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**Status:** Draft**Effective date:** N/A**Accounting impact:**

Proposes significant changes to accounting for business combinations, and an extension of the scope of IFRS 3.

# International Financial Reporting Bulletin

## Proposed amendments to IFRS 3 *Business Combinations*

**Background**

The exposure draft (ED) of amendments to IFRS 3 is the second phase of the International Accounting Standards Board's (IASB's) business combinations project. This is a joint project with the US Financial Accounting Standards Board (FASB).

**Proposals**

The ED retains the basic approach of the existing IFRS 3 to apply acquisition accounting in all cases and identify an acquirer. This includes much of the current guidance for the identification and recognition of intangible assets separately from goodwill. However, the ED proposes certain very significant changes.

*Scope*

The scope of the standard is proposed to be extended to cover business combinations involving only mutual entities, and those achieved by contract alone. Transactions under common control would continue to be outside the scope of the revised standard.

*Definition of a business combination*

The proposals focus on control in determining whether a transaction gives rise to a business combination. This compares to the current approach under IFRS 3 where a business combination is defined as the bringing together of separate entities or businesses into one reporting entity.

*Definition of a business*

The definition is extended to include integrated activities and assets that are **capable** of being conducted and managed as a business and that provide either;

- a return to investors; or
- dividends, lower costs, or other economic benefits directly or proportionately to owners, members or participants.

This means that to meet the definition of a business, assets and activities need not be conducted and managed as a business as at the acquisition date, so long as they can be in the future.

*The acquisition method* The acquisition method of accounting for a business combination involves four steps:

- Identifying the acquirer;
- Determining the acquisition date;
- Measuring the fair value of the acquiree; and
- Measuring and recognising the assets acquired and the liabilities assumed.

The ED retains the approach set out in IFRS 3 for the first two of these steps. Changes are proposed for the others.

*Measuring the fair value of the acquiree* The ED proposes that all acquired businesses are measured and recognised at their full fair value at the acquisition date, even if the business combination involves less than 100% of the acquiree or the business combination is achieved in stages. This represents a fundamental change from the current IFRS 3, where the business combination is measured and recognised on the basis of the cost of the acquisition.

It is presumed that the consideration transferred by the acquirer represents the best evidence of the fair value of the acquirer's interest in the acquired business. Where the presumption is overcome, it is proposed that valuation techniques are used to obtain a fair value. This might be the case where a substantial control premium is paid. Additional guidance is included within the proposals where valuation techniques are to be used.

*Consideration transferred by the acquirer* All items included in the consideration transferred by the acquirer would be measured at the acquisition date. This includes the valuation of contingent consideration arrangements. If contingent consideration was classified as a liability (rather than equity), subsequent changes in fair value would be recognised in accordance with either IAS 39 *Financial Instruments: Recognition and Measurement*, IAS 37 *Non-financial Liabilities*, or other IFRSs.

The consideration transferred would include the fair value of any non-controlling interest in the acquired business that the acquirer owned immediately prior to the acquisition of the controlling interest. This could be an interest accounted for as an investment, or an interest in an associate or a joint venture. At the point of acquisition of the controlling interest, the existing interest would be remeasured at fair value, with any gain or loss being recorded in profit or loss.

*Transaction costs* In a further significant change from IFRS 3, the ED proposes that costs such as advisory, legal, accounting and valuation fees, together with all administrative costs, are to be excluded from the fair value attributed to the acquired business. Instead, they would be accounted for in accordance with other IFRSs, meaning that they would be charged to the income statement as incurred.

*Measuring and recognising the assets acquired and the liabilities assumed*

All assets acquired (including goodwill – see below) and liabilities assumed as a result of the business combination are proposed to be measured at their full fair value, with fewer exceptions than under the current IFRS 3. The remaining exceptions are deferred tax assets and liabilities, operating leases, employee benefit plans, and assets held for sale that are within the scope of IFRS 5 *Non-current assets Held for Sale and Discontinued Operations*.

*Operating leases*

The proposed approach for operating leases is for each lease to be assessed, as at the acquisition date, to determine whether it is at a market rate (whether the acquiree is the lessee or lessor). If an operating lease is not at a market rate, then the acquirer recognises an intangible asset if the terms of the operating lease are more favourable than market rates, and a liability if the terms are less favourable.

*Contingent assets and liabilities*

The current IFRS 3 requires contingent liabilities to be measured at fair value at the acquisition date. It is proposed to extend this requirement to cover both contingent assets and liabilities. Other changes proposed to accounting for contingent assets and liabilities are summarised in IFRB 2005/02.

*Intangible assets*

The current IFRS 3 requires intangible assets to be recognised separately from goodwill if they meet the IAS 38 definition and are reliably measurable. It is proposed that the requirement that they be reliably measurable be dropped, which would result in additional intangible assets being recognised separately. However, an assembled workforce would continue not to be recognised as a separate intangible.

*Goodwill*

In a significant change, it is proposed that goodwill is recognised and measured at an amount equal to the excess of the fair value of the acquired business as a whole less the fair value of the identifiable assets, and liabilities assumed. While this does not represent a change where 100% of a business is acquired, it is very significantly different where an acquirer owns less than 100%. This is because goodwill attributable to the minority interest (renamed 'non-controlling interest') would be recognised in the consolidated balance sheet, with the amount attributed to the non-controlling interest in equity being increased accordingly.

*Exchanges not at equal values*

In certain cases, the fair value of the acquirer's interest in the business acquired may exceed the fair value of the consideration transferred. This might be the case in a forced sale of a business. In such circumstances, a review would be required of whether the acquiring entity has correctly identified and measured the assets acquired, liabilities assumed, and consideration transferred. If, after this review, the fair value of the interest in the business acquired still exceeded the fair value of the consideration transferred, the excess would first be applied against the carrying value of goodwill until its carrying value reached zero, with any further excess amount being recognised as a gain. The ED includes additional examples and guidance for the application of this requirement.

*Measurement period* The proposals carry forward the existing IFRS 3 requirement that if any of the measurements required can only be completed provisionally at the acquisition date, any adjustments to those measurements that are to be reflected in the business combination must be completed within 12 months of the acquisition date. However, in a change from the existing IFRS 3, all changes to provisional amounts are applied on a retrospective basis (meaning that prior period information would need to be restated if a financial period end occurred before the measurements were finalised). The existing IFRS 3 only required restatement where additional evidence obtained showed that an error had been made in the initial measurements. This would be relatively uncommon, as many adjustments result from the correction of estimates which are currently accounted for in the period in which they occur.

*Assessing whether the exchange consideration is all in respect of the acquired business*

The ED clarifies that the consideration is not necessarily all exchanged for the business acquired. The ED includes Application Guidance for a number of examples, including where payments are made to compensate employees or former owners of a business for service rendered after the acquisition.

In assessing whether consideration represents payment for the business acquired or a different transaction or event, the acquirer is required to consider:

- The reasons for the transaction or event;
- Who initiated the transaction or event; and
- The timing of the transaction or event.

*Deferred tax – recognition after the initial accounting is complete*

Fair value adjustments to the carrying values in the acquiree of assets acquired, and liabilities assumed, may give rise to temporary differences which will result in the recognition of deferred tax on the acquisition of the business. This will affect the amount of goodwill recognised on the business combination.

Where a deferred tax asset arises, the ED proposes to prohibit any subsequent reduction in the carrying value of goodwill arising from changes in the deferred tax asset that are recognised after the date of acquisition. However, there is an exception to this general rule. Where the deferred tax benefits were recognised within one year of the date of the business combination, there would be a rebuttable presumption that any adjustments to the deferred tax balance in that period relate to conditions that applied at the acquisition date. In these circumstances, the goodwill balance would be adjusted unless the change to the deferred tax balance was clearly as a consequence of events after the acquisition date.

The ED retains the existing IFRS 3 requirement that any adjustments to deferred tax assets of the acquirer that arise as a result of the business combination are excluded from the accounting for the business combination.

*Disclosures* The ED proposes certain new disclosures, and modifies existing disclosures, which are consistent with the proposed changes in approach to measuring the full fair value of the acquired business, whether or not a 100% interest is acquired. These additional proposed disclosures include:

- The acquisition date fair value of the acquiree and the basis for its measurement;
- The acquisition date fair value of the consideration transferred, analysed into each major class (such as cash, other tangible or intangible assets and debt instruments);
- The maximum potential amount of future payments (undiscounted) that the acquirer could be required to make under the acquisition agreement;
- The amount of costs incurred in connection with the business combination, the amount recognised as an expense and the line item(s) in the income statement in which those expenses are recognised;
- If the consideration transferred is less than the fair value of the assets acquired, and liabilities assumed, the line item in which the gain has been recognised and a description of the reasons why the acquirer was able to achieve a gain;
- In a business combination achieved in stages, the amount of any gain or loss recognised on the remeasurement of the non-controlling equity interest and the line item in which the gain or loss has been recognised;
- In a business combination where the acquirer and the acquiree have a pre-existing relationship:
  - The nature of the pre-existing relationship
  - The measurement of the settlement amount of the pre-existing relationship, if any, and the valuation method used to determine the settlement amount
  - The amount of any settlement gain or loss recognised and the line item in the income statement in which that gain or loss is recognised
- For each material business combination, and others in aggregate:
  - The amount of revenue and profit or loss of the acquiree since the acquisition date that are included in the consolidated income statement for the reporting period;
  - The revenue and profit or loss of the combined entity for the current reporting period as if the acquisition date for all business combinations that occurred during the year was the start of the reporting period;

**Effective date and transition**

It is proposed that the revised IFRS 3 will apply to business combinations taking place during accounting periods commencing on or after 1 January 2007. Earlier application is encouraged, although it is proposed that this would be limited to accounting periods commencing on or after the date on which the amended IFRS 3 was issued. If the revised IFRS 3 were to be applied early, this would need to be disclosed and the revised versions of IAS 27 and IAS 37 would also be applied.

**Action required**

The proposals are complex and, in certain respects, would bring accounting that is significantly different from that required by the current version of IFRS 3. Entities that report, or plan to report in future, in accordance with IFRS or a GAAP which will converge with IFRS may wish to review the proposals further and send comments to the IASB.

Copies of the exposure draft may be downloaded from the IASB's website at:

<http://www.iasb.org/current/ed.asp>

The deadline for comments is 28 October 2005.