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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting: **March 2006, London**

Project: **Business Combinations II**

Subject: **Business Combination Principles (Agenda Paper 2A)**

Introduction

1. The purpose of this paper is to outline to the Boards the basic presumptions, assertions and principles that form the foundations of the BC ED proposals. The Boards will be asked to affirm these foundation statements. The staff believe that most of the discussion that follows over the next few months will focus on exceptions to the principles and presumptions.

2. This paper also summarises the scope of the project and the main implications of the presumptions, assertions and principles. This is in response to concerns expressed by some respondents that the project has gone beyond its original scope and resulted in proposals that are fundamentally different from current practice.

Project scope

3. As the staff noted in January, in this phase of the project, the Boards are reconsidering the existing guidance for applying the purchase method of accounting for business combinations (now called the acquisition method).

4. Many respondents questioned the motivation for the proposals published in the BC ED. They stated that since this is a convergence project, the objective should be to develop a common standard that either moves toward IFRS 3 or Statement 141. That was never the intent or the objective of this joint project.

5. The primary objective of the business combinations project is to develop a single high-quality standard for accounting for business combinations that can be used for both domestic and cross-border financial reporting. That standard should reflect a common set of principles that provides decision-useful information and minimises exceptions to those principles. The standard should also <u>improve</u> the completeness, relevance, and comparability of financial information about business combinations that is reported in financial statements (emphasis added). That is to say, this phase of the project never was intended to be constrained to choosing between IFRS 3 and Statement 141.

The foundations for the proposals

6. The principles presented at the January meetings [reference IASB Agenda Paper 6, FASB Memo #4] were drawn from, and in some cases paraphrased, the proposals. At those meetings Board members suggested that some of the principles the staff identified in the BC ED were not in fact principles. Some Board members suggested that some of those principles were exceptions to principles and that some of those principles were requirements or rules, and in some cases, might be better labeled as presumptions. Board members also commented that there might be better ways to express the core concepts agreed to by the Boards. Although the final wording of the principles is a drafting matter, the staff are aware of the importance that the meaning of each principle be as clear as possible.

7. The principles as they are presented in this paper reflect comments received by Board members. In particular, a clearer distinction is made between presumptions and principles. Having said that, the staff believe that they have not introduced any new concepts or requirements from those proposed in the BC ED. [Remainder of paragraph 7 not reproduced in observer notes.]

Characterisation of the foundation statements

8. The staff have characterised the statements that follow as definitions, assertions, principles and presumptions. The labels are used within this paper with the following meaning:

- a *definition* is used to give a specified term special meaning;
- an *assertion* is a requirement from which the standard would not be expected to provide any exceptions;
- a *presumption* is a general belief, which would normally be based on observed behaviour or some other evidence; and
- a *principle* is a general proposition which serves as the foundation for the requirements. The principles will reflect the fundamental objective of the standard.

9. The distinction between these labels can be subtle. For example, the statement ‘an acquirer *can* be identified in every business combination’ is a presumption whereas ‘an acquirer *shall* be identified in every business combination’ is an assertion. There can also be some circularity in the development of these characterisations. For example, the proposed definition of a business combination draws on the presumption that an acquirer can be identified in every business combination. The foundation statements are also intended to be read together, rather than viewed in isolation.

Summary of the foundation statements

10. In the rest of this paper the staff outline and discuss the following definitions, assertions, presumptions and principles:

Basic assertions and definitions

A business combination is a transaction or other event in which an acquirer obtains control of one or more businesses.[1]

An acquirer can be identified in every business combination.

The business combination acquisition date is the date the acquirer obtains control of the acquiree.

A business combination is accounted for by applying the acquisition method.

By obtaining control of an acquiree, an acquirer becomes responsible and accountable for all of the acquiree’s assets, liabilities and activities, regardless of the percentage of its ownership in the acquiree.

Principles and presumptions for applying the acquisition method

Recognition

In a business combination, the acquirer recognises all of the assets acquired and all of the liabilities assumed.

Measurement

In a business combination, the acquirer measures each recognised asset acquired and each liability assumed at its acquisition-date fair value.

[1] The Boards discussed the definition of a business combination in February (IASB) and March (FASB). At those meetings the Boards agreed, in principle, with the definition and the presumption that an acquirer can be identified in every business combination. The staff are reviewing the wording as part of the drafting phase of this project. The staff are not seeking any further discussion on the definition at this meeting.

The acquisition-date fair value of the consideration transferred by the acquirer is presumed to be the best evidence of the fair value of the interest acquired.

Disclosure

Users of the acquirer's financial statements should be able to evaluate the nature and financial effect of business combinations recognised by the acquirer.

11. The staff believe that separating *recognition* and *measurement* will help ensure that any exceptions are related to the relevant principles. In some cases the Boards might decide not to recognise some or all of an asset or liability—under the proposals an assembled workforce would not be recognised as a *separate* asset. Some respondents have suggested that in a partial acquisition only a portion of goodwill should be recognised, which is a separate question from how this item might then be measured.

12. At the conclusion of this paper the Boards will be asked to agree that the definitions, assertions, presumptions and principles provide an appropriate basis for the standard.

13. Although the staff do not intend to carry these labels through to the final standard, they have used these characterisations here because they expect to find them helpful in framing and drafting the standard.

Objectives of this paper and Board affirmation

14. The staff are asking the Boards to endorse each of the foundation statements presented in this paper, which the staff believe are the appropriate basis for developing a standard on the application of acquisition accounting. The staff believe that agreeing on the foundations is the first critical step in meeting that objective.

15. *The staff emphasise that agreeing that the principles are the basis for the standard does not bind the Boards to accepting all of the consequences of applying the principles.* The Boards will be given the opportunity to consider the consequences of applying the principles beginning with the papers that follow from this one. To assist the Boards, the staff have identified what they believe to be the main implications of these principles based on the decisions made to date.

16. The staff are providing the Boards with detailed analysis of the implications of the principles as each topic is discussed. For example IASB Agenda Paper 2B - FASB Memo #9 provides an extensive analysis of the relative informational qualities of a fair value model and a cost accumulation model in a partial or step acquisition. The Boards will have the opportunity to make exceptions to the principles or amend the principles throughout the redeliberation process.

17. This paper therefore presents only the basic implications of the foundation statements. Those implications are discussed in the context of each definition, assertion, presumption or principle. The foundation statements presented here are the

consequence of extensive debate by both Boards. As the staff have emphasized, these foundation statements provide a framework within which the balance of the redeliberation process can be conducted.

Exceptions

18. When the Boards are asked to consider the consequences of applying the principles they will be asked whether they agree with each of the accounting requirements. If the Boards do not agree with an accounting requirement, the staff will ask the Boards to either specify that the accounting requirement is an exception to a principle or suggest an alternative principle.

19. The staff believe that if the Boards decide to make any exceptions to the principles, these should be clearly identified as exceptions within the standard. The objective of clearly identifying the exceptions is so that constituents will analogise to the principles rather than analogise to the exceptions.

Board decision

Do the Boards agree the final standard should label an exception clearly, and explain why that exception is being allowed?

Guidance

20. Some of the accounting requirements are designed to make clear the implications of the principles. For example, the guidance contained in the BC ED on valuation allowances, contingencies and liabilities associated with restructuring or exit activities is intended to make clear the implications of the recognition and measurement principles in relation to those matters.[2] The inclusion of guidance within a standard should not be seen as a substitute for having a clear principle.

21. In the BC ED guidance was included where application of the principle resulted in a change from current practice. The staff believe that even if the principles are clear, in some circumstances additional guidance may be necessary to ensure consistent application of the principle.

22. The staff will ask the Boards to confirm whether the guidance included in the BC ED should be retained for the final standard, and whether additional guidance should be included.

[2] See paragraphs 33 to 41 of the BC ED.

Control

23. The definition of a business combination states that 'a business combination is a transaction or other event in which an acquirer obtains control of one or more businesses.' The definition refers to the acquirer obtaining 'control' of the acquiree. Under the proposals, control is defined by reference to IAS 27 in the proposed revised IFRS 3 and the proposed replacement of ARB 51 in the proposed Statement 141R. A consequence of this approach is that it is possible that some transactions or events will meet the definition of a business combination under either IFRSs or US GAAP but not both. However, converging what constitutes 'control' in IFRSs and US GAAP is outside of the scope of this project.

24. Notwithstanding any differences in the definition of control, the proposals treat achieving control as a discrete and important event.

25. Under the proposals, by obtaining control of an acquiree, an acquirer becomes responsible and accountable for all of the acquiree's assets, liabilities and activities, regardless of the percentage of its ownership in the acquiree.[3]

26. The acquirer either has or does not have control. This is consistent with IAS 27 and the proposed replacement of ARB 51. Any ownership interest in the business held by the acquirer before achieving control would be, by definition, a non-controlling interest. Once an acquirer achieves control, acquiring an additional ownership interest in the business does not give the acquirer more control. And conversely, disposing of an ownership interest in a business without losing control does not give the acquirer less control.

27. The staff believe that it is clear that the definition of a business combination focuses on the transaction or event that gives the acquirer control of another business. That is to say, the proposals require that a business combination be accounted for *at* the date control is obtained.

Board decision

Do the Boards agree that by obtaining control of an acquiree, an acquirer becomes responsible and accountable for all of the acquiree's assets, liabilities and activities, regardless of the percentage of its ownership in the acquiree?

Date of the business combination

28. Notwithstanding that the definitions of control under IFRSs and US GAAP are different, what is common to the proposals is that achieving control is an important

[3] This statement is from the BC ED—IASB BC18(a) and FASB B23(a).

event. From that point the acquirer begins reporting the underlying assets, liabilities, and results of operations of the acquiree as part of its consolidated results. Identifying the date that control is obtained is, therefore, important, because this defines the date of the business combination itself. This is paragraph 17 of the proposals.

Board decision

Do the Boards agree that the acquisition date is the date that the acquirer obtains control of the acquiree?

Recognising and measuring the acquiree

29. The proposals carry forward from IFRS 3 and Statement 141 the shared belief of the Boards that the acquisition method is the appropriate method for accounting for a business combination. The current phase of the project has a goal of developing consistent application of the acquisition method in IFRSs and US GAAP.

Recognition

30. The Boards have agreed that control should be the basis for **recognising** all of and only the assets acquired and liabilities assumed as if those assets and liabilities were in a single economic entity.[4] This approach already underpins Statement 141 and IFRS 3. The staff are not aware of any good reason (conceptual, practical or otherwise) that would lead to any conclusion other than that, as a principle, an acquirer should recognise all of and only the assets acquired and the liabilities assumed at the date the acquirer achieves control of that business.

31. This principle is also the basis for excluding items that are currently accounted for as part of a business combination under IFRS 3 or Statement 141. For example, application of this principle would treat restructuring charges and acquisition costs as being outside of a business combination. The former because they are not a liability assumed at the acquisition date and the latter because they are not an asset acquired at the acquisition date. The Boards will have an opportunity to discuss these implications in future Board meetings.

Exceptions

32. There might be good reasons for making some exceptions to that recognition principle, but any final standard should be clear that they are exceptions.

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[4] The staff assume that the Boards will reaffirm this statement at this meeting.

Goodwill and non-controlling interests

33. Application of this recognition principle would result in the acquirer recognising all of the goodwill at the acquisition date. Under US GAAP and IFRS 3 all of the non-controlling interests in the recognised assets and liabilities are *recognised* at the acquisition date, with the exception of goodwill. The proposals did not include an exception from this principle for goodwill, which would therefore be a change from the requirements in US GAAP and IFRS 3.

34. A consequence of recognising all of the goodwill on the acquisition date is that all of the non-controlling interests in that goodwill would also be recognised at the acquisition date.

35. Some respondents have argued that only the portion of goodwill attributable to the controlling interests should be recognised—the partial or "purchased goodwill" method. Board members who expressed alternative views to the proposals indicated a preference for the partial method. However, those Board members expressed concerns about the reliability of measurement as the main grounds for their objection. The staff view is that those alternative views are best characterised as expressing such a fundamental concern with measuring all of the goodwill that they are motivated to accept an exception to the recognition principle. IASB Agenda Paper 2B, FASB Memo #9 discusses those comment letters, the alternative views, and the recognition of goodwill. If the Boards do decide to change to the partial method, it would be an exception to this principle because only some of the goodwill would be recognised.

36. The staff considered whether adding words to this principle would be appropriate to clarify that recognising all of the assets and all of the liabilities would result in the recognition of all of the non-controlling interests in those assets and liabilities. The staff are inclined towards using an explanatory paragraph to address non-controlling interests and how they relate to this principle. The reason the staff prefer to take this approach is that some departures from the principle for an asset or liability can cause a corresponding departure for non-controlling interests. It makes little sense to build what is a consequence of the accounting relationship into the principle.

37. Some respondents view the recognition of all of the non-controlling interests as being a simple consequence of requiring recognition of all of the goodwill on the acquisition date. Non-controlling interests provide part of the risk capital that has funded the assets of the subsidiary that will be recognised in the business combination. The staff believe that recognising all of the funding provided to the group by non-controlling interests is consistent with the recognition principle. For purposes of this paper, the staff are not asking the Boards to debate whether non-controlling interests should be classified as equity. That classification is discussed in IASB Agenda Paper 2D, FASB Memo #12.

Acquisition costs

38. The Boards concluded that acquisition costs are not part of the fair value exchange and that they are not assets acquired as part of the business combination. Discussions at the round-tables indicated that current application of IFRS 3 and Statement 141 is resulting in acquisition costs being recognised as part of goodwill. That is to say, acquisition related costs are not being allocated to identifiable assets and liabilities but are subsumed in goodwill.

39. The proposals would require acquisition-related costs to be expensed in the period they are incurred. Many respondents and two Board members have indicated that they disagree with the accounting treatment proposed, which would be a change from both IFRS 3 and Statement 141.

40. The Boards will have an opportunity to discuss the accounting for acquisition costs at a future Board meeting.[5]

Assembled work force

41. The Boards have also proposed that the acquirer recognise, separately, all identifiable intangible assets at the acquisition date, with the exception of an assembled workforce. Again, this should be identified as an exception to the recognition principle in the proposals.

Board decision

Do the Boards agree that in a business combination the principle should be that an acquirer should recognise all of, and only, the assets acquired and all of, and only, the liabilities assumed on the date the acquirer obtains control of those assets and liabilities?

Measurement

Measurement attribute

42. The proposals would require that the assets acquired and liabilities assumed be measured at *fair value* at the acquisition date.

43. Although fair value is the measurement attribute, the Boards have proposed some exceptions. Most of the exceptions have been made because the items of concern are the subject of other accounting standards. A requirement to measure those items at fair value on initial recognition in a business combination would create a ‘day two’

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[5] The staff believe that some might argue that the treatment of acquisition costs in the proposals is a measurement issue rather than a recognition issue. The staff view this as a recognition issue because acquisition costs are not assets acquired on the acquisition date.

conflict with those other accounting standards. The following items fall into this category:

- assets held for sale;
- deferred taxes;
- operating leases; and
- employee benefit plans.

44. Another exception is goodwill. The proposals acknowledge the difficulty in measuring the fair value of goodwill. The proposals would require that goodwill be measured as a residual—as the excess of the fair value of the acquiree over the fair value of the identifiable assets acquired less the fair value of the liabilities assumed.

Comparison with current requirements

Acquiring all of a business in one transaction

45. Many respondents have expressed concerns about fair value being the measurement attribute and have suggested that this is a fundamental change in the measurement basis from current requirements. Yet, fair value is already the measurement attribute in IFRS 3, with some exceptions, and for many assets and liabilities in Statement 141 where an acquirer obtains all of another business in one transaction.

Partial and step acquisitions

46. For a partial or step acquisition, the requirements in IFRS 3 are consistent with this approach for all *identifiable* assets and liabilities. Those assets and liabilities are measured at their fair values at the date control is achieved.

47. There is a difference between the proposed accounting and the current IFRS 3 in relation to goodwill. Under IFRS 3, goodwill is measured as an accumulation of the acquirer’s proportionate interest in the difference between the fair values of those identifiable assets and liabilities and the consideration paid for that interest until control is achieved. This requires the acquirer to remeasure all assets and liabilities at the date of each additional acquisition. IFRS 3 does not address the accounting for an additional acquisition after control is achieved.

48. The fair value measurement attribute is a significant shift for US GAAP constituents in a partial acquisition. Under US GAAP, for a partial or step acquisition, each asset and liability is measured as a series of layers based on the percentage of the fair value acquired at the date of each partial acquisition plus a layer based on the remaining non-controlling interest’s portion of the carrying amount of the asset or liability at the date of the most recent acquisition. This process also applies for additional acquisitions of ownership interests after control is achieved.

Fair value

49. The decision to make fair value the measurement attribute reflects the assertion that by obtaining control of an acquiree, an acquirer becomes responsible and accountable for all of the acquiree's assets and liabilities. As the staff have noted, the fair value measurement attribute is already the basis for measuring assets and liabilities when an acquirer obtains all of another business in one transaction. The Boards have agreed that an acquirer controls all of an acquiree's assets and is accountable for all of its liabilities once it has control of that acquiree. This establishes the unit of account (all of each asset and all of each liability), and it is this unit that is being measured. This is the principle in IFRS 3.

50. The Boards decided that this principle provides a more consistent measurement basis than a cost accumulation approach, is consistent with the consequences of obtaining control of a business, and is simpler to apply than a cost accumulation model, which requires fair value measurement at each change in ownership level.

51. At the beginning of the project the Boards were working with the assumption that the total amount recognised by an acquirer should be based on the fair value of the acquiree as a whole, at the acquisition date. As a principle, however, it is unlikely to be as helpful in developing the requirements as the principles expressed in this paper. To illustrate this point, consider a requirement that all assets and liabilities of the acquiree be recognised by the acquirer at their pre-acquisition date carrying amounts with the exception of goodwill, which would be recognised as the difference between the fair value of the acquiree as a whole and the net carrying amount of the assets and liabilities recognised. This requirement is consistent with recognising the fair value of the acquiree as a whole. Any requirements would be consistent with this principle, as long as there is a 'plug' that causes the total net recognised amounts to equal the fair value of the acquiree as a whole.

52. As noted earlier in this paper, IASB Agenda Paper 2B - FASB Memo #9 provides an extensive analysis of the relative informational qualities of a fair value model and a cost accumulation model in a partial or step acquisition. [Remainder of paragraph 52 not reproduced in observer notes.]

Board decision

Do the Boards agree that fair value should be the measurement attribute in a business combination rather than cost?

Do the Boards agree with the principle that the acquirer should measure each recognised asset acquired and liability assumed at its acquisition-date fair value?

Evidential presumption

53. The Boards have agreed that the acquisition-date fair value of the consideration transferred by the acquirer is likely to be the best evidence of the fair value of its interest in the acquiree. This reflects the presumption that business combinations, generally, are exchange transactions in which knowledgeable, unrelated willing parties exchange equal values. Paragraph 20 of the proposals captures this decision.

54. Several respondents to the proposals have expressed concerns that in a partial acquisition the BC ED implies that the fair value of the acquiree as a whole is measured by a simple extrapolation of the consideration transferred. These concerns have emerged even though the staff believe that the wording in the proposals is clear.

55. This presumption is consistent with IFRS 3 and Statement 141. The staff believe that it is an appropriate evidential presumption in the accounting for a business combination.[6]

Board decision

Do the Boards agree that the acquisition-date fair value of the consideration transferred by the acquirer should be presumed to be the best evidence of the fair value of the interest acquired?

Additional implications

56. Although this paper has not identified all of the implications, the staff have described the implications that appear to be of most interest to respondents. Application of these definitions, assertions, presumptions and principles has implications in addition to those described above. The accounting for consideration and step acquisitions are described next. The Boards are not being asked to affirm any decisions on these matters as part of this paper. The Boards will have an opportunity to revisit these issues in future papers.

Consideration

57. Establishing that the date the acquirer obtains control of the acquiree as the date the business combination is accounted for has implications for the date the consideration transferred is recognised and measured. The proposals would require that the consideration transferred and the interest acquired are measured on the date on which the acquirer achieves control of the acquiree—which is the date of the business

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[6] At the time the staff were preparing this paper they were aware of potential changes to the fair value guidance being considered by the FASB in relation to presumptions about transaction prices and fair value. The staff may ask the Boards to revisit this presumption once the fair value guidance is completed.

combination (acquisition date). Measuring any component of the consideration transferred or any of the assets, liabilities or non-controlling interests in the business acquired at any date other than the date control is achieved would conflict with the principle that assets and liabilities be recognised and measured at their acquisition-date fair values.

58. The Boards will be considering at subsequent meetings issues related to:

- the measurement date for equity securities issued as consideration in a business combination; and
- contingent consideration.

59. In both cases the Boards have agreed that these components of the consideration should be measured at their acquisition-date fair values.

60. Some respondents have argued that any difference between the contingent consideration the acquirer expects to pay at the acquisition date and the amount that they actually pay should be accounted for by adjusting the goodwill that was recognised on the acquisition date. The proposals would require contingent consideration to be measured at fair value as of the acquisition date and be remeasured each period in income until the contingent consideration is settled.

61. If the Boards decide to change the accounting for contingent consideration by allowing goodwill to be adjusted, it would be an exception to the principles that assets and liabilities are recognised and measured at the acquisition date.

Non-controlling interests in a step acquisition

62. The significance of obtaining control is that a change from holding a non-controlling investment in an entity to obtaining control of that entity is a change in the nature of the economic circumstances surrounding the investment. In effect, the acquirer exchanges its status as an owner of an investment asset for a controlling interest in all of the underlying assets and liabilities of that acquiree.

63. The acquirer's accounting for those assets, liabilities and activities begins at the acquisition date and, if the acquirer held a non-controlling equity investment in the acquired entity, its accounting for that interest as an investment should cease.

64. The proposals would require that the previously held non-controlling investment be measured at fair value at the acquisition date and any gain would be taken to income to reflect this change in status. The proposed accounting is different than both IFRS 3 and Statement 141.

65. The next paper [IASB Agenda Paper 2B, FASB Memo #9] focuses on these issues, and the Boards will have an opportunity to decide whether they want to make an exception to the measurement principle.

Disclosure

Disclosure principle

66. The proposals would require that the acquirer disclose information that will enable users of the acquirer's financial statements to evaluate the nature and financial effect of business combinations recognised by the acquirer.

67. The staff believe that this principle is unlikely to be considered controversial by the Boards, and the comment letter analysis did not highlight any concerns by respondents. It is also unlikely that the Boards would contemplate developing exceptions to this principle. The staff have not, therefore included any discussion of the development of this principle or an analysis of its implications. The Boards will have the opportunity to discuss the application of the principle when the staff analyse the disclosure requirements over the next few months.

68. This principle was not included in the summary presented in January.

Summary of principles, assertions, definitions and presumptions

69. Affirmation by the Boards of each of the items noted above would provide the following definitions, assertions, presumptions and principles:

Basic assertions and definitions

A business combination is a transaction or other event in which an acquirer obtains control of one or more businesses.

An acquirer can be identified in every business combination.

The business combination acquisition date is the date the acquirer obtains control of the acquiree.

A business combination is accounted for by applying the acquisition method.

By obtaining control of an acquiree, an acquirer becomes responsible and accountable for all of the acquiree's assets, liabilities and activities, regardless of the percentage of its ownership in the acquiree.

Principles and presumptions for applying the acquisition method

Recognition

In a business combination, the acquirer recognises all of the assets acquired and all of the liabilities assumed.

Measurement

In a business combination, the acquirer measures each recognised asset acquired and each liability assumed at its acquisition-date fair value.

The acquisition-date fair value of the consideration transferred by the acquirer is presumed to be the best evidence of the fair value of the interest acquired.

Disclosure

Users of the acquirer's financial statements should be able to evaluate the nature and financial effect of business combinations recognised by the acquirer.

Board decision

Do the Boards agree that the definitions, assertions, presumptions and principles identified here provide an appropriate basis for the standard?