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International Accounting Standards Board

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Note: These notes are based on the staff paper prepared for the Council. Paragraph numbers correspond to paragraph numbers used in the Council paper.

INFORMATION FOR OBSERVERS

SAC Meeting:	**February 2008, London**
Project:	**Business Combinations Phase II, Project Summary and Feedback Statement**
	(*Agenda Paper 2, Appendix B)*

International Accounting Standards Board

BUSINESS COMBINATIONS PHASE II

Project Summary and Feedback Statement

January 2008

International Accounting Standards Board®

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Business Combinations Phase II

Project Summary and Feedback Statement
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International
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Overview

In January 2008 we—the International Accounting Standards Board—completed the second phase of the business combinations project.

The objective of the project, which we undertook with the US Financial Accounting Standards Board (FASB), was to develop a single high quality standard of accounting for business combinations that would ensure that the accounting for M&A activity is the same whether an entity is applying IFRSs or US generally accepted accounting principles (GAAP).

The result of the project is that we have issued a revised version of IFRS 3 *Business Combinations* and an amended version of IAS 27 *Consolidated and Separate Financial Statements*. The FASB has issued SFAS 141(R) *Business Combinations* and SFAS 160 *Noncontrolling Interests in Consolidated Financial Statements*.

Why we undertook the project

Last year there were more than 13,000 M&A transactions with a combined value of more than €2 trillion.

A business combination is the acquisition of one business by another, and is part of what is commonly referred to as M&A (mergers and acquisitions) activity. Business combinations are an important feature of the capital markets. In 2006 there were more than 13,000 M&A transactions worldwide.* Just under half, with a combined value of €1.03 trillion (US$1.49 trillion), were completed by entities that apply US GAAP. Most of the rest, worth about €1.26 trillion (US$1.82 trillion), were completed by entities that apply International Financial Reporting Standards (IFRSs) or are moving to IFRSs. Over the last decade the average annual value of corporate acquisitions worldwide has been the equivalent of 8–10 per cent of the total market capitalisation of listed securities.

The project was designed to unify M&A accounting across the world's major capital markets. When we started the project we were observing rapidly accelerating movement of global capital flows—there has been a five-fold increase in the volume of transatlantic deals between 2003 and 2006.

Investors and their advisers assess how the activities of the acquirer and its acquired business will combine, which is challenging enough when entities use the same accounting. It is more difficult to make comparisons when acquirers are accounting for acquisitions in different ways, whether those differences are a consequence of differences between US GAAP and IFRSs or because IFRSs or US GAAP are not being applied on a consistent basis.

* On average, about 75–80 per cent of the transactions involved public companies with the rest being private equity transactions.

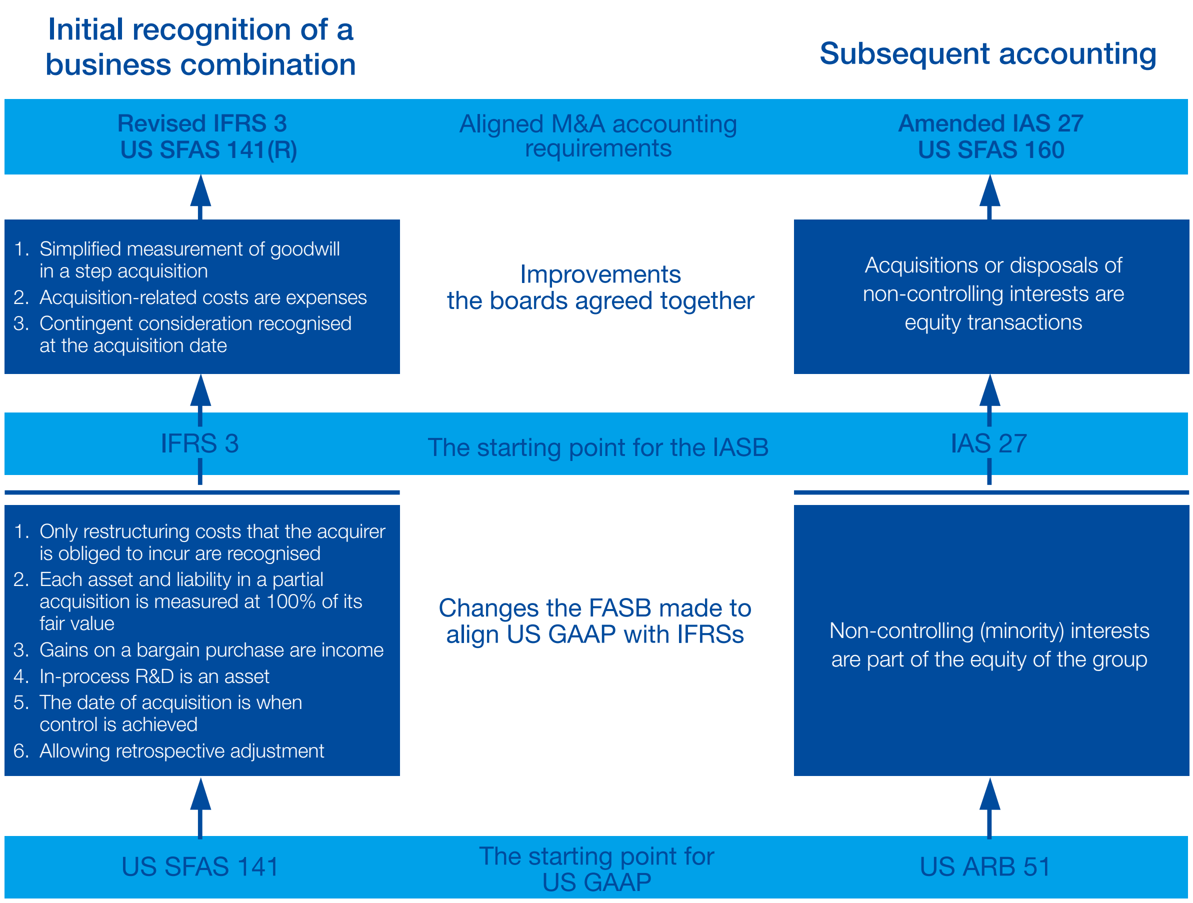
Why the business combinations project will lead to improved financial reporting

We think the revised IFRS 3 and the amended IAS 27 will improve financial reporting for those using IFRSs because:

- the new versions address deficiencies in the existing IFRS 3 and IAS 27 without changing the basic accounting; and
- by rewriting IFRS 3 we have been able to unify M&A accounting across the world's major capital markets.

The revised IFRS 3 reinforces the existing IFRS 3 model but remedies problems that have emerged in its application. The revised IFRS 3 will allow entities to choose to measure non-controlling interests using the existing IFRS 3 method or on the same basis as US GAAP.

The revised IFRS 3 is also more succinct than its predecessor, with a greater emphasis on laying out the principles for the application of the acquisition method to business combinations.



As a result of the project, the FASB has made fundamental changes to its accounting for business combinations, most of which bring US accounting into line with the existing IFRS 3 and IAS 27. Other improvements we made will change both IFRSs and US GAAP. These improvements are based on our experience with IFRS 3 and IAS 27 and the US experience with SFAS 141. We have learned from each other.

Next steps

There are still some differences between the revised IFRS 3 and SFAS 141(R). Most of those differences are because of differences between other IFRSs and US GAAP. We have designed the revised IFRS 3 with the intention that any future work on removing those differences will not cause us to have to make major revisions to IFRS 3. Rather, our focus will be on, eventually, removing the exceptions to the principles in IFRS 3.

In December 2007 we added to our agenda a project to consider one of the exceptions—the accounting for business combinations under common control. This is an area that preparers, regulators and auditors have asked us to address.

We will continue to monitor IFRS 3 and IAS 27 (which is part of an active agenda item dealing with consolidated financial statements) both informally and through the more formal process of post-implementation review.

Project history

The business combinations project became part of our initial agenda when the IASB was formed in 2001. Accounting for business combinations had been identified previously as an area of significant divergence within and across jurisdictions. Extensive work on the topic had been undertaken in the previous decade by national standard-setters, notably the group of national standard-setters and our predecessor, IASC, known as the G4+1.

By the time the IASB was formed, the FASB had finalised SFAS 141 *Business Combinations*, which removed the merging (or pooling) of interests method and replaced amortisation of goodwill with a goodwill impairment test. We received numerous requests from around Europe and Australia to make similar changes to the accounting for goodwill because entities applying IFRSs believed themselves to be at a disadvantage to those using US GAAP.

We decided to split the project into two phases. The first phase would be short-term, addressing pooling of interests and goodwill impairment and amortisation in a replacement of IAS 22 *Business Combinations*. The second phase would take a broader look at business combination accounting. We started the two phases at about the same time, which meant that they ran in parallel until the first phase was completed.

We worked with the FASB on the second phase. We concluded that sharing our resources and debating the issues together was the best way for each to improve the application of the acquisition method and to ensure a level playing field by eliminating as many as possible of the differences between IFRS 3 and SFAS 141.

Before the first phase had been completed we had already finished our analysis of the initial measurement of identifiable assets acquired and liabilities assumed in a business combination; the recognition of liabilities for terminating or reducing the activities of an acquiree; and the accounting for bargain purchases. We decided to incorporate those decisions in the original IFRS 3, which was issued in March 2004, bringing the first phase of the project to a conclusion. The changes we incorporated in IFRS 3 moved IFRSs ahead of US GAAP.

As we explained in the basis for conclusions on the original IFRS 3, the second phase of the project would address the aspects of M&A activity for which there was no guidance. We were also examining the requirements that we had carried forward from IAS 22 into IFRS 3 without reconsideration. The continuation of our work in the second phase of the project gave both boards the opportunity to address those parts of IFRS 3 and IAS 27 (and the US equivalents) that we knew required additional work. It also provided the FASB with the opportunity to catch up with the decisions already incorporated in IFRSs.

The revised IFRS 3 and amended IAS 27

Changes to the IFRSs

The revised IFRS 3 and amended IAS 27 incorporate many changes from the exposure drafts that we made as a result of debating the proposals in the light of comments we received during our consultations. The main changes that the revised IFRS 3 and amended IAS 27 will make to the existing requirements or practice are described below.

Step and partial acquisitions

The requirement to measure at fair value every asset and liability at each step in a step acquisition for the purposes of calculating a portion of goodwill has been removed. Instead, goodwill is measured as the difference at acquisition date between the value of any investment in the business held before the acquisition, the consideration transferred and the net assets acquired.

For a business combination in which the acquirer achieves control without buying all of the equity of the acquiree, the remaining (non-controlling) equity interests are measured either at fair value or at the non-controlling interests' proportionate share of the acquiree's net identifiable assets. Previously, only the latter was permitted. Allowing this choice was a change from the proposal that was made in response to concerns expressed by many respondents.

Transparency and comparability

Acquisition-related costs must be accounted for separately from the business combination, which usually means that they are recognised as expenses (rather than included in goodwill).

An acquirer must recognise at the acquisition date a liability for additional consideration (contingent consideration). Changes in the value of that liability after the acquisition date are recognised in accordance with other IFRSs, as appropriate, rather than by adjusting goodwill. The disclosures required to be made in relation to contingent consideration have been enhanced.

New guidance to address diverging practice

We added requirements to specify that changes in a parent's ownership interest in a subsidiary that do not result in the loss of control must be accounted for as equity transactions, remedying a deficiency in the existing IAS 27.

We clarified the requirements for how the acquirer accounts for some of the assets and liabilities acquired in a business combination that had been proving to be problematic—replacing the acquiree's share-based payment awards; being indemnified by the seller; rights, such as franchise rights, that the acquirer had sold to the acquiree previously and are part of the business combination; embedded derivatives; cash flow hedges; and operating leases.

Other improvements

We brought within the scope of IFRS 3 business combinations involving only mutual entities and business combinations achieved by contract alone. This ensures that the accounting for an important part of M&A activity for which there have been no IFRS requirements will be consistent with the accounting for other M&A activity.

We removed an inconsistency in the existing IAS 27 by requiring that an entity must attribute a share of any losses to the non-controlling interests even if this results in the non-controlling interests having a deficit balance.

We added requirements to specify how, upon losing control of a subsidiary, an entity measures any resulting gain or loss and any investment retained in the former subsidiary.

Eliminating the differences between IFRSs and US GAAP

The changes described above were also changes that the FASB made to US GAAP.

Changes to US GAAP

The changes made by the FASB to US GAAP are more fundamental than the changes we have made to IFRSs.

The changes made by the FASB to US GAAP are more fundamental than the changes we have made to IFRSs. Among the more significant of the changes it has made, all of which bring US GAAP into line with existing IFRSs, are:

- classifying non-controlling interests as equity.
- requiring restructuring charges to be accounted for as they are incurred, rather than allowing these to be anticipated at the time of the business combination.
- requiring in-process research and development (IPR&D) to be recognised as a separate intangible asset, rather than immediately written off as an expense.
- aligning the acquisition date with the date defined in the existing IFRS 3 (at present US GAAP uses the agreement date).
- recognising a gain on a bargain purchase in income (rather than by allocating it to some of the assets acquired).

Remaining differences

We were not able to eliminate all differences between the existing IFRS 3 and IAS 27 and their US GAAP equivalents.

Different conclusions

We reached decisions different from those reached by the FASB in relation to two matters—the measurement of non-controlling interests and three disclosure items. The revised IFRS 3 permits an acquirer to measure the non-controlling interests in an acquiree either at fair value or at their proportionate share of the acquiree's identifiable net assets whereas SFAS 141(R) requires the non-controlling interests in an acquiree to be measured at fair value.

Legacy differences between other IFRSs and US GAAP

Other differences remain because of the boards' decision to provide guidance for accounting for business combinations that is consistent with other IFRSs or US GAAP. Many of those differences are being considered in current projects or are candidates for future convergence projects, which is why the boards allowed those differences to continue at this time.

The boards have different definitions of control, because of differences between our consolidations standards. As a consequence it is possible that a transaction that is a business combination in accordance with the revised IFRS 3 might not be a business combination in accordance with SFAS 141(R). We have a separate project to replace IAS 27 and expect, as a first step, to publish a discussion paper in 2008.

The revised IFRS 3 carries forward the definition of *fair value* from the existing version, which is based on an exchange value. US GAAP defines *fair value* as an exit value. We have a separate project in which we are considering the definition of fair value and related measurement guidance.

The boards have very similar requirements for recognising and measuring assets and liabilities arising from contingencies, both initially and after the acquisition. However, differences between the criteria for initial recognition (IFRS 3 has a 'reliable measurement' threshold whereas SFAS 141(R) has a 'more likely than not' threshold for non-contractual liabilities) might to lead to some differences in application. We have an ongoing project to amend or replace the relevant IFRS—IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

Our consultation process

Our public consultations on business combinations have been extensive and spanned several years. The letters we received commenting on our exposure drafts were not our only source of feedback. As well as taking part in the round-table meetings, our staff and individual Board members attended and gave presentations at numerous conferences and seminars and met many individuals and representatives of organisations.

Consultations leading to the exposure drafts

Although exposure drafts are the most obvious part of our process of public consultation, our consultations on this project began much earlier. By the time we published the exposure drafts we had debated the proposals at 28 of our public Board meetings and three joint public meetings with the FASB. We also held meetings with our Standards Advisory Council (in public) and with industry groups and other interested parties to benefit from their insight and expertise on specific issues, including industry-related questions.

Because the project was conducted jointly with the FASB we were able to share staff and other resources. The FASB set up a business combinations resource group comprising accounting, auditing, analyst, valuation and related financial reporting experts in business combinations. We consulted the FASB's resource group members on various issues throughout the project and took part in meetings with them in April and August 2003. In 2004 FASB and IASB staff undertook field visits to five companies that had recently completed a business combination.

Exposure drafts

In June 2005 we published a joint exposure draft with the FASB to replace the original IFRS 3 and FASB Statement No. 141 *Business Combinations* (SFAS 141). We also published related proposed amendments to IAS 27 and the FASB published a proposed statement to replace Accounting Research Bulletin No. 51 *Consolidated Financial Statements* (ARB 51). The exposure drafts were open for comment for four months, ending on 28 October 2005.

Post-exposure draft consultation

In October and November 2005 we hosted, jointly with the FASB, five public round-table meetings, which were held in the FASB's offices (in Norwalk, Connecticut) and in London. Representatives of over 50 leading organisations from around the world participated in the discussions.

Throughout 2006 and the first half of 2007, we debated the issues raised by respondents to the 2005 exposure drafts and by participants in the round-table meetings. We also continued to consult the Standards Advisory Council, our Analysts Representative Group and other experts. We had 13 public decision-making meetings, plus three joint public meetings with the FASB. The FASB held a similar number of meetings, in all of which our staff took part.

The staff and Board members continued to make public presentations about the project, which gave the opportunity for those attending to provide us with additional comments and input. In addition, the project staff held many private meetings with respondents, to follow up on matters raised in their comment letters.

The staff field tested aspects of the proposals, to help them assess whether revisions to the exposure drafts were addressing the matters raised by respondents. This process included completing a case study in which participants were asked to account for a business combination. They were provided with a purchase agreement and other pertinent information about the businesses and were asked to identify the assets acquired and liabilities assumed and to measure them at fair value. This field test involved the participants spending up to 300 hours of staff time completing the case study.

The staff also analysed financial statements and M&A data, including undertaking simulations to assess the likely financial reporting effect of the proposals.

Drafting

In April 2007 we instructed our staff to prepare the revisions and amendments for our formal voting procedures. Those drafts were sent to selected external technical experts for review.

Post-implementation review

The standards will be subject to a post-implementation review.

The standards issued in January 2008 will be subject to a post-implementation review two years after they have become mandatory. Such reviews are limited to important issues identified as contentious during the development of the pronouncement and consideration of any unexpected costs or implementation problems encountered.

We will also continue informal consultations throughout the implementation of the revised IFRS 3 and the amended IAS 27.

Feedback statement

We and the FASB received comment letters on the exposure drafts of 2005 from 287 respondents.*

In our deliberation process we, together with the FASB, considered the matters raised in the comment letters along with matters raised through our other consultations. The result is that the revised IFRS 3 and the amended IAS 27 are different from those proposed in the exposure drafts. Among the more notable changes were:

- We decided not to proceed with the full goodwill model, which has a 'whole of business' emphasis. Instead, we shifted the focus back to the components of business combination transactions, being the consideration transferred and the assets, liabilities and equity instruments of the acquiree.
- In response to concerns expressed by respondents, we allow preparers to choose between measuring non-controlling interests as their proportionate interest in the net identifiable assets of the acquiree (which is the requirement in the original IFRS 3) and fair value (which is the new requirement in US GAAP). This will allow preparers to select the measurement basis most appropriate to their circumstances.
- In response to concerns expressed by respondents, we have added a requirement to present a schedule that will make it easier to assess the interests the parent shareholders have in the group.

We also ensured that the final documents are drafted in a style familiar to the IFRS community.

The sections that follow provide a more detailed explanation of the matters raised by respondents and how our thinking was influenced in developing the final standards.

General comments from respondents

Some respondents expressed surprise that the proposed revision of IFRS 3 was so different from the existing version. Those respondents appear not to have been expecting a major rewrite of IFRS 3, particularly so soon after the IFRS had been issued. Some respondents thought the documents were too long and detailed.

We think that this reaction is partly attributable to the style of the exposure draft and to the inclusion of illustrative examples in the application guidance. The drafting changes gave a false impression that the changes to the requirements were also extensive.

Rather than try to piece together a blend of IFRS 3 and SFAS 141 we had decided that a new common standard should be drafted. As a result, the drafting differences between the proposed and existing IFRS 3 were far more extensive than the technical differences. And it did not help that the proposed revision to IFRS 3 was published only 15 months after the original IFRS 3 was issued.

It was also clear that many respondents do not welcome change. We observed that any change from current practice was more likely to be criticised than retaining current practice. For example, many respondents applying US GAAP objected to the changes to US GAAP being proposed in relation to the classification of non-controlling interests, restructuring charges, IPR&D, bargain purchases and the acquisition date. Yet few IFRS respondents commented on those matters because they were not changes to existing IFRS requirements.

* About 70 of the letters were 'form' letters from co-operative organisations.

Not all the responses were negative. Some respondents welcomed the additional guidance we proposed for the initial recognition of leases and identification of what is part of a business combination. Many respondents supported the elimination of differences between IFRSs and US GAAP.

Initial measurement of goodwill and non-controlling interests

Full goodwill

The focus of changes in M&A accounting standards over the last twenty years has been to provide better guidance on identifying what the acquirer is paying for and how to measure those items. However, the most difficult area is acquisitions in which the acquirer gains control of the business but does not buy all of the shares (or equity) of the business. In those cases there will be others who are also shareholders in the business (minority or non-controlling equity interests).

The model that underpins the existing version of IFRS 3 is that because the acquirer has control of a business it recognises 100 per cent of each asset and liability, even if it does not own 100 per cent of the shares. The rationale is that by controlling a business an entity is able to control each of the assets and liabilities. IFRS 3 already requires each of those assets and liabilities to be measured at fair value at the date the acquirer gains control. In contrast, US GAAP requires each asset to be measured partly on the basis of fair value and partly on the basis of its carrying amount before the business was acquired. The FASB is changing to the original IFRS 3 model.

Goodwill is the one exception to this basic approach. Even though the acquirer controls the whole business, few accounting standards have required all of the goodwill to be recognised. The common practice has been to recognise only the acquirer's proportionate interest in the goodwill. This is the approach in the original IFRS 3.

In the exposure draft we proposed that the acquirer should be required to treat goodwill like other assets. That would mean that all of the goodwill would be recognised, rather than just the proportion attributable to the controlling party. To implement that principle the exposure draft suggested a different emphasis for accounting for a business combination. The idea was that the acquirer should start by measuring the fair value of the business as a whole. The goodwill could then be derived by measuring the difference between the fair value of the business and the sum of the net assets acquired and liabilities assumed. This approach is commonly referred to as the *full goodwill* method because it focuses on measuring the full value of the goodwill.

Respondents' comments—full goodwill

The proposal was not well received. Many respondents stated that the proposal placed too much emphasis on estimating the fair value of the business and that this estimate can be unreliable. Some respondents did not believe that goodwill is an asset and others believed that the full goodwill approach is inconsistent with their view that the financial statements should focus on the parent's shareholders.

Our response—a change in focus

... we decided not to continue with a focus on the fair value of the business as a whole or, as a consequence, the full goodwill method.

In response to the concerns raised by respondents, and in the light of our own analysis, we decided not to continue with a focus on the fair value of the business as a whole or, as a consequence, the full goodwill method. Instead, we shifted the focus back to the components of business combination transactions, being the consideration transferred and the assets, liabilities and equity instruments of the acquiree. Any difference between the consideration transferred and the components of the business would be attributed to goodwill (or a gain on a bargain purchase). This is the same approach as that in the existing IFRS 3.

Step acquisitions

The exposure draft proposed simplifying the accounting for goodwill in a step acquisition (ie an acquisition in which an entity obtains control of a business in two or more steps). The original IFRS 3 required entities to measure the fair value of each asset and liability at each step for the purposes of measuring the portion of goodwill attributable to that step. The exposure draft proposed that the measurement of goodwill should be calculated as a residual on the basis of the fair values of the assets and liabilities at the acquisition date. The exposure draft also proposed that any interest in the investment held immediately before the acquisition should be measured at fair value and any related gain or loss recognised in profit or loss.

Respondents' comments

Most respondents supported the change to the measurement of goodwill.

Our response

The revised IFRS 3 incorporates the change proposed.

Respondents' comments

Some respondents agreed that the previously held investment should be measured at fair value before being recognised but believed that the gain or loss from the initial measurement of the retained investment should not be recognised in profit or loss. They argued that, by analogy with available-for-sale financial assets, the gain or loss should be recognised in other comprehensive income.

Our response

We considered requiring any gain or loss to be reported as other comprehensive income. However, achieving control of an entity causes the group to derecognise the previously held investment. Recognising any related gain or loss in other comprehensive income would be inconsistent with the accounting for the derecognition of other assets.

Non-controlling interests

Our decision not to continue with a full goodwill model did not allow us to avoid the problem of how to measure non-controlling interests. A non-controlling interest is a component of equity in the acquirer's consolidated financial statements. We concluded that the usefulness of information about a non-controlling interest would be improved if the revised standards specified a basis for measuring non-controlling interests that provides information to investors.

Our consultations with groups of those who use financial statements for making (or making recommendations about) investment decisions suggested that information about the acquisition-date fair value of a non-controlling interest would be helpful in estimating the value of shares of the parent company, not only at the acquisition date but also at future dates. The fair value helps users to estimate the amount the acquirer would need to pay to acquire the remaining non-controlling interests. Measuring non-controlling interests at their acquisition-date fair value is also consistent with the way in which other components of equity are measured.

Respondents' comments—concerns about measuring non-controlling interests

Our discussions with respondents indicated that the change in focus from assessing the value of the business as a whole to assessing the values of the components of the business did not alleviate all of their concerns. They were particularly worried about how to measure the fair value of the non-controlling interests and the cost of doing so.

Our response—we are allowing a choice of measurement

After an extended debate we decided to allow an acquirer to choose between the two methods of measuring non-controlling interests by using the method required by the original IFRS 3, or measuring at fair value. US GAAP will require non-controlling interests to be measured at fair value.

Introducing a choice of measurement basis for non-controlling interests was not our first preference. In general, we think that alternative accounting methods reduce the comparability of financial statements. However, we were not able to agree on a single measurement basis for non-controlling interests because neither of the alternatives considered (fair value and proportionate share of the acquiree's identifiable net assets) was supported by enough Board members to enable a revised standard to be issued.

We decided to permit a choice of measurement basis for non-controlling interests because we concluded that the benefits of the other improvements to, and the convergence of, the accounting for business combinations developed in this project outweigh the disadvantages of allowing this particular option. We plan to include an assessment of the option in the post-implementation review of the revised IFRS 3.

Changes in the relative proportion of the controlling and non-controlling interests

After a parent has control of a business (subsidiary) the parent might increase its holding by buying additional shares from the non-controlling interests, or reduce its holding by selling some shares. A parent's relative interest in a subsidiary will also change if the subsidiary issues shares to a party other than the parent. IAS 27 did not deal with accounting for any of these transactions. At least six methods were being applied in practice.

The controlling and non-controlling shareholders are all equity holders. The exposure draft proposed that transactions between these equity holders should be accounted for on the same basis as any other transaction between equity holders—within equity. Not only is this one of the simplest of the six methods but, more importantly, it is the only method that leads to the appropriate reporting of income and equity. All of the other methods cause problems with how one or more of the components in the statement of financial position or statement of comprehensive income are measured.

Respondents' comments—little agreement on the preferred accounting

Few disagreed with the need to address the shortcomings in IAS 27 with regard to accounting for changes in non-controlling interests. However, respondents' views on the preferred approach were as diverse as the practice that had developed.

Our response—we retained our proposals

We decided to retain the accounting proposed in the exposure draft. We rejected the alternative approaches, which lead to assets being stated at inconsistent values or income being counted twice, as unacceptable.

The business combinations project page on our Website includes some examples illustrating why we have concluded that the accounting in the amended IAS 27 provides the most useful information about these transactions.*

* See the resources section at the end of this document for information about how to access the site.

Respondents' comments—non-controlling interests are a special class of equity and the financial statements should focus on the shareholders in the parent

Although most respondents agreed that non-controlling interests are not a liability, some stated that non-controlling interests are a special class of equity that should be treated differently from the equity of the owners of the parent. They noted that non-controlling interests represent equity claims that are restricted to particular subsidiaries, whereas the controlling interests are affected by the performance of the entire group. Therefore, non-controlling interests bear risks and benefit from the rights of the group to a degree different from owners of the parent entity.

Many respondents perceived that by accounting for the purchase, or creation, of non-controlling interests as a transaction within equity we were moving towards an accounting model that focuses on the reporting entity to the detriment of the parent's shareholders. Those respondents believe that such a move hinders the ability of a user to assess the financial position and performance of an entity from the perspective of the owners of the parent. Those respondents stated that:

- the primary purpose of consolidated financial statements is to provide useful information for the principal users of consolidated financial statements—ie the owners (current and potential) of the parent entity.
- non-controlling interests have information needs that are different from those of controlling interests. The information needs of non-controlling interests are best served by the financial statements of the entity in which they have an interest.
- the parent entity perspective provides the most relevant information for users of consolidated financial statements. Owners of a parent entity are interested in information about the financial performance and position of the group from the parent's perspective to evaluate the stewardship of the entity's management and the return on the entity's invested capital.

Our response

We agree (and have always done so) with those respondents who commented that the owners of the parent are important users of the consolidated financial statements and that the effects of transactions between the parent and the non-controlling interests should be clear. But we do not agree that the accounting we proposed obscures the financial performance of the parent.

Our *Framework* includes definitions of liabilities and equity. On the basis of those definitions, we concluded in our 2003 revision of IAS 27 that non-controlling interests are a separate component of equity. The amendments to IAS 27 reflect the consequences of that classification. We therefore decided to retain the basic proposals in the exposure draft.

Notwithstanding that the accounting is consistent with the *Framework* we decided to improve the disclosures by requiring entities to present a separate schedule showing the effects on the equity of the parent entity of transactions with the non-controlling interests.

We also know that the concerns of some respondents are more fundamental than disclosure and stem from their belief that we should adopt a parent perspective in business combination accounting and consolidations more generally. The accounting for changes in non-controlling interests is consistent with our *Framework*. Therefore, we did not comprehensively debate the economic entity and parent entity perspectives as part of our business combinations project. We will, however, consider these matters in the proposed discussion paper on consolidations and, possibly, a forthcoming discussion paper on the conceptual framework.

Respondents' comments—equity might be destroyed by these requirements

Some respondents disagreed with the proposed accounting because they were concerned about the effect on reported equity of the subsequent acquisition of non-controlling interests by the parent. Those respondents seemed to be particularly concerned about the effect on the reported leverage of an entity that acquires non-controlling interests and whether this might, for example, cause those entities to have to renegotiate loan agreements.

Our response

We analysed the reported equity of the 600 largest listed entities in Europe at 31 March 2007. Our analysis suggests that the concerns expressed by respondents about the possible widespread, and substantial, erosion of equity as a consequence of buying the non-controlling interest are not supported by the data we observed.

We stress, however, that even if we had concluded that there was a high probability that the accounting we were proposing was likely to cause equity to be reduced significantly we would not have made a different decision about the accounting. We know that the proposed accounting for subsequent acquisitions of non-controlling interests results in a reduction in equity. All acquisitions of an entity's own equity result in a reduction of that entity's reported equity. Even a simple cash dividend increases the leverage of an entity. Therefore, it should not have been surprising to respondents that acquiring non-controlling interests would also affect the leverage of an entity. Such an outcome is a fair representation of the fact that resources have been transferred outside the group and the equity has been reduced.

If acquiring non-controlling interests causes the equity of a group to decrease to a very low level, or even become negative, the underlying reason for that outcome will have been a difference between the carrying amount of the equity being acquired and the amount paid.

Our full analysis of these companies is available on the business combinations project Website.*

Fair value

The exposure draft included a requirement to measure the fair value of the business as a whole for the purposes of calculating goodwill. That requirement would not have increased the number of assets or liabilities measured at fair value, although the requirement to measure the fair value of the business would have been new.

Respondents' comments—too much fair value

Many respondents expressed a concern that the proposals would lead to a significant increase in the use of fair value measurement.

Our response

As has been explained already, we decided not to proceed with the full goodwill method and, accordingly, there will no longer be a requirement to fair value the business as a whole.

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* See the resources section at the end of this document for information about how to access the site.

The requirement to measure at fair value each asset acquired and liability assumed in a business combination was in IAS 22, which was issued in 1983.

The requirement to measure at fair value each asset acquired and liability assumed in a business combination was in IAS 22, which was issued in 1983. Hence, the principle of measuring the components of a business at fair value, which was maintained in the original IFRS 3, is not new.

We understand why respondents might have perceived that the proposals included more use of fair value, given the focus in the exposure draft on the fair value of the business as a whole.

The changes to the fair value requirements will affect only contingent consideration arrangements and step acquisitions. Whether an entity will need to make additional, or fewer, fair value measurements will depend on the circumstances of the acquisition, as the examples that follow illustrate.

For those business combinations in which the acquirer purchases all of the shares in a business in one transaction, and does not enter into any contingent consideration agreements, the fair value requirements in the revised IFRS 3 will be the same as those in the version it is replacing. This is the most common type of business combination.

For those business combinations in which the acquirer achieves control by acquiring shares in steps the revised IFRS 3 is likely to reduce the fair value measurement requirements. This is because, despite being required to measure at fair value the investment held immediately before achieving control, the acquirer will not have to measure the fair value of each asset and liability at each step. The greater the number of steps the acquirer takes before achieving control the more significant the relief provided by the revised IFRS 3.

For partial acquisitions, in which the acquirer does not own all of the equity of a business but controls the business, the revised IFRS 3 will not change the fair value requirements. The acquirer might elect to measure non-controlling interests at fair value, but this is not a requirement.

Other improvements to IFRS 3

Acquisition-related costs

The original IFRS 3 required fees paid in relation to a business acquisition to be included in the cost of the acquisition. The result is that they were measured as part of goodwill. These costs are not an asset, yet they could remain in the statement of financial position indefinitely.

The new requirement, which is what we proposed in the exposure draft, is that fees paid for professional services in relation to a business combination will generally have to be recognised as an expense at the time of the acquisition, and the amount disclosed. This will also be a change for US GAAP, which had the same requirements as the original IFRS 3.

Feedback on the proposal was mixed. Some preparers appeared to be unhappy about the effect on earnings of recognising those costs as an expense. Analysts tell us that they generally treat those costs as a 'one-off' and therefore make adjustments for items such as this if they use earnings as the basis of their valuation of a business.

Respondents' comments—recognising acquisition costs as an expense is a result of moving to a fair value model

Some respondents disagreed with the proposal because they think that recognising acquisition-related costs as expenses is a consequence of moving to a fair value model. They argued that other IFRSs require assets to be measured initially at cost and that this approach should be retained in the revised IFRS 3.

Our response

We disagree with these respondents. We have IFRSs that define the elements of cost for the purposes of initial recognition. Excluding acquisition-related costs from the cost of an asset is valid in a cost accumulation model. Put simply, the Board does not accept that fees paid in relation to an acquisition are an asset or part of an asset.

Respondents' comments—recognising acquisition costs as an expense is inconsistent with other IFRSs

Some respondents agreed with the proposal but would have preferred us to address matters that affect several standards, such as transaction and acquisition costs, more broadly rather than to amend each standard as it becomes part of an active project. Others disagreed with the proposal because they believed it will introduce new inconsistencies with how we measure assets in accordance with other IFRSs, particularly IAS 16 *Property, Plant and Equipment*.

Our response—we retained our proposals

We know that there are some inconsistencies in how our standards measure assets and liabilities. Some items include transaction costs and others exclude transaction costs on initial, and sometimes subsequent, recognition. We considered whether we should amend other standards, such as IAS 16 and IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* but decided that it would not be appropriate to do so without separately exposing such a proposal. Nevertheless, we see merit in considering smaller issues that affect many IFRSs, and will keep this in mind when we consider future projects.

Having said that, we disagree with those respondents who think that we are creating a new problem. The original IFRS 3 required assets to be measured at fair value, not fair value plus transaction or acquisition costs. The revised IFRS 3 does not change how those individual assets should be measured. We are now requiring those costs to be recognised as expenses rather than included in goodwill.

Respondents' comments—inability to assess return on assets

Some respondents believed that recognising acquisition costs as expenses would make it impossible to assess the return on the total investment in the new subsidiary. They argued that the acquisition costs need to be included in goodwill to ensure that the total outlay is reflected in the statement of financial position.

Our response—we disagree

This argument implies that the initial investment is in some way 'preserved' in the statement of financial position. This is not the case now, or under any business combinations standard we know. A group will start depreciating assets, selling inventory etc as soon as the new subsidiary becomes part of the group. This means that the initial 'investment' amount changes as soon as the parent takes control of the new subsidiary.

Entities will be recognising through income the expenses associated with acquiring a business. It is the (net) assets that will generate returns for the acquirer. Those returns will have to be enough to recover the costs related to the acquisition.

A user can identify the total outlay in the year the acquisition takes place by looking at the information that IFRS 3 (original and revised) requires entities to disclose.

Contingent consideration

As part of a business combination arrangement, an acquirer might agree to make an additional payment to the former owners of an acquiree (or have the right to a refund) depending on a particular outcome. For example, the acquirer might agree to pay more if specified sales or profit targets are met, or a seller might agree to refund some of the purchase price if the acquiree breaches a regulation before the acquisition date. These arrangements are commonly referred to as contingent consideration.

The original IFRS 3 required contingent consideration to be included in the cost of a business combination at the acquisition date, but only if the additional payment or refund is probable and can be measured reliably. Subsequent changes in the estimate of the amount of contingent consideration are accounted for as adjustments to the cost of the business combination and thus affect the amount of goodwill recognised. There are no specific disclosure requirements related to contingent consideration, in relation to either the initial agreement or subsequent payments.

We concluded that the delayed recognition of this part of the consideration is unacceptable. The acquirer has entered into an agreement obliging it make additional payments and this is part of the consideration exchanged at the acquisition date. The existing requirements fail to represent fairly the consideration exchanged at the acquisition date.

We proposed that the acquirer should be required to recognise the obligation to make additional payments as part of the business combination. That liability should be recognised at its fair value at the acquisition date. After the acquisition date the acquirer would account for changes in the fair value of the liability in accordance with other applicable standards (which will usually require changes in the fair value to be recognised in income). We also proposed requiring the acquirer to disclose the maximum potential amount of future payments under a contingent consideration agreement.

Respondents' views were mixed. Although the majority of respondents did not support the proposals, a significant minority did. There was more support for requiring a liability to be recognised at the acquisition date than there was for the subsequent accounting.

Respondents' comments—reliability

Respondents who disagreed with the requirement to recognise a liability, measured at its fair value, as part of the business combination argued that doing so would fail to provide users of financial statements with information about the ultimate settlement amount of that obligation. Many respondents were also concerned that it might not be possible to measure the acquisition-date fair value of contingent consideration reliably. They emphasised that some contingent consideration arrangements are a consequence of the inability of the acquirer and the seller of the acquiree to agree on the fair value of the acquiree. They argued that the lack of agreement means that it would not be possible to measure the fair value of any additional payment reliably.

Our response

The total consideration transferred will include any adjustments made as a result of contingent consideration. The principle is that the consideration should be recognised at fair value.

We think that it is inappropriate to allow an acquirer to keep this liability off the statement of financial position because of a difference in expectations.

When we published the exposure draft we thought that it is more informative to recognise the fair value of the liability and supplement this with a requirement to disclose the maximum potential amount of future payments under a contingent consideration agreement. The revised IFRS 3 now requires an estimate of the range of outcomes of contingent consideration to be disclosed.

We know that measuring the fair value of some contingent consideration can be difficult, but delaying the recognition of some assets acquired or liabilities incurred in a business combination would cause the acquirer's financial statements to be incomplete and diminish the usefulness of the information provided.

Respondents' comments—subsequent accounting

Most respondents disagreed with the subsequent accounting for contingent consideration. Many of those respondents stated that changes in the fair value of the liability confirm the acquisition-date fair value of the acquiree. They argue, therefore, that goodwill should be adjusted by the change in the fair value because it is an adjustment to the purchase price for the acquiree.

Our response

We think that this description of contingent consideration is an oversimplification. Many contingent consideration agreements are motivated by a wish to share some of the future performance risk. Rather than reflecting valuation uncertainty at the date of the acquisition, the deferred settlement might be designed to share future outcomes. If the business does not perform as expected there will be an adjustment to the deferred settlement, perhaps through a profit-sharing arrangement.

By obtaining control of the business, the acquirer has the ability to influence its performance. In many cases the changes in the fair value of consideration relate to post-combination events and changes in circumstances related to the combined entity. In such circumstances, subsequent changes in the fair value of contingent consideration should be reflected in the combined entity's financial performance. They are not related to the acquisition-date value of assets acquired or liabilities assumed in the business combination.

This accounting effect is the consequence of entering into a contingent consideration agreement related to the occurrence or non-occurrence of future events. Some contingent consideration arrangements that are recognised as a liability will have characteristics similar to those of a derivative. The subsequent measurement of contingent consideration is consistent with the subsequent accounting for derivatives in accordance with IAS 39.

Also, a change in the fair value of contingent consideration will often be offset by a corresponding change in the value of specific assets or liabilities to which the contingent consideration agreement relates. For example, the acquirer might have agreed to the payment of additional consideration upon favourable settlement of a legal action in which the acquiree is involved. If, after the acquisition date, a favourable settlement is obtained, two effects occur. First, the acquiree recognises a gain from the release of the liability for the legal action. Second, the acquirer recognises a loss from the increase in the fair value of contingent consideration.

Respondents' comments—incentives to manipulate results

Some respondents argued that the proposed subsequent accounting for contingent consideration would generate counter-intuitive results because the acquirer would recognise a gain from a decrease in contingent consideration caused by a deterioration of the financial condition of the acquiree. Some respondents thought that this also created incentives for an acquirer to overstate contingent consideration at the acquisition date because any subsequent decrease in fair value would be recognised as a gain in the acquirer's statement of comprehensive income.

Our response

We know that those incentives might exist. However, we think that the accounting principle should not be compromised because of concerns about accounting abuse.

It is intuitive, for such arrangements, that a poorer than expected performance of the acquired business is shared with the previous owners through a reduction in the additional consideration payable. By specifying the basis for how the liability has been measured the acquirer will also be stating its expectations about the performance of the acquiree. Presumably, the acquirer will need to explain to users why that expectation has not been met. In some circumstances, the poorer than expected performance could lead to an impairment expense being recognised.

We are aware that the majority of respondents disagreed with the revised accounting treatment for contingent consideration after the acquisition. Thus, we will monitor the application of the revised standard and include this aspect of IFRS 3 in the post-implementation review.

Extending the scope to include mutual organisations

A mutual entity is an entity other than an investor-owned entity that provides dividends, lower costs or other economic benefits directly and proportionately to its owners, members or participants. Common examples of mutual entities are credit unions, mutual insurance companies and co-operatives. Combinations of mutual entities were excluded from the scope of the original IFRS 3.

At present, a combination of mutual entities is accounted for either in accordance with the acquisition method or the pooling of interests method. As a consequence, the accounting for combinations of mutual entities is not consistent, either within that sector or with other business combinations. Therefore, we proposed removing the scope exemption for combinations of mutual entities.

Respondents' comments

Respondents that commented on the proposal were mostly mutual entities or their representative organisations. The majority of respondents disagreed that combinations of mutual entities should be included in the scope of the revised IFRS 3 because they believe that mutual entities have particular characteristics that distinguish them from other business entities.

Many respondents stated that combinations of mutual entities are economically different from business combinations of investor-owned entities. They believed that situations exist in which a combination of mutual entities should not be accounted for in accordance with the acquisition method. In their view, in the case of a 'merger of equals', the pooling of interests method or the so-called 'fresh start' method provides more faithfully representational information.

Our response

We know that mutual entities have some characteristics that set them apart from investor-owned businesses. However, they also have many common characteristics. As do other businesses, mutual entities strive to provide their members with a financial return or other economic benefits. A mutual entity often does that by focusing on providing its members with its products and services at lower prices.

We think that the economic motivation for combinations of mutual entities, such as to provide their constituents with a broader range of, or access to, services and cost savings through economies of scale, are not sufficiently different from those of other entities to justify different accounting for business combinations. Regardless of the intentions of the combining entities, the general result of a combination involving only mutual entities is that one entity obtains control of another entity.

Applying the fresh start method suggests that none of the combining entities is viewed as having survived the combination as an independent reporting entity. Rather, the combination is viewed as the transfer of the net assets of the combining entities to a new entity that assumes control over them. It is possible that there are combinations of mutual entities for which the fresh start method would provide better information than the acquisition method. However, we have yet to conduct a comprehensive review of the fresh start method and such a review is not part of our active agenda.

Respondents' comments

Some respondents stated that co-operatives do not fit within the definition of a mutual entity. They argued that co-operatives are different from mutual entities and those differences justify a different method of accounting for combinations of co-operatives.

Our response

We know that there are differences between co-operatives and other types of mutual entities. For example, the objective of a co-operative might include providing social and cultural benefits to its community in addition to the economic benefits provided to its members. However, co-operatives generally provide direct and indirect economic benefits such as dividends, lower costs of services or other products to their members. We concluded that differences in the amount of social and cultural benefits that an entity provides are not a sufficient basis to justify excluding co-operatives from the definition of a mutual entity.

Classifying and designating assets acquired and liabilities assumed

The accounting for a lease differs according to whether it is classified as a finance lease or as an operating lease. The original IFRS 3 did not provide guidance on whether the classification or designation of an asset or a liability could change in a business combination.

When we developed the exposure drafts we were concerned that practice was diverging, as a result of the lack of guidance. We proposed clarifying that the classification of an acquired lease should not change in a business combination. Therefore, if the acquiree had classified a lease contract as an operating lease before the business combination the acquirer would continue to account for the contract as an operating lease.

Respondents' comments

Respondents generally agreed with the proposed treatment of lease contracts and thought the guidance was helpful. Some asked us to go further and to provide additional guidance on how to classify or designate other assets acquired and liabilities assumed in a business combination, such as financial assets, embedded derivatives, cash flow hedges and insurance contracts.

Our response

We agree with those respondents who requested additional guidance and decided that the best way to address this was to develop a general principle for classifying and designating contracts.

The principle we developed is that the acquirer should classify and designate all items acquired in a business combination at the acquisition date in the context of the contractual terms, economic conditions and other pertinent factors at that date. We decided, however, that two exceptions to that principle should be leases and insurance contracts.

We think that the new principle will provide clarity in an area of divergence in practice. This should reduce compliance costs for preparers and benefit users of financial statements.

Contingent liabilities

The exposure draft proposed some improvements to the accounting for contingent liabilities. The original IFRS 3 requires contingent liabilities to be measured at fair value at the acquisition date, although an acquirer is not required to recognise a contingent liability if its fair value cannot be measured reliably. The exposure draft proposed removing that exception.

The exposure draft also proposed changes to the measurement of contingent liabilities after the acquisition date. The original IFRS 3 requires entities to measure contingent liabilities at the higher of the amount at which they were initially recognised or the amount that would be required to be recognised in accordance with IAS 37. The exposure draft proposed that, after a business combination, an acquirer should measure contingent liabilities at the amount that an entity would pay to settle or transfer the liability at the reporting date. This was consistent with the accounting for contingent liabilities occurring outside of a business combination proposed in the exposure draft of amendments to IAS 37 (which we published simultaneously with the business combinations exposure drafts).

Respondents' comments

Respondents generally disagreed with the proposed measurement of contingent liabilities after a business combination, expressing concerns about the ability to measure contingent liabilities reliably, ongoing costs of having to remeasure contingent liabilities at each reporting date and volatility in the statement of comprehensive income.

Our response

We understand the concerns respondents raised, most of which we have been debating as part of our deliberations in the IAS 37 project. We think that it is best to resolve the accounting for contingencies in that project. We therefore decided that the revised IFRS 3 should carry forward the original IFRS 3 requirements, with one difference. We now also require that the contingency must meet the definition of a liability. As a consequence, some contingencies that would be recognised when applying the original IFRS 3 will not be recognised when applying the revised IFRS 3.

Other improvements to IAS 27

Attribution of losses

The existing version of IAS 27 requires losses that exceed the non-controlling interests' equity to be deducted from the controlling interest's equity. Any profits the subsidiary reports subsequently are allocated to the controlling interest until the non-controlling interests' losses previously absorbed by the controlling interests have been recovered.

The amended IAS 27 requires all losses attributable to the non-controlling interests to be allocated to them, even if this results in the non-controlling interests having a deficit balance. We have made this change because the present accounting is inconsistent with our conclusion that non-controlling interests are part of the equity of the group.

Respondents' comments

Some respondents agreed with the proposal because they noted that controlling and non-controlling interests share proportionally in the risks and rewards of the investment in the subsidiary and the proposal was consistent with that view. Others disagreed, arguing that, even though controlling and non-controlling interests are presented in equity, they have different economic characteristics and should not be treated the same way. They highlighted that the non-controlling interests are generally not compelled to cover the deficit and that if the subsidiary requires additional capital in order to continue operations the non-controlling interests would abandon their investments.

Our response

Although it is true that non-controlling interests have no further obligation to contribute assets to the subsidiary, neither does the parent. If the financial position of a subsidiary subsequently improves, all owners of the subsidiary, including the non-controlling interests, will share in that recovery. Non-controlling interests participate proportionally in the risks and rewards of the subsidiary.

We will review the requirements for disclosures in consolidated financial statements as part of our discussion paper on consolidations.

Loss of control of a subsidiary

Sometimes a parent loses control of a subsidiary but retains an ownership interest. Depending on the degree of influence the former parent retains in the former subsidiary, the remaining investment is accounted for as a jointly controlled entity, an associate or a financial asset in accordance with other applicable IFRSs. Before we amended IAS 27, it required that at the date control is lost the carrying amount of the retained investment is the initial measurement for its subsequent accounting as a financial asset.

This accounting is not consistent with the general principle in IFRSs that when a financial asset is recognised initially it should be measured at fair value. When a parent entity loses control of a subsidiary the parent stops recognising the assets, liabilities and equity instruments and recognises, for the first time, an investment. That is to say, this is the initial recognition of that investment.

Therefore, we proposed that any investment the parent retains in a former subsidiary after control is lost should be measured initially at fair value, regardless of whether the retained investment is classified as an associate, a jointly controlled entity or a financial asset. At the date when control is lost, the difference between the fair value and carrying amount of the retained interest should be recognised in profit or loss.

Respondents' comments

Even though some respondents agreed with the proposal, most respondents disagreed that the former parent should account for the retained investment at fair value and recognise a gain or loss in profit or loss. They believed that the principles for gain or loss recognition in the *Framework* would not be satisfied for the retained investment in the subsidiary because there was no transaction that justified recognising a value change.

Our response

We think that measuring the investment at fair value is consistent with our conclusion that the loss of control is a significant economic event. The parent-subsidiary relationship ceases to exist and an investor-investee relationship begins that differs significantly from the former parent-subsidiary relationship. Therefore, the new investor-investee relationship is recognised and measured initially at fair value at the date when control is lost.

Measuring a retained investment at fair value will impose some additional costs on preparers of financial statements related to the valuation itself. However, those additional costs should be relatively small because in most cases when control is lost the former parent will have just sold shares and therefore has an exchange transaction that will assist it in measuring the fair value of the shares it has retained.

We also think that measuring the retained investment at fair value provides more relevant information to users of financial statements and is consistent with the proposals for step acquisitions. Therefore, we decided to affirm the accounting proposed in the exposure draft.

Respondents' comments

As with a gain or loss associated with a previously held investment in a step acquisition, some respondents argued that the gain or loss should be recognised in other comprehensive income.

Our response

Including any such gain or loss in other comprehensive income would be inconsistent with the fact that the nature of the investment has changed fundamentally—from having control over the assets and liabilities of the business to a non-controlling investment. We therefore retained the proposed accounting.

Resources

Additional information about the project is available on the Business Combinations project page of our Website, at *www.iasb.org/business-combinations*.

The project page gives access to:

- the exposure drafts published in June 2005.
- the letters we received in response to our request for comments on the exposure drafts.
- audio recordings of the public meetings we held to discuss the project and written summaries of the decisions we made at those meetings.
- examples demonstrating the different approaches in practice to accounting for acquisitions and disposals of non-controlling interests, including an assessment of why the accounting in the amended IAS 27 is the most appropriate of these methods.
- an analysis of the likely effects of the new requirements on IFRS-compliant financial statements and the associated costs and benefits to preparers and users of those financial statements.