28 October 2005

Dear Sir/Madam

Exposure Drafts:
Business Combinations, Proposed Amendments to IFRS 3;
Consolidated and Separate Financial Statements, Proposed Amendments to IAS 27;
Business Combinations, Proposed Replacement of FASB Statement No. 141 (File Reference No. 1204-001);
Consolidated Financial Statements, Including Accounting and Reporting of Noncontrolling Interests in Subsidiaries, Proposed Replacement of ARB No. 51 (File Reference No. 1205-001)

We appreciate the opportunity to respond to the International Accounting Standards Board and Financial Accounting Standards Board's exposure drafts of the proposed amendments to and replacements of IFRS 3 and FASB Statement No. 141, Business Combinations and IAS 27 Consolidated and Separate Financial Statements and Accounting Research Bulletin No. 51, Consolidated Financial Statements. This letter represents the views of KPMG International and its member firms including KPMG LLP (US) and is being submitted to both the IASB and the FASB. Although the majority of our comments apply to both the FASB and IASB exposure drafts, throughout our response we have identified any comments that we consider to be specific to either US GAAP or IFRS.

We support the Boards' efforts to achieve a converged solution to the accounting for business combinations and noncontrolling interests. However, we do not support fundamental change to the current accounting model proposed by the Boards in their Exposure Drafts for the reasons stated in the following paragraph. Rather, we propose that the Boards adopt a converged model based in large part on the current IFRS 3, Business Combinations, with improvements to address certain existing practice issues associated with its application. We believe our suggested approach will meet the key objectives of the Boards, including improving financial information about business combinations and achieving international convergence. Furthermore, in most of the areas covered by current IFRS 3, our experience is that the application of the standard has not led to issues that would necessitate substantial modifications to it.
We are not aware that financial statement users have expressed significant concern about the parent company approach used to account for business combinations and to prepare consolidated financial statements. Additionally, we are not aware of a body of research that supports the decision-usefulness of the economic entity approach and the resulting use of full fair value in accounting for business combinations. Therefore, we question the Boards' decision to abandon the parent company approach in favour of the economic entity approach without having undertaken research or other analysis that supports a conclusion that the economic entity approach provides more decision-useful information to financial statement users.

Summary of main points

The Boards' proposals on business combinations and noncontrolling interests are based on the economic entity concept as described in the FASB's 1991 Discussion Memorandum, Consolidation Policy and Procedures, and include classifying noncontrolling interests in equity and using the 'full fair value' method. However, we believe that the parent-company approach as defined in that same document provides more relevant information to users of the consolidated financial statements because it allows users of consolidated financial statements to understand the investment of the parent in the acquired entity. Based on the disclosures that would be required for the noncontrolling interests by the Exposure Drafts, it appears that the Boards also believe that the information that results from the parent-company approach is useful to the users of consolidated financial statements.

Consistent with the parent-company approach, we believe it is inappropriate to 'gross up' goodwill and noncontrolling interests in business combinations in which less than 100% of an acquiree is obtained. Goodwill should continue to be defined and measured as a residual asset in a business combination, based on the cost of the business combination incurred by the acquirer. The noncontrolling interests do not participate in the transaction, and therefore, there is no 'residual' attributable to the noncontrolling interests because that portion of the entity has not been acquired. Additionally, we are concerned about the reliability of the measurement of the full fair value of the acquired entity particularly when a significant portion of the acquisition price is comprised of contingent consideration and in situations where control is obtained through the acquisition of a small ownership interest (e.g., an investor increases its ownership interest from 49% to 51%).

We believe an approach based on current IFRS 3 would represent an improvement over the current business combinations accounting model in US GAAP literature:

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

Furthermore, an approach based on current IFRS 3 would provide a basis for achieving a converged solution for IFRS and US GAAP which is an important goal of the IASB/FASB joint business combinations project.

While we believe that current IFRS 3 can serve as a model to achieve a converged solution, there are additional issues that the Boards should consider under this approach:

- **Accounting for business combinations between mutual entities and for business combinations by contract alone are currently scoped out of IFRS 3.** We believe that such transactions should be included within the scope and that the principles for determining the acquirer and acquisition accounting should be applied to those transactions;

- Accounting for business combinations in which the acquirer’s interest in the net fair value of the identifiable assets and liabilities exceeds the cost of the business combination. For transactions that give rise to “negative goodwill”, we believe that any identifiable intangible assets acquired in a business combination that cannot be measured at fair value by reference to an active market (IAS 22 approach) should first be reduced to zero before any gain is recognized;

- **Accounting for subsequent acquisitions of additional ownership interests of the acquiree after control is obtained.** As discussed in Appendix E to our letter, we believe that there are several possible approaches to accounting for these transactions that would currently be acceptable under IFRS;

- **Accounting for transactions that reduce the parent-company’s ownership interest, either directly or indirectly while retaining control.** We believe that these transactions should result in recognizing gains or losses in profit and loss.

The following summarizes our responses to certain key questions or issues raised in the Exposure Drafts.

**Definition of a business combination**

We agree with the revised definition of a business that, especially under US GAAP, would result in more transactions being accounted for as business combinations than under the current definition of a business (e.g., under current US GAAP, development stage enterprises are presumed not to be a business). We note, however, that the significantly different accounting models applied to the acquisition of a business and the acquisition of assets (e.g., existence of goodwill, accounting for in-process research and development, contingencies, contingent consideration, bargain purchases, etc.) will continue to put pressure on the question of whether an acquired entity is a business.
Classification of Noncontrolling Interests in Equity

We do not object to the proposal and current requirement in IAS 27 that noncontrolling interests be included in consolidated equity (which represents a change from current practice in the US of presenting noncontrolling interests outside of equity) if presented separately from the parent company's equity. However, classification of noncontrolling interests in equity should only relate to presentation and not be regarded as an argument for an economic entity approach which in our view is not an appropriate basis for preparing the consolidated financial statements of the parent company.

Fair Value Measurement Issues

We do not support a full fair value model whereby goodwill and the noncontrolling interests are "grossed up." We believe that this does not depict fairly transactions where the acquirer obtains less than 100% of the equity interests of another entity. Furthermore, the proposed standard is inconsistent with the current and proposed measurement of goodwill as a residual asset. We also believe there are reliability-of-measurement issues in certain acquisitions such as in a partial acquisition (e.g., relationship of control premiums to the total consideration paid). Additionally, we are concerned that the collective guidance in the proposed Statements, including the implementation guidance and the basis for conclusions, creates a presumption that a "gross up" of the consideration exchanged in a partial acquisition is the best basis to measure the fair value of the acquiree as a whole. We believe that such a presumption is inappropriate.

Obtaining control

We do not agree that the acquirer should recognise in the income statement any gain or loss on previously acquired non-controlling investments on the date that it obtains control of the acquiree. We believe that the acquirer should recognise any gain on the remeasurement of an existing investment related to the identifiable net assets in equity rather than in profit and loss.

Measurement of Consideration

We agree with the proposed standard that the fair value of the consideration exchanged should be measured at the acquisition date.

We do not agree that contingent consideration based on the acquiree's earnings, or other performance measures, should be included in the acquisition price at the date of the acquisition except if payment is probable at the acquisition date. In our experience, such contingent consideration is often agreed to because the buyer and seller were unable to reach an agreement as to the fair value of the entity. As a consequence, we question the ability to reliably measure the fair value of such contingent consideration at the acquisition date in many cases. Rather, we believe that such amounts should be recognized when the amounts are probable of being paid and reliably measurable. We acknowledge that this will require the Boards to reach agreement on a common threshold for recognition and a common treatment when contingent consideration is recognized (i.e., retrospective vs. an adjustment to purchase consideration in the period of recognition).
We believe that the accounting for business combinations should continue to be based on a 'cost accumulation' approach. Therefore, transaction costs should generally be included in determining the cost of the acquired entity. Additionally, we note that the Board's conclusion that transaction costs should be expensed as incurred would create an inconsistency in the treatment of these costs in a business combination vs. an acquisition of assets.

**Contingent Assets and Liabilities**

We agree with the Boards' conclusions on the fair value measurement of contingent assets and liabilities in a business combination.

1. **Loss of control**

We do not agree that the loss of control should result in a remeasurement of the remaining investment at fair value with the adjustment recognized in profit or loss. We believe that upon the loss of control, gains and losses should be recognized for the portion of the investment that is sold. Any remaining investment would retain its carrying amount at that date and would be accounted for subsequently in accordance with appropriate existing GAAP (e.g., equity method investment, available-for-sale security, trading security).

**Identifying the Acquirer**

With respect to the FASB proposals we believe that the guidance currently found in Statement 141 for identification of the acquirer should be carried forward without revision. We have found that guidance to be operational as evidenced by the fact that the determination of the acquirer has not been a significant practice issue. We do not believe that concepts from FIN 46(R) are appropriate for the identification of the acquirer in a business combination. A business combination is defined as "a transaction or other event in which an acquirer obtains control of one or more businesses." Control is defined using the voting interest concept of ARB 51 as "controlling financial interest."

Conversely, FIN 46(R) provides guidance on accounting for variable interests in variable interest entities. As such, we disagree with using the guidance in FIN 46(R) to determine the acquirer in a business combination involving voting interest entities. The consolidation guidance in FIN 46(R) is based on an "effective control" model, not a voting control model. Because a business combination occurs when an acquirer obtains voting control, we believe that the FIN 46(R) guidance is not relevant or appropriate to consider. We believe that the concepts of voting control and effective control should not be used interchangeably and, therefore, we believe that an entity should not consider FIN 46(R) in determining the acquirer in a business combination.

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If you have any questions about our comments or wish to discuss any of these matters further, please contact Mark Vaessen at (44) 20 7694 8089 with KPMG's International Financial Reporting Group in London or Mark Bielstein at (212) 909-5419 or Paul Munter at (212) 909-5567 with KPMG LLP in New York.

Yours sincerely.

KPMG IFRG Limited

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Appendix A: Responses to the questions set out in the Invitation to Comment

2 Business Combinations

2.1 Objective, Definition, and Scope

2.1.1 Question 1: Are the objectives and the definition of a business combination appropriate for accounting for all business combinations? If not, for which business combinations are they not appropriate, why would you make an exception, and what alternative do you suggest?

While we support the Boards' objectives of undertaking this project to improve the completeness, relevance, and comparability of financial information about business combinations in financial statements and to achieve convergence between US GAAP and IFRS, we disagree with a fundamental principle on which the Boards made many of their decisions. Specifically, as it relates to existing guidance in the US, we disagree with the economic entity approach, as described in the FASB's 1991 Discussion Memorandum, "Consolidation Policy and Procedures" and the resulting consequences of applying the Exposure Drafts, including the acquirer recognizing (1) noncontrolling interests at their estimated fair value and allocating goodwill to the noncontrolling interests (the full fair value approach), (2) a gain or loss for any investments held in the acquiree before the business combination (i.e., in a step acquisition), and (3) no gains or losses on transactions that reduce the parent-company's ownership interest without loss of control. We believe that the parent-company approach as described in the 1991 Discussion Memorandum provides more relevant information to users of the consolidated financial statements because users of the consolidated financial statements are able to better understand the investment of the parent company in the acquired entity.

2.1.1.1 Scope and Definition of Business Combination

We agree that a business combination is a transaction or event in which an acquirer obtains control of one or more businesses. In that regard, we have found the guidance currently given in Statement 141 and IFRS 3 for identification of the acquirer to be operational as evidenced by the fact that the determination of the acquirer has not been a significant practice issue.

Additionally, in the US, FIN 46(R) provides guidance on accounting for variable interests in variable interest entities. We object to using the guidance in FIN 46(R) to determine the acquirer in a business combination involving voting interest entities. The consolidation guidance in FIN 46(R) is based on an "effective control" model, not a voting control model. We believe that the concepts of voting control and effective control should not be used interchangeably and, therefore, we believe that an entity should not consider FIN 46(R) in determining the acquirer in a business combination.
We support the Boards' decision to require all business combinations to be accounted for by the acquisition method of accounting. We believe that the proposed scope exceptions are appropriate including the exceptions for the formations of joint ventures and combinations involving entities under common control. The accounting for those transactions is an area where practice issues frequently arise. Accordingly, we support the Boards' intentions to consider those issues in a future project that will address whether, and, if so, when to apply a new basis of accounting to these entities. We note that unlike US GAAP there is no procedural guidance provided for common control transactions under IFRS, and we urge the IASB to add common control transactions to its list of potential future projects.

We agree with the Boards' conclusion that business combinations generally are exchange transactions in which knowledgeable, unrelated willing parties are presumed to exchange equal values. That is, the amount paid by the acquirer is the best evidence of fair value for the portion of the business acquired. Accordingly, we agree with the Boards' conclusion that the acquisition of 100 percent of an entity should be recognized based on the amount that the acquirer has paid. However, we are concerned about the application of the full fair value approach as described in the Exposure Drafts when (1) the acquirer obtains less than 100 percent ownership (partial acquisition), (2) the acquirer owned an investment in the acquiree before the business combination (step acquisition), and (3) the acquirer does not exchange consideration to obtain control.

2.1.1.2 Full Fair Value Approach

We disagree with the guidance in the Exposure Drafts that an acquirer should measure and recognize an acquiree at its full fair value and the related guidance on accounting for the noncontrolling interests based on the economic entity approach. We believe that the economic entity approach is not appropriate because the noncontrolling shareholders did not participate in the transaction and, accordingly, do not hold an economic interest in the parent company, which along with its subsidiaries, is the reporting entity. Further, we believe that the Boards' presentation and disclosure requirements are supportive of the usefulness of the information that results from applying a parent company approach because many of the proposed disclosures are based on that approach.

Ultimately, the proposed guidance should be evaluated as to whether it will provide more decision-useful information for the users of financial statements and, if so, whether the potential lack of reliability for fair value measurement may offset any increase in the relevance to users of the information.

We are not aware that financial statement users have expressed significant concern about the parent company approach to business combinations and consolidations. Additionally, we are not aware of a body of research that supports the decision-usefulness of the economic entity approach. Therefore, we question the Boards' decision to abandon the parent company approach in favour of the economic entity approach without having undertaken research or other analysis that supports a conclusion that the economic entity approach provides more decision-useful information to financial statement users.
2.1.1.3 KPMG's Proposed Approach to Business Combinations

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

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

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

- Upon acquisition of control, all identifiable assets and liabilities would be recognized at their fair values rather than using the “mixed” cost/fair value model that exists currently under Statement 141. Consistent with the fact that goodwill is the “residual amount”, any difference at the date of exchange between the purchase price and the acquirer’s ownership interest in the fair value of the identifiable net assets acquired would be recognized as goodwill;

- It does not introduce any new measurement issues that do not currently exist (i.e., although assets and liabilities are currently adjusted only to the extent of the interest acquired, the acquiring entity is still required to determine the fair value of identifiable assets and liabilities to apply purchase accounting under Statement 141).

We generally believe that combinations involving mutual entities and combinations by contract alone should be included within the scope of the standard using the same model as is used for other business combinations. With regard to combinations by contract alone, the Exposure Draft provides that the fair value of the acquiree shall be attributed to the equity holders of the acquiree and presented as non-controlling interest in the consolidated financial statements. Similarly, it seems that in business combinations involving mutual entities, whilst not explicitly stated, the application of the principles in the Exposure Draft would result in the fair value of the acquiree being attributed to the equity holders of the acquiree and presented as a non-controlling interest in the consolidated financial statements.
We do not believe that it is appropriate to present the equity holders of the acquiree as the non-controlling interest in many business combinations involving either combinations by contract alone or mutual entities. In our view owners of both combined entities generally have an ownership interest in the results of the combined entity as a whole and therefore should be presented as part of the controlling interest of the combined entity. They are equity holders as both the acquirer and the acquiree have homogeneous residual interests in the combined entity.

Regarding business combinations by contract alone and between mutual entities, in our view, purchase accounting, including identification of an acquirer, and measurement of the consideration involved, can be applied to these transactions. The effect is often the same as when entities combine through one entity by issuing shares to the other entity's shareholders. As the interests of the acquiring entity's shareholders in the combined entity can be identified readily, there is no practical issue in identifying the consideration paid by the acquiring entity to the acquired entity—it is the value allotted to the acquiree's shareholders. This can be computed with no more difficulty than the equivalent computations in reverse acquisition accounting.

2.2 Definition of a Business

2.2.1 Question 2: Are the definition of a business and the additional guidance appropriate and sufficient for determining whether the assets acquired and the liabilities assumed constitute a business? If not, how would you propose to modify or clarify the definition or additional guidance?

We agree with the revised definition of a business that, in particular under US GAAP, would result in more transactions being accounted for as business combinations than under the current definition of a business (e.g., under current US GAAP, development stage enterprises are presumed not to be a business). However, we believe that the Boards should add examples to the implementation guidance and remove the presumptions (a) that if goodwill exists, then a set of assets and activities is a business [paragraph A7], and (b) that administrative systems typically are not processes that are used to create output [paragraph A2(b)].
The definition of a business and its application is extremely important due to the differential accounting that would exist for business combinations versus asset acquisitions (i.e., existence of goodwill, accounting for in-process research and development, accounting for contingent assets and liabilities, accounting for contingent consideration, accounting for transaction costs, accounting for bargain purchases, accounting for deferred taxes). The determination of whether a transaction is a business combination or an asset acquisition is an area where practice issues frequently arise. Accordingly, we support the Boards' efforts to improve the definition of a business, including the expansion of the definition to include many development stage enterprises. Although we are supportive of the changes to the definition, we believe that practice issues will continue based on the proposed implementation guidance. For example, it is unclear how to apply the definition and the implementation guidance to a common real estate transaction in which an income-producing property is acquired or in determining whether certain outsourcing agreements would constitute a business. Accordingly, we believe that the implementation guidance in a final Statement should include a number of examples to assist in the application of the definition.

As noted above, we also believe that the Boards should remove the presumption that if goodwill exists, then the set of assets and activities constitute a business. We agree with the observations in the basis for conclusions that this presumption results in circular logic and that it is not especially useful guidance. That is, goodwill is the result of a business combination, not an indicator.

2.3 Measuring the Fair Value of the Acquiree

2.3.1 Question 3—In a business combination in which the acquirer holds less than 100 percent of the equity interests of the acquiree at the acquisition date, is it appropriate to recognize 100 percent of the acquisition-date fair value of the acquiree, including 100 percent of the values of identifiable assets acquired, liabilities assumed, and goodwill, which would include the goodwill attributable to the noncontrolling interest? If not, what alternative do you propose and why?

We do not support the use of the economic entity model and the resulting recognition of 100 percent of the acquisition-date fair value of the acquiree in a business combination in which the acquirer holds less than 100 percent of the equity interests of the acquiree. Goodwill represents the excess of the consideration paid over the fair value of the identifiable net assets acquired, and should be recognized only for the portion of the business acquired. The noncontrolling interests do not participate in the transaction, and therefore, there is no "residual" attributable to the noncontrolling interests because that portion of the entity has not been acquired. Accordingly, we propose that the Boards adopt a model based on the current IFRS 3 model, with certain improvements we have suggested throughout this response. We believe it is appropriate to record the acquired identifiable net assets at their fair values rather than the mixture of cost and fair value that results from the application of Statement 141. As defined in current IFRS 3, goodwill would be the excess, if any between the purchase price and the acquirer's ownership interest in the fair value of the identifiable net assets acquired.
2.3.2 **Question 4:** Do paragraphs A8–A26 provide sufficient guidance for measuring the fair value of an acquiree? If not, what additional guidance is needed?

As noted in our previous responses, we do not support the model proposed by the Boards. Additionally, even if we were in support of the proposed model, we believe that the proposed Statement does not provide sufficient guidance for measuring the fair value of an acquiree in transactions where the acquirer obtains less than 100% ownership in the acquiree. Clearly, the Boards' decision to use the economic entity concept with the resulting full fair value approach for business combinations coupled with the expanded definition of a business would significantly increase the instances where the fair value of the acquiree must be estimated based on information other than the price paid by the acquirer. Accordingly, guidance on when the acquirer will need to look to other information to measure the fair value of the acquiree as well as how to measure fair value is extremely important if the Boards' proposed model is to be operational.

While we acknowledge and support the Boards' efforts to provide fair value measurement guidance in the implementation section of the proposed Standards and the FASB's separate project on Fair Value Measurement, we still have concerns about the reliability of the resulting information in certain situations. The proposed guidance is at a very high level with little in the way of operational guidance. Many of those concerns were articulated in KPMG LLP's comment letter on the FASB's project on Fair Value Measurements.

Consistent with our recommendation on the FASB's project on Fair Value Measurement, we believe that the Boards should work actively with the PCAOB, the Valuation Resource Group and others to ensure that, if the model proposed is retained, the guidance for valuing an acquiree is operational, diversity in valuation practice is minimized, and the resulting information is sufficiently reliable.

Additionally, if the Boards adopt an economic entity approach and the resulting full fair value model, we believe that the Boards should provide specific guidance on the identification and measurement of control premiums and buyer-specific synergies that arise in business combinations and when the acquirer should look to measures other than “grossed up” consideration paid to measure the fair value of the acquired entity.

2.3.2.1 **Presumption that consideration exchanged represents fair value**

We agree with the Boards' conclusion that the acquisition of 100 percent of an entity in a single transaction should be recognized based on the consideration exchanged. Although we note that in such transactions, the price paid may not be consistent with the Boards' definition of fair value. In an acquisition of 100 percent of an entity, the buyer often will be paying for buyer-specific synergies as part of the purchase price. Since buyer-specific synergies are not available to marketplace participants, the price paid by the buyer could exceed the fair value of the business as defined by the Boards.
Additionally, we are concerned that the collective guidance in the proposed Statements, including the implementation guidance and the basis for conclusions, creates a presumption that a "gross up" of the consideration exchanged in a partial acquisition is the best basis to measure the fair value of the acquiree as a whole. We believe that such a presumption is inappropriate. It is our experience that most, if not all, business combinations, including partial acquisitions, include a control premium. This control premium should be considered when determining the fair value of the acquiree. Additionally, the purchase price paid by the acquirer will typically include some portion of the buyer-specific synergies that the buyer expects to realize. The amount of the consideration paid by the buyer that represents the buyer-specific synergies is difficult to quantify in many business combinations. Accordingly, we believe that extrapolating the exchange price in a partial acquisition to estimate the fair value of the acquiree, as suggested by the implementation guidance, may not be representative of the fair value of the acquiree in some business combinations. It appears that the Boards provided this guidance as a practicality exception but doing so would effectively override the proposed requirement to measure and recognize the full fair value of the acquiree. Accordingly, while we do not support the proposal, if the Boards retain the proposed model, we believe that the Boards should remove the presumption that for a partial acquisition the exchange price is the best evidence upon which to base the measurement of the full fair value of the acquiree.

Further, if the Boards' proposal is to be operational, we believe that additional implementation guidance is required in the standard. Specifically, the Boards should provide guidance about the types of evidence and the evaluation of that evidence that indicates that the exchange price is not the best basis for measuring the full fair value (i.e., when the presumption would be overcome). In Example 1 (paragraphs A12 and A13), the exchange price presumption is not overcome and, therefore, the exchange price is extrapolated to calculate the fair value of the acquiree as a whole. We disagree with the example's conclusion and believe that there is likely a control premium and buyer-specific synergies that should be considered when measuring the full fair value of the acquiree, and note that this example does not explain the rationale for not overcoming the exchange price presumption. In contrast, the exchange price presumption is overcome in Example 3 (paragraphs A15-A17); however, the example is not useful in determining how the presumption is overcome. We believe that the Boards must provide guidance about the evidence that would overcome the exchange price presumption for a partial acquisition and how fair value of the acquiree would be measured in such circumstances. Additionally, we believe that the list in paragraph A18 should be expanded to include other common situations for which the exchange price is not the best basis to measure the full fair value of the acquiree.

If there is no presumption that the exchange price is the best evidence of full fair value of the acquiree in a partial acquisition, an acquirer will use valuation techniques. The Boards should consider the costs of using these other valuation techniques in relation to the perceived benefits when performing its cost/benefit analysis of requiring the economic entity and full fair value approaches.

2.3.3 Question 5—Is the acquisition-date fair value of the consideration transferred in exchange for the acquirer's interest in the acquiree the best evidence of the fair value of
that interest? If not, which forms of consideration should be measured on a date other than the acquisition date, when should they be measured, and why?

We generally agree with the Boards' conclusion that the acquisition-date fair value of the consideration transferred should be used to account for the portion of an entity acquired in a business combination because we believe that the business combination should be accounted for using a cost accumulation approach. Further, we agree that the fair value of contingent consideration based on security prices can be reliably measured on the acquisition date and should be part of the acquisition cost. Such consideration should subsequently be accounted for in accordance with applicable GAAP (e.g., Statement 133, IAS 39).

However, we believe that contingent consideration based on the acquiree's earnings levels or other performance measures (performance-based contingent consideration) should be included in the acquisition price on the date of acquisition only if payment is probable at acquisition.

We believe that performance-based contingent consideration generally is not reliably measurable at the acquisition date. In our experience, such contingent consideration is often agreed to because the buyer and seller were unable to reach an agreement as to the fair value of the entity. As a consequence, we question the ability to reliably measure the fair value of such contingent consideration at the acquisition date in most cases. Rather, we believe that such amounts should be recognized as an adjustment to acquisition accounting when the amounts are probable of being paid. We acknowledge that this will require the Boards to reach agreement on a common threshold for recognition and a common treatment when it is recognized (i.e., retrospective vs. an adjustment to purchase consideration in the period of recognition).

We agree with the Boards conclusion that the consideration paid should be measured at the acquisition date since that is the date when the transaction is being recognized in the financial statements. We acknowledge that this conclusion would result in a change in US GAAP (i.e., EITF 99-12).

2.3.4 Question 6 - Is the accounting for contingent consideration after the acquisition date appropriate? If not, what alternative do you propose and why?

As discussed in our response to Question 5, we believe that performance-based contingent consideration and security price-based contingent consideration should be accounted for differently at the acquisition date and, as a result, the accounting after the acquisition date also should be different.

For security price-based contingent consideration, consistent with existing guidance in IFRS 3, we agree with the Boards' conclusion that subsequent changes in the fair value that do not qualify as measurement period adjustments should be accounted for as follows - (1) equity-classified contingent consideration should not be remeasured and (2) liability-classified contingent consideration should be accounted for under applicable GAAP (e.g., Statement 133 or IAS 39).
We believe that performance-based contingent consideration should be recognized as an adjustment to acquisition accounting when payment is probable. Because of concerns about reliability of measurement (as discussed in our response to Question 5) and the fact that period-to-period fair value changes based on unreliable measures will impact earnings comparability, we believe that it is not appropriate for the acquirer to recognize changes in the estimated fair value of performance-based contingent consideration in earnings, rather those changes should be recognized as adjustments to acquisition accounting.

However, if the Boards decide to issue Statements based on the proposed model, we believe that additional guidance should be provided on the interaction of performance-based contingent consideration and the measurement period. The proposed standard defines the measurement period as "the period after the acquisition date during which the acquirer may adjust the provisional amounts recognized at the acquisition date in accounting for a business combination." The measurement period ends as soon as the acquirer receives all the necessary information that existed at the acquisition date or learns information is not obtainable. However, the measurement period does not exceed one year. The proposed standard is unclear whether changes in the estimated fair value of performance-based contingent consideration due to progress towards the performance measure are considered measurement period adjustments. As we noted earlier, contingent consideration often is agreed to because the buyer and seller are unable to reach an agreement as to the fair value of the entity. We believe that the resolution of a performance contingency confirms the value that existed at the acquisition date and therefore should be recognized as an adjustment to acquisition accounting.

2.3.5 Question 7—Do you agree that the costs that the acquirer incurs in connection with a business combination are not assets and should be excluded from the measurement of the consideration transferred for the acquiree? If not, why?

We believe that the accounting for business combinations should continue to be based on a "cost accumulation" approach. Whether transaction costs are included in the purchase price for a business combination does not affect our overall conclusion that, upon acquisition of control, all identifiable assets and liabilities should be recognized at their fair values and the difference between the purchase price and the acquirer's ownership in the fair value of those identifiable net assets should be recognized as goodwill. However, we note that the Boards' conclusion that transaction costs be expensed would create an inconsistency in the treatment of these costs in a business combination versus an acquisition of assets. Accordingly, we believe the Boards should initiate a separate project that would address these inconsistencies and provide a single standard for the accounting for costs associated with asset acquisitions under a cost-accumulation approach (e.g., available-for-sale securities, equity-method investments, tangible and intangible assets acquired outside of a business combination).

2.4 Measuring and Recognizing the Assets Acquired and the Liabilities Assumed

2.4.1 Question 8—Do you believe that these proposed changes to the accounting for business combinations are appropriate? If not, which changes do you believe are inappropriate, why, and what alternatives do you propose?
We agree that receivables (including loans) acquired in a business combination should be recognised at fair value and that no separate valuation allowance should be recognised for uncollectible amounts. We observe that the FASB states in BC113 that "in determining the fair value of receivables any uncertainties about the collectibility of receivables should affect their fair value." In our view, this is not a significant change from how the guidance in current IFRS 3 generally is interpreted; however, we recognize that this may result in a change for certain U.S. companies.

We also agree that contingent assets and liabilities should be recognized at fair value in a business combination. In our view, a different treatment for contingent assets and liabilities acquired or assumed, in a business combination vs. the treatment for contingent assets and liabilities arising outside a business combination, is acceptable and is consistent with existing guidance under IFRS.

We agree that costs associated with restructuring or exit activities that do not meet the recognition criteria in Statement 146 and IAS 37 as of the acquisition date are not liabilities at the acquisition date and should be expensed as incurred, consistent with accounting under current IFRS.

Additionally, we agree with the proposed change to current US GAAP to eliminate the requirement to measure and immediately expense IPR&D assets acquired in a business combination. We concur with the FASB's observation in B142 that the current requirement results in information that is not representationally faithful of the assets acquired in a business combination. We also note that the proposed treatment is consistent with current IFRS. However, we believe that the FASB will need to address the accounting for IPR&D for transactions that do not constitute business combinations and are accounted for as the acquisition of assets.

2.4.2 Question 9—Do you believe that these exceptions to the fair value measurement principle are appropriate? Are there any exceptions you would eliminate or add? If so, which ones and why?

We generally believe the exceptions to the fair value measurement principle listed in paragraphs 42 through 51 of the proposed Statement are appropriate.

To promote consistent application of the standards, we also recommend that the IASB explicitly states in paragraph 43 of its proposed amendments to IFRS 3 that assets held for sale should be measured at fair value less cost to sell for assets meeting the requirements of IFRS 5 to be classified as held for sale.

2.5 Additional Guidance for Applying the Acquisition Method to Particular Types of Business Combinations

2.5.1 Question 10—Is it appropriate for the acquirer to recognise in profit or loss any gain or loss on previously acquired noncontrolling equity investments on the date it obtains control of the acquiree? If not, what alternative do you propose and why?
We agree with the Boards' conclusion that obtaining control is an event that should trigger remeasurement, but only of the identifiable net assets rather than of the acquirer's investment in the investee. We also agree with the Boards' reasoning in BC 151, "a change from holding a non-controlling investment in an entity to obtaining control of that entity is a significant change in the nature of the economic circumstances surrounding the investment. That change warrants a change in the classification and measurement of the investment." Therefore, in our view, obtaining control justifies the recognition of identifiable assets and liabilities at fair value. As stated in our response to Question 1, we do not believe that the acquirer should recognize the full fair value of the acquiree.

Additionally, we disagree with the Boards' conclusion that unrealised gains on remeasurement should be recognised in earnings. Rather, we support the alternative view that "The acquirer has obtained rights to direct the use of the underlying net assets of acquiree as a result of the purchase of an additional investment that achieves a controlling interest. It has not disposed of the original investment, and it is therefore inappropriate to reclassify past gains or losses on that investment to profit or loss, as would be done if they were realized by disposal." Therefore, we believe that the adjustment for the remeasurement of an existing investment in an acquirer related to the identifiable net assets should be recognised in equity, which is consistent with the current accounting under IFRS 3.

We recognise that there is no consistent principle for recognition of unrealised gains under existing authoritative literature. For example, some IFRSs and US standards require recognition of unrealized gains in profit or loss, others directly in equity, and in some cases gains recognised in equity would be recycled on disposal/derecognition. Until the issues related to remeasurement, including recognition in equity and recycling, have been addressed, we believe that remeasurement gains when control is obtained should be recognised in equity on the date of the acquisition consistent with the approach in current IFRS 3. Any indicated loss on the pre-existing investment should trigger an impairment evaluation using the appropriate impairment model for the pre-existing investment. If the application of the appropriate impairment model does not trigger the recognition of the loss in earnings, the loss should be recognised in equity. The Boards should provide guidance on whether this equity component is subject to 'recycling' upon disposition of some or all of the investment in the acquired entity.

2.5.2 Question 11—Do you agree with the proposed accounting for business combinations in which the consideration transferred for the acquirer's interest in the acquiree is less than the fair value of that interest? If not, what alternative do you propose and why?

Consistent with the current approach in IFRS 3, we believe that an excess of an acquirer's interest in the net fair value of an acquiree's identifiable net assets over cost should be recognized in income on the acquisition date. However, in situations where a portion of the purchase price has been assigned to intangible assets that are not measured by reference to an active market, we believe that those intangible assets should first be reduced to zero before any gain is recognised in profit and loss.
If the Boards proceed with the proposals, we agree that goodwill should be reduced to zero for business combinations in which the consideration transferred for the acquirer’s interest in the acquiree is less than the fair value of that interest. We also agree that any remaining excess should be recognized in income on the acquisition date. We believe it is a practical approach to dealing with circumstances in which it is not clear whether a business combination is a bargain purchase or whether ‘negative goodwill’ arises as a result of measurement errors or measurement bias.

However, we believe that the Boards should consider providing additional guidance when negative goodwill occurs in a business combination with performance-based contingent consideration.

2.5.3 Question 12—Do you believe that there are circumstances in which the amount of an overpayment could be measured reliably at the acquisition date? If so, in what circumstances?

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

2.6 Measurement Period

2.6.1 Question 13—Do you agree that comparative information for prior periods presented in financial statements should be adjusted for the effects of measurement period adjustments? If not, what alternative do you propose and why?

We disagree that comparative information for prior periods presented in financials statements should be restated as a result of measurement period adjustments. We believe that measurement period adjustments should be reported in the period those adjustments are made consistent with the accounting for a change in estimate.

IAS 8 and Statement 154 distinguish between corrections of errors and changes in estimates. The Exposure Drafts appear to treat the measurement period adjustments as if they were errors. However, if the provisional fair values were estimated on a reasonable basis, the measurement period adjustments would not meet the definition of ‘prior period errors’ in IAS 8 and Statement 154. We, therefore, would expect such adjustments to be treated as changes in estimates.

2.7 Assessing What is Part of the Exchange for the Acquiree
2.7.1 **Question 14**—Do you believe that the guidance provided is sufficient for making the assessment of whether any portion of the transaction price or any assets acquired and liabilities assumed or incurred are not part of the exchange for the acquiree? If not, what other guidance is needed?

We agree with the Boards’ conclusion that only the consideration transferred and the assets acquired or liabilities assumed or incurred that are part of the exchange for the acquiree should be included in the business combination accounting. Any portion of the transaction price or any assets acquired or liabilities assumed or incurred that are not part of the exchange for the acquiree should be accounted for separately from the business combination. While this will involve judgment (e.g., determining the settlement amount for pre-existing litigation), we consider the guidance provided in paragraphs A87-A109 to be helpful. We acknowledge that this may result in the recognition of either gains or losses in profit and loss by the acquirer as illustrated in paragraph A92.

We disagree, however, with the guidance provided in paragraph A93. That guidance would require the recognition of a separately-identifiable intangible asset when the pre-existing relationship is a contract that had previously granted the acquiree with the right to use the acquirer's intangible assets (e.g., the right to use the acquirer's trade name under a franchise agreement). Application of the guidance in paragraph A92 results in a settlement of that pre-existing relationship. As a consequence, subsequent to the settlement, the acquiree no longer has an identifiable intangible asset. To the extent that an identifiable intangible asset continues to exist subsequent to the acquisition date, it is an asset of the acquirer. Because acquisition accounting only applies to the assets and liabilities of the acquiree, we believe it is inappropriate to recognize such reacquired rights as separately-identifiable intangible assets in a business combination. If the Boards proceed as proposed, then we believe that it should be clarified as to how the acquirer estimates the useful life (and the amortisation) of the reacquired intangible asset.

2.8 **Disclosures**

2.8.1 **Question 15**—Do you agree with the disclosure objectives and the minimum disclosure requirements? If not, how would you propose amending the objectives or what disclosure requirements would you propose adding or deleting, and why?

We agree with the Exposure Drafts’ overall disclosure objectives which do not represent a change to the current provisions in IFRS 3. We believe that the disclosure objectives provide a useful reference point in providing information about the financial effects of a business combination. Refer to our response to Question 18 for comments on certain specific disclosure requirements.
We also agree with the IASB's decision to remove the disclosures currently required by IFRS 3 for the carrying amounts for each class of the acquiree's assets and liabilities determined in accordance with IFRSs immediately before the combination. We believe that this disclosure is very costly if the acquiree is not an IFRS preparer and we believe that the information is not useful.

If the Boards issue a Statement that is consistent with our proposed model, which is based on a parent company approach, the Boards should re-evaluate the need for certain disclosures including paragraphs 72c., 72 f.(6), and 72 j.

2.9 The IASB's and the FASB's Convergence Decisions

2.9.1 Question 16—Do you believe that an intangible asset that is identifiable can always be measured with sufficient reliability to be recognised separately from goodwill? If not, why? Do you have any examples of an intangible asset that arises from legal or contractual rights and has both of the following characteristics:
(a) the intangible asset cannot be sold, transferred, licensed, rented, or exchanged individually or in combination with a related contract, asset, or liability; and
(b) cash flows that the intangible asset generates are inextricably linked with the cash flows that the business generates as a whole?

We agree with the proposal to achieve convergence between IFRS and US GAAP by removing the requirement that an intangible asset be reliably measurable to be recognised separately from goodwill under IFRS 3. In our experience, the fair value of identifiable intangible assets acquired in a business combination can be measured with sufficient reliability to be recognised separately from goodwill. Additionally, we believe that the IASB should clearly explain that this guidance differs from the guidance in the Framework which requires that amounts be reliably measurable and that preparers cannot look to the Framework to override the conclusions in IFRS 3. Finally, the IASB should consider the conclusions in IAS 38.BC19-BC25 and explain how and why its views now differ from those previously expressed.

We also agree that an assembled workforce acquired in a business combination should not be recognized as an intangible asset separately from goodwill.

2.9.2 Question 17—Do you agree that any changes in an acquirer's deferred tax benefits that become recognisable because of the business combination are not part of the fair value of the acquiree and should be accounted for separately from the business combination? If not, why?
We agree that the acquirer's deferred tax assets that become recognizable as a result of the business combination are not part of the fair value of the acquiree and, therefore, should be accounted for separately from the business combination. This is consistent with the principle in the Exposure Drafts that only those assets and liabilities that are part of the exchange for the acquiree should be included in the accounting for that business combination. This treatment also is consistent with the concept that entity specific valuation criteria (as opposed to any other marketplace participant's criteria) should not be considered in the determination of the acquiree's fair value.

We believe that in certain instances the acquirer may pay more than other market participants to obtain control of the acquiree to utilize its own deferred tax assets. In those instances, specifically from a US GAAP perspective, it is unclear whether a portion of the consideration should be attributed to the future utilization of acquirer's deferred tax benefits or whether the change in the valuation allowance for the acquirer's deferred tax assets always should be recognized in earnings. We recommend that the Boards consider providing additional guidance to address this issue.

Additionally, we agree with the Boards' decision not to require deferred tax assets and liabilities acquired in a business combination be measured at fair value. The Boards acknowledge that accounting at fair value as of the acquisition date and then accounting in accordance with Statement 109 and IAS 12 in subsequent periods would result in post combination gains and losses. However, the Boards propose to recognize post combination gains or losses when the acquirer's valuation allowance (or previously unrecognized deferred tax assets under IAS 12) changes in subsequent periods if these changes occur after the measurement period. We propose to apply consistent accounting for all changes of the acquiree's valuation allowance regardless of whether the changes occur before or after the measurement period. As a result, changes would be accounted for as part of the business combination rather than post combination gains or losses. Consequently, we disagree with the amendments proposed to paragraph 30 of Statement 109 and to paragraph 68 of IAS 12, whereby future changes to the valuation allowance subsequent to a one-year period after the acquisition date would be recognized in income, rather than as an adjustment to goodwill. Since deferred tax assets are not measured at fair value, we believe future reductions in the valuation allowance, including those that occur after a one-year period, should be applied first to reduce goodwill to zero before being recognized in income tax expense.

2.9.3 Question 18—Do you believe it is appropriate for the IASB and the FASB to retain those disclosure differences? If not, which of the differences should be eliminated, if any, and how should this be achieved?
We believe that the Boards should strive to eliminate as many differences in disclosure requirements as possible. However, we acknowledge that some differences in disclosure requirements are inevitable as long as there are IFRS/US GAAP differences. For example, we believe that it would not be appropriate at this time to eliminate the difference in disclosure requirements relating to paragraph 78(b). This difference is a consequence of differences in the standards dealing with impairment under IFRS and US GAAP. Therefore, we believe that this difference should be retained until the time that the Boards converge on the accounting for impairments.

With respect to the pro forma information that would be required by paragraph 74(b), we understand that the FASB's disclosure requirements are unaudited information whereas the IASB's required disclosures would be audited. We believe it is inappropriate for the acquirer to be required to provide audited pro forma information since this includes information for periods prior to the date when the acquirer obtained control over the acquiree.

2.10 Style of This Exposure Draft

2.10.1 Question 19—Do you find the bold type-plain type style of the Exposure Draft helpful? If not, why? Are there any paragraphs you believe should be in bold type, but are in plain type, or vice versa?

We support the use of the bold type-plain type style of the presentation in the Exposure Draft. We believe that the distinction between principles (bold-letter paragraphs) and explanations and/or additional guidance (grey-letter paragraphs) is useful and facilitates understanding of the standards.
3 Noncontrolling Interests in Subsidiaries

3.1 Reporting Noncontrolling Interests in the Consolidated Statement of Financial Position

3.1.1 ARB 51 Question 1—Do you agree that the noncontrolling interest is part of the equity of the consolidated entity? If not, what alternative do you propose and why?

ARB 51 Question 2—Do you agree with the proposed requirement to present the noncontrolling interest in the consolidated statement of financial position within equity, separately from the parent shareholders’ equity? If not, what alternative do you propose and why?

We do not object to the proposal that noncontrolling interests be included in consolidated equity if presented separately from the parent company's equity. With respect to this proposal, we believe that classification of noncontrolling interests in equity should only relate to presentation as we believe that the economic entity approach is not an appropriate basis for preparing consolidated financial statements of the parent company.

We also agree that noncontrolling interests should be presented separately from the equity attributable to shareholders of the parent. We observe that shareholders representing noncontrolling interests have rights very distinct from the shareholders of the parent. Noncontrolling interests represent equity claims that are restricted to particular subsidiaries, whereas the shareholders of the parent have equity claims on the entire consolidated group. Paragraph 6 of the Exposure Draft of the proposed replacement of ARB 51 clarifies that "The purpose of consolidated financial statements is to present, primarily for the benefit of the shareholders and creditors of the parent, the results of operations and the financial position of a parent and all its subsidiaries as if the group were a single economic entity." Accordingly, we believe that presenting noncontrolling interest as a separate component of equity is important for consolidated financial statements to meet their purpose of providing useful information about the parent company.

However, classification of noncontrolling interests in equity should only relate to presentation and should not affect the accounting for transactions with the noncontrolling interests. That is, we believe that the economic entity approach is inappropriate for consolidated financial statements. We also believe that the Boards have concluded that information resulting from the parent company approach is important to the users of consolidated financial statements as evidenced by the numerous disclosure requirements that are consistent with the parent-company approach.

3.2 Attributing Consolidated Net Income and Consolidated Comprehensive Income to the Controlling and Noncontrolling Interests

3.2.1 ARB 51 Question 3, IAS 27 Question 4—Do you agree with the proposed requirements for attributing net income or loss and the components of other comprehensive income to
We agree that net income and loss and each component of other comprehensive income should be attributed to the controlling and noncontrolling interests based on relative ownership interests unless contractual arrangements require a different attribution between them. In that case, net income and loss should be attributed based on those contractual terms. Additionally, we do not object to attributing losses to the noncontrolling interests even when those losses exceed the noncontrolling interest in the subsidiary's equity.

We recommend the Boards require disclosure of summarised financial information of those subsidiaries in which the noncontrolling interests are recognised as a deficit, either individually or in groups, including the amount of total assets, total liabilities and the noncontrolling interests' proportionate interest.

3.3 Changes in Ownership Interests in a Subsidiary

3.3.1 ARB 51 Question 4, IAS 27 Question 1—Do you agree that changes in ownership interests in a subsidiary after control is obtained that do not result in a loss of control should be accounted for as equity transactions? If not, what alternative do you propose and why?

As noted in our response to Questions 1 and 2, while we do not object to the proposal that noncontrolling interests be included in consolidated equity if presented separately from the parent company's equity, we believe that an economic entity approach is not an appropriate basis for preparing the consolidated financial statements of the parent company. The noncontrolling interests are not equity holders in the parent entity, and therefore transactions with the noncontrolling interest should not be treated as transactions between equity holders.

We propose a model that is consistent with current practice in the US whereby transactions, either directly or indirectly, that result in a reduction of the parent-company's ownership interest while retaining control should be recognized in earnings (with the possible inclusion of any recycled equity recorded from the initial business combination). Further, additional direct or indirect investments in a consolidated subsidiary should be treated as acquisitions of additional interest in the subsidiary. Under IFRSs, diversity in practice currently exists on the accounting for these additional investments in controlled subsidiaries. As described more fully in Appendix E to this letter in the form of an extract from KPMG's IFRS accounting guidance, we believe there are several approaches which are currently acceptable. Accordingly, if the Boards accept our proposal to adopt a converged model based primarily on current IFRS 3, the Boards should provide guidance on the accounting for these subsequent acquisitions to address that diversity in practice. Consistent with our view on sale transactions, we believe that such transactions should result in a change in goodwill and not in a remeasurement of identifiable assets and liabilities.

3.4 Loss of Control of Subsidiaries
3.4.1 **ARB 51 Question 5, IAS 27 Question 2—**Do you agree that any gain or loss resulting from the remeasurement of a retained investment in a former subsidiary should be recognized in income of the period? If not, what alternative do you propose and why?

We disagree with the Boards' proposal that loss of control should give rise to a remeasurement of the remaining investment at fair value with the adjustment recognized in profit or loss. We believe that upon the loss of control, gains and losses should be recognized for the portion of the investment that is sold. Any remaining investment would retain its carrying amount at that date and would be accounted for subsequently in accordance with appropriate existing GAAP (e.g., equity method investment, available-for-sale security, trading security).

We agree that loss of control of a subsidiary is a significant economic event. However, we do not believe that such an event, in and of itself, justifies the recognition of revaluation gains and losses. Instead we propose that when control of a subsidiary is lost, any remaining investment initially should be recorded based on the proportionate retained interest of the net carrying amount of the former subsidiary at that date and would be accounted for subsequently in accordance with appropriate existing GAAP. Our recommendation is consistent with the existing requirement in IAS 27.32 that "The carrying amount of the investment at the date that the entity ceases to be a subsidiary shall be regarded as the cost on initial measurement of a financial asset in accordance with IAS 39."

As stated in our response to the Business Combinations Exposure Draft question 10, we do not believe that a gain or loss on remeasurement of the retained investment should be recognised in profit and loss. Therefore, if the Boards decide to continue with their proposals, we believe that such a gain or loss should be recognised directly in equity.

In addition, we note that the IASB proposes extending the remeasurement for the retained investment on loss of control of a subsidiary to events or transactions in which an investor loses significant influence or joint control over an entity. The FASB decided that these issues are beyond the scope of the Business Combinations Project as explained in paragraph B34 of the Exposure Draft of revised ARB 51. For that same reason we believe the IASB should follow the same approach.

3.4.2 **ARB 51 Question 6, IAS 27 Question 3—**Do you agree with the proposed guidance for determining whether multiple arrangements should be accounted for as a single arrangement? If not, what alternative do you propose and why?

In accordance with our proposal that the Boards adopt a converged model based in large part on the IFRS 3, with improvements to address certain existing practice issues associated with its application, we believe that guidance on multiple arrangements as currently proposed is not required. Our proposal would require an entity to recognize gains and losses on the portion of a subsidiary that is sold, regardless of whether control is retained. Any remaining investment in that entity would retain its carrying amount. Accordingly, the concerns about structuring transactions around a change of control to achieve an accounting result do not exist under our proposal.
However, if the Boards decide to issue a Statement based on the proposed model, we generally agree with the guidance for determining whether multiple arrangements should be accounted for as a single arrangement. However, we believe that the factor in paragraph 29b is not helpful when the other factors are considered and, therefore, we believe that factor should be removed.

3.5 Reporting Earnings per Share

3.5.1 ARB 51 Question 7 – Do you agree that earnings per share amounts should be calculated using only amounts attributable to the controlling interest? If not, what alternative do you propose and why?

Consistent with our view that the parent-company approach results in more useful information to the users of the consolidated financial statements, we agree that basic and diluted earnings per share amounts should be calculated using only amounts attributable to the controlling interest. In this regard, we concur with the FASB's conclusion that earnings per share information is for the benefit of the common equity holders of the parent (i.e., the reporting entity)—a conclusion consistent with the parent-company view.

3.6 Disclosures

3.6.1 ARB 51 Question 8 – Do you agree that disclosure of the total amounts of consolidated net income and consolidated comprehensive income, and the amounts of each attributable to the controlling interest and the noncontrolling interest should be required? If not, why?

We agree that a parent company with one or more partially-owned subsidiaries should disclose the total consolidated net income and total consolidated comprehensive income, and the amounts of each that are attributable to the controlling interest and noncontrolling interest, separately on the face of the financial statements. Such disclosures are necessary because noncontrolling interests in subsidiaries have no interest in the equity of the parent.

Additionally, paragraph 30 of the proposed Statement should clarify whether the disclosure requirements apply to both interim and annual financial statements.

3.6.2 ARB 51 Question 9 – Do you agree that disclosure of the amounts attributable to the controlling interest should be required? If not, why?

We agree that a parent with one or more partially-owned subsidiaries should separately disclose the various components of the entity's income statement (and statement of comprehensive income) that are attributable to the controlling interest and noncontrolling interests. We believe such disclosures provide relevant information to users of the consolidated financial statements.

Additionally, we believe that the standard should require any cumulative effect adjustment for a change in accounting principle recognized directly in retained earnings to be included in the reconciliation of the noncontrolling interests equity that is proposed in paragraph 30(c).
Additionally, paragraph 30 of the proposed Statement should clarify whether the disclosure requirements apply to both interim and annual financial statements.

3.6.3 ARB 51 Question 10—Do you agree that a reconciliation of the changes in the noncontrolling interest should be required? If not, why?

We agree that if noncontrolling interests are included as an element of equity, then a reconciliation of the changes in the noncontrolling interests should be provided with the statement of changes in equity. We agree with the FASB's observation in paragraph B39 that users of financial statements will continue to be interested in amounts attributable to controlling interest since it is the shareholders of the parent company who are the primary users of those consolidated financial statements.

3.6.4 ARB 51 Question 11—Do you agree that disclosure of a separate schedule that shows the effects of any transactions with the noncontrolling interest on the equity attributable to the controlling interest should be required? Please provide the basis for your position.

We believe that this information should be provided but we do not agree that a separate schedule that shows the effects of any transactions with the noncontrolling interests on the equity attributable to the controlling interest needs to be provided. Rather, this information should be included within the statement of changes in equity along with other changes in equity items. We agree with the FASB's observation in paragraph B39 that users of financial statements will continue to be interested in amounts attributable to controlling interest since it is the shareholders of the parent company who are the primary users of those consolidated financial statements.

We note that the disclosures referred to in both Questions 10 and 11 are provided for the purpose of providing users of the financial statements with information to evaluate the performance of the parent company's controlling interest. If the Boards believe the economic entity concept provides more decision-useful information to financial statement users, we question why the disclosures related to the controlling interest are required. As we have discussed earlier in our comment letter, we believe that the parent-company approach results in more useful information to the users of the consolidated financial statements than the economic entity approach.

However, if the Boards decide to issue a Statement based on the proposed model, we disagree with the FASB's conclusion that an entity that presents earnings per share data should be required to also disclose an additional per-share metric that includes the effects of any equity transactions with the noncontrolling interests. To do so is inconsistent with the Boards' conclusion that such transactions are equity transactions that should not result in the recognition of profit or loss.

3.6.5 ARB 51 Question 12—Do you agree that disclosure of the gain or loss recognized on the loss of control of a subsidiary should be required? If not, why?
As discussed in our response to Questions 5 and 6, we believe that a gain should not be recognized on the portion of the investment that is retained. Nonetheless, we agree that entities should be required to disclose gains or losses recognized on loss of control of a subsidiary if those amounts are material to the financial statements. Upon the loss of control, gains or losses should be recognized only for the portion of the investment that is disposed. Any remaining investment initially should be recognized based on its proportionate interest of the net carrying amount of the former subsidiary and would be accounted for subsequently in accordance with appropriate existing guidance (e.g., equity method, available-for-sale investment, trading security). If the Boards' follow our proposal, we do not think that there is a need for any additional disclosure requirements beyond those that exist currently with respect to these transactions.

3.7 Transition

3.7.1 ARB 51 Question 13, IAS 27 Question 5 — Do you agree with the proposed transition requirements? If not, what alternative do you propose and why?

We agree with the proposed transitional provisions.
Appendix B: Other comments related to IFRS 3 (Comments of KPMG's International Financial Reporting Group in London)

4 Business Combinations

**Paragraph 56**

It is our understanding that the last sentence only applies to adjustments that can be recycled under existing Standards as, for example, IASs 21 and 39; i.e., not to revaluation of property, plant and equipment in equity accounted investments. We recommend this to be clarified.

**Appendix A: Application Guidance**

**Paragraph A62**

We recommend that the Boards clarify that the statement "[T]he goodwill allocated to the acquirer shall not exceed the total goodwill calculated in accordance with paragraph 49' does not apply in case of an overpayment. If not, the result would be that noncontrolling interests in some instances would be recognised at an amount less than their proportionate share of identifiable net assets. In our view, this would not be appropriate.

**Paragraph A94-A96**

We appreciate that the example illustrates the guidance in paragraph A92. We believe, however, that the accounting entries in example 13 are difficult to understand and recommend the Boards to clarify the 'debits and credits'.

4.1 Appendix E: Fair Value Measurements

We acknowledge that the IASB may change the proposed guidance either when the FASB issues its final Statement on Fair Value Measurement or as a result of the Board's fair value measurements project. We therefore are not commenting on the proposed guidance. Nevertheless, we believe that there are some issues that the IASB should consider when finalising the IFRS.

Firstly, we believe that any fair value guidance for business combinations should be consistent with the guidance in other IFRSs. The proposed guidance would introduce a different concept of fair value in business combinations than the concept that would apply under, for example, IAS 39.
Secondly, we believe that guidance on fair value measurements also should address practical issues as, for example, whether fair value is determined on a pre-tax or a post-tax basis when valuation techniques are applied, whether an entity should consider future profit margin when determining fair value, and how fair value should be determined for individual assets and liabilities when acquired in a business combination. In relation to the latter, we observe that fair value of a loss-making business may be lower than the fair value of acquired identifiable assets and liabilities, if those assets and liabilities are measured as individual assets and liabilities. However, if an asset is an integrated part of the business, then the fair value, in our view, should be determined on a basis that the asset is acting as part of that business and not, for example, sold separately because such an approach would disregard the fact that the disposal of individual assets in the market may result in lay-offs and impairment of other assets (e.g., aircrafts will lose value if the landing rights are sold).
Appendix C: Consequential amendments to other IFRSs (Comments of KPMG’s International Financial Reporting Group in London)

5 IFRS 1

Appendix D2 of the ED proposes to amend IFRS 1 as follows:

“In Appendix B, paragraphs B1 and B2(g)(ii) are deleted.”

We understand that the intention of this proposed amendment is that a first-time adopter that applies the revised IFRS 3 is not able to apply IFRS 3 retrospectively i.e., business combinations which occurred before the date of transition cannot be restated using IFRS 3. In other words, the entity’s Previous GAAP business combination accounting is retained, subject to the requirements of IFRS 1.B2. This is a significant change to the current IFRS 3 and IFRS 1 which permit an entity to apply IFRS business combination accounting to earlier combinations.

The Board has not explained this significant change in the Basis for Conclusions. We assume that the Board is concerned at the potential use of hindsight that may be required to apply the proposed IFRS 3, IAS 27, IAS 37 to earlier combinations. For example, in the Basis for Conclusion to the proposed IAS 37 (BC92), the Board indicates that retrospective application of IAS 37 is likely to be impracticable as the IAS 37 ED would require the recognition of non-financial liabilities that were previously not recognised and an entity generally would not have collected the information necessary to apply the standard.

The concerns regarding availability of business combination information are discussed in paragraphs BC32 of the current IFRS 1. Paragraph BC33 of this standard expresses the opposing concern, that business combinations have a long lasting impact, previous GAAP accounting for acquisitions may be significantly different to IFRSs and may fail to provide useful information. The Board concludes in BC34 that the restatement of past business combinations is conceptually preferable.

We believe these continue to be valid concerns and do not believe the option to restate previous business combinations should be eliminated as proposed in this ED. If the Board has concerns with specific elements of the application of these EDs (IFRS 3, IAS 27 and IAS 37) to earlier combinations, our preference is for the Board to consider limited exemptions or exceptions to their retrospective application to avoid the need for hindsight, rather than to completely remove the option of earlier application.

Whatever approach is adopted, the final standard that consequentially amends IFRS 1 also must consequentially amend the Basis for Conclusions of that standard to explain adequately the Board’s (revised) conclusions.

Finally, the transitional requirements for the application of IAS 21 by a first-time adopter to fair value adjustments and goodwill will require reconsideration by the Board as IFRS 1.B1B(b)
continues to make references "all business combinations that the entity elects to restate to comply with IFRS 3, as permitted by paragraph B1 above."

**Drafting points**

If the Board finalises the standard consistent with the proposals, the following drafting amendments are required:

- The introduction to IFRS 1.B2 continues to say "If a first-time adopter does not apply IFRS 3 retrospectively....". The reference should be amended.
- IFRS 1.B3, which allows the exemption to be applied to past acquisitions of investments in associates and of interest in joint ventures, will also need to be amended.
- Finally, as noted above, the Basis for Conclusions of IFRS 1 will require consequential amendment to explain the Board's conclusions.

**IFRS 2**

We note that certain aspects of the application guidance are inconsistent with the requirements in IFRS 2.26-29 for accounting for modifications to equity-settled share-based payment arrangements. We have concerns about some, but not all aspects of the proposals.

Specifically, we note paragraph A103(a) of the ED requires that on the acquisition date, the acquirer recognises as an expense in the post-combination profit or loss any excess of the fair value of the replacement awards over the replacement date fair value of the original award (termed "incremental fair value" as in IFRS 2). It is not clear to us why the Board required immediate recognition of this amount as an expense. It appears that accounting for modifications in IFRS 2 is a basis for the requirements in paragraph A103(a). Therefore, we would expect that any incremental value would be recognised prospectively over the remaining vesting period, rather than recognised immediately. The Board in setting standards sought to limit the number of models used; consistency enhances the perception and application of IFRSs as principles based standards.

If the Board's proposal for the immediate recognition of the incremental fair value as an expense is an extension of the Board's proposal for expensing transaction costs associated with a business combination, then it would be helpful to explain this in the Basis for Conclusion. However, if the award has a remaining vesting period, then we believe it would be more appropriate to treat the excess as a modification. We do not view the incremental fair value as a transaction cost which should be accounted for under paragraph 27 (this is notwithstanding our concerns expressed above regarding the expensing of these costs). Under IFRS 2.28(c) and B43, the incremental fair value is included in the measurement of the amount recognised for services received over the period from the modification date until the modified equity instruments vest in addition to the amount based on the grant date fair value of the original award, which is recognised over the remainder of the original vesting period. In effect, the total fair value of the
modified option is recognised in the profit or loss after modification. IFRS 2.BC223-229 discusses the rationale behind expensing the incremental fair value over the modified option vesting period and says"This suggests that the entity expects to receive additional or enhanced employee services equivalent in value to the incremental value of the repriced share options.” and also"Hence it follows that the incremental value has been granted to the share option holders in their capacity as employees (rather than equity participants), as part of their remuneration for services in respect of the incremental value given.” Therefore, based on this same rationale, we believe that the incremental fair value should not be expensed immediately in post-combination profit or loss, but over the vesting period of the replacement awards.

Under IFRS 2.B43 (a), the replacement date fair value of the replaced awards is not recognised in profit or loss after the modification date; instead the original grant date fair value continues to be recognised, along with the incremental fair value, if any. This may create differences between the financial statements of the acquiree, in which we presume modification accounting is applied, compared to the consolidated financial statements of the acquirer in which the guidance as proposed in the ED is applied. We believe that this inconsistency may be appropriate because, in the financial statements of the acquiree, a modification of the terms and conditions of the award has occurred. In contrast, in the consolidated financial statements of the acquirer, a business combination has occurred and any existing assets and liabilities are remeasured, consistent with the concept of purchase accounting.

Paragraph A103 of the ED provides guidance regarding what portion of the replacement award is part of the consideration transferred in exchange for the acquiree. This portion (past services?) is determined as “the remaining fair value-based measure of the acquiree’s replacement award [i.e.,] the amount that remains after deducting the excess, if any, recognised in post-combination profit or loss under (a) multiplied by the ratio of the portion of the vesting period completed to the total vesting period. In effect, the amount of the replacement grant attributed to past services includes amounts that previously have been expensed in the acquiree’s financial statements. We believe this is consistent with the ED’s proposal to measure the fair value of the acquiree.

Under the accounting proposed, the post-combination profit or loss will include an amount for future service which reflects the ‘repriced’ fair value of the original award (i.e. the fair value of the replacement award). While we agree that it is appropriate to reflect the modification (combination date) fair value of the replacement award attributable to future service in post-combination profit or loss over the vesting period, we have identified several concerns / questions:

(1) Should “true-ups” in respect of past services for forfeitures that occur after the business combination date be based on the fair value of the original award, as determined on grant date or on the fair value of the replacement awards?

One view is that the ‘true-up’ should be based on the grant date fair value of the original award grant, consistent with the requirements for modification accounting in IFRS 2. The other view is that since the ‘true-up’ is in respect of equity and equity is reflected at the fair
value of the replacement award, the ‘true up’ of both past and future services would be based on the fair value of the replacement awards. We believe that the ‘true-up’ will be in respect of the fair value of the replacement awards as the original award was made by the predecessor company whose accounting does not carry forward in consolidated financial statements.

(2) This then raises the question of whether true-up adjustments (e.g., forfeitures) of the replacement award which occur within the measurement period, as defined by paragraph 62-68 of the ED, will result in adjustments to consideration paid for the acquiree and consequently adjustments to goodwill. We believe the answer cannot be derived clearly from the ED. We believe that it would not be appropriate to adjust the consideration paid for the acquiree as it is not clear that the employee's failure to vest in the replacement awards were circumstances existing at acquisition date. We encourage the Board to state more clearly what the basis of accounting for post-acquisition ‘true-ups’. For example, the Board could state that post-acquisition ‘true-ups’ are revisions of estimates from post-acquisition events and therefore all adjustments do not impact purchase accounting.

Drafting points

Paragraph A108 refers to an allocation between past and future services limit contained in paragraph A103 (‘the limit’). We do not believe that this limit is mentioned in paragraph A103.

Paragraph A108 provides an example of the limit, however in this example the limit is discussed in terms of amounts (‘because the amount of the acquiree's replacement award attributable to past services, exceeds the amount of the replaced acquired awards attributable to those services, the excess is not part of the consideration transferred’). We believe it would be more appropriate to express the limit as a ratio of past service under the replacement award to the ratio of service attributable to past service under the original awards (e.g., ‘because the proportion of the acquiree's replacement awards...’). In the example, the original vesting period was four years, with two years vested as of acquisition date. The replacement award contained one year of vesting. Based on paragraph A103(c), the portion attributable to past services is equal to the remaining fair value-based measure of the replacement award (or settlement) multiplied by the ratio of the portion of the vesting period completed to the total vesting period. Therefore, the proportion attributable to past services as defined by paragraph A103(c) is 2/3 as compared to 1/2 that was expensed up until the acquisition date, the excess being 1/6 should be expensed as future services. Even though the acquiree has recognised only 1/2 of the grant date fair value of the original award, we support the implicit principle in the ED; a modification that changes the vesting should not impact the attribution of replacement awards between services provided and services to be provided. However, we believe that this point should be added to paragraph A103(b) and that the Board should explain its reasoning in the Basis for Conclusion.

The Basis for Conclusion (BC82-83) identifies a difference to the FASB ED relating to how replacement awards should be allocated between consideration transferred in the business combination and compensation expense. The FASB concluded that the allocation should be based on the requisite service period of the replacement award as compared to the total vesting period that is contained in the Board's ED. We are unsure whether the difference relates to the
portion vs. amount discussion above, but we encourage the two Boards to come to a single conclusion regarding the allocation between consideration transferred in the business combination and compensation expense building on the comments received on the two EDs.

In addition, all the examples provided in the ED include a ‘modification’ to the award. In order to simplify the principles of the ED, we suggest that the Board consider adding an example that does not involve a modification i.e., a replacement award that has the same exercise price and remaining vesting period as the original award. This has the benefit of providing a basic example which makes the principles clearer on which the more advanced examples can build on.

**IAS 19**

The ED proposes in paragraph 48 that assets and liabilities related to the acquiree’s employee benefit plan that is within the scope of IAS 19 Employee Benefits be measured in accordance with paragraph 108 of IAS 19. The ED then proposes consequential amendment to paragraph 108 of IAS 19. However, paragraph 108 does not incorporate the asset ceiling requirement in IAS 19.58. We believe that this is an oversight in the drafting as any resulting post-employment asset that is acquired also should be subject to the ‘recoverability’ test contained in IAS 19.58.

**IAS 34**

The consequential amendment to IAS 34 Interim Financial Reporting expands disclosure requirements in the interim financial statements to include a disclosure of information about changes in the carrying amount of goodwill, including detailed goodwill reconciliation, during the interim reporting periods. We believe that this disclosure would be overly burdensome for the interim financial statements and recommend deleting it.
Appendix D: Consequential amendments to US Statements (Comments of KPMG, US)

5.1 Impact on Related Authoritative Literature - EITF Issues

We believe that the FASB should reconsider the accounting guidance provided in EITF Issue No. 88-16, “Basis in Leveraged Buyout Transactions.” Based on the proposed changes to the EITF 88-16 Abstract, we believe that the FASB has concluded that the proposed Statements will not have a significant effect on the EITF consensus. This conclusion appears to be based, at least in part, on a determination that such a transaction is not a business combination. We believe that such a transaction can, in fact, constitute a business combination based on the guidance in the proposed Statement. Additionally, we believe that the Task Force based its consensus on guidance that the FASB is now proposing to change. Accordingly, we believe that the guidance in EITF 88-16 should be nullified.
Appendix E: Extract of KPMG’s IFRS accounting guidance (Insights into IFRS, section 2.6.4)

2.6.4 Business combination achieved in stages

When control is obtained in successive share purchases (a “step acquisition”), each significant transaction is accounted for separately and the identifiable assets, liabilities and contingent liabilities acquired are stated at fair value when control is obtained. [IFRS 3.40]

As with an acquisition achieved in a single transaction, minority interest is measured at the minority’s proportion of the net fair value of the identifiable assets, liabilities and contingent liabilities (see 2.6.3).

For example, P acquires a 10 percent interest in S and an additional 60 percent some years later. Assuming that P did not have significant influence over S, the business combination requirements of IFRSs will apply only at the date that the additional 60 percent is acquired since this is when control is obtained. Prior to the acquisition of the additional 60 percent, the 10 percent interest would be accounted for as a financial instrument asset (see 3.6).

IFRSs require the share of the identifiable assets, liabilities and contingent liabilities acquired in previous transactions to be revalued, with the adjustment recorded directly in equity. This fair value adjustment does not require the acquirer to apply a policy of revaluing those items after initial recognition in accordance with, for example, the revaluation alternative for fixed assets (see 3.2). [IFRS 3.59]

Worked example

The following example illustrates purchase accounting for a step acquisition.

L acquired 20 percent of M for 300 on 1 January 2002. L acquired an additional 40 percent of M for 600 (including directly attributable costs of 20) on 1 January 2005.

<table>
<thead>
<tr>
<th>Financial position of M</th>
<th>1 January 2002</th>
<th>1 January 2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity</td>
<td>800</td>
<td>1,000</td>
</tr>
<tr>
<td>Fair value of assets in excess of book value</td>
<td>100</td>
<td>150</td>
</tr>
<tr>
<td>Fair value of net assets</td>
<td>900</td>
<td>1,150</td>
</tr>
<tr>
<td>Fair value of portion acquired</td>
<td>180 900 x 20%</td>
<td>4601,150 x 40%</td>
</tr>
</tbody>
</table>
In this case:

- the acquired identifiable assets and liabilities assumed are recognised at their fair value at the acquisition date, which is the date at which control passes to the acquirer;
- minority interests are measured using the fair value of the acquiree’s net assets at the date of acquisition (i.e., a portion of the 150 excess of the fair value over book value of net assets is recognised in respect of minority interests); and
- previously acquired interests are revalued by L when the additional 40 percent interest is acquired (i.e., a portion of the increase of 50 (100 - 50) in the fair value of the net assets in excess of their book values since L acquired a 20 percent interest is recognised).

**Consolidated financial position of L**

<table>
<thead>
<tr>
<th>1 January 2005</th>
<th>L</th>
<th>MConsolidation</th>
<th>Consolidated entries</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in subsidiary</td>
<td>940</td>
<td>-</td>
<td>(940)</td>
</tr>
<tr>
<td>Goodwill</td>
<td>-</td>
<td>-</td>
<td>260</td>
</tr>
<tr>
<td>Other net assets</td>
<td>5,000</td>
<td>1,000</td>
<td>150</td>
</tr>
<tr>
<td>Net assets</td>
<td>5,940</td>
<td>1,000</td>
<td>(530)</td>
</tr>
<tr>
<td>Revaluation reserve</td>
<td>-</td>
<td>-</td>
<td>10</td>
</tr>
<tr>
<td>Other equity components</td>
<td>5,940</td>
<td>1,000</td>
<td>(1,000)</td>
</tr>
<tr>
<td>Minority interests</td>
<td>-</td>
<td>-</td>
<td>460</td>
</tr>
<tr>
<td></td>
<td>5,940</td>
<td>1,000</td>
<td>(530)</td>
</tr>
</tbody>
</table>

In this example, it is assumed that the 20 percent interest has been accounted for as an equity-accounted associate in the consolidated financial statements of L (see 3.5). If significant influence did not exist, then the investment would be a financial asset (see 3.6). As a result, L recognised an increase of 40 in its investment in M ((1,000 - 800) x 20 percent).
The consolidation entries comprise the following (see calculations below):

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity</td>
<td>1,000</td>
</tr>
<tr>
<td>Other net assets</td>
<td>150</td>
</tr>
<tr>
<td>Goodwill</td>
<td>260</td>
</tr>
<tr>
<td>Minority interests</td>
<td>460</td>
</tr>
<tr>
<td>Revaluation reserve</td>
<td>10</td>
</tr>
<tr>
<td>Investment</td>
<td>940</td>
</tr>
</tbody>
</table>

The credit to minority interests is the minority share of the fair values of M’s assets and liabilities (i.e., 1,150 x 40 percent).

The credit to investment is the sum of the consideration paid (300 + 600) plus L’s share of the increase in M’s equity between 1 January 2002 and 1 January 2005 when L accounted for its investment in M in accordance with the equity method ((1,000 - 800) x 20 percent).

The revaluation reserve is the increase in the fair value of M’s net assets from L’s previously acquired interest (i.e., 150 - 100 x 20 percent).

**Further acquisition after control is obtained**

IFRSs are silent regarding the requirements for share purchases after control has been obtained; i.e., acquisition of minority interests. Below are examples of different accounting policies that are applied in practice.

Continuing the above example, on 1 January 2006, L acquires an additional 20 percent of M. The consideration paid (including directly attributable costs) for the additional shares of M is 400, and the financial position of M on that date is as follows:

<table>
<thead>
<tr>
<th>Equity</th>
<th>1,200</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value of assets over book value</td>
<td>400</td>
</tr>
<tr>
<td>Fair value of net assets</td>
<td>1,600</td>
</tr>
<tr>
<td>Fair value of portion acquired</td>
<td>320</td>
</tr>
</tbody>
</table>

How should L account for its additional investment in M? A number of alternative approaches can be identified.
Approach 1

L would determine goodwill as the residual after measuring the cost of the additional investment and the fair value of the identifiable net assets at the date of exchange. L would remeasure its new portion of the identifiable net assets of M at fair value and recognise its additional portion of, for example, intangible assets of M even if those assets were not recognised previously. Under the partial step-up approach, L initially would account for its additional investment as follows:

<table>
<thead>
<tr>
<th>Consideration paid</th>
<th>400</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minority interests</td>
<td>270</td>
</tr>
<tr>
<td>Goodwill</td>
<td>80</td>
</tr>
<tr>
<td>Fair value adjustment on identifiable net assets on the additional investment</td>
<td>50</td>
</tr>
</tbody>
</table>

\[ \text{Min} = (1,200 + 150) \times 20\% \]

\[ \text{Good} = 400 - 320 \]

\[ \text{Adj} = (400 - 150) \times 20\% \]

1 The minority interest immediately before L increases its investment in M from 60 percent to 80 percent is 540. This is calculated as the minority interest recognised when L obtained additional control (460) plus profits attributed to minority shareholders since L obtained control (80 = (1,200 - 1,000) x 40 percent).

This accounting policy is consistent with the accounting under U.S. GAAP (SFAS 141 Business Combinations).

Approach 2

L would determine goodwill on the basis of the cost of the additional investment and the carrying amount of net assets at the date of exchange, as follows:

<table>
<thead>
<tr>
<th>Consideration paid</th>
<th>400</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minority interests acquired</td>
<td>270</td>
</tr>
<tr>
<td>Goodwill</td>
<td>130</td>
</tr>
</tbody>
</table>

\[ \text{Adj} = (1,200 + 150) \times 20\% \]

| 400 - 270 |
| 400 - 270 |

No fair value adjustments would be recognised. Instead fair value changes of the net identifiable assets are subsumed into goodwill.

Approach 3

L would account for the additional investment entirely as an equity transaction, as follows:
Under this approach an entity recognises directly in equity increases (or decreases) in the parent shareholders’ interest, so long as the parent controls the subsidiary. The presentation of minority interest within equity supports the recognition of increases and decreases in ownership interests in subsidiaries without a change in control as equity transactions in the consolidated financial statements. Accordingly, any premiums or discounts on subsequent purchases of equity instruments from (or sales of equity instruments to) minority interests would be recognised directly in the parent shareholders’ equity. [IAS 27.33]

**Approach 4**

L would recognise an increase to goodwill that represents that portion of goodwill that now is attributable to L while the residual (i.e., the fair value change of identifiable net assets since control was obtained) is considered as a transaction between two classes of shareholders and therefore recognised directly in equity, as follows:

<table>
<thead>
<tr>
<th>Consideration paid</th>
<th>400</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minority interests acquired</td>
<td>270</td>
</tr>
<tr>
<td>Goodwill</td>
<td>80</td>
</tr>
<tr>
<td>Other equity</td>
<td>50</td>
</tr>
</tbody>
</table>

A similar model is prescribed under the Australian IFRS equivalent (AASB 127 Consolidation and Separate Financial Statements) although this approach is based on the goodwill when control was obtained, rather than the goodwill when the additional investment was acquired. If, for example, at the date L originally obtained control of M the full amount of goodwill of M could be determined at 350 (while only the portion relating to the acquired interest was recognised at that time), L would account for the additional investment as follows:

<table>
<thead>
<tr>
<th>Consideration paid</th>
<th>400</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minority interests</td>
<td>270</td>
</tr>
<tr>
<td>Goodwill</td>
<td>70</td>
</tr>
<tr>
<td>Other equity</td>
<td>60</td>
</tr>
</tbody>
</table>

* * * * *
We believe that all of the approaches identified above are acceptable as an entity's elected accounting policy, if applied consistently to all such transactions. The accounting for acquisitions of minority interests is part of phase II of the IASB's project on business combinations. Therefore, this area of IFRSs may be subject to Future developments (see 2.6.7).

The above illustrates the accounting treatment when an entity acquires minority interests. In our view, though, similar approaches may be applied when an entity reduces its ownership interest in a subsidiary but retains control.