



**INTERNATIONAL FEDERATION
OF ACCOUNTANTS**

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Agenda Item
9

DATE: March 2, 2007
MEMO TO: Members of the International Public Sector Accounting Standards Board
FROM: Barry Naik
SUBJECT: Entity Combinations

ACTION REQUIRED

The IPSASB is asked to approve a project proposal on entity combinations.

AGENDA MATERIAL:

Papers

- 9.1 Project Proposal – Entity Combinations
- 9.2 Background information - IFRS 3 *Business Combinations*

BACKGROUND

As discussed in IFRS 3 *Business Combinations*:

Business combinations are “*The bringing together of separate entities or businesses into one reporting entity. The result of nearly all business combinations is that one entity, the acquirer, obtains control of one or more other businesses, the acquiree. If an entity obtains control of one or more other entities that are not businesses, the bringing together of those entities is not a business combination.*”

The initial stage of the IPSASB standards setting program was established with the specific limited objectives of developing a credible core set of IPSASs within a short period of time.

At present, the IPSASB Handbook does not provide any public sector specific guidance for public sector entities involved in entity combinations (entity combinations is scoped out of IPSAS 23 *Revenue from Non-Exchange Transactions (Taxes and Transfers)*). In the absence of public sector specific guidance, improved IPSAS 3 *Accounting Policies, Changes In Accounting Estimates And Errors* states the following in para 23:

“*In the absence of an International Public Sector Accounting Standard that specifically applies to a transaction, other event or condition, management may, in accordance with paragraph 15, apply an accounting policy from the most recent pronouncements of other*

standard setting bodies and accepted public or private sector practices to the extent, but only to the extent, that these are consistent with paragraph 14. For example, pronouncements of the International Accounting Standards Board (IASB), including the “Framework for the Preparation and Presentation of Financial Statements”, International Financial Reporting Standards and Interpretations issued by the IASB’s International Financial Reporting Interpretations Committee (IFRIC)...”

The end result is that arguably most public sector entities who are entering into entity combination transactions would in the first instance refer to IFRS 3 *Business Combinations* for guidance.

IFRS 3

IFRS 3 requires application of the ‘purchase method’ to business combinations within its scope. This is in contrast to the accounting guidance which it replaced (IAS 22 *Business Combinations*) which among other things, permitted business combinations to be accounted for using one of two methods: the pooling of interests method (in limited circumstances for combinations classified as uniting of interests) or the purchase method (for combinations classified as acquisitions).

Very briefly, the key provisions for business combinations within the scope of IFRS 3 include (for a fuller discussion, please see item 9.2):

- applying the purchase method;
- identifying an ‘acquirer’ (ie: the combining entity that obtains ‘control’).
- requiring the acquirer to measure the combination as the aggregate of the fair values, at the date of exchange, of the net assets, and equity instruments issued by the acquirer.
- requiring the identifiable assets, liabilities and contingent liabilities that satisfy stated criteria to be measured initially by the acquirer at their fair values at the acquisition date, irrespective of the extent of any minority interest.
- requiring goodwill acquired to be recognized as an asset from the acquisition date, initially measured as the excess of the cost of the business combination over the acquirer’s interest in the net fair value of the acquiree’s identifiable assets, liabilities and contingent liabilities.
- requiring at least annual impairment testing of goodwill (with supporting disclosures).
- recognizing bargain purchase options immediately in profit or loss.
- requiring disclosures to help evaluate the nature/financial effect of business combinations that were effected:

- during the period;
- after the balance date but before the financial statements are authorized for issue;
and
- in previous periods (some only).

Staff do not believe that the underlying assumptions and above mechanics supporting IFRS 3 are significantly problematic for application to the public sector. The project proposal does however identify examples of where the IFRS will need to be ‘public sectorized’. Staff’s key concern with IFRS 3 (and proposed revisions – discussed further below) relate to scope exclusions for entity combinations involving entities or businesses under common control.

Revisions to IFRS 3

Based on the IASB project schedule on its website, the IASB is currently revising IFRS 3 with a final revised IFRS scheduled for Q3 2007. The revision represents phase II of its project in relation to accounting for business combinations (phase I saw the replacement of IAS 22 and other related material with existing IFRS 3). Phase II, being conducted jointly with the FASB, seeks among other things, to converge accounting for business combinations by both Boards. For more information about phases I and II, please see item 9.2.

Phase II resulted in the issue in June 2005 of an exposure draft of proposed amendments to IFRS 3 (coupled with an exposure draft of proposed amendments to IAS 27 *Consolidated and Separate Financial Statements*) – both with a response date of October 28, 2005.

While numerous amendments are being considered to existing IFRS 3, it is proposed at this point to carry forward without reconsideration the need to apply the purchase method (renamed ‘acquisition’ method) with the need to identify an ‘acquirer’ in all cases.

On the understanding that the IASB project is not yet finished, staff’s initial review of the proposed amendments to IFRS 3 again do not raise significant issues for application to the public sector. Further, staff’s initial review of IASB meeting summaries since January 2006 in relation to their project, do not highlight any significant divergence from many of the proposed amendments.

One of the key changes proposed by the exposure draft (and tentatively reaffirmed at the IASB June 2006 meeting) is a broadening of the scope of IFRS 3 to include business combinations involving mutual entities and those effected by contract alone or in the absence of a transaction involving the acquirer. The scoping out of business combinations involving entities or businesses under common control remains.

Scope Exclusion – Entity Combinations Involving Entities or Businesses Under Common Control

While staff do not have any significant concerns with respect to the applicability of either the requirements of existing IFRS 3 or the proposed revisions to it, staff believe a significant issue relates to those entity combinations which have been scoped out of both documents – entity combinations involving entities or businesses under common control.

While these types of combinations may not be frequent or significant transactions for some public sector entities, some governments do ‘control’ a huge amount of entities which at some stage, could be subject to restructuring resulting in the combination of entities under the governments common control. As alluded to above, *Revenue from Non-Exchange Transactions (Taxes and Transfers)* scopes out entity combinations.

The issue of how to account for these types of combinations is not new nor unique to the public sector.

The IASB acknowledges the significance of scoping out business combinations involving entities or businesses under common control. In its basis for conclusions for the June 2005 exposure draft of proposed amendments to IFRS 3 it states that it will consider, as part of future phases of its project on business combinations the accounting for business combinations involving entities under common control. Staff are unaware of any timeframe in this respect.

The topic of common control is currently a brief agenda item for the meeting of National Standard Setters in Hong Kong, March 24-25 (the exact nature of the discussion is not known at the time of writing). The Chair, Technical Director and Senior Advisor will be attending that meeting of NSSs subsequent to the IPSASB meeting.

Given the potential significance of this topic for the IPSASB project on entity combinations, staff have carved it out as a topic in itself to be dealt with in tandem but also separately from the development of more general accounting guidance for entity combinations based on IFRS 3.

Depending on the IPSASB’s view of entity combinations involving entities or businesses under common control, staff believe this project could be relatively straight-forward or it could be more complicated. Staff consider that a key question in considering these types of entity combinations is ‘what has changed as a result of the combination?’

The IPSASB has options as to how it could approach this project. One of these options would be to delay issuing entirely any public sector specific guidance on Entity Combinations until the IPSASB has resolved issues in relation to how to account for entity combinations involving entities or businesses under common control. This would arguably result in many (as noted above) public sector entities defaulting to IFRS 3 for guidance in the interim.

However, staff believe that considering guidance on accounting for entity combinations is believed to be noticeably absent from the IPSASB Handbook, that such guidance for public sector entities should be developed and issued sooner rather than later. Further, while aspects of the application of IFRS 3 are now in a phase of transition, the underlying principles of IFRS 3 are expected to remain constant which can be used as a relatively stable starting point for the IPSASB project.

The proposed approach would result firstly in converged IFRS-3 guidance being approved and issued by the IPSASB. At the same time as developing converged IFRS-3, separate but related guidance on entity combinations involving entities or businesses under common control would be developed alongside. Finalized common control guidance would be approved by the IPSASB some time after the approval of converged IFRS 3.

This approach would help to ensure IFRS-3 guidance is made available as quickly as possible for the public sector, whilst at the same time seeing progress on developing guidance on entity combinations involving entities or businesses under common control.

Item 9.1 Project Proposal – Entity Combinations, provides more details on this proposed approach.



**INTERNATIONAL PUBLIC SECTOR
ACCOUNTING STANDARDS BOARD**

PROJECT BRIEF AND OUTLINE

ENTITY COMBINATIONS

1. Subject

How to account for entity combinations in the public sector

Business combinations are defined in IFRS 3 *Business Combinations* as:

“The bringing together of separate entities or businesses into one reporting entity.”

Further, it states in IFRS 3:

“The result of nearly all business combinations is that one entity, the acquirer, obtains control of one or more other businesses, the acquiree. If an entity obtains control of one or more other entities that are not businesses, the bringing together of those entities is not a business combination.”

2. Project Rationale and Objectives

At present, the IPSASB Handbook does not provide guidance for public sector entities involved in entity combinations. Entity combinations is scoped out of IPSAS 23 *Revenue from Non-Exchange Transactions (Taxes and Transfers)*.

Entity combinations are transactions that public sector entities enter into and, as such, public sector specific guidance would assist in ensuring those transactions are appropriately reflected in the financial statements.

In addition, for combinations involving entities or businesses under common control, there is currently no international guidance available. Given the many activities and entities that governments can control, this type of combination would not be an unrealistic undertaking in the public sector.

a) Issue identification

As alluded to above and elaborated on further below, the key issue for this project will be the development of guidance for entity combinations involving entities or businesses under

common control. All existing and proposed international guidance on business combinations currently scope out this type of combination.

b) Objectives to be achieved

Key objectives of the project will be to:

- Converge IFRS 3 *Business Combinations* as much as possible for the public sector; and
 - Develop public sector specific guidance on accounting for entity combinations involving entities or businesses under common control (which may be stand-alone guidance or incorporated into a converged IFRS 3 above).
- c) Link to IFAC/IPSASB Strategic Plans

Link to IFAC Strategic Plan

Issuing international public sector accounting standards (IPSAS) is a key role of the IPSASB. The development of accounting guidance on entity combinations (which is viewed as a ‘gap’ in the IPSASB Handbook – see below) would directly contribute to the IFAC mission by establishing and promoting adherence to high quality professional standards.

Link to IPSASB Strategy

The absence of public sector specific guidance of this nature is viewed as a large ‘gap’ in the IPSASB Handbook and as such needs to be addressed if the IPSASB is to support its mission. As such, a project on Entity Combinations is currently ranked as a high priority within the IPSASB draft strategic and operational plan.

Further, guidance on accounting for entity combinations involving entities or businesses under common control is an area where at present, neither the IPSASB Handbook or IASB Handbook currently provide any authoritative guidance. Given there is a need for this form of guidance in the public sector, its provisions will be in alignment with the IPSASB strategy.

3. Outline of the Project

a) Project Scope

The project will scope in all those entity combination arrangements which are currently scoped within IFRS 3 *Business Combinations* (and subsequent proposed revisions – referred to here as draft IFRS 3) as appropriate for the public sector. Proposed revisions to IFRS 3 scope in all but the following arrangements:

- (a) formations of joint ventures
- (b) combinations involving only entities or businesses under common control

Given the relevance of combinations involving entities or businesses under common control to the public sector, the IPSASB project will also scope in those transactions.

Final approved guidance will be applicable to public sector entities only.

Government Business Enterprises (GBEs) are profit seeking entities. As noted in the “Preface to International Public Sector Accounting Standards” GBEs apply IFRSs issued by the IASB and are therefore subject to the IASB’s “Framework for Preparation and Presentation of Financial Statements” (the IASB Framework).

However, while GBEs are required to apply IFRSs, given that they form part of the government reporting entity and, as such, are ultimately subject to consolidation into the governments financial statements, the IPSASB project may decide to consider possible reporting implications with GBEs if considered appropriate.

b) Major Problems and Key Issues that Should be Addressed

As a starting premise, staff believe the underlying principles of IFRS 3 are convergent for the public sector. Similarly, the proposed amendments in draft IFRS 3 stemming from phase II of the IPSASB’s review of IFRS 3 also seem convergent with the public sector on initial review. IASB deliberations on proposed revisions to IFRS 3 do not appear to have resulted in any significant deviations from many of the proposals in draft IFRS 3. The IPSASB project will make a final decision as to the applicability of the revised IFRS 3 to the public sector once the IASB project is complete (expected Q3 2007).

Regardless of the content of the revised IFRS 3, there are aspects of IFRS 3 that would require ‘public sectorization’ in order to make it more relevant to the public sector. These are discussed later in this proposal. More significant issues are considered first.

BUSINESS COMBINATIONS INVOLVING ENTITIES OR BUSINESSES UNDER COMMON CONTROL

IFRS 3 is scoped as follows – it does not apply to:

- (a) business combinations in which separate entities or businesses are brought together to form a joint venture.
- (b) business combinations involving entities or businesses under common control.
- (c) business combinations involving two or more mutual entities.
- (d) business combinations in which separate entities or businesses are brought together to form a reporting entity by contract alone without the obtaining of an ownership interest (for example, combinations in which separate entities are brought together by contract alone to form a dual listed corporation).

As alluded to above, draft IFRS 3 proposes to broaden the scope effectively addressing business combinations except for situations a) and b) above.

The IPSASB currently has IPSAS 8 *Financial Reporting of Interests in Joint Ventures*. (note the IASB currently has a project on Joint Ventures - An Exposure Draft is expected to be published in the first half of 2007).

However, neither the IASB nor IPSASB has any guidance on accounting for entity combinations involving entities or businesses under common control.

The IASB defines these types of arrangements as follows:

A business combination involving entities or businesses under common control is a business combination in which all of the combining entities or businesses are ultimately controlled by the same party or parties both before and after the business combination, and that control is not transitory. (paragraph 10, IFRS 3)

Governments can control a wide variety of entity types, and like any controlling entity, can choose to restructure its activities in response to any number of factors such as changes in its economic or political environment. While perhaps not a regular occurrence for governments or public sector entities, given the broad scope of government activities, governments do choose to amalgamate or consolidate activities in such a way that would meet the definition above.

While there are many ways the project could view this issue and consequently determine methodologies for the most appropriate accounting, staff believe the project could pivot on a key question – the answer to which will significantly influence to size of the project. ‘Has anything changed as a result of the combination?’

In substance, nothing has changed by combining these commonly controlled entities

Accounting should reflect the economic substance of transactions and events. By combining commonly controlled entities, the controlling government arguably has not changed the substance of what existed pre-combination. It has merely brought together the resources of two or more entities (businesses) into a newer entity.

Through-out the consolidation, there was never an acquirer or acquiree in the context of IFRS 3 (though the legal reality could be that one entity sub-sumes the activities of another entity), as none of the commonly controlled parties to the arrangement actually attained control, in the truest sense, of another other party to the restructuring.

The decision for a business combination and final implementation was all based on the government’s intentions and plan so as to enable it to better fulfill its own objectives – not those of the parties who were combined. In the end, the primary functions and activities of government (and possibly also the combined entities themselves) continue the same post combination as they did before.

If in substance nothing has changed, then the financial statements of the newly created entity should reflect this economic reality. As such, arguably there should be no need to consider matters or provide guidance related to matters such as:

- Determining an acquirer;
- Determining an acquiree;
- Defining control with supporting guidance;
- Asset revaluations;
- Liability revaluations;
- Guidance on valuation techniques;
- Recognition of goodwill upon combining;
- Amortization or impairment testing of goodwill; and
- Bargain purchase considerations

Instead, the financial statements for the newly created entity, at their simplest, could merely be an amalgamation (consolidation) of the existing financial information for each of the entities pre-combination.

From a user perspective, assuming that pre-combination each commonly controlled entity issued its own separate financial statements relevant to the users of those statements, users of the financial statements of the newly combined entity will continue to receive equally relevant and meaningful financial information.

In substance, something has changed by combining these commonly controlled entities

An alternative perspective to viewing the combination as being ‘nothing has changed’, is that by combining commonly controlled entities, the controlling government arguably has changed the substance of what existed pre-combination - ‘something has changed’. As such, the accounting should reflect this.

The creation of the new entity is much more than simply amalgamating the assets and liabilities of two or more entities (businesses). While it may be very difficult to determine an acquirer and acquiree, and the final combined entity is the result of a plan developed and implemented by a greater controlling body - the sum of the individual entities aggregate to something different than simply adding together the assets and liabilities of the individual entities.

As such, it may be necessary to develop guidance for public sector entities which address many of the matters considered within IFRS 3 – for example:

- A basis for valuing and recognizing the assets and liabilities of the combined entities;
- Given the sometimes unique nature of some fixed assets of public sector entities, determining appropriate surrogates for valuation when application of mainstream valuation approaches do not appear appropriate;
- If the combined entities are considered to create new synergies or intangible benefits which were believed not to exist pre-combination (or believed to exist in some/all of the individual entities but were unable to be recognized – eg: internally generated goodwill,

previously expensed R&D) such as goodwill or other intangible assets – how these should be identified, measured and recognized in the financial statements;

- If goodwill is recognized, how to account for amortization/impairment;
- Treatment of any revaluations;
- Treatment of any benefit, akin to a perceived bargain purchase, by any of the parties to the arrangement;
- Treatment of any subsequent revenues and expenses associated with combining the entities;
- Supporting disclosures for all the above;
- How to account for all the above upon consolidation into the government reporting entity.

In substance, something has changed for some, nothing has changed for others

Is there a need to consider the economic substance of these arrangements on an individual basis acknowledging that entity combinations involving entities or businesses under common control can result in newly combined entities where nothing has changed in some instances, but where something has changed in some other instances.

If this is considered appropriate, criteria will need to be developed which will enable a distinction to be made.

APPLICABILITY OF THE OBJECTIVES OF IFRS 3

The underlying premise of existing and draft IFRS 3 are substantially the same – namely for the acquisition method of accounting to be used for all business combinations and for an acquirer to be identified for every business combination (extract from draft IFRS).

The IASB acknowledges that in some business combinations, domestic legal, taxation or economic factors can make it extremely difficult to identify an acquirer. Does a public sector context add an additional layer of complexity to determining an acquirer which could make application of IFRS 3 even more difficult? Staff do not consider that a public sector context does in fact add an additional layer of complexity.

However, there are a few matters within existing IFRS 3 which will need modification in order to make it applicable to the public sector environment.

Definition of a business

A key ingredient for a business combination is for the combination to involve businesses – a business is defined as:

an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing either:

- (1) a return to investors, or*
- (2) dividends, lower costs, or other economic benefits directly and proportionately to owners, members or participants. (extract from draft IFRS)*

Both existing and proposed revised definitions of business in IFRS 3 do not seem completely applicable to the public sector.

The profit oriented focus of the IFRSs understandably do not fully embrace the notion of a 'business' as a means of achieving an output beyond a return of economic benefit. While there may be entities within the government reporting entity which have this type of focus and for which, the above definition would be relevant (such entities would likely be GBEs who would not be required to comply with IPSASs), given that the majority of activities of the public sector are not profit oriented but more the achievement of social policy objectives, the project would need to review the definition of a business to ensure it encompasses circumstances when a public sector entity is not a profit oriented entity or becomes the acquirer of an entity which does not have a profit focus.

RELEVANCE OF SOME DISCUSSION WITHIN IFRS 3 FOR THE PUBLIC SECTOR

While staff consider IFRS 3 is convergent for the public sector, the project will need to consider the appropriateness of some of the content of IFRS 3 for the public sector – examples follow:

Shares of the acquirer

IFRS 3 discusses scenarios involving the acquirer issuing shares/equity in relation to the business combination transaction (eg: reverse acquisition). The need for such guidance for a government does not seem appropriate as a government is not made up of share capital.

Similarly, for entities within the government reporting entity who do issue share capital, they would arguably be entities to which IPSASs would not apply and as such would not require IPSASB guidance in relation to the issuance of shares as part of a business combination.

Mutual Entities

Draft IFRS 3 proposes to broaden its scope to include business combinations involving mutual entities. Mutual entities are defined as 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. The project will need to consider the relevance of mutual entities to the public sector.

Recognition of Tax Benefits

IFRS 3 discusses the creation and recognition of tax benefits that can result from a business combination. It is arguable that there is a need for such guidance in a public sector context.

4. Describe the Implications for any Specific Persons or Groups

a) Relationship to IASB

The most direct implication with the IASB will be use of IASB materials as a basis for the IPSASB project. Implications may also flow from the final composition of the IPSASB task force – if considered it is appropriate to have IASB representation or some other involvement. At the very least, staff believe that close liaison with the IASB will be a reality for the IPSASB project.

b) Relationship to other projects in process and planned

Existing IFRS 3 has relationships with many other IASs (IPSASB equivalent in brackets) – examples are listed below.

IFRS 5: Non-current Assets Held for Sale and Discontinued Operations

IAS 8: Accounting Policies, Changes in Accounting Estimates and Errors (IPSAS 3: improved version)

IAS 18: Revenue (IPSAS 9: Revenue from Exchange Transactions)

IAS 27: Consolidated and Separate Financial Statement (IPSAS 6 improved version)

IAS 28: Investment in Associates (IPSAS 7: Investment in Associates (improved))

IAS 38: Intangible Assets

IAS 39: Financial Instruments: Recognition and Measurement

Dependent upon the final form of the IPSASB work plan, the Entity Combinations project could impact on a number of proposed IPSASB projects in both the short or long term. For example, in the short term, approval for a project brief on financial instruments may be impacted. In the longer term, approval for a project on intangible assets could also be impacted by entity combinations.

As with all IPSASB projects, an IPSASB Entity Combination project will need to be cognizant of developments with the IPSASB's conceptual framework project.

c) Other

Nothing at this stage.

5. Development Process, Project Timetable and Project Output

a) Development process

The development of guidance will be subject to the IPSASB's formal due process. As the project progresses, regular assessment will be made to confirm the proposed path remains the most appropriate.

At a high level, for development of an IPSAS, the following steps will be taken:

- Development of a consultation paper (only the 'common control' component – see below)
- Issuance for public comment of an exposure draft (ED) of proposed requirements of an IPSAS;
- Consideration of ED responses; and
- Approval and issuance of a final IPSAS.

The issuance of documents for public comment will be subject to the usual IPSASB voting rules. Once approved for release, documents may also be released by the NSS for domestic review together with any contextual commentary considered necessary by the NSS in each jurisdiction.

Documents will be developed using a task force approach – details below.

Staff envisage the project be developed in two components.

- 1) To converge IFRS 3 for the public sector as soon as possible and will essentially follow the last three bullets of the due process outlined above.
- 2) Working in tandem with 1) but focusing on developing public sector specific guidance for combinations involving entities or businesses under common control.

Given the potential difficulty and less-evolved nature of accounting for combinations involving entities or businesses under common control, staff plan to commence that portion of the project with a consultative paper which will consider the issue from a more fundamental level and which will eventually be used as a basis to develop final guidance.

It is planned that a final IPSAS (a public-sectorized IFRS 3) would be approved first with guidance on common control to follow.

As a public-sectorized IFRS 3 is developed, the guidance on common control could either eventually be incorporated within the approved public-sectorized IFRS 3 (similar to what was done when the IPSASB approved the cash-basis components portion relating to budget reporting), or if felt more appropriate, establish entirely separate guidance.

The decision to either incorporate or issue separate guidance in relation to accounting for entity combinations involving entities or businesses under common control does not need to be finalized at this phase of the project.

b) Project timetable

2007	Converged IFRS 3	Common Control
March	Project proposal approved	
March/April	Task Force selected and confirmed	
April-July	Task force develop: <ul style="list-style-type: none"> IPSAS ED of IFRS 3; and Consultative paper on accounting for entity combinations involving entities or businesses under common control; for public comment	
22-26 July - Montreal	Update IPSASB on progress of task force	
July - October	Task force continue developing: <ul style="list-style-type: none"> IPSAS ED of IFRS 3; and Consultative paper on accounting for entity combinations involving entities or businesses under common control; for public comment	
27-30 November Beijing	ED presented for IPSASB approval	Update IPSASB on progress of task force on consultation paper
December – January 2008	ED issued for public comment	Task force continue developing consultative paper
2008		
January-March	Responses to ED considered IPSAS drafted	Task force continue developing consultative paper
March IPSASB Meeting Wellington	Update IPSASB on ED responses	Consultative paper presented for IPSASB approval
March/April		Consultative paper issued
March-July	IPSAS drafted	
July IPSASB Meeting	IPSASB approve IPSAS on Entity Combinations	Update IPSASB on consultative paper responses
July-November		ED on common control drafted
November Meeting		ED on common control approved by IPSASB
November/December		ED on common control issued
2009		
March Meeting		Update IPSASB on ED responses
July Meeting		IPSAS on common control approved

c) Project output

- November 2007: ED – Public sectorized IFRS 3 *Entity Combinations*
- March 2008: Consultative paper - accounting for entity combinations involving entities or businesses under common control
- July 2008: IPSAS - Public sectorized IFRS 3 *Entity Combinations*
- November 2008: ED - accounting for entity combinations involving entities or businesses under common control

- July 2009: IPSAS - accounting for entity combinations involving entities or businesses under common control (to be issued either as a separate document or integrated within IPSAS on entity combinations)

6. Resources Required

a) Task Force/subcommittee required?

A task force is proposed with a membership of six (incl Chair) – a group sizing which will make the task force more manageable. Representation should reflect a broad cross section of IPSASB constituents to enable a broad range of points of view, technical expertise and discussion to be brought to task force meetings.

Where possible, geographical representation should also be a consideration. Staff envisage that the composition would approximate the following mix:

- One surrogate for an acquirer (eg: government preparer);
- One surrogate for an acquiree (eg: government entity preparer);
- One legislative auditor (who will be required to opine on these arrangements);
- Two surrogates for users of financial statements (eg: from the IPSASB Observer group, academics, member of legislative assembly); and
- One IASB representative (preferably whose had involvement with the IASB's current project on revising IFRS 3 *Business Combinations*).

Selection of task force members will be made by the Technical Director and IPSASB Chair.

The majority of meetings are expected to be by conference call, with at least one face-to-face meeting expected.

Unless an offer of resources can be negotiated with NSS, all project materials will be written by IPSASB staff.

b) Staff

It is envisaged that one Technical Manager will be required to resource the project.

7. Important Sources of Information that Address the Matter being Proposed

- IFRS 3 *Business Combination*
- Exposure Draft of proposed Amendments to IFRS 3 Business Combinations – and IFRS deliberations resulting from.
- Any known guidance in member bodies which address entity combinations and accounting for common control
- Understood the IASB could have compiled a report on the status of business combination accounting amongst NSS – staff to follow up.

8. Factors that might add to complexity or length

The project, in particular the component relating to accounting for entity combinations involving entities or businesses under common control, could potentially become very complex – particularly if the view is taken that the entity combination has in substance resulted in more than simply two controlled entities being merged together.

Further, as evidenced by discussion under section 4(b), accounting for entity combinations involves relationships with numerous other standards. Consideration of any implications and/or consequential amendments stemming from this project could add complexity.

Prepared by _____

Date _____

(Technical Manager IPSASB)

The following should be completed after board or committee approval and after revising the project proposal form to reflect any changes by the board or committee.

Approved by _____

Date _____

(Chair IPSASB)

COMMENTS BY TECHNICAL MANAGERS

The comments of Technical Manager from each technical area are required before this Project Proposal is considered by the board or committee proposing to undertake the project.

Technical Manager to the Compliance Advisory Panel

[Insert comments (prompts – views on importance of project, other matters wished to be communicated)]

Signed _____

Date _____

Technical Manager to the DNC

[Insert comments (prompts – views on importance of project, other matters wished to be communicated)]

Signed _____

Date _____

Technical Manager to the SMPC

[Insert comments (prompts – views on importance of project, other matters wished to be communicated)]

Signed _____

Date _____

Technical Manager to the IESBA

[Insert comments (prompts – views on importance of project, other matters wished to be communicated)]

Signed _____

Date _____

Technical Manager to the IAASB

[Insert comments (prompts – views on importance of project, other matters wished to be communicated)]

Signed _____

Date _____

Technical Manager to the PAIB Committee

[Insert comments (prompts – views on importance of project, other matters wished to be communicated)]

Signed _____

Date _____

Technical Manager to the IAESB

[Insert comments (prompts – views on importance of project, other matters wished to be communicated)]

Signed _____

Date _____

Technical Manager to the Transnational Auditors Committee

[Insert comments (prompts – views on importance of project, other matters wished to be communicated)]

Signed _____

Date _____

BACKGROUND INFORMATION - IFRS 3 *BUSINESS COMBINATIONS*

This agenda item provides background information about IFRS 3 *Business Combinations* and also the IASB project on IFRS 3 (all taken from IASB material). It covers the following:

- Main features of IFRS 3 *Business Combinations*
- Phase I and II of the IASB project on accounting for Business combinations
- Main features of the Exposure Draft of Proposed Amendments to IFRS 3 *Business Combinations*
- Main proposed changes between the Exposure Draft and existing IFRS 3.

Main Features of IFRS 3 *Business Combinations*

IFRS 3:

- (a) requires all business combinations within its scope to be accounted for by applying the purchase method.
- (b) requires an acquirer to be identified for every business combination within its scope. The acquirer is the combining entity that obtains control of the other combining entities or businesses.
- (c) requires an acquirer to measure the cost of a business combination as the aggregate of: the fair values, at the date of exchange, of assets given, liabilities incurred or assumed, and equity instruments issued by the acquirer, in exchange for control of the acquiree; plus any costs directly attributable to the combination.
- (d) requires an acquirer to recognise separately, at the acquisition date, the acquiree's identifiable assets, liabilities and contingent liabilities that satisfy the following recognition criteria at that date, regardless of whether they had been previously recognised in the acquiree's financial statements:
 - (i) in the case of an asset other than an intangible asset, it is probable that any associated future economic benefits will flow to the acquirer, and its fair value can be measured reliably;
 - (ii) in the case of a liability other than a contingent liability, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation, and its fair value can be measured reliably; and
 - (iii) in the case of an intangible asset or a contingent liability, its fair value can be measured reliably.

- (e) requires the identifiable assets, liabilities and contingent liabilities that satisfy the above recognition criteria to be measured initially by the acquirer at their fair values at the acquisition date, irrespective of the extent of any minority interest.
- (f) requires goodwill acquired in a business combination to be recognised by the acquirer as an asset from the acquisition date, initially measured as the excess of the cost of the business combination over the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities recognised in accordance with (d) above.
- (g) prohibits the amortisation of goodwill acquired in a business combination and instead requires the goodwill to be tested for impairment annually, or more frequently if events or changes in circumstances indicate that the asset might be impaired, in accordance with IAS 36 *Impairment of Assets*.
- (h) requires the acquirer to reassess the identification and measurement of the acquiree's identifiable assets, liabilities and contingent liabilities and the measurement of the cost of the business combination if the acquirer's interest in the net fair value of the items recognised in accordance with (d) above exceeds the cost of the combination. Any excess remaining after that reassessment must be recognised by the acquirer immediately in profit or loss.
- (i) requires disclosure of information that enables users of an entity's financial statements to evaluate the nature and financial effect of:
 - (i) business combinations that were effected during the period;
 - (ii) business combinations that were effected after the balance sheet date but before the financial statements are authorised for issue; and
 - (iii) some business combinations that were effected in previous periods.
- (j) requires disclosure of information that enables users of an entity's financial statements to evaluate changes in the carrying amount of goodwill during the period.

**Brief History of IASB Project to Revise IFRS 3
(taken from IASB material)**

The project on business combinations is being undertaken in stages.

The first phase resulted in the Board issuing simultaneously the current version of IFRS 3 and revised versions of IAS 36 *Impairment of Assets* and IAS 38 *Intangible Assets*. In developing IFRS 3 the Board carried forward without reconsideration some of the requirements in the predecessor standard IAS 22 *Business Combinations*. The Board's primary focus in that process was on:

- (a) the method of accounting for business combinations;
- (b) the initial measurement of the identifiable assets acquired and liabilities and contingent liabilities assumed in a business combination;
- (c) the recognition of liabilities for terminating or reducing the activities of an acquiree;
- (d) the treatment of any excess of the acquirer's interest in the fair value of identifiable net assets acquired in a business combination over the cost of the combination; and
- (e) the accounting for goodwill and intangible assets acquired in a business combination.

The second phase is being conducted as a joint project with the FASB. It involves a broad reconsideration of the requirements in IFRSs and US generally accepted accounting principles (US GAAP) on applying the purchase method (which the draft revised IFRS 3 refers to as the acquisition method). An objective of the second phase of the project is to reconsider existing guidance on the application of the acquisition method in order to improve the completeness, relevance, and comparability of financial information about business combinations that is provided in financial statements. Another objective of this phase is to achieve convergence of IFRSs and US GAAP on how the acquisition method is applied.

The second phase also addresses how the acquisition method should be applied to business combinations involving only mutual entities and to combinations achieved by contract alone. A business combination achieved by contract alone includes combinations in which separate entities are brought together by contract to form a dual listed corporation.

The current project plan envisages that a final Standard will be issued in the second half of 2007.

Main features of the Exposure Draft of Proposed Amendments to IFRS 3 Business Combinations (referred to as ‘this draft IFRS’)

Scope

- (a) The requirements of this [draft] IFRS are applicable to business combinations involving only mutual entities and business combinations achieved by contract alone.

Definition of a business combination

- (b) This [draft] IFRS amends the definition of a *business combination* provided in the previous version of IFRS 3. This [draft] IFRS defines a business combination as ‘a transaction or other event in which an acquirer obtains control of one or more businesses’.

Definition of a business

- (c) This [draft] IFRS provides a definition of a *business* and additional guidance for identifying when a group of assets constitutes a business. This [draft] IFRS amends the definition provided in the previous version of IFRS 3.

Measuring the fair value of the acquiree

- (d) This [draft] IFRS requires business combinations to be measured and recognised as of the acquisition date at the fair value of the acquiree, even if the business combination is achieved in stages or if less than 100 per cent of the equity interests in the acquiree are owned at the acquisition date. The previous version of IFRS 3 required a business combination to be measured and recognised on the basis of the accumulated cost of the combination.
- (e) This [draft] IFRS requires the costs the acquirer incurs in connection with the business combination to be accounted for separately from the business combination accounting. The previous version of IFRS 3 required direct costs of the business combination to be included in the cost of the acquiree.
- (f) This [draft] IFRS requires all items of consideration transferred by the acquirer to be measured and recognised at fair value at the acquisition date. Therefore, this [draft] IFRS requires the acquirer to recognise contingent consideration arrangements at fair value as of the acquisition date. Subsequent changes in the fair value of contingent consideration classified as liabilities are recognised in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*, IAS 37 or other IFRSs, as appropriate.
- (g) This [draft] IFRS requires the acquirer in a business combination in which the acquisition-date fair value of the acquirer’s interest in the acquiree exceeds the fair value of the consideration transferred for that interest (referred to as a bargain purchase) to account for that excess by first reducing the goodwill related to that business combination to zero, and then by recognising any excess in income. The previous version of IFRS 3 required the excess of the acquirer’s interest in the net

fair values of the acquiree's assets and liabilities over cost to be recognised immediately in profit or loss.

Measuring and recognising the assets acquired and the liabilities assumed

- (h) This [draft] IFRS requires the assets acquired and liabilities assumed to be measured and recognised at their fair values as of the acquisition date, with limited exceptions. The previous version of IFRS 3 required the cost of an acquisition to be allocated to the individual assets acquired and liabilities assumed based on their estimated fair values. However, it also provided guidance for measuring some assets and liabilities that was inconsistent with fair value measurement objectives. Thus, those assets or liabilities may not have been recognised at fair value as of the acquisition date in accordance with that version of IFRS 3.
- (i) This [draft] IFRS requires an identifiable asset or liability to be measured and recognised at fair value at the acquisition date even if the amount of the future economic benefits embodied in the asset or required to settle the liability are contingent (or conditional) on the occurrence or non-occurrence of one or more uncertain future events. The previous version of IFRS 3 required the recognition of contingent liabilities at fair value as of the acquisition date.
- (j) *Not used.*
- (k) This [draft] IFRS requires the acquirer in business combinations in which the acquirer holds less than 100 per cent of the equity interests in the acquiree at the acquisition date to recognise the identifiable assets and liabilities at the full amount of their fair values, with limited exceptions, and goodwill as the difference between the fair value of the acquiree, as a whole, and the fair value of the identifiable assets acquired and liabilities assumed. The previous version of IFRS 3 required the identifiable assets acquired and liabilities assumed to be recognised at fair value but goodwill to be recognised as the difference between the cost of the interest acquired and the acquirer's proportional interest in the fair value of the identifiable assets acquired and liabilities assumed. If the business combination was achieved in stages, IFRS 3 previously required goodwill to be determined by a step-by-step comparison of the cost of the individual investments with the acquirer's interest in the fair values of the identifiable assets acquired and liabilities assumed at each step.
- (l) Acquisitions of additional non-controlling equity interests after the business combination are not permitted to be accounted for using the acquisition method. In accordance with [draft] IAS 27 (as revised in 200X), acquisitions (or disposals) of non-controlling equity interests after the business combination are accounted for as equity transactions.
- (m) The acquirer is required to recognise separately from goodwill an acquiree's intangible assets if they meet the definition of an intangible asset in IAS 38 *Intangible Assets*. The previous version of IFRS 3 required the recognition of

intangible assets separately from goodwill only if they met the IAS 38 definition and were reliably measurable. For the purposes of this [draft] IFRS, an assembled workforce is not to be recognised as an intangible asset separately from goodwill.

(n) *Not used.*

Main Proposed Changes Between the Exposure Draft and Existing IFRS 3 (referred to as ‘this draft IFRS’)

This [draft] IFRS retains the fundamental requirements in the previous version of IFRS 3 for the acquisition method of accounting to be used for all business combinations and for an acquirer to be identified for every business combination. Additionally, this [draft] IFRS requires:

- (a) the acquirer to measure the fair value of the acquiree, as a whole, as of the acquisition date.
- (b) for the purposes of applying the acquisition method, the consideration transferred by the acquirer in exchange for the acquiree to be measured at its fair value as of the acquisition date calculated as the sum of:
 - (i) the assets transferred by the acquirer, liabilities incurred by the acquirer, and equity interests issued by the acquirer, including contingent consideration, and
 - (ii) any non-controlling equity investment in the acquiree owned by the acquirer immediately before the acquisition date.
- (c) the acquirer to assess whether any portion of the transaction price paid and any assets acquired or liabilities assumed or incurred are not part of the exchange for the acquiree. Only the consideration transferred or the assets acquired or liabilities assumed or incurred that are part of the exchange for the acquiree are to be accounted for as part of the business combination accounting.
- (d) the acquirer to account for acquisition-related costs incurred in connection with the business combination separately from the business combination (generally as expenses).
- (e) the acquirer to measure and recognise the acquisition-date fair value of the assets acquired and liabilities assumed as part of the business combination, with limited exceptions. Those exceptions are:
 - (i) goodwill is to be measured and recognised as the excess of the fair value of the acquiree, as a whole, over the net amount of the recognised identifiable assets acquired and liabilities assumed. If the acquirer owns less than 100 per cent of the equity interests in the acquiree at the acquisition date, goodwill attributable to the non-controlling interest is recognised.

- (ii) non-current assets (or disposal group) classified as held for sale, deferred tax assets or liabilities, and assets or liabilities related to the acquiree's employee benefit plans are measured in accordance with other IFRSs.
- (iii) if the acquiree is a lessee to an operating lease, no asset or related liability is recognised if the lease is at market terms.
- (f) the acquirer to recognise separately from goodwill an acquiree's intangible assets that meet the definition of an intangible asset in IAS 38 *Intangible Assets* and are identifiable (ie arise from contractual-legal rights or are separable).
- (g) *Not used.*
- (h) in a business combination in which the acquisition-date fair value of the acquirer's interest in the acquiree exceeds the fair value of the consideration transferred for that interest (referred to as a bargain purchase), the acquirer to account for that excess by reducing goodwill until the goodwill related to that business combination is reduced to zero and then by recognising any remaining excess in profit or loss.
- (i) the acquirer to recognise any adjustments made during the measurement period to the provisional values of the assets acquired and liabilities assumed as if the accounting for the business combination had been completed at the acquisition date. Thus, comparative information for prior prior periods presented in financial statements is to be adjusted