

30 Cannon Street, London EC4M 6XH, United Kingdom
Phone: +44 (0)20 7246 6410, Fax: +44 (0)20 7246 6411
Email: iasb@iasb.org Website: <http://www.iasb.org>

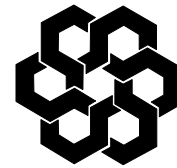
**International
Accounting
Standards
Board**

This document is provided as a convenience to observers at IASB meetings to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.

Note: These notes are based on the staff paper prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB paper. However because these notes are less detailed some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: **January 2006, London**
Project: **Business Combinations**
Agenda Item: **6A**
Subject: **Comment letter analysis – IFRS 3 and SFAS 141r proposals**



Exposure Draft, *Business Combinations* Comment Letter Summary

1. The comment period on the Exposure Draft, *Business Combinations* (BC ED) ended on October 28, 2005. The FASB and the IASB received 282 comment letters. The FASB and the IASB held public roundtable discussions with approximately 50 of those respondents.
2. The breakdown of the letters received are as follows:

	U.S. GAAP	IFRS	Both	<i>Total</i>
Academics	8	3	0	11
Accounting associations	6	27	1	34
Standard setters	0	10	0	10
Accounting firms	1	1	4	6
Appraisers	2	0	2	4
Industry groups	10	19	0	29
Industry: Mutuals/Coops	16	36	0	52
Industry: Banking	13	10	0	23
Industry: Insurance	4	1	1	6
Industry: Other	45	44	0	89
Securities analysts	0	0	2	2
Other	9	7	0	16
<i>Total</i>	114	158	10	282

ISSUE SUMMARY

3. Respondents commented on most issues raised in the proposals, which include the following:

- a. **Principle 1: A business combination is a transaction or other event in which an acquirer obtains control of one or more businesses**
 - (1) Definition of a *business combination* (paragraphs 5–7)
 - (2) Scope: should the acquisition method apply to mutual entities/cooperatives or business combinations achieved by contract alone? (paragraphs 8–16)
 - (3) Scope: joint ventures and common control transactions (paragraphs 17 and 18)
 - (4) Definition of a *business* (paragraphs 19 and 21)
 - (5) Scope: should the scope of the BC ED be expanded to include asset acquisitions? (paragraph 20)
- b. **Principle 2: The acquisition date is the date the acquirer obtains control of the acquiree**
 - (1) Designating an effective date other than the acquisition date (paragraphs 22–24)
- c. **Principle 3: An acquirer shall be identified in every business combination**
 - (1) Criteria for identifying the acquirer (paragraphs 25 and 26)
- d. **Principle 4: The acquirer shall measure and recognize the fair value of the acquiree, as a whole, on the acquisition date**
 - (1) Accounting for partial acquisitions (identifiable net assets, goodwill, and allocation of goodwill) (paragraphs 27–35)
 - (2) Accounting for step acquisitions (paragraphs 36–43)
 - (3) Accounting for bargain purchases (paragraphs 44–46)
 - (4) Accounting for overpayments (paragraphs 47 and 48).
 - (5) Fair value measurement guidance (paragraphs 49–52)
- e. **Principle 5: The acquisition–date fair value of the consideration transferred shall be used to measure the fair value of the acquiree except when it can be demonstrated that the consideration transferred is not the best evidence**
 - (1) Accounting for contingent consideration (paragraphs 53–61)
 - (2) Measurement date of the acquirer’s equity securities issued as consideration (paragraphs 62–64)
 - (3) Transaction costs (paragraphs 65–67).
- f. **Principle 6: The acquirer shall measure and recognize the fair value of the acquiree, as a whole, by recognizing the fair value of**

the acquiree's identifiable assets and liabilities as of the acquisition date.

- (1) Valuation allowances (paragraphs 68–74)
- (2) Accounting for contingencies (FASB only) (paragraphs 75–85)
- (3) Restructuring costs (FASB only) (paragraphs 86–88)
- (4) Accounting for insurance contracts (paragraphs 89–93)
- (5) In-process research and development (FASB only) (paragraphs 94–98)
- (6) Intangible assets:
 - (i) Accounting for preexisting relationships and reacquired rights (codification of EITF Issue No. 04–1, “Accounting for Preexisting Relationships between the Parties to a Business Combination”) (paragraphs 99–102)
 - (ii) Reliably measurable criterion (paragraphs 103–108)
 - (iii) Valuing intangible assets using the market participant view (paragraph 109)

g. Principle 7: Some assets and liabilities shall be measured and recognized in accordance with other standards rather than fair value for practical reasons and to avoid Day 2 complexities.

- (1) Exceptions to the fair value measurement principle
 - (i) Assets held for sale (paragraph 112)
 - (ii) Deferred taxes (paragraphs 113–121)
 - (iii) Operating leases (paragraphs 122–124)
 - (iv) Employee benefit plans (paragraph 125)

h. Principle 8: Only what is actually part of the exchange for the acquiree shall be accounted for as part of the business combination

- (1) Guidance for determining what is part of the business combination (paragraphs 126–129)

i. Principle 9: The acquirer is allowed reasonable time to obtain the information necessary to identify and measure the acquisition-date fair values of the acquiree and the assets acquired and liabilities assumed (measurement period).

- (1) Recognition of measurement period adjustments (paragraphs 130–133)

j. Disclosures (paragraphs 134–136)

k. Transition (paragraph 137)

l. Bold-type/plain-type style (paragraph 138)

m. Other comments

- (1) Due process (paragraph 139)
- (2) Drafting comments (paragraph 140).

4. The remainder of this memo summarizes the comments received by issue. The issues are organized first by principle, then by issue.

Principle 1: A Business Combination Is a Transaction or Other Event in which an Acquirer Obtains Control of One or More Businesses

Definition of a *Business Combination*

5. The BC ED defines a business combination as “a transaction or other event in which an acquirer obtains control of one or more businesses” (paragraph 3(e)). This definition is broader than the definition in FASB Statement No. 141, *Business Combinations*, and narrower than the definition in IFRS 3, *Business Combinations*. Statement 141 describes a business combination as occurring “when an entity acquires net assets that constitute a business or acquires equity interests of one or more other entities and obtains control over that entity or entities” (paragraph 9; footnote references omitted). IFRS 3 defines a business combination as “the bringing together of separate businesses or businesses into one reporting entity” (paragraph 4).

6. Question 1 of the Notice for Recipients/Invitation to Comment asked respondents whether the definition of a business combination in the BC ED is appropriate for accounting for all business combinations. Respondents’ views varied. Many respondents stated that the definition was appropriate for accounting for all business combinations. Those respondents generally did not provide the rationale for why they believed the definition was appropriate.

7. Some respondents believe that the definition was not appropriate. They believe that a definition based on one entity obtaining control of a business excluded “true mergers” or “mergers of equals.” For example, London Society of Chartered Accountants response was representative of those respondents. They stated:

We believe that the definition in IFRS 3 should be retained: ‘the bringing together of separate entities or businesses into one reporting entity’. The proposed definition does not take into account of what companies might believe to be, or try to present as true mergers. While we agree that all business combinations should be accounted for using the purchase method and that, inter alia, an acquirer must be identified, the proposed definition would appear to exclude true

mergers from the standard's scope and opens up an area of unnecessary debate between preparers and auditors. [CL #150]

Scope: Should the Acquisition Method Apply to Mutual Entities and Cooperatives?

8. The BC ED proposes that mutual entities and cooperatives (coops) be included in the scope of the standard and be required to apply the acquisition method. The majority of respondents who addressed this issue are either mutual entities or coops or organizations that represent mutual entities or coops. A few respondents stated that mutual entities and coops should apply the acquisition method. For example, KPMG stated that the "accounting for business combinations between mutual entities and for business combinations by contract alone are currently scoped out of IFRS 3. We believe that such transactions should be included within the scope and that the principles for determining the acquirer and acquisition accounting should be applied to those transactions" (CL #88).

9. The majority of respondents stated that mutual entities and coops should not apply the acquisition method. However, those respondents disagreed on the method that those entities should use. Of the respondents who believed that mutual entities or coops should not apply the acquisition method, the majority preferred retaining the pooling-of-interests method. They believe that combinations between mutual entities and coops are mergers and that the acquisition method is not reflective of the true economics of those combinations. In addition, a few respondents cited the increased costs that the acquisition method would impose since it would require costly valuations on both the acquisition date and going forward. For example, American Council of Life Insurers stated:

We do not believe the objective and definition of a business combination should apply to business combinations involving only mutual entities. A mutual merger is a true pooling of interest transaction with no consideration exchanged between the parties. With no consideration in a transaction, it is not practical to determine an accurate fair value of the acquired company to the acquirer. We are concerned that by using purchase accounting for a mutual merger, the results may be misleading to the financial statement users, who for the most part are regulators, bondholders and policyholders. The factors that motivate a merger between two mutual companies are very different than the factors that motivate an acquiring company paying cash or stock for a business.... [CL #46]

10. A few respondents indicated that they prefer a net asset approach. For example, American Community Bankers, a representative of credit unions, stated:

ACB maintains the position that the use of acquisition accounting, as described in the ED, is inappropriate for mutual combinations and will result in arbitrary and costly revaluations, and financial statements that will not truly reflect the essence of the underlying combination transaction. We are not advocating the maintenance of pooling-of-interests, rather we believe that FASB should require mutuals to use a net asset value approach, or similar variation of acquisition accounting using estimations of the fair market values of assets and liabilities assumed.... [CL #96]

11. A few respondents indicated that they prefer a fresh-start approach. For example, the Accounting Standards Board, the UK standard setter, stated:

We wish to emphasise that in our view it is inappropriate to require a single method of accounting for all business combinations. Acquisition accounting is capable of providing a representationally faithful depiction of reporting the acquisition of one business by another. It is, however, not a representationally faithful way of reporting a business combination in which one entity does not acquire another—no party to the transaction is an acquirer and accounting should not be based on the fiction that one of them is. For this reason ASB continues to advocate research into 'fresh start accounting'. [CL #130]

12. A few credit unions stated that if they are required to apply the acquisition method, the credit to equity should be recorded in retained earnings because “by creating a separate equity classification for the acquiring institution, it creates unnecessary confusion and regulatory problems for credit unions, without adding value” (Taylor Community Credit Union; CL #117).

Applicability to Coops

13. The IASB received a number of comment letters from coops that apply IFRS. The letters contained similar comments and recommendations. The major themes within those letters are as follows:

- (1) The term and definition of "mutual entity" used in the BC ED is inappropriate for cooperatives. The proposed definition mixes different business structures that should not be accounted for in the same manner. There is a difference between cooperative and mutuals because coops

issue member shares but mutuals do not. Mutuals have neither nominal nor transferable shares whatsoever. Membership in a mutual is often (but not systematically) granted upon payment of a fixed entry fee which does not carry any right to the member and is never negotiable.

- (2) A coop is an association of persons not of capital, which is not part of the IASB's concept of "mutual entity." In terms of corporate governance and control, a coop is jointly owned and democratically controlled. (one member one vote), irrespective of the amount of financial involvement of the different members.
- (3) A coop is an association of persons that cannot be sold because that would mean selling persons, and, certainly, the members as persons cannot be sold. To sell its business, a coop must be first terminated as an association of persons by the democratic sovereign decision of its general assembly. Only after its necessary conversion into a capital company can the business be sold. At this stage, what is being sold is not the coop (which no longer exists) but a conventional capital company. This is why coops cannot be included in the scope of IFRS 3.
- (4) If adopted as proposed, the provisions of IFRS 3 risk being in conflict with existing law. (CL #124)

14. The majority of the comment letters received by the IASB from coops included the following suggestions for the IASB:

- (1) IFRS 3 should exclude coops and mutual entities from its scope.
- (2) Coops do not fit into the IASB's definition of "mutual entities" that is in the BC ED because coops are not profit oriented entities.
- (3) The IASB should recognize the distinctive characteristics of coops and mutuals and provide differential accounting for them that is appropriate to their distinctive nature, function, mission, and modes of operation.
 - i. This category could be common with mutual entities provided that the differences between the two models are explicitly clarified, and provided that this common category is clearly different from the present "mutual entity" concept in the BC ED.
 - ii. The practice of joint ownership plus democratic control in coops and mutual entities should become a central element in a distinctive accounting treatment for these types of entities in the future.
- (4) The IASB should establish a specific working group on this topic with the participation of experts on coops and mutual entities from around the world.

Scope: Should the Acquisition Method Apply to Business Combinations Achieved by Contract Alone?

15. Few respondents addressed whether the acquisition method should be applied to business combinations achieved by contract alone. Of those that did, views were mixed. Some agreed that the acquisition method should be applied when control of a business is achieved by contract alone. They believed that all business combinations should be accounted for the same way regardless of how control is obtained. Some respondents stated that the acquisition method should not apply when control is obtained by contract alone because there is no readily measurable consideration by which to measure the fair value of the acquiree.

16. PwC agreed with the proposal, but cited some issues that could arise given the proposals in the BC ED:

We agree with the Boards' proposal that an acquirer can be identified in a business combination achieved by contract alone. However, the accounting acquirer in a dual headed group or a stapling transaction often does not acquire an equity interest in the acquiree. In these circumstances, the definition of a non-controlling interest would require that all of the fair value of the acquiree and its subsequent net income be allocated to the non-controlling interest.

This presentation does not reflect the economic substance of these arrangements in which the shareholders in the acquirer and the acquiree have the same residual economic interest in the net assets and results of the combined entity (as if they had been merged into a single entity). We suggest that the Boards consider this anomaly and revise the definition of a non-controlling interest so that it applies only to that part of the capital and reserves and profit or loss of the acquiree that is not attributable to those that have ownership interests in the reporting entity. [CL #66]

Scope: Joint Ventures and Common Control Transactions

17. Some respondents indicated that they were disappointed that the BC ED did not address joint venture accounting and common control transactions.

18. One respondent, PwC, stated “that in order to exclude joint ventures from the scope of the new standard and to achieve convergence, the Boards must define the difference between the creation of a joint venture and a business combination so that consistency of application can be achieved” (CL #66).

Definition of a *Business*

19. The BC ED proposes a new definition of a *business* and proposes that the acquiree constitute a business to account for the acquisition as a business combination. If the acquiree does not constitute a business, then the acquisition would be accounted for as an asset acquisition. This proposal prompted two types of comments:

(1) The Boards should consider broadening the scope of the BC ED to include accounting for asset acquisitions, which are conceptually similar to business combinations, and doing so would eliminate the need for a definition of a business.

(2) The Boards should further improve the definition of a business.

Scope: Should the Scope of the BC ED Be Expanded to Include Asset Acquisitions?

20. Some respondents questioned the conceptual basis for requiring that business combinations and assets acquisitions be accounted for differently. They believed that the proposed changes to accounting for business combinations that would be created by the BC ED put additional pressure on whether differential accounting should exist. For example, Mindthegaap, an accounting organization, stated "...the current Business Combinations project presents a timely opportunity to conform the accounting for business combinations and asset acquisitions wherever possible. In particular, we believe that the accounting for acquisition-related costs and in-process research and development assets should be made consistent irrespective of whether a transaction involves a business combination or the acquisition of assets" (CL #57).

Suggested Improvements to the Definition of a *Business*

21. Respondents generally agreed that the proposed definition of a business in the BC ED is an improvement over the definition in EITF Issue No. 98-3 "Determining Whether a Nonmonetary Transaction Involves a Receipt of Productive Assets or of a Business." However, some respondents offered suggestions about how to further improve the definition of a business. Those suggestions included:

- (1) Retaining the presumption from EITF 98-3 that “if all but a de minimus amount of the fair value of the transferred set of activities and assets is represented by a single tangible or identifiable intangible asset, the concentration of value in the single asset is an indicator that an asset rather than a business is being received.” Retaining that guidance would help identify transactions that are in substance asset acquisitions but may be structured to qualify as business combinations. (First Data Corporation; CL #9)
- (2) The clarity of the definition would be improved through the use of examples. (Deloitte; CL #22)
- (3) The proposed definition could be applied so broadly as to inappropriately identify an asset or asset group as a business. The Boards have proposed that an integrated set of assets and activities need only be "capable" of being managed and conducted for the purpose of providing a return to investors and that all of the assets and processes need not be present if a willing buyer is capable of acquiring the set and continuing to produce outputs, for example, by integrating the acquired set. However, the proposed definition may be too expansive and include in the scope of the standard a variety of transactions for which the impact of business combination accounting may not have been thoroughly considered.” (PwC; CL #66)
- (4) The presumption that if goodwill is present in a particular set of assets and activities then the set shall be presumed to be a business is circular. If there is a difference between the consideration paid and the fair value of the identifiable net assets that should raise the question as to whether the set is a business.

Principle 2: The Acquisition Date Is the Date the Acquirer Obtains Control of the Acquiree

Designating an Effective Date Other than the Acquisition Date

22. Statement 141 allows an acquirer, for convenience, to designate as the effective date the end of an accounting period between the date a business combination is initiated and the date a business combination is consummated. The designated date is the acquisition date for accounting purposes if a written agreement provides that effective control of the acquiree is transferred to the acquirer on that date (paragraph 48, paraphrased). Paragraph 25 IFRS 3 states that “the acquisition date is the date on which the acquirer *effectively* obtains control of the acquiree” (emphasis added).

23. The BC ED proposes to eliminate the guidance that allows an acquirer to designate a different date as the acquisition date. Paragraphs B54 and B55 of the FASB's basis for conclusions in the BC ED states:

....the [FASB] Board also decided to eliminate the “convenience” exception that Statement 141 carried forward from Opinion 16 and the reporting alternative permitted by Accounting Research Bulletin No. 51, *Consolidated Financial Statements*. Previously an acquirer could designate “an effective date other than the date assets or equity interests are transferred or liabilities are assumed or incurred [which required] adjusting the cost of an acquired entity and net income otherwise reported to compensate for recognizing income before consideration is transferred” (Statement 141, paragraph 48).... The [FASB] Board concluded that to faithfully represent an acquirer's financial position and results of operations, the acquirer should account for all business combinations at the acquisition date. That is, its financial position should reflect the assets acquired and liabilities assumed at the acquisition date—not before they are obtained or assumed.

24. This issue was not addressed in the Notice/Invitation, but two comment letters addressed it. Both disagreed with eliminating the convenience exception and asked that the Boards reconsider adding this guidance for practicability reasons. For example, Altria Group, a preparer, stated:

We disagree with the proposal, as discussed in paragraphs B53 – B55, to eliminate the “convenience” exception. This exception allowed the acquirer to designate an alternative date for the acquisition (i.e., as if it took place at the beginning of the acquirer's reporting period). Given the disruption that occurs in an acquired entity, forcing a mid-month closing can be onerous, can delay the preparation of quarterly and annual filings (the timing for which gets tighter and tighter) and, frankly, can produce a slow start for the more important process of the fair value allocations. Allowing for a date of convenience permits the acquiree to close on its historical closing schedule without developing an artificial stub-period that disrupts general ledger closings and adds tremendous work to the process without any clear benefit. [CL #240]

Principle 3: An Acquirer Shall Be Identified in Every Business Combination

Criteria for Identifying the Acquirer

25. Although the Boards specifically did not address the guidance for identifying the acquirer in phase II of the business combinations project, the guidance in Statement 141 and IFRS 3 was rewritten to make it the same. Those respondents noted that because the criteria for identifying the acquirer is based on control and because the FASB and the IASB have different definitions of control, a transaction might be accounted for as a business combination under IFRS but not under US GAAP or vice versa.

26. Two other respondents addresses the criteria for identifying the acquirer and raised the following points:

- (1) KPMG stated that it preferred the guidance from Statement 141 because it did not believe the concepts in FASB Interpretation No. 46 (revised 2003), *Consolidation of Variable Interest Entities*, are appropriate for determining the acquirer in a business combination (CL #88).
- (2) The South African Institute of Chartered Accountants stated that they disagreed with the guidance in the BC ED because it appears to be “based on de facto control rather than the power to control as required by IAS 27” (CL #215).

Principle 4: The acquirer shall measure and recognize the fair value of the acquiree, as a whole, on the acquisition date

Accounting for Partial Acquisitions

27. Question 3 in the Notice/Invitation addresses the accounting for partial acquisitions (that is, those in which the acquirer holds less than 100 percent of the equity interests in the acquiree at the acquisition date). The BC ED proposes that in all business combinations, including partial acquisitions, the acquirer should recognize the acquiree at its full fair value at the acquisition date.

Recognition of the Acquiree’s Identifiable Assets and Liabilities in a Partial Acquisition

28. The BC ED proposes that in a partial acquisition, the acquirer recognize the acquiree’s identifiable net assets at full fair value at the acquisition date. That

proposal is the same as the current requirements in IFRS 3, but differs from the requirements in US GAAP. Under US GAAP, the acquirer measures and recognizes the acquiree's net assets as the sum of (a) the fair value of the interest the acquirer obtained in the net assets and (b) the acquiree's carrying value of the noncontrolling interest portion in the net assets.

Recognition of the Acquiree's Goodwill in a Partial Acquisition

29. The BC ED proposes that in a partial acquisition, the acquirer recognize goodwill as the difference between the fair value of the acquiree and the fair value of the acquiree's net assets (with limited exceptions). The staff and Boards refer to this approach as the "full goodwill method." Under both IFRS 3 and current US GAAP, the acquirer recognizes goodwill as the difference between the cost of the combination (that is, the amount paid for the partial interest) and the fair value of the portion of the net assets in which the acquirer obtained an interest. Respondents' views were mixed and can be broken down into three categories. Those that:

- (1) Disagree with recognizing both the identifiable net assets and goodwill at 100 percent of their full value in a partial acquisition.
- (2) Agree with recognizing the identifiable net assets at full fair value, but disagree with recognizing goodwill at full value in a partial acquisition.
- (3) Agree with recognizing both the identifiable net assets and goodwill at 100 percent of their full value in a partial acquisition.

Disagree with recognizing both the identifiable net assets and goodwill at 100 percent of their full value in a partial acquisition

30. Some respondents disagreed with the proposals in the BC ED for recognizing the identifiable net assets and goodwill at 100 percent of their full value in a partial acquisition. Those respondents generally supported a cost accumulation model and believed that since the noncontrolling shareholders do not participate in the transaction, no amount of the assets or liabilities attributable to them should be remeasured when another entity obtains control of the acquiree. For example, Microsoft stated:

Microsoft is opposed to the requirement to recognize 100 percent of the fair value of the acquiree at the acquisition date for step acquisitions or when the acquirer holds less than 100 percent of the

equity interests of the acquiree. We agree with the Board that the principles underlying standards should strive to reflect the underlying economics of transactions and events. However, we do not believe the Board's conclusion that recognizing the entire economic value of the acquiree, regardless of the ownership interest in the acquiree at the acquisition date, reflects the underlying economics....we disagree with the Board's position 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". In fact, we believe a method that involves accumulating and allocating costs provides relevant information over time in accessing an entity's returns from an acquisition relative to the costs incurred in acquiring another entity. [CL #21]

Agree with recognizing the identifiable net assets at full fair value, but disagree with recognizing goodwill at full value in a partial acquisition

31. The majority of responses were in this category. They agreed that in a partial acquisition the acquiree's identifiable net assets should be recognized at full fair value, but they disagreed that goodwill attributable to the noncontrolling interest should be recognized. In general, those respondents believed that (a) goodwill is a different type of asset that warrants different treatment since it cannot be measured directly, and (b) the fair value of the acquiree cannot be reliably measured unless 100 percent of the acquiree is purchased. A few respondents specifically stated that the FASB should converge to the existing requirements in IFRS 3. For example, KPMG stated:

....we propose that the Boards adopt a converged model based in large part on the current IFRS 3, with certain improvements to address existing practice issues associated with its application. We believe this approach will meet the key objectives of the Boards, including improving financial reporting for business combinations and achieving international convergence. Additionally, while we acknowledge that this project is not a short-term convergence project, this approach is nonetheless consistent with the approach used by the Boards for short-term convergence, whereby the most recent standard becomes the basis for improvements and convergence.

From a US GAAP perspective, we believe an approach based on current IFRS 3 would represent an improvement over the current business combinations accounting model in Statement 141 because:

- It provides a basis to achieve a converged solution with IFRS;

- Upon acquisition of control, all identifiable assets and liabilities would be recognized at their fair values rather than using the “mixed” cost/fair value model that exists currently under Statement 141. Consistent with the fact that goodwill is the “residual amount”, any difference at the date of exchange between the purchase price and the acquirer’s ownership interest in the fair value of the identifiable net assets acquired would be recognized as goodwill;
- It does not introduce any new measurement issues that do not currently exist (i.e., although assets and liabilities are currently adjusted only to the extent of the interest acquired, the acquiring entity is still required to determine the fair value of identifiable assets and liabilities to apply purchase accounting under Statement 141). [CL #88]

Agree with recognizing both the identifiable net assets and goodwill at 100 percent of their full value in a partial acquisition

32. A few respondents agreed with the proposals in the BC ED that the acquirer should recognize both the acquiree’s net assets and goodwill at 100 percent of their values in a partial acquisition. Those respondents generally supported the full fair value model proposed in the BC ED and with the principle that when an acquirer obtains control of an acquiree, it obtains control of the underlying net assets and receives the benefit from the use of those assets. It should also be noted that the users of financial statement who provided comment letters were generally in this category. For example, CFA Institute, stated:

We agree that it is appropriate, where the acquirer holds less than 100 per cent of the equity interests of the acquiree at the acquisition date, that the acquirer recognize 100 per cent of the fair values of the identifiable assets acquired, liabilities assumed, and goodwill, including goodwill attributable to the non-controlling interest. We believe that full and complete transparency require that 100 per cent of the assets acquired be recorded at fair value at the date of acquisition (transfer of control), including any interests of the non-controlling equity holders. Similarly, all of the interests, claims, and obligations must be fully recognized and measured at fair value as of the acquisition date on the right-hand-side of the balance sheet. **These amounts would include the fair value of the non-controlling interest assumed by the company, which should be measured at fair value, including goodwill.** In short, we believe that the transfer of control of the acquiree to the acquirer is a major economic event and should result in the revaluation of all interests to fair value, including any prior equity interests of the acquirer as well as those of the non-controlling interests.

A particular advantage of this approach to the recognition and measurement is that all such acquisitions will be recognized and measured in a similar manner with 100% recognition of all acquired assets at fair value, and with full recognition of the various claims and interests in those assets. That is, financial reporting will not depend upon the particular structure, method or terms of an acquisition. We believe that this approach will result in greater clarity, comparability and usefulness of the information to investors and other users. [CL #273]

33. Another respondent, The New Zealand Treasury, agreed with the proposal on conceptual grounds and stated:

We agree taking this approach to goodwill is more conceptually sound than the current approach. If goodwill is considered to be an asset associated with the business, then minority interest must also own some, and therefore it makes sense to consolidate the full amount of goodwill similar to any other asset being consolidated. The opposing argument would be that goodwill holds little meaning as an asset and is really just a soft way of expensing the excess portion of consideration that can't be linked to an identifiable asset. If this view was valid, there would be an equally strong argument for not recognising goodwill in the first place and expensing any excess immediately. (CL #29)

Allocation of Goodwill in a Partial Acquisition

34. The BC ED proposes that in a partial acquisition the acquirer:

- (1) First, calculate goodwill as the difference between the fair value of the acquiree and the fair value (with limited exceptions) of the acquiree's identifiable net assets.
- (2) Second, allocate goodwill to the acquirer and noncontrolling interest. The amount of goodwill allocated to the acquirer would be measured as the difference between the acquisition-date fair value of the acquirer's equity interest in the acquiree (often, the consideration paid) and the acquirer's share in the acquisition-date fair value of the separately recognized assets acquired and liabilities assumed. The remainder would be allocated to the noncontrolling interest. (Paragraph A62, paraphrased)

35. Very few respondents addressed the issue of allocating goodwill between the acquirer and noncontrolling interests. First, the respondents who did not support the full goodwill method generally did not address the issue in their letters. Even of those that did support the full goodwill method, very few addressed the issue fully. However, several respondents did question the proposed goodwill allocation approach in the BC ED. Those respondents preferred that goodwill be treated like

other acquired assets and liabilities in a partial acquisition and be attributed to the acquirer and noncontrolling interests based on proportional ownership interests. For example, three respondents stated:

From a practical viewpoint, with the proposed goodwill allocation method, the percentage of ownership would no longer be able to be used as a reasonableness check on the reported amount of non-controlling interests. Because of this, the proposals would complicate the accounting for non-controlling interests, and result in less understandable financial statements for users. [Syngenta; CL #161]

....we are concerned that the proposals would substantially increase the complexity of tracking and calculating minority interests. With the proposed goodwill allocation method, the percentage of ownership would no longer be an indication which can be used directly. [Industrie-Holding; CL #183]

AcSEC also observes that the allocation of goodwill as described in paragraphs B154 and B155 will likely raise a number of implementation and valuation issues. As a result of the lack of precision that may be inherent in determining the fair value of business when less than 100% is acquired, [respondent] questions whether the prescribed method to allocate to the controlling and noncontrolling interests on other than a proportionate basis is operational. [AcSEC; CL #208]

Accounting for Step Acquisitions

36. Question 10 in the Notice/Invitation addresses the accounting for step acquisitions. The BC ED proposes that in all business combinations, including step acquisitions, the acquirer recognize the acquiree at its full fair value at the acquisition date. As a result, the acquirer would recognize all of the acquiree's assets and liabilities at full fair value, would remeasure any previously held noncontrolling equity interest, and would recognize a gain or loss on the remeasurement in income.

37. Statement 141 did not change the accounting for step acquisitions described in AICPA Accounting Interpretation 2, "Goodwill in a Step Acquisition," of APB Opinion No. 17, *Intangible Assets*. That Interpretation stated that when an entity acquires another entity in a series of purchases, the entity should identify the cost of each investment, the fair value of the underlying assets acquired, and the goodwill for each step acquisition.

38. IFRS 3 requires that in a step acquisition, the identifiable assets acquired and liabilities assumed be recognized at fair value but that goodwill be recognized as the difference between the cost of the interest acquired and the acquirer's proportional interest in the fair value of the identifiable assets acquired and liabilities assumed. Therefore, goodwill is determined by a step-by-step comparison of the cost of the individual investments with the acquirer's interest in the fair values of the identifiable assets acquired and liabilities assumed at each step.

39. Respondents' views on the proposed accounting for step acquisitions were mixed and can be broken down into four categories. Those that:

- (1) Disagree with recognizing the acquiree at fair value and with remeasuring previously held noncontrolling equity interests.
- (2) Disagree with recognizing the acquiree at fair value. Would recognize the identifiable net assets at full fair value but would recognize goodwill using a step by step approach (use current IFRS 3 model).
- (3) Agree with recognizing the acquiree at fair value and with remeasuring previously held noncontrolling equity interests and recognizing any gain or loss in income.
- (4) Agree with recognizing the acquiree at fair value and with remeasuring previously held noncontrolling equity interest but would recognize any gain or loss in other comprehensive income.

Disagree with recognizing the acquiree at fair value and with remeasuring previously held noncontrolling equity interests

40. Some respondents disagreed with recognizing the acquiree at fair value and with remeasuring previously held noncontrolling equity interests when the acquirer obtains control of the business. Those respondents generally believed that the acquirer should account for step acquisitions using a cost-accumulation approach. For example, Citigroup stated:

We disagree with the proposal to remeasure previously acquired noncontrolling interests at fair value, and the resultant recognition of a gain or loss in earnings. We fail to see how the acquisition of an additional ownership stake that results in control is a trigger for a realized or realizable gain as contemplated by paragraph 83 of Concept Statement No. 5. As with the "economic unit" view that underlies much of the conceptual basis for this Proposal, we believe this topic warrants further consideration within the Conceptual

Framework project before making significant changes to existing practice. [CL #42]

Disagree with recognizing the acquiree at fair value. Would recognize the identifiable net assets at full fair value but would recognize goodwill using a step by step approach (current IFRS 3 model)

41. Some respondents stated that in a step acquisition they would recognize (a) the identifiable net assets at fair value, and (b) goodwill as the difference between the cost of the interest acquired and the acquirer's proportional interest in the fair value of the identifiable assets acquired and liabilities assumed. This is the approach currently required by IFRS 3. For example, Deloitte stated:

....we believe that the current IFRS 3, *Business Combinations*, model provides sufficiently relevant and reliable information. International Financial Reporting Standards should retain IFRS 3 (with the limited modifications proposed in the responses to the remaining questions) and U.S. GAAP should converge with that model. Paragraph 51 of IFRS 3 computes goodwill as the excess of the cost of the business combination over the acquirer's interest in the net fair value of the identifiable assets, liabilities, and contingent liabilities recognized. Paragraphs 25 and 58 of IFRS 3 indicate that when a business combination involves more than one exchange transaction, the cost of the combination is the aggregate cost of the individual transactions, with the cost of each individual transaction determined at the date of each exchange transaction. Unless multiple arrangements are viewed as forming a single arrangement (as addressed in the noncontrolling interests exposure drafts), each exchange transaction should be treated separately by the acquirer, using the cost of the transaction and the fair value of the net identifiable assets acquired at the date of each exchange transaction, to determine the amount of any goodwill associated with that transaction. This results in a step-by-step comparison of the cost of the individual investments with the acquirer's interest in the fair values of the acquiree's identifiable assets and liabilities at each step. [CL #22]

Agree with recognizing the acquiree at fair value and with remeasuring previously held noncontrolling equity interests and recognizing any gain or loss in income

42. A few respondents agreed with the proposal in the BC ED. Those respondents agreed with the Boards' view that obtaining control of a business is an economic event that changes the nature of any previously held investments. For example, CPA Australia stated that they "consider...it...appropriate for the acquirer

to recognise in profit or loss any gain or loss on previously acquired non-controlling equity investments on the date it obtains control of the acquiree” (CL #118).

Agree with recognizing the acquiree at fair value and with remeasuring previously held noncontrolling equity interest but would recognize any gain or loss in other comprehensive income

43. The majority of respondents who agreed that the acquiree should be recognized at fair value and that any previously held noncontrolling equity interests should be remeasured believed that the remeasurement adjustment should be recognized in other comprehensive income (or directly in equity) rather than income. For example, Grant Thornton stated:

We do not agree that the acquisition-date remeasurement gains or losses on the previously acquired noncontrolling equity interests should be recognized in profit or loss (IASB)/income (FASB). Those remeasurement gains and losses would not have been realized through an acquisition-date exchange with an outside party. Therefore, we do not believe that they should be recognized in a measure of performance. We think that those acquisition-date remeasurement gains and losses are analogous to unrealized gains and losses on available-for-sale securities. Accordingly, we recommend that the effect of remeasuring previously acquired noncontrolling equity interests in the acquiree as part of a business combination be recognized in equity (other comprehensive income (FASB)) and recycled to profit or loss (IASB)(reclassified to income (FASB)) upon impairment or disposal of the related interests. We acknowledge that preparers will need to account for those gains and losses subsequent to the acquisition-date. [CL #20]

Accounting for Bargain Purchases

44. Question 11 in the Notice/Invitation addresses the issue of business combinations in which the consideration transferred for the acquirer’s interest in the acquiree is less than the fair value of that interest (referred to as a bargain purchase). The BC ED proposes that in a bargain purchase, any excess of the fair value of the acquirer’s interest in the acquiree over the fair value of the consideration transferred for that interest would reduce goodwill until the goodwill related to that business combination is reduced to zero, and any remaining excess would be recognized in income on the acquisition date.

45. The requirement in IFRS 3 for accounting for bargain purchases is effectively the same as what is proposed in the BC ED. IFRS 3 is based on a cost-accumulation model, so the requirement is that if the acquiree's recognized identifiable net assets and contingent liabilities exceed the cost of the combination, the excess is recognized in profit or loss (paragraph 56, paraphrased). However, mathematically, the result under IFRS 3 and the BC ED would be the same. Statement 141 requires that in a bargain purchase, the excess of the amounts assigned to the acquiree's net assets over the cost of the combination is allocated as a pro rata reduction of the amounts assigned to the acquired assets except financial assets, assets to be disposed of by sale, deferred tax assets, prepaid assets relating to employee benefit plans, and other current assets. The acquirer would then recognize an extraordinary gain for any excess remaining after reducing the acquiree's assets to zero (paragraphs 44 and 45, paraphrased).

46. Respondents' views were mixed. The respondents that supported the proposal generally did not provide the rationale for their support. Those that did not support the proposal generally believed that a business combination should not give rise to a gain on the acquisition date and that the accounting was inconsistent with the Boards' decision regarding overpayments. They believed that bargain purchases either do not or very rarely exist and the most likely explanation is (a) errors in measuring the assets acquired and liabilities assumed or (b) the requirement to measure certain assets or liabilities in accordance with other standards rather than at fair value. As a result, they did not agree with the proposals in the BC ED. Respondents provided the following alternatives:

- (1) Apply the IAS 22 accounting (PwC; CL #66). IAS 22 required the acquirer to recognize "negative goodwill"
 - i. Related to expectation of future losses and expenses identified in the acquirer's acquisition plan in income in the period in which the future losses or expenses were recognized
 - ii. As a contra-account against any recognized identifiable non-monetary assets (intangible assets). The acquirer would then reduce the contra-account in income over the life of the related assets
 - iii. In income immediately for any remaining excess

(2) First reduce to zero the value of intangible assets “that are not measured by reference to an active market,” and then recognize any remaining difference in income (KPMG; CL # 88).

(3) Retain the existing accounting in Statement 141 (AICPA PCPS; CL #116).

Overpayments

47. Question 12 in the Notice/Invitation addresses the issue of overpayments. The BC ED proposes that the acquirer not recognize an expense at the acquisition date if it overpaid to acquire a business because (a) an acquirer would not knowingly overpay to acquire a business so it would not be known at the acquisition date, and (b) the amount of the overpayment could not be reliably measured at the acquisition date. Overpayments are not addressed in either IFRS 3 or Statement 141 because those standards are based on cost-accumulation models. Thus, the amount paid is the amount recognized as the fair value of the acquiree at the acquisition date.

48. The majority of respondents agreed with the Boards on this issue. However, a few respondents stated that if the Boards believe that an overpayment cannot be reliably measured, then it calls into question the Boards’ decision that the fair value of the acquiree should be measured in a partial or step acquisition. For example, KPMG stated:

We agree with the Boards’ conclusion that overpayments may not be reliably measured. However, this conclusion by the Boards raises questions about the ability to reliably measure the fair value of the acquired entity and the related use of the full fair value approach. Conceptually, if fair value of the acquired entity can be reliably measured and the consideration paid can also be reliably measured, the amount of the overpayment can be easily computed. Therefore the fact that the Boards have concluded that overpayments cannot be reliably measured raises questions about the Boards’ conclusion that the fair value of the acquired entity can be reliably measured in all business combinations except those when there is an overpayment.
[CL #88]

Fair value measurement guidance

49. Question 4 in the Notice/Invitation asked respondents whether the BC ED provides sufficient guidance for measuring the fair value of the acquiree. Respondents’ views were mixed. Some respondents believed that the BC ED

provides sufficient guidance; the majority of respondents believed that it does not provide sufficient guidance; and a few respondents, namely appraisers, believed it provides too much guidance or guidance that is too specific.

50. The respondents who stated that the BC ED provides sufficient fair value measurement guidance generally did not provide the rationale for their position. The respondents who stated that the BC ED does *not* provide sufficient fair value measurement guidance expressed concern in two circumstances: partial acquisitions and step acquisitions. They generally believed that the guidance for measuring the fair value of the acquiree in a 100 percent acquisition was sufficient. They also generally supported the presumption that the fair value of the consideration transferred should be used to measure the fair value of the acquiree in a 100 percent acquisition (notwithstanding the fact that some of those respondents would not recognize contingent consideration at fair value at the acquisition date and would capitalize transaction costs). However, those respondents stated that the BC ED does not provide sufficient guidance for measuring the fair value of the acquiree in a step acquisition or partial acquisition. Most of the concerns related to how control premiums should or should not be factored into the measurement of the fair value of the acquiree. The BC ED does not provide guidance on accounting for control premiums, and some constituents asked for further clarification. For example, two accounting firms stated that:

...if the Boards retain the Exposure Drafts' requirement to measure the fair value of the acquiree as a whole, additional guidance will be needed to address the issues raised in the remainder of our response to this question. The Exposure Drafts explain that the acquisition date fair value of consideration transferred in exchange for a partial interest in an acquiree is most likely not representative of the fair value of the acquiree as a whole; the Boards attribute this conclusion at least in part to the existence of control premiums.....As a result, the Boards should provide additional guidance on the measurement and accounting for control premiums, including indicators for when they do or do not exist. We believe such guidance is necessary to improve the comparability of the financial information produced and the operationality of the guidance contained in the Exposure Drafts. [Deloitte; CL #22]

For example, it would be helpful to understand the Boards' thinking in connection with the allocation of value to a control premium

and the valuation issues that arise when an entity that owns 45% of another entity acquires a further 10%, giving rise to a business combination. What should the valuation professional and the preparer consider when using the price paid for the 10% interest as a basis to value the acquiree as a whole? [PwC; CL #66]

51. Chiltern PLC, tax advisers, who believed the BC ED provides too much fair value measurement guidance gave the following rationale:

Paragraphs 8–26 of Appendix A are too specific to sit comfortably in the middle of an IFRS. As noted in our introduction, the majority of preparers of accounts do not have in-depth valuation expertise. Attempting to provide guidance to such “laymen” as an integral part of IFRS could mislead preparers of accounts into thinking that they have the ability and technical toolkit to prepare robust valuations. We consider that this approach is both dangerous and imprudent and could lead to highly unreliable financial reporting. [CL #128]

52. It also should be noted that a number of the IASB’s constituents expressed concerns about the fair value measurement guidance provided in the BC ED and in an appendix in the IASB’s version of the BC ED because that guidance is based on the FASB’s Exposure Draft, *Fair Value Measurements*. For example, the Accounting Standards Board, the UK standard setter, stated:

We would also like to take this opportunity to record our concern regarding the [IASB] Board's decision at its September 2005 meeting to issue the FASB's final statement on fair value measurement as an IASB Exposure Draft with an Invitation to Comment. As detailed in 'IASB Update' the IASB will only be briefed on and discuss the FASB document in order to identify issues that should be included in the Invitation to Comment before issuing the Exposure Draft. Only after the comment period for the Exposure Draft will the [IASB] Board debate the issues identified by the [IASB] Board and constituents, and make any required changes to the Exposure Draft before issuing an IFRS. We consider that it is incumbent on the IASB only to issue an Exposure Draft when it has fully debated the issues and is satisfied it has fulfilled its objective to develop high quality, understandable and enforceable global accounting standards. [CL #130]

Principle 5: The Acquisition-Date Fair Value of the Consideration Transferred Shall Be Used to Measure the Fair Value of the Acquiree Unless It Can Be Demonstrated that the Consideration Transferred Is Not the Best Evidence

Contingent Consideration

Initial Recognition of Contingent Consideration

53. The BC ED proposes that the acquirer recognize the fair value of contingent consideration at the acquisition date. The accounting for contingent consideration under Statement 141 and IFRS 3 differs. Paragraph 27 of Statement 141 requires that contingent consideration usually be recorded “**when the contingency is resolved and consideration is issued or becomes issuable**” (emphasis added). Paragraph 32 of IFRS 3 requires that contingent consideration be recognized at the acquisition date “**if the adjustment is *probable* and can be measured reliably**” (emphasis added). However, IFRS 3 also requires that the acquirer adjust the cost of the combination:

- (1) For changes in the acquisition-date value of the contingent consideration (paragraph 33, paraphrased).
- (2) When the contingent consideration becomes probable and reliably measurable (paragraph 34, paraphrased).

54. Respondents’ views were mixed. Although the majority of respondents did not support the proposal to recognize contingent consideration at fair value at the acquisition date, a significant minority of respondents did support the proposal. (Please note that many respondents who supported initial recognition at fair value did not support the proposed subsequent accounting.)

55. Respondents who supported the proposal stated the following:

- (1) Acquirers value contingent consideration in determining what they are willing to pay for the acquiree.
- (2) All forms of consideration and all the assets acquired and liabilities assumed should be valued on the same date. Looking past the acquisition date to value the consideration or assets or liabilities is not consistent with the notion of accounting for what was acquired on the acquisition date.

56. For example, Duff & Phelps, an appraiser, stated:

As a practical matter, although current accounting does not compel either the measurement or recognition of contingent consideration in all cases, valuation practitioners typically develop valuation models that are based on the expected case Projected Financial Information ("PFI") of the acquiree as a whole. These valuation models, which are consistent with the valuation guidance provided in the ED as referred to above, are derived from the projections developed by the acquirer in their assessment of the acquiree and their deal negotiations, internal evaluations and Board presentations. The expected case PFI as a whole forms the foundation for the derivation of the valuation of the underlying acquired assets and liabilities, including both the assessment of income contribution (or cost savings) and the related risk-adjusted discount rate for each identifiable acquired asset and liability. The expected case PFI is also used to estimate the fair value of the acquiree as a whole in order to assess and correlate the assumptions and respective values of the component assets and liabilities with those of the overall business.

The fair value of contingent consideration requires an identification and evaluation of the possible future scenarios that may give rise to such contingent payment. This analysis should be explicitly or implicitly embedded in the expected case PH that is currently used to determine the fair value of identifiable assets and liabilities of the acquiree and to estimate the value of the acquiree as a whole. As such, the expected case PFI should provide a reasonable and consistent framework to estimate the fair value of contingent consideration. [CL #27]

57. Another respondent, The New Zealand Government, as represented by the New Zealand Treasury, that supported the proposal, stated:

We agree that acquisition date fair value is the best evidence of determining fair value. We do not support looking past the acquisition date for any aspects of the consideration, for example contingent consideration. Firms are always going to get a better idea later on down the track of whether the price they paid at day 1 was too high or too low. Shifting the valuation of some, but not other, aspects of the consideration out to get the benefit of hindsight would create an inconsistent anomaly. Any aspects of consideration that turn out differently to that expected at acquisition date should be left to an examination of goodwill impairment later down the track. [CL #29]

58. For the respondents who disagreed with the proposal, the approach they recommended depended on whether they apply US GAAP or IFRS. US GAAP respondents generally preferred the approach in Statement 141; IFRS respondents

generally prefer the IFRS 3 approach. However, the respondents who disagreed with the proposal did so for similar reasons, which include:

- (1) Contingent consideration cannot be measured reliably at the acquisition date. Contingent consideration occurs because the buyer and seller are not able to agree upon the fair value of the acquiree; therefore, reliably estimating the fair value of the contingent consideration is by definition impossible.
- (2) Recognizing the fair value of contingent consideration at the acquisition date based on a Concepts Statement 7 approach does not provide users of financial statements with valuable information about the ultimate settlement amount of that obligation. Users would be provided better information by disclosing the range of possible payout amounts.
- (3) The proposal might motivate acquirers to overestimate the acquisition-date fair value of contingent consideration so that the reversal of those liabilities results in income in future periods.

59. A few respondents stated that that *performance-based* contingent consideration and *security price-based* contingent consideration should be accounted for differently at the acquisition date. For example, FAR, a professional accounting organization, stated:

For security price-based contingent consideration, FAR agrees that subsequent changes in the fair value that do not qualify as measurement period adjustments should be accounted for in the following way; equity-classified contingent consideration should not be remeasured and liability-classified contingent consideration should be accounted for under applicable IFRS.

FAR believes the resolution of a performance contingency confirms the value that existed at the acquisition date and therefore should be recognized as an adjustment to acquisition accounting.... [CL #142]

Subsequent Accounting for Contingent Consideration

60. Paragraph 26 of the BC ED proposes that after initial recognition at fair value, the acquirer shall account for changes in the fair value of contingent consideration as follows:

- a. Contingent consideration classified as equity shall not be remeasured.
- b. Contingent consideration classified as liabilities that:

- (1) Are financial instruments and within the scope of [IAS 39 Financial Instruments: Recognition and Measurement, / FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities, as amended by paragraph D21 of this Statement,] shall be accounted for in accordance with that [IFRS / Statement].
- (2) [Are non-financial liabilities that include a contingency shall be accounted for in accordance with [draft] IAS 37 Non-financial Liabilities, or other IFRSs as appropriate. (IASB) / Are not within the scope of Statement 133 shall be measured at fair value with changes in the fair value recognized in income in each reporting period. (FASB)]

61. Although some respondents supported the proposed subsequent accounting for contingent consideration, most respondents disagreed. The comments from respondents depended on whether the respondent agreed with the proposed initial recognition at fair value or not, but the substance of the comments was the same. Most respondents believed that either subsequent changes in the fair value of contingent consideration that was recognized at the acquisition date or the subsequent recognition of an obligation for contingent consideration should be recognized as adjustments to the “cost” of the combination (that is, as adjustments to goodwill). The reasons given by respondents who disagreed with the proposal included the inability to reliably measure the obligation, the increased costs associated with the need for external valuations to value the obligation, and the lack of decision-useful information that would be provided to users.

Measurement Date of the Acquirer’s Equity Securities Issued as Consideration

62. The BC ED proposes that the acquisition date fair value of the consideration transferred is the best measure of the fair value of the acquiree. Therefore, all forms of consideration transferred should be measured on the acquisition date. Accordingly, the BC ED proposes that the acquirer’s equity securities issued as consideration should be measured on the acquisition date also. EITF Issue No. 99-12, “Determination of the Measurement Date for the Market Price of Acquirer Securities Issued in a Purchase Business Combination,” requires that the value of the acquirer’s marketable equity securities issued to effect a business combination should be determined “based on the market price of the securities over a reasonable period of time before and after the terms of the acquisition are agreed to and

announced.” In contrast, IFRS 3 requires that the acquirer’s equity securities issued as consideration be measured “on the date of exchange” or the acquisition date (paragraph 27, paraphrased).

63. Respondents’ views were mixed. Those respondents who supported the proposal to measure equity interests on the acquisition date stated that it makes sense to measure all forms of consideration and the assets and liabilities on the same date. The supporters represented both those who apply IFRS and those who apply US GAAP.

64. Other respondents disagreed with the proposal. The majority of respondents who disagreed with the proposal apply US GAAP and Issue 99-12. The following comment from Citigroup summarizes the views of the respondents who disagreed:

We disagree with the proposal to measure stock consideration paid as of the closing date and support the continued application of EITF Issue No. 99-12, Determination of the Measurement Date for the Market Price of Acquirer Securities Issued in a Purchase Business Combination, as we believe that ancillary events, such as approval from shareholders and regulators, should not have an impact on fair value. An acquirer’s evaluation of a target is based upon the announcement date economics and, accordingly, form the most appropriate fair value basis of an acquired company. Changes in the market price of securities subsequent to this date bear no correlation to the value of what will be acquired and, accordingly, should not become part of the basis of what was acquired. If there were significant decreases in the acquirer’s stock price prior to the acquisition date, the resulting carrying amounts of assets and liabilities would not reflect economic reality. [CL #42]

Transaction Costs

65. The BC ED proposes that transaction costs not be included in the measure of the fair value of the acquiree. Therefore, transaction costs, other than the costs of issuing debt or equity securities (issuance costs), would be expensed as incurred. The accounting for issuance costs differs under US GAAP and IFRS. Under IFRS 39, *Financial Instruments: Recognition and Measurement*, issuance costs are included in the amount recognized on initial recognition. Under US GAAP, there is diversity in practice in the accounting for issuance costs. APB Opinion No. 21, *Interest on Receivables and Payables*, requires debt issuance costs to be

recognized as deferred charges (this guidance is interpreted in different ways), business combinations literature requires equity issuance costs to become part of APIC, and practice has developed in diverse ways for instruments in the mezzanine. Some constituents bury issuance costs in APIC (as required by business combination guidance), others set up a contra-equity account and amortize the costs (as is done with other debt), and still others set up an asset and amortize the costs (as Opinion 21 could be interpreted). The FASB is addressing this issue in its project on liabilities and equity and has tentatively decided that issuance costs should be expensed (May 11, 2005 FASB Board meeting).

66. The majority of respondents who responded to the issue disagreed with the proposal. Those who disagreed with the proposal generally provided similar reasons, which are as follows:

- (1) Expensing transaction costs is a significant change in practice that is contradictory to how transaction costs are treated under other standards. The Boards should address the accounting for transaction costs comprehensively, not just in a business combination.
- (2) Transaction costs are an integral part of the purchase price. Every acquirer considers transaction costs in determining what they are willing to pay for an acquiree, therefore, they form part of the consideration transferred and part of the fair value of the acquiree.
- (3) Accounting for business combinations should be based on a cost accumulation approach and, therefore, should include transaction costs.

67. The minority of respondents who agreed with the proposal generally agreed with the fair value model proposed in the BC ED and that the fair value of the acquiree does not include transaction costs. Houlihan, Lokey, Howard & Zukin, an appraiser, stated that “we agree that transaction costs sometimes vary and, although common, do not represent a fair value addition to the net assets acquired. You cannot, for example, turn around and sell the asset acquired for the price you paid for the asset plus the transaction costs” (CL #47). In general, financial statement users agreed with the proposal. For example, Fitch Ratings, a securities analyst that agreed with the proposal, stated:

We are supportive of the notion that acquisition related costs are not a part of the “consideration transferred” in exchange for the

acquired business. While we understand the notion that these costs were incurred solely to consummate the transaction, we do not believe they are relevant for assessing the future financial performance of the acquired business and therefore, should be excluded from the costs of the acquired business. (CL #16)

Principle 6: The Acquirer Shall Measure and Recognize the Fair Value of the Acquiree, as a Whole, by Recognizing the Fair Value of the Acquiree's Identifiable Assets and Liabilities as of the Acquisition Date.

Valuation Allowances

68. Paragraph 34 of the BC ED proposes that:

The acquirer shall not recognize a separate valuation allowance as of the acquisition date for assets required to be recognized at fair value in accordance with this Statement. For example, an acquirer would recognize receivables (including loans) acquired in a business combination at fair value as of the acquisition date and would not recognize a separate valuation allowance for uncollectible receivables at that date. Uncertainty about collections and future cash flows is included in the fair value measure.

69. Most respondents did not address this issue in their comment letters. The majority of those that did address the issue are in the banking industry. Their concern related primarily to acquired loans receivable. The respondents who were supportive of the proposal were generally not in the banking industry. For example, five accounting firms indicated their support for the proposal, although they did not provide the rationale for their support. Respondents who disagreed with the proposal fell into two categories:

- (1) Those who believe that the acquirer should carryover the acquiree's valuation allowance without change.
- (2) Those who believe that receivables should be recognized at fair value, but that the fair value should be the net of the gross amount of the receivables less a separate valuation allowance.

Carryover acquiree's valuation allowance without change

70. The majority of respondents believed that they should be allowed to carryover the acquiree's valuation allowance without adjustment. Those respondents cited the following reasons for their views:

- (1) Lack of comparable loan ratios and statistics between entities with originated loans versus entities with loans acquired in business combinations.
- (2) The costs of developing and maintaining two separate accounting systems for originated loans and acquired loans.
- (3) Inability to carryover the acquiree's allowance will result in less understandable and transparent information for users.
- (4) Inconsistency with the requirements of SEC Staff Accounting Bulletin No. 61, "Adjustments to Allowances for Loan Losses in Connection with Business Combinations," which requires acquirers to carryover the acquiree's allowance for loan losses for loans acquired in a business combination.
- (5) Implementation difficulties associated with AICPA Statement of Position 03-3, "Accounting for Certain Loans or Debt Securities Acquired in a Transfer," which prohibits carrying over or creation of valuation allowances in the initial accounting for all loans that have experienced credit deterioration acquired in transfers, including those acquired in connection with a business combination.

71. For example, Wells Fargo, a preparer bank, stated:

We note that the Board's conclusions in this area are consistent with the fair value measurement approach in AICPA Statement of Position 03-3, Accounting for Certain Loans or Debt Securities Acquired in a Transfer (SOP 03-3), which also prohibits carrying over or creation of valuation allowances in the initial accounting for all loans that have experienced credit deterioration acquired in transfers, including those acquired in connection with a business combination. We have encountered negative consequences to date with these SOP 03-3 requirements. Today's automated loan systems do not adequately handle accounting for loans under SOP 03-3. As a result, institutions have been forced to manually account for acquired loans within the scope of SOP 03-3. The complexity of the accounting and manual effort involved are significant and will grow under the current provisions of the proposed statement. The proposed statement will also result in inconsistent reporting of loans for a single institution, depending on whether the loans were originated by that institution or acquired in a business combination. The inconsistent reporting of

loans will result in lack of comparability of financial statements between companies depending on the volume of loans acquired by each entity, providing less transparency to financial statement users. No amount of disclosure can remedy inconsistency of accounting for the same asset class.

Any proposed accounting guidance must acknowledge the uniquely regulated environment of financial institutions where stability and capital preservation are important considerations and primary regulatory concerns. The allowance for loan losses protects capital, in a federally insured and regulated financial institution, under a wide range of economic conditions. The current accounting rule of carrying over an allowance for loan losses has proven very effective during a wide range of economic cycles, and is accepted by all bank regulators and the Securities and Exchange Commission in Staff Accounting Bulletin Topic 2.A.5, Adjustments to Allowances for Loan Losses in Connection with Business Combinations. The inability under the proposed statement to carry over the allowance for loan losses of an acquired institution will negatively impact a key measure of an institution's safety and soundness. [CL #77]

Recognize receivables at fair value using a separate valuation allowance

72. A few respondents agreed that the acquirer should recognize the acquiree's receivables at fair value, but believed that that fair value should be the net of the receivables at contractual amounts less a separate valuation allowance. Those respondents agreed with the principle that assets and liabilities should be recognized at fair value. They believed that allowing the acquirer to recognize a separate valuation allowance was consistent with that principle since the net receivable balance would be at fair value. In addition to being consistent with the principle, they believed that a separate valuation allowance would provide users with better, more transparent information, and would eliminate the system issues they would encounter with the proposal.

73. For example, the Institute of Chartered Accountants in Ireland stated:

In relation to receivables, the Accounting Committee considers that it is not relevant whether the measurement to fair value is performed using a separate valuation allowance or whether the receivables are themselves rebased. The impact on the consolidated financial statements will not be significantly different and it could mean significant additional record keeping and cost to be incurred by the acquirer with no real benefit to the user of the consolidated financial statements. The underlying entity will still record its receivables gross

with a valuation allowance netted against them and to require a different treatment on consolidation appears harsh. The Accounting Committee does not believe that the arguments regarding the benefits to be derived from this are sufficiently persuasive. [CL #151]

74. Fitch Ratings, a securities analyst, supported requiring recognition of receivables at fair value, stating:

The Boards' proposal not to recognize valuation allowances separately will pose difficulties to the users of the financial statements in evaluating the overall propriety of the credit assumptions built into the valuation of assets such as receivables. The existing disclosures under the Exposure Draft should be enhanced to provide clearly the credit related discount and other assumptions that were utilized to determine fair value at date of acquisition for all material asset classes. (CL #16)

Contingencies (FASB ONLY)

75. This summary only addresses comments received by the FASB. The IASB comment letter summary on the responses to [draft] IAS 37 will address this issue for the IASB.

Initial Recognition of Contingencies (FASB ONLY)

76. The FASB's version of the BC ED proposes that:

The acquirer shall recognize, separately from goodwill, the acquisition-date fair value of assets and liabilities arising from contingencies that were acquired or assumed as part of the business combination. Therefore, the acquirer shall recognize as of the acquisition date an asset or a liability for a contingency acquired in a business combination if it meets the definition of an asset or a liability in Concepts Statement 6 even if that contingency does not meet the recognition criteria in Statement 5, as amended by this Statement. [Paragraph 35]

77. In contrast, Statement 141 requires that:

- (1) If the fair value of a preacquisition contingency can be determined during the allocation period, it should be included in the allocation of the purchase price.
- (2) If the fair value of a preacquisition contingency cannot be determined during the allocation period, it shall be included in the allocation of the purchase price if (i) it can be reasonably estimated and (ii) information available prior to the end of the allocation period indicates that it is

probable that an asset existed, a liability had been incurred, or an asset had been impaired at the consummation of the business combination. (It is implicit in this condition that it must be probable that one or more future events will occur confirming the existence of the asset, liability, or impairment.) (Paragraph 40, paraphrased)

78. The majority of respondents did not support the initial recognition of contingencies at fair value at the acquisition date. (It should be noted that while a minority of respondents did support initial recognition at fair value, many of those respondents did not support the proposed subsequent accounting.) The respondents who disagreed with the proposal generally believed that:

- (1) The FASB should address the accounting for contingencies in business combinations and FASB Statement No. 5, *Accounting for Contingencies*, comprehensively and not on a piecemeal basis. It is not acceptable to have differential accounting for those contingencies acquired in a business combination versus those contingencies that occur outside of a business combination.
- (2) The fair value of a contingency on the acquisition date is not an accurate picture of what the acquirer will ultimately pay or receive because the settlement amount will differ from the fair value recognized on the acquisition date. As a result, recognizing contingencies at fair value will confuse users and make financial statement less transparent.
- (3) Most contingencies cannot be reliably measured at the acquisition date. Therefore, the FASB should retain the accounting in Statement 5.

79. For example, Eaton Corporation stated:

We believe the risk of measurement error in accounting for contingencies and contingent consideration at fair value will be high and, in our view, unacceptable. We agree with the alternative view expressed in paragraphs B206 through B208 of the proposal, particularly that the fair value measures will be "artificial constructs that lack representational faithfulness with actual economic phenomena."
[CL 37]

80. A few respondents suggested that the Boards consider a minimum recognition threshold for contingencies. For example, one respondent, who agreed with recognizing contingencies at fair value at the acquisition date, suggested that "remote" contingencies be excluded from initial recognition. For example, PwC stated:

We agree that assets and liabilities arising from contingencies acquired or assumed in a business combination should be recognised at fair value at the acquisition date, except those that are remote. We do not believe remote contingencies are a substantive factor in the determination of the fair value of a business by either the buyer or the seller. The identification of and determination of fair values for remote contingencies will require a substantial effort by many companies. We do not believe the benefits, if any, that would result from recording the fair value of remote contingencies would justify the costs, particularly given most of these items will not result in an asset or liability that will require settlement. Therefore, for operational and simplicity reasons, we do not believe remote contingencies should be recognised in a business combination. [CL #66]

81. Another respondent, who agreed with initial recognition of *contractual* contingencies at fair value, suggested that the Boards develop a recognition threshold for *non-contractual* contingencies at the acquisition date. IOSCO stated:

We generally agree with measuring, initially, contingencies arising from contractual commitments at fair value, as we believe that such commitments should be clearly identifiable to the entities involved in the combination, and the contractual commitments makes it clear that the definition of a liability or asset has been met. We note, however, that a number of contingencies do not result from contractual arrangements. In these cases, an element of the contingency is often whether the potential obligor even has an obligation at all. We are not convinced that the so-called "stand-ready" obligation to defend against inappropriate claims represents a liability at all. If it does, then such obligations are surely too numerous to identify or evaluate, as they exist whether a claim has been filed or not. As such, we believe there are both conceptual and practical reasons to reconsider the proposed accounting for non-contractual contingencies and any implications to the accounting of negative goodwill due to not measuring non-contractual contingencies.

We encourage the Board to consider adopting a recognition threshold for such non-contractual items. For example, only those non-contractual contingent liabilities for which it is deemed "more likely than not" at the acquisition date that the company will ultimately be obligated would be recognized. In such cases, it seems clear that the definition of a liability has been met. Additionally, by not requiring analysis of the likelihood of various outcomes for items whose settlement is not probable, the burden on reporting entities would be significantly reduced. Disclosures related to contingencies where settlement is deemed less than "more likely than not" would be appropriate. [CL #260]

82. A few respondents were concerned that recognizing litigation contingencies at fair value would give the other party information about the acquirer's assessment of the case and could compromise the acquirer's ability to settle or litigate. For example, Houlihan, Lokey, Howard & Zukin, an appraiser, agreed with initially recognizing contingencies at fair value, but stated that "...in some situations, a company may impair its ability to settle a contingent claim if it fairly estimates value for that contingency (litigation contingencies) and provides the disclosures in its public filings. The Exposure Draft should either make an exemption for litigation contingencies or offer a qualified exemption for those instances where measurement and disclosure may cause material economic damage to the company" (CL #47).

Subsequent Accounting for Contingencies (FASB ONLY)

83. Paragraph 36 of the FASB's version of the BC ED proposes that after initial recognition at fair value, the acquirer shall account for changes in the fair value of contingent consideration as follows:

After initial recognition, contingencies shall be accounted for as follows:

- a. A contingency that would be accounted for in accordance with Statement 5 if it were acquired or incurred in an event other than a business combination shall continue to be measured at fair value with any changes in fair value recognized in income in each reporting period.
- b. All other contingencies shall be accounted for in accordance with generally accepted accounting principles. For example:
 - (1) A contingency that is a financial instrument shall be accounted for in accordance with applicable financial instrument guidance.
 - (2) A contingency that is an asset or liability arising from an insurance contract shall be accounted for in accordance with FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, as amended (including the intangible asset, if any, recognized for the difference between the amounts recognized on the acquisition date at fair value and the amounts that would be recognized in accordance with Statement 60).

84. The majority of respondents disagreed with the proposed subsequent accounting for contingencies. The respondents who disagreed with the initial recognition of contingencies at fair value also disagreed with the subsequent accounting proposed in the BC ED. In addition to the reasons noted in paragraph 78

against initial recognition, some respondents cited the on-going costs of having to remeasure contingencies to fair value at each reporting period.

85. The majority of respondents who agreed with initial recognition of contingencies at fair value disagreed with the subsequent accounting proposed in the BC ED. As an alternative, they proposed that after initial recognition either that:

- (1) The acquirer not adjust the fair value of the contingency until it is resolved or settled. Some respondents suggested that the settlement adjustment be recognized in income; others suggested that the settlement adjustment be recognized by adjusting goodwill.
- (2) The acquirer recognize changes in the fair value of the contingency at each reporting period as adjustments to goodwill.

Restructuring Costs (FASB ONLY)

86. This summary only addresses comments received by the FASB. The BC ED does not change the accounting for restructuring costs that is currently required by IFRS 3. The FASB's version of the BC ED proposes prohibiting the acquirer from recognizing liabilities assumed for planned restructuring costs that do not meet the recognition criteria in FASB Statement No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*, at the acquisition date. The recognition criteria in Statement 146 provide guidance for determining when a planned restructuring cost meets the criteria for recognition as a liability. Thus, if the planned restructuring cost does not meet the recognition criteria in Statement 146 at the acquisition date, it is not a liability and cannot be recognized as a liability assumed in the business combination. Rather, the restructuring cost would be recognized as postcombination expenses of the combined entity when it does meet the recognition criteria in Statement 146. This proposal is consistent with the current requirements in IFRS 3.

87. Currently, EITF Issue No. 95-3, "Recognition of Liabilities in Connection with a Purchase Business Combination," permits certain costs that would result from a plan to exit an activity of an acquiree to be recognized as liabilities assumed at the acquisition date if specific criteria were met. Respondents' views on this issue were mixed. However, a majority of respondents did not support the proposal. The respondents who agreed with the proposal provided the following reasons:

- (1) Anticipated restructuring costs should not be recognized as liabilities assumed in a business combination since they are not liabilities at the acquisition date.
- (2) The proposal would eliminate the inconsistency that exists under US GAAP in accounting for restructuring costs. That is, Issue 95-3 allows acquirers to accrue liabilities as part of the business combination if they intend to restructure the acquiree's operations; however, acquirers are not allowed to accrue liabilities as part of the business combination if they intend to restructure their own operations as a result of the business combination.

88. The respondents who disagreed with the proposal provided the following reasons:

- a. Acquirers factor those costs in determining what they will pay to acquire the acquiree. As a result, those costs should be part of the business combination accounting.
- b. The proposal is inconsistent with the Board's decisions regarding contingencies. That is, it is not clear why the Board decided that restructuring costs should not be recognized as liabilities assumed in the business combination when they are much more likely to be incurred than some remote contingencies that the Board proposes to recognize at fair value.

Accounting for Insurance Contracts

Exception from fair value measurement

89. The BC ED proposes that all of the acquiree's assets and liabilities be recognized at fair value with a few exceptions (income taxes, employee benefits, assets held for sale, etc.) Therefore, assets and liabilities related to insurance contracts would be required to be recognized at fair value at the acquisition date. This proposal is consistent with the current requirements of Statement 141 and IFRS 3. Although, it should be noted that this proposal would be a change for mutual insurance companies that have not applied IFRS 3 or Statement 141.

90. Although this issue was not specifically addressed in the Notice to Recipients/Invitation to Comment, a few respondents, mostly those who represent insurance companies or insurance industry groups, requested that the Boards exclude insurance contracts from the fair value measurement requirements and require that they be measured in accordance with other applicable standards. For

example, Prudential, whose comments were representative of other insurance companies, stated:

Insurance contracts should be excluded at present from the specific fair value measurement requirements of the proposed Business Combinations statement. In current industry practice, insurance contract liabilities that are acquired as part of a business combination are fair-valued at acquisition through the “Value of Business Acquired (VOBA)” adjustment (also referred to as “Present Value of Future Profits (PVFP)”). This adjustment accounts for the difference between the fair-value liability amount recognized at acquisition date and the amount that would otherwise be recognized in accordance with other insurance accounting standards such as Statement 60. The VOBA (or PVFP) adjustment is sufficient in current practice to achieve fair valuation at acquisition date of insurance liabilities acquired as part of a business combination.

The IASB’s Phase II initiative includes the accounting for insurance contracts. The IASB Working Group is currently deliberating insurance contract accounting and has deferred the expected completion of its insurance contract project due the need to properly address the many complex issues defined by the Working Group. Since the IASB has not yet reached conclusions on accounting for insurance contracts and what components should be included in measuring them, it is premature for the FASB to include in the Business Combinations statement a specific requirement that insurance contracts be fair valued. [CL 85]

91. For an acquirer to recognize acquired insurance contracts at fair value, the FASB proposes to amend FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, to require an expanded presentation that splits the fair value of acquired insurance contracts into two components:

- (1) A liability measured in accordance with the insurer’s accounting policies for insurance contracts that it issues.
- (2) An intangible asset that represents difference between (i) the fair value of the contractual rights acquired and obligations assumed and (ii) the amount described in (1).

IFRS 4 *Insurance Contracts* allows, but does not require, that acquirers use the expanded presentation described above.

92. Some constituents have suggested that this expanded presentation may not be appropriate for all types of insurance contracts (that is short-duration versus long-

duration contracts). In addition, a few respondents suggested that the fair value of acquired insurance contracts should be split into three components, rather than two. Those components would be:

- (1) A liability measured in accordance with the insurer's accounting policies for insurance contracts that it issues.
- (2) A contra liability to adjust the first component to fair value
- (3) An intangible asset representing the value of future expected renewals of the acquired insurance contracts.

Are all insurance contracts contingencies?

93. Some respondents who apply US GAAP stated that they were unclear which insurance contracts should be considered liabilities for contingencies based on the guidance in the BC ED. Paragraph 36(b)(2) of the BC states that a contingency that is an asset or liability arising from an insurance contract shall be accounted for in accordance with Statement 60 (including the intangible asset, if any, recognized for the difference between the amounts recognized on the acquisition date at fair value and the amounts that would be recognized in accordance with Statements 60). Several respondents suggested that this guidance needs to be expanded to include other insurance contracts accounted for under Statements 97 and 113 assuming that the Boards believe that all insurance contracts should be accounted for as contingencies.

In-Process Research and Development (FASB ONLY)

94. This summary only addresses comments received by the FASB. The BC ED would not change the accounting for in-process research and development (IPR&D) that is currently required by IFRS. The BC ED proposes that the acquirer recognize separately from goodwill an acquiree's research and development assets acquired in a business combination if they meet the recognition criteria for intangible assets (that is, arise from contractual-legal rights or are separable). The BC ED would supersede FASB Interpretation No. 4, *Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method*, which requires research and development assets acquired in a business combination that have no alternative future use to be measured at their fair value and expensed at the acquisition date.

95. Very few respondents addressed this issue. Those that did comment on this issue were generally accounting firms or preparers in the pharmaceutical or high-technology industries. The majority of respondents disagreed with the proposal. Those respondents believed that the fair value of IPR&D is not reliably measurable. They also believed that IPR&D does not meet the definition of an asset since its low-likelihood of success does not represent “probable, future economic benefits.”

96. Respondents who agreed with the proposal and those that did not both expressed concerns about the mixed-model this proposal would create. That is, the BC ED proposes that IPR&D *acquired in a business combination* would be capitalized, while IPR&D *acquired in an asset acquisition* would continue to be expensed under FASB Statement No. 2, *Accounting for Research and Development Costs*. In addition, some respondents suggested that the Board address IPR&D accounting comprehensively rather than on a piecemeal basis. For example, PwC stated:

We believe that it is appropriate to recognise and measure IPR&D at fair value as of the acquisition date. However, we note that the FASB does not plan to amend the guidance dealing with IPR&D outside a business combination. We do not believe it would be appropriate to capitalise IPR&D in business combinations and not have the same accounting for when a group of assets that do not meet the definition of a business is acquired. The underlying economics of these transactions are too similar to result in different accounting treatment upon acquisition. We are concerned that limiting the proposed change to only the acquisition of a business increases the potential for transactions to be structured to achieve a desired accounting result. Consequently, while we support the FASB's proposal to require capitalisation of IPR&D in business combinations, we encourage the FASB to have the same accounting model applied to the purchase of a group of assets.

We also note that capitalisation of IPR&D in a business combination raises additional questions regarding the overall accounting for research and development costs. Specifically, under US GAAP, subsequent expenditures for acquired IPR&D projects will be expensed. Under IFRS, these costs may be capitalised if certain criteria are met. In addition to conforming the accounting models for business combinations and asset acquisitions, it will ultimately be necessary for the Boards to address the underlying framework for the accounting for ongoing research and development costs. [CL #66]

97. A few respondents raised issues about subsequent impairment testing of IPR&D. The BC ED proposes to amend paragraph 16 of FASB Statement No. 142, *Goodwill and Other Intangible Assets*, to require that intangible assets that are acquired in a business combination for use in a particular research and development project and that have no alternative future use be considered indefinite-lived until the completion or abandonment of the associated research and development efforts. Consistent with other intangible assets, indefinite-lived intangible assets would be tested for impairment in accordance with Statement 142. If the research and development asset was completed, the asset would become finite-lived and would be amortized over the useful life of that asset. For example, Duff & Phelps, an appraiser, stated:

In addressing a question raised by the FASB only, with regard to research and development assets ("IPR&D"), there is a valuation issue that we believe the Board should be aware of. The valuation of IPR&D must consider the existence and magnitude of core technology. Such core technology can be recognized as a separate asset to the extent that it benefits a variety of other assets (e.g. a number of different current products or technology) or included in the fair value of another singular asset if the IPR&D is the beneficiary of that asset's core technology. In many cases, the amount of the core technology may be significant. The proposed impairment testing under Statement 142 where IPR&D would be treated as an indefinite-lived asset is based on a fair value measurement. The other intangible assets, a portion of the fair value of which is directly correlated to the IPR&D, would continue to be subject to impairment testing under Statement 144.

For example an IPR&D project valuation may result in the apportionment of a majority of its expected cash flows to a current intangible asset and the fair value of this asset would include a significant expected benefit from the successful completion of the IPR&D project. A negative event subsequent to the acquisition date would result in an impairment of the IPR&D due to its proposed fair value measurement, however, the related intangible asset might not fail the recoverability test under Statement 144 and thus would not be restated to fair value. Therefore, the proposed interim impairment testing for the IPR&D could provide outcomes inconsistent with that of other related intangible assets. [CL #27]

98. PwC stated:

We also believe that there will be a need for the Boards to articulate their principles related to impairment guidance for capitalised

IPR&D. These projects evolve and change over time. They may be combined with other research projects and lose their individual identity. Although the proposed guidance indicates that IPR&D should be treated as an indefinite lived intangible, it is not clear how such a model should be applied when the state of the underlying asset evolves over time. [CL #66]

Intangible assets

Accounting for Preexisting Relationships and Reacquired Rights (Codification of Issue 04-1)

99. The BC ED codifies and incorporates the guidance that currently exists in EITF Issue No. 04-1, "Accounting for Preexisting Relationships between the Parties to a Business Combination." As a result, consistent with the guidance in Issue 04-1, the BC ED proposes:

- (1) ***Reacquired rights:*** If as part of the business combination an acquirer reacquires a right that it had granted to the acquiree to use the acquirer's intangible assets, that right is an identifiable intangible asset that would be recognized separately from goodwill. Examples of such rights are 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. If the pricing terms in the contract giving rise to the reacquired right are favorable or unfavorable when compared with pricing terms for current market transactions for the same or similar items, the acquirer would recognize a settlement gain or loss. (Paragraph 41, paraphrased.)
- (2) ***Preexisting relationships:*** If the acquirer and acquiree have a contractual or noncontractual preexisting relationship that existed before the business combination, the acquirer would recognize a settlement gain or loss if the business combination results in the effective settlement of that relationship. As a result, the effective settlement of that preexisting relationship would be accounted for the same way regardless of whether it was settled as part of the business combination or separately. (Paragraphs A91 and A92, paraphrased.)

100. The Boards did not solicit input on this issue in the Notice/Invitation; however, a few respondents did raise this issue in their comment letters. Those who responded generally disagreed that the acquirer should recognize a reacquired right as a separately identifiable intangible asset. They believed that the proposal would lead to the acquirer recognizing an internally generated intangible asset as part of the business combination. For example, two respondents stated:

We are confused by FASB's proposal to require the recognition of a right that the acquirer had previously granted to the acquiree to use the acquirer's recognized or unrecognized intangible assets. In our view, this is inconsistent with ¶10 of FAS 142, Goodwill and Other Intangible Assets, and could effectively result in the recognition of internally generated intangibles (e.g., brand-name). [Citigroup; CL #42]

We would, however, note that we disagree with paragraph 41 of the Exposure Draft. In our opinion, the acquisition of a right that the acquirer had previously granted should not give rise to the recognition of an intangible asset because it is internally generated. [Accounting Standards Board; CL #130]

101. KPMG also disagreed with recognizing a reacquired right as a separately identifiable intangible asset. They believed that for consistency with the accounting for preexisting relationships, the effective settlement of a reacquired right should result in a settlement gain or loss.

102. Houlihan, Lokey, Howard & Zukin, an appraiser, stated that the gain or loss that results from the effective settlement of a preexisting relationship is inconsistent with the market participant view. They stated:

As described in paragraphs A94 through A96, AC would record a settlement loss of \$5 million related to the unfavorable portion of its preexisting supply contract with TC, along with a \$3 million intangible asset related to the at-market portion of the contract. A marketplace participant buyer, however, would only record an intangible asset with a fair value of \$8 million, which would be amortized over the remaining useful life of the contract. Although the amount of goodwill recorded by AC and the marketplace participant would be the same, AC's ongoing earnings would be higher than any marketplace participant buyer due to the lower fair value of the contract and hence lower annual amortization expense. Additional clarification on FASB's intent would be useful in this matter. [CL #47]

Intangible Assets and the Reliably Measurable Criterion

103. Question 16 in the Notice/Invitation addresses the issue of whether, in addition to the identifiability criteria (that is, arising from contractual-legal rights or separable), the standard should require that an intangible asset also be reliably measurable to be recognized separately from goodwill. In Statement 141, the FASB concluded that when acquired in a business combination, all intangible assets (except for an assembled workforce) that are identifiable can be measured with

sufficient reliability to warrant recognition separately from goodwill. In addition to the identifiability criterion, IFRS 3 and IAS 38 require that an intangible asset acquired in a business combination be reliably measurable to be recognized separately from goodwill.

104. Paragraphs 35–41 of IAS 38 provide guidance for determining whether an intangible asset acquired in a business combination is reliably measurable. IAS 38 presumes that the fair value of an intangible asset with a finite useful life can be measured reliably. Therefore, a difference between IFRS 3 and Statement 141 would arise only if the intangible asset has an indefinite life. The IASB decided to converge with the FASB in this Exposure Draft by (a) eliminating the requirement that an intangible asset be reliably measurable to be recognized separately from goodwill and (b) precluding the recognition of an assembled workforce acquired in a business combination as an intangible asset separately from goodwill.

105. The Boards asked constituents whether they believed that an intangible asset that is identifiable can always be measured with sufficient reliability to be recognized separately from goodwill and whether they had any examples of an intangible asset that was identifiable but not reliably measurable. Respondents' views on this issue were mixed. Many agreed that identifiable intangible assets can be measured with sufficient reliability. Those respondents were represented by those that apply US GAAP those that apply IFRS. For example, PwC stated:

We agree that identifiable intangible assets should be able to be measured with sufficient reliability to be recognised separately from goodwill. There has been a requirement in US GAAP to measure the fair value of all of the identifiable intangible assets acquired in a business combination for some years. There is also guidance prohibiting the use of the residual method to value certain of these assets. The determination of fair value for many identifiable intangibles has been challenging, but we believe it has fostered a healthy debate regarding how such fair values should be determined. We believe that more needs to be done with respect to providing principles to achieve consistent determination of fair values in practice and we would be pleased to work closely with the Boards to develop this guidance....
[CL #66]

106. Some respondents disagreed that an identifiable intangible asset can always be measured with sufficient reliability. The majority of respondents in this category are users of IFRS.

107. A few respondents offered examples of identifiable intangible assets that they believe cannot be measured reliably, such as noncontractual customer relationships and certain licenses that are so integral to the business that they do not have separate cash flows and cannot be distinguished from goodwill. One respondent also cited those examples as being difficult to measure, but offered an approach for measuring those types of intangibles:

We have identified certain intangible assets that cannot be sold, rented or exchanged individually or in combination with a related contract, asset or liability and that generate cash flows that are linked inextricably with the cash flows that are generated by the business as a whole. These include a license to operate a nuclear power plant, some broadcast licenses and some liquor/gaming licenses. These licenses are essential to operate the business, but in some situations we believe they cannot be sold separately from the business. The approach often used to value these assets is typically the "greenfield approach", which assumes a hypothetical situation in which a business is built from a starting point where the operator owns only the license. We believe it would be helpful for the Boards' to specifically consider this approach and determine whether they agree with its conceptual merits for determining fair value. [CL #66]

108. A few respondents questioned why the Boards preclude the separate recognition of assembled workforce in a business combination. For example, AcSEC stated:

AcSEC believes that the Board should reconsider its conclusion that the fair value of workforce acquired in a business combination not be recorded as an intangible asset separate from goodwill. AcSEC notes that workforce is already valued in many cases for purposes of calculating a contributory asset charge when valuing other intangible assets. Further, due to the advances in determining fair values, AcSEC believes that this asset is capable of being measured. [CL #208]

Valuing Intangible Assets Using the Market Participant View

109. Although the Boards did not solicit feedback on this issue, some respondents stated that they believe intangible assets should be valued using "entity-specific"

measures rather than fair value or a “market participant view.” As a result, they believed that if an acquirer does not intend to use an intangible asset it acquires in a business combination, then the acquirer should assign that asset a zero or a low value. Whereas under fair value, the acquirer would assign the intangible asset an amount based on the value of the asset to other marketplace participants.

Principle 7: Some Assets and Liabilities Shall Be Measured and Recognized in Accordance with Other Standards Rather than Fair Value for Practical Reasons and to Avoid Day 2 Complexities.

Exceptions to the Fair Value Measurement Principle

110. The BC ED proposes that the acquirer measure some assets acquired and liabilities assumed in accordance with other standards rather than at fair value. This is to avoid Day 2 complexities that would result if those assets or liabilities were initially recognized at fair value and then subsequently accounted for under a different standard whose measurement attribute is something other than fair value. The BC ED proposes that the acquirer measure the following assets and liabilities in accordance with other standards:

- (1) Assets held for sale
- (2) Deferred taxes
- (3) Operating leases
- (4) Employee benefit plans.

111. Most respondents agreed with the proposed exceptions. Even though most respondents were in agreement with the proposals, the following paragraphs discuss any specific suggestions that were received regarding these exceptions.

Assets held for sale

112. One respondent disagreed that assets held for sale should be an exception given that the BC ED requires the market participant view for valuation and measurement. PwC stated:

We understand the Boards' concern that recording assets held for sale at fair value may result in a loss shortly after the acquisition date since SFAS 144 and IFRS 5 would apply and require the recognition of selling costs. However, we have difficulty reconciling this view with other changes proposed by the Boards. The exposure draft refers to the proposed SFAS on Fair Value Measurements for the definition of fair value. That proposed statement would require the use

of market participant data to determine fair values. Recording assets held for sale at fair value, less cost to sell, takes into consideration buyer specific intentions with regard to those assets. Under a market participant notion, buyer specific actions are not considered in the determination of fair value. This is consistent with the Boards' proposed treatment of restructuring liabilities. Therefore, we do not believe the exception for assets held for sale is consistent with the framework proposed by the Boards. [CL #66]

Deferred taxes

Exception from fair value measurement requirement

113. Paragraph 44 of the BC ED proposes that the acquirer shall measure and recognize, separately from goodwill, a deferred tax asset or liability in accordance with:

- (1) FASB Statement No. 109, *Accounting for Income Taxes*, as amended by paragraph D17 of this Statement, or
- (2) IAS 12 *Income Taxes* as amended by paragraph D4 of this IFRS.

114. Although respondents agreed that deferred taxes should be measured in accordance with IAS 12 or Statement 141, some suggested that the exception not be limited to deferred taxes only. For example, Deloitte stated:

Paragraph 44 of the Exposure Drafts explains that deferred tax assets and liabilities accounted for under FASB Statement No. 109, *Accounting for Income Taxes*, and IAS 12, *Income Taxes*, are not recorded at fair value as of the acquisition date. However, the Exposure Drafts do not provide guidance on how to measure (1) other income tax assets or liabilities, which are accounted for under Statement 109 or IAS 12, or (2) the effects of uncertain tax positions, at the acquisition date. We believe that all other income tax assets or liabilities accounted for in accordance with Statement 109 and IAS 12 should also be given the exception from measurement at fair value as of the acquisition date, since these Statements do not permit measuring income taxes at fair value. Additionally, the final Statements should clarify whether the effects of uncertain tax positions should be accounted for (1) as acquired or assumed contingencies or (2) under other applicable accounting literature (e.g., proposed FASB Interpretation, *Accounting for Uncertain Tax Positions*). [CL #22]

Changes in the acquirer's deferred tax benefits that become recognizable because of the business combination

115. The BC ED proposes that any changes in the **acquirer's** deferred tax benefits that become recognizable because of the business combination should be

accounted for separately from the business combination. That decision is consistent with the notion in paragraph 30 of the BC ED that "a business combination does not affect the measurement of the acquirer's assets and liabilities, except for those assets or liabilities that are not recognized at fair value by the acquirer before the business combination and are part of the consideration transferred in exchange for the acquiree."

116. In the deliberations leading to the BC ED, the Boards considered the provisions of IAS 12, *Income Taxes*, and FASB Statement No. 109, *Accounting for Income Taxes*, relating to an acquirer's deferred tax benefits that become recognizable because of a business combination. IAS 12 requires the acquirer to recognize separately from the business combination accounting any changes in its deferred tax assets that become recognizable because of the business combination. Such changes are recognized in postcombination profit and loss or equity. On the other hand, Statement 109 requires any recognition of an acquirer's deferred tax benefits (through the reduction of the acquirer's valuation allowance) that results from a business combination to be accounted for as part of the business combination, generally as a reduction of goodwill. The FASB decided to amend Statement 109 to require the recognition of any changes in the acquirer's deferred tax benefits (through a change in the acquirer's previously recognized valuation allowance) as a transaction separately from the business combination. As amended, Statement 109 would require such changes in deferred tax benefits to be recognized either in income from continuing operations in the period of the combination or directly to contributed capital, depending on the circumstances. Question 17 in the Notice/Introduction asked respondents whether they agreed with this proposal.

117. Respondents' views on this issue were mixed, but they generally did not provide the rationale for their positions. The majority of respondents who supported the proposal were users of IFRS. In contrast, the respondents who did not support the proposal were represented by both users of IFRS and users of US GAAP.

Amendments to IAS 12 and Statement 109

118. The BC ED proposes to amend paragraph 68 of IAS 12 and paragraph 30 of Statement 109 to:

- (1) Include a rebuttable presumption that changes to the valuation allowance within one year from the acquisition date would be recognized as an adjustment to goodwill until goodwill is reduced to zero.
- (2) Require changes to the valuation allowance subsequent to the measurement period (one year) after the acquisition date to be recognized in income, rather than as an adjustment to goodwill.

119. Few respondents addressed this issue. However, KPMG stated that:

...We propose to apply consistent accounting for all changes of the acquiree's valuation allowance regardless of whether the changes occur before or after the measurement period. As a result, changes would be accounted for as part of the business combination rather than post combination gains or losses. Consequently, we disagree with the amendments proposed to paragraph 30 of Statement 109 and to paragraph 68 of IAS 12, whereby future changes to the valuation allowance subsequent to a one-year period after the acquisition date would be recognized in income, rather than as an adjustment to goodwill. Since deferred tax assets are not measured at fair value, we believe future reductions in the valuation allowance, including those that occur after a one-year period, should be applied first to reduce goodwill to zero before being recognized in income tax expense. [CL #88]

120. Another respondent noted the inconsistency between the proposed amendments to paragraph 30 of Statement 109 and the accounting for the reversal of other tax contingencies under EITF Issue No. 93-7, "Uncertainties Related to Income Taxes in a Purchase Business Combination." Mindthegaap stated:

Paragraph D17(d) of the Exposure Draft states that valuation allowances for deferred tax assets that are reversed after one year following the acquisition date shall reduce income tax expense. In contrast, under EITF 93-7, reversals of provisions for other types of tax contingencies are adjusted against goodwill, no matter how long after the acquisition date these contingencies are resolved. In our view, valuation allowances for deferred tax assets are of the same ilk as provisions for other types of tax contingencies. Consequently, the same accounting should apply in both cases. Moreover, the ability to credit valuation allowances against income tax expense (as called for in the Exposure Draft) presents an incentive and opportunity for companies to excessively provide for valuation allowances at the acquisition date. For these reasons, we recommend that all reversals of valuation allowances for deferred tax assets acquired in a business combination should first reduce goodwill, irrespective of when these reversals occur. [CL #57]

Respondents' suggested amendments to Statement 109 for indefinite-lived intangible assets

121. Two respondents requested that the FASB consider an amendment to Statement 109 such that indefinite-lived intangible assets would receive the same deferred tax exemption as goodwill. For example, one of those respondents stated:

In addition, we recommend that in conjunction with the Board's consideration of the proposal to continue the deferred tax exception, they also reconsider an amendment to FAS 109 to allow indefinite lived intangibles to receive the same deferred tax exemption given to goodwill (i.e., do not require the recognition of deferred taxes related to nondeductible intangibles that are expected to be held indefinitely). If an indefinite lived intangible asset were to change to a definite live, the deferred tax could be recorded at that time. Recognition of deferred taxes on indefinite lived intangibles results in incremental goodwill and a balance sheet gross up in the financial statements which does not reflect the underlying economics of the transaction. Further, it does not seem appropriate to recognize deferred taxes related to indefinite lived intangibles when the taxes will be realized only in the unlikely event that the business is sold. [Pepsi Co.; CL #282]

Operating leases

122. The BC ED proposes that the acquirer account for acquired operating leases as follows:

If the acquiree is the lessee to an operating lease, the acquirer shall not recognize separately the asset and related liability embodied in the lease. If the acquiree is the lessor to an operating lease, the acquirer shall measure and recognize the asset subject to the operating lease at its acquisition-date fair value in accordance with paragraph 39. The acquirer also shall assess whether each of the acquiree's operating leases are at market terms as of the acquisition date, regardless of whether the acquiree is the lessee or lessor. If an operating lease is not at market terms as of the acquisition date, the acquirer shall recognize:

- a. An intangible asset if the terms of the operating lease are favorable relative to market terms.
- b. A liability if the terms of the operating lease are unfavorable relative to market terms. [Paragraph 47]

123. A few respondents asked the Boards to clarify the first sentence of paragraph 47 and specifically state that the leased asset and the lease obligation are not recognized because they are netted together. One respondent questioned whether

“recognizing the net fair value of a market-rate lease at an amount greater than zero would be permitted under the proposed standard.” That respondent stated: “we believe that the guidance in paragraph 47 should be consistent with the FASB’s conclusion, stated in paragraph 173 of Statement 141, that at-the-money operating leases are contracts that ‘...may have value for reasons other than terms that are favorable relative to market prices’” (Grant Thornton; CL #20).

124. AcSEC asked “why operating leases are specifically highlighted as an exception to the fair value measurement principle. AcSEC also believed that other executory contracts may have characteristics similar to those of an operating lease and the inclusion of the operating lease exception could raise questions about whether other executory contracts should be separated into various elements” (CL #208).

Employee benefit plans

125. Almost all respondents agreed that employee benefit plan assets and liabilities should be measured under IAS 19, *Employee Benefits*, or FASB Statements No. 87, *Employers’ Accounting for Pensions*, and No. 106, *Employers’ Accounting for Postretirement Benefits Other Than Pensions*. One respondent stated that they believed that postemployment benefits should be accounted for under FASB Statement No. 112, *Employers’ Accounting for Postretirement Benefits*, rather than at fair value. The BC ED would require that Statement 112 postemployment benefits be measured and recognized at fair value rather than under Statement 112. Statement 112 requires that postemployment benefits be measured and recognized if (a) the obligation relates to services rendered, (b) the rights vest or accumulate, (c) payment is probable, and (d) they can be reliably measured. If the rights do not meet those conditions, then they are accounted for under Statement 5. (Statement 112, paragraph 6, paraphrased). Since the BC ED proposes to amend Statement 5 such that contingencies acquired in a business combination would be accounted for at fair value, the FASB concluded that Statement 112 postemployment benefits should be measured and recognized at fair value, also. However, AcSEC stated:

AcSEC also recommends that the Board include postemployment benefit plans in the scope of FASB 112, *Employer's Accounting for Postemployment Benefits*, that are accounted for on an actuarial basis as an additional exception to the fair value measurement principle. These postemployment benefit plans are accounted for similarly to Statement 87 employee benefit plans, and accordingly should also be excluded from fair value measurement. [CL #208]

Principle 8: Only What Is Actually Part of the Exchange for the Acquiree Shall Be Accounted for as Part of the Business Combination

Guidance for Determining What Is Part of the Business Combination

126. Most respondents agreed with the principle in paragraph 69 of the BC ED, which states:

The acquirer shall assess whether any portion of the transaction price (payments or other arrangements) and any assets acquired or liabilities assumed or incurred are not part of the exchange for the acquiree. Only the consideration transferred and the assets acquired or liabilities assumed or incurred that are part of the exchange for the acquiree shall be included in the business combination accounting. Any portion of the transaction price or any assets acquired or liabilities assumed or incurred that are not part of the exchange for the acquiree shall be accounted for separately from the business combination.

127. The implementation/application guidance then provided guidance about how to apply that principle. Some respondents indicated that the implementation/application guidance was “excessive” and not in the spirit of a principle-based standard. However, those respondents generally did not provide suggestions for which guidance could be eliminated. Some respondents offered suggestions or requested clarification about how to apply some of the implementation/application guidance. For example, paragraph A88 of the BC ED states:

Judgment is required to determine whether a portion of the transaction price paid, or the assets acquired and liabilities assumed or incurred, are part of the exchange for the acquiree. A transaction or event arranged primarily for the economic benefit of the acquirer or the combined entity is not part of the exchange for the acquiree and is accounted for separately from the business combination. One arranged primarily for the benefit of the acquiree or its former owners

generally is part of the exchange and is included in the business combination accounting.... [Paragraph A88]

128. Grant Thornton stated in response:

Paragraph A88 provides that a transaction or event arranged primarily for the economic benefit of the combined entity would not be accounted for as part of the business combination, in contrast to the treatment of a transaction or event arranged primarily for the benefit of the acquiree. Because the acquiree is part of the combined entity, we believe the Boards should either (1) eliminate references to the acquiree from the guidance on identifying elements of a transaction that are not part of the business combination or (2) clarify (a) how a transaction or event could benefit the acquiree without also providing the same benefit to the combined entity and (b) whether transactions that provide significant benefits to both the acquiree and the combined entity should be included in the business combination accounting. [CL #20]

129. Paragraphs A98 and A99 of the BC ED codify the guidance in EITF Issue No. 95-8, "Accounting for Contingent Consideration Paid to the Shareholders of an Acquired Enterprise in a Purchase Business Combination." That guidance is intended to help assess whether an arrangement to pay for employee services should be accounted for as part of the exchange for the acquiree or separately from the business combination. The guidance in the BC ED was paraphrased and not all of Issue 95-8 was incorporated. Several respondents suggested that by not incorporating all of Issue 95-8 or by paraphrasing parts of Issue 95-8, the guidance may be more difficult to apply in practice.

Principle 9: The Acquirer Is Allowed Reasonable Time to Obtain the Information Necessary to Identify and Measure the Acquisition-Date Fair Values of the Acquiree and the Assets Acquired and Liabilities Assumed (Measurement Period).

Recognition of Measurement Period Adjustments

130. Paragraph 67 of the BC ED proposes:

The acquirer shall recognize any adjustments to the provisional values during the measurement period as if the accounting for the business combination had been completed at the acquisition date. Thus, **comparative information for prior periods presented in financial statements shall be adjusted**, including any change in depreciation, amortization, or other income effect recognized as a result of completing the initial accounting.... [Emphasis added.]

Therefore, acquirers would be required to adjust prior period comparative information presented in financial statements any time they recognize an adjustment to the provisional amount recognized in the business combination.

131. Statement 141 is silent about how an acquirer should recognize allocation period adjustments. Based on conversations with the BC resource group members, acquirers generally recognize allocation period adjustments prospectively unless the adjustment is so significant that it was likely an error in the provisional accounting. Only in the case of an error would acquirers adjust prior periods. The requirement in paragraph 62(iii) of IFRS 3 is the same as what is proposed in the BC ED. Thus, IFRS 3 requires that acquirers adjust prior period comparative information presented in financial statements any time they recognize an adjustment to the provisional amount recognized in the business combination.

132. The majority of respondents disagreed with the proposal. Those who disagreed with the proposal likened measurement period adjustments to changes in estimate. Those constituents raised the point that Statement 154 and IAS 8 require retrospective adjustment only for changes in accounting policy or restatement for errors. Since measurement period adjustments are neither a change in accounting policy nor an error, those constituents had difficulty understanding why the Boards would propose retrospective adjustment for measurement period adjustments. Additionally, constituents who supported recognizing measurement period adjustments prospectively pointed out that “restatements” are confusing to users and imply that the company’s financial statement were “wrong.”

133. The constituents who supported recognizing measurement period adjustments retrospectively were generally constituents who apply IFRS. Those respondents supported retrospective adjustment on the basis that it provided better comparative information.

Disclosures

134. The BC ED proposes broad disclosure objectives that are intended to ensure that users of financial statements are provided adequate information to evaluate the nature and financial effects of business combinations. Those objectives are

supplemented by specific minimum disclosure requirements. Question 15 in the Notice/Invitation asked whether constituents agreed with the disclosure objectives and the minimum disclosure requirements. Respondents generally agreed with the broad disclosure objectives. However, some respondents stated that the minimum disclosure requirements were excessive. Some respondents suggested eliminating or modifying some disclosures as a result of their suggested changes to the proposed guidance in the BC ED. For example, a respondent may have suggested that transaction costs be capitalized as part of the cost of the combination rather than expensed. As a result, the respondent may have suggested modifying the disclosure that requires the acquirer to disclose the amount of transaction costs recognized in expense. This summary does not summarize those suggestions because the staff will address any necessary modification to the disclosure requirements after the Boards reach final decisions in redeliberations.

135. The following paragraphs discuss the disclosure requirements that respondents suggested eliminating or modifying and the reasons those respondents gave for their suggestions:

Par.	Disclosure	Suggestion
¶72(d)	The primary reasons for the business combination, including a description of the factors that contributed to the recognition of goodwill.	Multiple respondents suggested modifying this disclosure. They believed that since goodwill is calculated as a residual, the factors that contributed to the recognition of goodwill may not be clear other than the cost of the business exceeded the fair value of the identifiable net assets acquired.
¶72(f)(6)	The acquisition-date fair value of the consideration transferred, including the fair value of each major class of consideration, such as: The acquirer's previously acquired noncontrolling equity investment in the acquiree in a business combination achieved in stages	Multiple respondents suggested modifying this disclosure. They believed that the acquirer's previously acquired noncontrolling equity interests in the acquiree should not be characterized as consideration transferred because such interests were not part of an acquisition-date exchange with an outside party.
¶72(h)	The maximum potential amount of future payments (undiscounted) the acquirer could be required to make under the terms of the acquisition agreement.	One respondent suggested that a description of the contingency payments would be more relevant than disclosing the maximum potential amount of future payments. That respondent believed that disclosure in this area could be enhanced by disclosing the nature of such arrangements and what milestones or other performance factors could trigger subsequent payments and their duration and amounts. (CL

		#208)
¶72(k)	<p>In a business combination in which the acquirer and acquiree have a preexisting relationship:</p> <ol style="list-style-type: none"> (1) The nature of the preexisting relationship (2) The measurement of the settlement amount of the preexisting relationship, if any, and the valuation method used to determine the settlement amount (3) The amount of any settlement gain or loss recognized and the line item in the income statement in which that gain or loss is recognized. 	<p>One respondent suggested replacing this disclosure with a broader, more general disclosure of the elements of the transaction that are not included in the business combination. He believed that requiring detailed disclosures only for preexisting relationship settlements and not for other elements of the transaction excluded from the business combination, incorrectly implies that in all circumstances, any preexisting relationship element of the transaction is itself significant and is more significant than other elements of the transaction. (CL #20)</p>
¶74(a) and (b)	<p>An acquirer [that is a public business enterprise, as described in paragraph 9 of FASB Statement No. 131, <i>Disclosures about Segments of an Enterprise and Related Information</i>, (FASB Only)] shall also disclose the following information for each material business combination that occurs during the reporting period or in the aggregate for individually immaterial business combinations that are material collectively and occur during the reporting period....</p> <p>(a) The amounts of revenue and [profit and loss (IASB) / net income (FASB)] of the acquiree since the acquisition date included in the consolidated income statement for the reporting period.</p> <p>(b) The following supplemental pro forma information:</p> <ol style="list-style-type: none"> (1) The [revenue and profit and loss (IASB) / <i>results of operations</i> (FASB)] of the combined entity for the current reporting period as though the acquisition date for all business combinations that occurred during the year had been as of the beginning of the annual reporting period. <p>[Not Used (IASB) / (2) If comparative financial statements are presented, the <i>results of operations</i> of the combined entity for the comparable prior reporting period as though the acquisition date for all business combinations that occurred during the current year had occurred as of the beginning of the comparable prior annual reporting period. (FASB)]</p>	<p>Paragraph 74(a)</p> <p>Multiple respondents suggested eliminating the disclosure requirement in paragraph 74(a). They believed that many acquirers will not be able to comply with this requirement because the acquirer quickly loses its ability to track the necessary information if the acquirer integrates the acquiree. Once integration occurs, the revenues and net income of the acquiree cannot be separated from the combined entity.</p> <p>Paragraph 74(b) (FASB Only)</p> <p>Multiple respondents suggested that the FASB eliminate or modify the disclosure requirement in paragraph 74(b). A few respondents stated that this disclosure is redundant with the disclosure requirement in paragraph 74(a). One respondent stated that since the disclosures in paragraph 74(b) are unaudited pro forma information and required only in the U.S. in financial statements of public companies, that disclosure would be more appropriate in Management's Discussion and Analysis of Financial Condition and Results of Operations. (CL #20)</p>
¶76(d) (IASB)	[Paragraph not used (FASB) / The amount and an explanation of any gain or loss	A few respondents suggested that the IASB eliminate this disclosure. They stated that the

	<p>recognised in the current reporting period that both:</p> <p>(1) Relates to the identifiable assets acquired or liabilities assumed in a business combination that was effected in the current or a previous reporting period</p> <p>(2) Is of such a size, nature, or incidence that disclosure is relevant to understanding the combined entity's financial statements. (IASB Only)]</p>	<p>disclosure:</p> <ul style="list-style-type: none"> • Imposes additional costs and effort in return for questionable benefits. • Is not effective for its apparent purpose of deterring or identifying the use of unreasonable valuations in accounting for a business combination.
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Disclosure Differences

136. In their deliberations leading to issuing the BC ED, the Boards reconsidered disclosure requirements in IFRS 3 and Statement 141. For some of the disclosures, the Boards decided to converge. However, divergence continues to exist for some disclosures as described in Appendix F (that is, the disclosures in paragraphs 74 and 76(d)). Question 18 in the Notice/Invitation asked respondents whether it is appropriate for the IASB and the FASB to retain those disclosure differences. Few respondents responded to this question. A few indicated that they understood the reasons for the differences and agreed with the disclosure differences. Most respondents expressed concern that the remaining disclosure differences should be eliminated if they would make financial statements prepared in accordance with IFRS from being acceptable for filing with the SEC without reconciliation to US GAAP.

Transition

137. A few of the respondents stated that they agreed with the proposed prospective transition provision. However, none of the comment letters addressed the specific transition requirements in the BC ED, such as the transition requirements for mutual entities or the subsequent recognition of acquired deferred tax benefits related to business combinations completed before the BC ED becomes effective.

Bold-Type/Plain-Type Style of the Exposure Draft

138. The vast majority of respondents supported the bold-type/plain-type style of the BC ED. They stated that the style made the document easier to read and understand. A few of the respondents questioned the need for the bold-type if all the paragraphs have equal authority, but those respondents were in the minority.

Other Comments

Due Process

139. Multiple respondents stated that they were surprised that the proposals in the BC ED and the noncontrolling interest proposals were not first issued as a Discussion Paper. They believed that the changes were so fundamental, that the Boards should have given constituents the opportunity to consider them as part of a broader Discussion Paper before issuing them in an Exposure Draft. For example, the Institute of Chartered Accountants of Scotland stated:

We consider that the subject matter of this exposure draft should first have been exposed as a discussion paper rather than proceeding straight to an exposure draft as we consider that the proposals would involve a fundamental change to existing practice. We are concerned that no indication has been given of why it is believed necessary to move away from the existing parent entity view and we believe that it is essential that a change such as this should have been opened to proper debate via a discussion paper prior to an exposure draft being issued. We firmly believe that the argument for this fundamental change has not been made by the proposals contained in the exposure draft and we will require to see reasoned argument before we can be persuaded that this change is necessary to improve the quality of financial reporting. In our view, if a principles-based approach to standard setting is desired, then it is essential that the principles should form the basis of the argument.
[CL #198]

Drafting Comments

140. Respondents provided some drafting comments on the BC ED for the Boards' consideration:

- (1) One respondent (Grant Thornton; CL #20) suggested that the Boards consider whether some information provided in the basis for conclusions is important guidance that should be included in the standard. This is

especially important because the IASB's basis for conclusions is not translated out of English and because the FASB's codification will not codify the FASB's bases for conclusions.

- (2) Some respondents were supportive of including the definitions of the key terms in the standard rather than in an appendix. They believed that placing the key terms in the standard made the document easier to read and understand.
- (3) One respondent (Anglo American PLC; CL #176) suggested that the main body of the standard include more detail and examples rather than cross-referencing examples in another appendix.