

OBJECTIVE OF THIS ADDITIONAL ITEM: ENTITY COMBINATIONS

The objective of this additional item is to **approve** the Illustrative Examples for ED 41 “Entity Combinations from Exchange Transactions”. The Illustrative Examples are non-authoritative and should be read in conjunction with the draft ED at Agenda Item 4.1.

ADDITIONAL AGENDA MATERIAL

- 4.3 Illustrative Examples for ED 41, “Entity Combinations from Exchange Transactions”: Marked-up copy reflecting changes to IFRS 3 “Business Combinations – Illustrative Examples”.

OVERVIEW

1. This Agenda Item is based on the Illustrative Examples that accompany IFRS 3 and has been adapted to reflect the changes proposed in ED 41 “Entity Combinations from Exchange Transactions”, as follows.
 - a. Reverse acquisitions: Paragraphs IE1–IE15 are deleted as the related paragraphs, B19-B27, have been deleted because Staff considers that the usual drivers for a reverse acquisition, such as a back door listing, do not exist for public sector entities.
 - b. Gain on a bargain purchase: The paragraphs illustrating a gain on a bargain purchase has been limited to situations where the acquiree is a business.
 - c. Determining what is part of the entity combination transaction: The paragraphs illustrating the determination of what is part of the entity combination transactions has been limited to situations where the combination arises from an exchange transaction.
 - d. Replacement awards: Paragraphs IE61–IE71 are deleted as the related paragraphs, B56-B62, have been deleted because Staff considers that an acquirer will not replace the acquiree’s share-based payment award with another share-based payment award because public sector entities do not award share-based payment.
 - e. Disclosure requirements: The illustrative disclosure requirements have been limited to an acquisition when the acquiree is a business.
2. Staff will table public sector specific examples at the meeting.

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ILLUSTRATIVE EXAMPLES

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ILLUSTRATIVE EXAMPLES

These examples accompany, but are not part of, ~~IFRS 3~~ IPSAS xx.

Reverse acquisitions [this section has been deleted – see B19 for explanation]

Illustrating the consequences of recognising a reverse acquisition by applying paragraphs B19–B27 of IFRS 3.

~~IE1 This example illustrates the accounting for a reverse acquisition in which Entity B, the legal subsidiary, acquires Entity A, the entity issuing equity instruments and therefore the legal parent, in a reverse acquisition on 30 September 20X6. This example ignores the accounting for any income tax effects.~~

~~IE2 The statements of financial position of Entity A and Entity B immediately before the business combination are:~~

	Entity A (legal parent, accounting acquiree)	Entity B (legal subsidiary, accounting acquirer)
	CU	CU
Current assets	500	700
Non-current assets	1,300	3,000
Total assets	1,800	3,700
Current liabilities	300	600
Non-current liabilities	400	1,100
Total liabilities	700	1,700
Shareholders' equity		
Retained earnings	800	1,400
Issued equity		

100 ordinary shares	300-	
60 ordinary shares		600-
Total shareholders' equity	1,100-	2,000-
Total liabilities and shareholders' equity	1,800-	3,700-

~~IE3 This example also uses the following information:~~

- ~~(a) On 30 September 20X6 Entity A issues 2.5 shares in exchange for each ordinary share of Entity B. All of Entity B's shareholders exchange their shares in Entity B. Therefore, Entity A issues 150 ordinary shares in exchange for all 60 ordinary shares of Entity B.~~
- ~~(b) The fair value of each ordinary share of Entity B at 30 September 20X6 is CU40. The quoted market price of Entity A's ordinary shares at that date is CU16.~~
- ~~(c) The fair values of Entity A's identifiable assets and liabilities at 30 September 20X6 are the same as their carrying amounts, except that the fair value of Entity A's non-current assets at 30 September 20X6 is CU1,500.~~

Calculating the fair value of the consideration transferred

~~IE4 As a result of Entity A (legal parent, accounting acquiree) issuing 150 ordinary shares, Entity B's shareholders own 60 per cent of the issued shares of the combined entity (ie 150 of 250 issued shares). The remaining 40 per cent are owned by Entity A's shareholders. If the business combination had taken the form of Entity B issuing additional ordinary shares to Entity A's shareholders in exchange for their ordinary shares in Entity A, Entity B would have had to issue 40 shares for the ratio of ownership interest in the combined entity to be the same. Entity B's shareholders would then own 60 of the 100 issued shares of Entity B—60 per cent of the combined entity. As a result, the fair value of the consideration effectively transferred by Entity B and the group's interest in Entity A is CU1,600 (40 shares with a fair value per share of CU40).~~

~~IE5 The fair value of the consideration effectively transferred should be based on the most reliable measure. In this example, the quoted market price of Entity A's shares provides a more reliable basis for measuring the consideration effectively transferred than the estimated fair value of the shares in Entity B, and the consideration is measured using the market price of Entity A's shares—100 shares with a fair value per share of CU16.~~

Measuring goodwill

~~IE6 Goodwill is measured as the excess of the fair value of the consideration effectively transferred (the group's interest in Entity A) over the net amount of Entity A's recognised identifiable assets and liabilities, as follows:~~

	CU	CU
Consideration effectively transferred		1,600-
Net recognised values of Entity A's identifiable assets and liabilities		
Current assets	500-	

Non-current assets	1,500	
Current liabilities	(300)	
Non-current liabilities	(400)	(1,300)
Goodwill		300

Consolidated statement of financial position at 30 September 20X6

IE7 — The consolidated statement of financial position immediately after the business combination is:

		CU
Current assets [CU700 + CU500]		1,200
Non-current assets [CU3,000 + CU1,500]		4,500
Goodwill		300
Total assets		6,000
Current liabilities [CU600 + CU300]		900
Non-current liabilities [CU1,100 + CU400]		1,500
Total liabilities		2,400
Shareholders' equity		
Retained earnings		1,400
Issued equity		
250 ordinary shares [CU600 +		2,200

~~CU1,600}~~

~~Total
shareholders'
equity~~

~~3,600-~~

~~Total
liabilities and
shareholders'
equity~~

~~6,000-~~

~~IE8 The amount recognised as issued equity interests in the consolidated financial statements (CU2,200) is determined by adding the issued equity of the legal subsidiary immediately before the business combination (CU600) and the fair value of the consideration effectively transferred (CU1,600). However, the equity structure appearing in the consolidated financial statements (ie the number and type of equity interests issued) must reflect the equity structure of the legal parent, including the equity interests issued by the legal parent to effect the combination.~~

Earnings per share

~~IE9 Assume that Entity B's earnings for the annual period ended 31 December 20X5 were CU600 and that the consolidated earnings for the annual period ended 31 December 20X6 were CU800. Assume also that there was no change in the number of ordinary shares issued by Entity B during the annual period ended 31 December 20X5 and during the period from 1 January 20X6 to the date of the reverse acquisition on 30 September 20X6. Earnings per share for the annual period ended 31 December 20X6 is calculated as follows:~~

~~Number of shares deemed to be outstanding for the period from 1 January 20X6 to the acquisition date (ie the number of ordinary shares issued by Entity A (legal parent, accounting acquiree) in the reverse acquisition)~~

~~150-~~

~~Number of shares outstanding from the acquisition date to 31 December 20X6~~

~~250-~~

~~Weighted average number of ordinary shares outstanding $[(150 \times 9/12) + (250 \times 3/12)]$~~

~~175-~~

~~Earnings per share $[800/175]$~~

~~CU4.57~~

~~IE10 Restated earnings per share for the annual period ended 31 December 20X5 is CU4.00 (calculated as the earnings of Entity B of 600 divided by the number of ordinary shares Entity A issued in the reverse acquisition (150)).~~

Non-controlling interest

~~IE11 Assume the same facts as above, except that only 56 of Entity B's 60 ordinary shares are exchanged. Because Entity A issues 2.5 shares in exchange for each ordinary share of Entity B, Entity A issues only 140 (rather than 150) shares. As a result, Entity B's shareholders own 58.3 per cent of the issued shares of the combined entity (140 of 240 issued shares). The fair value of the consideration transferred for Entity A, the accounting acquiree, is calculated by assuming that the combination had been effected by Entity B issuing additional ordinary shares to the shareholders of Entity A in exchange for their ordinary shares in Entity A. That is because Entity A is the accounting acquirer, and~~

~~paragraph B20 of IFRS 3 require the acquirer to measure the consideration exchanged for the accounting acquiree.~~

~~IE12 In calculating the number of shares that Entity B would have had to issue, the non-controlling interest is excluded from the calculation. The majority shareholders own 56 shares of Entity B. For that to represent a 58.3 per cent equity interest, Entity B would have had to issue an additional 40 shares. The majority shareholders would then own 56 of the 96 issued shares of Entity B and, therefore, 58.3 per cent of the combined entity. As a result, the fair value of the consideration transferred for Entity A, the accounting acquiree, is CU1,600 (ie 40 shares, each with a fair value of CU40). That is the same amount as when all 60 of Entity B's shareholders tender all 60 of its ordinary shares for exchange. The recognised amount of the group's interest in Entity A, the accounting acquiree, does not change if some of Entity B's shareholders do not participate in the exchange.~~

~~IE13 The non-controlling interest is represented by the four shares of the total 60 shares of Entity B that are not exchanged for shares of Entity A. Therefore, the non-controlling interest is 6.7 per cent. The non-controlling interest reflects the proportionate interest of the non-controlling shareholders in the pre-combination carrying amounts of the net assets of Entity B, the legal subsidiary. Therefore, the consolidated statement of financial position is adjusted to show a non-controlling interest of 6.7 per cent of the pre-combination carrying amounts of Entity B's net assets (ie CU134 or 6.7 per cent of CU2,000).~~

~~IE14 The consolidated statement of financial position at 30 September 20X6, reflecting the non-controlling interest is as follows:~~

	CU
Current assets [CU700 + CU500]	1,200
Non-current assets [CU3,000 + CU1,500]	4,500
Goodwill	300
Total assets	6,000
Current liabilities [CU600 + CU300]	900
Non-current liabilities [CU1,100 + CU400]	1,500
Total liabilities	2,400
Shareholders' equity	
Retained earnings [CU1,400 x 93.3 per cent]	1,306
Issued equity	
240 ordinary shares [CU560 + CU1,600]	2,160
Non-controlling interest	134

Total shareholders' equity

3,600-

Total liabilities and shareholders' equity

6,000-

~~IE15 The non-controlling interest of CU134 has two components. The first component is the reclassification of the non-controlling interest's share of the accounting acquirer's retained earnings immediately before the acquisition (CU1,400 x 6.7 per cent or CU93.80). The second component represents the reclassification of the non-controlling interest's share of the accounting acquirer's issued equity (CU600 x 6.7 per cent or CU40.20).~~

Identifiable intangible assets

Illustrating the consequences of applying paragraphs ~~1020-14-24~~ and ~~B31B27-B40-B36~~ of ~~IFRS-3IPSAS xx~~.

~~IE16IE1~~ The following are examples of identifiable intangible assets acquired in ~~a business-an entity~~ combination from an exchange transaction. Some of the examples may have characteristics of assets other than intangible assets. The acquirer should account for those assets in accordance with their substance. The examples are not intended to be all-inclusive.

~~IE17IE2~~ Intangible assets identified as having a contractual basis are those that arise from contractual or other legal rights. Those designated as having a non-contractual basis do not arise from contractual or other legal rights but are separable. Intangible assets identified as having a non-contractual basis may arise from a binding arrangement. Intangible assets identified as having a contractual basis might also be separable but separability is not a necessary condition for an asset to meet the contractual-legal-binding criterion.

Marketing-related intangible assets

~~IE18IE3~~ Marketing-related intangible assets are used primarily in the marketing or promotion of products or services. Examples of marketing-related intangible assets are:

Class	Basis
Trademarks, trade names, service marks, collective marks and certification marks	Contractual
Trade dress (unique color, shape or package design)	Contractual
Newspaper mastheads	Contractual
Internet domain names	Contractual
Non-competition agreements	Contractual

Trademarks, trade names, service marks, collective marks and certification marks

~~IE19IE4~~ Trademarks are words, names, symbols or other devices used in trade to indicate the source of a product and to distinguish it from the products of others. A service mark identifies and distinguishes the source of a service rather than a product. Collective marks identify the goods or services of members of a group. Certification marks certify the geographical origin or other characteristics of a good or service.

~~IE20~~IE5 Trademarks, trade names, service marks, collective marks and certification marks may be protected legally through registration with governmental agencies, continuous use in commerce or by other means. If it is protected legally through registration or other means, a trademark or other mark acquired in ~~a business-an entity~~ combination ~~from an exchange transaction~~ is an intangible asset that meets the contractual-legal-binding criterion. Otherwise, a trademark or other mark acquired in ~~a business-an entity~~ combination can be recognized separately from ~~purchase premium or~~ goodwill if the separability criterion is met, which normally it would be.

~~IE24~~IE6 The terms *brand* and *brand name*, often used as synonyms for trademarks and other marks, are general marketing terms that typically refer to a group of complementary assets such as a trademark (or service mark) and its related trade name, formulas, recipes and technological expertise. ~~IFRS-3-IPSAS xx~~ does not preclude an entity from recognizing, as a single asset separately from ~~purchase premium or~~ goodwill, a group of complementary intangible assets commonly referred to as a brand if the assets that make up that group have similar useful lives.

Internet domain names

~~IE22~~IE7 An Internet domain name is a unique alphanumeric name that is used to identify a particular numeric Internet address. Registration of a domain name creates an association between that name and a designated computer on the Internet for the period of the registration. Those registrations are renewable. A registered domain name acquired in ~~a business combination-an entity combination from an exchange transaction~~ meets the contractual-legal-binding criterion.

Customer- ~~or user~~-related intangible assets

~~IE23~~IE8 Examples of customer- ~~or user~~-related intangible assets are:

Class	Basis
Customer lists	Non-contractual
List of users of a service	Non-contractual
Order or production backlog	Contractual
Customer contracts and related customer relationships	Contractual
Non-contractual user relationships	Non-contractual
Non-contractual customer relationships	Non-contractual

Customer lists ~~and user lists~~

~~IE24~~IE9 A customer list ~~or list of users of services~~ consists of information about customers ~~or users~~, such as their names and contact information. A customer ~~or user~~ list also may be in the form of a database that includes other information about the customers ~~or users~~, such as their order histories and demographic information. A customer ~~or user~~ list does not usually arise from contractual or other legal rights. However, customer lists are often leased or exchanged ~~and, in rare circumstances, a user list may be exchanged~~. Therefore, a customer ~~or user~~ list acquired in ~~a business-an entity~~ combination ~~from an exchange transaction~~ normally meets the separability criterion.

Order or production backlog

~~IE25~~IE10 An order or production backlog arises from contracts such as purchase or sales orders. An order or production backlog acquired in ~~a business-an entity~~ combination from an exchange transaction meets the contractual-legal-binding criterion even if the purchase or sales orders can be cancelled.

Customer contracts and the related customer relationships

~~IE26~~IE11 If an entity establishes relationships with its customers through contracts, those customer relationships arise from contractual rights. Therefore, customer contracts and the related customer relationships acquired in ~~a business-an entity~~ combination from an exchange transaction meet the contractual-legal-binding criterion, even if confidentiality or other contractual terms prohibit the sale or transfer of a contract separately from the acquiree.

~~IE27~~IE12 A customer contract and the related customer relationship may represent two distinct intangible assets. Both the useful lives and the pattern in which the economic benefits of the two assets are consumed may differ.

~~IE28~~IE13 A customer relationship exists between an entity and its customer if (a) the entity has information about the customer and has regular contact with the customer and (b) the customer has the ability to make direct contact with the entity. Customer relationships meet the contractual-legal-binding criterion if an entity has a practice of establishing contracts with its customers, regardless of whether a contract exists at the acquisition date. Customer relationships may also arise through means other than contracts, such as through regular contact by sales or service representatives.

~~IE29~~IE14 As noted in paragraph ~~IE25~~IE10, an order or a production backlog arises from contracts such as purchase or sales orders and is therefore considered a contractual right. Consequently, if an entity has relationships with its customers through these types of contracts, the customer relationships also arise from contractual rights and therefore meet the contractual-legal-binding criterion.

Examples

~~IE30~~IE15 The following examples illustrate the recognition of customer contract and customer relationship intangible assets acquired in ~~a business-an entity~~ combination from an exchange transaction.

- (a) Acquirer Company (AC) acquires Target Company (TC) in an entity combination from an exchange transaction ~~a business-combination~~ on 31 December 20X5. TC has a five-year agreement to supply goods to Customer. Both TC and AC believe that Customer will renew the agreement at the end of the current contract. The agreement is not separable.

The agreement, whether cancellable or not, meets the contractual-legal-binding criterion. Additionally, because TC establishes its relationship with Customer through a contract, not only the agreement itself but also TC's customer relationship with Customer meet the contractual-legal-binding criterion.

- (b) AC acquires TC in an entity combination from an exchange transaction ~~a business combination~~ on 31 December 20X5. TC manufactures goods in two distinct lines of business: sporting goods and electronics. Customer purchases both sporting goods and electronics from TC. TC has a contract with Customer to be its exclusive provider of sporting goods but has no contract for the supply of electronics to Customer. Both TC and AC believe that only one overall customer relationship exists between TC and Customer.

The contract to be Customer's exclusive supplier of sporting goods, whether cancellable or not, meets the contractual-legal-binding criterion. Additionally, because TC establishes its relationship with Customer through a contract, the customer relationship with Customer meets the contractual-legal-binding criterion. Because TC has only one customer relationship with Customer, the fair value of that relationship incorporates assumptions about TC's relationship with Customer related to both sporting goods and electronics. However, if AC determines that the customer relationships with Customer for sporting goods and for electronics are separate from each other, AC would assess whether the

customer relationship for electronics meets the separability criterion for identification as an intangible asset.

- (c) AC acquires TC in an entity combination from an exchange transaction a business combination on 31 December 20X5. TC does business with its customers solely through purchase and sales orders. At 31 December 20X5, TC has a backlog of customer purchase orders from 60 per cent of its customers, all of whom are recurring customers. The other 40 per cent of TC's customers are also recurring customers. However, as of 31 December 20X5, TC has no open purchase orders or other contracts with those customers.

Regardless of whether they are cancellable or not, the purchase orders from 60 per cent of TC's customers meet the contractual-legal binding criterion. Additionally, because TC has established its relationship with 60 per cent of its customers through contracts, not only the purchase orders but also TC's customer relationships meet the contractual-legal binding criterion. Because TC has a practice of establishing contracts with the remaining 40 per cent of its customers, its relationship with those customers also arises through contractual rights and therefore meets the contractual-legal binding criterion even though TC does not have contracts with those customers at 31 December 20X5.

- (d) AC acquires TC, an insurer, in an entity combination from an exchange transaction a business combination on 31 December 20X5. TC has a portfolio of one-year motor insurance contracts that are cancellable by policyholders.

Because TC establishes its relationships with policyholders through insurance contracts, the customer relationship with policyholders meets the contractual-legal binding criterion. IAS 36 Impairment of Assets IPSAS 26 "Impairment of Cash-Generating Assets" and IAS 38 Intangible Assets IPSAS xx "Intangible Assets" apply to the customer relationship intangible asset.

Non-contractual customer relationships

IE34IE16 A customer relationship acquired in an entity combination from an exchange transaction a business combination that does not arise from a contract may nevertheless be identifiable because the relationship is separable. Exchange transactions for the same asset or a similar asset that indicate that other entities have sold or otherwise transferred a particular type of non-contractual customer relationship would provide evidence that the relationship is separable.

Artistic-related intangible assets

IE32IE17 Examples of artistic-related intangible assets are:

Class	Basis
Plays, operas and ballets	Contractual
Books, magazines, newspapers and other literary works	Contractual
Musical works such as compositions, song lyrics and advertising jingles	Contractual
Pictures and photographs	Contractual
Video and audiovisual material, including motion pictures or films, music videos and television programs	Contractual

~~IE33~~IE18 Artistic-related assets acquired in an entity combination from an exchange transaction ~~a business combination~~ are identifiable if they arise from contractual or legal rights such as those provided by copyright. The holder can transfer a copyright, either in whole through an assignment or in part through a licensing agreement. An acquirer is not precluded from recognizing a copyright intangible asset and any related assignments or license agreements as a single asset, provided they have similar useful lives.

Contract-based intangible assets

~~IE34~~IE19 Contract-based intangible assets represent the value of rights that arise from contractual arrangements. Customer contracts are one type of contract-based intangible asset. If the terms of a contract give rise to a liability (for example, if the terms of an operating lease or customer contract are unfavorable relative to market terms), the acquirer recognizes it as a liability assumed in the entity combination from an exchange transaction ~~business combination~~. Examples of contract-based intangible assets are:

Class	Basis
Licensing, royalty and standstill agreements	Contractual
Advertising, construction, management, service or supply contracts	Contractual
Lease agreements (whether the acquiree is the lessee or the lessor)	Contractual
Construction permits	Contractual
Franchise agreements	Contractual
Operating and broadcast rights	Contractual
Servicing contracts, such as mortgage servicing contracts	Contractual
Employment contracts	Contractual
Use rights, such as drilling, water, air, timber cutting and route authorities	Contractual

Servicing contracts, ~~such as mortgage servicing contracts~~

~~IE35~~IE20 Contracts to service financial assets are one type of contract-based intangible asset. Although servicing is inherent in all financial assets, it becomes a distinct asset (or liability) by one of the following:

- (a) when contractually separated from the underlying financial asset by sale or securitization of the assets with servicing retained;
- (b) through the separate purchase and assumption of the servicing.

~~IE36~~IE21 If mortgage loans, credit card receivables or other financial assets are acquired in an entity combination from an exchange transaction ~~a business combination~~ with servicing retained, the inherent servicing rights are not a separate intangible asset because the fair value of those servicing rights is included in the measurement of the fair value of the acquired financial asset.

Employment contracts

~~IE37~~~~IE22~~ Employment contracts that are beneficial contracts from the perspective of the employer because the pricing of those contracts is favorable relative to market terms are one type of contract-based intangible asset.

Use rights

~~IE38~~~~IE23~~ Use rights include rights for drilling, water, air, timber cutting and route authorities. Some use rights are contract-based intangible assets to be accounted for separately from purchase premium or goodwill. Other use rights may have characteristics of tangible assets rather than of intangible assets. An acquirer should account for use rights on the basis of their nature.

Technology-based intangible assets

~~IE39~~~~IE24~~ Examples of technology-based intangible assets are:

Class	Basis
Patented technology	Contractual
Computer software and mask works	Contractual
Unpatented technology	Non-contractual
Databases, including title plants	Non-contractual
Trade secrets, such as secret formulas, processes and recipes	Contractual

Computer software and mask works

~~IE40~~~~IE25~~ Computer software and program formats acquired in an entity combination from an exchange transaction ~~a business combination~~ that are protected legally, such as by patent or copyright, meet the contractual-legal-binding criterion for identification as intangible assets.

~~IE41~~~~IE26~~ Mask works are software permanently stored on a read-only memory chip as a series of stencils or integrated circuitry. Mask works may have legal protection. Mask works with legal protection that are acquired in an entity combination from an exchange transaction ~~a business combination~~ meet the contractual-legal-binding criterion for identification as intangible assets.

Databases, including title plants

~~IE42~~~~IE27~~ Databases are collections of information, often stored in electronic form (such as on computer disks or files). A database that includes original works of authorship may be entitled to copyright protection. A database acquired in an entity combination from an exchange transaction ~~a business combination~~ and protected by copyright meets the contractual-legal-binding criterion. However, a database typically includes information created as a consequence of an entity's normal operations, such as customer or user lists, or specialized information, such as scientific data or credit information. Databases that are not protected by copyright can be, and often are, exchanged, licensed or leased to others in their entirety or in part. Therefore, even if the future economic benefits from a database do not arise from legal rights, a database acquired in an entity combination from an exchange transaction ~~a business combination~~ meets the separability criterion.

~~IE43~~~~IE28~~ Title plants constitute a historical record of all matters affecting title to parcels of land in a particular geographical area. Title plant assets are bought and sold, either in whole or in part, in exchange transactions or are licensed. Therefore, title plant assets acquired in an entity combination from an exchange transaction ~~a business combination~~ meet the separability criterion.

Trade secrets, such as secret formulas, processes and recipes

~~IE44~~~~IE29~~ A trade secret is ‘information, including a formula, pattern, recipe, compilation, program, device, method, technique, or process that (a) derives independent economic value, actual or potential, from not being generally known and (b) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.’¹ If the future economic benefits or service potential from a trade secret acquired in an entity combination from an exchange transaction ~~a business combination~~ are legally protected, that asset meets the contractual-legal-binding criterion. Otherwise, trade secrets acquired in an entity combination from an exchange transaction ~~a business combination~~ are identifiable only if the separability criterion is met, which is likely to be the case.

Gain on a bargain purchase when the acquiree is a business

Illustrating the consequences of recognizing and measuring a gain from a bargain purchase by applying paragraphs ~~3242–3646~~ of IFRS 3/IPSAS xx.

~~IE45~~~~IE30~~ The following example illustrates the accounting for an entity combination from an exchange transaction when the acquiree is a business ~~a business combination~~ in which a gain on a bargain purchase is recognized.

~~IE46~~~~IE31~~ On 1 January 20X5 AC acquires 80 per cent of the equity interests of TC, a private entity, in exchange for cash of CU150. Because the former owners of TC needed to dispose of their investments in TC by a specified date, they did not have sufficient time to market TC to multiple potential buyers. The management of AC initially measures the separately recognizable identifiable assets acquired and the liabilities assumed as of the acquisition date in accordance with the requirements of IFRS 3. The identifiable assets are measured at CU250 and the liabilities assumed are measured at CU50. AC engages an independent consultant, who determines that the fair value of the 20 per cent non-controlling interest in TC is CU42.

~~IE47~~~~IE32~~ The amount of TC’s identifiable net assets (CU200, calculated as CU250 – CU50) exceeds the fair value of the consideration transferred plus the fair value of the non-controlling interest in TC. Therefore, AC reviews the procedures it used to identify and measure the assets acquired and liabilities assumed and to measure the fair value of both the non-controlling interest in TC and the consideration transferred. After that review, AC decides that the procedures and resulting measures were appropriate. AC measures the gain on its purchase of the 80 per cent interest as follows:

	CU
Amount of the identifiable net assets acquired (CU250 – CU50)	200
Less: Fair value of the consideration transferred for AC’s 80 per cent interest in TC; plus	150
Fair value of non-controlling interest in TC	42
	<hr/>
	192
Gain on bargain purchase of 80 per cent interest	<hr/> 8

¹ Melvin Simensky and Lanning Bryer, *The New Role of Intellectual Property in Commercial Transactions* (New York: John Wiley & Sons, 1998), page 293.

~~IE48~~IE33 AC would record its acquisition of TC in its consolidated financial statements as follows:

	CU	CU
Dr Identifiable assets acquired	250	
Cr Cash		150
Cr Liabilities assumed		50
Cr Gain on the bargain purchase		8
Cr Equity—non-controlling interest in TC		42

~~IE49~~IE34 If the acquirer chose to measure the non-controlling interest in TC on the basis of its proportionate interest in the identifiable net assets of the acquiree, the recognized amount of the non-controlling interest would be CU40 (CU200 x 0.20). The gain on the bargain purchase then would be CU10 (CU200 – (CU150 + CU40)).

Measurement period

Illustrating the consequences of applying paragraphs ~~45-59~~–50–64 of ~~IFRS 3~~IPSAS xx.

~~IE50~~IE35 If the initial accounting for an entity combination from an exchange transaction when the acquiree is a business ~~a business combination~~ is not complete at the end of the financial reporting period in which the combination occurs, paragraph ~~45-59~~ of ~~IFRS 3~~IPSAS xx requires the acquirer to recognize in its financial statements provisional amounts for the items for which the accounting is incomplete. During the measurement period, the acquirer recognizes adjustments to the provisional amounts needed to reflect new information obtained about facts and circumstances that existed as of the acquisition date and, if known, would have affected the measurement of the amounts recognized as of that date. Paragraph ~~49-63~~ of ~~IFRS 3~~IPSAS xx requires the acquirer to recognize such adjustments as if the accounting for the entity combination from an exchange transaction ~~business combination~~ had been completed at the acquisition date. Measurement period adjustments are not included in ~~profit or loss~~surplus or deficit.

~~IE51~~IE36 Suppose that AC acquires TC on 30 September 20X7. AC seeks an independent valuation for an item of property, plant and equipment acquired in the combination, and the valuation was not complete by the time AC authorized for issue its financial statements for the year ended 31 December 20X7. In its 20X7 annual financial statements, AC recognized a provisional fair value for the asset of CU30,000. At the acquisition date, the item of property, plant and equipment had a remaining useful life of five years. Five months after the acquisition date, AC received the independent valuation, which estimated the asset's acquisition-date fair value as CU40,000.

~~IE52~~IE37 In its financial statements for the year ended 31 December 20X8, AC retrospectively adjusts the 20X7 prior year information as follows:

- The carrying amount of property, plant and equipment as of 31 December 20X7 is increased by CU9,500. That adjustment is measured as the fair value adjustment at the acquisition date of CU10,000 less the additional depreciation that would have been recognized if the asset's fair value at the acquisition date had been recognized from that date (CU500 for three months' depreciation).
- The carrying amount of goodwill as of 31 December 20X7 is decreased by CU10,000.
- Depreciation expense for 20X7 is increased by CU500.

~~IE53~~IE38 In accordance with paragraph ~~B67-B56~~ of ~~IFRS 3~~IPSAS xx, AC discloses:

- (a) in its 20X7 financial statements, that the initial accounting for the entity combination from an exchange transaction~~business combination~~ has not been completed because the valuation of property, plant and equipment has not yet been received.
- (b) in its 20X8 financial statements, the amounts and explanations of the adjustments to the provisional values recognized during the current reporting period. Therefore, AC discloses that the 20X7 comparative information is adjusted retrospectively to increase the fair value of the item of property, plant and equipment at the acquisition date by CU9,500, offset by a decrease to goodwill of CU10,000 and an increase in depreciation expense of CU500.

Determining what is part of the entity combination from an exchange transaction~~business combination~~ transaction

Settlement of a pre-existing relationship

Illustrating the consequences of applying paragraphs ~~5465~~, ~~52-66~~ and ~~B50B46-B53-B49~~ of IFRS 3/IPSAS xx.

- ~~IE54~~IE39 AC purchases electronic components from TC under a five-year supply contract at fixed rates. Currently, the fixed rates are higher than the rates at which AC could purchase similar electronic components from another supplier. The supply contract allows AC to terminate the contract before the end of the initial five-year term but only by paying a CU6 million penalty. With three years remaining under the supply contract, AC pays CU50 million to acquire TC, which is the fair value of TC based on what other market participants would be willing to pay.
- ~~IE55~~IE40 Included in the total fair value of TC is CU8 million related to the fair value of the supply contract with AC. The CU8 million represents a CU3 million component that is 'at market' because the pricing is comparable to pricing for current market transactions for the same or similar items (selling effort, customer relationships and so on) and a CU5 million component for pricing that is unfavorable to AC because it exceeds the price of current market transactions for similar items. TC has no other identifiable assets or liabilities related to the supply contract, and AC has not recognized any assets or liabilities related to the supply contract before the entity combination from an exchange transaction~~business combination~~.
- ~~IE56~~IE41 In this example, AC calculates a loss of CU5 million (the lesser of the CU6 million stated settlement amount and the amount by which the contract is unfavorable to the acquirer) separately from the entity combination from an exchange transaction~~business combination~~. The CU3 million 'at-market' component of the contract is part of goodwill.
- ~~IE57~~IE42 Whether AC had recognized previously an amount in its financial statements related to a pre-existing relationship will affect the amount recognized as a gain or loss for the effective settlement of the relationship. Suppose that ~~IFRSs-IPSASs~~ had required AC to recognize a CU6 million liability for the supply contract before the entity combination from an exchange transaction~~business combination~~. In that situation, AC recognizes a CU1 million settlement gain on the contract in profit or loss-surplus or deficit at the acquisition date (the CU5 million measured loss on the contract less the CU6 million loss previously recognized). In other words, AC has in effect settled a recognized liability of CU6 million for CU5 million, resulting in a gain of CU1 million.

Contingent payments to employees

Illustrating the consequences of applying paragraphs ~~5465~~, ~~5266~~, ~~B50B46~~, ~~B54-B50~~ and ~~B55-B51~~ of IFRS 3/IPSAS xx.

- ~~IE58~~IE43 TC appointed a candidate as its new CEO under a ten-year contract. The contract required TC to pay the candidate CU5 million if TC is acquired before the contract expires. AC acquires TC eight years later. The CEO was still employed at the acquisition date and will receive the additional payment under the existing contract.
- ~~IE59~~IE44 In this example, TC entered into the employment agreement before the negotiations of the combination began, and the purpose of the agreement was to obtain the services of CEO. Thus, there is no evidence

that the agreement was arranged primarily to provide benefits to AC or the combined entity. Therefore, the liability to pay CU5 million is included in the application of the acquisition method.

~~IE60~~IE45 In other circumstances, TC might enter into a similar agreement with CEO at the suggestion of AC during the negotiations for the entity combination from an exchange transaction~~business combination~~. If so, the primary purpose of the agreement might be to provide severance pay to CEO, and the agreement may primarily benefit AC or the combined entity rather than TC or its former owners. In that situation, AC accounts for the liability to pay CEO in its post-combination financial statements separately from application of the acquisition method.

Replacement awards [this section has been deleted – see B56 for explanation]

Illustrating the consequences of applying paragraphs 51, 52 and B56–B62 of IFRS 3.

~~IE61~~ — The following examples illustrate replacement awards that the acquirer was obliged to issue in the following circumstances:

		Acquiree awards Has the vesting period been completed before the business combination?		
		Completed	Not completed	
Replacement awards Are employees required to provide additional service after the acquisition date?	Not required	Example 1	Example 4	
	Required	Example 2	Example 3	

~~IE62~~ — The examples assume that all awards are classified as equity.

Example 1

<i>Acquiree awards</i>	<i>Vesting period completed before the business combination</i>	
<i>Replacement awards</i>	<i>Additional employee services are not required after the acquisition date</i>	

~~IE63~~ — AC issues replacement awards of CU110 (market-based measure) at the acquisition date for TC awards of CU100 (market-based measure) at the acquisition date. No post combination services are required for the replacement awards and TC's employees had rendered all of the required service for the acquiree awards as of the acquisition date.

~~IE64~~ — The amount attributable to pre-combination service is the market-based measure of TC's awards (CU100) at the acquisition date; that amount is included in the consideration transferred in the business combination. The amount attributable to post-combination service is CU10, which is the difference between the total value of the replacement awards (CU110) and the portion attributable to pre-combination service (CU100). Because no post-combination service is required for the replacement awards, AC immediately recognises CU10 as remuneration cost in its post-combination financial statements.

Example 2

<i>Acquiree awards</i>	<i>Vesting period completed before the business combination</i>
<i>Replacement awards</i>	<i>Additional employee services are required after the acquisition date</i>

~~IE65 — AC exchanges replacement awards that require one year of post combination service for share based payment awards of TC, for which employees had completed the vesting period before the business combination. The market-based measure of both awards is CU100 at the acquisition date. When originally granted, TC's awards had a vesting period of four years. As of the acquisition date, the TC employees holding unexercised awards had rendered a total of seven years of service since the grant date.~~

~~IE66 — Even though TC employees had already rendered all of the service, AC attributes a portion of the replacement award to post combination remuneration cost in accordance with paragraph B59 of IFRS 3, because the replacement awards require one year of post combination service. The total vesting period is five years — the vesting period for the original acquiree award completed before the acquisition date (four years) plus the vesting period for the replacement award (one year).~~

~~IE67 — The portion attributable to pre combination services equals the market-based measure of the acquiree award (CU100) multiplied by the ratio of the pre combination vesting period (four years) to the total vesting period (five years). Thus, CU80 ($CU100 \times 4/5$ years) is attributed to the pre combination vesting period and therefore included in the consideration transferred in the business combination. The remaining CU20 is attributed to the post combination vesting period and is therefore recognised as remuneration cost in AC's post combination financial statements in accordance with IFRS 2.~~

Example 3

<i>Acquiree awards</i>	<i>Vesting period not completed before the business combination</i>
<i>Replacement awards</i>	<i>Additional employee services are required after the acquisition date</i>

~~IE68 — AC exchanges replacement awards that require one year of post combination service for share based payment awards of TC, for which employees had not yet rendered all of the service as of the acquisition date. The market-based measure of both awards is CU100 at the acquisition date. When originally granted, the awards of TC had a vesting period of four years. As of the acquisition date, the TC employees had rendered two years' service, and they would have been required to render two additional years of service after the acquisition date for their awards to vest. Accordingly, only a portion of the TC awards is attributable to pre combination service.~~

~~IE69 — The replacement awards require only one year of post combination service. Because employees have already rendered two years of service, the total vesting period is three years. The portion attributable to pre combination services equals the market based measure of the acquiree award (CU100) multiplied by the ratio of the pre combination vesting period (two years) to the **greater of** the total vesting period (three years) or the original vesting period of TC's award (four years). Thus, CU50 ($CU100 \times 2/4$ years) is attributable to pre combination service and therefore included in the consideration transferred for the acquiree. The remaining CU50 is attributable to post combination service and therefore recognised as remuneration cost in AC's post combination financial statements.~~

Example 4

<i>Acquiree awards</i>	<i>Vesting period not completed before the business combination</i>
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Replacement awards	Additional employee services are not required after the acquisition date
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~~IE70~~ Assume the same facts as in Example 3 above, except that AC exchanges replacement awards that require no post-combination service for share-based payment awards of TC for which employees had not yet rendered all of the service as of the acquisition date. The terms of the replaced TC awards did not eliminate any remaining vesting period upon a change in control. (If the TC awards had included a provision that eliminated any remaining vesting period upon a change in control, the guidance in Example 1 would apply.) The market-based measure of both awards is CU100. Because employees have already rendered two years of service and the replacement awards do not require any post-combination service, the total vesting period is two years.

~~IE71~~ The portion of the market-based measure of the replacement awards attributable to pre-combination services equals the market-based measure of the acquiree award (CU100) multiplied by the ratio of the pre-combination vesting period (two years) to the ~~greater of~~ the total vesting period (two years) or the original vesting period of TC's award (four years). Thus, CU50 (CU100 x 2/4 years) is attributable to pre-combination service and therefore included in the consideration transferred for the acquiree. The remaining CU50 is attributable to post-combination service. Because no post-combination service is required to vest in the replacement award, AC recognises the entire CU50 immediately as remuneration cost in the post-combination financial statements.

Disclosure requirements when the acquiree is a business

Illustrating the consequences of applying the disclosure requirements in paragraphs ~~5973-63-77~~ and ~~B64B53-B67-B56~~ of ~~IFRS-3IPSAS xx~~.

~~IE72IE46~~ The following example illustrates some of the disclosure requirements of ~~IFRS-3IPSAS xx~~; it is not based on an actual transaction. The example assumes that ~~AC is a listed entity and that~~ TC is an unlisted entity. The illustration presents the disclosures in a tabular format that refers to the specific disclosure requirements illustrated. An actual footnote might present many of the disclosures illustrated in a simple narrative format.

Footnote X: Acquisitions

Paragraph reference

~~B64B53~~(a-d) On 30 June 20X0 AC acquired 15 per cent of the outstanding ordinary shares of TC. On 30 June 20X2 AC acquired 60 per cent of the outstanding ordinary shares of TC and obtained control of TC. TC is a provider of data networking products and services in Canada and Mexico. As a result of the acquisition, AC is expected to be the leading provider of data networking products and services in those markets. It also expects to reduce costs through economies of scale.

~~B53 B64~~(e) The goodwill of CU2,500 arising from the acquisition consists largely of the synergies and economies of scale expected from combining the operations of AC and TC.

~~B53 B64~~(k) None of the goodwill recognized is expected to be deductible for income tax purposes. The following table summarizes the consideration paid for TC and the amounts of the assets acquired and liabilities assumed recognized at the acquisition date, as well as the fair value at the acquisition date of the non-controlling interest in TC.

At 30 June 20X2

	Consideration	CU
B53 B64 (f)(i)	Cash	5,000

B53 B64 (f)(iv)	Equity instruments (100,000 ordinary shares of AC)	4,000
B53 B64 (f)(iii); B53 B64 (g)(i)	Contingent consideration arrangement	1,000
B53 B64 (f)	Total consideration transferred	10,000
B53 B64 (p)(i)	Fair value of AC's equity interest in TC held before the business-entity combination	2,000
		12,000
B53 B64 (m)	Acquisition-related costs (included in selling, general and administrative expenses in AC's statement of comprehensive income-financial performance for the year ended 31 December 20X2)	1,250
B53 B64 (i)	Recognized amounts of identifiable assets acquired and liabilities assumed	
	Financial assets	3,500
	Inventory	1,000
	Property, plant and equipment	10,000
	Identifiable intangible assets	3,300
	Financial liabilities	-4,000
	Contingent liability	-1,000
	Total identifiable net assets	12,800
B53 B64 (o)(i)	Non-controlling interest in TC	-3,300
	Goodwill	2,500
		12,000
B53 B64 (f)(iv)	The fair value of the 100,000 ordinary shares issued as part of the consideration paid for TC (CU4,000) was determined on the basis of the closing market price of AC's ordinary shares on the acquisition date.	
B53 B64 (f)(iii) B53 B64 (g) B67 B56 (b)	The contingent consideration arrangement requires AC to pay the former owners of TC 5 per cent of the revenues of XC, an unconsolidated equity investment owned by TC, in excess of CU7,500 for 20X3, up to a maximum amount of CU2,500 (undiscounted).	
	The potential undiscounted amount of all future payments that AC could be required to make under the contingent consideration arrangement is between CU0 and CU2,500.	

The fair value of the contingent consideration arrangement of CU1,000 was estimated by applying the income approach. The fair value estimates are based on an assumed discount rate range of 20–25 per cent and assumed probability-adjusted revenues in XC of CU10,000–20,000.

As of 31 December 20X2, neither the amount recognized for the contingent consideration arrangement, nor the range of outcomes or the assumptions used to develop the estimates had changed.

- ~~B53B64~~(h) The fair value of the financial assets acquired includes receivables under finance leases of data networking equipment with a fair value of CU2,375. The gross amount due under the contracts is CU3,100, of which CU450 is expected to be uncollectible.
- ~~B67B56~~(a) The fair value of the acquired identifiable intangible assets of CU3,300 is provisional pending receipt of the final valuations for those assets.
- ~~B53B64~~(j)
~~B67B56~~(c)
~~IAS 37.84~~,
~~85IPSAS 19.97~~,
~~98~~ A contingent liability of CU1,000 has been recognized for expected warranty claims on products sold by TC during the last three years. We expect that the majority of this expenditure will be incurred in 20X3 and that all will be incurred by the end of 20X4. The potential undiscounted amount of all future payments that AC could be required to make under the warranty arrangements is estimated to be between CU500 and CU1,500. As of 31 December 20X2, there has been no change since 30 June 20X2 in the amount recognized for the liability or any change in the range of outcomes or assumptions used to develop the estimates.
- ~~B53B64~~(o) The fair value of the non-controlling interest in TC, an unlisted company, was estimated by applying a market approach and an income approach. The fair value estimates are based on:
- (a) an assumed discount rate range of 20–25 per cent;
 - (b) an assumed terminal value based on a range of terminal EBITDA multiples between 3 and 5 times (or, if appropriate, based on long term sustainable growth rates ranging from 3 to 6 per cent);
 - (c) assumed financial multiples of companies deemed to be similar to TC; and
 - (d) assumed adjustments because of the lack of control or lack of marketability that market participants would consider when estimating the fair value of the non-controlling interest in TC.
- ~~B53B64~~(p)(ii) AC recognized a gain of CU500 as a result of measuring at fair value its 15 per cent equity interest in TC held before the ~~business combination~~entity combination. The gain is included in other ~~income~~revenue in AC's statement of ~~comprehensive income~~financial performance for the year ending 31 December 20X2.
- ~~B53B64~~(q)(i) The revenue included in the consolidated statement of ~~comprehensive income~~financial performance since 30 June 20X2 contributed by TC was CU4,090. TC also contributed ~~profit~~surplus of CU1,710 over the same period.
- ~~B53B64~~(q)(ii) Had TC been consolidated from 1 January 20X2 the consolidated statement of ~~comprehensive income~~financial performance would have included revenue of CU27,670 and ~~profit~~surplus of CU12,870.