International ACCOUNTANT

May 08

REVISED REPORTING

Thayne Forbes advises accountants to take heed of the revised reporting requirements for business combinations

The current era of reporting was heralded when the Financial Accounting Standards Board (FASB) issued SFAS141, which was effective for all business combinations initiated after 30 June 2001. IFRS 3 followed with an effective date of 31 March 2004, although in many jurisdictions adoption of IFRS came later. The purpose of both standards is to improve the relevance, comparability and reliability of the information that a reporting entity provides in its financial reports about a business combination. The statements set out principles and requirements for how the acquirer recognises and measures acquired assets, assumed liabilities, non-controlling interests and goodwill, and prescribes the information disclosure requirements.

The definition of fair-value accounting is a highly debatable issue central to the interpretation and applicability of both reporting standards

In 2002, the FASB and the IASB agreed to jointly review their guidance for applying the purchase method (now called the acquisition method) of accounting for business combinations. The revisions to SFAS141 issued in December 2007 and to IFRS3 issued in January 2008 represent a significant step forward towards international convergence of the treatment of business combinations. SFAS141(R) becomes effective from 15 December 2008 and IFRS3(R) from 1 July 2009, though unlike SFAS141(R) it can be implemented earlier.

THE CHANGES

Given that the original SFAS141 was issued almost three years earlier than IFRS3, it is not surprising that this statement required more revisions to realise the convergence target. In fact, the revisions can be classified into two categories: revisions to SFAS141 to attain closer harmonisation with IFRS3, and revisions to both standards to improve their relevance and utility. Changes to SFAS141 are:

- A broader scope by applying to all transactions and events resulting in a business combination rather than to only business combinations in which control was obtained by transferring consideration.
- The acquirer to recognise assets acquired, liabilities assumed and any non-controlling interest in the acquiree at the acquisition date, measured at fair values. (The original SFAS141 statement used a cost-allocation process whereby the cost of acquisition was allocated to individual assets and liabilities based on their estimated fair values.)
- Restructuring costs expected but not obliged to pay to be expensed rather than included in acquisition cost and allocated to assets acquired and liabilities assumed.
- Negative goodwill (bargain purchases) was previously allocated pro rata to assets acquired. Under the revised statement, this excess is recognised in earnings as a gain attributable to the acquirer.
- Acquired research and development assets to be recognised separately from goodwill at acquisition-date fair values.
- A requirement to measure all assets and liabilities acquired in step acquisitions at fair value including minority interests which were previously measured at book value.
- Amends to FASB 109, requiring changes in the amount of the acquirer's deferred tax benefits because of a business combination

International ACCOUNTANT

May 08

recognised either in income from continuing operations or directly in contributed capital.

- Required explanation of the factors that make up goodwill recognised such as synergies and intangible assets that do not qualify for separate recognition.

Revisions to SFAS141 and IFRS3:

- Costs incurred to effect the acquisition recognised separately as an expense rather than being included in the acquisition cost and allocated to assets acquired and liabilities assumed.
- Contingent considerations to be recognised at fair value at the acquisition date rather than recognition when the additional consideration becomes payable.
- Previously held equity interests in a step or partial acquisitions recognised at fair value at the acquisition date.

REMAINING DIFFERENCES

Despite the scale of revisions to converge the two standards, a number of differences still remain. Many of these occur to maintain consistency with existing FASB or IASB standards and are likely to be considered for further convergence in the future.

There are light differences in the definitions of the acquirer, control and fair value.

For example, while non-controlling interests are to be valued at fair value at the acquisition date under the revised SFAS141 statement, IFRS3(R) gives acquirers the option of recognising non-controlling interests at fair value or as proportion of net asset value. Other differences include:

- SFAS141(R) does not apply to not-for-profit combinations, while IFRS3(R) does not have any exceptions.
- IFRS3(R) requires recognition of a contingent liability if it is a present obligation that arises from past events and its fair value can be measured reliably. SFAS141(R) goes further, requiring recognitions of assets acquired and liabilities assumed that arise from contractual contingencies. All other 'non-contractual' contingencies are to be recognised as of the acquisition date if it is more likely that the contingency gives rise to an asset or liability. The disclosure requirements are also slightly different between the two revised standards.
- SFAS141(R) requires the acquirer to recognise an intangible asset or liability if the terms of an operating lease differs from market rates. An asset subject to an operating lease in which the acquiree is the lessor is recognised at fair value separately from the lease contract. In contrast, IFRS3(R) requires the acquirer to take into account the terms of a lease in measuring the fair value of the asset subject to the operating lease in which the acquiree is the lessor but does not require recognition of a separate asset or liability if the terms of an operating lease differs from market terms.

Differences in each board's respective statements for accounting for income taxes, SFAS109 and IAS12, and each board's statement for share-based payment, SFAS123(R) and IFRS2, may result in differing amounts recognised under SFAS141(R) and IFRS3(R).

Under SFAS141 the acquirer must disclose goodwill by segment if the combined entity is required to report segment information in accordance with SFAS131. Disclosure by segment is not required under IFRS3.

COMMENTS

Some may argue that these standards do not go far enough towards accurate and informative reporting of business combinations, while others may argue that they go too far and the level of detail required is unnecessary. It is a fine line between reporting adequate information to serve the needs of investors and revealing so much information that may undermine a company's competitive advantages.

The definition of fair-value accounting is a highly debatable issue central to the interpretation and applicability of both reporting standards. In the simplest terms, fair value is equivalent to market value; however, there is not an active market for many balance-sheet assets leading to fair value estimates based on other measurement methods (for example replacement cost, and discounted cash flows). Furthermore, calculating such estimates of fair value can be expensive and impractical while the accuracy may be spurious. Though the intentions are noble, at times it is a bit like using a hammer to crack a walnut.

The benefits to the investor community will only be reaped if the companies themselves actually comply with the revised standards. This is less of an issue in the US, where companies fear the sanctions for non-compliance imposed by the SEC. In contrast, compliance in the UK largely rests in the hands of the auditors, which, based on the initial implementation of FRS3, is not enough.

There are numerous examples of poor compliance – 84 percent of the purchase consideration of BAE's acquisition of United Defense was reported as inadequately described goodwill; it was 97 percent for BSkyB's acquisition of EasyNet, and 69 percent for ITV's acquisition of Friends Reunited.

I hope that market forces induce compliance to the revised standard. If the investor community reacts adversely to non-compliance, companies will no longer be able to hide behind poorly explained goodwill figures and consequently adhere to the revised standard.

CONCLUSIONS

Overall, the changes made to both standards represent progress towards more useful and comparable financial reporting at a global level. While companies and auditors may need to work a little harder while they get to grips with the new standards, investors and shareholders will be rewarded with more representative information on which to base their decisions.

By having to fully explain the purchase consideration of each acquisition, the standards indirectly enhance the investment decisions of the companies themselves. As companies will no longer be able to hide over-payment for acquisitions in the goodwill bucket, management will perhaps carry out a more robust due diligence process to avoid paying significantly over the odds for target acquisitions. In addition, more detailed reporting of acquired intangibles may lead to a greater appreciation of the contribution to the business of these valuable assets and prompt management to protect, utilise and exploit them more effectively.

It's up to the accountants who implement the revised standards to ensure compliance; there should be no excuses this time round.