained in Part B of this edition. This part presents the following documents:

**BASIS FOR CONCLUSIONS**

**APPENDIX TO THE BASIS FOR CONCLUSIONS**

**Amendments to the Basis for Conclusions on other IFRSs**

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## **Basis for Conclusions on IFRS 3 *Business Combinations***

*This Basis for Conclusions and its appendix accompany, but are not part of, IFRS 3.*

### **Background information**

In 2001 the International Accounting Standards Board began a project to review IAS 22 *Business Combinations* (revised in 1998) as part of its initial agenda, with the objective of improving the quality of, and seeking international convergence on, the accounting for business combinations. The Board decided to address the accounting for business combinations in two phases.

As part of the first phase, the Board published in December 2002 ED 3 *Business Combinations*, together with an exposure draft of proposed related amendments to IAS 36 *Impairment of Assets* and IAS 38 *Intangible Assets*, with a comment deadline of 4 April 2003. The Board received 136 comment letters.

The Board concluded the first phase in March 2004 by issuing simultaneously IFRS 3 *Business Combinations* and revised versions of IAS 36 and IAS 38. The Board's primary conclusion in the first phase was that virtually all business combinations are acquisitions. Accordingly, the Board decided to require the use of one method of accounting for business combinations – the acquisition method.

The US Financial Accounting Standards Board (FASB) also conducted a project on business combinations in multiple phases. The FASB concluded its first phase in June 2001 by issuing FASB Statements No. 141 *Business Combinations* (SFAS 141) and No. 142 *Goodwill and Other Intangible Assets*. The scope of that first phase was similar to IFRS 3 and the FASB reached similar conclusions on the major issues.

The two boards began deliberating the second phase of their projects at about the same time. They decided that a significant improvement could be made to financial reporting if they had similar standards for accounting for business combinations. They therefore agreed to conduct the second phase of the project as a joint effort with the objective of reaching the same conclusions.

The second phase of the project addressed the guidance for applying the acquisition method. In June 2005 the boards published an exposure draft of revisions to IFRS 3 and SFAS 141, together with exposure drafts of related amendments to IAS 27 *Consolidated and Separate Financial Statements* and Accounting Research Bulletin No. 51 *Consolidated Financial Statements*, with a comment deadline of 28 October 2005. The boards received more than 280 comment letters.

The boards concluded the second phase of the project by issuing their revised standards, IFRS 3 *Business Combinations* (as revised in 2008) and FASB Statement No. 141 (revised 2007) *Business Combinations* and the related amendments to IAS 27 and FASB Statement No. 160 *Noncontrolling Interests in Consolidated Financial Statements*.

## Introduction

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- BC1 This Basis for Conclusions summarises the considerations of the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) in reaching the conclusions in their revised standards, IFRS 3 *Business Combinations* (as revised in 2008) and FASB Statement No. 141 (revised 2007) *Business Combinations* (SFAS 141(R)). It includes the reasons why each board accepted particular approaches and rejected others. Individual board members gave greater weight to some factors than to others.
- BC2 The revised IFRS 3 and SFAS 141(R) carry forward without reconsideration the primary conclusions each board reached in IFRS 3 (issued in 2004) and FASB Statement No. 141 (SFAS 141, issued in 2001), both of which were titled *Business Combinations*. The conclusions carried forward include, among others, the requirement to apply the *purchase method* (which the revised standards refer to as the *acquisition method*) to account for all business combinations and the identifiability criteria for recognising an intangible asset separately from goodwill. This Basis for Conclusions includes the reasons for those conclusions, as well as the reasons for the conclusions the boards reached in their joint deliberations that led to the revised standards. Because the provisions of the revised standards on applying the acquisition method represent a more extensive change to SFAS 141 than to the previous version of IFRS 3, this Basis for Conclusions includes more discussion of the FASB's conclusions than of the IASB's in the second phase of their respective business combinations projects.
- BC3 In discussing the boards' consideration of comments on exposure drafts, this Basis for Conclusions refers to the exposure draft that preceded the previous version of IFRS 3 as *ED 3* and to the one that preceded SFAS 141 as the *1999 Exposure Draft*; it refers to the joint exposure draft that preceded the revised standards as the *2005 Exposure Draft*. Other exposure drafts published by each board in developing IFRS 3 or SFAS 141 are explained in the context of the issues they addressed. As used in this Basis for Conclusions, *the revised IFRS 3*, *SFAS 141(R)* and *the revised standards* refer to the revised versions of IFRS 3 and SFAS 141; references to *IFRS 3* and *SFAS 141* are to the original versions of those standards.
- BC4 The IASB and the FASB concurrently deliberated the issues in the second phase of the project and reached the same conclusions on most of them. The table of differences between the revised IFRS 3 and SFAS 141(R) (presented after the illustrative examples) describes the substantive differences that remain; the most significant difference is the measurement of a non-controlling interest in an acquiree (see paragraphs BC205–BC221).<sup>1</sup> In addition, the application of some provisions of the revised standards on which the boards reached the same conclusions may differ because of differences in:

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<sup>1</sup> [Editor's note: The table of differences between IFRS 3, as revised in 2008, and SFAS 141 (R) has not been updated since it was issued in 2008. This outdated table appeared in the Bound Volume up to 2018 and was removed in 2019.]

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- (a) other accounting standards of the boards to which the revised standards refer. For example, recognition and measurement requirements for a few particular assets acquired (eg a deferred tax asset) and liabilities assumed (eg an employee benefit obligation) refer to existing IFRSs or US generally accepted accounting principles (GAAP) rather than fair value measures.
- (b) disclosure practices of the boards. For example, the FASB requires particular supplementary information or particular disclosures by public entities only. The IASB has no similar requirements for supplementary information and does not distinguish between listed and unlisted entities.
- (c) particular transition provisions for changes to past accounting practices of US and non-US companies that previously differed.

### Definition of a business combination

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- BC5 The FASB's 1999 Exposure Draft proposed that a *business combination* should be defined as occurring when one entity acquires net assets that constitute a business or acquires equity interests in one or more other entities and thereby obtains control over that entity or entities. Many respondents who commented on the proposed definition said that it would exclude certain transactions covered by APB Opinion No. 16 *Business Combinations* (APB Opinion 16), in particular, transactions in which none of the former shareholder groups of the combining entities obtained control over the combined entity (such as roll-ups, put-togethers and so-called mergers of equals). During its redeliberations of the 1999 Exposure Draft, the FASB concluded that those transactions should be included in the definition of a business combination and in the scope of SFAS 141. Therefore, paragraph 10 of SFAS 141 indicated that it also applied to business combinations in which none of the owners of the combining entities as a group retain or receive a majority of the voting rights of the combined entity. However, the FASB acknowledged at that time that some of those business combinations might not be acquisitions and said that it intended to consider in another project whether business combinations that are not acquisitions should be accounted for using the fresh start method rather than the purchase method.
- BC6 IFRS 3 defined a business combination as 'the bringing together of separate entities or businesses into one reporting entity.' In developing IFRS 3, the IASB considered adopting the definition of a business combination in SFAS 141. It did not do so because that definition excluded some forms of combinations encompassed in IAS 22 *Business Combinations* (which IFRS 3 replaced), such as those described in paragraph BC5 in which none of the former shareholder groups of the combining entities obtained control over the combined entity. Accordingly, IFRS 3 essentially retained the definition of a business combination from IAS 22.

- BC7 The definition of a business combination was an item of divergence between IFRS 3 and SFAS 141. In addition, the definition in SFAS 141 excluded combinations in which control is obtained by means other than acquiring net assets or equity interests. An objective of the second phase of the FASB's project leading to SFAS 141(R) was to reconsider whether the accounting for a change in control resulting in the acquisition of a business should differ because of the way in which control is obtained.
- BC8 The FASB considered several alternatives for improving the definition of a business combination, including adopting the definition of a business combination in IFRS 3. That definition would encompass all transactions or other events that are within the scope of the revised standards. The FASB concluded, however, that the definition of a business combination in IFRS 3 was too broad for its purposes because it would allow for the inclusion in a business combination of one or more businesses that the acquirer does not control.
- BC9 Because the FASB considers all changes of control in which an entity acquires a business to be economically similar transactions or events, it decided to expand the definition of a business combination to include all transactions or other events in which an entity obtains control of a business. Application of the expanded definition will improve the consistency of accounting guidance and the relevance, completeness and comparability of the resulting information about the assets, liabilities and activities of an acquired business.
- BC10 The IASB also reconsidered the definition of a business combination. The result was that the IASB and the FASB adopted the same definition. The IASB observed that the IFRS 3 definition could be read to include circumstances in which there may be no triggering economic event or transaction and thus no change in an economic entity, per se. For example, under the IFRS 3 definition, an individual's decision to prepare combined financial statements for all or some of the entities that he or she controls could qualify as a business combination. The IASB concluded that a business combination should be described in terms of an economic event rather than in terms of consolidation accounting and that the definition in the revised standards satisfies that condition.
- BC11 The IASB also observed that, although the IFRS 3 definition of a business combination was sufficiently broad to include them, formations of joint ventures were excluded from the scope of IFRS 3. Because joint ventures are also excluded from the scope of the revised standards, the revised definition of a business combination is intended to include all of the types of transactions and other events initially included in the scope of IFRS 3.
- BC12 Some respondents to the 2005 Exposure Draft who consider particular combinations of businesses to be 'true mergers' said that the definition of a business combination as a transaction or other event in which an acquirer obtains control of one or more businesses seemed to exclude true mergers. The boards concluded that the most straightforward way of indicating that the scope of the revised standards, and the definition of a business

combination, is intended to include true mergers, if any occur, is simply to state that fact.

- BC13 Some respondents to the 2005 Exposure Draft also said that it was not clear that the definition of a business combination, and thus the scope of the revised standards, includes reverse acquisitions and perhaps other combinations of businesses. The boards observed that in a reverse acquisition, one entity—the one whose equity interests are acquired—obtains economic (although not legal) control over the other and is therefore the acquirer, as indicated in paragraph B15 of the revised IFRS 3. Therefore, the boards concluded that it is unnecessary to state explicitly that reverse acquisitions are included in the definition of a business combination and thus within the scope of the revised standards.

### **Change in terminology**

- BC14 As defined in the revised standards, a business combination could occur in the absence of a purchase transaction. Accordingly, the boards decided to replace the term *purchase method*, which was previously used to describe the method of accounting for business combinations that the revised standards require, with the term *acquisition method*. To avoid confusion, this Basis for Conclusions uses that term throughout, including when it refers to IFRS 3 and SFAS 141 (and earlier exposure drafts or other documents), which used the term *purchase method*.

### **Definition of a business**

- BC15 The definition of a business combination in the revised standards provides that a transaction or other event is a business combination only if the assets acquired and liabilities assumed constitute a business (an acquiree), and Appendix A defines a *business*.
- BC16 SFAS 141 did not include a definition of a business. Instead, it referred to EITF Issue No. 98-3 *Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business* for guidance on whether a group of net assets constitutes a business. Some constituents said that particular aspects of the definition and the related guidance in EITF Issue 98-3 were both unnecessarily restrictive and open to misinterpretation. They suggested that the FASB should reconsider that definition and guidance as part of this phase of the project, and it agreed to do so. In addition to considering how its definition and guidance might be improved, the FASB, in conjunction with the IASB, decided that the boards should strive to develop a joint definition of a business.
- BC17 Before issuing IFRS 3, the IASB did not have a definition of a business or guidance similar to that in EITF Issue 98-3. Consistently with the suggestions of respondents to ED 3, the IASB decided to provide a definition of a business in IFRS 3. In developing that definition, the IASB also considered the guidance in EITF Issue 98-3. However, the definition in IFRS 3 benefited from deliberations in this project to that date, and it differed from EITF Issue 98-3



in some aspects. For example, the definition in IFRS 3 did not include either of the following factors, both of which were in EITF Issue 98-3:

- (a) a requirement that a business be self-sustaining; or
- (b) a presumption that a transferred set of activities and assets in the development stage that has not commenced planned principal operations cannot be a business.

BC18 In the second phase of their business combinations projects, both boards considered the suitability of their existing definitions of a business in an attempt to develop an improved, common definition. To address the perceived deficiencies and misinterpretations, the boards modified their respective definitions of a business and clarified the related guidance. The more significant modifications, and the reasons for them, are:

- (a) to continue to exclude self-sustaining as the definition in IFRS 3 did, and instead, provide that the integrated set of activities and assets must be **capable** of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants. Focusing on the capability to achieve the purposes of the business helps avoid the unduly restrictive interpretations that existed in accordance with the former guidance.
- (b) to clarify the meanings of the terms *inputs*, *processes* and *outputs* that were used in both EITF Issue 98-3 and IFRS 3. Clarifying the meanings of those terms, together with other modifications, helps eliminate the need for extensive detailed guidance and the misinterpretations that sometimes stem from such guidance.
- (c) to clarify that inputs and processes applied to those inputs are essential and that although the resulting outputs are normally present, they need not be present. Therefore, an integrated set of assets and activities could qualify as a business if the integrated set is capable of being conducted and managed to produce the resulting outputs. Together with item (a), clarifying that outputs need not be present for an integrated set to be a business helps avoid the unduly restrictive interpretations of the guidance in EITF Issue 98-3.
- (d) to clarify that a business need not include all of the inputs or processes that the seller used in operating that business if a market participant is capable of continuing to produce outputs, for example, by integrating the business with its own inputs and processes. This clarification also helps avoid the need for extensive detailed guidance and assessments about whether a missing input or process is minor.
- (e) to continue to exclude a presumption that an integrated set in the development stage is not a business merely because it has not yet begun its planned principal operations, as IFRS 3 did. Eliminating that presumption is consistent with focusing on assessing the capability to achieve the purposes of the business (item (a)) and helps avoid the

unduly restrictive interpretations that existed with the former guidance.

- BC19 The boards also considered whether to include in the revised standards a presumption similar to the one in EITF Issue 98-3 that an asset group is a business if goodwill is present. Some members of the FASB's resource group suggested that that presumption results in circular logic that is not especially useful guidance in practice. Although the boards had some sympathy with those views, they noted that such a presumption could be useful in avoiding interpretations of the definition of a business that would hinder the stated intention of applying the revised standards' guidance to economically similar transactions. The presumption might also simplify the assessment of whether a particular set of activities and assets meets the definition of a business. Therefore, the revised standards' application guidance retains that presumption.
- BC20 The boards considered whether to expand the scope of the revised standards to all acquisitions of groups of assets. They noted that doing so would avoid the need to distinguish between those groups that are businesses and those that are not. However, both boards noted that broadening the scope of the revised standards beyond acquisitions of businesses would require further research and deliberation of additional issues and delay the implementation of the revised standards' improvements to practice. The boards therefore did not extend the scope of the revised standards to acquisitions of all asset groups. Paragraph 2(b) of the revised IFRS 3 describes the typical accounting for an asset acquisition.
- BC21 SFAS 141(R) amends FASB Interpretation No. 46 (revised December 2003) *Consolidation of Variable Interest Entities* (FASB Interpretation 46(R)) to clarify that the initial consolidation of a variable interest entity that is a business is a business combination. Therefore, the assets, liabilities and non-controlling interests of the variable interest entity should be measured in accordance with the requirements of SFAS 141(R). Previously, FASB Interpretation 46(R) required assets, liabilities and non-controlling interests of variable interest entities that are businesses to be measured at fair value. The FASB concluded that variable interest entities that are businesses should be afforded the same exceptions to fair value measurement and recognition that are provided for assets and liabilities of acquired businesses. The FASB also decided that upon the initial consolidation of a variable interest entity that is not a business, the assets (other than goodwill), liabilities and non-controlling interests should be recognised and measured in accordance with the requirements of SFAS 141(R), rather than at fair value as previously required by FASB Interpretation 46(R). The FASB reached that decision for the same reasons described above, ie if SFAS 141(R) allows an exception to fair value measurement for a particular asset or liability, it would be inconsistent to require the same type of asset or liability to be measured at fair value. Except for that provision, the FASB did not reconsider the requirements in FASB Interpretation 46(R) for the initial consolidation of a variable interest entity that is not a business.

### Clarifying the definition of a business

- BC21A Following a Post-implementation Review (PIR) of IFRS 3, the Board noted that many stakeholders had concerns about how to interpret and apply the definition of a business. Stakeholders indicated that these concerns arose for one or more of the following main reasons:
- (a) IFRS 3 requires a fact-driven assessment that adopts the perspective of market participants and does not consider the business rationale, strategic considerations and objectives of the acquirer (see paragraph BC21G);
  - (b) some sets of activities and assets might have been considered a business from the perspective of particular market participants who could integrate the set in their processes. However, the same sets of activities and assets might not have been considered a business from the perspective of other market participants (see paragraphs BC21H–BC21I);
  - (c) the definition of a business used the wording ‘capable of being conducted and managed for the purpose of providing’ a return. That wording did not help in determining whether a transaction includes a business (see paragraphs BC21J–BC21K);
  - (d) it was difficult to assess:
    - (i) whether the processes acquired are sufficient to constitute one of the elements required for an acquired set of activities and assets to be a business, and whether any missing processes are so significant that the set is not a business; and
    - (ii) how to apply the definition of a business if the acquired set of activities and assets does not generate revenue (see paragraphs BC21L–BC21R); and
  - (e) the definition of a business was broad and IFRS 3 had no guidance identifying when an acquired set of activities and assets is not a business (see paragraphs BC21S–BC21AC).
- BC21B To consider those concerns, the Board added to its agenda a project to clarify the definition of a business, with the objective of assisting entities to determine whether a transaction should be accounted for as a business combination or as an asset acquisition. In 2016 the Board published an exposure draft *Definition of a Business and Accounting for Previously Held Interests* (2016 Exposure Draft). The 2016 Exposure Draft attracted 80 comment letters. The Board reviewed those comment letters and consulted the Accounting Standards Advisory Forum (ASAF), the Capital Markets Advisory Committee and the Global Preparers Forum. In 2018 the Board issued *Definition of a Business* (2018 Amendments). In the 2018 Amendments, the Board:
- (a) clarified that to be considered a business, an acquired set of activities and assets must include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create outputs (see paragraph BC21F);

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- (b) removed the assessment of whether market participants are capable of replacing any missing inputs or processes and continuing to produce outputs (see paragraphs BC21H–BC21I);
- (c) added guidance and illustrative examples to help entities assess whether a substantive process has been acquired (see paragraphs BC21L–BC21R);
- (d) narrowed the definitions of a business and of outputs by focusing on goods and services provided to customers and by removing the reference to an ability to reduce costs (see paragraph BC21S);
- (e) added an optional concentration test that permits a simplified assessment of whether an acquired set of activities and assets is not a business (see paragraphs BC21T–BC21AC); and
- (f) decided that an entity is permitted but not required to apply the amendments to transactions that occurred before the effective date of the amendments. Retrospective application of the amendments to earlier transactions is not required because it is unlikely to provide useful information to users of financial statements, could have been costly and could have been impracticable if hindsight were to be needed. Retrospective application was not prohibited because there may be instances when it would provide useful information and because when it is used it would not deprive users of useful information.

BC21C The 2016 Exposure Draft also dealt with a second topic, accounting for previously held interests. The Board finalised its work on that topic, among others, in 2017 by issuing *Annual Improvements to IFRS Standards 2015–2017 Cycle*.

BC21D IFRS 3 is the result of a joint project between the Board and the FASB and it contained the same definition of a business as the definition in US GAAP. The PIR of IFRS 3 and a PIR of SFAS 141(R) identified similar difficulties in applying the definition of a business. Moreover, the FASB received feedback from many stakeholders that the definition of a business in US GAAP was, in practice, viewed as capturing a broader range of transactions than the identical definition in IFRS 3. Consequently, the FASB amended US GAAP in 2017 by issuing Accounting Standards Update No. 2017-01 *Clarifying the Definition of a Business* (FASB 2017 Amendments). The 2018 Amendments addressed the issues identified during the PIR of IFRS 3 and, though worded differently, are based on conclusions similar to those reached by the FASB. The Board concluded that its 2018 Amendments and the FASB 2017 Amendments could together be expected to lead to more consistency in applying the definition of a business across entities applying US GAAP and entities applying IFRS Standards.

BC21E The 2018 Amendments differ in some respects from the FASB 2017 Amendments. Before finalising the 2018 Amendments, the Board discussed those differences with ASAF. The differences are as follows:

- (a) the concentration test set out in paragraphs B7A–B7B of IFRS 3 is optional. The corresponding test in the FASB 2017 Amendments is mandatory. The guidance on how to identify concentration of fair value is substantially the same, but the Board added confirmation of the calculations normally needed (see paragraph B7B(b)) and an illustrative example (Example I).
- (b) the Board concluded that an acquired outsourcing contract may give access to an organised workforce that performs a substantive process, even if the acquired set of activities and assets has no outputs. In some cases, that may lead to a conclusion that a business was acquired. In contrast, the FASB concluded that when outputs are not present, a business has been acquired only if the acquired set includes an organised workforce made up of employees.
- (c) the Board clarified in paragraph B12D that difficulties in replacing an organised workforce may indicate that the organised workforce performs a process that is critical to the ability to create outputs. The FASB 2017 Amendments do not include this clarification.
- (d) the FASB 2017 Amendments include a statement that the presence of more than an insignificant amount of goodwill may be an indicator that an acquired process is substantive. The Board did not include such a statement in the 2018 Amendments (see paragraph BC21R(d)).
- (e) the Board clarified in paragraph B7(c) of IFRS 3 that the narrowed definition of outputs includes other income from ordinary activities. An example of such other income is income from contracts outside the scope of IFRS 15 *Revenue from Contracts with Customers*. The FASB expressed a similar view as an observation in its Basis for Conclusions.
- (f) the Board aligned the definition of a business with the revised definition of outputs in paragraph B7(c) of IFRS 3. The FASB did not align the two definitions, but its definition of a business refers explicitly to supporting guidance, including guidance on outputs.

### **Minimum requirements to be a business**

BC21F The existence of a process (or processes) is what distinguishes a business from a set of activities and assets that is not a business. Consequently, the Board decided that to be considered a business, an acquired set of activities and assets must include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create outputs. The Board incorporated this requirement in paragraph B8. To clarify that a business can exist without including all of the inputs and processes needed to create outputs, the Board replaced the term ‘ability to create outputs’ with ‘ability to contribute to the creation of outputs’ in paragraph B7 of IFRS 3.

### **Market participant's perspective**

BC21G Paragraph B11 of IFRS 3 adopts a market participant's perspective in determining whether an acquired set of activities and assets is a business. Some participants in the PIR of IFRS 3 noted that adopting that perspective requires a fact-driven assessment that does not consider the business rationale, strategic considerations and objectives of the acquirer. They expressed concerns that excluding those factors would not result in the most useful information for users of financial statements. Nevertheless, the Board concluded that the assessment should continue to be made from a market participant's perspective and to be driven by facts that indicate the current state and condition of what has been acquired, rather than by considering what the acquirer might intend to do with the acquired set of activities and assets. Basing this determination on facts, rather than on the intentions of the acquirer, helps to prevent similar transactions being accounted for differently. In the Board's view, bringing the business rationale, strategic considerations and objectives of the acquirer into the determination would have made the determination more subjective and thus would have increased diversity in practice. Consequently, the Board did not change paragraph B11 in this regard.

### **Market participant's ability to replace missing elements**

BC21H Before the 2018 Amendments, paragraph B8 of IFRS 3 stated that a business need not include all of the inputs or processes that the seller used in operating that business 'if market participants are capable of acquiring the business and continuing to produce outputs, for example, by integrating the business with their own inputs and processes'. Many participants in the PIR of IFRS 3 stated that it can be challenging to assess whether market participants are capable of performing such an integration, especially if only some market participants are capable of performing such an integration.

BC21I In the light of those comments, the Board decided to base the assessment on what has been acquired in its current state and condition, rather than on whether market participants would be capable of replacing any missing inputs or processes, for example by integrating the acquired activities and assets. Therefore, the Board deleted the reference to such integration. Instead, as discussed in paragraph BC21F, the 2018 Amendments focus on whether acquired inputs and acquired substantive processes together significantly contribute to the ability to create outputs.

### **The term 'capable of' in the definition of a business**

BC21J The definition of a business includes the phrase 'capable of being conducted and managed for the purpose of providing' a return. Many participants in the PIR indicated that this phrase was too broad in scope to be helpful in distinguishing businesses from assets. However, the Board concluded that it was not necessary to change or clarify this phrase because the 2018 Amendments:

- (a) removed the assessment of whether market participants are capable of integrating the acquired activities and assets;

- (b) clarified that the acquired processes need to be substantive;
- (c) narrowed the definition of output; and
- (d) added more robust guidance and illustrative examples supporting various aspects of the definition.

BC21K The Board considered whether additional guidance was needed regarding the acquisition of suppliers. In some cases, the acquirer integrates an acquired business with the result that it no longer generates revenue. For example, an entity may acquire a supplier and subsequently consume all the output from the supplier. The acquired inputs and processes are still 'capable of generating revenue at the acquisition date and so could qualify as a business, if the criteria in paragraph B12C are met. The Board concluded that this outcome was appropriate because the assessment focuses on what the acquirer acquired, not on what the acquirer intends to do with what it acquired. Accordingly, the Board retained the term 'capable of' as the basis for assessment.

#### **Assessing whether an acquired process is substantive**

BC21L Many participants in the PIR of IFRS 3 stated that it is difficult to assess:

- (a) whether the processes acquired are sufficient to constitute one of the elements required for an acquired set of activities and assets to be a business;
- (b) whether any processes missing from that set are so significant that the set is not a business; and
- (c) how to apply the definition of a business when the acquired set of assets does not generate revenue.

BC21M To address these concerns, the 2018 Amendments added guidance to help entities to assess whether an acquired process is substantive. That guidance seeks more persuasive evidence when there are no outputs because the existence of outputs already provides some evidence that the acquired set of activities and assets is a business. In particular, if the set has no outputs at the acquisition date, the inputs acquired must include:

- (a) an organised workforce that meets specified criteria (see paragraphs BC21N–BC21P); and
- (b) other inputs that the organised workforce could develop or convert into outputs (see paragraph BC21Q)

BC21N The Board concluded that the presence of an organised workforce is an indicator of a substantive process. Consequently, the Board decided that, except in limited circumstances, an organised workforce is required in order to conclude that the set of activities and assets is a business. The limited circumstances are when the acquired set both:

- (a) has outputs; and

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- (b) includes a process (or a group of processes) that is unique or scarce, or cannot be replaced without significant cost, effort, or delay in the ability to continue producing outputs. The Board concluded that such processes are usually valuable and that this would often indicate that the processes are substantive, even if no organised workforce is acquired.

BC21O The Board concluded that although an organised workforce is an input to a business, it is not in itself a business. To conclude otherwise would mean that hiring a skilled employee without acquiring any other inputs could be considered to be acquiring a business. The Board decided that such an outcome would be inconsistent with the definition of a business.

BC21P Although the Board concluded that an organised workforce is an input, paragraph B7(b) indicates that the intellectual capacity of an organised workforce having the necessary skills and experience following rules and conventions may provide the necessary processes that are capable of being applied to inputs to create outputs. The Board concluded that this is the case even if the processes are not documented. The Board inserted the phrase 'intellectual capacity' to provide clarity.

BC21Q For an acquired set of activities and assets to be considered a business if the set has no outputs, the Board concluded that the set should include not only a substantive process but also both an organised workforce and other inputs that the acquired organised workforce could develop or convert into outputs. Entities will need to evaluate the nature of those inputs to assess whether that process is substantive. The Board observed that many entities in the development stage will meet this criterion because technology, intellectual property, or other assets are being developed into a good or service. Conversely, if a set is producing outputs at the acquisition date, the set already contains inputs that are being converted into outputs, and, therefore, there is no need to consider specifically the type of inputs to which the acquired process is applied.

BC21R In finalising the 2018 Amendments, the Board also:

- (a) specified in paragraph B12D(a) that an acquired contract is not a substantive process, in order to clarify that a contract that provides a continuing revenue stream (eg a lease contract) is not itself a process.
- (b) clarified in paragraph B12D(a) that an acquired outsourcing agreement may give access to an organised workforce and that an entity should assess whether an organised workforce accessed through an outsourcing arrangement performs a substantive process that the entity controls, and thus has acquired. The Board added this paragraph because some IFRS Interpretations Committee members observed that IFRS 3 did not provide guidance on whether an outsourced process should be considered in assessing whether a set of activities and assets is a business.



- (c) clarified in paragraph B12D(b) that difficulties in replacing an acquired organised workforce may indicate that the organised workforce performs a process that is critical to the ability to create outputs, because the Board expected that it would normally be more difficult to replace a workforce that performs a critical process than to replace a workforce that performs, for example, an ancillary process. The Board provided this indicator because some respondents to the 2016 Exposure Draft commented that the proposed guidance on substantive processes would require too much judgement.
- (d) removed the presumption, proposed in the 2016 Exposure Draft, that the presence of more than an insignificant amount of goodwill may be an indicator that an acquired process is substantive. Responses to the 2016 Exposure Draft showed that this proposal created more confusion than clarity. For example, some respondents were unclear whether this proposal referred to 'core goodwill' that is economically present in a business, or to the accounting measurement of goodwill that is determined in accounting for business combinations. Some respondents wondered whether this proposal would, in effect, force entities to apply business combination accounting to measure goodwill in order to assess whether what was acquired was in fact a business.
- (e) deleted paragraph B10 of IFRS 3, which described factors to consider when assessing an integrated set of activities and assets in the development stage. The Board deleted that paragraph because the 2018 Amendments provide a more general discussion of acquired sets of activities and assets that do not have outputs.
- (f) added illustrative examples in paragraphs IE73–IE123 to assist with the interpretation of what is considered a business. The draft illustrative examples in the 2016 Exposure Draft also included an example on the acquisition of oil and gas operations. To be consistent with the FASB 2017 Amendments, the Board did not include that example in the 2018 Amendments.

### **Narrowed definition of outputs**

BC21S In the 2018 Amendments, the Board narrowed the definition of outputs to focus on goods and services provided to customers, investment returns and other income from ordinary activities and to exclude returns in the form of lower costs, and other economic benefits provided directly to investors or other owners, members, or participants. The Board also amended the definition of a business to make it consistent with the narrowed definition of outputs. The Board made these changes because:

- (a) IFRS 15 *Revenue from Contracts with Customers* focuses on goods or services that are an output of an entity's ordinary activities. Nevertheless, because not all businesses have revenue within the scope of IFRS 15, the revised definition also includes outputs that are investment income or other income from ordinary activities.

- (b) the previous definition of outputs referred to lower costs and economic benefits provided directly to investors. This reference did not help to distinguish between an asset and a business, because it confused motives for acquiring an asset with the characteristics of the activities and assets acquired. Many asset acquisitions (for example, the purchase of new manufacturing equipment) may be made with the motive of lowering costs but may not involve acquiring a substantive process.

### Concentration test

- BC21T Many participants in the PIR of IFRS 3 noted that applying the definition of a business involves significant judgements and that IFRS 3 provided little or no guidance that identifies situations in which an acquired set of activities and assets is not a business. To address these concerns, in the 2018 Amendments the Board added a concentration test that is designed to reduce cost and complexity by avoiding the need for a detailed assessment in some circumstances. If substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset, or group of similar identifiable assets, the concentration test is met and the set of activities and assets is considered not to be a business. If the concentration test is met, no further assessment is needed.
- BC21U The Board designed the concentration test with the aim of making it easy to understand and—in some straightforward cases that are easy to explain—simple to operate and less costly than applying the detailed assessment otherwise required by paragraphs B8–B12D. To target that aim, the concentration test focuses on a single identifiable asset or a single group of similar identifiable assets. The Board did not expect entities to carry out detailed calculations to apply the test, because detailed calculations would have frustrated the purpose of the test, which is to permit a simplified assessment. In addition, the Board wanted the test to have the same outcome in most circumstances as the detailed assessment and wanted to minimise the risk that the outcome of applying the concentration test could deprive users of financial statements of useful information.
- BC21V To confirm that the Board did not expect detailed calculations, paragraph B7B(b) clarifies how the fair value of the gross assets acquired may normally be determined by reference to the fair value of the consideration transferred. In finalising the 2018 Amendments, the Board added an illustrative example showing that calculation (Example I).
- BC21W The Board concluded that whether a set of activities and assets includes a substantive process does not depend on how the set is financed. Consequently, the concentration test is based on the gross assets acquired, not on net assets. Thus, the existence of debt (for example, a mortgage loan financing a building) or other liabilities does not alter the conclusion on whether an acquisition is a business combination. In addition, in response to requests from respondents, the Board specified, in finalising the 2018 Amendments, that the gross assets considered in the concentration test exclude cash and cash equivalents acquired, deferred tax assets, and goodwill resulting from the effects of

deferred tax liabilities. These exclusions were made because cash acquired, and the tax base of the assets and liabilities acquired, are independent of whether the acquired set of activities and assets includes a substantive process.

BC21X In finalising the 2018 Amendments, the Board made the concentration test optional. This change enables entities to assess whether they have acquired a substantive process when, for example, such an assessment would be more efficient than applying the concentration test, or would result in a conclusion that more faithfully represents the economics of a particular transaction. In line with the purpose of the concentration test, the 2018 Amendments:

- (a) specify that the election to carry out that test is available transaction by transaction; and
- (b) do not prohibit an entity from carrying out the detailed assessment required by paragraphs B8–B12D if the entity has carried out the concentration test and concluded that the acquired set of activities and assets is not a business. The Board decided that such a prohibition was unnecessary, because if an entity intended to disregard the outcome of the concentration test, it could have elected not to apply it.

BC21Y In making the concentration test optional, the Board considered the accounting consequences that would occur if, when applied to a particular transaction, the concentration test does not achieve the same outcome as the detailed assessment otherwise required by paragraphs B8–B12D. The concentration test identifies some transactions as an asset acquisition. For all other transactions, the entity must go on to perform the detailed assessment. The concentration test never determines that a transaction is a business combination.

BC21Z In theory, the concentration test might sometimes identify a transaction as an asset acquisition when the detailed assessment would identify it as a business combination. That outcome would be a false positive. The Board designed the concentration test to minimise the risk that a false positive could deprive users of financial statements of useful information. A false positive has two consequences:

- (a) the entity fails to recognise ‘core goodwill’ that is economically present in a business combination but is not present in an asset acquisition.<sup>2</sup> Nevertheless, if substantially all of the fair value of the gross assets acquired (including core goodwill) is concentrated in a single identifiable asset (or a group of similar identifiable assets), the fair value of the core goodwill cannot be a substantial part of the total fair value of the gross assets acquired. Thus, information about the value of that core goodwill is unlikely to be material. Moreover, if the fair value of the processes acquired is not significant, the detailed assessment required by paragraphs B8–B12D would be unlikely to conclude that the processes are substantive.

<sup>2</sup> Paragraphs BC313–BC318 describe ‘core goodwill’. Those paragraphs also note that, because goodwill is measured as a residual, the carrying amount of goodwill includes several other factors as well as core goodwill.

## IFRS 3 BC

- (b) there are some other differences between the accounting required for a business combination and the accounting required for an asset acquisition, including differences relating to deferred tax, contingent consideration, acquisition-related costs, and gains on bargain purchases. Those differences in accounting requirements are not driven by differences between the economics of a business combination and the economics of an asset acquisition. Therefore, the Board did not expect a false positive to result in a loss of information about the economics of a business combination.
- BC21AA The concentration test might not identify an asset acquisition that would be identified by the detailed assessment required by paragraphs B8–B12D. That outcome would be a false negative. An entity is required to carry out the detailed assessment in such a case and is expected to reach the same conclusion as if it had not applied the concentration test. Thus, a false negative has no accounting consequences.
- BC21AB In finalising the 2018 Amendments, the Board also clarified some aspects of the guidance on a single identifiable asset and on similar identifiable assets (see paragraphs B7B(c)–(f) and B7C).
- BC21AC In finalising the 2018 Amendments, the Board did not:
- (a) make the concentration test an indicator, rather than determinative. Such a change would have been inconsistent with the objective of reducing the costs of applying IFRS 3 by providing a test that is designed to be simple in some straightforward cases that are easy to explain.
  - (b) provide further guidance on the term ‘substantially all’ because that term is already used in several IFRS Standards.

## Method of accounting for business combinations

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- BC22 Both IAS 22 and APB Opinion 16 permitted use of either the acquisition method or the pooling of interests (pooling) method of accounting for a business combination, although the two methods were not intended as alternatives for the same set of facts and circumstances. ED 3 and the 1999 Exposure Draft proposed, and IFRS 3 and SFAS 141 required, use of the acquisition method to account for all business combinations. The boards did not redeliberate that conclusion during the project that led to the revised standards.
- BC23 In developing IFRS 3 and SFAS 141, the IASB and the FASB considered three possible methods of accounting for business combinations—the pooling method, the acquisition method and the fresh start method. In assessing those methods, both boards were mindful of the disadvantages of having more than one method of accounting for business combinations, as evidenced by the experience with IAS 22 and APB Opinion 16. The boards concluded that having more than one method could be justified only if the alternative method (or methods) could be demonstrated to produce information that is more decision-useful and if unambiguous and non-arbitrary boundaries could be

established that unequivocally distinguish when one method is to be applied instead of another. The boards also concluded that most business combinations are acquisitions and, for the reasons discussed in paragraphs BC24–BC28, that the acquisition method is the appropriate method for those business combinations. Respondents to ED 3 and the 1999 Exposure Draft generally agreed. Therefore, neither the pooling method nor the fresh start method could be appropriately used for all business combinations.

### Reasons for adopting the acquisition method

- BC24 Both boards concluded that the acquisition method is the appropriate method of accounting for all business combinations in which one entity obtains control of one or more other businesses<sup>3</sup> because that method is consistent with how the accounting model generally accounts for transactions in which assets are acquired and liabilities are assumed or incurred. Therefore, it produces information that is comparable with other accounting information.
- BC25 The acquisition method views a combination from the perspective of the acquirer—the entity that obtains control of the other combining businesses. The acquirer purchases or otherwise obtains control over net assets and recognises in its financial statements the assets acquired and liabilities assumed, including those not previously recognised by the acquiree. Consequently, users of financial statements are better able to assess the initial investments made and the subsequent performance of those investments and compare them with the performance of other entities. In addition, by initially recognising almost all of the assets acquired and liabilities assumed at their fair values, the acquisition method includes in the financial statements more information about the market’s expectation of the value of the future cash flows associated with those assets and liabilities, which enhances the relevance of that information.
- BC26 Most of the respondents to ED 3 supported the proposal to eliminate the pooling method and to require all business combinations to be accounted for by applying the acquisition method, pending the IASB’s future consideration of whether the fresh start method might be applied to some combinations. Respondents to the 1999 Exposure Draft generally agreed that most business combinations are acquisitions, and many said that all combinations involving only two entities are acquisitions. Respondents also agreed that the acquisition method is the appropriate method of accounting for business combinations in which one of the combining entities obtains control over the other combining entities. However, some qualified their support for the acquisition method as contingent upon the FASB’s decisions about some aspects of applying that method, particularly the accounting for goodwill.

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3 In October 2012 the Board issued *Investment Entities* (Amendments to IFRS 10, IFRS 12 and IAS 27), which removed from the scope of IFRS 3 *Business Combinations* the acquisition by an investment entity, as defined in IFRS 10 *Consolidated Financial Statements*, of an investment in a subsidiary required to be measured at fair value through profit or loss.

## IFRS 3 BC

- BC27 The boards concluded that most business combinations, both two-party transactions and those involving three or more entities (multi-party combinations), are acquisitions. The boards acknowledged that some multi-party combinations (in particular, those that are commonly referred to as roll-up or put-together transactions) might not be acquisitions; however, they noted that the acquisition method has generally been used to account for them. The boards decided not to change that practice at this time. Consequently, the revised standards require the acquisition method to be used to account for all business combinations, including those that some might not consider acquisitions.
- BC28 Both boards considered assertions that exceptions to the acquisition method should be provided for circumstances in which identifying the acquirer is difficult. Respondents taking that view generally said that the pooling method would provide better information in those circumstances. Although acknowledging that identifying the acquirer sometimes may be difficult, the boards concluded that it would be practicable to identify an acquirer in all business combinations. Moreover, in some jurisdictions an acquirer must be identified for tax purposes, regardless of how difficult it may be to do so. Both boards also concluded that in no circumstances does the pooling method provide better information than the acquisition method.

### **Reasons for rejecting the pooling method**

#### **Mergers and acquisitions are economically similar**

- BC29 Some observers, including some respondents to the ED 3 and to the 1999 Exposure Draft, argued that business combinations in which the predominant form of consideration is equity interests, generally referred to as *mergers*, are different from acquisitions and should be accounted for differently. They said that the pooling method is appropriate for a merger because ownership interests are continued (either completely or substantially), no new capital is invested and no assets are distributed, post-combination ownership interests are proportional to those before the combination, and the intention is to unite commercial strategies. Those respondents said that a merger should be accounted for in terms of the carrying amounts of the assets and liabilities of the combining entities because, unlike acquisitions in which only the acquirer survives the combination, all of the combining entities effectively survive a merger.
- BC30 Most respondents who favoured retaining the pooling method also supported limiting its application. Many of those respondents suggested limiting use of the pooling method to 'true mergers' or 'mergers of equals', which they described as combinations of entities of approximately equal size or those in which it is difficult to identify an acquirer.
- BC31 The boards also considered the assertion that the pooling method properly portrays true mergers as a transaction between the owners of the combining entities rather than between the combining entities. The boards rejected that assertion, noting that business combinations are initiated by, and take place because of, a transaction between the combining entities themselves. The

entities – not their owners – engage in the negotiations necessary to carry out the combination, although the owners must eventually participate in and approve the transaction.

- BC32 Many respondents agreed with the boards that although ownership interests are continued in a combination effected by an exchange of equity instruments, those interests **change** as a result of the combination. The former owners of each entity no longer have an exclusive interest in the net assets of the pre-combination entities. Rather, after the business combination, the owners of the combining entities have a residual interest in the net assets of the combined entity. The information provided by the pooling method fails to reflect that and is therefore not a faithful representation.
- BC33 Both boards observed that all business combinations entail some bringing together of commercial strategies. Accordingly, the intention to unite commercial strategies is not unique to mergers and does not support applying a different accounting method to some combinations from that applied to others.
- BC34 Some respondents said that, economically, mergers are virtually identical to acquisitions, making them in-substance acquisitions. Some noted that shares could have been issued for cash and that cash then used to effect the combination, with the result being economically the same as if shares had been used to effect the combination.
- BC35 Both boards concluded that ‘true mergers’ or ‘mergers of equals’ in which none of the combining entities obtains control of the others are so rare as to be virtually non-existent, and many respondents agreed. Other respondents stated that even if a true merger or merger of equals did occur, it would be so rare that a separate accounting treatment is not warranted. The boards also observed that respondents and other constituents were unable to suggest an unambiguous and non-arbitrary boundary for distinguishing true mergers or mergers of equals from other business combinations and concluded that developing such an operational boundary would not be feasible. Moreover, even if those mergers could feasibly be distinguished from other combinations, both boards noted that it does not follow that mergers should be accounted for on a carry-over basis. If they were to be accounted for using a method other than the acquisition method, the fresh start method would be better than the pooling method.

#### **Information provided is not decision-useful**

- BC36 Some proponents of the pooling method argued that it provides decision-useful information for the business combinations for which they favour its use. They said that the information is a more faithful representation than the information that the acquisition method would provide for those combinations. However, other respondents said that the information provided by the acquisition method is more revealing than that provided by the pooling method. Respondents also noted that the pooling method does not hold management accountable for the investment made and the subsequent performance of that investment. In contrast, the accountability that results

from applying the acquisition method forces management to examine business combination deals carefully to see that they make economic sense.

- BC37 Both boards observed that an important part of decision-useful information is information about cash-generating abilities and cash flows generated. The IASB's *Framework<sup>4</sup> for the Preparation and Presentation of Financial Statements* says that 'The economic decisions that are taken by users of financial statements require an evaluation of the ability of an entity to generate cash and cash equivalents and of the timing and certainty of their generation' (paragraph 15). FASB Concepts Statement No. 1 *Objectives of Financial Reporting by Business Enterprises* indicates that '... financial reporting should provide information to help investors, creditors, and others assess the amounts, timing, and uncertainty of prospective net cash inflows to the related enterprise' (paragraph 37; footnote reference omitted). Neither the cash-generating abilities of the combined entity nor its future cash flows generally are affected by the method used to account for the combination. However, fair values reflect the expected cash flows associated with acquired assets and assumed liabilities. Because the pooling method records the net assets acquired at their carrying amounts rather than at their fair values, the information that the pooling method provides about the cash-generating abilities of those net assets is less useful than that provided by the acquisition method.
- BC38 Both boards also concluded that the information provided by the pooling method is less relevant because it has less predictive value and feedback value than the information that is provided by other methods. It is also less complete because it does not reflect assets acquired or liabilities assumed that were not included in the pre-combination financial statements of the combining entities. The pooling method also provides a less faithful representation of the combined entity's performance in periods after the combination. For example, by recording assets and liabilities at the carrying amounts of predecessor entities, post-combination revenues may be overstated (and expenses understated) as the result of embedded gains that were generated by predecessor entities but not recognised by them.
- BC39 The *Framework* and FASB Concepts Statement No. 2 *Qualitative Characteristics of Accounting Information* describe comparability as an important characteristic of decision-useful information. Use of different accounting methods for the same set of facts and circumstances makes the resulting information less comparable and thus less useful for making economic decisions. As discussed in paragraphs BC29–BC35, the boards concluded that all business combinations are economically similar. Accordingly, use of the same method to account for all combinations enhances the comparability of the resulting financial reporting information. Both boards observed that the acquisition method, but not the pooling method, could reasonably be applied to all business combinations in which one party to the combination obtains control over the combined entity.

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<sup>4</sup> References to the *Framework* in this Basis for Conclusions are to the IASC's *Framework for the Preparation and Presentation of Financial Statements*, adopted by the IASB in 2001 and in effect when the Standard was developed.



BC40 Opponents of the pooling method generally said that eliminating that method would enhance the comparability of financial statements of entities that grow by means of acquisitions. Both boards agreed.

**Inconsistent with historical cost accounting model**

BC41 Both boards observed that the pooling method is an exception to the general concept that exchange transactions are accounted for in terms of the fair values of the items exchanged. Because the pooling method records the combination in terms of the pre-combination carrying amounts of the parties to the transaction, it fails to record and thus to hold management accountable for the investment made in the combination.

BC42 Some respondents to the FASB's 1999 Exposure Draft who advocated use of the pooling method asserted that it is consistent with the historical cost model and that eliminating the pooling method would be a step towards adopting a fair value model. They argued that before eliminating the pooling method, the FASB should resolve the broad issue of whether to adopt a fair value model in place of the historical cost model. The FASB disagreed, noting that, regardless of the merits of a fair value model, the pooling method is an aberration that is inconsistent with the historical cost model.

BC43 Although the historical cost model is frequently described as being 'transaction based', the fair value model also records all transactions. In both models, transactions are recognised on the basis of the fair values exchanged at the transaction date. In contrast, the pooling method does not result in recognising in the records of the combined entity the values exchanged; instead, only the carrying amounts of the predecessor entities are recognised. Failure to record those values can adversely affect the relevance and reliability of the combined entity's financial statements for years—and even decades—to come. For those reasons, both boards concluded that the pooling method is inconsistent with the historical cost model. Requiring use of the acquisition method is not a step towards adopting a fair value accounting model. Rather, it eliminates an exception to the historical cost model and requires accounting for assets acquired and liabilities assumed in a business combination consistently with other acquisitions of assets and incurrences of liabilities.

**Disclosure not an adequate response**

BC44 In urging that the pooling method should be retained, a few respondents to the 1999 Exposure Draft said that any perceived problems with having two methods of accounting could be addressed by enhanced disclosures in the notes to the financial statements. However, they generally did not specify what those disclosures should be and how they would help overcome the comparability problems that inevitably result from having two methods.

BC45 The FASB considered whether enhanced disclosures might compensate for the deficiencies of the pooling method but doubted the usefulness of almost any disclosures short of disclosing what the results would have been had the acquisition method been used to account for the business combination. Providing disclosures that would enable users of financial statements to determine what the results would have been had the transaction been

accounted for by the acquisition method would be a costly solution that begs the question of why the acquisition method was not used to account for the transaction in the first place. Thus, the FASB rejected enhanced disclosures as a viable alternative.

#### **Not cost-beneficial**

BC46 Some of the boards' constituents cited cost-benefit considerations as a reason for retaining the pooling method. They argued that the pooling method is a quicker and less expensive way to account for a business combination because it does not require an entity to hire valuation experts to value assets for accounting purposes.

BC47 Other constituents favoured eliminating the pooling method for cost-benefit reasons. Some argued that the pooling method causes preparers of financial statements, auditors, regulators and others to spend unproductive time dealing with the detailed criteria required by IAS 22 or APB Opinion 16 in attempts to qualify some business combinations for the pooling method. Others noted that using the acquisition method of accounting for all business combinations would eliminate the enormous amount of interpretative guidance necessary to accommodate the pooling method. They also said that the benefits derived from making the acquisition method the only method of accounting for business combinations would significantly outweigh any issues that might arise from accounting for the very rare true merger or merger of equals by the acquisition method.

BC48 Both boards concluded that requiring a single method of accounting is preferable because having more than one method would lead to higher costs associated with applying, auditing, enforcing and analysing the information produced by the different methods. The IASB's conclusions on benefits and costs are more fully discussed in paragraphs BC435–BC439.

#### **Perceived economic consequences not a valid reason for retention**

BC49 Some of the respondents to ED 3 and the 1999 Exposure Draft who favoured retaining the pooling method cited public policy considerations or other perceived economic consequences of eliminating it. Some argued that eliminating the pooling method would require some investors to adjust to different measures of performance, potentially affecting market valuations adversely in some industries during the transition period. Others argued that it would impede desirable consolidation in some industries, reduce the amount of capital flowing into those industries, slow the development of new technology and adversely affect entrepreneurial culture. Some argued that eliminating the pooling method would reduce the options available to some regulatory agencies and possibly require regulated entities to maintain a second set of accounting records.

BC50 Other respondents did not share those views. Some said that because business combinations are (or should be) driven by economic rather than accounting considerations, economically sound deals would be completed regardless of the method used to account for them. Others noted that the financial community values business combinations in terms of their fair values rather

than book values; therefore, those transactions should initially be recognised in the financial statements at fair value.

- BC51 Both boards have long held that accounting standards should be neutral; they should not be slanted to favour one set of economic interests over another. Neutrality is the absence of bias intended to attain a predetermined result or to induce a particular behaviour. Neutrality is an essential aspect of decision-useful financial information because biased financial reporting information cannot faithfully represent economic phenomena. The consequences of a new financial reporting standard may indeed be negative for some interests in either the short term or the long term. But the dissemination of unreliable and potentially misleading information is, in the long run, harmful for all interests.
- BC52 Both boards rejected the view that the pooling method should be retained because eliminating it could have adverse consequences for some economic interests. Accounting requirements for business combinations should seek neither to encourage nor to discourage business combinations. Instead, those standards should produce unbiased information about those combinations that is useful to investors, creditors and others in making economic decisions about the combined entity.

#### **Acquisition method flaws remedied**

- BC53 Some respondents to ED 3 or to the 1999 Exposure Draft supported retaining the pooling method because of perceived problems associated with the acquisition method. Most of those comments focused on the effects of goodwill amortisation.
- BC54 Both boards concluded that the pooling method is so fundamentally flawed that it does not warrant retention, regardless of perceived problems with the acquisition method. The boards also observed that the most frequently cited concern is remedied by the requirement of IAS 36 *Impairment of Assets* and FASB Statement No. 142 *Goodwill and Other Intangible Assets* (SFAS 142) to test goodwill for impairment and recognise a loss if it is impaired rather than to amortise goodwill.

#### **The fresh start method**

- BC55 In the fresh start method, none of the combining entities is viewed as having survived the combination as an independent reporting entity. Rather, the combination is viewed as the transfer of the net assets of the combining entities to a new entity that assumes control over them. The history of that new entity, by definition, begins with the combination.
- BC56 In the first part of their respective business combinations projects, both the IASB and the FASB acknowledged that a case could be made for using the fresh start method to account for the relatively rare business combination that does not clearly qualify as an acquisition. Such a combination might be defined either as one in which an acquirer cannot be identified or as one in which the acquirer is substantially modified by the transaction. However, the

boards observed that those transactions have been accounted for by the acquisition method and they decided not to change that practice.

BC57 Neither the IASB nor the FASB has on its agenda a project to consider the fresh start method. However, both boards have expressed interest in considering whether joint venture formations and some formations of new entities in multi-party business combinations should be accounted for by the fresh start method. Depending on the relative priorities of that topic and other topics competing for their agendas when time becomes available, the boards might undertake a joint project to consider those issues at some future date.

## Scope

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BC58 The revised standards exclude from their scope some transactions that were also excluded from the scope of both IFRS 3 and SFAS 141. However, the revised standards include within their scope combinations involving only mutual entities and combinations achieved by contract alone, which were excluded from the scope of IFRS 3 and SFAS 141. Paragraphs BC59–BC79 discuss the boards' reasons for those conclusions.

### **Joint ventures and combinations of entities under common control**

BC59 Formations of joint ventures and combinations of entities under common control are excluded from the scope of the revised standards. Those transactions were also excluded from the scope of both IFRS 3 and SFAS 141, and the boards continue to believe that issues related to such combinations are appropriately excluded from the scope of this project. The boards are aware of nothing that has happened since IFRS 3 and SFAS 141 were issued to suggest that the revised standards should be delayed to address the accounting for those events.

BC60 In developing IFRS 3, the IASB considered whether it should amend the definition of joint control in IAS 31 *Interests in Joint Ventures*<sup>5</sup> because it was concerned that its decision to eliminate the pooling method would create incentives for business combinations to be structured to meet the definition of a joint venture. After considering comments on the definition proposed in ED 3, the IASB revised the definition of joint control in IAS 31 to clarify that:

- (a) unanimous consent on **all** financial and operating decisions is not necessary for an arrangement to satisfy the definition of a joint venture—unanimous consent on only strategic decisions is sufficient.
- (b) in the absence of a contractual agreement requiring unanimous consent to strategic financial and operating decisions, a transaction in which the owners of multiple businesses agree to combine their businesses into a new entity (sometimes referred to as a roll-up transaction) should be accounted for by the acquisition method. Majority consent on such decisions is not sufficient.

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<sup>5</sup> IFRS 11 *Joint Arrangements*, issued in May 2011, replaced IAS 31.

BC61 In developing SFAS 141, the FASB noted that constituents consider the guidance in paragraph 3(d) of APB Opinion No. 18 *The Equity Method of Accounting for Investments in Common Stock* in assessing whether an entity is a joint venture, and it decided not to change that practice in its project on business combinations.

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BC61A The IASB observed that there was uncertainty about whether paragraph 2(a) of IFRS 3, which excludes the formation of joint ventures from the scope of IFRS 3, should have been amended to refer to joint arrangements when IFRS 11 was issued. IFRS 11 had changed the use of the term ‘joint venture’ from having a general meaning that included ‘jointly controlled operations’, ‘jointly controlled assets’ and ‘jointly controlled entities’, to meaning a specific type of joint arrangement, which does not include ‘joint operations’. The IASB did not change the wording of the scope exclusion in paragraph 2(a) of IFRS 3 for ‘the formation of a joint venture’ when it replaced IAS 31 with IFRS 11 *Joint Arrangements*, although it had not intended to change the scope of IFRS 3.

BC61B There was also uncertainty about whether the scope exclusion in paragraph 2(a) of IFRS 3 addresses:

- (a) the accounting by the joint arrangements themselves in their financial statements only; or also
- (b) the accounting by the parties to the joint arrangement for their interests in the joint arrangement.

BC61C The IASB noted that paragraph 2(a) of IFRS 3 should exclude formations of every type of joint arrangement (ie joint ventures and joint operations) from the scope of IFRS 3. It also noted that paragraph 2(a) of IFRS 3 excludes, from the scope of IFRS 3, only the accounting by the joint arrangements themselves in their financial statements.

BC61D The IASB concluded that paragraph 2(a) of IFRS 3 should be amended to address all types of joint arrangements and to remove uncertainty about the financial statements to which it applies.

BC61E Consequently, the IASB amended paragraph 2(a) of IFRS 3 to:

- (a) exclude the formation of all types of joint arrangements from the scope of IFRS 3 by replacing ‘joint venture’ with ‘joint arrangement’; and
- (b) clarify that the only scope exclusion needed from the scope of IFRS 3 is the accounting for the formation of a joint arrangement in the financial statements of the joint arrangement itself.

### **Not-for-profit organisations**

- BC62 The FASB also decided to exclude from the scope of SFAS 141(R) business combinations of not-for-profit organisations and acquisitions of for-profit businesses by not-for-profit organisations. Some aspects of combinations of not-for-profit organisations are different from combinations of business entities. For example, it cannot be presumed that combinations of organisations that serve a public interest are necessarily exchange transactions in which willing parties exchange equal values. For that reason, the FASB is addressing the accounting for combinations of not-for-profit organisations in a separate project. It published an exposure draft in October 2006 that addresses accounting for combinations of not-for-profit organisations.
- BC63 IFRSs generally do not have scope limitations for not-for-profit activities in the private or public sector. Although IFRSs are developed for profit-oriented entities, a not-for-profit entity might be required, or choose, to apply IFRSs. A scope exclusion for combinations of not-for-profit organisations is not necessary.

### **Combinations of mutual entities**

- BC64 During its deliberations leading to SFAS 141, the FASB concluded that combinations involving only mutual entities should also be accounted for using the acquisition method but decided not to mandate its use until the FASB had considered implementation questions raised about the application of that method. Similarly, IFRS 3 did not require use of the acquisition method for combinations of mutual entities, although the IASB had also concluded that the acquisition method was appropriate for those combinations. Instead, as part of the first phase of its business combinations project, the IASB published an exposure draft of proposed amendments to IFRS 3 – *Combinations by Contract Alone or Involving Mutual Entities*, which proposed an interim approach for accounting for those combinations until the IASB had considered related implementation issues in the second phase of its project. In the light of respondents' comments, the IASB decided not to proceed with the proposals in the exposure draft, primarily for reasons of timing and impending consideration of those issues in the second phase of this project.
- BC65 After SFAS 141 was issued, the FASB began a joint project with the Canadian Accounting Standards Board (AcSB). The objective of that project was to develop guidance for combinations of two or more mutual entities. In October 2001 the FASB and the AcSB held a round-table discussion with representatives of mutual banks, credit unions, co-operatives and other mutual entities. In January 2004 the FASB met representatives of organisations of co-operative and other mutual entities to discuss its tentative conclusions and specific concerns raised by constituents. In addition, the FASB conducted field visits to three mutual entities in 2004.

- BC66 A few participants in those meetings indicated a preference for the fresh start method as an alternative to the acquisition method for particular mergers, especially for those in which it is difficult to identify the acquirer. On both occasions, however, those participants acknowledged the costs and practical difficulties that a fresh start alternative would impose, especially on entities with recurring combinations. After considering those views, the FASB concluded that any potential advantages of using the fresh start method for some combinations of mutual entities would be outweighed by the disadvantages of having two methods of accounting.
- BC67 During the deliberations leading to the 2005 Exposure Draft, some representatives of mutual entities reiterated concerns expressed during the development of SFAS 141 about requiring all combinations of mutual entities to be accounted for using the acquisition method. Many of those constituents reiterated public policy concerns similar to those discussed in paragraphs BC49–BC52. For example, some said that eliminating the pooling method could impede desirable combinations and reduce the amount of capital flowing into their industries. They suggested, for example, that the requirement to identify an acquirer could impede mergers of neighbouring mutual entities when both the fact and appearance of a merger of equals are of paramount importance to their directors, members and communities. The boards did not find those arguments persuasive for the same reasons discussed in paragraphs BC49–BC52.
- BC68 Although mutual entities have particular characteristics that distinguish them from other business entities, the boards noted that the two types of entities also have many common characteristics. The boards also observed that the economic motivations for combinations of mutual entities, such as to provide their constituents with a broader range of, or access to, services and cost savings through economies of scale, are similar to those for combinations of other business entities. For example:
- (a) although mutual entities generally do not have shareholders in the traditional sense of investor-owners, they are in effect 'owned' by their members and are in business to serve their members or other stakeholders. Like other businesses, mutual entities strive to provide their members with a financial return or benefits. A mutual entity generally does that by focusing on providing its members with its products and services at lower prices. For example, the benefit provided by a credit union may be a lower interest rate on a borrowing than might be obtainable through an investor-owned financial institution. In a wholesale buying co-operative, the benefit might be lower net costs, after reflecting patronage dividends.
  - (b) members' interests in a mutual entity are generally not transferable like other ownership interests. However, they usually include a right to share in the net assets of the mutual entity in the event of its liquidation or conversion to another form of entity.

- (c) a higher percentage of combinations of mutual entities than of combinations of other business entities occur without an exchange of cash or other readily measurable consideration, but such combinations are not unique to mutual entities. Business combinations of other entities, particularly private entities, also take place without an exchange of cash or other readily measurable consideration.

BC69 Thus, the boards concluded that the attributes of mutual entities are not sufficiently different from those of other entities to justify different accounting for business combinations. The boards also concluded that the benefits of requiring combinations of mutual entities to be accounted for by the acquisition method would justify the related costs. Therefore, combinations of mutual entities were included within the scope of the 2005 Exposure Draft.

BC70 Many of the respondents to the 2005 Exposure Draft who commented on combinations of mutual entities objected to including them in the scope of the revised standards and thus requiring them to be accounted for by the acquisition method. Respondents objected to the use of the acquisition method for conceptual, practical and cost-benefit reasons. For example, some said that a combination involving only mutual entities is a 'true pooling of interests' and that the acquisition method would not reflect the economics of the transactions. Some also said that it would often be difficult to identify an acquirer. Some also noted the absence of readily measurable consideration transferred in many combinations of mutual entities, which would make it necessary to use other valuation techniques to develop the fair values needed to apply the acquisition method. For those reasons, respondents also said that using the acquisition method for combinations of mutual entities would not be cost-beneficial. Respondents proposed other methods of accounting for mutual entities, including the pooling method, the fresh start method and a net asset method that was the same as the modified version of the acquisition method proposed by the IASB in its exposure draft mentioned in paragraph BC64.

BC71 In considering those comments, the boards noted that respondents' reasons for their objections to the acquisition method were generally the same as the factors discussed in paragraphs BC67 and BC68. For the same reasons discussed in those paragraphs, the boards affirmed their conclusion that the attributes of mutual entities are not sufficiently different from those of investor-owned entities to justify a different method of accounting for combinations of mutual entities. The boards also noted that, regardless of the intentions of the combining entities, the general result of a combination involving only mutual entities is that one entity obtains control of the other entity (or entities). Thus, combinations involving only mutual entities are included in the scope of the revised standards.

BC72 Some representatives of mutual entities suggested that the revised standards should permit an acquisition of a mutual entity to be reported as an increase in the retained earnings of the acquirer (combined entity) as had been the practice in accordance with the pooling method of accounting. The boards observed that in a combination of two investor-owned entities in which the



acquirer issues its equity shares as consideration for all of the acquiree's equity shares, the fair value of the acquiree's equity is recognised as an addition to the acquirer's equity—generally as an increase to the acquirer's ordinary shares and capital. Thus, the equity (net assets) of the combined entity is increased from the acquisition of the acquiree (and the fair value of its net assets), but retained earnings of the acquirer are unaffected. The boards concluded that business combinations of two investor-owned entities are economically similar to those of two mutual entities in which the acquirer issues member interests for all the member interests of the acquiree. Thus, the boards concluded that those similar transactions should be similarly reported. Therefore, the revised standards clarify that if the only consideration exchanged is the member interests of the acquiree for the member interests of the acquirer (or the member interests of the newly combined entity), the amount of the acquiree's net assets is recognised as a direct addition to capital or equity, not retained earnings (paragraph B47 of the revised IFRS 3).

- BC73 During the boards' redeliberations of the 2005 Exposure Draft, some representatives of mutual entities also proposed that the entire amount of the acquiree's net assets recognised in accordance with the revised standards should be considered a gain on a bargain purchase. They contended that the exchange of member interests in at least some forms of mutual entities does not constitute consideration because the interests the acquirer transfers have no economic value. The boards disagreed, noting that one mutual entity—the acquiree—would presumably not be willing to transfer its net assets to the control of another—the acquirer—in exchange for nothing of value.
- BC74 The FASB also considered more specific concerns of representatives of credit unions about adverse economic consequences for those entities. Those representatives argued that requiring the application of the acquisition method would impede consolidation within that industry and might misrepresent the financial soundness and regulatory capital of two credit unions that combine their operations. They noted that in the United States, applicable federal law defines net worth for credit unions as the 'retained earnings balance of the credit union, as determined under generally accepted accounting principles.' Because the regulatory definition of net worth is narrower than equity under US GAAP, they expressed concern that the exclusion of the equity of an acquired credit union from retained earnings of the combined entity could make a financially sound combined entity appear to be financially unsound. Thus, they suggested that credit unions should be permitted to continue to report the equity of an acquired mutual entity as an addition to retained earnings of the combined entity. The FASB was not persuaded by those arguments; it believes that Statement 141(R) will not affect the ability of credit unions to restructure and combine with other credit unions.
- BC75 Additionally, constituents told the FASB that the number of combinations of credit unions in which the regulatory net worth calculation could be significantly affected is relatively small in any given year. The FASB also noted that the regulatory filings of credit unions and other entities and the needs of

their regulators are separate matters beyond the purpose of financial statements. The FASB's Concepts Statement 2 states that a necessary and important characteristic of accounting information is neutrality. In the context of business combinations, neutrality means that accounting standards should neither encourage nor discourage business combinations but rather provide information about those combinations that is fair and even-handed. The FASB observed that its public policy goal is to issue accounting standards that result in neutral and representationally faithful financial information. Eliminating use of the pooling method for all entities and requiring all entities, including mutual entities, to report the resulting increase directly in equity other than retained earnings is consistent with that public policy goal.

BC76 Some respondents to the 2005 Exposure Draft said that co-operatives do not fit within the definition of a mutual entity and that co-operatives are sufficiently different from other entities to justify a different method of accounting for combinations involving only co-operatives. To support their view, they cited factors such as differences in legal characteristics and different purposes of co-operatives in addition to providing economic benefits to members.

BC77 The boards considered the differences between, for example, a co-operative that provides electricity to its members in a rural area and other types of mutual entities, such as a mutual insurance company. The boards acknowledged particular differences between the two types of entities, for example, the co-operative issues member shares and the mutual insurance company does not. In addition, the objective of the co-operative may include providing more social and cultural benefits to its community in addition to the economic benefits provided to its members than does another type of mutual entity. However, the boards concluded that co-operatives generally provide direct and indirect economic benefits such as dividends and lower costs of services, including credit, or other products directly to its members. The boards concluded that differences in the amount of social and cultural benefits an entity seeks to provide do not justify a conclusion that co-operatives are sufficiently different from other mutual entities that they do not fit within the definition of a mutual entity in the revised standards. Thus, co-operatives are included in the definition of a mutual entity in the revised standards.

### **Combinations achieved by contract alone**

BC78 Both boards also concluded that business combinations achieved by contract alone should be included in the scope of the revised standards. Those combinations were not included in the scope of either IFRS 3 or SFAS 141, although the boards understand that practice in the United States generally was to account for them in accordance with SFAS 141. For example, in EITF Issue No. 97-2 *Application of FASB Statement No. 94 and APB Opinion No. 16 to Physician Practice Management Entities and Certain Other Entities with Contractual Management Arrangements*, the Task Force reached a consensus that a transaction in which a physician practice management entity executes a management agreement with the physician practice should be accounted for as a business combination. Technically, that transaction would not meet the

definition of a business combination in APB Opinion 16 or SFAS 141 because the physician practice management entity does not acquire either equity interests in, or the net assets of, the physician practice.

- BC79 The boards understand that difficulties may arise in applying the acquisition method to combinations achieved by contract alone. In particular, such business combinations normally do not involve the payment of readily measurable consideration and in rare circumstances it might be difficult to identify the acquirer. However, as for combinations of mutual entities and for the reasons discussed above, the boards concluded that the acquisition method can and should be applied in accounting for such business combinations. In reaching that conclusion, the boards also concluded that in a business combination achieved by contract alone:
- (a) difficulties in identifying the acquirer are not a sufficient reason to justify a different accounting treatment, and no further guidance is necessary for identifying the acquirer for combinations by contract alone.
  - (b) in the United States, these transactions are already being accounted for by the acquisition method and insurmountable issues have not been encountered.
  - (c) determining the fair value of the identifiable assets acquired and liabilities assumed and calculating the related goodwill should be consistent with decisions reached in the second phase of the project.

### **Applying the acquisition method**

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- BC80 The 2005 Exposure Draft identified four steps in applying the acquisition method, and it discussed the requirements for applying the acquisition method in terms of those steps:
- (a) identifying the acquirer;
  - (b) determining the acquisition date;
  - (c) measuring the fair value of the acquiree; and
  - (d) measuring and recognising the assets acquired and the liabilities assumed.
- BC80A In contrast, the revised standards indicate (paragraph 5 of the revised IFRS 3) that applying the acquisition method requires:
- (a) identifying the acquirer;
  - (b) determining the acquisition date;
  - (c) recognising and measuring the identifiable assets acquired, liabilities assumed and any non-controlling interest in the acquiree; and
  - (d) recognising and measuring goodwill or a gain from a bargain purchase.

## IFRS 3 BC

- BC81 The main changes to the list of steps in applying the acquisition method are to eliminate measuring the fair value of the acquiree as a whole and to add recognising and measuring goodwill as a separate step. The primary reason for those changes is the boards' decision to focus on measuring the components of the business combination, including any non-controlling interest in the acquiree, rather than measuring the fair value of the acquiree as a whole. The boards observed that neither the requirements of the 2005 Exposure Draft nor those of the revised standards for applying the acquisition method result in a fair value measure of either the acquiree as a whole or the acquirer's interest in the acquiree. For example, the revised standards do not provide for recognising a loss if the acquirer overpays for the acquiree, ie if the acquisition-date fair value of the consideration transferred exceeds the acquisition-date fair value of the acquirer's interest in the acquiree. The IASB's decision to allow an acquirer to choose to measure any non-controlling interest in the acquiree at fair value or on the basis of its proportionate interest in the acquiree's identifiable net assets adds another potential difference between the results of applying the requirements of the revised IFRS 3 and measuring the acquisition-date fair value of the acquiree as a whole. (See paragraphs BC209–BC221 for discussion of the reasons why the IASB provided that choice.) Paragraphs BC330 and BC331 discuss the reasons why the revised standards also eliminate the related presumption in the 2005 Exposure Draft that the consideration transferred in exchange for the acquiree measures the fair value of the acquirer's interest in the acquiree.

### **Identifying the acquirer**

- BC82 The boards' decision that all business combinations within the scope of the revised standards should be accounted for by the acquisition method means that the acquirer must be identified in every business combination.
- BC83 The IASB and the FASB separately developed the guidance on identifying the acquirer that appeared in IFRS 3 and SFAS 141, respectively. Paragraphs BC84–BC92 discuss the FASB's development of the guidance in SFAS 141 and paragraphs BC93–BC101 discuss the IASB's development of the guidance in IFRS 3. Paragraphs BC102–BC105 discuss the boards' joint consideration of how to identify the acquirer in a business combination in the second phase of their projects on business combinations.

### **Developing the guidance in SFAS 141**

- BC84 SFAS 141's guidance on identifying the acquirer focused on the types of business combinations included in its scope, which excluded transactions in which one entity obtains control over one or more other entities by means other than transferring assets, incurring liabilities or issuing equity securities. Thus, SFAS 141 did not include the general guidance that the entity that obtains control is the acquirer, although that was the effect of the guidance for the combinations within its scope.

- BC85 In developing its 1999 Exposure Draft, the FASB affirmed the guidance in APB Opinion 16 that in a business combination effected primarily through the distribution of cash or other assets or by incurring liabilities, the acquirer is generally the entity that distributes cash or other assets or assumes or incurs liabilities. The FASB considered a variety of suggestions on factors that should be considered in identifying the acquirer in a business combination effected through an exchange of equity interests. The guidance proposed in the 1999 Exposure Draft reflected the FASB's conclusion that all pertinent facts and circumstances should be considered when identifying the acquirer, particularly the relative voting rights in the combined entity after the combination. That proposed guidance said that the existence of unusual or special voting arrangements and options, warrants or convertible securities should be considered in determining which shareholder group retained or received the larger portion of the voting rights in the combined entity. In addition, factors related to the composition of the board of directors and senior management of the combined entity should be considered and should be weighted equally with the factors related to voting rights.
- BC86 Respondents to the 1999 Exposure Draft who commented on the proposed criteria for identifying the acquirer generally agreed that they were appropriate. Some respondents said that the proposed guidance was an improvement over APB Opinion 16 because it provided additional factors to consider in determining which shareholder group retained or received the larger share of the voting rights in the combined entity. However, many respondents suggested improvements to the proposed criteria, and some suggested that the FASB should consider other criteria.
- BC87 Several respondents suggested that the FASB should retain the presumptive approach in APB Opinion 16 for identifying the acquirer in transactions effected through an exchange of equity interests. That approach presumes that, in the absence of evidence to the contrary, the acquirer is the combining entity whose owners as a group retain or receive the larger share of the voting rights in the combined entity. Other respondents suggested that the factors to be considered in identifying the acquirer should be provided in the form of a hierarchy. Some of those respondents also suggested that the FASB should provide additional guidance explaining how factors relating to voting rights (unusual special voting arrangements and options, warrants or convertible securities) would affect the determination of the acquirer.
- BC88 In considering those suggestions, the FASB observed, as it did in developing the 1999 Exposure Draft, that because each business combination is unique, the facts and circumstances relevant to identifying the acquirer in one combination may be less relevant in another. Therefore, SFAS 141 did not retain the presumptive approach in APB Opinion 16 nor did it provide hierarchical guidance because to do so would have implied that some factors are always more important than others in identifying the acquirer. However, as suggested by respondents, the FASB modified the proposed guidance to explain how some of the factors influence the identification of the acquirer.

## IFRS 3 BC

- BC89 The 1999 Exposure Draft did not propose requiring consideration of the payment of a premium over the market value of the equity securities acquired as evidence of the identity of the acquirer. Some respondents to the 1999 Exposure Draft said that the payment of a premium is a strong indicator of the identity of the acquirer. Upon reconsideration, the FASB decided to include in SFAS 141 the payment of a premium as a criterion to be considered in identifying the acquirer.
- BC90 In developing SFAS 141, the FASB observed that identifying the acquirer might be difficult in some multi-party business combinations, particularly those that might not be acquisitions but are required to be accounted for as such. The FASB noted that in those circumstances it might be helpful to consider additional factors such as which of the entities initiated the combination and whether the reported amounts of assets, revenues and earnings of one of the combining entities significantly exceed those of the others. Respondents to the 1999 Exposure Draft generally agreed, and SFAS 141 included that guidance.
- BC91 In addition, as suggested by respondents, the FASB decided that SFAS 141 should explicitly state that in some business combinations, such as reverse acquisitions, the entity that issues the equity interests may not be the acquirer. In a reverse acquisition, one entity (Entity A) obtains ownership of the equity instruments of another entity (Entity B), but Entity A issues enough of its own voting equity instruments as consideration in the exchange transaction for control of the combined entity to pass to the owners of Entity B.
- BC92 If a new entity is formed to issue equity instruments to effect a business combination, SFAS 141 required that one of the combining entities that existed before the combination must be identified as the acquirer for essentially the same reasons as those discussed in paragraphs BC98–BC101 in the context of IFRS 3's similar requirement.

### **Developing the guidance in IFRS 3**

- BC93 As proposed in ED 3, IFRS 3 carried forward from IAS 22 the principle that in a business combination accounted for using the acquisition method the acquirer is the combining entity that obtains control of the other combining entities or businesses. The IASB observed that using the control concept as the basis for identifying the acquirer is consistent with using the control concept in IAS 27 *Consolidated and Separate Financial Statements* to define the boundaries of the reporting entity and to provide the basis for establishing the existence of a parent-subsidary relationship.<sup>6</sup> IFRS 3 also carried forward the guidance in IAS 22 that control is the power to govern the financial and operating policies of the other entity so as to obtain benefits from its activities. IFRS 3 also provided the same guidance as IAS 22 for identifying the acquirer if one of the combining entities might have obtained control even if it does not acquire more than one-half of the voting rights of another combining entity.

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<sup>6</sup> The consolidation requirements in IAS 27 were superseded, and the definition of control was revised, by IFRS 10 *Consolidated Financial Statements* issued in May 2011.

*Identifying an acquirer in a business combination effected through an exchange of equity interests*

- BC94 In developing ED 3 and IFRS 3, the IASB decided not to carry forward the guidance in IAS 22 on identifying which of the combining entities is the acquirer in a reverse acquisition. IAS 22 required the entity whose owners control the combined entity to be treated as the acquirer. That approach presumed that in a 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 IASB observed that because the presumption is not always accurate, carrying it forward would in effect override the control concept for identifying the acquirer.
- BC95 The IASB observed that the control concept focuses on the relationship between two entities, in particular, whether one entity has the power to govern the financial and operating policies of another so as to obtain benefits from its activities. Therefore, determining which of the combining entities 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 is fundamental to identifying the acquirer, regardless of the form of the consideration.
- BC96 The IASB also observed that in some reverse acquisitions, the acquirer may be the entity whose equity interests have been acquired and the acquiree is the issuing entity. For example, a private entity might arrange to have itself 'acquired' by a smaller public entity through an exchange of equity interests as a means of obtaining a stock exchange listing. As part of the agreement, the directors of the public entity resign and are replaced by directors appointed by the private entity and its former owners. The IASB observed that in such circumstances, the private entity, which is the legal subsidiary, has the power to govern the financial and operating policies of the combined entity so as to obtain benefits from its activities. Treating the legal subsidiary as the acquirer in such circumstances is thus consistent with applying the control concept for identifying the acquirer. Treating the legal parent as the acquirer in such circumstances would place the form of the transaction over its substance, thereby providing less useful information than would be provided using the control concept to identify the acquirer.
- BC97 Therefore, the IASB proposed in ED 3 that the acquirer in a business combination effected through an issue of equity interests should be identified by considering all pertinent facts and circumstances to determine which of the combining entities has the power to govern the financial and operating policies of the other so as to obtain benefits from its activities. Pertinent facts and circumstances include, but are not limited to, the relative ownership interests of the owners of the combining entities. Respondents to ED 3 generally supported that requirement, which was consistent with the requirement of SFAS 141.

*Identifying an acquirer if a new entity is formed to effect a business combination*

- BC98 If a new entity is formed to issue equity instruments to effect a business combination, ED 3 proposed and IFRS 3 required one of the combining entities that existed before the combination to be identified as the acquirer on the basis of the evidence available. In considering that requirement, the IASB identified two approaches to applying the acquisition method that had been applied in various jurisdictions. The first approach viewed business combinations from the perspective of one of the combining entities that existed before the combination. Under that approach, the acquirer must be one of the combining entities that existed before the combination and therefore cannot be a new entity formed to issue equity instruments to effect a combination. The second approach viewed business combinations from the perspective of the entity providing the consideration, which could be a newly formed entity. Under that approach, the acquirer must be the entity providing the consideration. Some jurisdictions interpreted IAS 22 as requiring the first approach; other jurisdictions interpreted IAS 22 as requiring the second approach.
- BC99 If a new entity is formed to issue equity instruments to effect a business combination involving two or more other entities, viewing the combination from the perspective of the entity providing the consideration would result in the newly formed entity applying the acquisition method to each of the other combining entities. The IASB noted that the result would be the same as applying the fresh start method to account for the business combination, which would potentially provide users of the financial statements with more relevant information than requiring one of the pre-existing entities to be treated as the acquirer.
- BC100 The IASB also considered whether treating a new entity formed to issue equity instruments to effect a business combination as the acquirer would place the form of the transaction over its substance, because the new entity may have no economic substance. The formation of such entities is often related to legal, tax or other business considerations that do not affect the identification of the acquirer. For example, a combination of 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. To do otherwise would impair both the comparability and the reliability of the information.
- BC101 The IASB concluded that the users of an entity's financial statements are provided with more useful information about a business combination when that information faithfully represents the transaction it purports to represent. Therefore, IFRS 3 required the acquirer to be one of the combining entities that existed before the combination.



**Convergence and clarification of SFAS 141's and IFRS 3's guidance for identifying the acquirer**

BC102 The deliberations of the FASB and the IASB described in paragraphs BC84–BC101 resulted in similar but not identical guidance for identifying the acquirer in SFAS 141 and IFRS 3. But the guidance was worded differently, and the boards were concerned that differences in identifying the acquirer could arise. Therefore, as part of the effort to develop a common standard on accounting for business combinations, the boards decided to develop common guidance for identifying the acquirer that could be applied internationally. For example, the FASB adopted the IASB's definition of an acquirer as the entity that obtains control of the other combining entities, and both boards decided to include in the revised standards an explicit reference to their other standards that provide guidance for identifying the acquirer. That guidance, although previously implicit, was not in SFAS 141. The intention of the boards is to conform and clarify their guidance but not to change the substance of the provisions for identifying an acquirer previously provided in SFAS 141 and IFRS 3.

BC103 Some respondents to the 2005 Exposure Draft noted that the existing IASB and FASB definitions of control in their respective consolidations standards are somewhat different and, in rare instances, may lead to identifications of different acquirers. The boards agreed with that observation, but they affirmed their conclusion in developing the 2005 Exposure Draft that developing a common definition of control is outside the scope of the business combinations project.

**Identifying the acquirer in business combinations involving only mutual entities**

BC104 The boards considered whether differences between mutual entities and investor-owned entities or differences between combinations of mutual entities and combinations of investor-owned entities result in a need for different or additional guidance for identifying the acquirer in combinations of mutual entities. The boards did not note any such differences. As a result, the boards concluded that an acquirer must be identified for all business combinations, including those involving only mutual entities.

BC105 The boards also concluded that the indicators for identifying the acquirer in a business combination are applicable to mutual entities and that no additional indicators are needed to identify the acquirer in those combinations. Both boards acknowledged that difficulties may arise in identifying the acquirer in combinations of two virtually equal mutual entities but observed that those difficulties also arise in combinations of two virtually equal investor-owned entities. The boards concluded that those difficulties, which are not unique to mutual entities, could be resolved in practice.

### **Determining the acquisition date**

- BC106 IFRS 3 and SFAS 141 carried forward without reconsideration the provisions of IAS 22 and APB Opinion 16, respectively, on determining the acquisition date. With one exception that applies only to SFAS 141 (see paragraphs BC108–BC110), that guidance resulted in the same acquisition date as the guidance in the revised standards.
- BC107 In both IFRS 3 and SFAS 141, the guidance on the acquisition date, which IFRS 3 also referred to as the *exchange date*, was incorporated within the guidance on determining the cost of the acquisition rather than being stated separately. The revised standards clarify the acquisition-date guidance to make explicit that the acquisition date is the date that the acquirer obtains control of the acquiree. Paragraphs BC338–BC342 discuss the related issue of the measurement date for equity securities transferred as consideration in a business combination and the changes the revised standards make to the previous requirements on that issue.
- BC108 The FASB also eliminated the ‘convenience’ exception that SFAS 141 carried forward from APB Opinion 16 and the reporting alternative permitted by Accounting Research Bulletin No. 51 *Consolidated Financial Statements* (ARB 51). SFAS 141, paragraph 48, permitted an acquirer to designate an effective date other than the date that assets or equity interests are transferred or liabilities are assumed or incurred (the acquisition date) if it also reduced the cost of the acquiree and net income as required by that paragraph to compensate for recognising income before consideration was transferred. Paragraph 11 of ARB 51 permitted an acquirer to include a subsidiary that was purchased during the year in the consolidation as though it had been acquired at the beginning of the year and to deduct the pre-acquisition earnings at the bottom of the consolidated income statement.
- BC109 The FASB concluded that to represent faithfully an acquirer’s financial position and results of operations, the acquirer should account for all business combinations at the acquisition date. In other words, its financial position should reflect the assets acquired and liabilities assumed at the acquisition date—not before or after they are obtained or assumed. Moreover, the acquirer’s financial statements for the period should include only the cash inflows and outflows, revenues and expenses and other effects of the acquiree’s operations after the acquisition date.
- BC110 Very few respondents to the 2005 Exposure Draft commented on the proposed guidance on determining the acquisition date. Those who did so generally raised practicability issues related to eliminating the ability to designate an effective date other than the acquisition date. The boards concluded that the financial statement effects of eliminating that exception were rarely likely to be material. For example, for convenience an entity might wish to designate an acquisition date of the end (or the beginning) of a month, the date on which it closes its books, rather than the actual acquisition date during the month. Unless events between the ‘convenience’ date and the actual acquisition date result in material changes in the amounts recognised, that entity’s practice would comply with the requirements of the revised

standards. Therefore, the boards decided to retain the guidance in the 2005 Exposure Draft about determining the acquisition date.

## **Recognising and measuring the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree**

### **Recognition**

BC111 The revised standards' recognition principle is stated in paragraph 10 of the revised IFRS 3. Paragraphs BC112–BC130 discuss the recognition conditions the acquirer is to use in applying the recognition principle. The revised standards also provide guidance for recognising particular assets and liabilities, which is discussed in paragraphs BC131–BC184. The revised standards' guidance on classifying and designating assets acquired and liabilities assumed is discussed in paragraphs BC185–BC188, and the limited exceptions to the recognition principle provided in the revised standards are discussed in paragraphs BC263–BC303.

### *Conditions for recognition*

BC112 The boards decided that to achieve a reasonably high degree of consistency in practice and to resolve existing inconsistencies, the revised standards should provide guidance on applying the recognition principle. That guidance emphasises two fundamental conditions. To measure and recognise an item as part of applying the acquisition method, the item acquired or assumed must be:

- (a) an asset or liability at the acquisition date; and
- (b) part of the business acquired (the acquiree) rather than the result of a separate transaction.

### **An asset or a liability at the acquisition date**

BC113 In determining whether an item should be recognised at the acquisition date as part of the business combination, the boards decided that the appropriate first step is to apply the definitions of assets and liabilities in the IASB's *Framework* or FASB Concepts Statement No. 6 *Elements of Financial Statements*, respectively.

BC114 The boards observed that in accordance with both IFRS 3 and SFAS 141, and their predecessors and the related interpretative guidance, particular items were recognised as if they were assets acquired or liabilities assumed at the acquisition date even though they did not meet the definition of an asset or a liability. That practice was related to the previous emphasis on measuring the cost of (or investment in) the acquiree rather than the acquisition-date fair values of the assets acquired and liabilities assumed. For example, as discussed in paragraphs BC365–BC370, some expenses for services received in connection with a business combination were capitalised as part of the cost of the acquiree (and recognised as part of goodwill) as if they were an asset at the acquisition date. In addition, some future costs that an acquirer expected to incur often were viewed as a cost of the acquiree and recognised as if they

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were a liability at the acquisition date—expected restructuring costs were an example. The boards concluded that the representational faithfulness, consistency and understandability of financial reporting would be improved by eliminating such practices.

- BC114A Paragraph 11 of IFRS 3 referred to the definitions of an asset and a liability in the *Framework for the Preparation and Presentation of Financial Statements (Framework)*. It required those definitions to be used when deciding whether to recognise assets and liabilities as part of a business combination. In developing the revised *Conceptual Framework for Financial Reporting*, issued in 2018 (2018 *Conceptual Framework*), the IASB considered whether it should replace that reference with a reference to the revised definitions in the 2018 *Conceptual Framework*. In some cases, applying the revised definitions could change which assets and liabilities qualify for recognition in a business combination. In some such cases, the post-acquisition accounting required by other IFRS Standards could then lead to immediate derecognition of assets or liabilities recognised in a business combination, resulting in so-called *Day 2 gains or losses* that do not depict an economic gain or loss.
- BC114B Although the IASB intended to replace all references to the *Framework* with references to the 2018 *Conceptual Framework*, the IASB did not intend to make significant changes to the requirements of IFRS Standards containing those references. Consequently, the IASB decided to retain the reference to the *Framework* in paragraph 11 of IFRS 3 until it had completed an analysis of the possible consequences of referring in that paragraph to the revised definitions of an asset and a liability.
- BC114C The IASB's analysis led it to conclude that the problem of *Day 2 gains or losses* would be significant in practice only for liabilities that an acquirer accounts for after the acquisition date by applying IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* or IFRIC 21 *Levies*. To avoid the problem, the IASB decided to add a further exception to the recognition principle in IFRS 3. The reasons for making this exception are explained in paragraphs BC264A–BC264E. The IASB noted that adding this exception to the recognition principle would not only avoid *Day 2 gains or losses*; it would also avoid any changes to the assets and liabilities recognised in a business combination ahead of any future amendments to align IAS 37 and IFRIC 21 with the 2018 *Conceptual Framework*.
- BC114D The IASB replaced the reference to the *Framework* and added the exception to its recognition principle in May 2020. At the same time, the IASB made two other amendments to clarify aspects of IFRS 3 that it concluded would not be affected by replacing the reference to the *Framework*:
- (a) the IASB added paragraph 23A to IFRS 3 to clarify the requirements for contingent assets – that is, possible assets whose existence is uncertain. IFRS 3 prohibits the recognition of contingent assets acquired in a business combination. This prohibition can be inferred from the recognition principle and is confirmed in paragraph BC276 of this Basis for Conclusions. However, the prohibition was not stated explicitly in IFRS 3 itself, and questions arose as to how it would be affected by replacing the reference to the *Framework*. The IASB

concluded it would be unaffected—the 2018 *Conceptual Framework* specifies criteria for recognising assets and liabilities, and paragraph 5.14 says that these criteria might not be met if it is uncertain whether an asset exists. The IASB added paragraph 23A to IFRS 3 to make its requirements for contingent assets explicit and clarify that replacing the reference to the *Framework* does not change them.

- (b) the IASB deleted paragraph BC125 from this Basis for Conclusions. In applying any IFRS Standard, an entity should apply only the recognition criteria specified in that Standard. However, paragraph BC125 referred to the *Framework* in a way that could be read to mean that, in applying IFRS 3, an acquirer of a business should apply both the recognition criteria specified in IFRS 3 and other recognition criteria discussed in the *Framework*. The IASB deleted paragraph BC125 because of its potential to cause misunderstanding. The IASB does not usually amend the basis for its previous conclusions, but decided that, in this instance, the importance of reducing the risk of misunderstanding warranted the deletion.

#### **Part of the business combination**

- BC115 The second condition for recognising an asset acquired or a liability assumed or incurred in a business combination is that the asset or liability must be part of the business combination transaction rather than an asset or a liability resulting from a separate transaction. Making that distinction requires an acquirer to identify the components of a transaction in which it obtains control over an acquiree. The objective of the condition and the guidance on identifying the components of a business combination is to ensure that each component is accounted for in accordance with its economic substance.
- BC116 The boards decided to provide application guidance to help address concerns about the difficulty of determining whether a part of the consideration transferred is for the acquiree or is for another purpose. The boards observed that parties directly involved in the negotiations of an impending business combination may take on the characteristics of related parties. Therefore, they may be willing to enter into other agreements or include as part of the business combination agreement some arrangements that are designed primarily for the benefit of the acquirer or the combined entity, for example, to achieve more favourable financial reporting outcomes after the business combination. Because of those concerns the boards decided to develop a principle for determining whether a particular transaction or arrangement entered into by the parties to the combination is part of what the acquirer and acquiree exchange in the business combination or is a separate transaction.
- BC117 The boards concluded that a transaction that is designed primarily for the economic benefit of the acquirer or the combined entity (rather than the acquiree or its former owners before the business combination) is not part of the exchange for the acquiree. Those transactions should be accounted for separately from the business combination. The boards acknowledge that judgement may be required to determine whether part of the consideration

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paid or the assets acquired and liabilities assumed stems from a separate transaction. Accordingly, the 2005 Exposure Draft included both a general principle and implementation guidance for applying that principle, including several examples.

- BC118 Respondents' comments on the proposed guidance on identifying the components of a business combination transaction were mixed. For example, some respondents said that the general principle was clear and provided adequate guidance; others said that the proposed principle was not clear. Several respondents said that the focus on determining whether a transaction benefits the acquiree or the acquirer was not clear because a transaction or event that benefits the acquiree would also benefit the combined entity because the acquiree is part of the combined entity.
- BC119 The boards agreed with respondents that the proposed principle for distinguishing between components of a business combination needed improvement. Accordingly, they revised the principle to focus on whether a transaction is entered into by or on behalf of the acquirer or **primarily** for the benefit of the acquirer or the combined entity, rather than **primarily** for the benefit of the acquiree or its former owners **before the combination** (paragraph 52 of the revised IFRS 3).
- BC120 The boards also concluded that the focus of the principle should be on identifying whether a business combination includes separate transactions that should be accounted for separately in accordance with their economic substance rather than solely on assessing whether a transaction is part of the exchange for the acquiree (paragraph 51 of the revised IFRS 3). Focusing solely on whether assets or liabilities are part of the exchange for the acquiree might not result in all transactions being accounted for in accordance with their economic substance. For example, if an acquirer asks the acquiree to pay some or all of the acquisition-related costs on its behalf and the acquiree has paid those costs before the acquisition date, at the acquisition date the acquiree will show no liability for those costs. Therefore, some might think that the principle as stated in the 2005 Exposure Draft does not apply to the transactions giving rise to the acquisition-related costs. The boards concluded that focusing instead on whether a transaction is separate from the business combination will more clearly convey the intention of the principle and thus will provide users with more relevant information about the financial effects of transactions and events entered into by the acquirer. The acquirer's financial statements will reflect the financial effects of all transactions for which the acquirer is responsible in accordance with their economic substance.
- BC121 To help in applying the principle, paragraph 52 of the revised IFRS 3 includes three examples of transactions that are separate from the transaction in which an acquirer obtains control over an acquiree, and Appendix B provides additional application guidance.

- BC122 The first example in paragraph 52 is directed at ensuring that a transaction that in effect settles a pre-existing relationship between the acquirer and the acquiree is excluded from the accounting for the business combination. Assume, for example, that a potential acquiree has an asset (receivable) for an unresolved claim against the potential acquirer. The acquirer and the acquiree's owners agree to settle that claim as part of an agreement to sell the acquiree to the acquirer. The boards concluded that if the acquirer makes a lump sum payment to the seller-owner, part of that payment is to settle the claim and is not part of the consideration transferred to acquire the business. Thus, the portion of the payment that relates to the claim settlement should be excluded from the accounting for the business combination and accounted for separately. In effect, the acquiree relinquished its claim (receivable) against the acquirer by transferring it (as a dividend) to the acquiree's owner. Thus, at the acquisition date the acquiree has no receivable (asset) to be acquired as part of the combination, and the acquirer would account for its settlement payment separately. The FASB observed that the conclusion that a transaction that settles a pre-existing relationship is not part of applying the acquisition method is consistent with the conclusion in EITF Issue No. 04-1 *Accounting for Preexisting Relationships between the Parties to a Business Combination*, which is incorporated into SFAS 141(R) and therefore superseded.
- BC123 The second and third examples are also directed at ensuring that payments that are not part of the consideration transferred for the acquiree are excluded from the business combination accounting. The boards concluded that the payments for such transactions or arrangements should be accounted for separately in accordance with the applicable requirements for those transactions. Paragraph BC370 also discusses potential abuses related to the third example—payments to reimburse the acquiree or its former owners for paying the acquirer's costs incurred in connection with the business combination.
- BC124 To provide additional help in identifying the components of a business combination, paragraph B50 of the revised IFRS 3 includes three factors to be considered in assessing a business combination transaction: (a) the reason for the transaction, (b) who initiated the transaction and (c) the timing of the transaction. Although those factors are neither mutually exclusive nor individually conclusive, the boards decided that the factors could help in considering whether a transaction or event is arranged primarily for the economic benefit of the acquirer or the combined entity or primarily for the benefit of the acquiree and its former owners before the business combination.
- BC125 [Deleted]<sup>7</sup>

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<sup>7</sup> See paragraph BC114D(b).

**IFRS 3's criterion on probability of an inflow or outflow of benefits**

- BC126 IFRS 3 provided that an acquirer should recognise the acquiree's identifiable assets (other than intangible assets) and liabilities (other than contingent liabilities) only if it is probable that the asset or liability will result in an inflow or outflow of economic benefits. The revised IFRS 3 does not contain that probability recognition criterion and thus it requires the acquirer to recognise identifiable assets acquired and liabilities assumed regardless of the degree of probability of an inflow or outflow of economic benefits.
- BC127 The recognition criteria in the *Framework* include the concept of probability to refer to the degree of uncertainty that the future economic benefits associated with an asset or liability will flow to or from the entity.
- BC128 During the development of the revised IFRS 3, the IASB reconsidered items described in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* as contingent assets and contingent liabilities. Analysing the rights or obligations in such items to determine which are conditional and which are unconditional clarifies the question of whether the entity has an asset or a liability at the acquisition date.<sup>8</sup> As a result, the IASB concluded that many items previously described as contingent assets or contingent liabilities meet the definition of an asset or a liability in the *Framework* because they contain unconditional rights or obligations as well as conditional rights or obligations. Once the unconditional right in an asset (the unconditional obligation in a liability) is identified, the question to be addressed becomes what is the inflow (outflow) of economic benefits relating to that unconditional right (unconditional obligation).
- BC129 The IASB noted that the *Framework* articulates the probability recognition criterion in terms of a flow of economic benefits rather than just direct cash flows. If an entity has an unconditional obligation, it is certain that an outflow of economic benefits from the entity is required, even if there is uncertainty about the timing and the amount of the outflow of benefits associated with a related conditional obligation. Hence, the IASB concluded that the liability (the unconditional obligation) satisfies the *Framework's* probability recognition criterion. That conclusion applies equally to unconditional rights. Thus, if an entity has an unconditional right, it is certain that it has the right to an inflow of economic benefits, and the probability recognition criterion is satisfied.
- BC130 Therefore, the IASB decided that inclusion of the probability criterion in the revised IFRS 3 is unnecessary because an unconditional right or obligation will always satisfy the criterion. In addition, the IASB made consequential amendments to paragraphs 25 and 33 of IAS 38 *Intangible Assets* to clarify the reason for its conclusion that the probability recognition criterion is always considered to be satisfied for intangible assets that are acquired separately or in a business combination. Specifically, the amendment indicates that an entity expects there to be an inflow of economic benefits embodied in an intangible asset acquired separately or in a business combination, even if there is uncertainty about the timing and the amount of the inflow.

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<sup>8</sup> Paragraphs BC11–BC17 and BC22–BC26 of the Basis for Conclusions on the draft amendments to IAS 37, published for comment in June 2005, discuss this issue in more detail.



*Recognising particular identifiable assets acquired and liabilities assumed*

BC131 To help ensure the consistent application of the requirements of the revised standards, the boards decided to provide specific recognition guidance for particular types of identifiable assets acquired and liabilities assumed in a business combination. That guidance and the reasons for it are discussed in the following paragraphs.

**Liabilities associated with restructuring or exit activities of the acquiree**

BC132 The revised standards explain that an acquirer recognises liabilities for restructuring or exit activities acquired in a business combination only if they meet the definition of a liability at the acquisition date (paragraph 11 of the revised IFRS 3). Costs associated with restructuring or exiting an acquiree's activities that are not liabilities at that date are recognised as post-combination activities or transactions of the combined entity when the costs are incurred. In considering acquired restructuring or exit activities the FASB and the IASB began at different points because the requirements of SFAS 141 and IFRS 3 on the issue differed.

BC133 In applying SFAS 141, acquirers looked to EITF Issue No. 95-3 *Recognition of Liabilities in Connection with a Purchase Business Combination* for guidance on recognising liabilities associated with restructuring or exit activities of an acquirer. EITF Issue 95-3 provided that the costs of an acquirer's plan (a) to exit an activity of an acquired company, (b) to involuntarily terminate the employment of employees of an acquired company or (c) to relocate employees of an acquired company should be recognised as liabilities assumed in a purchase business combination if specified conditions were met. Those conditions did not require the existence of a present obligation to another party. In developing the 2005 Exposure Draft, the FASB concluded, as it did in FASB Statement No. 146 *Accounting for Costs Associated with Exit or Disposal Activities* (SFAS 146), that only present obligations to others are liabilities under the definition in the FASB's Concepts Statement 6. An exit or disposal plan, by itself, does not create a present obligation to others for costs an entity expects to incur under the plan. Thus, an entity's commitment to an exit or disposal plan, by itself, is not a sufficient condition for recognition of a liability. Consistently with that conclusion, SFAS 141(R) nullifies the guidance in EITF Issue 95-3, which was not consistent with SFAS 146.

BC134 Before the IASB issued IFRS 3, IAS 22, like EITF Issue 95-3, required the acquirer to recognise as part of allocating the cost of a combination a provision for terminating or reducing the activities of the acquiree (*a restructuring provision*) that was not a liability of the acquiree at the acquisition date, provided that the acquirer had satisfied specified criteria. The criteria in IAS 22 were similar to those in EITF Issue 95-3. In developing ED 3 and IFRS 3, the IASB considered the view that a restructuring provision that was not a liability of the acquiree at the acquisition date should nonetheless be recognised by the acquirer as part of allocating the cost of the combination if the specified conditions were met. Those supporting this view, including some respondents to ED 3, argued that:

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- (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.
- (b) the acquirer is committed to the costs of terminating or reducing the activities of the acquiree because 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.

BC135 In developing IFRS 3, the IASB rejected those 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. IFRS 3 did not provide for recognising those costs as liabilities because they do not represent liabilities of the acquiree at the acquisition date, although the expected future outflows may affect the value of existing recognised assets. The IASB concluded that it would be inconsistent to recognise 'unavoidable' restructuring costs that arise in a business combination but to prohibit recognition of a liability for other 'unavoidable' costs to be incurred as a result of the combination.

BC136 The IASB's general criteria for identifying and recognising restructuring provisions are set out in IAS 37. IAS 37 states that a constructive obligation to restructure (and therefore a liability) arises only when the entity has developed a detailed formal plan for the restructuring and either raised a valid expectation in those affected that it will carry out the restructuring by publicly announcing details of the plan or begun implementing the plan. IAS 37 requires such a liability to be recognised when it becomes probable that an outflow of resources embodying economic benefits will be required to settle the obligation and the amount of the obligation can be reliably estimated.

BC137 IFRS 3 reflected the IASB's conclusion 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 differently. 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 IASB decided that such a difference 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. Accordingly, IFRS 3 contained the same requirements as the revised IFRS 3 for recognising liabilities associated with restructuring or exit activities.

BC138 Few of the comments on the 2005 Exposure Draft from respondents who apply IFRSs in preparing their financial statements addressed its proposal on accounting for costs to restructure or exit activities of an acquiree (restructuring costs). Those who did so generally agreed with its proposal to carry forward the requirement of IFRS 3 for recognising liabilities associated with restructuring or exit activities of an acquiree. But the provisions of the 2005 Exposure Draft on that issue represented a change to GAAP in the United States, and the FASB received several responses objecting to the proposed

change. It also received some responses that agreed with them, generally for the same reasons that the boards proposed the provisions in the 2005 Exposure Draft.

- BC139 Respondents who disagreed with the proposed accounting for liabilities associated with restructuring or exit activities of an acquiree generally cited one or more of the following reasons in support of their view:
- (a) Acquirers factor restructuring costs into the amount they are willing to pay for the acquiree. Therefore, those costs should be included in accounting for the business combination.
  - (b) It is not clear why the boards decided that restructuring costs should not be recognised as liabilities assumed in the business combination when those costs are more likely to be incurred than some of the liabilities related to contingencies that the boards proposed to recognise as liabilities assumed in a combination.
  - (c) Capitalising restructuring costs as part of a business combination would be consistent with the accounting for other asset acquisitions in which the amount capitalised is equal to the amount paid to acquire and place the asset in service.
- BC140 The boards were not persuaded by those views. They observed that the view described in paragraph BC139(a) is essentially the same as the view of some respondents to ED 3 discussed in paragraph BC134(a). In addition, the boards noted that the acquirer does not pay the acquiree or its owners for the anticipated costs to restructure or exit activities and the acquirer's plans to do so do not give rise to an obligation and associated liability at the acquisition date. The acquirer ordinarily incurs a liability associated with such costs after it gains control of the acquiree's business.
- BC141 The boards also disagreed with the view that the accounting for costs to restructure or exit some of an acquiree's activities is inconsistent with the requirements of the revised standards on contingencies. On the contrary, the two requirements are consistent with each other because both require recognition of a liability only if an obligation that meets the definition of a liability exists at the acquisition date.
- BC142 The boards also observed that the requirements of the revised standards on restructuring costs are consistent with current practice in accounting for many similar costs expected to be incurred in conjunction with other acquisitions of assets. For example, one airline might acquire an aircraft from another airline. The acquirer was likely to consider the costs of changing the logo on the aircraft and making any other intended changes to its configuration in deciding what it was willing to pay for the aircraft. Other airlines bidding for the aircraft might also have plans to change the aircraft if they were the successful bidders. The nature and extent of the changes each airline expected to make and the costs each would incur were likely to differ.

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BC143 In accordance with both US GAAP and IFRSs, the airline would recognise none of those expected, post-acquisition costs at the date the aircraft is acquired. Instead, those costs are accounted for after control of the aircraft is obtained. If the costs add to the value of the aircraft and meet the related requirements of US GAAP or IFRSs, they will be recognised as assets (probably as an addition to the carrying amount of the aircraft). Otherwise, those additional costs are likely to be charged to expense when incurred.

### **Operating leases**

BC144 In accordance with both FASB Statement No. 13 *Accounting for Leases* (SFAS 13) and IAS 17 *Leases*, an acquirer that is the lessee in an operating lease does not recognise separately the rights and obligations embodied in operating leases. The boards considered whether to require, for example, the separate recognition of an asset acquired for an acquirer's rights to use property for the specified period and related renewal options or other rights and a liability assumed for an acquirer's obligations to make required lease payments for an operating lease acquired in a business combination. However, at the time they considered how to account for operating leases in a business combination, they were considering adding to their agendas a joint project on accounting for leases. That project was added in 2006. Accordingly, the boards concluded that the revised standards should be consistent with the existing accounting requirements on accounting for leases. Therefore, the revised standards provide that the acquirer recognises no assets or liabilities related to an operating lease in which the acquirer is the lessee other than those referred to in paragraphs B29 and B30 of the revised IFRS 3, which are discussed in the following paragraphs.

BC145 The 2005 Exposure Draft proposed that the amount by which the terms of an operating lease are favourable or unfavourable in relation to market terms should be recognised as a separate intangible asset, regardless of whether the acquirer is the lessee or the lessor. For the FASB, that proposal would have carried forward the related guidance in SFAS 141 for leases in which the acquirer is the lessee. Some respondents suggested that, instead, the measure of the fair value of an asset subject to an operating lease in which the acquirer is the lessor should take into account the favourable or unfavourable aspect of the lease terms.

BC146 The boards considered this issue in the context of their respective guidance in other standards on how to determine the fair value of an asset. As noted above, the proposal in the 2005 Exposure Draft was generally consistent with US GAAP for business combinations. However, FASB Statement No. 157 *Fair Value Measurements* (SFAS 157) does not provide guidance on the *unit of valuation* – the level at which an asset or liability is aggregated or disaggregated to determine what is being measured. The IASB also does not have general guidance on determining the unit of valuation. However, IAS 40 *Investment Property* provides that the fair value of investment property takes into account rental income from current leases, and the IASB understands that practice in measuring the fair value of investment property is to take into account the contractual terms of the leases and other contracts in place relating to the asset.

- BC147 The FASB concluded that SFAS 141 should retain the guidance in the 2005 Exposure Draft that the favourable or unfavourable aspect of an operating lease in which the acquirer is the lessor should be separately recognised as an intangible asset or liability. It concluded that separately reporting that amount rather than embedding an aspect of a lease contract in the fair value of the leased asset would provide more complete information to users of the post-combination financial statements. In addition, the FASB noted that reporting the favourable or unfavourable aspect of the lease contract separately would facilitate appropriate amortisation of that amount over the term of the lease rather than over the remaining life of the leased asset. Unlike IAS 16 *Property, Plant and Equipment*, US GAAP does not require an item of property, plant or equipment to be separated into components, with the components depreciated or amortised over different useful lives.
- BC148 The IASB decided to require the acquirer in a business combination to follow the guidance in IAS 40 for assets subject to operating leases in which the acquirer is the lessor. The IASB observed that, for lessors who choose the cost option in IAS 40, both IAS 16 and IAS 38 require use of a depreciation or amortisation method that reflects the pattern in which the entity expects to consume the asset's future economic benefits. In addition, IAS 16 requires each part of an item of property, plant and equipment that has a cost that is significant in relation to the total cost of the item to be depreciated separately. Thus, an entity would be required to adjust the depreciation or amortisation method for the leased asset to reflect the timing of cash flows attributable to the underlying leases. Therefore, although the presentation of operating leases and the underlying leased assets in the statement of financial position will differ depending on whether an entity applies IFRSs or US GAAP, the IASB observed that the identifiable net assets and the depreciation or amortisation recognised in the post-combination financial statements will be the same.

#### **Research and development assets**

- BC149 The revised standards require an acquirer to recognise all tangible and intangible research and development assets acquired in a business combination, as was proposed in the 2005 Exposure Draft. Previously, FASB Interpretation No. 4 *Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method* (FASB Interpretation 4) required an acquirer to measure and immediately recognise as expense tangible and intangible assets to be used in research and development that had no alternative future use. A research and development asset was recognised as such only if it had an alternative future use. In contrast, IFRS 3 did not require a research and development asset to have an alternative future use for it to be recognised. The revised standards therefore do not change the provisions of IFRS 3 on that issue. Accordingly, most of the discussion in paragraphs BC150–BC156 pertains to the FASB's consideration of this issue.
- BC150 The FASB concluded that the requirement to write off assets to be used in research and development activities immediately if they have no alternative future use resulted in information that was not representationally faithful. In addition, eliminating that requirement furthers the goal of international convergence of accounting standards. Therefore, SFAS 141(R) supersedes FASB

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Interpretation 4 and requires research and development assets acquired in a business combination to be recognised regardless of whether they have an alternative future use.

BC151 Relatively few respondents to the 2005 Exposure Draft commented on the proposed accounting for research and development assets. Those who did so generally disagreed with those proposals (they also generally applied US GAAP rather than IFRSs), citing either or both of the following concerns as support for their view:

- (a) In-process research and development may not meet the definition of an asset in the FASB's Concepts Statement 6 because its low likelihood of success does not represent **probable** future economic benefits.
- (b) The fair value of in-process research and development may not be measurable with sufficient reliability for recognition in financial statements.

The boards rejected both of those views for the reasons explained in the following paragraphs.

BC152 The boards agreed with respondents that the likelihood that an individual research and development project will result in a profitable product is often low. However, the boards also noted that the use of the word *probable* in the FASB's Concepts Statement 6 refers only to something that is not certain. The definition does not use that term as a recognition criterion that specifies the degree of probability of the inflow or outflow of future economic benefits that must be present for an item to qualify for recognition. Therefore, the boards concluded that in-process research and development acquired in a business combination will generally satisfy the definition of an asset because the observable exchange at the acquisition date provides evidence that the parties to the exchange expect future economic benefits to result from that research and development. Uncertainty about the outcome of an individual project is reflected in measuring its fair value.

BC153 The boards also agreed that determining the fair value of in-process research and development requires the use of estimates and judgement, and the resulting amount will generally not be as reliable as the fair values of other assets for which quoted prices in active markets are available. However, the boards observed that use of estimates and judgement, by itself, does not mean that information is unreliable; reliability does not require precision or certainty. For example, paragraph 86 of the IASB's *Framework* says that 'In many cases, cost or value must be estimated; the use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability.' The boards also noted that the requirement to measure the fair value of in-process research and development assets acquired in a business combination is not new—not even in US GAAP. In accordance with FASB Interpretation 4, that amount was measured but immediately written off. Moreover, respondents to the 2005 Exposure Draft that apply IFRSs generally did not mention any problems with complying with the provisions of IFRS 3 on research and development assets, which are the same as those in the revised standards.

BC154 In developing the 2005 Exposure Draft, the FASB also considered whether it could make further improvements by extending the recognition provisions of SFAS 141(R) for research and development assets to purchases of in-process research and development assets outside a business combination. At that time, the FASB decided not to do so because the additional time needed to deliberate the related issues would have unduly delayed the revised standards.

BC155 Some respondents to the 2005 Exposure Draft objected to the resulting inconsistent US GAAP requirements for research and development assets acquired in a business combination and those acquired in another type of transaction. The FASB agreed with respondents that inconsistent accounting for research and development assets depending on how they are acquired is undesirable. Therefore, the FASB expects to reconsider the accounting for research and development assets acquired by means other than in a business combination separately from its project on business combinations.

BC156 The FASB also decided to provide guidance on the impairment testing of in-process research and development projects that are temporarily idled or abandoned. It did that by means of an amendment to SFAS 142.

#### **Distinguishing identifiable intangible assets from goodwill**

BC157 Early in their respective projects on accounting for business combinations, the IASB and the FASB both observed that intangible assets make up an increasing proportion of the assets of many (if not most) entities. The boards also observed that intangible assets acquired in a business combination were often included in the amount recognised as goodwill.

BC158 Both the IASB and the FASB decided that they needed to provide explicit criteria for determining whether an acquired intangible asset should be recognised separately from goodwill. The FASB provided such criteria in SFAS 141 and the IASB provided similar, although not identical, criteria in IAS 38.<sup>9</sup> One reason for providing such criteria was the boards' conclusion that the decision-usefulness of financial statements would be enhanced if intangible assets acquired in a business combination were distinguished from goodwill. For example, the FASB's Concepts Statement No. 5 *Recognition and Measurement in Financial Statements of Business Enterprises* says that classification in financial statements facilitates analysis by grouping items with essentially similar characteristics and separating items with essentially different characteristics. Analysis aimed at objectives such as predicting amounts, timing and uncertainty of future cash flows requires financial information segregated into reasonably homogeneous groups.

BC159 In developing its 1999 Exposure Draft, the FASB considered various characteristics that might distinguish other intangible assets from goodwill. Because the FASB concluded that identifiability is the characteristic that conceptually distinguishes other intangible assets from goodwill, the 1999 Exposure Draft proposed that intangible assets that are identifiable and reliably measurable should be recognised as assets separately from goodwill.

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<sup>9</sup> More detailed information about the IASB's reasoning in developing the criteria in IAS 38 is available in its Basis for Conclusions.

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Most respondents to the 1999 Exposure Draft agreed that many intangible assets are identifiable and that various intangible assets are reliably measurable. However, respondents' views on the proposed recognition criteria varied. Many of those respondents suggested alternative recognition criteria and many urged the FASB to clarify the term *reliably measurable*.

BC160 The FASB considered those suggestions and decided to modify the proposed recognition criteria to provide a clearer distinction between intangible assets that should be recognised separately from goodwill and those that should be subsumed into goodwill. The FASB then published a revised exposure draft *Business Combinations and Intangible Assets—Accounting for Goodwill* (2001 Exposure Draft) which proposed that an intangible asset should be recognised separately from goodwill if either:

- (a) control over the future economic benefits of the asset results from contractual or other legal rights (the contractual-legal criterion); or
- (b) the intangible asset is capable of being separated or divided and sold, transferred, licensed, rented or exchanged (either separately or as part of a group of assets) (the separability criterion).

The FASB concluded that sufficient information should exist to measure reliably the fair value of an asset that satisfies either of those criteria. Thus, the change in the recognition criteria eliminated the need explicitly to include *reliably measurable* as a recognition criterion or to clarify the meaning of that term.

BC161 IAS 38 (as issued by the IASB's predecessor body in 1998) clarified that the definition of an intangible asset required an intangible asset to be identifiable to distinguish it from goodwill. However, it did not define the term *identifiable*. Instead, IAS 38 stated that an intangible asset could be distinguished from goodwill if the asset was separable, though separability was not a necessary condition for identifiability.

BC162 In developing IFRS 3, the IASB affirmed the conclusion in IAS 38 that identifiability is the characteristic that conceptually distinguishes other intangible assets from goodwill. In addition, the IASB concluded that to provide a definitive basis for identifying and recognising intangible assets separately from goodwill, the concept of identifiability needed to be articulated more clearly. As a result of that consideration, which is discussed in paragraphs BC163–BC165, the IASB developed more definitive criteria for distinguishing between identifiable intangible assets and goodwill and included those criteria in both IFRS 3 and IAS 38 (as revised in 2004).

### **Reasons for the contractual-legal criterion**

BC163 In developing IFRS 3 and SFAS 141, the IASB and the FASB observed that many intangible assets arise from rights conveyed legally by contract, statute or similar means. For example, franchises are granted to car dealers, fast food outlets and professional sports teams. Trademarks and service marks may be registered with the government. Contracts are often negotiated with customers or suppliers. Technological innovations are often protected by patents. In contrast, goodwill arises from the collection of assembled assets



that make up an acquiree 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 businesses. Therefore, both boards concluded that the fact that an intangible asset arises from contractual or other legal rights is an important characteristic that distinguishes many intangible assets from goodwill and an acquired intangible asset with that characteristic should be recognised separately from goodwill.

#### **Reasons for the separability criterion**

- BC164 As already noted (paragraph BC161), the original version of IAS 38 included separability as a characteristic that helps to distinguish intangible assets from goodwill. In developing IFRS 3, the IASB affirmed that conclusion for the reasons discussed in the following paragraphs.
- BC165 In developing IFRS 3 and SFAS 141, the IASB and the FASB observed that some intangible assets that do not arise from rights conveyed by contract or other legal means are nonetheless capable of being separated from the acquiree and exchanged for something else of value. Others, like goodwill, cannot be separated from an entity and sold or otherwise transferred. Both boards thus concluded that separability is another important characteristic that distinguishes many intangible assets from goodwill. An acquired intangible asset with that characteristic should be recognised separately from goodwill.
- BC166 The FASB's 2001 Exposure Draft proposed that an intangible asset that was not separable individually would meet the separability criterion if it could be sold, transferred, licensed, rented or exchanged along with a group of related assets or liabilities. Some respondents suggested that the FASB should eliminate that requirement, arguing that unless the asset is separable individually it should be included in the amount recognised as goodwill. Others asked the FASB to clarify the meaning of the term *group of related assets*, noting that even goodwill can be separated from the acquiree if the asset group sold constitutes a business.
- BC167 The FASB noted that some intangible assets are so closely related to another asset or liability that they are usually sold as a 'package' (eg deposit liabilities and the related depositor relationship intangible asset). If those intangible assets were subsumed into goodwill, gains might be inappropriately recognised if the intangible asset was later sold along with the related asset or obligation. However, the FASB agreed that the proposed requirement to recognise an intangible asset separately from goodwill if it could be sold or transferred as part of an asset group was a broader criterion than it had intended. For those reasons, SFAS 141 provided, as do the revised standards, that an intangible asset that is not separable individually meets the separability criterion if it can be separated from the entity and sold, transferred, licensed, rented or exchanged in combination with a related contract, other identifiable asset or other liability.
- BC168 Some respondents to the 2001 Exposure Draft suggested limiting the separability criterion to intangible assets that are separable **and** are traded in observable exchange transactions. Although the FASB agreed that exchange transactions provide evidence of an asset's separability, it concluded that

those transactions were not necessarily the only evidence of separability and it did not adopt that suggestion.

- BC169 Other respondents suggested that the separability criterion should be modified to require recognition of an intangible asset separately from goodwill only if management of the entity **intends** to sell, lease or otherwise exchange the asset. The FASB rejected that suggestion because it concluded that the asset's **capability** of being separated from the entity and exchanged for something else of value is the pertinent characteristic of an intangible asset that distinguishes it from goodwill. In contrast, management's intentions are not a characteristic of an asset.

**The FASB's reasons for rejecting other recognition criteria suggested for SFAS 141**

- BC170 Some respondents suggested that the FASB should eliminate the requirement to recognise intangible assets separately from goodwill. Others suggested that all intangible assets with characteristics similar to goodwill should be included in the amount recorded as goodwill. The FASB rejected those suggestions because they would diminish rather than improve the decision-usefulness of reported financial information.

- BC171 Some respondents doubted their ability to measure reliably the fair values of many intangible assets. They suggested that the only intangible assets that should be recognised separately from goodwill are those that have direct cash flows and those that are bought and sold in observable exchange transactions. The FASB rejected that suggestion. Although the fair value measures of some identifiable intangible assets might lack the precision of the measures for other assets, the FASB concluded that the information that will be provided by recognising intangible assets at their estimated fair values is a more faithful representation than that which would be provided if those intangible assets were subsumed into goodwill. Moreover, including finite-lived intangible assets in goodwill that is not being amortised would further diminish the representational faithfulness of financial statements.

**Convergence of criteria in SFAS 141 and IFRS 3**

- BC172 The criteria in IFRS 3 for determining if an intangible asset is identifiable and thus should be recognised separately from goodwill included the same contractual or legal and separability conditions as SFAS 141. However, IFRS 3 also included a requirement that the fair value of an identifiable intangible asset should be reliably measurable to be recognised separately. In developing the 2005 Exposure Draft, the boards considered how best to achieve convergence of their respective recognition criteria for intangible assets.

- BC173 In developing IFRS 3, the IASB noted that the fair value of identifiable intangible assets acquired in a business combination is normally measurable with sufficient reliability to be recognised separately from goodwill. The effects of uncertainty because of a range of possible outcomes with different probabilities are reflected in measuring the asset's fair value; the existence of such a range does not demonstrate an inability to measure fair value reliably. IAS 38 (before amendment by the revised IFRS 3) included a rebuttable

presumption that the fair value of an intangible asset with a finite useful life acquired in a business combination can be measured reliably. The IASB had concluded that it might not always be possible to measure reliably the fair value of an asset that has an underlying contractual or legal basis. However, IAS 38 provided that the only circumstances in which it might not be possible to measure reliably the fair value of an intangible asset that arises from legal or other contractual rights acquired in a business combination were if it either:

- (a) is not separable; or
- (b) is separable, but there is no history or evidence of exchange transactions for the same or similar assets, and otherwise estimating fair value would depend on immeasurable variables.

BC174 In developing the 2005 Exposure Draft, the IASB concluded that separate recognition of intangible assets, on the basis of an estimate of fair value, rather than subsuming them in goodwill, provides better information to the users of financial statements even if a significant degree of judgement is required to estimate fair value. For that reason, the IASB decided to propose consequential amendments to IAS 38 to remove the reliability of measurement criterion for intangible assets acquired in a business combination. In redeliberating the proposals in the 2005 Exposure Draft, the IASB affirmed those amendments to IAS 38.

#### **Illustrative list of intangible assets**

BC175 The illustrative examples that accompanied IFRS 3 included a list of examples of identifiable intangible assets that might be acquired in a business combination. A similar list accompanies the revised IFRS 3 (see the illustrative examples). The list reflects various changes to similar lists in the exposure drafts that the boards published earlier in their respective projects on business combinations. The boards observed that the list is not exhaustive, and a particular type of intangible asset that was included on an earlier list might not be mentioned in the illustrative examples. That does not necessarily mean that the intangible asset does not qualify as identifiable in accordance with the criteria in the revised standards. An acquirer must consider the nature of each acquired intangible asset in determining whether those criteria are met.

#### *Assembled workforce*

BC176 In developing SFAS 141, the FASB did not consider whether an assembled workforce met either the contractual-legal or the separability criterion for recognition as an identifiable intangible asset. Instead, SFAS 141 precluded separate recognition of an assembled workforce because of the FASB's conclusion that techniques to measure the value of an assembled workforce with sufficient reliability were not currently available. IFRS 3 and IAS 38, on the other hand, did not explicitly preclude separate recognition of an assembled workforce. However, paragraph 15 of IAS 38 noted that an entity would not usually have sufficient control over the expected future economic benefits arising from an assembled workforce for it to meet the definition of a separate intangible asset.

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- BC177 In developing the 2005 Exposure Draft, the boards concluded that an acquirer should not recognise an assembled workforce as a separate intangible asset because it meets neither the contractual-legal nor the separability criterion. The views of respondents who commented on recognition of an assembled workforce were mixed. Some agreed with its proposed recognition prohibition. Others suggested that the boards should reconsider that prohibition; they generally said that an assembled workforce is already valued in many situations for the purpose of calculating a ‘contributory asset charge’ in determining the fair value of some intangible assets. (In using an ‘excess earnings’ income valuation technique, a contributory asset charge is required to isolate the cash flows generated by the intangible asset being valued from the contribution to those cash flows made by other assets, including other intangible assets. Contributory asset charges are hypothetical ‘rental’ charges for the use of those other contributing assets.) Those respondents opposed a prohibition on recognising an assembled workforce as a separate intangible asset; they favoured permitting acquirers to assess whether an assembled workforce is separable in each situation and to recognise those that are separable.
- BC178 In reconsidering the proposal in the 2005 Exposure Draft, the boards concluded that the prohibition of recognising an assembled workforce should be retained. Because an assembled workforce is a collection of employees rather than an individual employee, it does not arise from contractual or legal rights. Although individual employees might have employment contracts with the employer, the collection of employees, as a whole, does not have such a contract. In addition, an assembled workforce is not separable, either as individual employees or together with a related contract, identifiable asset or liability. An assembled workforce cannot be sold, transferred, licensed, rented or otherwise exchanged without causing disruption to the acquirer’s business. In contrast, an entity could continue to operate after transferring an identifiable asset. Therefore, an assembled workforce is not an identifiable intangible asset to be recognised separately from goodwill.
- BC179 The boards observed that neither IAS 38 nor SFAS 141 defined an assembled workforce, and that inconsistencies have resulted in practice. In addition, some who objected to the recognition prohibition in the 2005 Exposure Draft apparently consider that an assembled workforce represents the intellectual capital of the skilled workforce—the (often specialised) knowledge and experience that employees of an acquiree bring to their jobs. However, the boards view an assembled workforce as an existing collection of employees that permits an acquirer to continue to operate an acquired business from the acquisition date and they decided to include that definition in the revised standards (paragraph B37 of the revised IFRS 3).
- BC180 The boards observed that the value of intellectual capital is, in effect, recognised because it is part of the fair value of the entity’s other intangible assets, such as proprietary technologies and processes and customer contracts and relationships. In that situation, a process or methodology can be documented and followed to the extent that the business would not be materially affected if a particular employee left the entity. In most

jurisdictions, the employer usually ‘owns’ the intellectual capital of an employee. Most employment contracts stipulate that the employer retains the rights to and ownership of any intellectual property created by the employee. For example, a software program created by a particular employee (or group of employees) would be documented and generally would be the property of the entity. The particular programmer who created the program could be replaced by another software programmer with equivalent expertise without significantly affecting the ability of the entity to continue to operate. But the intellectual property created in the form of a software program is part of the fair value of that program and is an identifiable intangible asset if it is separable from the entity. In other words, the prohibition of recognising an assembled workforce as an intangible asset does not apply to intellectual property; it applies only to the value of having a workforce in place on the acquisition date so that the acquirer can continue the acquiree’s operations without having to hire and train a workforce.

*Reacquired rights*

- BC181 As part of a business combination, an acquirer may reacquire a right that it had previously granted to the acquiree to use the acquirer’s recognised or unrecognised intangible assets. Examples of such rights include a right to use the acquirer’s trade name under a franchise agreement or a right to use the acquirer’s technology under a technology licensing agreement. The 2005 Exposure Draft proposed, and the revised standards require, an acquirer to recognise such a reacquired right as an identifiable intangible asset (paragraph B35 of the revised IFRS 3). The fair value of a reacquired right is to be amortised over the remaining term of the contract that gave rise to the right. For entities applying US GAAP, that guidance is not new; it is the same as the related guidance in EITF Issue 04-1. (Paragraphs BC308–BC310 discuss the measurement of reacquired rights.)
- BC182 A few respondents to the 2005 Exposure Draft disagreed with recognising a reacquired right as an identifiable intangible asset because they considered that doing so was the same as recognising an internally generated intangible asset. Some suggested recognising a reacquired right as the settlement of a pre-existing relationship; others said that a reacquired right should be recognised as part of goodwill.
- BC183 The boards rejected the alternative of treating a reacquired right as the termination of a pre-existing relationship because reacquisition of, for example, a franchise right does not terminate the right. After a business combination, the right to operate a franchised outlet in a particular region continues to exist. The difference is that the acquirer, rather than the acquiree by itself, now controls the franchise right.
- BC184 The boards also rejected recognising a reacquired right as part of goodwill. Supporters of that alternative consider that such a right differs from other identifiable intangible assets recognised in a business combination because, from the perspective of the combined entity, a franchising relationship with an outside party no longer exists. As already noted, however, the reacquired right and the related cash flows continue to exist. The boards concluded that

recognising that right separately from goodwill provides users of the financial statements of the combined entity with more decision-useful information than subsuming the right into goodwill. The boards also observed that a reacquired right meets the contractual-legal and the separability criteria and therefore qualifies as an identifiable intangible asset.

*Classifying and designating assets acquired and liabilities assumed*

- BC185 In some situations, IFRSs and US GAAP provide for different accounting depending on how a particular asset or liability is classified or designated. For example, in accordance with both IAS 39 *Financial Instruments: Recognition and Measurement*<sup>10</sup> and FASB Statement No. 115 *Accounting for Certain Investments in Debt and Equity Securities*, the accounting for particular financial instruments differs depending on how the instrument is classified, for example, as at fair value through profit or loss, available for sale or held to maturity. Another example is the accounting for a derivative instrument in accordance with either IAS 39<sup>11</sup> or FASB Statement No.133 *Accounting for Derivative Instruments and Hedging Activities* (SFAS 133), which depends on whether the derivative is designated as a hedge, and if so, the type of hedge designated.
- BC186 The 2005 Exposure Draft proposed that the classification of an acquired lease would not change from the acquiree's classification at lease inception unless the terms of the lease were modified as a result of the business combination in a way that would require a different classification in accordance with IAS 17 or SFAS 13. But that exposure draft did not address classification or designation issues pertaining to other types of contracts. Some respondents and others asked the boards to provide additional guidance on when the acquirer in a business combination should reconsider and perhaps change the classification or designation of a contract for the purpose of applying other accounting requirements.
- BC187 The boards decided that providing a general principle for classifying or designating contracts acquired in a business combination would facilitate consistent implementation of the revised standards. They observed that application of the acquisition method results in the initial recognition in the acquirer's financial statements of the assets acquired and liabilities assumed in a business combination. Therefore, in concept, the acquirer should classify and designate all items acquired in a business combination at the acquisition date in the context of the contractual terms, economic conditions and other pertinent factors at that date. That concept underlies the classification and designation principle (paragraph 15 of the revised IFRS 3).
- BC188 In the two situations described in paragraph 17 of the revised IFRS 3, classification of a lease contract as an operating lease or a finance lease and classification of a contract as an insurance or reinsurance contract or a deposit contract, other IFRSs and US GAAP require an entity to classify a contract only at its inception, on the basis of contractual terms and other factors at that date. Because those requirements apply to specific types of contracts

<sup>10</sup> IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

<sup>11</sup> IFRS 9 *Financial Instruments* replaced the hedge accounting requirements in IAS 39.

regardless of the identity of the parties to the contract, the boards concluded that such requirements should also apply in accounting for a business combination. Thus, the revised standards provide an exception to the principle for classifying and designating assets acquired and liabilities assumed in a business combination for the two types of contracts identified in paragraph 17.

*Recognition, classification and measurement guidance for insurance and reinsurance contracts*

- BC189 SFAS 141(R) provides guidance specific to insurance and reinsurance contracts acquired or assumed in a business combination, primarily by means of amendments to other insurance-related standards. Paragraphs BC190–BC195 discuss that guidance. Paragraph BC196 discusses the IASB’s guidance on recognition and measurement of insurance contracts in a business combination, which is provided in IFRS 4 *Insurance Contracts*.
- BC190 The FASB decided that insurance and reinsurance contracts acquired in a business combination should be accounted for on a fresh start (new contract) basis. Accordingly, all assets and liabilities arising from the rights and obligations of insurance and reinsurance contracts acquired in a business combination are recognised at the acquisition date, measured at their acquisition-date fair values. That recognition and measurement might include a reinsurance recoverable, a liability to pay future contract claims and claims expenses on the unexpired portion of the acquired contracts and a liability to pay incurred contract claims and claims expenses. However, those assets acquired and liabilities assumed would not include the acquiree’s insurance and reinsurance contract accounts such as deferred acquisition costs and unearned premiums that do not represent future cash flows. The FASB considers that model the most consistent with the acquisition method and with the accounting for other types of contracts acquired in a business combination.
- BC191 The FASB also decided to require the acquirer to carry forward the acquiree’s classification of a contract as an insurance or reinsurance contract (rather than a deposit) on the basis of the terms of the acquired contract and any related contracts or agreements at the inception of the contract. If the terms of those contracts or agreements have been modified in a manner that would change the classification, the acquirer determines the classification of the contract on the basis of its terms and other pertinent factors as of the modification date, which may be the acquisition date. Consideration of related contracts and arrangements is important in assessing whether a contract qualifies as insurance or reinsurance because they can significantly affect the amount of risk transferred.
- BC192 SFAS 141(R) also requires the fair value of the insurance and reinsurance contracts acquired in a business combination to be separated into (a) insurance and reinsurance US GAAP accounting balances using the acquirer’s accounting policies and (b) an intangible asset (or, at times that are expected to be rare, another liability). That guidance permits the acquirer to report the acquired business subsequently on the same basis as its written business (with

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the exception of the amortisation of the intangible asset). Other contracts providing for third-party contingent commissions would be accounted for in the same way as other contingencies, and contracts that provide guarantees of the adequacy of claims liabilities would be accounted for as indemnifications.

- BC193 The FASB concluded that the intangible asset should be amortised on a basis consistent with the measurement of the liability. For example, for most short-duration contracts such as property and liability insurance contracts, US GAAP claims liabilities are not discounted, so amortising the intangible asset like a discount using an interest method could be an appropriate method. For particular long-duration contracts such as most traditional life insurance contracts, using a basis consistent with the measurement of the liability would be similar to the guidance provided in paragraph 31 of FASB Statement No. 60 *Accounting and Reporting by Insurance Enterprises* (SFAS 60).
- BC194 The FASB considered several implementation issues identified by respondents to the 2005 Exposure Draft but decided that specifying the fresh start model for acquired insurance and reinsurance contracts and providing limited guidance on subsequent accounting, including requiring the intangible asset to be amortised on a basis consistent with the liability, should be sufficient to resolve most practice issues. That level of guidance is also consistent with the limited guidance provided by IFRS 4.
- BC195 The FASB decided to provide the guidance on recognition and measurement, including subsequent measurement, of insurance and reinsurance contracts acquired in a business combination by means of an amendment to SFAS 60. That parallels the location of the IASB's business combination guidance for insurance contracts in IFRS 4 and will make it easier to address any changes in that guidance that might result if the FASB and the IASB eventually undertake a joint project to reconsider comprehensively the accounting for insurance contracts.
- BC196 Paragraphs 31–33 of IFRS 4 deal with limited aspects of insurance contracts acquired in a business combination. That guidance was developed in phase I of the IASB's project on insurance contracts. The IASB decided not to amend those paragraphs in phase II of the business combinations project, so as not to pre-empt phase II of the IASB's project on insurance contracts. In May 2007 the IASB published its initial thoughts for phase II of that project in a discussion paper *Preliminary Views on Insurance Contracts*.

### Measurement

- BC197 Paragraph 18 of the revised IFRS 3 establishes the principle that the identifiable assets acquired and liabilities assumed should be measured at their acquisition-date fair values. The reasons for that principle and its application to contingencies and non-controlling interests are discussed in paragraphs BC198–BC245, and the definition of fair value<sup>12</sup> is discussed in paragraphs BC246–BC251. The revised standards provide guidance on determining the acquisition-date fair value of particular types of assets

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<sup>12</sup> IFRS 13 *Fair Value Measurement*, issued in May 2011, defines fair value and contains the requirements for measuring fair value.



acquired, which is discussed in paragraphs BC252–BC262. The exceptions to the measurement principle are discussed in paragraphs BC279–BC311.

*Why establish fair value as the measurement principle?*

#### **Identifiable assets acquired and liabilities assumed**

- BC198 In developing the measurement principle in the revised standards, the boards concluded that fair value is the most relevant attribute for assets acquired and liabilities assumed in a business combination. Measurement at fair value also provides information that is more comparable and understandable than measurement at cost or on the basis of allocating the total cost of an acquisition. Both IFRS 3 and SFAS 141 required allocation of that cost on the basis of the fair value of the assets acquired and the liabilities assumed. However, other guidance in those standards required measurements that were other than fair value. Moreover, SFAS 141's requirements for measuring identifiable assets acquired and liabilities assumed in an acquisition achieved in stages (a step acquisition) and in acquisitions of less than all of the equity interests in the acquiree resulted in another difference between fair value measurement of identifiable assets and liabilities and the process of accumulating and allocating costs. Those requirements were the same as the benchmark treatment in IAS 22, which IFRS 3 replaced. The following paragraphs discuss both the IASB's reasons for that change to IAS 22 and the FASB's reasons for the change to SFAS 141's requirements for step acquisitions, as well as providing additional discussion of the reasons for the fair value measurement principle in the revised standards.
- BC199 In developing IFRS 3 and SFAS 141(R), respectively, the boards examined the inconsistencies that resulted from applying the benchmark treatment in IAS 22 and the provisions of SFAS 141, and the related implementation guidance, to acquisitions of businesses. For a step acquisition, that process involved accumulating the costs or carrying amounts of earlier purchases of interests in an entity, which may have occurred years or decades ago. Those amounts were added to the current costs to purchase incremental interests in the acquiree on the acquisition date. The accumulated amounts of those purchases were then allocated to the assets acquired and liabilities assumed. Allocating the accumulated amounts generally resulted in recognising the identifiable assets and liabilities of the acquiree at a mixture of current exchange prices and carry-forward book values for each earlier purchase rather than at their acquisition-date fair values. Users of financial statements have long criticised those practices as resulting in information that lacks consistency, understandability and usefulness. For example, in response to the September 1991 FASB Discussion Memorandum *Consolidation Policy and Procedures*, an organisation representing lending officers said:

[We believe] that the assets and liabilities of the subsidiary [acquiree] reported in the consolidation should reflect the full values established by the exchange transaction in which they were purchased. ... [We believe] the current practice of reporting individual assets and liabilities at a mixture of some current exchange prices and some carry-forward book values is **dangerously misleading**. [emphasis added]

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- BC200 The boards concluded that no useful purpose is served by reporting the assets or liabilities of a newly acquired business using a mixture of their fair values at the date acquired and the acquirer's historical costs or carrying amounts. Amounts that relate to transactions and events occurring before the business is included in the acquirer's financial statements are not relevant to users of those financial statements.
- BC201 The boards also observed the criticisms of the information resulting from application of the cost accumulation and allocation process to acquisitions of businesses that resulted in ownership of less than all of the equity interests in the acquiree. In those circumstances, application of the cost accumulation and allocation process also resulted in identifiable assets and liabilities being assigned amounts that were generally not their acquisition-date fair values. For example, in its 1993 Position Paper *Financial Reporting in the 1990s and Beyond* the Association for Investment Management and Research (AIMR)<sup>13</sup> said:
- An even more difficult situation arises when Firm B acquires less than total ownership of Firm A. Under current practice, only the proportionate share of Firm A's assets and liabilities owned by Firm B are re-valued, but all of Firm A's assets and liabilities—partially re-valued, partially not—are consolidated with those of Firm B, none of whose assets and liabilities have been re-valued. What a mélange! **The result is a combination of historic and current values that only a mystic could sort out with precision.** [page 28, emphasis added]
- BC202 In contrast, if all of the interests in the business were acquired in a single purchase, the process of assigning that current purchase price generally resulted in the assets and liabilities being measured and recognised at their acquisition-date fair values. Thus, the reported amounts of assets and liabilities differed depending on whether an acquirer purchased all of the equity interests in an acquiree in one transaction or in multiple transactions.
- BC203 The boards concluded that measuring assets acquired or liabilities assumed at amounts other than their fair values at the acquisition date does not faithfully represent their economic values or the acquirer's economic circumstances resulting from the business combination. As discussed in paragraph BC37, an important purpose of financial statements is to provide users with relevant and reliable information about the performance of the entity and the resources under its control. That applies regardless of the extent of the ownership interest a parent holds in a particular subsidiary. The boards concluded that measurement at fair value enables users to make a better assessment of the cash-generating abilities of the identifiable net assets acquired in the business combination and the accountability of management for the resources entrusted to it. Thus, the fair value measurement principle in the revised standards will improve the completeness, reliability and relevance of the information reported in an acquirer's financial statements. The boards also concluded that application of that measurement principle should not impose undue incremental costs on entities because it was also necessary to measure the fair values of assets acquired and liabilities assumed

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<sup>13</sup> Subsequently, the AIMR changed its name to the CFA Institute. References to the organisation in this Basis for Conclusions use its name at the date it published a particular paper.

under the provisions of IFRS 3 and SFAS 141, even though those fair values were not always the amounts at which assets and liabilities were recognised.

BC204 Thus, the revised standards reflect the decisions of the IASB and the FASB to develop a standard (and related application guidance) for measuring assets acquired and liabilities assumed in a business combination that:

- (a) is consistent with the general principle of initially measuring assets acquired and liabilities assumed at their fair values, thereby improving the relevance and comparability of the resulting information about the assets acquired and liabilities assumed;
- (b) eliminates inconsistencies and other deficiencies of the purchase price allocation process, including those in acquisitions of businesses that occur in stages and those in which the acquirer obtains a business without purchasing all, or perhaps any, of the acquiree's equity interests on the acquisition date; and
- (c) can be applied in practice with a reasonably high degree of consistency and without imposing undue costs.

#### **Non-controlling interests**

BC205 The 2005 Exposure Draft proposed that a non-controlling interest in an acquiree should be determined as the sum of the non-controlling interest's proportional interest in the identifiable assets acquired and liabilities assumed plus the non-controlling interest's share of goodwill. Thus, because goodwill is measured as a residual, the amount recognised for a non-controlling interest in an acquiree would also have been a residual. Also, an important issue in deciding how to measure a non-controlling interest was whether its share of goodwill should be recognised (often referred to as the 'full goodwill versus partial goodwill issue'). In developing the 2005 Exposure Draft, the boards concluded that it should be recognised (in other words, they selected the 'full goodwill' alternative).

BC206 In redeliberating the 2005 Exposure Draft, the boards observed that they had specified the mechanics of determining the reported amount of a non-controlling interest but had not identified its measurement attribute. The result of those mechanics would have been that the non-controlling interest was effectively measured as the 'final residual' in a business combination. That is to say, the reported amount of the non-controlling interest depended on the amount of goodwill attributed to it, and goodwill is measured as a residual. Thus, in a sense, a non-controlling interest would have been the residual after allocating the residual, or the residual of a residual.

BC207 The boards concluded that, in principle, it is undesirable to have two residual amounts in accounting for a business combination. They also observed that goodwill cannot be measured as other than as a residual; measuring the fair value of goodwill directly would not be possible. In contrast, an acquirer can measure the fair value of a non-controlling interest, for example, on the basis of market prices for the shares held by non-controlling shareholders or by applying another valuation technique. The non-controlling interest in the acquiree is a component of a business combination in which less than 100 per

cent of the equity interests are acquired, and the boards concluded that, in concept, the non-controlling interest, like other components of the combination, should be measured at fair value. The boards concluded that the decision-usefulness of information about a non-controlling interest would be improved if the revised standards specified a measurement attribute for a non-controlling interest rather than merely mechanics for determining that amount. They also concluded that, in principle, the measurement attribute should be fair value. The boards also understand from consultation with some constituents who use financial statements for making (or making recommendations about) investment decisions that information about the acquisition-date fair value of a non-controlling interest would be helpful in estimating the value of shares of the parent company, not only at the acquisition date but also at future dates.

- BC208 The boards also observed that a non-controlling interest is a component of equity in the acquirer's consolidated financial statements and that measuring a non-controlling interest at its acquisition-date fair value is consistent with the way in which other components of equity are measured. For example, outstanding shares of the parent company, including shares issued to former owners of an acquiree to effect a business combination, were measured in the financial statements at their fair value (market price) on the date they were issued. Accordingly, the fair value measurement principle in SFAS 141(R) applies to a non-controlling interest in an acquiree, and the revised IFRS 3 permits an acquirer to measure a non-controlling interest in an acquiree at its acquisition-date fair value.

*IFRS 3's choice of measurement basis for a non-controlling interest*

- BC209 The IASB concluded that, in principle, an acquirer should measure all components of a business combination, including any non-controlling interest in an acquiree, at their acquisition-date fair values. However, the revised IFRS 3 permits an acquirer to choose whether to measure any non-controlling interest in an acquiree at its fair value or as the non-controlling interests' proportionate share of the acquiree's identifiable net assets.
- BC210 Introducing a choice of measurement basis for non-controlling interests was not the IASB's first preference. In general, the IASB believes that alternative accounting methods reduce the comparability of financial statements. However, the IASB was not able to agree on a single measurement basis for non-controlling interests because neither of the alternatives considered (fair value and proportionate share of the acquiree's identifiable net assets) was supported by enough board members to enable a revised business combinations standard to be issued. The IASB decided to permit a choice of measurement basis for non-controlling interests because it concluded that the benefits of the other improvements to, and the convergence of, the accounting for business combinations developed in this project outweigh the disadvantages of allowing this particular option.

- BC211 The following sections (a) provide additional information about the measurement alternatives considered by the IASB, (b) summarise the main effects of permitting a choice in measurement basis and (c) discuss the effect on convergence.

*Measurement alternatives*

- BC212 Although the IASB supports the principle of measuring all components of a business combination at fair value, support for that principle was not unanimous. Some IASB members did not support that principle because it would require measuring non-controlling interests at fair value. For that reason, those IASB members supported making an exception to the measurement principle for the non-controlling interest in an acquiree.
- BC213 Some other IASB members supported an exception for the non-controlling interest for different reasons. Some advocated an exception on the basis that they did not have sufficient evidence to assess the marginal benefits of reporting the acquisition-date fair value of non-controlling interests. Those members concluded that, generally, the fair value of the non-controlling interest could be measured reliably, but they noted that it would be more costly to do so than measuring it at its proportionate share of the acquiree's identifiable net assets. Those members observed that many respondents had indicated that they saw little information of value in the reported non-controlling interest, no matter how it is measured.
- BC214 Those IASB members who did not support making an exception concluded that the marginal benefits of reporting the acquisition-date fair value of non-controlling interests exceed the marginal costs of measuring it.
- BC215 The IASB considered making it a requirement to measure non-controlling interests at fair value unless doing so would impose undue cost or effort on the acquirer. However, feedback from constituents and staff research indicated that it was unlikely that the term *undue cost or effort* would be applied consistently. Therefore, such a requirement would be unlikely to increase appreciably the consistency with which different entities measured non-controlling interests.
- BC216 The IASB reluctantly concluded that the only way the revised IFRS 3 would receive sufficient votes to be issued was if it permitted an acquirer to measure a non-controlling interest either at fair value or at its proportionate share of the acquiree's identifiable net assets, on a transaction-by-transaction basis.

*Effects of the optional measurement of non-controlling interests*

- BC217 The IASB noted that there are likely to be three main differences in outcome that occur when the non-controlling interest is measured as its proportionate share of the acquiree's identifiable net assets, rather than at fair value. First, the amounts recognised in a business combination for non-controlling interests and goodwill are likely to be lower (and these should be the only two items affected on initial recognition). Second, if a cash-generating unit is subsequently impaired, any resulting impairment of goodwill recognised through income is likely to be lower than it would have been if the

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non-controlling interest had been measured at fair value (although it does not affect the impairment loss attributable to the controlling interest).

- BC218 The third difference arises if the acquirer subsequently purchases some (or all) of the shares held by the non-controlling shareholders. If the non-controlling interests are acquired, presumably at fair value, the equity of the group is reduced by the non-controlling interests' share of any unrecognised changes in the fair value of the net assets of the business, including goodwill. If the non-controlling interest is measured initially as a proportionate share of the acquiree's identifiable net assets, rather than at fair value, that reduction in the reported equity attributable to the acquirer is likely to be larger. This matter was considered further in the IASB's deliberations on the proposed amendments to IAS 27.<sup>14</sup>

### *Convergence*

- BC219 Both boards decided that, although they would have preferred to have a common measurement attribute for non-controlling interests, they had considered and removed as many differences between IFRS 3 and SFAS 141 as was practicable.
- BC220 The boards were unable to achieve convergence of their respective requirements in several areas because of existing differences between IFRSs and US GAAP requirements outside a business combination. The boards observed that the accounting for impairments in IFRSs is different from that in US GAAP. This means that even if the boards converged on the initial measurement of non-controlling interests, and therefore goodwill, the subsequent accounting for goodwill would not have converged. Although this is not a good reason for allowing divergence in the initial measurement of non-controlling interests, it was a mitigating factor.
- BC221 Because most business combinations do not involve a non-controlling interest, the boards also observed that the revised standards will align most of the accounting for most business combinations regardless of the different accounting for non-controlling interests in the revised standards.

### **Subsequent improvements to IFRS 3**

- BC221A In *Improvements to IFRSs* issued in May 2010, the Board addressed a concern that permitting the measurement choice for certain components of non-controlling interest might result in inappropriate measurement of those components in some circumstances. The Board decided to limit the choice to non-controlling interests that are present ownership instruments and entitle their holders to a proportionate share of the entity's net assets in the event of liquidation. The amendment requires the acquirer to measure all other components of non-controlling interest at the acquisition-date fair value, unless IFRSs require another measurement basis. For example, if a share-based payment transaction is classified as equity, an entity measures it in accordance with IFRS 2 *Share-based Payment*. Without this amendment, if the

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<sup>14</sup> The consolidation requirements in IAS 27 were superseded by IFRS 10 *Consolidated Financial Statements* issued in May 2011. The requirements with respect to transactions between owners in their capacity as owners did not change.

acquirer chose to measure non-controlling interest at its proportionate share of the acquiree's identifiable net assets, the acquirer might have measured some equity instruments at nil. In the Board's view, this would result in not recognising economic interests that other parties have in the acquiree. Therefore, the Board amended IFRS 3 to limit the scope of the measurement choice.

**Measuring assets and liabilities arising from contingencies, including subsequent measurement**

- BC222 FASB Statement No. 5 *Accounting for Contingencies* (SFAS 5) defines a *contingency* as an existing condition, situation or set of circumstances involving uncertainty as to possible gain or loss to an entity that will ultimately be resolved when one or more future events occur or fail to occur. SFAS 141(R) refers to the assets and liabilities to which contingencies relate as *assets and liabilities arising from contingencies*. For ease of discussion, this Basis for Conclusions also uses that term to refer broadly to the issues related to contingencies, including the issues that the IASB considered in developing its requirements on recognising and measuring contingent liabilities in a business combination (paragraphs BC242–BC245 and BC272–BC278).
- BC223 The revised standards require the assets and liabilities arising from contingencies that are recognised as of the acquisition date to be measured at their acquisition-date fair values. That requirement is generally consistent with the measurement requirements of IFRS 3, but it represents a change in the way entities generally applied SFAS 141. In addition, the IASB's measurement guidance on contingent liabilities carries forward the related guidance in IFRS 3, pending completion of the project to revise IAS 37 (paragraphs BC272–BC276). Accordingly, the FASB's and the IASB's conclusions on measuring assets and liabilities arising from contingencies are discussed separately.
- The FASB's conclusions on measuring assets and liabilities arising from contingencies*
- BC224 The amount of an asset or a liability arising from a contingency recognised in accordance with SFAS 141 was seldom the acquisition-date fair value. Rather, it was often the settlement amount or a best estimate of the expected settlement amount on the basis of circumstances existing at a date after the acquisition date.
- BC225 In developing the 2005 Exposure Draft, the FASB considered whether to require a strict SFAS 5 approach for the initial measurement and recognition of all contingencies in a business combination. That would mean that contingencies that did not meet the SFAS 5 'probability' criterion would be measured at zero (or at a minimum amount that qualifies as probable) rather than at fair value. Some constituents said that applying SFAS 5 in accounting for a business combination might be a practical way to reduce the costs and measurement difficulties involved in obtaining the information and legal counsel needed to measure the fair value of numerous contingencies that the acquiree had not recognised in accordance with SFAS 5.

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- BC226 The FASB observed that paragraph 17(a) of SFAS 5 states that ‘Contingencies that might result in gains usually are not reflected in the accounts since to do so might be to recognize revenue prior to its realization.’ Thus, to apply SFAS 5 in accounting for a business combination in the same way it is applied in other situations was likely to result in non-recognition of gain contingencies, including those for which all of the needed information is available at the acquisition date. The FASB concluded that that would be a step backwards; SFAS 141 already required the recognition of gain contingencies at the acquisition date and for which fair value is determinable (paragraphs 39 and 40(a) of SFAS 141). Also, in accordance with SFAS 5’s requirements, contingent losses that arise outside a business combination are not recognised unless there is a high likelihood of a future outflow of resources. In addition, because goodwill is calculated as a residual, omitting an asset for an identifiable contingent gain would also result in overstating goodwill. Similarly, omitting a liability for a contingent loss would result in understating goodwill. Thus, the FASB rejected the SFAS 5 approach in accounting for a business combination.
- BC227 The FASB also considered but rejected retaining existing practice based on FASB Statement No. 38 *Accounting for Preacquisition Contingencies of Purchased Enterprises* (SFAS 38), which SFAS 141 carried forward without reconsideration. For the reasons described in the preceding paragraph, the FASB concluded that continuing to permit the delayed recognition of most assets and liabilities arising from contingencies that occurred in applying SFAS 141 and the related guidance would fail to bring about needed improvements in the accounting for business combinations. The FASB decided that requiring an acquirer to measure at fair value and recognise any assets and liabilities arising from contingencies that meet the conceptual elements definition would help bring about those needed improvements, in particular, improvements in the completeness of reported financial information.
- BC228 Some respondents to the 2005 Exposure Draft were concerned about the ability to measure reliably the fair value of assets and liabilities arising from contingencies at the acquisition date. The FASB concluded that measuring the fair value of an asset or a liability arising from a contractual contingency with sufficient reliability as of the acquisition date should not be more difficult than measuring the fair value of many other assets and liabilities that the revised standards require to be measured at fair value as of that date. The terms of the contract, together with information developed during the acquisition process, for example, to determine the price to be paid, should provide the needed information. Sufficient information is also likely to be available to measure the acquisition-date fair value of assets and liabilities arising from non-contractual contingencies that satisfy the more-likely-than-not criterion (see paragraphs BC270 and BC271). The FASB acknowledges that non-contractual assets and liabilities that do not meet that criterion at the acquisition date are most likely to raise difficult measurement issues and concerns about the reliability of those measures. To address those reliability concerns, the FASB decided that an acquirer should not measure and recognise such assets and liabilities. Rather, assets and liabilities arising from non-contractual contingencies that do not satisfy the



more-likely-than-not criterion at the acquisition date are accounted for in accordance with other US GAAP, including SFAS 5.

- BC229 The FASB also observed that respondents who are concerned about the reliability with which the fair values of assets and liabilities arising from contingencies can be measured may be interpreting *reliable measurement* differently from the FASB. To determine a reliable measure of the fair value of a contingency, the acquirer need not be able to determine, predict or otherwise know the ultimate settlement amount of that contingency at the acquisition date (or within the measurement period) with certainty or precision.
- BC230 In 2006 the FASB and the IASB published for comment the first discussion paper in their joint project to improve their respective conceptual frameworks. Paragraph QC21 of that paper – *Preliminary Views on an improved Conceptual Framework for Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics of Decision-useful Financial Reporting Information* – discusses the relationship between faithful representation, the quality of decision-useful financial reporting information that pertains to the reliability of information, and precision. It says that accuracy of estimates is desirable and some minimum level of accuracy is necessary for an estimate to be a faithful representation of an economic phenomenon. However, faithful representation implies neither absolute precision in the estimate nor certainty about the outcome.
- BC231 The FASB concluded that the fair values of assets and liabilities arising from contingencies meeting the recognition criteria of SFAS 141(R) are measurable with sufficient reliability as of the acquisition date for recognition in accounting for a business combination if the estimates are based on the appropriate inputs and each input reflects the best available information about that factor. The FASB acknowledges that the fair value measured at the acquisition date will not be the amount for which the asset or liability is ultimately settled, but it provides information about the current value of an asset or a liability by incorporating uncertainty into the measure.

*Subsequent measurement of assets and liabilities arising from contingencies*

- BC232 The FASB observed that applying SFAS 5 in the post-combination period to a recognised liability or asset arising from a contingency that did not meet the SFAS 5 probability threshold at the acquisition date would result in derecognising that liability or asset and reporting a gain or loss in income of the post-combination period. That result would not faithfully represent the economic events occurring in that period. The FASB noted that similar concerns about the potential for misleading reporting consequences do not exist for many financial instruments arising from contingencies, such as options, forward contracts and other derivatives. Such assets and liabilities generally would continue to be measured at fair value in accordance with other applicable US GAAP, which also provides guidance on how to report subsequent changes in the fair values of financial instruments in earnings or comprehensive income. Thus, the FASB decided that it must address the subsequent measurement of assets and liabilities arising from contingencies

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recognised in a business combination. However, it limited the scope of that effort to assets and liabilities that would be subsequently subject to SFAS 5.

- BC233 The FASB considered five alternatives for subsequent measurement of assets and liabilities arising from contingencies that would be subject to SFAS 5 if not acquired or assumed in a business combination:

Alternative 1 – Subsequently measuring at fair value

Alternative 2 – Subsequently reporting amounts initially recognised in a business combination at their acquisition-date fair values until the acquirer obtains new information about the possible outcome of the contingency. When new information is obtained the acquirer evaluates that new information and measures a liability at the **higher** of its acquisition-date fair value or the amount that would be recognised if applying SFAS 5 and an asset at the **lower** of its acquisition-date fair value or the best estimate of its future settlement amount

Alternative 3 – ‘Freezing’ amounts initially recognised in a business combination

Alternative 4 – Applying an interest allocation method (similar to the model in FASB Statement No. 143 *Accounting for Asset Retirement Obligations* (SFAS 143))

Alternative 5 – Applying a deferred revenue method, but only to those items that relate to revenue-generating activities.

- BC234 Paragraphs BC224–BC231 discuss the reasons for the FASB’s decision to require fair value measurement for initial recognition of assets and liabilities arising from contingencies. For many of those same reasons, the FASB considered requiring Alternative 1 – subsequent measurement at fair value. For a variety of reasons, the FASB ultimately rejected that alternative. Adopting this alternative would mean that for some entities (maybe many entities) assets and liabilities arising from contingencies acquired in a business combination would be reported at fair value, while other similar assets and liabilities would be reported at SFAS 5 amounts – different measurement of similar assets and liabilities would make financial reports more difficult to understand. The FASB noted that a project on business combinations would not be the appropriate place to address broadly perceived deficiencies in SFAS 5. Moreover, at the same time as SFAS 141(R) was finalised, the FASB was considering adding a project to its technical agenda to reconsider comprehensively the accounting for contingencies in SFAS 5. (The FASB added a project to reconsider the accounting for contingencies to its agenda in September 2007.) The FASB concluded that requiring assets and liabilities arising from contingencies to be subsequently measured at fair value was premature and might prejudice the outcome of its deliberations in that project.

- BC235 The FASB decided, as a practical alternative, to require Alternative 2. In accordance with that approach, the acquirer continues to report an asset or liability arising from a contingency recognised as of the acquisition date at its acquisition-date fair value in the absence of new information about the

possible outcome of the contingency. When such new information is obtained, the acquirer evaluates that information and measures the asset or liability as follows:

- (a) a liability is measured at the **higher** of:
  - (i) its acquisition-date fair value; and
  - (ii) the amount that would be recognised if applying SFAS 5.
- (b) an asset is measured at the **lower** of:
  - (i) its acquisition-date fair value; and
  - (ii) the best estimate of its future settlement amount.

- BC236 The FASB concluded that this alternative was a practical bridge between improved reporting at the acquisition date and subsequent accounting under the existing requirements of SFAS 5. It would not prejudice the outcome of deliberations that the FASB will have in a project to reconsider SFAS 5. It also addressed the concerns of some constituents that requiring contingencies to be subsequently measured at fair value would result in contingencies acquired or assumed in a business combination being measured differently from contingencies that arise outside of a business combination.
- BC237 The FASB observed that this alternative provides slightly different guidance for liabilities from its guidance for assets. Unlike liabilities, it could not require assets to be measured at the lower of their acquisition-date fair values or *the amounts that would be recognised if applying SFAS 5*. Because SFAS 5 does not allow recognition of gain contingencies, the amount that would be recognised by applying SFAS 5 to an asset would be zero. Thus, the FASB decided that an asset arising from a contingency should be measured at the lower of its acquisition-date fair value or *the best estimate of its future settlement amount*. The FASB believes that that measure is similar to the measure required by SFAS 5 for liabilities (loss contingencies). The FASB also observed that the approach for assets allows for the recognition of impairments to the asset; it requires an asset to be decreased to the current estimate of the amount the acquirer expects to collect.
- BC238 The FASB rejected Alternative 3—freezing the amounts initially recognised. The FASB observed that this alternative results in less relevant information than Alternative 2. Because the FASB views Alternative 2 as a practical and operational solution, it saw no compelling reason to adopt a less optimal alternative. The FASB also rejected Alternative 4—the interest allocation method. In accordance with that method, the contingency would be remeasured using a convention similar to SFAS 143 whereby interest rates are held constant for initial cash flow assumptions. The FASB noted that the reasons for selecting the interest allocation method in SFAS 143 for long-term asset retirement obligations, including concerns about income statement volatility, are not compelling for contingencies such as warranties and pending litigation that generally have shorter lives.

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- BC239 In accordance with Alternative 5—the deferred revenue method—the acquisition-date fair value of a deferred revenue liability (performance obligation) would be amortised after the acquisition date, like the approach for separately priced extended warranties and product maintenance contracts acquired outside a business combination. Accruals would be added to the contingency for subsequent direct costs. The FASB acknowledged that the costs to apply that measurement approach would be lower than other measurement approaches. However, the FASB concluded that the potential reduction in costs does not justify (a) creating inconsistencies in the subsequent accounting for particular classes of contingencies acquired or assumed in a business combination and (b) the diminished relevance of the resulting information. Thus, the FASB also rejected Alternative 5. Some respondents to the 2005 Exposure Draft supported recognition of subsequent changes in the amounts recognised for assets and liabilities arising from contingencies either as adjustments to goodwill or in comprehensive income rather than in earnings. Some who favoured reporting such changes as adjustments to goodwill did so at least in part because of the difficulties they see in distinguishing between changes that result from changes in circumstances after the acquisition date and changes that pertain more to obtaining better information about circumstances that existed at that date. They noted that the latter are measurement period adjustments, many of which result in adjustments to goodwill.
- BC240 The FASB understands that distinguishing between measurement period adjustments and other changes in the amounts of assets and liabilities arising from contingencies will sometimes be difficult. It observed, however, that similar difficulties exist for other assets acquired and liabilities assumed in a business combination; changes in the amounts of those assets and liabilities after the acquisition date are included in earnings. The FASB saw no compelling reason to treat items arising from contingencies differently.
- BC241 Those who favoured reporting subsequent changes in the amounts recognised for assets and liabilities arising from contingencies in other comprehensive income rather than in earnings generally analogised to the present accounting for available-for-sale securities. They said that items arising from contingencies were not ‘realised’ until the contingency is resolved. The FASB rejected that alternative because it saw no compelling reason to add to the category of items that are initially recognised as other comprehensive income and later ‘recycled’ to earnings. The FASB considers reporting subsequent changes in the amounts of items arising from contingencies in earnings not only conceptually superior to reporting those changes only in comprehensive income but also consistent with the way in which other changes in amounts of items acquired or assumed in a business combination are recognised.

### *The IASB’s conclusions on initial and subsequent measurement of contingent liabilities*

- BC242 As noted in paragraph BC223, the IASB’s measurement guidance on contingencies carries forward the related guidance in IFRS 3 (except for clarifying that an acquirer cannot recognise a contingency that is not a liability), pending completion of the project to revise IAS 37. Accordingly,

contingent liabilities recognised in a business combination are initially measured at their acquisition-date fair values.

- BC243 In developing IFRS 3, the IASB observed that not specifying the subsequent accounting for contingent liabilities recognised in a business combination might result in inappropriately derecognising some or all of those contingent liabilities immediately after the combination.
- BC244 In ED 3 the IASB proposed that a contingent liability recognised in a business combination should be excluded from the scope of IAS 37 and subsequently measured at fair value with changes in fair value recognised in profit or loss until the liability is settled or the uncertain future event described in the definition of a contingent liability is resolved. In considering respondents' comments on this issue, the IASB noted that subsequently measuring such contingent liabilities at fair value would be inconsistent with the conclusions it reached on the accounting for financial guarantees and commitments to provide loans at below-market interest rates when it revised IAS 39.<sup>15</sup>
- BC245 The IASB decided to revise the proposal in ED 3 for consistency with IAS 39. Therefore, the revised IFRS 3 requires contingent liabilities recognised in a business combination to be measured after their initial recognition at the higher of:
- (a) the amount that would be recognised in accordance with IAS 37; and
  - (b) the amount initially recognised less, when appropriate, cumulative amortisation recognised in accordance with IAS 18 *Revenue*.<sup>16</sup>

*Definition of fair value*<sup>17</sup>

- BC246 The revised IFRS 3 and SFAS 141(R) each use the same definition of fair value that the IASB and the FASB respectively use in their other standards. Specifically, IAS 39<sup>18</sup> and other IFRSs define fair value as 'the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction' and the revised IFRS 3 uses that definition. SFAS 157, on the other hand, defines fair value as 'the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date' and that definition is used in SFAS 141(R).<sup>19</sup>

<sup>15</sup> IFRS 9 *Financial Instruments* relocated to IFRS 9 the requirements on the accounting for financial guarantees and commitments to provide loans at below-market interest rates.

<sup>16</sup> IFRS 15 *Revenue from Contracts with Customers*, issued in May 2014, replaced IAS 18 *Revenue* and amended paragraph 56 of IFRS 3 for consistency with the requirements in IFRS 15.

<sup>17</sup> IFRS 13, issued in May 2011, defines fair value.

<sup>18</sup> IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

<sup>19</sup> IFRS 13, issued in May 2011, is the result of the IASB's and the FASB's joint project on fair value measurement. As a result, the definition of fair value in IFRSs is identical to the definition in US GAAP (Topic 820 *Fair Value Measurement* in the *FASB Accounting Standards Codification* codified SFAS 157).

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- BC247 The IASB considered also using the definition of fair value from SFAS 157 but decided that to do so would prejudice the outcome of its project on fair value measurements. Similarly, the FASB considered using the definition of fair value from IFRS 3 but decided that to do so would be inappropriate in the light of SFAS 157, which it intends for use in all situations in which a new standard requires measurement at fair value.
- BC248 The boards acknowledge that the differing definitions of fair value might result in measuring the fair values of assets acquired and liabilities assumed in a business combination differently depending on whether the combination is accounted for in accordance with the revised IFRS 3 or SFAS 141(R). However, the boards consulted valuation experts on the likely effects of the differing definitions of fair value. As a result of that consultation, the boards understand that such differences are unlikely to occur often. The boards also observed that the definitions use different words to articulate essentially the same concepts in two general areas—the non-performance risk and credit standing of financial liabilities and the market-based measurement objective.
- BC249 SFAS 157 defines non-performance risk as the risk that an obligation will not be fulfilled and indicates that it affects the fair value of a liability. Non-performance risk includes but may not be limited to the reporting entity's own credit risk. In comparison, IFRSs do not use the term *non-performance risk* in discussing the fair value of a liability. However, IAS 39 requires the fair value of a financial liability to reflect its credit risk. Although the words are different, the boards believe that the underlying concepts are essentially the same.
- BC250 The definition of fair value from SFAS 157 indicates that it is a price in an orderly transaction between market participants. In comparison, IFRSs indicate that fair value reflects an arm's length transaction between knowledgeable, willing parties. Paragraphs 42–44 of IAS 40 discuss what a *transaction between knowledgeable, willing parties* means:

... In this context, 'knowledgeable' means that both the willing buyer and the willing seller are reasonably informed about the nature and characteristics of the investment property, its actual and potential uses, and market conditions at the end of the reporting period ...

... The willing seller is motivated to sell the investment property at market terms for the best price obtainable. The factual circumstances of the actual investment property owner are not a part of this consideration because the willing seller is a hypothetical owner (eg a willing seller would not take into account the particular tax circumstances of the investment property owner).

The definition of fair value refers to an arm's length transaction. An arm's length transaction is one between parties that do not have a particular or special relationship that makes prices of transactions uncharacteristic of market conditions. The transaction is presumed to be between unrelated parties, each acting independently.

Thus, although the two definitions use different words, the concept is the same—fair value is a market-based measure in a transaction between unrelated parties.

BC251 However, differences in the results of applying the different definitions of fair value may occur in particular areas. For example, SFAS 157 defines fair value as an exit price between market participants and IFRSs define fair value as an exchange price in an arm's length transaction. Most valuation experts the boards consulted said that, because transaction costs are not a component of fair value in either definition, an exit price for an asset or liability acquired or assumed in a business combination would differ from an exchange price (entry or exit) only (a) if the asset is acquired for its defensive value or (b) if a liability is measured on the basis of settling it with the creditor rather than transferring it to a third party. However, the boards understand that ways of measuring assets on the basis of their defensive value in accordance with paragraph A12 of SFAS 157 are developing, and it is too early to tell the significance of any differences that might result. It is also not clear that entities will use different methods of measuring the fair value of liabilities assumed in a business combination.

*Measuring the acquisition-date fair values of particular assets acquired*

**Assets with uncertain cash flows (valuation allowances)**

BC252 Both IFRS 3 and SFAS 141 required receivables to be measured at the present values of amounts to be received determined at appropriate current interest rates, less allowances for uncollectibility and collection costs, if necessary. The boards considered whether an exception to the fair value measurement principle is necessary for assets such as trade receivables and other short-term and long-term receivables acquired in a business combination. Several of the boards' constituents suggested that an exception should be permitted for practical and other reasons, including concerns about comparing credit losses on loans acquired in a business combination with those on originated loans. In developing the 2005 Exposure Draft, however, the boards saw no compelling reason for such an exception. The boards observed that using an acquirer's carrying basis and including collection costs is inconsistent with the revised standards' fair value measurement requirement and the underlying notion that the acquirer's initial measurement, recognition and classification of the assets acquired and liabilities assumed begins on the acquisition date. Because uncertainty about collections and future cash flows is included in the fair value measure of a receivable, the 2005 Exposure Draft proposed that the acquirer should not recognise a separate valuation allowance for acquired assets measured at fair value.

BC253 In developing the 2005 Exposure Draft, the FASB acknowledged that including uncertainties about future cash flows in a fair value measure, with no separate allowance for uncollectible amounts, differed from the current practice for SEC registrants. That practice was established in SEC Staff Accounting Bulletin Topic 2.A.5 *Adjustments to Allowances for Loan Losses in Connection with Business Combinations* which states that generally the acquirer's estimation of the uncollectible portion of the acquirer's loans should not change from the acquirer's estimation before the acquisition. However, the FASB also observed that fair value measurement is consistent with guidance in AICPA Statement of Position 03-3 *Accounting for Certain Loans or Debt Securities Acquired in a Transfer* (AICPA SOP 03-3), which prohibits 'carrying over' or

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creating valuation allowances in the initial accounting of all loans acquired in transfers that are within its scope, including business combinations accounted for as an acquisition.

- BC254 In developing the 2005 Exposure Draft, the boards also acknowledged that the fair value measurement approach has implications for the capital requirements for financial institutions, particularly banks. The boards noted, however, that regulatory reporting requirements are a separate matter that is beyond the scope of general purpose financial reporting.
- BC255 Some respondents to the 2005 Exposure Draft who commented on this issue agreed with the proposal, but many who commented on it disagreed with not recognising a separate valuation allowance for receivables and similar assets. Some of those respondents favoured retaining the guidance in IFRS 3 and SFAS 141. They said that the costs of measuring the fair value of trade receivables, loans, receivables under financing leases and the like would be high; they did not think the related benefits would justify those costs. Some also said that software systems currently available for loans and other receivables do not provide for separate accounting for acquired and originated loans; they have to account manually for loans to which AICPA SOP 03-3 applies, incurring significant costs to do so.
- BC256 As they did in developing the 2005 Exposure Draft, the boards acknowledged that the requirement to measure receivables and similar assets at fair value with no separate valuation allowance may lead to additional costs for some entities. However, the boards observed that entities that apply IAS 39<sup>20</sup> are required to measure financial assets acquired outside a business combination, as well as those originated, at fair value on initial recognition. The boards do not think financial or other assets should be measured differently because of the nature of the transaction in which they are acquired. Because the boards saw no compelling reason to provide an exception to the measurement principle for receivables or other assets with credit risk, they affirmed their conclusion that the benefits of measuring receivables and similar assets at fair value justify the related costs.
- BC257 Some respondents to the 2005 Exposure Draft said that separate recognition of valuation allowances for loans and similar assets was important to users in evaluating the credit assumptions built into loan valuations. They suggested that the fair value of receivables should be split into three components: (a) the gross contractual amounts, (b) a separate discount or premium for changes in interest rates and (c) a valuation allowance for the credit risk, which would be based on the contractual cash flows expected to be uncollectible. In evaluating that alternative presentation, the boards noted that the valuation allowance presented would differ from the valuation allowance for receivables under IAS 39 and SFAS 5, each of which is determined on the basis of incurred, rather than expected, losses. Thus, how to determine the valuation allowance on an ongoing basis would be problematic. For example, if requirements for other receivables were applied,

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<sup>20</sup> IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.



an immediate gain would be recognised for the difference between incurred losses and expected losses. In contrast, if the valuation allowance for receivables acquired by transfer, including in a business combination, rather than by origination was determined subsequently on an expected loss basis, the result would be a new accounting model for those receivables. The boards concluded that this project is not the place to consider the broader issues of how best to determine the valuation allowances for receivables, regardless of the manner in which the receivables are acquired.

*Disclosure of information about receivables acquired*

BC258 Some constituents asked the boards to consider requiring additional disclosures about receivables measured at fair value to help in assessing considerations of credit quality included in the fair value measures, including expectations about receivables that will be uncollectible. Those constituents were concerned that without additional disclosure, it would be impossible to determine the contractual cash flows and the amount of the contractual cash flows not expected to be collected if receivables were recognised at fair value. In response to those comments, the boards decided to require disclosure of the fair value of receivables acquired, the gross contractual amounts receivable and the best estimate at the acquisition date of the contractual cash flows not expected to be collected. The disclosures are required for each major class of receivable.

BC259 In January 2007 the FASB added a project to its technical agenda to improve disclosures relating to the allowance for credit losses associated with financing receivables. As part of that project, the FASB is considering potential new disclosures and enhanced current disclosures about the credit quality of an entity's portfolio, the entity's credit risk exposures, its accounting policies on valuation allowances and possibly other areas.

BC260 The boards observed that the work involved in developing a complete set of credit quality disclosures to be made for receivables acquired in a business combination would be similar to that required in the FASB's disclosure project related to valuation allowances. Combining those efforts would be a more efficient use of resources. Accordingly, the FASB decided to include disclosures that should be made in a business combination in the scope of its project on disclosures related to valuation allowances and credit quality, and the IASB will monitor that project. In the interim, the disclosures required by the revised standards (paragraph B64(h) of the revised IFRS 3) will provide at least some, although perhaps not all, of the information users need to evaluate the credit quality of receivables acquired.

**Assets that the acquirer intends not to use or to use in a way that is different from the way other market participants would use them**

BC261 While the revised standards were being developed, the FASB received enquiries about inconsistencies in practice in accordance with SFAS 141 related to measuring particular intangible assets that an acquirer intends not to use or intends to use in a way different from the way other market participants would use them. For example, if the acquirer did not intend to use a brand name acquired in a business combination, some entities assigned

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no value to the asset and other entities measured it at the amount at which market participants could be expected to exchange the asset, ie at its fair value.

- BC262 To avoid such inconsistencies in practice, the boards decided to clarify the measurement of assets that an acquirer intends not to use (paragraph B43 of the revised IFRS 3). The intention of both IFRS 3 and SFAS 141 was that assets, both tangible and intangible, should be measured at their fair values regardless of how or whether the acquirer intends to use them. The FASB observed that measuring such assets in accordance with their highest and best use is consistent with SFAS 157. Paragraph A12 of SFAS 157 illustrates determining the fair value of an in-process research and development project acquired in a business combination that the acquirer does not intend to complete. The IASB understands from its consultation with preparers, valuation experts and auditors that IFRS 3 was applied in the way the revised standards require.<sup>21</sup>

### **Exceptions to the recognition or measurement principle**

- BC263 As indicated in paragraphs 14 and 20 of the revised IFRS 3, the revised standards include limited exceptions to its recognition and measurement principles. Paragraphs BC265–BC311 discuss the types of identifiable assets and liabilities for which exceptions are provided and the reasons for those exceptions.
- BC264 It is important to note that not every item that falls into a particular type of asset or liability is an exception to either the recognition or the measurement principle (or both). For example, contingent liabilities are identified as an exception to the recognition principle because the revised IFRS 3 includes a recognition condition for them in addition to the recognition conditions in paragraphs 11 and 12. Although applying that additional condition will result in not recognising some contingent liabilities, those that meet the additional condition will be recognised in accordance with the recognition principle. Another example is employee benefits, which are identified as a type of asset or liability for which exceptions to both the recognition and the measurement principles are provided. As discussed further in paragraphs BC296–BC300, the acquirer is required to recognise and measure liabilities and any related assets resulting from the acquiree's employee benefit arrangements in accordance with IAS 19 *Employee Benefits* rather than by applying the recognition and measurement principles in the revised IFRS 3. Applying the requirements of IAS 19 will result in recognising many, if not most, types of employee benefit liabilities in the same way as would result from applying the recognition principle (see paragraph BC297). However, others, for example withdrawal liabilities from multi-employer plans for entities applying US GAAP, are not necessarily consistent with the recognition principle. In addition, applying the requirements of IAS 19 generally will result in measuring liabilities for employee benefits (and any related assets) on a basis other than their acquisition-date fair values. However, applying the requirements of SFAS 146

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<sup>21</sup> IFRS 13, issued in May 2011, describes the concept of highest and best use and provides examples of its application in a business combination.

to one-off termination benefits results in measuring liabilities for those benefits at their acquisition-date fair values.

*Exceptions to the recognition principle*

**Liabilities and contingent liabilities within the scope of IAS 37 or IFRIC 21 (paragraphs 21A–21C)**

- BC264A Paragraph 11 of IFRS 3 specifies that, to qualify for recognition at the acquisition date, the identifiable assets acquired and liabilities assumed must meet the definitions of assets and liabilities in the 2018 *Conceptual Framework*. Paragraph 54 of IFRS 3 specifies that after the acquisition date, an entity generally accounts for those assets and liabilities in accordance with other applicable IFRS Standards for those items.
- BC264B As a result of applying the definition of a liability in the 2018 *Conceptual Framework*, an acquirer might recognise at the acquisition date a liability to pay a levy that it would not recognise subsequently when applying IFRIC 21 *Levies*. This difference arises because an entity might recognise a liability earlier applying the 2018 *Conceptual Framework*. Applying IFRIC 21, an entity recognises a liability to pay a levy only when it conducts the activity that triggers the payment of the levy, whereas applying the 2018 *Conceptual Framework*, an entity recognises a liability when it conducts an earlier activity if:
- (a) conducting that earlier activity means the entity may have to pay a levy it would not otherwise have had to pay; and
  - (b) the entity has no practical ability to avoid the later activity that will trigger payment of the levy.
- BC264C If an acquirer recognised a liability to pay a levy at the acquisition date when applying the 2018 *Conceptual Framework* and derecognised the liability immediately afterwards when applying IFRIC 21, it would recognise a so-called *Day 2 gain*. This recognised gain would not depict an economic gain, so would not faithfully represent any aspect of the entity's financial performance.
- BC264D The IASB noted that IFRIC 21 is an interpretation of IAS 37, and so concluded that the problem of *Day 2 gains* could arise not only for levies within the scope of IFRIC 21 but also for other obligations within the scope of IAS 37. To avoid this problem, the IASB added paragraph 21B to IFRS 3. This paragraph makes an exception from the requirements of paragraph 11 for liabilities and contingent liabilities that would be within the scope of IAS 37 or IFRIC 21 if incurred separately, rather than assumed in a business combination. The exception requires an entity to apply criteria in IAS 37 or IFRIC 21 respectively to determine whether a present obligation exists at the acquisition date. The exception refers to IFRIC 21 as well as IAS 37 because, although IFRIC 21 is an interpretation of IAS 37, it also applies to levies whose timing and amount are certain and so are outside the scope of IAS 37.

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BC264E A present obligation identified applying the exception in paragraph 21B of IFRS 3 might meet the definition of a contingent liability. This will be the case if it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation, or if the amount of the obligation cannot be measured with sufficient reliability. The IASB added paragraph 21C to IFRS 3 to clarify that, if the present obligation identified applying paragraph 21B meets the definition of a contingent liability, paragraph 23 of IFRS 3 also applies to that contingent liability.

### **Assets and liabilities arising from contingencies (paragraphs 22–23A)**

BC265 Both the FASB's conclusions on recognising assets and liabilities arising from contingencies and the IASB's conclusions on recognising contingent liabilities resulted in exceptions to the recognition principle in the revised standards because both will result in some items being unrecognised at the acquisition date. However, the details of the exceptions differ. The reasons for those exceptions and the differences between them are discussed in paragraphs BC266–BC278.

#### *The FASB's conclusions on assets and liabilities arising from contingencies*

BC266 SFAS 141 carried forward without reconsideration the requirements of SFAS 38, which required an acquirer to include in the purchase price allocation the fair value of an acquiree's contingencies if their fair value could be determined during the allocation period. For those contingencies whose fair value could not be determined during the allocation period, SFAS 141 required the acquirer to recognise the contingency in earnings when the occurrence of the contingency became probable and its amount could be reasonably estimated.

BC267 Members of its resource group and others told the FASB that in practice acquirers often did not recognise an acquiree's assets and liabilities arising from contingencies at the acquisition date. Instead, contingencies were recognised after the acquisition date at an amount determined at that later date either because their amount could not be 'reasonably estimated' or because the contingency was determined not to meet the SFAS 5 'probability' criterion for recognition.

BC268 The 2005 Exposure Draft proposed that an acquirer should recognise all assets and liabilities arising from an acquiree's contingencies if they meet the definition of an asset or a liability in the FASB's Concepts Statement 6 regardless of whether a contingency meets the recognition criteria in SFAS 5. The FASB, like the IASB, concluded that to represent faithfully the economic circumstances at the acquisition date, in principle, all identifiable assets acquired and liabilities assumed should be recognised separately from goodwill, including assets and liabilities arising from contingencies at the acquisition date.

BC269 Respondents to the 2005 Exposure Draft that apply US GAAP expressed concern about how to deal with uncertainty about whether and when a contingency gives rise to an asset or a liability that meets the definition in the FASB's Concepts Statement 6, referred to as *element uncertainty*. An example

cited by some respondents involved an acquiree's negotiations with another party at the acquisition date for reimbursement of costs incurred on the other party's behalf. How should the acquirer determine whether that contingency gave rise to an asset that should be recognised as part of the accounting for the business combination? Respondents suggested several means of dealing with element uncertainty, which generally involved introducing a threshold either for all contingencies or for the non-contractual contingencies an acquirer is required to recognise at the acquisition date. Other respondents suggested requiring recognition of only those assets and liabilities arising from contingencies whose fair values can be reliably determined, which would be similar to the requirements of SFAS 141.

- BC270 The FASB understands the potential difficulty of resolving element uncertainty, especially for assets or liabilities arising from non-contractual contingencies. It considered whether to deal with element uncertainty by requiring assets and liabilities arising from contingencies to be recognised only if their fair values are reliably measurable. The FASB concluded that applying the guidance in SFAS 157 on measuring fair value should result in an estimate of the fair value of assets and liabilities arising from contingencies that is sufficiently reliable for recognition. The FASB also observed that adding a measurement condition is an indirect way of dealing with uncertainty involving recognition; it would be better to deal with such uncertainty more directly.
- BC271 The FASB concluded that most cases of significant uncertainty about whether a potential asset or liability arising from a contingency meets the pertinent definition (element uncertainty) are likely to involve non-contractual contingencies. To help preparers and their auditors deal with element uncertainty, the FASB decided to add a requirement for the acquirer to assess whether it is **more likely than not** that the contingency gives rise to an asset or a liability as defined in the FASB's Concepts Statement 6. For an asset arising from a contingency, applying that criterion focuses on whether it is more likely than not that the acquirer has obtained control of a future economic benefit as a result of a past transaction or other event. For a liability, the more-likely-than-not criterion focuses on whether the acquirer has a present obligation to sacrifice future economic benefits as a result of a past transaction or other event. If that criterion is met at the acquisition date, the acquirer recognises the asset or liability, measured at its acquisition-date fair value, as part of the accounting for the business combination. If that criterion is not met at the acquisition date, the acquirer accounts for the non-contractual contingency in accordance with other US GAAP, including SFAS 5, as appropriate. The FASB concluded that adding the more-likely-than-not criterion would permit acquirers to focus their efforts on the more readily identifiable contingencies of acquirees, thereby avoiding spending disproportionate amounts of time searching for contingencies that, even if identified, would have less significant effects.

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### *The IASB's conclusions on contingent liabilities and contingent assets*

- BC272 In developing the 2005 Exposure Draft, the IASB concluded that an asset or a liability should be recognised separately from goodwill if it satisfies the definitions in the *Framework*. In some cases, the amount of the future economic benefits embodied in the asset or required to settle the liability is contingent (or conditional) on the occurrence or non-occurrence of one or more uncertain future events. That uncertainty is reflected in measurement. The FASB reached a consistent conclusion.
- BC273 At the same time as it published the 2005 Exposure Draft, the IASB also published for comment a separate exposure draft containing similar proposals on the accounting for contingent assets and contingent liabilities within the scope of IAS 37. At that time, the IASB expected that the effective date of the revised IAS 37 would be the same as the effective date of the revised IFRS 3. However, the IASB now expects to issue a revised IAS 37 at a later date. Accordingly, except for clarifying that an acquirer should not recognise a so-called contingent liability that is not an obligation at the acquisition date, the IASB decided to carry forward the related requirements in the original IFRS 3. The IASB expects to reconsider and, if necessary, amend the requirements in the revised IFRS 3 when it issues the revised IAS 37.
- BC274 The IASB concluded that an acquirer should recognise a contingent liability assumed in a business combination only if it satisfies the definition of a liability in the *Framework*. This is consistent with the overall objective of the second phase of the project on business combinations in which an acquirer recognises the assets acquired and liabilities assumed at the date control is obtained.
- BC275 However, the IASB observed that the definition of a contingent liability in IAS 37 includes both (a) 'possible obligations' and (b) present obligations for which either it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation or the amount of the obligation cannot be measured reliably. The IASB concluded that a contingent liability assumed in a business combination should be recognised only if it is a present obligation. Therefore, unlike the previous version of IFRS 3, the revised IFRS 3 does not permit the recognition of 'possible obligations'.
- BC276 Like its decision on the recognition of contingent liabilities assumed in a business combination, the IASB concluded that an acquirer should recognise a contingent asset acquired in a business combination only if it satisfies the definition of an asset in the *Framework*. However, the IASB observed that the definition of a contingent asset in IAS 37 includes only 'possible assets'. A contingent asset arises when it is uncertain whether an entity has an asset at the end of the reporting period, but it is expected that some future event will confirm whether the entity has an asset. Accordingly, the IASB concluded that contingent assets should not be recognised, even if it is virtually certain that they will become unconditional or non-contingent. If an entity determines that an asset exists at the acquisition date (ie that it has an unconditional right at the acquisition date), that asset is not a contingent asset and should be accounted for in accordance with the appropriate IFRS.

BC276A In May 2020 the IASB added paragraph 23A to IFRS 3 to clarify the requirements for contingent assets. This amendment is explained further in paragraph BC114D(a).

BC276B The requirements for recognising contingent liabilities and contingent assets include both applications of and exceptions to the recognition principle. The IASB located all these requirements in the section headed ‘exceptions to the recognition principle’ because it concluded the requirements are clearest if they are all located together.

#### *Convergence*

BC277 The result of the FASB’s and the IASB’s conclusions on recognising assets and liabilities arising from contingencies is that the criteria for determining which items to recognise at the acquisition date differ, at least for the short term. That lack of convergence is inevitable at this time, given the status of the IASB’s redeliberations on its revision of IAS 37 and the fact that the FASB had no project on its agenda to reconsider the requirements of SFAS 5 while the boards were developing the revised standards. (The FASB added a project to reconsider the accounting for contingencies to its agenda in September 2007.) To attempt to converge on guidance for recognising assets and liabilities arising from contingencies in a business combination now would run the risk of establishing requirements for a business combination that would be inconsistent with the eventual requirements for assets and liabilities arising from contingencies acquired or incurred by means other than a business combination.

BC278 However, the boards observed that the assets or liabilities arising from contingencies that are recognised in accordance with the FASB’s recognition guidance and the contingent liabilities recognised in accordance with the IASB’s recognition guidance will be measured consistently. In other words, the initial measurement requirements for assets and liabilities arising from contingencies recognised at the acquisition date have converged. However, the boards acknowledge that the subsequent measurement requirements differ because SFAS 5’s measurement guidance differs from that in IAS 37. The reasons for the boards’ conclusion on measuring those assets and liabilities are discussed in paragraphs BC224–BC245.

#### *Exceptions to both the recognition and measurement principles*

##### **Income taxes**

BC279 The 2005 Exposure Draft proposed, and the revised standards require, that a deferred tax asset or liability should be recognised and measured in accordance with either IAS 12 *Income Taxes* or FASB Statement No. 109 *Accounting for Income Taxes* (SFAS 109) respectively. IAS 12 and SFAS 109 establish requirements for recognising and measuring deferred tax assets and liabilities—requirements that are not necessarily consistent with the recognition and measurement principles in the revised standards.

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BC280 The boards considered identifying deferred tax assets and liabilities as an exception to only the measurement principle because most, if not all, of the requirements of IAS 12 and SFAS 109 are arguably consistent with the revised standards' recognition principle. The recognition principle requires the acquirer to recognise at the acquisition date the assets acquired and liabilities assumed that meet the conceptual definition of an asset or a liability at that date. However, the boards concluded that exempting deferred tax assets and liabilities from both the recognition and the measurement principles would more clearly indicate that the acquirer should apply the recognition and measurement provisions of IAS 12 and SFAS 109 and their related interpretations or amendments.

BC281 Deferred tax assets or liabilities generally are measured at undiscounted amounts in accordance with IAS 12 and SFAS 109. The boards decided not to require deferred tax assets or liabilities acquired in a business combination to be measured at fair value because they observed that:

- (a) if those assets and liabilities were measured at their acquisition-date fair values, their subsequent measurement in accordance with IAS 12 or SFAS 109 would result in reported post-combination gains or losses in the period immediately following the acquisition even though the underlying economic circumstances did not change. That would not faithfully represent the results of the post-combination period and would be inconsistent with the notion that a business combination that is a fair value exchange should not give rise to the recognition of immediate post-combination gains or losses.
- (b) to measure those assets and liabilities at their acquisition-date fair values and overcome the reporting problem noted in (a) would require a comprehensive consideration of whether and how to modify the requirements of IAS 12 and SFAS 109 for the subsequent measurement of deferred tax assets or liabilities acquired in a business combination. Because of the complexities of IAS 12 and SFAS 109 and the added complexities that would be involved in tracking deferred tax assets acquired and liabilities assumed in a business combination, the boards concluded that the benefits of applying the revised standards' fair value measurement principle would not warrant the costs or complexities that would cause.

Respondents to the 2005 Exposure Draft generally supported that exception to the fair value measurement requirements.

BC282 To align IAS 12 and SFAS 109 more closely and to make the accounting more consistent with the principles in the revised standards, the boards decided to address four specific issues pertaining to the acquirer's income tax accounting in connection with a business combination:

- (a) accounting for a change in the acquirer's recognised deferred tax asset that results from a business combination;



- (b) accounting for a change after the acquisition date in the deferred tax benefits for the acquiree's deductible temporary differences or operating loss or tax credit carryforwards acquired in a business combination;
- (c) accounting for tax benefits arising from tax-deductible goodwill in excess of goodwill for financial reporting; and
- (d) accounting for changes after the acquisition date in the uncertainties pertaining to acquired tax positions.

BC283 The boards addressed the first issue because the existing requirements of IAS 12 and SFAS 109 differed, with IAS 12 accounting for a change in recognised deferred tax assets separately from the business combination and SFAS 109 including a change in the acquirer's valuation allowance for its deferred tax asset in the business combination accounting. The FASB decided to converge with the IAS 12 requirement on the first issue, which the IASB decided to retain. Thus, the acquirer would recognise the change in its recognised deferred tax assets as income or expense (or a change in equity), as required by IAS 12, in the period of the business combination.

BC284 Because the boards considered the first issue primarily in an attempt to achieve convergence, they limited their consideration to the requirements of IAS 12 and SFAS 109. The FASB acknowledged that both alternatives are defensible on conceptual grounds. However, it concluded that on balance the benefits of converging with the IAS 12 method outweigh the costs related to a change in the accounting in accordance with SFAS 109. SFAS 141(R) therefore amends SFAS 109 accordingly.

BC285 Most of the respondents to the 2005 Exposure Draft supported its proposal on accounting for changes to the acquirer's own deferred taxes in conjunction with a business combination. But some disagreed; they said that an acquirer factors its expected tax synergies into the price it is willing to pay for the acquiree, and therefore those tax synergies constitute goodwill. Those respondents were concerned about the potential for double-counting the synergies once in the consideration and a second time by separately recognising the changes in the acquirer's income taxes.

BC286 The boards acknowledged that in some situations a portion of the tax synergies might be factored into the price paid in the business combination. However, they concluded that it would be difficult, if not impossible, to identify that portion. In addition, an acquirer would not pay more for an acquiree because of tax synergies unless another bidder would also pay more; an acquirer would not knowingly pay more than necessary for the acquiree. Therefore, in some situations none (or only a very small portion) of the tax synergies are likely to be factored into the price paid. The boards also observed that the revised standards (paragraph 51 of the revised IFRS 3) require only the portion of the consideration transferred for the acquiree and the assets acquired and liabilities assumed in the exchange for the acquiree to be included in applying the acquisition method. Excluding effects on the acquirer's ability to utilise its deferred tax asset is consistent with that

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requirement. Therefore, the boards decided to retain the treatment of changes in an acquirer's tax assets and liabilities proposed in the 2005 Exposure Draft.

- BC287 The revised standards also amend IAS 12 and SFAS 109 to require disclosure of the amount of the deferred tax benefit (or expense) recognised in income in the period of the acquisition for the reduction (or increase) of the acquirer's valuation allowance for its deferred tax asset that results from a business combination. The boards decided that disclosure of that amount is necessary to enable users of the acquirer's financial statements to evaluate the nature and financial effect of a business combination.
- BC288 The second issue listed in paragraph BC282 relates to changes after the acquisition date in the amounts recognised for deferred tax benefits acquired in a business combination. IAS 12 and SFAS 109 both required subsequent recognition of acquired tax benefits to reduce goodwill. However, IAS 12 and SFAS 109 differed in that:
- (a) IAS 12 did not permit the reduction of other non-current intangible assets, which SFAS 109 required; and
  - (b) IAS 12 required the recognition of offsetting income and expense in the acquirer's profit or loss when subsequent changes are recognised.
- BC289 In developing the 2005 Exposure Draft, the FASB concluded that the fair value of other long-lived assets acquired in a business combination should no longer be reduced for changes in a valuation allowance after the acquisition date. That decision is consistent with the boards' decision not to adjust other acquired assets or assumed liabilities, with a corresponding adjustment to goodwill, for the effects of other events occurring after the acquisition date.
- BC290 Few respondents to the 2005 Exposure Draft addressed this issue, and the views of those who commented differed. Some favoured providing for reduction of goodwill indefinitely because they view the measurement exception for deferred tax assets as resulting in a measure that is drastically different from fair value. Those who supported not permitting the indefinite reduction of goodwill said that, conceptually, changes in estimates pertaining to deferred taxes recognised in a business combination should be treated the same as other revisions to the amounts recorded at acquisition. The boards agreed with those respondents that a measurement exception should not result in potentially indefinite adjustments to goodwill. The revised standards provide other limited exceptions to the recognition and measurement principles, for example, for employee benefits—none of which result in indefinite adjustments to goodwill for subsequent changes.
- BC291 The 2005 Exposure Draft proposed a rebuttable presumption that the subsequent recognition of acquired tax benefits within one year of the acquisition date should be accounted for by reducing goodwill. The rebuttable presumption could have been overcome if the subsequent recognition of the tax benefits resulted from a discrete event or circumstance occurring after the acquisition date. Recognition of acquired tax benefits after the one-year period would be accounted for in profit or loss (or, if IAS 12 or SFAS 109 so requires, outside profit or loss). Respondents suggested particular modifications to that

proposal, including removing the rebuttable presumption about subsequent recognition of acquired tax benefits within one year of the acquisition date and treating increases and decreases in deferred tax assets consistently. (IAS 12 and SFAS 109 provided guidance on accounting for decreases.) The boards agreed with those suggestions and revised the requirements of the revised standards accordingly.

- BC292 As described in paragraph BC282(c), the boards considered whether a deferred tax asset should be recognised in a business combination for any excess amount of tax-deductible goodwill over the goodwill for financial reporting purposes (excess tax goodwill). From a conceptual standpoint, the excess tax goodwill meets the definition of a temporary difference. Not recognising the tax benefit of that temporary difference at the date of the business combination would be inappropriate and inconsistent with IAS 12 and SFAS 109; it would also be inconsistent with the recognition principle in the revised standards. Thus, the revised IFRS 3 clarifies IAS 12 and SFAS 141(R) amends SFAS 109 accordingly.
- BC293 On the issue in paragraph BC282(d), respondents to the 2005 Exposure Draft suggested that the revised standards should address how to account for subsequent adjustments to amounts recognised for acquired income tax uncertainties. Respondents supported accounting for subsequent adjustments to amounts recognised for tax uncertainties using the same approach as the accounting for subsequent adjustments to acquired deferred tax benefits.
- BC294 The FASB agreed with respondents' suggestion that an acquirer should recognise changes to acquired income tax uncertainties after the acquisition in the same way as changes in acquired deferred tax benefits. Therefore, SFAS 141(R) amends FASB Interpretation No. 48 *Accounting for Uncertainty in Income Taxes* (FASB Interpretation 48) to require a change to an acquired income tax uncertainty within the measurement period that results from new information about facts and circumstances that existed at the acquisition date to be recognised through a corresponding adjustment to goodwill. If that reduces goodwill to zero, an acquirer would recognise any additional increases of the recognised income tax uncertainty as a reduction of income tax expense. All other changes in the acquired income tax uncertainties would be accounted for in accordance with FASB Interpretation 48.
- BC295 The IASB also considered whether to address the accounting for changes in acquired income tax uncertainties in a business combination. IAS 12 is silent on income tax uncertainties. The IASB is considering tax uncertainties as part of the convergence income tax project. Therefore, the IASB decided not to modify IAS 12 as part of this project to address specifically the accounting for changes in acquired income tax uncertainties in a business combination.

#### **Employee benefits**

- BC296 The revised standards provide exceptions to both the recognition and measurement principles for liabilities and any related assets resulting from the employee benefit arrangements of an acquiree. The acquirer is required to recognise and measure those assets and liabilities in accordance with IAS 19 or applicable US GAAP.

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- BC297 As with deferred tax assets and liabilities, the boards considered identifying employee benefits as an exception only to the measurement principle. The boards concluded that essentially the same considerations discussed in paragraph BC280 for deferred tax assets and liabilities also apply to employee benefits. In addition, the FASB observed that FASB Statements No. 43 *Accounting for Compensated Absences* and 112 *Employers' Accounting for Postemployment Benefits* require recognition of a liability for compensated absences or post-employment benefits, respectively, only if payment is probable. Arguably, a liability for those benefits exists, at least in some circumstances, regardless of whether payment is probable. Accordingly, to make it clear that the acquirer should apply the recognition and measurement requirements of IAS 19 or applicable US GAAP without separately considering the extent to which those requirements are consistent with the principles in the revised standards, the boards exempted employee benefit obligations from both the recognition and the measurement principles.
- BC298 The FASB decided to amend FASB Statements No. 87 *Employers' Accounting for Pensions* (SFAS 87) and 106 *Employers' Accounting for Postretirement Benefits Other Than Pensions* (SFAS 106) to require the acquirer to exclude from the liability it recognises for a single-employer pension or other post-retirement benefit plan the effects of expected plan amendments, terminations or curtailments that it has no obligation to make at the acquisition date. However, those amendments also require the acquirer to include in the liability it recognises at the acquisition date the expected withdrawal liability for a multi-employer plan if it is probable at that date that the acquirer will withdraw from the plan. For a pension or other post-retirement benefit plan, the latter requirement brings into the authoritative literature a provision that previously appeared only in the Basis for Conclusions on SFASs 87 and 106. The FASB acknowledges that the provisions for single-employer and multi-employer plans are not necessarily consistent, and it considered amending SFASs 87 and 106 to require recognition of withdrawal liabilities not yet incurred in post-combination financial statements of the periods in which withdrawals occur. However, it observed that the liability recognised upon withdrawal from a multi-employer plan represents the previously unrecognised portion of the accumulated benefits obligation, which is recognised as it arises for a single-employer plan. In addition, the FASB observed that some might consider the employer's contractual obligation upon withdrawal from a multi-employer plan an unconditional obligation to 'stand ready' to pay if withdrawal occurs and therefore a present obligation. Therefore, the FASB decided not to require the same accounting for expected withdrawals from a multi-employer plan as it requires for expected terminations or curtailments of a single-employer plan.
- BC299 The effect of the revised standards' measurement exception for liabilities and any related assets resulting from the acquiree's employee benefit plans is more significant than the related recognition exception. The boards concluded that it was not feasible to require all employee benefit obligations assumed in a business combination to be measured at their acquisition-date fair values. To do so would effectively require the boards to reconsider comprehensively the relevant standards for those employee benefits as a part of their business

combinations projects. Given the complexities in accounting for employee benefit obligations in accordance with existing requirements, the boards decided that the only practicable alternative is to require those obligations, and any related assets, to be measured in accordance with their applicable standards.

- BC300 The 2005 Exposure Draft proposed exempting only employee benefits subject to SFASs 87 and 106 from its fair value measurement requirement. Some respondents observed that existing measurement requirements for other types of employee benefits are not consistent with fair value and said that those benefits should also be exempted. The FASB agreed and modified the measurement exception for employee benefits accordingly.

#### **Indemnification assets**

- BC301 A few constituents asked about the potential inconsistency if an asset for an indemnification is measured at fair value at the acquisition date and the related liability is measured using a different measurement attribute. Members of the FASB's resource group raised the issue primarily in the context of FASB Interpretation 48, which requires an entity to measure a tax position that meets the more-likely-than-not recognition threshold at the largest amount of tax benefit that is more than 50 per cent likely to be realised upon ultimate settlement with a taxing authority.
- BC302 The boards understand that a business combination sometimes includes an indemnification agreement under which the former owners of the acquiree are required to reimburse the acquirer for any payments the acquirer eventually makes upon settlement of a particular liability. If the indemnification pertains to uncertainty about a position taken in the acquiree's tax returns for prior years or to another item for which the revised standards provide a recognition or measurement exception, not providing a related exception for the indemnification asset would result in recognition or measurement anomalies. For example, for an indemnification pertaining to a deferred tax liability, the acquirer would recognise at the acquisition date a liability to the taxing authority for the deferred taxes and an asset for the indemnification due from the former owners of the acquiree. In the absence of an exception, the asset would be measured at fair value, and the liability would be measured in accordance with the pertinent income tax accounting requirements, such as FASB Interpretation 48 for an entity that applies US GAAP, because income taxes are an exception to the fair value measurement principle. Those two amounts would differ. The boards agreed with constituents that an asset representing an indemnification related to a specific liability should be recognised and measured on the same basis as that liability.
- BC303 The boards also provided an exception to the recognition principle for indemnification assets. The reasons for that exception are much the same as the reasons why the boards exempted deferred tax assets and liabilities and employee benefits from that principle. Providing an exception to the recognition principle for indemnification assets clarifies that the acquirer does not apply that principle in determining whether or when to recognise such an

asset. Rather, the acquirer recognises the asset when it recognises the related liability. Therefore, the revised standards provide an exception to the recognition and measurement principles for indemnification assets.

*Exceptions to the measurement principle*

BC304 In addition to the exceptions to both the recognition and measurement principles discussed above, the revised standards provide exceptions to the measurement principle for particular types of assets acquired or liabilities assumed in a business combination. Those exceptions are discussed in paragraphs BC305–BC311.

**Temporary exception for assets held for sale**

BC305 The 2005 Exposure Draft proposed that non-current assets qualifying as held for sale at the acquisition date under IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* or FASB Statement No. 144 *Accounting for the Impairment or Disposal of Long-Lived Assets* (SFAS 144) should be measured as those standards require—at fair value less costs to sell. The purpose of that proposed exception was to avoid the need to recognise a loss for the selling costs immediately after a business combination (referred to as a *Day 2 loss* because in theory it would be recognised on the day after the acquisition date). That Day 2 loss would result if the assets were initially measured at fair value but the acquirer then applied either IFRS 5 or SFAS 144, requiring measurement at fair value less costs to sell, for subsequent accounting. Because that loss would stem entirely from different measurement requirements for assets held for sale acquired in a business combination and for assets already held that are classified as held for sale, the reported loss would not faithfully represent the activities of the acquirer.

BC306 After considering responses to the 2005 Exposure Draft, the boards decided that the exception to the measurement principle for assets held for sale should be eliminated. The definitions of fair value<sup>22</sup> in the revised standards, and their application in other areas focuses on market data. Costs that a buyer (acquirer) incurs to purchase or expects to incur to sell an asset are excluded from the amount at which an asset is measured. The boards concluded that disposal costs should also be excluded from the measurement of assets held for sale.

BC307 However, avoiding the Day 2 loss described in paragraph BC305 will require the boards to amend IFRS 5 and SFAS 144 to require assets classified as held for sale to be measured at fair value rather than at fair value less costs to sell. The boards decided to do that, but their respective due process procedures require those amendments to be made in separate projects to give constituents the opportunity to comment on the proposed changes. Although the boards intend the amendments of IFRS 5 and SFAS 144 to be effective at the same time as the revised standards, they decided as an interim step to include a measurement exception until completion of the amendments.

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<sup>22</sup> IFRS 13, issued in May 2011, defines fair value and describes the effect that transaction costs have on a fair value measurement.

**Reacquired rights**

- BC308 The revised standards (paragraph 29 of the revised IFRS 3) require the fair value of a reacquired right recognised as an intangible asset to be measured on the basis of the remaining contractual term of the contract that gave rise to the right, without taking into account potential renewals of that contract. In developing the 2005 Exposure Draft, the boards observed that a reacquired right is no longer a contract with a third party. An acquirer who controls a reacquired right could assume indefinite renewals of its contractual term, effectively making the reacquired right an intangible asset with an indefinite life. (The boards understood that some entities had been classifying reacquired rights in that way.) The boards concluded that a right reacquired from an acquiree has in substance a finite life; a renewal of the contractual term after the business combination is not part of what was acquired in the business combination. Accordingly, the 2005 Exposure Draft proposed, and the revised standards require, limiting the period over which the intangible asset is amortised (its useful life) to the remaining contractual term of the contract from which the reacquired right stems.
- BC309 The 2005 Exposure Draft did not include guidance on determining the fair value of a reacquired right. Some constituents indicated that determining that value is a problem in practice, and the boards agreed that the revised standards should include guidance on that point. To be consistent with the requirement for determining the useful life of a reacquired right, the boards concluded that the fair value of the right should be based on the remaining term of the contract giving rise to the right. The boards acknowledge that market participants would generally reflect expected renewals of the term of a contractual right in the fair value of a right traded in the market. The boards decided, however, that determining the fair value of a reacquired right in that manner would be inconsistent with amortising its value over the remaining contractual term. The boards also observed that a contractual right transferred to a third party (traded in the market) is not a **reacquired** right. Accordingly, the boards decided that departing from the assumptions that market participants would use in measuring the fair value of a reacquired right is appropriate.
- BC310 A few constituents asked for guidance on accounting for the sale of a reacquired right after the business combination. The boards concluded that the sale of a reacquired right is in substance the sale of an intangible asset, and the revised standards require the sale of a reacquired right to be accounted for in the same way as sales of other assets (paragraph 55 of the revised IFRS 3). Thus, the carrying amount of the right is to be included in determining the gain or loss on the sale.

**Share-based payment awards**

- BC311 FASB Statement No. 123 (revised 2004) *Share-Based Payment* (SFAS 123(R)) requires measurement of share-based payment awards using what it describes as the *fair-value-based method*. IFRS 2 *Share-based Payment* requires essentially the same measurement method, which the revised IFRS 3 refers to as the *market-based measure*. For reasons identified in those standards, application of the measurement methods they require generally does not result in the

amount at which market participants would exchange an award at a particular date—its fair value at that date. Therefore, the revised standards provide an exception to the measurement principle for share-based payment awards. The reasons for that exception are essentially the same as the reasons already discussed for other exceptions to its recognition and measurement principles that the revised standards provide. For example, as with both deferred tax assets and liabilities and assets and liabilities related to employee benefit arrangements, initial measurement of share-based payment awards at their acquisition-date fair values would cause difficulties with the subsequent accounting for those awards in accordance with IFRS 2 or SFAS 123(R).

*Un-replaced and voluntarily replaced share-based payment transactions*

- BC311A In *Improvements to IFRSs* issued in May 2010, the Board addressed a concern that there was insufficient application guidance for share-based payment transactions that are replaced in the context of a business combination. After the revised IFRS 3 was issued in 2008, some constituents raised concerns about the lack of explicit guidance with respect to share-based payment transactions of the acquiree that the acquirer chooses to replace, even though either they are unaffected by the business combination or vesting is accelerated as a consequence of the business combination. In addition, some were concerned that the measurement guidance for share-based payment transactions applies only to replacement awards but not to acquiree awards that the acquirer chooses not to replace. In response to those concerns, the Board added explicit guidance in paragraphs B56 and B62A to clarify that those awards should be accounted for in the same way as acquiree awards that the acquirer is obliged to replace.
- BC311B Employee share-based payment awards might expire in the event of a business combination. When this occurs, the acquirer may choose to grant a new award to those employees voluntarily. The new award granted in such circumstances can only be for future services, because the acquirer has no obligation to the employees in respect of past services that they provided to the acquiree. Accordingly, paragraph B56 requires the whole of the market-based value of the new award to be accounted for as a post-combination expense, which is recognised in accordance with IFRS 2. This accounting treatment is different from that required in circumstances when the employee share-based payment award does not expire in the event of a business combination. When an unexpired award is replaced by the acquirer, part of the market-based value of the replacement award reflects the acquiree's obligation that remains outstanding at the date of the business combination, and is accounted for as part of the consideration transferred in the business combination. The balance of the market-based value of the replacement award is accounted for as a post-combination expense for the services to be received over the period to when the replacement award vests, in accordance with IFRS 2. The accounting for the replacement of unexpired awards is the same for awards that are replaced voluntarily by the acquirer and those that the acquirer is obliged to replace because the substance is the same in both circumstances.



## Recognising and measuring goodwill or a gain from a bargain purchase

- BC312 Consistently with IFRS 3 and SFAS 141, the revised standards require the acquirer to recognise goodwill as an asset and to measure it as a residual.

### Goodwill qualifies as an asset

- BC313 The FASB's 1999 and 2001 Exposure Drafts listed six components of the amount that in practice, under authoritative guidance in effect at that time, had been recognised as goodwill. The IASB's ED 3 included a similar, but not identical, discussion. The components and their descriptions, taken from the FASB's exposure drafts, were:

Component 1 – The excess of the fair values over the book values of the acquiree's net assets at the date of acquisition.

Component 2 – The fair values of other net assets that the acquiree had not previously recognised. They may not have been recognised because they failed to meet the recognition criteria (perhaps because of measurement difficulties), because of a requirement that prohibited their recognition, or because the acquiree concluded that the costs of recognising them separately were not justified by the benefits.

Component 3 – The fair value of the *going concern* element of the acquiree's existing business. The going concern element represents the ability of the established business to earn a higher rate of return on an assembled collection of net assets than would be expected if those net assets had to be acquired separately. That value stems from the synergies of the net assets of the business, 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 – either legal or because of transaction costs – by potential competitors).

Component 4 – The fair value of the expected synergies and other benefits from combining the acquirer's and acquiree's net assets and businesses. Those synergies and other benefits are unique to each combination, and different combinations would produce different synergies and, hence, different values.

Component 5 – Overvaluation of the consideration paid by the acquirer stemming from errors in valuing the consideration tendered. Although the purchase price in an all-cash transaction would not be subject to measurement error, the same may not necessarily be said of a transaction involving the acquirer's equity interests. For example, the number of ordinary shares being traded daily may be small relative to the number of shares issued in the combination. If so, imputing the current market price to all of the shares issued to effect the combination may produce a higher value than those shares would command if they were sold for cash and the cash then used to effect the combination.

Component 6—Overpayment or underpayment by the acquirer. Overpayment might occur, for example, if the price is driven up in the course of bidding for the acquiree; underpayment may occur in a distress sale (sometimes termed a fire sale).

- BC314 The boards observed that the first two components, both of which relate to the acquiree, are conceptually not part of goodwill. The first component is not itself an asset; instead, it reflects gains that the acquiree had not recognised on its net assets. As such, that component is part of those assets rather than part of goodwill. The second component is also not part of goodwill conceptually; it primarily reflects intangible assets that might be recognised as individual assets.
- BC315 The fifth and sixth components, both of which relate to the acquirer, are also not conceptually part of goodwill. The fifth component is not an asset in and of itself or even part of an asset but, rather, is a measurement error. The sixth component is also not an asset; conceptually it represents a loss (in the case of overpayment) or a gain (in the case of underpayment) to the acquirer. Thus, neither of those components is conceptually part of goodwill.
- BC316 The boards also observed that the third and fourth components are part of goodwill. The third component relates to the acquiree and reflects the excess assembled value of the acquiree's net assets. It represents the pre-existing goodwill that was either internally generated by the acquiree or acquired by it in prior business combinations. The fourth component relates to the acquiree and the acquirer jointly and reflects the excess assembled value that is created by the combination—the synergies that are expected from combining those businesses. The boards described the third and fourth components collectively as 'core goodwill'.
- BC317 The revised standards try to avoid subsuming the first, second and fifth components of goodwill into the amount initially recognised as goodwill. Specifically, an acquirer is required to make every effort:
- (a) to measure the consideration accurately (eliminating or reducing component 5);
  - (b) to recognise the identifiable net assets acquired at their fair values rather than their carrying amounts (eliminating or reducing component 1); and
  - (c) to recognise all acquired intangible assets meeting the criteria in the revised standards (paragraph B31 of the revised IFRS 3) so that they are not subsumed into the amount initially recognised as goodwill (reducing component 2).
- BC318 In developing IFRS 3 and SFAS 141, the IASB and the FASB both considered whether 'core goodwill' (the third and fourth components) qualifies as an asset under the definition in their respective conceptual frameworks. (That consideration was based on the existing conceptual frameworks. In 2004, the IASB and the FASB began work on a joint project to develop an improved conceptual framework that, among other things, would eliminate both substantive and wording differences between their existing frameworks.

Although the asset definition is likely to change as a result of that project, the boards observed that nothing in their deliberations to date indicates that any such changes are likely to call into question whether goodwill continues to qualify as an asset.)

*Asset definition in the FASB's Concepts Statement 6*

BC319 Paragraph 172 of the FASB's Concepts Statement 6 says that an item that has future economic benefits has the capacity to serve the entity by being exchanged for something else of value to the entity, by being used to produce something of value to the entity or by being used to settle its liabilities.

BC320 The FASB noted that goodwill cannot be exchanged for something else of value to the entity and it cannot be used to settle the entity's liabilities. Goodwill also lacks the capacity singly to produce future net cash inflows, although it can—in combination with other assets—produce cash flows. Thus, the future benefit associated with goodwill is generally more nebulous and may be less certain than the benefit associated with most other assets. Nevertheless, goodwill generally provides future economic benefit. The FASB's Concepts Statement 6 observes that 'Anything that is commonly bought and sold has future economic benefit, including the individual items that a buyer obtains and is willing to pay for in a "basket purchase" of several items or in a business combination' (paragraph 173).

BC321 For the future economic benefit embodied in goodwill to qualify as an asset, the acquirer must control that benefit. The FASB observed that the acquirer's control is demonstrated by means of its ability to direct the policies and management of the acquiree. The FASB also observed that the past transaction or event necessary for goodwill to qualify as the acquirer's asset is the transaction in which it obtained the controlling interest in the acquiree.

*Asset definition in the IASB's Framework*

BC322 Paragraph 53 of the IASB's *Framework* explains 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 entity.'

BC323 The IASB concluded that core goodwill represents resources from which future economic benefits are expected to flow to the entity. In considering whether core goodwill represents a resource **controlled** by the entity, the IASB considered the assertion that core goodwill arises, at least in part, through factors such as a well-trained workforce, loyal customers and so on, and that these factors cannot be regarded as controlled by the entity because the workforce could leave and the customers could go elsewhere. However, the IASB, like the FASB, concluded that control of core goodwill is provided by means of the acquirer's power to direct the policies and management of the acquiree. Therefore, both the IASB and the FASB concluded that core goodwill meets the conceptual definition of an asset.

*Relevance of information about goodwill*

- BC324 In developing SFAS 141, the FASB also considered the relevance of information about goodwill. Although the IASB's Basis for Conclusions on IFRS 3 did not explicitly discuss the relevance of information about goodwill, the FASB's analysis of that issue was available to the IASB members as they developed IFRS 3, and they saw no reason not to accept that analysis.
- BC325 More specifically, in developing SFAS 141, the FASB considered the views of users as reported by the AICPA Special Committee<sup>23</sup> and as expressed by the Financial Accounting Policy Committee (FAPC) of the Association for Investment Management and Research (AIMR) in its 1993 position paper *Financial Reporting in the 1990s and Beyond*. The FASB observed that users have mixed views about whether goodwill should be recognised as an asset. Some are troubled by the lack of comparability between internally generated goodwill and acquired goodwill that results under present standards, but others do not appear to be particularly bothered by it. However, users appear to be reluctant to give up information about goodwill acquired in a business combination. In the view of the AICPA Special Committee, users want to retain the option of being able to use that information. Similarly, the FAPC said that goodwill should be recognised in financial statements.
- BC326 The FASB also considered the growing use of 'economic value added' (EVA)<sup>24</sup> and similar measures, which are increasingly being employed as means of assessing performance. The FASB observed that such measures commonly incorporate goodwill, and in business combinations accounted for by the pooling method, an adjustment was commonly made to incorporate a measure of the goodwill that was not recognised under that method. As a result, the aggregate amount of goodwill is included in the base that is subject to a capital charge that is part of the EVA measure and management is held accountable for the total investment in the acquiree.
- BC327 The FASB also considered evidence about the relevance of goodwill provided by a number of research studies that empirically examined the relationship between goodwill and the market value of business entities.<sup>25</sup> Those studies generally found a positive relationship between the reported goodwill of entities and their market values, thereby indicating that investors in the markets behave as if they view goodwill as an asset.

23 AICPA Special Committee on Financial Reporting, *Improving Business Reporting—A Customer Focus* (New York: AICPA, 1994).

24 EVA was developed by the consulting firm of Stern Stewart & Company (and is a registered trademark of Stern Stewart) as a financial performance measure that improves management's ability to make decisions that enhance shareholder value.

25 Refer to, for example, Eli Amir, Trevor S Harris and Elizabeth K Venuti, 'A Comparison of the Value-Relevance of U.S. versus Non-U.S. GAAP Accounting Measures Using Form 20-F Reconciliations', *Journal of Accounting Research*, Supplement (1993): 230–264; Mary Barth and Greg Clinch, 'International Accounting Differences and Their Relation to Share Prices: Evidence from U.K., Australian and Canadian Firms', *Contemporary Accounting Research* (spring 1996): 135–170; Keith W Chauvin and Mark Hirschey, 'Goodwill, Profitability, and the Market Value of the Firm', *Journal of Accounting and Public Policy* (summer 1994): 159–180; Ross Jennings, John Robinson, Robert B Thompson and Linda Duvall, 'The Relation between Accounting Goodwill Numbers and Equity Values', *Journal of Business Finance and Accounting* (June 1996): 513–533; and Mark G McCarthy and Douglas K Schneider, 'Market Perception of Goodwill: Some Empirical Evidence', *Accounting and Business Research* (winter 1995): 69–81.

### Measuring goodwill as a residual

BC328 The revised standards require the acquirer to measure goodwill as the excess of one amount (described in paragraph 32(a) of the revised IFRS 3) over another (described in paragraph 32(b) of the revised IFRS 3). Therefore, goodwill is measured as a residual, which is consistent with IFRS 3 and SFAS 141, in which the IASB and the FASB, respectively, concluded that direct measurement of goodwill is not possible. The boards did not reconsider measuring goodwill as a residual in the second phase of the business combinations project. However, the boards simplified the measurement of goodwill acquired in a business combination achieved in stages (a step acquisition). In accordance with IFRS 3 and SFAS 141, an entity that acquired another entity in a step acquisition measured goodwill by reference to the cost of each step and the related fair value of the underlying identifiable net assets acquired. This process was costly because it required the acquirer in a step acquisition to determine the amounts allocated to the identifiable net assets acquired at the date of each acquisition, even if those steps occurred years or decades earlier. In contrast, the revised standards require goodwill to be measured once—at the acquisition date. Thus, the revised standards reduce the complexity and costs of accounting for step acquisitions.

BC329 Both boards decided that all assets acquired and liabilities assumed, including those of an acquiree (subsidiary) that is not wholly-owned, as well as, in principle, any non-controlling interest in the acquiree, should be measured at their acquisition-date fair values (or in limited situations, their amounts determined in accordance with other US GAAP or IFRSs). Thus, SFAS 141(R) eliminates the past practice of not recognising the portion of goodwill related to the non-controlling interests in subsidiaries that are not wholly-owned. However, as discussed in paragraphs BC209–BC211, the IASB concluded that the revised IFRS 3 should permit entities to measure any non-controlling interest in an acquiree as its proportionate share of the acquiree's identifiable net assets. If an entity chooses that alternative, only the goodwill related to the acquirer is recognised.

### *Using the acquisition-date fair value of consideration to measure goodwill*

BC330 As discussed in paragraph BC81, the revised standards do not focus on measuring the acquisition-date fair value of either the acquiree as a whole or the acquirer's interest in the acquiree as the 2005 Exposure Draft did. Consistently with that change, the boards also eliminated the presumption in the 2005 Exposure Draft that, in the absence of evidence to the contrary, the acquisition-date fair value of the consideration transferred is the best evidence of the fair value of the acquirer's interest in the acquiree at that date. Therefore, the revised standards describe the measurement of goodwill in terms of the recognised amount of the consideration transferred—generally its acquisition-date fair value (paragraph 32 of the revised IFRS 3)—and specify how to measure goodwill if the fair value of the acquiree is more reliably measurable than the fair value of the consideration transferred or if no consideration is transferred (paragraph 33 of the revised IFRS 3).

BC331 Because business combinations are generally exchange transactions in which knowledgeable, unrelated willing parties exchange equal values, the boards continue to believe that the acquisition-date fair value of the consideration transferred provides the best evidence of the acquisition-date fair value of the acquirer's interest in the acquiree in many, if not most, situations. However, that is not the case if the acquirer either makes a bargain purchase or pays more than the acquiree is worth at the acquisition date if the acquirer underpays or overpays. The revised standards provide for recognising a gain in the event of a bargain purchase, but they do not provide for recognising a loss in the event of an overpayment (paragraph BC382). Therefore, the boards concluded that focusing directly on the fair value of the consideration transferred rather than on the fair value of the acquirer's interest in the acquiree, with a presumption that the two amounts are usually equal, would be a more straightforward way of describing how to measure goodwill. (The same conclusion applies to measuring the gain on a bargain purchase, which is discussed in paragraphs BC371–BC381.) That change in focus will also avoid unproductive disputes in practice about whether the consideration transferred or another valuation technique provides the best evidence for measuring the acquirer's interest in the acquiree in a particular situation.

*Using the acquirer's interest in the acquiree to measure goodwill*

BC332 The boards acknowledge that in the absence of measurable consideration, the acquirer is likely to incur costs to measure the acquisition-date fair value of its interest in the acquiree and incremental costs to have that measure independently verified. The boards observed that in many of those circumstances companies already incur such costs as part of their due diligence procedures. For example, an acquisition of a privately held entity by another privately held entity is often accomplished by an exchange of equity shares that do not have observable market prices. To determine the exchange ratio, those entities generally engage advisers and valuation experts to assist them in valuing the acquiree as well as the equity transferred by the acquirer in exchange for the acquiree. Similarly, a combination of two mutual entities is often accomplished by an exchange of member interests of the acquirer for all of the member interests of the acquiree. In many, but not necessarily all, of those cases the directors and managers of the entities also assess the relative fair values of the combining entities to ensure that the exchange of member interests is equitable to the members of both entities.

BC333 The boards concluded that the benefits in terms of improved financial information resulting from the revised standards outweigh the incremental measurement costs that the revised standards may require. Those improvements include the increased relevance and understandability of information resulting from applying the revised standards' measurement principle and guidance on recognising and measuring goodwill, which are consistent with reflecting the change in economic circumstances that occurs at that date.

- BC334 The 2005 Exposure Draft included illustrative guidance for applying the fair value measurement requirement if no consideration is transferred or the consideration transferred is not the best evidence of the acquisition-date fair value of the acquiree. That illustrative guidance drew on related guidance in the FASB's exposure draft that preceded SFAS 157. Because SFAS 157 provides guidance on using valuation techniques such as the market approach and the income approach for measuring fair value, the FASB decided that it is unnecessary for SFAS 141(R) to provide the same guidance.
- BC335 The IASB decided not to include in the revised IFRS 3 guidance on using valuation techniques to measure the acquisition-date fair value of the acquirer's interest in the acquiree. The IASB has on its agenda a project to develop guidance on measuring fair value. While deliberations on that project are in progress, the IASB considers it inappropriate to include fair value measurement guidance in IFRSs.
- BC336 The FASB, on the other hand, completed its project on fair value measurement when it issued SFAS 157. SFAS 141(R), together with SFAS 157, provides broadly applicable measurement guidance that is relevant and useful in measuring the acquirer's interest in the acquiree. However, both boards were concerned that without some discussion of special considerations for measuring the fair value of mutual entities, some acquirers might neglect to consider relevant assumptions that market participants would make about future member benefits when using a valuation technique. For example, the acquirer of a co-operative entity should consider the value of the member discounts in its determination of the fair value of its interest in the acquiree. Therefore, the boards decided to include a discussion of special considerations in measuring the fair value of mutual entities (paragraphs B47–B49 of the revised IFRS 3).<sup>26</sup>

**Measuring consideration and determining whether particular items are part of the consideration transferred for the acquiree**

- BC337 Paragraphs BC338–BC360 discuss the boards' conclusions on measuring specific items of consideration that are often transferred by acquirers. Paragraphs BC361–BC370 then discuss whether particular replacement awards of share-based remuneration and acquisition-related costs incurred by acquirers are part of the consideration transferred for the acquiree.

*Measurement date for equity securities transferred*

- BC338 The guidance in IFRS 3 and SFAS 141 on the measurement date for equity securities transferred as consideration in a business combination differed, and SFAS 141's guidance on that issue was contradictory. Paragraph 22 of SFAS 141, which was carried forward from APB Opinion 16, said that the market price for a reasonable period before and after the date that the terms of the acquisition are agreed to and announced should be considered in determining the fair value of the securities issued. That effectively established the agreement date as the measurement date for equity securities issued as

<sup>26</sup> The combination of IFRS 3 and IFRS 13, issued in May 2011, provides guidance for measuring the fair value of an acquirer's interest in the acquiree (including mutual entities).

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consideration. However, paragraph 49 of SFAS 141, which was also carried forward from APB Opinion 16, said that the cost of an acquiree should be determined as of the acquisition date. IFRS 3, on the other hand, required measuring the consideration transferred in a business combination at its fair value on the exchange date, which was the acquisition date for a combination in which control is achieved in a single transaction. (IFRS 3, like SFAS 141, included special guidance on determining the cost of a business combination in which control is achieved in stages.) In their deliberations leading to the 2005 Exposure Draft, the boards decided that the fair value of equity securities issued as consideration in a business combination should be measured at the acquisition date.

BC339 In reaching their conclusions on this issue, the boards considered the reasons for the consensus reached in EITF Issue No. 99-12 *Determination of the Measurement Date for the Market Price of Acquirer Securities Issued in a Purchase Business Combination*. That consensus states that the value of the acquirer's marketable equity securities issued to effect a business combination should be determined on the basis of the market price of the securities over a reasonable period before and after the terms of the acquisition are agreed to and announced. The arguments for that consensus are based on the view that the announcement of a transaction, and the related agreements, normally bind the parties to the transaction so that the acquirer is obliged at that point to issue the equity securities at the closing date. If the parties are bound to the transaction at the agreement (announcement) date, the value of the underlying securities on that date best reflects the value of the bargained exchange. The boards did not find those arguments compelling. The boards observed that to make the announcement of a recommended transaction binding generally requires shareholders' authorisation or another binding event, which also gives rise to the change in control of the acquiree.

BC340 Additionally, the boards noted that measuring the fair value of equity securities issued on the agreement date (or on the basis of the market price of the securities for a short period before and after that date) did not result in a consistent measure of the consideration transferred. The fair values of all other forms of consideration transferred are measured at the acquisition date. The boards decided that all forms of consideration transferred should be valued on the same date, which should also be the same date as when the assets acquired and liabilities assumed are measured. The boards also observed that negotiations between an acquirer and an acquiree typically provide for share adjustments in the event of material events and circumstances between the agreement date and acquisition date. In addition, ongoing negotiations after announcement of agreements, which are not unusual, provide evidence that agreements are generally not binding at the date they are announced. Lastly, the boards also observed that the parties typically provide for cancellation options if the number of shares to be issued at the acquisition date would not reflect an exchange of approximately equal fair values at that date.



BC341 Respondents to the 2005 Exposure Draft expressed mixed views on the measurement date for equity securities. Some supported the proposal to measure equity securities at their fair value on the acquisition date, generally for the same reasons given in that exposure draft. Others, however, favoured use of the agreement date. They generally cited one or more of the following as support for their view:

- (a) An acquirer and a target entity both consider the fair value of a target entity on the agreement date in negotiating the amount of consideration to be paid. Measuring equity securities issued as consideration at fair value on the agreement date reflects the values taken into account in negotiations.
- (b) Changes in the fair value of the acquirer's equity securities between the agreement date and the acquisition date may be caused by factors unrelated to the business combination.
- (c) Changes in the fair value of the acquirer's equity securities between the agreement date and the acquisition date may result in inappropriate recognition of either a bargain purchase or artificially inflated goodwill if the fair value of those securities is measured at the acquisition date.

BC342 In considering those comments, the boards observed, as they did in the 2005 Exposure Draft, that valid conceptual arguments can be made for both the agreement date and the acquisition date. However, they also observed that the parties to a business combination are likely to take into account expected changes between the agreement date and the acquisition date in the fair value of the acquirer and the market price of the acquirer's securities issued as consideration. The argument against acquisition date measurement of equity securities noted in paragraph BC341(a) is mitigated if acquirers and targets generally consider their best estimates at the agreement date of the fair values of the amounts to be exchanged on the acquisition dates. The boards also noted that measuring the equity securities on the acquisition date avoids the complexities of dealing with situations in which the number of shares or other consideration transferred can change between the agreement date and the acquisition date. The boards therefore concluded that equity instruments issued as consideration in a business combination should be measured at their fair values on the acquisition date.

*Contingent consideration, including subsequent measurement*

BC343 In accordance with the guidance in SFAS 141, which was carried forward from APB Opinion 16 without reconsideration, an acquirer's obligations to make payments conditional on the outcome of future events (often called *contingent consideration*) were not usually recognised at the acquisition date. Rather, acquirers usually recognised those obligations when the contingency was resolved and consideration was issued or became issuable. In general, issuing additional securities or distributing additional cash or other assets upon resolving contingencies on the basis of reaching particular earnings levels resulted in delayed recognition of an additional element of cost of an acquiree. In contrast, issuing additional securities or distributing additional assets upon

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resolving contingencies on the basis of security prices did not change the recognised cost of an acquiree.

- BC344 The IASB carried forward in IFRS 3 the requirements for contingent consideration from IAS 22 without reconsideration. In accordance with IFRS 3, an acquirer recognised consideration that is contingent on future events at the acquisition date only if it is probable and can be measured reliably. If the required level of probability or reliability for recognition was reached only after the acquisition date, the additional consideration was treated as an adjustment to the accounting for the business combination and to goodwill at that later date.
- BC345 Therefore, in accordance with both SFAS 141 and IFRS 3, unlike other forms of consideration, an obligation for contingent consideration was not always measured at its acquisition-date fair value and its remeasurement either sometimes (SFAS 141) or always (IFRS 3) resulted in an adjustment to the business combination accounting.
- BC346 In developing the 2005 Exposure Draft, both boards concluded that the delayed recognition of contingent consideration in their previous standards on business combinations was unacceptable because it ignored that the acquirer's agreement to make contingent payments is the obligating event in a business combination transaction. Although the amount of the future payments the acquirer will make is conditional on future events, the obligation to make them if the specified future events occur is unconditional. The same is true for a right to the return of previously transferred consideration if specified conditions are met. Failure to recognise that obligation or right at the acquisition date would not faithfully represent the economic consideration exchanged at that date. Thus, both boards concluded that obligations and rights associated with contingent consideration arrangements should be measured and recognised at their acquisition-date fair values.
- BC347 The boards considered arguments that it might be difficult to measure the fair value of contingent consideration at the acquisition date. The boards acknowledged that measuring the fair value of some contingent payments may be difficult, but they concluded that to delay recognition of, or otherwise ignore, assets or liabilities that are difficult to measure would cause financial reporting to be incomplete and thus diminish its usefulness in making economic decisions.
- BC348 Moreover, a contingent consideration arrangement is inherently part of the economic considerations in the negotiations between the buyer and seller. Such arrangements are commonly used by buyers and sellers to reach an agreement by sharing particular specified economic risks related to uncertainties about future outcomes. Differences in the views of the buyer and seller about those uncertainties are often reconciled by their agreeing to share the risks in such ways that favourable future outcomes generally result in additional payments to the seller and unfavourable outcomes result in no or lower payments. The boards observed that information used in those negotiations will often be helpful in estimating the fair value of the contingent obligation assumed by the acquirer.

- BC349 The boards noted that most contingent consideration obligations are financial instruments, and many are derivative instruments. Reporting entities that use such instruments extensively, auditors and valuation professionals are familiar with the use of valuation techniques for estimating the fair values of financial instruments. The boards concluded that acquirers should be able to use valuation techniques to develop estimates of the fair values of contingent consideration obligations that are sufficiently reliable for recognition. The boards also observed that an effective estimate of zero for the acquisition-date fair value of contingent consideration, which was often the result under IFRS 3 and SFAS 141, was unreliable.
- BC350 Some respondents to the 2005 Exposure Draft were especially concerned about the reliability with which the fair value of performance-based contingent consideration can be measured. The IASB and the FASB considered those concerns in the context of related requirements in their standards on share-based payments (IFRS 2 and SFAS 123(R), respectively), neither of which requires performance conditions that are not market conditions to be included in the market-based measure of an award of share-based payment at the grant date. For example, remuneration cost is recognised for a share option with vesting requirements that depend on achievement of an earnings target based on the number of equity instruments expected to vest and any such cost recognised during the vesting period is reversed if the target is not achieved. Both IFRS 2 and SFAS 123(R) cite constituents' concerns about the measurability at the grant date of the expected outcomes associated with performance conditions as part of the reason for that treatment.
- BC351 The boards concluded that the requirements for awards of share-based payment subject to performance conditions should not determine the requirements for contingent (or conditional) consideration in a business combination. In addition, the boards concluded that the negotiations between buyer and seller inherent in a contingent consideration arrangement in a business combination provide better evidence of its fair value than is likely to be available for most share-based payment arrangements with performance conditions.
- BC352 The boards also noted that some contingent consideration arrangements oblige the acquirer to deliver its equity securities if specified future events occur. The boards concluded that the classification of such instruments as either equity or a liability should be based on existing IFRSs or US GAAP, as indicated in paragraph 40 of the revised IFRS 3.

#### **Subsequent measurement of contingent consideration**

- BC353 For reasons similar to those discussed in the context of contingent liabilities (paragraphs BC232 and BC243), the boards concluded that the revised standards must address subsequent accounting for contingent consideration. For consistency with the accounting for other obligations that require an entity to deliver its equity shares, the boards concluded that obligations for contingent payments that are classified as equity should not be remeasured after the acquisition date.

## IFRS 3 BC

- BC354 The boards observed that many obligations for contingent consideration that qualify for classification as liabilities meet the definition of derivative instruments in IAS 39<sup>27</sup> or SFAS 133. To improve transparency in reporting particular instruments, the boards concluded that all contracts that would otherwise be within the scope of those standards (if not issued in a business combination) should be subject to their requirements if issued in a business combination. Therefore, the boards decided to eliminate their respective provisions (paragraph 2(f) of IAS 39 and paragraph 11(c) of SFAS 133) that excluded contingent consideration in a business combination from the scope of those standards. Accordingly, liabilities for payments of contingent consideration that are subject to the requirements of IAS 39 or SFAS 133 would subsequently be measured at fair value at the end of each reporting period, with changes in fair value recognised in accordance with whichever of those standards an entity applies in its financial statements.
- BC355 In considering the subsequent accounting for contingent payments that are liabilities but are not derivatives, the boards concluded that, in concept, all liabilities for contingent payments should be accounted for similarly. Therefore, liabilities for contingent payments that are not derivative instruments should also be remeasured at fair value after the acquisition date. The boards concluded that applying those provisions would faithfully represent the fair value of the liability for the contingent payment of consideration that remains a liability until settled.
- BC356 The boards also considered whether subsequent changes in the fair values of liabilities for contingent consideration should be reflected as adjustments to the consideration transferred in the business combination (usually in goodwill). Some respondents to the 2005 Exposure Draft favoured that alternative because they thought that changes in the fair value of contingent consideration effectively resolve differing views of the acquirer and the former owners of the acquiree about the acquisition-date fair value of the acquiree. The boards acknowledged that a conclusive determination at the acquisition date of the fair value of a liability for contingent consideration might not be practicable in the limited circumstances in which particular information is not available at that date. As discussed in more detail in paragraphs BC390–BC400, the boards decided that the revised standards should provide for provisional measurement of the fair value of assets acquired or liabilities assumed or incurred, including liabilities for contingent payments, in those circumstances.
- BC357 Except for adjustments during the measurement period to provisional estimates of fair values at the acquisition date, the boards concluded that subsequent changes in the fair value of a liability for contingent consideration do not affect the acquisition-date fair value of the consideration transferred. Rather, those subsequent changes in value are generally directly related to post-combination events and changes in circumstances related to the combined entity. Thus, subsequent changes in value for post-combination events and circumstances should not affect the measurement of the

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<sup>27</sup> IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

consideration transferred or goodwill on the acquisition date. (The boards acknowledge that some changes in fair value might result from events and circumstances related in part to a pre-combination period. But that part of the change is usually indistinguishable from the part related to the post-combination period and the boards concluded that the benefits in those limited circumstances that might result from making such fine distinctions would not justify the costs that such a requirement would impose.)

- BC358 The boards also considered arguments that the results of the requirements of the revised standards for recognition of changes in the fair value of contingent consideration after the acquisition date are counter-intuitive because they will result in:
- (a) recognising gains if the specified milestone or event requiring the contingent payment is not met. For example, the acquirer would recognise a gain on the reversal of the liability if an earnings target in an earn-out arrangement is not achieved.
  - (b) recognising losses if the combined entity is successful and the amount paid exceeds the estimated fair value of the liability at the acquisition date.
- BC359 The boards accept the consequence that recognising the fair value of a liability for payment of contingent consideration is likely to result subsequently in a gain if smaller or no payments are required or result in a loss if greater payments are required. That is a consequence of entering into contingent consideration arrangements related to future changes in the value of a specified asset or liability or earnings of the acquiree after the acquisition date. For example, if a contingent consideration arrangement relates to the level of future earnings of the combined entity, higher earnings in the specified periods may be partially offset by increases in the liability to make contingent payments based on earnings because the acquirer has agreed to share those increases with former owners of the acquiree.
- BC360 The boards also observed that liabilities for contingent payments may be related to contingencies surrounding an outcome for a particular asset or another liability. In those cases, the effect on income of the period of a change in the fair value of the liability for the contingent payment may be offset by a change in the value of the asset or other liability. For example, after an acquisition the combined entity might reach a favourable settlement of pending litigation of the acquiree for which it had a contingent consideration arrangement. If the combined entity is thus required to make a contingent payment to the seller of the acquiree that exceeds the initially estimated fair value of the liability for contingent consideration, the effect of the increase in that liability may be offset in part by the reduction in the liability to the litigation claimant. Similarly, if the acquirer is not required to make a contingent payment to the seller because an acquired research and development project failed to result in a viable product, the gain from the elimination of the liability may be offset, in whole or in part, by an impairment charge to the asset acquired.

*Clarification on the accounting for contingent consideration in a business combination*

- BC360A The IASB clarified the accounting for contingent consideration arising from business combinations.

**Classification of contingent consideration in a business combination**

- BC360B The IASB noted that the classification requirements in paragraph 40 of IFRS 3 were unclear as to when, if ever, “other applicable IFRSs” would need to be used to determine the classification of contingent consideration as a financial liability or as an equity instrument. Consequently, the IASB deleted the reference to “other applicable IFRSs” in paragraph 40.

**Subsequent measurement of contingent consideration in a business combination**

- BC360C The IASB also noted that the requirements for subsequent measurement in paragraph 58 require contingent consideration, other than that which meets the definition of equity in accordance with IAS 32 *Financial Instruments: Presentation*, to be subsequently measured at fair value. However, paragraph 58 then refers to IFRS 9 *Financial Instruments* (or IAS 39, if IFRS 9 has not yet been applied), IAS 37 or other IFRSs as appropriate, which may not require subsequent measurement at fair value.

**Subsequent measurement of contingent consideration that is a financial instrument**

- BC360D The IASB noted that the requirements for subsequent measurement in paragraph 58 for contingent consideration that is a financial instrument within the scope of IFRS 9 (or IAS 39<sup>28</sup>) were inconsistent with the accounting requirements of IFRS 9 (or IAS 39). Because paragraph 58 referred to IFRS 9 (or IAS 39), which allows amortised cost measurement in some circumstances, contingent consideration that is a financial liability might be classified as being measured at amortised cost. This would conflict with the requirement in paragraph 58 that such contingent consideration should be subsequently measured at fair value. Consequently, the IASB amended the classification requirements of IFRS 9 (and IAS 39) to ensure that the subsequent measurement requirement for contingent consideration that is a financial liability is fair value. The IASB thinks that this clarifies the original intention for subsequent measurement of contingent consideration as explained in paragraph BC355.
- BC360E In redeliberating this issue, the IASB decided that it would not be possible for contingent consideration that is a financial asset that meets the requirements in IFRS 9 to be subsequently measured at amortised cost (because the contractual terms of contingent consideration that is a financial asset would not give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding). Consequently,

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<sup>28</sup> IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

the IASB decided that the proposed amendments to paragraph 4.1.2 of IFRS 9 in the Exposure Draft *Annual Improvements to IFRSs 2010–2012 Cycle* were not needed.

- BC360F The IASB also decided that changes in fair value of any contingent consideration that is a financial asset or a financial liability should be recognised in profit or loss. Consequently, the IASB decided to amend paragraph 5.7.5 of IFRS 9 to ensure that any change in the fair value of investments in equity instruments that are contingent consideration in a business combination should be presented in profit or loss. The IASB noted that it was unlikely that contingent consideration that is an asset would meet the definition of equity. However, it decided to amend the paragraph to ensure that all contingent consideration that is made up of financial instruments is accounted for consistently.

#### **Subsequent measurement of contingent consideration that is a non-financial asset or a non-financial liability**

- BC360G The IASB also noted that the subsequent measurement requirements in paragraph 58(b) for contingent consideration that is a non-financial asset or a non-financial liability may conflict with the measurement requirements in other applicable Standards. The conflict arises because paragraph 58 refers to changes in the fair value of contingent consideration but paragraph 58(b) refers to Standards that do not require fair value as a measurement basis, for example, IAS 37. Consequently, the IASB deleted the reference to “IAS 37 or other IFRSs as appropriate” from paragraph 58(b). This, therefore, maintains fair value as the subsequent measurement basis for all non equity contingent consideration to which IFRS 3 applies. The IASB thinks that this clarifies the original intention for subsequent measurement of contingent consideration as explained in paragraph BC355.
- BC360H The IASB also decided that the full change in the fair value of any contingent consideration that is a non-financial asset or a non-financial liability should be recognised in profit or loss.

#### **Other considerations given to subsequent measurement of contingent consideration**

- BC360I The IASB considered alternatives for the subsequent measurement requirements for contingent consideration. It considered whether all references to other Standards, including references to IFRS 9 (or IAS 39<sup>29</sup>), should be removed and instead all necessary guidance for the subsequent measurement of contingent consideration should be included in IFRS 3. It decided, however, to amend IFRS 9 (and IAS 39) as a consequential amendment derived from the amendment to IFRS 3 and to retain the link to IFRS 9 (or IAS 39) so that the general guidance in IFRS 9 (or IAS 39) applies to contingent consideration that is within the scope of IFRS 9 (or IAS 39). The IASB also considered whether some liability contingent consideration should be measured at fair value with some fair value changes being presented in

<sup>29</sup> IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

other comprehensive income. It decided that it was preferable that the guidance was consistent for all liability contingent consideration and, consequently, it decided that all liability contingent consideration should be subsequently measured at fair value with any resulting gain or loss, including gain or loss attributable to changes in own credit risk, being recognised in profit or loss.

### **Disclosure**

BC360J Some stakeholders had asked whether the IASB had intended the disclosure requirements in IFRS 7 *Financial Instruments: Disclosures* to apply to contingent consideration, noting that there are disclosure requirements for contingent consideration in IFRS 3. The IASB thinks that it is appropriate for the disclosure requirements of IFRS 7 to apply to contingent consideration that is a financial instrument within the scope of IFRS 7. Consequently, the IASB decided not to make any changes to the scope of IFRS 7 to exclude such financial instruments.

### *Replacement awards*

BC361 An acquirer sometimes issues replacement awards to benefit the employees of the acquiree for past services, for future services or for both. Accordingly, the 2005 Exposure Draft included guidance for determining the extent to which replacement awards are for past services (and thus part of the consideration transferred in the business combination) or future services (and thus not part of the consideration transferred). In developing that guidance, the boards' objective was, as far as possible, to be consistent with the guidance in their respective standards on share-based payments.

BC362 Few respondents to the 2005 Exposure Draft commented on this issue, and those who did so generally agreed with the proposals, at least as they related to entities that apply IFRS 2 in accounting for share-based payment awards granted otherwise than in a business combination. However, in redeliberating the 2005 Exposure Draft, the FASB observed that some of its proposals on share-based payment awards were not consistent with SFAS 123(R), which was published after the related deliberations in the second phase of its business combinations project. For example, the 2005 Exposure Draft proposed that the excess, if any, of the fair value of replacement awards over the fair value of the replaced acquiree awards should be immediately recognised as remuneration cost in the post-combination financial statements even if employees were required to render future service to earn the rights to the replacement awards. SFAS 123(R), on the other hand, requires recognition of additional remuneration cost arising in a modification of the terms of an award (which is the same as the replacement of one award with another) over the requisite service period. The FASB concluded that, in general, the requirements of SFAS 141(R) on accounting for replacements of share-based payment awards should be consistent with the requirements for other share-based payment awards in SFAS 123(R). To achieve that goal the FASB modified the guidance in SFAS 141(R) on accounting for any excess of the fair value of replacement awards over the fair value of the replaced awards.



BC363 In addition, the FASB's constituents raised questions about other aspects of the guidance on accounting for the replacement of share-based payment awards. Those questions generally related to interpretative guidance that SFAS 123(R) superseded or nullified without providing comparable guidance—specifically, FASB Interpretation No. 44 *Accounting for Certain Transactions Involving Stock Compensation* and EITF Issue No. 00-23 *Issues Related to the Accounting for Stock Compensation under APB Opinion No. 25 and FASB Interpretation No. 44*. Paragraphs B56–B62 of the revised IFRS 3 provide guidance to help in resolving those implementation questions. In developing that guidance, the FASB sought to apply the same principles to the replacement of share-based payment awards in a business combination that are applied to share-based payment awards in other situations. The IASB agreed with that goal, and it decided that the guidance on accounting for replacement awards of share-based payment is consistent with the guidance in IFRS 2 on accounting for modification of share-based payment awards.

BC364 The boards concluded that the guidance in the revised standards is consistent with the objective that the consideration transferred for an acquired business includes those payments that are for the business and excludes those payments that are for other purposes. Remuneration for future services to be rendered to the acquirer by former owners or other employees of the acquiree is not, in substance, consideration for the business acquired.

#### *Acquisition-related costs*

BC365 The boards considered whether acquisition-related costs are part of the consideration transferred in exchange for the acquiree. Those costs include an acquirer's costs incurred in connection with a business combination (a) for the services of lawyers, investment bankers, accountants and other third parties and (b) for issuing debt or equity instruments used to effect the business combination (issue costs). Generally, acquisition-related costs are charged to expense as incurred, but the costs to issue debt or equity securities are an exception. Currently, the accounting for issue costs is mixed and conflicting practices have developed in the absence of clear accounting guidance. The FASB is addressing issue costs in its project on liabilities and equity and has tentatively decided that those costs should be recognised as expenses as incurred. Some FASB members would have preferred to require issue costs to effect a business combination to be recognised as expenses, but they did not think that the business combinations project was the place to make that decision. Therefore, the FASB decided to allow mixed practices for accounting for issue costs to continue until the project on liabilities and equity resolves the issue broadly.

BC366 The boards concluded that acquisition-related costs are not part of the fair value exchange between the buyer and seller for the business. Rather, they are separate transactions in which the buyer pays for the fair value of services received. The boards also observed that those costs, whether for services performed by external parties or internal staff of the acquirer, do not generally represent assets of the acquirer at the acquisition date because the benefits obtained are consumed as the services are received.

## IFRS 3 BC

- BC367 Thus, the 2005 Exposure Draft proposed, and the revised standards require, the acquirer to exclude acquisition-related costs from the measurement of the fair value of both the consideration transferred and the assets acquired or liabilities assumed as part of the business combination. Those costs are to be accounted for separately from the business combination, and generally recognised as expenses when incurred. The revised standards therefore resolve inconsistencies in accounting for acquisition-related costs in accordance with the cost-accumulation approach in IFRS 3 and SFAS 141, which provided that the cost of an acquiree included *direct* costs incurred for an acquisition of a business but excluded *indirect* costs. Direct costs included out-of-pocket or incremental costs, for example, finder's fees and fees paid to outside consultants for accounting, legal or valuation services for a successful acquisition, but direct costs incurred in unsuccessful negotiations were recognised as expenses as incurred. Indirect costs included recurring internal costs, such as maintaining an acquisition department. Although those costs also could be directly related to a successful acquisition, they were recognised as expenses as incurred.
- BC368 Some respondents to the 2005 Exposure Draft said that acquisition-related costs, including costs of due diligence, are unavoidable costs of the investment in a business. They suggested that, because the acquirer intends to recover its due diligence cost through the post-acquisition operations of the business, that transaction cost should be capitalised as part of the total investment in the business. Some also argued that the buyer specifically considers those costs in determining the amount that it is willing to pay for the acquiree. The boards rejected those arguments. They found no persuasive evidence indicating that the seller of a particular business is willing to accept less than fair value as consideration for its business merely because a particular buyer may incur more (or less) acquisition-related costs than other potential buyers for that business. Furthermore, the boards concluded that the intentions of a particular buyer, including its plans to recover such costs, are a separate matter that is distinct from the fair value measurement objective in the revised standards.
- BC369 The boards acknowledge that the cost-accumulation models in IFRS 3 and SFAS 141 included some acquisition-related costs as part of the carrying amount of the assets acquired. The boards also acknowledge that all asset acquisitions are similar transactions that, in concept, should be accounted for similarly, regardless of whether assets are acquired separately or as part of a group of assets that may meet the definition of a business. However, as noted in paragraph BC20, the boards decided not to extend the scope of the revised standards to all acquisitions of groups of assets. Therefore, the boards accept that, at this time, accounting for most acquisition-related costs separately from the business combination, generally as an expense as incurred for services received in connection with a combination, differs from some standards or accepted practices that require or permit particular acquisition-related costs to be included in the cost of an asset acquisition. The boards concluded, however, that the revised standards improve financial reporting by eliminating inconsistencies in accounting for acquisition-related costs in connection with a business combination and by applying the fair

value measurement principle to all business combinations. The boards also observed that in practice under IFRS 3 and SFAS 141, most acquisition-related costs were subsumed in goodwill, which was also not consistent with accounting for asset acquisitions.

- BC370 The boards also considered concerns about the potential for abuse. Some constituents, including some respondents to the 2005 Exposure Draft, said that if acquirers could no longer capitalise acquisition-related costs as part of the cost of the business acquired, they might modify transactions to avoid recognising those costs as expenses. For example, some said that a buyer might ask a seller to make payments to the buyer's vendors on its behalf. To facilitate the negotiations and sale of the business, the seller might agree to make those payments if the total amount to be paid to it upon closing of the business combination is sufficient to reimburse the seller for payments it made on the buyer's behalf. If the disguised reimbursements were treated as part of the consideration transferred for the business, the acquirer might not recognise those expenses. Rather, the measure of the fair value of the business and the amount of goodwill recognised for that business might be overstated. To mitigate such concerns, the revised standards require any payments to an acquiree (or its former owners) in connection with a business combination that are payments for goods or services that are not part of the acquired business to be assigned to those goods or services and accounted for as a separate transaction. The revised standards specifically require an acquirer to determine whether any portion of the amounts transferred by the acquirer are separate from the consideration exchanged for the acquiree and the assets acquired and liabilities assumed in the business combination. The revised standards (see paragraphs 51–53 and B50 of the revised IFRS 3) provide guidance for making that determination.

### **Bargain purchases**

- BC371 Paragraphs 34–36 of the revised IFRS 3 set out the accounting requirements for a bargain purchase. The boards consider bargain purchases anomalous transactions—business entities and their owners generally do not knowingly and willingly sell assets or businesses at prices below their fair values. However, bargain purchases have occurred and are likely to continue to occur. Circumstances in which they occur include a forced liquidation or distress sale (eg after the death of a founder or key manager) in which owners need to sell a business quickly, which may result in a price that is less than fair value.
- BC372 The boards observed that an economic gain is inherent in a bargain purchase. At the acquisition date, the acquirer is better off by the amount by which the fair value of what is acquired exceeds the fair value of the consideration transferred (paid) for it. The boards concluded that, in concept, the acquirer should recognise that gain at the acquisition date. However, the boards acknowledged that although the reasons for a forced liquidation or distress sale are often apparent, sometimes clear evidence might not exist, for example, if a seller uses a closed (private) process for the sale and to maintain its negotiating position is unwilling to reveal the main reason for the sale. The appearance of a bargain purchase without evidence of the underlying reasons would raise concerns in practice about the existence of measurement errors.

## IFRS 3 BC

BC373 Constituents, including some respondents to the 2005 Exposure Draft, expressed concerns about recognising gains upon the acquisition of a business, particularly if it is difficult to determine whether a particular acquisition is in fact a bargain purchase. They also suggested that an initial determination of an excess of the acquisition-date fair value (or other recognised amounts) of the identifiable net assets acquired over the fair value of the consideration paid by the acquirer plus the recognised amount of any non-controlling interest in the acquiree might arise from other factors, including:

- (a) errors in measuring the fair values of (i) the consideration paid for the business, (ii) the assets acquired or (iii) the liabilities assumed; and
- (b) using measures in accordance with IFRSs or US GAAP that are not fair values.

### *Distinguishing a bargain purchase from measurement errors*

BC374 The boards acknowledged concerns raised by constituents that a requirement to recognise gains on a bargain purchase might provide an opportunity for inappropriate gain recognition from intentional errors resulting from the acquirer's:

- (a) understating or failing to identify the value of items of consideration that it transferred;
- (b) overstating values attributed to particular assets acquired; or
- (c) understating or failing to identify and recognise particular liabilities assumed.

BC375 The boards think that problems surrounding intentional measurement errors by acquirers are generally best addressed by means other than setting standards specifically intended to avoid abuse. Strong internal control systems and the use of independent valuation experts and external auditors are among the means by which both intentional and unintentional measurement errors are minimised. Standards specifically designed to avoid abuse would inevitably lack neutrality. (See paragraph BC51 for a discussion of the need for neutrality in accounting and accounting standards.) However, the boards share constituents' concerns about the potential for inappropriate gain recognition resulting from measurement bias or undetected measurement errors. Thus, the boards decided (see paragraph 36 of the revised IFRS 3) to require the acquirer to reassess whether it has correctly identified all of the assets acquired and all of the liabilities assumed before recognising a gain on a bargain purchase. The acquirer must then review the procedures used to measure the amounts the revised standards require to be recognised at the acquisition date for all of the following:

- (a) the identifiable assets acquired and liabilities assumed;
- (b) the non-controlling interest in the acquiree, if any;
- (c) for a business combination achieved in stages, the acquirer's previously held equity interest in the acquiree; and

- (d) the consideration transferred.

The objective of that review is to ensure that appropriate consideration has been given to all available information in identifying the items to be measured and recognised and in determining their fair values. The boards believe that the required review will mitigate, if not eliminate, undetected errors that might have existed in the initial measurements.

BC376 The boards acknowledged, however, that the required review might be insufficient to eliminate concerns about unintentional measurement bias. They decided to address that concern by limiting the extent of gain that can be recognised. Thus, the revised standards provide that a gain on a bargain purchase is measured as the excess of:

- (a) the net of the acquisition-date amounts of the identifiable assets acquired and liabilities assumed; over
- (b) the acquisition-date fair value of the consideration transferred plus the recognised amount of any non-controlling interest in the acquiree and, if the transaction is an acquisition achieved in stages, the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree.

That means that a gain on a bargain purchase and goodwill cannot both be recognised for the same business combination. The 2005 Exposure Draft defined a bargain purchase as a transaction in which the fair value of the acquirer's interest in the acquiree exceeds the consideration transferred for it, but it would have required that any resulting goodwill should be written off before a gain was recognised. The result of the revised standards' requirement is the same, but there will be no goodwill to write off if the gain is measured with reference to the identifiable net assets acquired rather than the fair value of the acquirer's interest in the acquiree. In addition, the revised standards require (paragraph B64(n) of the revised IFRS 3) the acquirer to disclose information about a gain recognised on a bargain purchase.

BC377 The main purpose of the limitation on gain recognition is to mitigate the potential for inappropriate gain recognition through measurement errors, particularly those that might result from unintended measurement bias. The main purpose of the disclosure requirement is to provide information that enables users of an acquirer's financial statements to evaluate the nature and financial effect of business combinations that occur during the period. The boards acknowledged, however, that the limitation and disclosure requirements may also help to mitigate constituents' concerns about potential abuse, although that is not their primary objective.

BC378 Moreover, the boards believe that concerns about abuse resulting from the opportunity for gain recognition may be overstated. Financial analysts and other users have often told the boards that they give little weight to one-off or unusual gains, such as those resulting from a bargain purchase transaction. In addition, the boards noted that managers of entities generally have no incentive to overstate assets acquired or understate liabilities assumed in a business combination because that would generally result in higher

post-combination expenses—when the assets are used or become impaired or liabilities are remeasured or settled.

*Distinguishing a bargain purchase from a 'negative goodwill result'*

- BC379 The boards acknowledged that a so-called negative goodwill result remains a possibility (although in most situations, a remote possibility) because the revised standards continue to require particular assets acquired and liabilities assumed to be measured at amounts other than their acquisition-date fair values. The boards observed, however, that the revised standards address most deficiencies in past requirements on accounting for business combinations that previously led to negative goodwill results—ie a result that had the appearance but not the economic substance of a bargain purchase. For example, often no liability was recognised for some contingent payment arrangements (eg earn-outs) at the acquisition date, which could result in the appearance of a bargain purchase by understating the consideration paid. The revised standards, in contrast, require the measurement and recognition of substantially all liabilities at their fair values on the acquisition date.
- BC380 The boards also considered concerns raised by some constituents that a buyer's expectations of future losses and its need to incur future costs to make a business viable might give rise to a negative goodwill result. In other words, a buyer would be willing to pay a seller only an amount that is, according to that view, less than the fair value of the acquiree (or its identifiable net assets) because to make a fair return on the business the buyer would need to make further investments in that business to bring its condition to fair value. The boards disagreed with that view for the reasons noted in paragraphs BC134–BC143 in the context of liabilities associated with restructuring or exit activities of the acquiree, as well as those that follow.
- BC381 Fair values are measured by reference to unrelated buyers and sellers that are knowledgeable and have a common understanding about factors relevant to the business and the transaction and are also willing and able to transact business in the same market(s) and have the legal and financial ability to do so. The boards are aware of no compelling reason to believe that, in the absence of duress, a seller would willingly and knowingly sell a business for an amount less than its fair value. Thus, the boards concluded that careful application of the revised standards' fair value measurement requirements will mitigate concerns that negative goodwill might result and be misinterpreted as a bargain purchase transaction.

**Overpayments**

- BC382 The boards considered whether the revised standards should include special provisions to account for a business combination in which a buyer overpays for its interest in the acquiree. The boards acknowledged that overpayments are possible and, in concept, an overpayment should lead to the acquirer's recognition of an expense (or loss) in the period of the acquisition. However, the boards believe that in practice any overpayment is unlikely to be detectable or known at the acquisition date. In other words, the boards are not aware of instances in which a buyer knowingly overpays or is compelled to

overpay a seller to acquire a business. Even if an acquirer thinks it might have overpaid in some sense, the amount of overpayment would be difficult, if not impossible, to quantify. Thus, the boards concluded that in practice it is not possible to identify and reliably measure an overpayment at the acquisition date. Accounting for overpayments is best addressed through subsequent impairment testing when evidence of a potential overpayment first arises.

### **Additional guidance for particular types of business combinations**

- BC383 To help entities apply the acquisition method as required by the revised standards, the boards decided to provide additional guidance for business combinations achieved in stages and those achieved without the transfer of consideration. Paragraphs BC384–BC389 discuss the guidance provided on business combinations achieved in stages. The guidance on combinations achieved without the transfer of consideration merely responds to a question about how to report the acquiree’s net assets in the equity section of the acquirer’s post-combination statement of financial position, and this Basis for Conclusions does not discuss that guidance further.

#### **Business combinations achieved in stages**

- BC384 In a business combination achieved in stages, the acquirer remeasures its previously held equity interest at its acquisition-date fair value and recognises the related gain or loss in profit or loss (paragraph 42 of the revised IFRS 3). The boards concluded that a change from holding a non-controlling investment in an entity to obtaining control of that entity is a significant change in the nature of and economic circumstances surrounding that investment. That change warrants a change in the classification and measurement of that investment. Once it obtains control, the acquirer is no longer the owner of a non-controlling investment asset in the acquiree. As in present practice, the acquirer ceases its accounting for an investment asset and begins reporting in its financial statements the underlying assets, liabilities and results of operations of the acquiree.<sup>30</sup> In effect, the acquirer exchanges its status as an owner of an investment asset in an entity for a controlling financial interest in all of the underlying assets and liabilities of that entity (acquiree) and the right to direct how the acquiree and its management use those assets in its operations.
- BC385 In August 2003 the FASB held a round-table meeting with members of its resource group on business combinations and other constituents to discuss, among other things, the decision to require an acquirer to remeasure any previously held equity investment in an acquiree at its acquisition-date fair value and to recognise in earnings any gain or loss. The users of financial statements indicated they did not have significant concerns with that change to present practice, as long as the amount of the gain or loss is clearly

<sup>30</sup> In October 2012 the Board issued *Investment Entities* (Amendments to IFRS 10, IFRS 12 and IAS 27), which required investment entities, as defined in IFRS 10, to measure their investments in subsidiaries, other than those providing investment-related services or activities, at fair value through profit or loss.

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disclosed in the financial statements or in the notes. Paragraph B64(p) of the revised IFRS 3 requires that disclosure.

- BC386 The boards rejected the view expressed by some constituents that the carrying amount of any pre-acquisition investment should be retained in the initial accounting for the cost of the business acquired. The boards concluded that cost-accumulation practices led to many of the inconsistencies and deficiencies in financial reporting as required by SFAS 141 and, to a lesser extent, by IFRS 3 (see paragraphs BC198–BC202).
- BC387 Some constituents also expressed concern about what they described as allowing an opportunity for gain recognition on a purchase transaction. The boards noted that the required remeasurement could also result in loss recognition. Moreover, the boards rejected the characterisation that the result is to recognise a gain or loss on a purchase. Rather, under today's mixed attribute accounting model, economic gains and losses are recognised as they occur for some, but not all, financial instruments. If an equity interest in an entity is not required to be measured at its fair value, the recognition of a gain or loss at the acquisition date is merely a consequence of the delayed recognition of the economic gain or loss that is present in that financial instrument. If the investment asset had been measured at fair value at the end of each reporting period, the gain or loss would have been recognised as it occurred and measurement of the asset at its acquisition-date fair value would result in no further gain or loss.
- BC388 Some respondents who agreed that an acquirer should remeasure its previously held equity interest at fair value would recognise any resulting gain or loss in other comprehensive income rather than in profit or loss. Those respondents said that the accounting for previously held equity interests is similar to the accounting for available-for-sale securities. Changes in the value of available-for-sale securities are recognised in other comprehensive income. They view each step in a step acquisition as a transaction in which the acquirer only obtains more shares in the acquiree. Because the shares that the acquirer previously held have not been exchanged or sold, they think that the recognition of profit or loss is not appropriate.
- BC389 The boards understand that the required treatment of a previously held equity investment in a step acquisition is different from the initial recognition of gains or losses on available-for-sale securities.<sup>31</sup> However, the boards noted that changes in the value of available-for-sale securities are recognised in profit or loss when the securities are derecognised. In a business combination achieved in stages, the acquirer derecognises its investment asset in an entity in its consolidated financial statements when it achieves control. Thus, the boards concluded that it is appropriate to recognise any resulting gain or loss in profit or loss at the acquisition date.

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<sup>31</sup> IFRS 9 *Financial Instruments* eliminated the category of available-for-sale financial assets.



**Previously held interest in a joint operation (amendments issued in December 2017)**

- BC389A The IASB was informed that entities, on obtaining control of a business that is a joint operation, accounted for their previously held interest in the joint operation differently. In particular, there were different views on whether the term ‘equity interest’ in paragraphs 41–42 of IFRS 3 applied to such a previously held interest.
- BC389B The IASB concluded that the transaction described in paragraph BC389A is a business combination achieved in stages. This transaction results in a significant change in the nature of, and economic circumstances surrounding, any interest in the joint operation; remeasuring the previously held interest at fair value is therefore warranted. Accordingly, the IASB added paragraph 42A to clarify that, when obtaining control of a business that is a joint operation, the acquirer applies the requirements for a business combination achieved in stages, including remeasuring its previously held interest in the joint operation at its acquisition-date fair value.
- BC389C Some respondents to the exposure draft of the proposed amendments to IFRS 3 suggested that the IASB clarify whether an acquirer would be required to remeasure its entire previously held interest in a joint operation or only the assets and liabilities relating to the joint operation it had recognised before obtaining control. In response, the IASB clarified that an entity remeasures its entire previously held interest in the joint operation. IFRS 3 views a business combination achieved in stages as a transaction in which an acquirer exchanges its status as an owner of a non-controlling interest in a business for a controlling interest in all of the underlying assets and liabilities of that business. Accordingly, when an acquirer obtains control of a business that is a joint operation, it effectively (a) derecognises its previously held interest (ie non-controlling interest) in the joint operation, and (b) recognises a controlling interest in all of the assets and liabilities of the former joint operation. The IASB observed that remeasuring the entire previously held interest would result in an entity recognising the same gain or loss on remeasurement that it would have recognised had it otherwise disposed of its previously held interest in the joint operation in an exchange transaction.

**Measurement period**

- BC390 The revised standards provide an acquirer with a reasonable period after the acquisition date, a *measurement period*, during which to obtain the information necessary to identify and measure the items specified in paragraph 46 of the revised IFRS 3 as of the acquisition date in accordance with the requirements of the revised standards. If sufficient information is not available at the acquisition date to measure those amounts, the acquirer determines and recognises provisional amounts until the necessary information becomes available.
- BC391 The boards concluded that providing for retrospective adjustments during the measurement period should help to resolve concerns about the quality and availability of information at the acquisition date for measuring the fair values of particular items at that date. Constituents especially indicated such

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concerns about contingent liabilities and contingent consideration arrangements, which also affect the amount of goodwill or the gain recognised on a bargain purchase.

- BC392 The boards decided to place constraints on the period for which it is deemed reasonable to be seeking information necessary to complete the accounting for a business combination. The measurement period ends as soon as the acquirer receives the necessary information about facts and circumstances that existed as of the acquisition date or learns that the information is not obtainable. However, in no circumstances may the measurement period exceed one year from the acquisition date. The boards concluded that allowing a measurement period longer than one year would not be especially helpful; obtaining reliable information about circumstances and conditions that existed more than a year ago is likely to become more difficult as time passes. Of course, the outcome of some contingencies and similar matters may not be known within a year. But the objective of the measurement period is to provide time to obtain the information necessary to measure the fair value of the item as of the acquisition date. Determining the ultimate settlement amount of a contingency or other item is not necessary. Uncertainties about the timing and amount of future cash flows are part of the measure of the fair value of an asset or liability.
- BC393 The boards also concluded that acquirers should provide users of their financial statements with relevant information about the status of items that have been measured only provisionally. Thus, paragraph B67(a) of the revised IFRS 3 specifies particular disclosures about those items.
- BC394 Both IFRS 3 and SFAS 141 included a period during which an acquirer might measure particular amounts provisionally if the necessary information was not available at the acquisition date. Neither of those provisions was identical to the measurement period guidance in the revised standards, although IFRS 3's was quite similar. However, the measurement period provisions in the revised standards differ in important ways from the allocation period guidance of SFAS 141 and its cost-allocation method. The revised standards emphasise the principle that assets acquired, liabilities assumed and any non-controlling interest in the acquiree should be measured at their acquisition-date fair values. SFAS 141's allocation period and its post-combination adjustments delayed the recognition of assets and liabilities, and those assets and liabilities were not measured at their acquisition-date fair values when they were recognised. Therefore, the FASB decided to replace the SFAS 141 term *allocation period* and its guidance with the measurement period guidance in the revised standards.
- BC395 The FASB also decided that to improve the quality of comparative information reported in financial statements and to converge with the requirements of IFRS 3, SFAS 141(R) should require an acquirer:
- (a) to recognise adjustments made during the measurement period to the provisional values of the assets acquired and liabilities assumed as if the accounting for the business combination had been completed at the acquisition date.

- (b) to adjust comparative information in previously issued financial statements, including any change in depreciation, amortisation or other income effect recognised as a result of completing the initial accounting.
- BC396 SFAS 141 was silent about whether adjustments during its allocation period were to be reported retrospectively, but the FASB noted that in practice the effects of those adjustments were typically reported in the post-combination period, not retrospectively. The FASB acknowledged concerns that retrospective adjustments and adjusting previously issued comparative information are more costly. The FASB observed, however, that applying measurement period adjustments retrospectively would result in at least two significant benefits: (a) improvements in comparative period information and (b) avoidance of divergent accounting between US entities and others and the reduction of reconciling items and their attendant costs. The FASB concluded, as had the IASB in developing IFRS 3, that those overall benefits outweigh the potential costs of retrospective application.
- BC397 Some respondents to the 2005 Exposure Draft (generally those who apply US GAAP rather than IFRSs) disagreed with retrospective application of measurement period adjustments. They regarded measurement period adjustments as similar to changes in estimates, which are accounted for prospectively. They noted that FASB Statement No. 154 *Accounting Changes and Error Corrections* (SFAS 154) and IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* both require retrospective adjustment only for changes in accounting policy or restatement for errors.
- BC398 In considering those responses, the boards observed that measurement period adjustments in a business combination differ from the changes in estimates dealt with by SFAS 154 and IAS 8. Measurement period adjustments result from information about assets, liabilities and non-controlling interests as of the acquisition date that becomes available only after that date. In contrast, adjustments for changes in estimates generally result from changes in facts and circumstances that affect an estimate, for example, a change in technology that affects the useful life of an asset.
- BC399 The boards concluded that adjustments during the measurement period following a business combination are more analogous to adjusting events after the end of the reporting period (IAS 10 *Events after the Reporting Period*) than to changes in estimates. The effects of events that occur after the end of an accounting period but before the financial statements for the period are authorised for issue and provide evidence of a condition that existed at the date of the financial statements are reflected in financial statements as of that date. Similarly, the effects of information that first becomes available during the measurement period and provides evidence of conditions or circumstances that existed at the acquisition date should be reflected in the accounting as of that date.

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- BC400 To recognise measurement period adjustments only prospectively would be inconsistent with the recognition and measurement principles in the revised standards. Thus, although the boards understand the practical and other difficulties with retrospective adjustments, on balance, they concluded that requiring such adjustments in this situation is appropriate.

## Disclosures

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- BC401 Because a business combination often results in a significant change to an entity's operations, the nature and extent of the information disclosed about the transaction bear on users' abilities to assess the effects of such changes on post-combination profit or loss and cash flows. Accordingly, as part of their respective projects that led to IFRS 3 and SFAS 141, the IASB and the FASB both considered the usefulness of the disclosure requirements required by IAS 22 and APB Opinion 16, respectively, for the acquisition method. IFRS 3 and SFAS 141 carried forward disclosures from the earlier requirements for business combinations that remained relevant, eliminated those that did not and modified those that were affected by changes in the recognition or measurement requirements. In the second phase of their projects on business combinations, the boards undertook essentially the same sort of reconsideration of the disclosure requirements in IFRS 3 and SFAS 141, and they also considered particular disclosures requested by respondents to the 2005 Exposure Draft.
- BC402 The remainder of this section first reviews the changes that SFAS 141 and IFRS 3 made to the disclosure requirements of APB Opinion 16 and IAS 22 respectively (paragraphs BC403–BC418). Paragraphs BC419–BC428 then discuss the changes the revised standards make to the disclosure requirements of SFAS 141 and IFRS 3.

### Disclosure requirements of SFAS 141

#### Disclosure of information about the purchase price allocation and pro forma sales and earnings

- BC403 The 1999 Exposure Draft would have required tabular disclosure of the fair values allocated to each of the major classes of assets and liabilities presented in the statement of financial position and the acquiree's related carrying amounts immediately before its acquisition. That exposure draft also proposed eliminating the pro forma sales and earnings disclosures required by APB Opinion 16.
- BC404 Approximately half of the respondents who commented on the proposed requirement to disclose information about the purchase price allocation agreed that the information would be useful in assessing post-acquisition earnings and cash flows of the acquirer. However, some respondents questioned the usefulness of the proposed disclosure of information about the acquiree's carrying amounts of assets acquired and liabilities assumed, particularly if the financial statements of the acquiree were not audited or were prepared on a basis other than US GAAP. After considering those views, the FASB affirmed its conclusion that information about the allocation of the

purchase price to major classes of assets and liabilities in the statement of financial position would be useful in assessing the amount and timing of future cash flows. However, it agreed that information about the related carrying amounts might be of limited usefulness. Thus, SFAS 141 required disclosure of information about the allocation of the purchase price to each major class of asset and liability in the acquiree's statement of financial position but not their previous carrying amounts.

- BC405 After considering respondents' views, the FASB included in SFAS 141 the pro forma disclosure requirements from APB Opinion 16. However, the FASB also continued the exemption of non-public entities from the pro forma disclosure requirements. Preparers and auditors of financial statements of non-public entities urged the FASB to continue that exemption, which was initially provided by FASB Statement No. 79 *Elimination of Certain Disclosures for Business Combinations by Nonpublic Enterprises*.

#### **Disclosures related to goodwill**

- BC406 The FASB's 2001 Exposure Draft (see paragraph BC160 for a discussion of that exposure draft) would have required the acquirer to disclose (a) the reasons for the acquisition, including a description of the factors that led to a purchase price that resulted in goodwill and (b) the amount of goodwill assigned to each reportable segment. The requirement to disclose goodwill by reportable segment was limited to entities that are within the scope of FASB Statement No. 131 *Disclosures about Segments of an Enterprise and Related Information*. That exposure draft also proposed requiring disclosure of the amount of goodwill expected to be deductible for tax purposes if the goodwill initially recognised in a material business combination was significant in relation to the total cost of the acquiree. After considering the comments of respondents, the FASB affirmed its conclusion that the information would be useful in estimating the amount and timing of future impairment losses, and SFAS 141 required that disclosure.

#### **Disclosure of information about intangible assets other than goodwill**

- BC407 If the amount assigned to intangible assets was significant in relation to the total cost of an acquiree, SFAS 141 required disclosure of the following information to help users of financial statements assess the amount and timing of future cash flows:
- (a) the total amount assigned to intangible assets subject to amortisation and the total amount assigned to those that are not subject to amortisation;
  - (b) the amount assigned to each major intangible asset class;
  - (c) for intangible assets subject to amortisation, the weighted average amortisation period in total and for each major intangible asset class; and
  - (d) the amount of any significant residual value assumed, both in total and for each major class of intangible asset.

### **Other disclosure requirements**

BC408 The 1999 Exposure Draft proposed, and SFAS 141 required, disclosure of specified information for a series of immaterial business combinations that are material in the aggregate completed in a reporting period:

- (a) the number of entities acquired and a brief description of them;
- (b) the aggregate cost of the acquired entities, the number of equity interests issued or issuable and the value assigned to them;
- (c) the aggregate amount of any contingent payments, options or commitments and the accounting treatment that will be followed should any such contingency occur (if potentially significant in relation to the aggregate cost of the acquired entities); and
- (d) the information about goodwill required for a material acquisition if the aggregate amount assigned to goodwill or to other intangible assets acquired was significant in relation to the aggregate cost of the acquired entities.

BC409 In addition, the 1999 Exposure Draft proposed, and SFAS 141 required, that the information required to be disclosed for a completed business combination would also be disclosed for a material business combination completed after the balance sheet date but before the financial statements are authorised for issue (unless disclosure of such information was not practicable). That requirement was consistent with auditing standards on subsequent events.

### **Disclosures in interim financial information**

BC410 Several analysts and other users recommended that the FASB should require disclosure of supplemental pro forma revenues and earnings in interim financial information because that information would be more useful if it was available earlier. SFAS 141 amended APB Opinion No. 28 *Interim Financial Reporting* to require disclosure of that information.

### **Disclosure requirements of IFRS 3**

BC411 IFRS 3 identified three objectives that its disclosure requirements were intended to meet, specifically, to provide the users of an acquirer's financial statements with information that enables them to evaluate:

- (a) 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 were authorised for issue.
- (b) the financial effects of gains, losses, error corrections and other adjustments recognised in the current period that relate to business combinations that were effected in the current period or in previous periods.
- (c) changes in the carrying amount of goodwill during the period.

- BC412 The IASB began its discussion of the disclosure requirements necessary to meet the objectives by assessing the disclosure requirements in SIC-28 *Business Combinations – “Date of Exchange” and Fair Value of Equity Instruments* and IAS 22. The IASB concluded that information disclosed in accordance with SIC-28 about equity instruments issued as part of the cost of a business combination helped to meet the first of the three objectives outlined above. Therefore, IFRS 3 carried forward the disclosure requirements in SIC-28.
- BC413 The IASB also concluded that information previously disclosed in accordance with IAS 22 about business combinations classified as acquisitions and goodwill helped to meet the objectives in paragraph BC411. Therefore, IFRS 3 carried forward the related disclosure requirements in IAS 22, amended as necessary to reflect changes IFRS 3 made to the provisions of IAS 22. For example, IAS 22 required disclosure of the amount of any adjustment during the period to goodwill or ‘negative goodwill’ resulting from subsequent identification or changes in value of the acquiree’s identifiable assets and liabilities. IFRS 3 required an acquirer, with specified exceptions, to adjust the initial accounting for a combination after that accounting was complete only to correct an error. Thus, IFRS 3 revised the IAS 22 disclosure requirement to require disclosure of information about error corrections required to be disclosed by IAS 8.
- BC414 The IASB then assessed whether any additional disclosure requirements should be included in IFRS 3 to ensure that the three disclosure objectives were met and considered the disclosure requirements in the corresponding standards of its partner standard-setters. As a result, and after considering respondents’ comments on ED 3, the IASB identified, and IFRS 3 required, the following additional disclosures to help meet the first of the three disclosure objectives in paragraph BC411:
- (a) For each business combination effected during the period:
    - (i) the amounts recognised at the acquisition date for each class of the acquiree’s assets, liabilities and contingent liabilities and, if practicable, the carrying amounts of each of those classes, determined in accordance with IFRSs, immediately before the combination. If such disclosure was impracticable, an entity disclosed that fact, together with an explanation of why disclosure was impracticable.
    - (ii) a description of the factors that contributed to the recognition of goodwill—including a description of each intangible asset that was not recognised separately from goodwill and an explanation of why the intangible asset’s fair value could not be measured reliably. If the acquirer’s interest in the acquiree’s identifiable net assets exceeded the cost, the acquirer was required to describe the nature of that excess.

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- (iii) the amount of the acquiree's profit or loss since the acquisition date included in the acquirer's profit or loss for the period, unless disclosure was impracticable. If such disclosure was impracticable, the acquirer disclosed that fact, together with an explanation of why disclosure was impracticable.
  - (b) The information required to be disclosed for each business combination that was effected during the period in aggregate for business combinations that are individually immaterial.
  - (c) The revenue and profit or loss of the combined entity for the period as though the acquisition date for all business combinations that were effected during the period had been the beginning of that period, unless such disclosure was impracticable.
- BC415 To aid in meeting the second disclosure objective in paragraph BC411, IFRS 3 also required disclosure of the amount and an explanation of any gain or loss recognised in the current period that both:
  - (a) related to the identifiable assets acquired or liabilities or contingent liabilities assumed in a business combination that was effected in the current or a previous period; and
  - (b) was of such size, nature or incidence that disclosure was relevant to an understanding of the combined entity's financial performance.
- BC416 To help achieve the third disclosure objective in paragraph BC411, the IASB concluded that the previous requirement to disclose a reconciliation of the carrying amount of goodwill at the beginning and end of the period should be amended to require separate disclosure of net exchange rate differences arising during the period in accordance with IAS 21 *The Effects of Changes in Foreign Exchange Rates*.
- BC417 The IASB observed that there might be situations in which the information disclosed under the specific requirements would not completely satisfy IFRS 3's three disclosure objectives. In that situation, IFRS 3 required disclosure of any additional information necessary to meet those objectives.
- BC418 IFRS 3 also required the acquirer to disclose the number of equity instruments issued or issuable as part of the cost of a business combination, the fair value of those instruments and the basis for determining that fair value. Although IAS 22 did not explicitly require disclosure of that information, the IASB concluded that the acquirer should have provided it as part of disclosing the cost of acquisition and a description of the purchase consideration paid or contingently payable in accordance with paragraph 87(b) of IAS 22. The IASB decided that to avoid inconsistent application, IFRS 3 should explicitly require disclosure of that information.



### Disclosure requirements of the revised standards

- BC419 The boards decided that the revised standards should include overall objectives for the disclosure of information that would be useful to investors, creditors and others in evaluating the financial effects of a business combination. The objectives, which are stated in paragraphs 59 and 61 of the revised IFRS 3, are, in substance, the same as those in IFRS 3 and the 2005 Exposure Draft. Respondents to the 2005 Exposure Draft who discussed the proposed disclosures generally agreed with the disclosure objectives. In reconsidering that exposure draft, however, the boards noted that the third objective in IFRS 3, to provide information that enables users of an entity's financial statements to evaluate changes in the carrying amount of goodwill during the period, is effectively included in the objective in paragraph 61. Thus, the boards combined those two objectives.
- BC420 In addition, both boards concluded, as the IASB did in developing IFRS 3, that it is not necessary (or possible) to identify all of the specific information that may be necessary to meet those objectives for all business combinations. Rather, the revised standards specify particular disclosures that are generally required to meet those objectives and require acquirers to disclose any additional information about the circumstances surrounding a particular business combination that they consider necessary to meet those objectives (paragraph 63 of the revised IFRS 3).
- BC421 Changes to the disclosure requirements of IFRS 3 and SFAS 141 include the elimination of disclosures of amounts or information that was based on applying the cost allocation (purchase price) method for assigning amounts to assets and liabilities that is replaced by the revised standards' fair value measurement principle. Some of those disclosures are modified to retain the information but conform the amounts to be disclosed with the fair value measurement principle.
- BC422 The boards added some disclosure requirements to those in IFRS 3, SFAS 141 or both and modified or eliminated others. Those changes are described below, together with an indication of how the changes relate to each board's previous requirements and references to related discussions in other parts of this Basis for Conclusions where pertinent.<sup>32</sup>
- (a) In response to requests from some commentators on the 2005 Exposure Draft, the boards added to both IFRS 3 and SFAS 141 disclosure of information about receivables acquired. (paragraphs BC258–BC260)
  - (b) The boards modified both IFRS 3's and SFAS 141's disclosures about contingent consideration in a business combination to make them consistent with the revised standards' requirements for contingent consideration. Paragraph B64(g) of the revised IFRS 3 describes the specific disclosures now required.

<sup>32</sup> IFRS 13, issued in May 2011, requires disclosures about fair value measurements after initial recognition. Although the disclosures required by IFRS 13 are not required for IFRS 3, the wording has been aligned.

- (c) The FASB added to SFAS 141 disclosure of the revenue and earnings of the acquiree, if practicable, for a minimum of the period from the acquisition date to the end of the current year. The disclosure is required only from public business entities for the current year, the current interim period and cumulative interim periods from the acquisition date to the end of the current year. IFRS 3 already required disclosure of the amount of the acquiree's profit or loss included in the acquirer's profit or loss for the period, unless that was impracticable; the IASB added revenues to that disclosure. (paragraphs BC423–BC428)
- (d) The FASB modified SFAS 141's disclosure of supplemental pro forma information about results of operations for the comparable prior period presented to focus on revenue and earnings of the combined entity for the comparable prior reporting period as though the acquisition date for all business combinations during the current year had been the beginning of the comparable prior annual reporting period. The disclosure is required only from public entities and only if practicable. The IASB decided not to add that disclosure. (paragraph BC428)
- (e) The FASB replaced SFAS 141's disclosure of the period for which the results of operations of the acquiree are included in the income statement of the combined entity with disclosure of the acquisition date—a disclosure that IFRS 3 already required. SFAS 141(R) no longer permits the alternative practice of reporting revenues and expenses of the acquiree as if the acquisition occurred as of the beginning of the year (or a designated date) with a reduction to eliminate the acquiree's pre-acquisition period earnings. (paragraphs BC108–BC110)
- (f) The boards revised both IFRS 3's and SFAS 141's disclosures about contingencies, at the acquisition date and subsequently, to make them consistent with the requirement of the revised standards on assets and liabilities arising from contingencies. The IASB's and the FASB's disclosures on contingencies differ because the recognition requirements to which they relate differ. (paragraphs BC265–BC278)
- (g) The FASB added to SFAS 141 disclosure of the amount of acquisition-related costs, which IFRS 3 already required, and the boards added to both IFRS 3 and SFAS 141 disclosure of the amount of acquisition-related costs recognised as expense and the statement of comprehensive income line item in which that expense is reported.
- (h) The FASB eliminated SFAS 141's requirement to disclose the amount of in-process research and development acquired that had been measured and immediately written off to expense in accordance with FASB Interpretation 4. SFAS 141(R) no longer permits that practice. (paragraphs BC149–BC155)
- (i) The boards added to both IFRS 3 and SFAS 141 disclosure of the acquisition-date fair value or other recognised amount of the non-controlling interest in the acquiree and the valuation techniques and key model inputs used for determining that value. An entity that

prepares its financial statements in accordance with IFRSs also discloses the measurement basis selected for the non-controlling interest.

- (j) For a business combination achieved in stages, the boards added to both IFRS 3 and SFAS 141 disclosure of the fair value of the acquirer's previously held equity interest in the acquiree, the amount of gain or loss recognised in accordance with paragraph 42 of the revised IFRS 3 and the line item in the statement of comprehensive income in which that gain or loss is recognised.
- (k) The FASB replaced SFAS 141's disclosure of extraordinary gains recognised for 'negative goodwill' with disclosure of the amount of any gain recognised in the period for a bargain purchase, the line item in the statement of comprehensive income in which it is recognised and a description of the reasons why the transaction resulted in a gain (paragraphs BC371–BC381). IFRS 3 already required disclosure of that amount (although it was not called a gain on a bargain purchase).
- (l) The boards added to both IFRS 3 and SFAS 141 the disclosures described in paragraph B64(l) of the revised IFRS 3 about transactions that are separate from the acquisition of assets and assumption of liabilities in the exchange for the acquiree. The 2005 Exposure Draft proposed requiring disclosures about only pre-existing relationships between the acquirer and acquiree. The boards broadened the disclosure to all separate transactions in response to comments on the exposure draft.
- (m) The boards revised the disclosures in IFRS 3 and SFAS 141 about aspects of the purchase price allocation not yet completed to make them consistent with the requirements of the revised standards about the measurement period. The specific disclosures required are in paragraph B67(a) of the revised IFRS 3.
- (n) The IASB eliminated IFRS 3's required disclosure of the acquiree's carrying amounts in accordance with IFRSs for each class of its assets and liabilities immediately before the combination. The IASB concluded that providing that disclosure could often involve significant costs because the acquiree might not be applying IFRSs and that those costs might exceed the benefits of the information to users.

### **Disclosure of information about post-combination revenue and profit or loss of the acquiree**

- BC423 Paragraph B64(q) of the revised IFRS 3 requires an entity to disclose, for each business combination (and for individually immaterial business combinations that are material collectively), the amounts of revenue and profit or loss of the acquiree since the acquisition date included in the consolidated statement of comprehensive income for the period. At its August 2003 round-table discussion with users of financial statements, the FASB discussed the potential usefulness of information about increases or decreases in post-combination revenues and earnings from acquired businesses versus revenues and earnings

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from the operations already owned by the acquirer (organic growth). The FASB also asked whether that information would be preferable to the pro forma supplemental disclosure of revenue and results of operations of the combined entity for the current period as though the acquisition date for all business combinations during the year had been as of the beginning of the annual reporting period. SFAS 141 carried that disclosure forward from APB Opinion 16 and IFRS 3 required a similar disclosure.

- BC424 The FASB also questioned whether those disclosures are directed at similar objectives and, if so, whether one may be preferable. The FASB observed that making post-combination distinctions might be too costly or impossible if the operations of the acquiree are integrated with those of the acquirer. Although users acknowledged that point, they indicated that information about actual post-combination revenues and earnings is preferable to the pro forma disclosures and should be required whenever possible. Some also said that distinguishing acquired revenues from organic revenues is most important and suggested that acquirers should be required to provide that information for a twelve-month period following an acquisition rather than only to the end of the annual period.
- BC425 The boards agreed with users that the information about post-combination revenues and profit or loss of the acquiree is useful. However, for practical reasons, the boards concluded that the revised standards should provide an exception to that requirement if distinguishing the post-combination earnings of the acquiree from earnings of the combined entity is impracticable. The boards also decided that in those circumstances the acquirer should disclose that fact and the reasons why it is impracticable to provide the post-combination information. The period for that disclosure is limited to the end of the current annual period because the boards concluded that the information needed to provide the disclosure during that period will generally be available. A short period is often required to integrate an acquiree's operations fully with those of the acquirer. The boards also observed that the usefulness of the separate information diminishes as the operations of the acquiree are integrated with the combined entity.
- BC426 The FASB proposed in its version of the 2005 Exposure Draft that the post-combination disclosures should focus on *results of operations* rather than on revenues and earnings. *Results of operations* was defined as revenue, income before extraordinary items and the cumulative effect of accounting changes, earnings and earnings per share. In considering the responses to the exposure draft and opportunities for further convergence, the FASB decided to revise its disclosures to focus on revenues and earnings, which is consistent with the related requirements of the IASB. The boards observed that the term *results of operations* is not used or defined in IFRSs; it would thus have been more difficult for the IASB to converge with the disclosures initially proposed by the FASB.
- BC427 The FASB considered expanding the disclosure of post-combination revenues and earnings of an acquiree to all entities because the information would be valuable to any investor, not merely investors in public business entities. To do so would also converge with the requirements of the IASB. However, the

FASB was concerned about imposing the additional costs on non-public entities because it believes that the benefits to users of those entities would not be sufficient to warrant imposing those costs. The FASB also observed that the IASB has not completed its separate deliberations on its small and medium-sized entities project and thus does not have an established practice of differential disclosure for circumstances in which it is clear that the benefits would be sufficient for some entities but not so clear for all entities. Because of those cost-benefit concerns, the FASB decided not to extend this disclosure requirement to all entities.

- BC428 If comparative financial statements are presented, the FASB decided to require disclosure of supplemental pro forma information about the revenue and earnings of the combined entity for the comparable prior reporting period as though the acquisition date for all business combinations during the current year had been the beginning of the comparable prior annual reporting period. The disclosure is required only for public entities and only if practicable. The IASB considered also requiring that disclosure, but it observed that the needed information would be particularly difficult and costly to obtain in the international environment. An entity that prepares its financial statements in accordance with IFRSs might in a given year acquire other entities that had previously applied the domestic reporting requirements of several different countries. Because the IASB did not consider it feasible to require the disclosure in the international environment, the revised IFRS 3 requires only disclosure of revenues and profit or loss for the current reporting period determined as though the acquisition date for all combinations during the period had been as of the beginning of the annual reporting period.

### Effective date and transition

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- BC429 SFAS 141(R) is effective for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after 15 December 2008, ie for 2009 financial statements. The IASB decided to provide a slightly later effective date. The revised IFRS 3 is effective for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after 1 July 2009. The IASB made a commitment to its constituents that there would be a transition period of approximately 18 months between the publication date and the effective date of the revised IFRS 3 as part of its commitment to have a period of stability following the initial transition to IFRSs. The FASB decided to make SFAS 141(R) effective as soon as practicable, ie for 2009 financial statements. The FASB believes that that effective date provides sufficient time for entities and their auditors to analyse, interpret and prepare for implementation of the provisions of SFAS 141(R).
- BC430 The boards also concluded that the effective date of the revised standards should be the same as that of the amendments to their respective consolidation standards (FASB Statement No. 160 *Noncontrolling Interests in Consolidated Financial Statements* and the IASB's amendments to IAS 27). Particular provisions in those amendments, which address the subsequent accounting for an acquiree in consolidated financial statements, are related to

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provisions in the revised standards that address the initial accounting for an acquiree at the acquisition date.<sup>33</sup> The boards concluded that linking the timing of the changes in accounting required by those amendments to those required by the revised standards would minimise disruptions to practice, which benefits both preparers and users of financial statements.

- BC431 SFAS 141(R) prohibits early application and the revised IFRS 3 permits early application. The FASB's Investors Technical Advisory Committee and other users of financial statements told the FASB that providing alternatives for when entities adopt a new standard impairs comparability. The IASB observed, however, that the changes to IFRS 3 are less extensive than the changes to SFAS 141. In addition, the IASB observed that IAS 27 is silent on the accounting for changes in controlling ownership interests in a subsidiary and it wanted entities to be able to adopt the guidance in the amended IAS 27 as soon as it is published. Accordingly, the IASB retained the proposal in the 2005 Exposure Draft to permit entities to adopt the revised IFRS 3 early if they so choose.
- BC432 The IASB and the FASB also concluded that the revised standards should be applied prospectively. As with most other requirements that relate to particular types of transactions, applying the revised standards retrospectively would not be feasible.

### **Effective date and transition for combinations of mutual entities or by contract alone**

- BC433 IFRS 3 excluded from its scope combinations of mutual entities and those achieved by contract alone. In developing IFRS 3, the IASB decided that these combinations should be excluded from its scope until the IASB published interpretative guidance for the application of the acquisition method to those transactions. The revised IFRS 3 provides that guidance. The effective date for combinations of mutual entities and those achieved by contract alone is the same as the effective date for all other entities applying the revised IFRS 3.
- BC434 For the reasons outlined in paragraph BC180 of IFRS 3 the IASB concluded that the transitional provisions for combinations involving mutual entities only or those achieved by contract alone should be prospective. Given that these combinations were not within the scope of IFRS 3, they may have been accounted for differently from what IFRS 3 required. The transitional provisions in IFRS 3 took into consideration that entities may have used a range of alternatives in accounting for combinations in the past. The IASB concluded that the transitional provisions for these combinations should incorporate the transitional provisions in IFRS 3 for other business combinations. In addition, the IASB concluded that the transitional provisions should provide that an entity should continue to classify prior combinations in accordance with its previous accounting for such combinations. This is consistent with the prospective approach. Those provisions are contained in paragraphs B68 and B69 of the revised IFRS 3.

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<sup>33</sup> The consolidation requirements in IAS 27 were superseded by IFRS 10 *Consolidated Financial Statements* issued in May 2011. The requirements for the subsequent accounting for an acquiree in consolidated financial statements were not changed.

### **Transition requirements for contingent consideration from a business combination that occurred before the effective date of IFRS 3 (as revised in 2008)**

- BC434A In *Improvements to IFRSs* issued in May 2010, the Board addressed a perceived conflict in the guidance on accounting for contingent consideration in a business combination. The perceived conflict related to the transition guidance for contingent consideration arising from business combinations that had been accounted for in accordance with IFRS 3 (as issued in 2004). Before their deletion in January 2008, paragraph 3(c) of IFRS 7, paragraph 4(c) of IAS 32 and paragraph 2(f) of IAS 39<sup>34</sup> excluded contingent consideration arrangements from the scope of those IFRSs. To allow the acquirer to account for contingent consideration as required by IFRS 3 (revised 2008), the Board deleted those scope exceptions in the second phase of its project on business combinations.
- BC434B Some interpreted the deletion of the scope exception as meaning that IAS 39 would apply to all contingent consideration, including contingent consideration from business combinations with an acquisition date earlier than the application date of IFRS 3 (revised 2008). However, this interpretation is inconsistent with the transition guidance in paragraph 65 of IFRS 3 (revised 2008).
- BC434C Therefore, the Board reproduced paragraphs 32–35 of IFRS 3 (as issued in 2004) as paragraphs 65B–65E in IFRS 3 (revised 2008) and made the conforming changes to IFRS 7, IAS 32 and IAS 39. The Board did this to clarify that the requirements in IAS 39 do not apply to contingent consideration that arose from a business combination whose acquisition date preceded the application of IFRS 3 (revised 2008) and to provide guidance on how to account for such balances. The Board believes that the amendments will not cause IFRS 3 to diverge from FASB ASC Topic 805 *Business Combinations* (SFAS 141(R) *Business Combinations*).

### **Effective date and transition for clarifications of the accounting for contingent consideration that arises from business combinations**

- BC434D *Annual Improvements to IFRSs 2010–2012 Cycle*, issued in December 2013, clarifies the accounting for contingent consideration that arises from business combinations. The IASB considered whether the transition provisions of paragraph 19 in IAS 8 should apply, which require retrospective application. The IASB considered that the amendments required fair value measurement, and that some entities might not have previously applied fair value measurement for the subsequent measurement of contingent consideration. Retrospective application might therefore require the determination of fair value for contingent consideration, which might not have been previously measured at fair value following initial recognition. It may be impracticable for an entity to determine the fair value of such contingent consideration

<sup>34</sup> IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

without using hindsight. Consequently, the IASB decided to require prospective application to avoid the risk of hindsight being applied. The IASB also decided on a 1 July 2014 mandatory effective date for the amendments to IFRS 3 and the consequential amendments to IAS 37 as well as to IFRS 9 and IAS 39, depending on the financial instruments Standard that is applied by the entity at the time that this amendment becomes effective.

### **Scope exceptions for joint ventures**

BC434E *Annual Improvements Cycle 2011–2013* issued in December 2013 amended paragraph 2(a) and added paragraph 64J to clarify the scope exception in paragraph 2(a) of IFRS 3. It took into consideration the transition provisions and effective date of the amendment to IFRS 3. In order to be consistent with the prospective initial application of IFRS 3, the IASB decided that an entity shall apply the amendment to IFRS 3 prospectively for annual periods beginning on or after 1 July 2014.

### **Previously held interest in a joint operation (amendments issued in December 2017)**

BC434F The IASB decided that an entity applies paragraph 42A to business combinations occurring on or after the date it first applies the amendments. Applying the amendments to business combinations occurring before that date may have required the use of hindsight to remeasure the entity's previously held interest.

### **Amendments issued in May 2020**

BC434G *Reference to the Conceptual Framework*, issued in May 2020, updated paragraph 11 of IFRS 3, replacing a reference to the *Framework* with a reference to the 2018 *Conceptual Framework*. It made further amendments to avoid unintended consequences of updating the reference.

BC434H Paragraph 64Q of IFRS 3 requires an entity to apply these amendments prospectively. It also permits an entity to apply the amendments before their effective date, without disclosing that it has done so. The IASB concluded that no significant benefits would be gained from requiring either retrospective application or disclosure of early application. The IASB reached this conclusion because it did not expect the amendments to change significantly the population of assets and liabilities recognised in a business combination.

### **Benefits and costs**

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BC435 The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions. However, the benefits derived from information should exceed the cost of providing it. The evaluation of benefits and costs is substantially a judgemental process. Furthermore, the costs do not necessarily fall on those who enjoy the benefits. For these reasons, it is difficult to apply a cost-benefit test in any particular case. In making its judgement, the IASB considers:



- (a) the costs incurred by preparers of financial statements;
- (b) the costs incurred by users of financial statements when information is not available;
- (c) the comparative advantage that preparers have in developing information, when compared with the costs that users would incur to develop surrogate information; and
- (d) the benefit of better economic decision-making as a result of improved financial reporting.

In the second phase of the business combinations project the IASB also considered the costs and benefits of the revised IFRS 3 relative to IFRS 3.

BC436 The IASB concluded that the revised IFRS 3 benefits both preparers and users of financial statements by converging to common high quality, understandable and enforceable accounting standards for business combinations in IFRSs and US GAAP. This improves the comparability of financial information around the world and it also simplifies and reduces the costs of accounting for entities that issue financial statements in accordance with both IFRSs and US GAAP.

BC437 The revised IFRS 3 builds on the core principles established by IFRS 3. However, the IASB sought to improve the understandability, relevance, reliability and comparability of information provided to users of financial statements as follows:

(a) **Scope**

The revised IFRS 3 has a broader scope than IFRS 3. Those entities that will now be required to apply the acquisition method might incur additional costs to obtain valuations and account for intangible assets and goodwill after the acquisition date. However, the IASB observes that much of the information required to account for a business combination by applying the acquisition method is already prepared by those entities that are currently applying the pooling of interests method. There might be additional costs associated with presenting this information within the financial statements, such as audit costs, but much of the information will already be available to management. The IASB concluded therefore that the benefits of improved comparability and faithful representation outweigh the costs that those entities will incur.

(b) **Non-controlling interest**

Paragraph 19 of the revised IFRS 3 provides preparers of financial statements with a choice for each business combination to measure initially a non-controlling interest either at fair value or as the non-controlling interest's proportionate share of the acquiree's identifiable net assets. Paragraphs BC209–BC221 discuss the benefits and costs associated with granting a choice on how non-controlling interests should be measured.

**(c) Contingent consideration**

Paragraph 58 of the revised IFRS 3 requires contingent consideration that is classified as a liability and is within the scope of IAS 39<sup>35</sup> to be remeasured to fair value (or for those within the scope of IAS 37 or another IFRS, to be accounted for in accordance with that IFRS)<sup>36</sup> and that contingent consideration classified as equity is not remeasured. The IASB understands that remeasuring the fair value of contingent consideration after the acquisition date results in additional costs to preparers. Preparers will need to measure the fair value of these arrangements or will need to obtain external valuations at the end of each reporting period. However, users have stated that the information they receive under IFRS 3 is too late to be useful. The IASB concluded therefore that the benefits of relevance and representational faithfulness and the increased information that would be provided to users outweigh the costs.

**(d) Acquisition-related costs**

Paragraph 53 of the revised IFRS 3 requires the costs the acquirer incurs in connection with a business combination to be accounted for separately from the business combination. The IASB concluded that this treatment would improve the understandability of the information provided to users of financial statements. The IASB observed that the new requirement does not create significant additional costs for preparers of financial statements because paragraph 67(d) of IFRS 3 already required disclosure of acquisition-related costs.

**(e) Business combinations achieved in stages**

The revised IFRS 3 establishes the acquisition date as the single measurement date for all assets acquired, liabilities assumed and any non-controlling interest in the acquiree.

In a business combination achieved in stages, the acquirer also remeasures its previously held equity interest in the acquiree at its acquisition-date fair value and recognises the resulting gain or loss, if any, in profit or loss. In contrast, IFRS 3 required that for a business combination achieved in stages each exchange transaction should be treated separately by the acquirer, using the cost of the transaction and fair value information at the date of each exchange transaction, to determine the amount of any goodwill associated with that transaction. Therefore, the previous treatment required a comparison of the cost of the individual investments with the acquirer's interest in the fair values of the acquiree's identifiable assets and liabilities at

<sup>35</sup> IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

<sup>36</sup> *Annual Improvements to IFRSs 2010–2012 Cycle*, issued in December 2013, amended IFRS 3, IFRS 9, IAS 37 and IAS 39 to clarify that contingent consideration in a business combination that is classified as an asset or a liability shall be subsequently measured at fair value with changes in fair value recognised in profit or loss.

each step. The IASB concluded that the revised treatment of business combinations achieved in stages would improve understandability and relevance of the information provided as well as reduce the cost of accounting for such transactions.

- BC438 The IASB concluded that the guidance in the revised IFRS 3 is not unduly complex. Indeed, it eliminates guidance that many have found to be complex, costly and arbitrary and that has been the source of considerable uncertainties and costs in the marketplace. Moreover, the revised IFRS 3 does not introduce a new method of accounting but rather expands the use of the acquisition-method of accounting that is familiar, has been widely used and for which there is a substantial base of experience. However, the IASB also sought to reduce the costs of applying the revised IFRS 3 by:
- (a) requiring particular assets and liabilities (eg those related to deferred taxes and employee benefits) to continue to be measured in accordance with existing accounting standards rather than at fair value;
  - (b) carrying over the basic requirements of IFRS 3 on contingent liabilities assumed in a business combination into the revised IFRS 3 until the IASB has comprehensively reconsidered the accounting for contingencies in its liabilities project; and
  - (c) requiring the revised IFRS 3 to be applied prospectively rather than retrospectively.
- BC439 The IASB acknowledges that those steps may result in some sacrifice to the benefits of improved information in financial statements in accordance with the revised IFRS 3. However, the IASB concluded that the complexities and related costs that would result from applying the fair value measurement requirement to all assets and liabilities, at this time, and requiring retrospective application are not justified.

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## **Appendix** **Amendments to the Basis for Conclusions on other IFRSs**

*This appendix contains amendments to the Basis for Conclusions on other IFRSs that are necessary in order to ensure consistency with IFRS 3 (as revised in 2008) and the related amendments to other IFRSs. Amended paragraphs are shown with new text underlined and deleted text struck through.*

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*The amendments contained in this appendix when the revised IFRS 3 was issued in 2008 have been incorporated into the text of the Basis for Conclusions on IFRSs 2, 4 and 5 and on IASs 36 and 38 as issued at 10 January 2008.*

## Dissenting opinions

### Dissent of Mary E Barth, Robert P Garnett and John T Smith

- DO1 Professor Barth and Messrs Garnett and Smith dissent from the publication of IFRS 3 *Business Combinations* (as revised in 2008), for the reasons set out below.

#### Measurement of non-controlling interest

- DO2 Professor Barth and Mr Smith disagree with the Board's decision to make an exception to the IFRS's measurement principle and permit acquirers a free choice, acquisition by acquisition, to measure any non-controlling interest in an acquiree as the non-controlling interest's proportionate share of the acquiree's identifiable net assets, rather than at fair value (paragraph 19 of the IFRS).
- DO3 Professor Barth and Mr Smith agree with the measurement principle as explained in paragraph BC207 that the acquirer should recognise the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree at their acquisition-date fair values. Paragraph BC209 indicates that the Board also supports this principle, but decided to make an exception. Professor Barth and Mr Smith support the Board's general view that exceptions should be avoided because they undermine principle-based standards, but understand that they are necessary in well-justified circumstances. Professor Barth and Mr Smith do not believe that an exception to this principle, with a free choice in applying it, is justified in this situation.
- DO4 First, Professor Barth and Mr Smith are among those Board members mentioned in paragraph BC213 who believe that non-controlling interests can be measured reliably. Second, Professor Barth and Mr Smith believe that the benefits of consistently measuring all assets acquired and liabilities assumed outweigh the costs involved in conducting the measurement. To address concerns about costs exceeding benefits in particular acquisitions, they would have supported an exception to the principle based on undue cost or effort. Such an exception would not have been a free choice, but would have required assessment of the facts and circumstances associated with the acquisition. Professor Barth and Mr Smith disagree with the Board's decision to permit a free choice, rather than to adopt such an exception. They also disagree with the Board's decision not to require fair value measurement even for acquisitions of listed acquirees, for which the cost would be nil. Third, a consequence of failure to measure non-controlling interests at fair value is that acquired goodwill is not measured at fair value. In addition to being an exception to the IFRS's measurement principle, this has several undesirable effects beyond the initial accounting for goodwill. The Board acknowledges these in paragraphs BC217 and BC218. In particular, if goodwill is impaired the impairment loss is understated, and if the acquirer subsequently purchases more of the non-controlling interests equity is reduced more than it would be had goodwill been measured initially at fair value. Fourth, based on staff research, the choice will benefit only a minority of acquirers because

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most acquisitions are for 100 per cent of the acquiree. As noted above, any benefit is reduced if such acquirers subsequently impair goodwill or acquire more of the non-controlling interest because of the resulting anomalous accounting results.

- DO5 Professor Barth and Mr Smith agree with the Board that permitting entities a choice between alternative accounting methods impairs comparability, as noted in paragraph BC210. They disagree with the Board's decision not to support a single method, particularly a method consistent with the IFRS's measurement principle. However, Professor Barth and Mr Smith disagree with the Board that the benefits of other changes to the IFRS outweigh the disadvantages of permitting entities that acquire less than 100 per cent of an acquiree a free choice as to how to account for the acquisition. Although Professor Barth and Mr Smith agree with the other changes to IFRS 3, they believe that these changes are not as important as having a consistent measurement principle.
- DO6 In addition to improving the accounting for business combinations, a primary goal of the business combinations project was to achieve convergence between IFRS 3 and FASB Statement No. 141 (revised 2007) *Business Combinations* (SFAS 141(R)). Professor Barth and Mr Smith strongly support that goal. The Board's decision to make the exception to the measurement principle for non-controlling interests creates a divergence from SFAS 141(R). Both the FASB and the IASB made compromises to achieve a converged result in other aspects of the IFRS, and the FASB made a number of changes to its standard that conform to IFRS 3 (as issued in 2004). Professor Barth and Mr Smith believe that the Board's compromise on this particular issue diminishes the importance of convergence, establishes a precedent for allowing a choice when the two boards cannot reach agreement and may suggest that full convergence in the long term cannot be achieved. This is particularly concerning for this decision given that the Board supports the principle underlying the FASB's answer, there are comparability costs inherent in a free choice of accounting methods and there are likely to be few benefits arising from the exception.
- DO7 Mr Garnett dissents from the issue of the IFRS because it both establishes a measurement principle for non-controlling interests with which he disagrees, and permits an exception to that principle. Whilst the exception permits the accounting that he considers appropriate, the use of alternative accounting methods reduces the comparability of financial statements.
- DO8 Mr Garnett observes that the application of the measurement principle that an acquirer should measure the components of a business combination, including non-controlling interests, at their acquisition-date fair values results in the recognition of not only the purchased goodwill attributable to the acquirer as a result of the acquisition transaction, but also the goodwill attributable to the non-controlling interest in the acquiree. This is often referred to as the 'full goodwill' method.

DO9 Mr Garnett considers that goodwill is unlike other assets since it cannot be identified separately, or measured directly. Purchased goodwill is a residual resulting from a calculation that absorbs the effects of recognition and measurement exceptions made in the IFRS (such as the accounting for employee benefit plans and deferred taxes) and any differences between an entry price used in valuing the business as a whole and the valuation of the individual assets and liabilities acquired.

DO10 Mr Garnett notes that the 'parent-only' approach to goodwill in the previous version of IFRS 3 (as issued in 2004) avoids this difficulty by measuring goodwill as the difference between the fair value of the consideration paid by the parent for the acquiree and its share of the fair value of the identifiable net assets of the acquiree. Thus, purchased goodwill is the amount implicit in the acquisition transaction and excludes any goodwill attributable to non-controlling interests. This method gives rise to more reliable measurement because it is based on the purchase consideration, which can usually be reliably measured, and it reflects faithfully the acquisition transaction to which the non-controlling interests were not a party.

#### **A business combination achieved in stages**

DO11 Mr Garnett disagrees with the requirement in a business combination achieved in stages to recognise the effect of remeasuring any previously-held equity interest in the acquiree to fair value through profit or loss (paragraph 42 of the IFRS), because that investment was not part of the exchange. Mr Garnett agrees that gaining control is a significant economic event that warrants a change from investment accounting to consolidation. However, the previous investment has not been sold. Under current IFRSs, gains and losses on cost method, available-for-sale and equity method investments are recognised in profit or loss only when the investment is sold (other than impairment). Mr Garnett would have recognised the effect of those remeasurements as a separate component of other comprehensive income instead of profit or loss.

