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Accounting alert

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IASB/FASB joint phase II business combination proposals

The exposure drafts are now freely available on the IASB, FASB and AASB web sites.

The International Accounting Standards Board and Financial Accounting Standards Board of the United States have jointly issued exposure drafts on phase II of their joint business combinations project. The AASB last week consequently issued ED *139 Proposed Amendments to AASB 3 'Business Combinations'* and ED *141 Proposed Amendments to AASB 127 'Consolidated and Separate Financial Statements'*.

The phase II business combinations proposals will see some radical changes to accounting for business combinations and changes in ownership interests. This Accounting Alert provides an Australian perspective on some of the key proposals and their impacts.

Overview

At first glance, the phase II proposals appear to simply reinstate some of the conceptual approach to business combinations that existed in Australian prior to the transition to Australian equivalents to IFRS (A-IFRS): the 'economic entity' approach to consolidation, focus on control and move to 'non-controlling interests' outwardly seem quite familiar concepts.

The proposals extend well beyond the old A-GAAP concepts of 'economic entity' accounting

However, in many respects, the phase II proposals extend far beyond these initial observations and reveal a new way of accounting for business combinations and investments that may significantly impact outcomes for affected entities.

Some of the commercial impacts include:

- acquisition costs will be generally be expensed and cannot be taken into consideration in accounting for business combinations – expensing costs such as legal, valuation and consulting fees and perhaps also stamp duties may significantly impact reported profits
- more volatility in reported profits arising from business combinations – key areas include restructuring costs, contingencies, deferred tax assets, acquisition costs, contingent consideration and existing ownership interests
- intangible assets required to be recognised in a business combination more often and in conjunction with a new 'fair value hierarchy' – any need for specialist valuers might add to costs and uncertainties surrounding business combinations
- full fair value accounting for all controlled entities, even where less than 100% interest in a subsidiary is obtained – total goodwill needs to allocated between controlling and 'non-controlling' interests allowing for control premiums
- volatility in post-combination controlling equity with changes in ownership levels giving rise to equity adjustments – thereby often reducing parent entity equity rather than increasing goodwill
- the introduction of a 'fair value hierarchy' that may also have wider application to transactions and events other than business combinations by analogy
- consequential considerations – such as loan covenants, key management personnel remuneration (bonus schemes, targets, etc).

The phase II proposals have wide ranging impacts on many other Standards, with AASB 137 *Provisions, Contingent Liabilities and Contingent Assets* being largely rewritten as a 'consequential' amendment – details of these wide ranging changes can be found in *Accounting Alert 2005/09.*

What are the 'principles'?

There is a strong emphasis on a *principles based* approach to accounting in the phase II proposals.

There is also an emphasis on fair value accounting with the acquiree as a whole being fair valued and new fair value guidance in relation to acquired assets and liabilities.

The table below outlines the 'fundamental principles' that the IASB and FASB used to develop the proposals, along with some perhaps unexpected consequences of those principles.

Key principle	Consequences compared to current accounting
The acquirer obtains control of all the acquiree's assets, liabilities and activities at the acquisition date	• a business combination is a transaction that should give rise to a remeasurement at the acquisition date to reflect the changed circumstances • business combinations can give rise to gains and losses in relation to pre-combination ownership interests • a business combination can only occur once, i.e. when control is obtained – therefore subsequent changes in ownership interests are not business combinations but are equity transactions between the controlling and non-controlling interests.
The total amount recognised for the acquiree should be the fair value of the acquiree as a whole	• the 'cost of a business combination' has been deemphasised in favour of fair value accounting of the acquiree as a whole • the 'full goodwill' method is used to account for business combinations, i.e. 100% of the goodwill is recognised even if less than a 100% ownership interest is acquired • combinations involving mutual entities, by contract alone or not involving a 'purchase' must be accounted for using the same principles • acquisition related costs are accounted for separately from the business combination itself – leading to an expense in most cases, e.g. legal fees, accounting fees, valuers fees and transaction costs.
Business combinations are generally exchange transactions in which knowledgeable, unrelated willing parties are presumed to exchange equal values	• consideration transferred might not equal the fair value of the acquiree, and fair value should be measured by valuation techniques • contingent consideration should be measured at the acquisition date • 'bargain purchase' transactions would be rare, and any excess is first used to reduce the carrying amount of goodwill to zero before recognising any amount in profit and loss • transactions that accompanying the combination are accounted for separately from the exchange transaction.
The identifiable assets acquired and liabilities assumed in a business combination should be recognised at their fair values on the date control is obtained	• restructuring liabilities can only be recognised if they are a liability of the acquiree at acquisition date • there is a limited 'measurement period' during which information gathering is permitted – but new information that doesn't relate to circumstances at acquisition date cannot be taken into account • changes in the values of contingent consideration and assets and liabilities outside the 'measurement period' will not be adjusted against the initial accounting for the business combination, but measured and recognised in accordance with other Standards, generally through profit and loss.

Summary of accounting under the proposals

Accounting for business combinations under the phase II proposals requires the following steps:

1. the identification of the acquirer
2. determining the acquisition date
3. measuring the fair value of the acquiree
4. measuring and recognising the assets acquired and the liabilities assumed.

The measurement of goodwill is calculated as follows:

Fair value of acquiree as a whole	less	Aggregate fair value of assets and liabilities acquired	=	Goodwill
• can be determined by reference to the 'consideration transferred' (including the fair value of all contingent consideration)		• new 'fair value' hierarchy (with some exceptions) • some adjustments permitted during the 'measurement period'		• based on 100% of goodwill • allocated between controlling and non-controlling interests – which might not equal ownership interests

Fair value accounting

As noted above, the concept of fair value accounting is integral to the phase II proposals.

The changes to fair value have impacts in two areas:

- the requirement to determine the fair value of an acquiree *as a whole* – this has the effect of valuing the non-controlling interest in the net assets of the acquiree (including goodwill) at fair value at the acquisition date
- the guidance on the determination of 'fair value' included in the existing AASB 3 has been replaced with more generic guidance – thereby moving from a 'rules' to 'principles based' approach.

New fair value guidance replaces the specific rules in the current AASB 3

Exceptions to the fair value requirement are proposed for assets held for sale, deferred tax assets and liabilities, operating leases and employee benefit obligations which will instead be measured in accordance with other Standards to avoid 'day two' measurement adjustments. Goodwill will also continue to be a residual rather than being separately measured but any 'bargain purchase' amount will be reduced from the carrying amount calculated.

Measuring fair value

A 'fair value hierarchy' is proposed that might have wider impacts by analogy

The phase II proposals incorporate parts of the FASB's proposed SFAS on *Fair Value Measurements*. The fair value measurements guidance would be added as an appendix to the revised AASB 3/IFRS 3 and provides a definition of 'fair value' and a 'fair value hierarchy'. The hierarchy gives the highest priority to market based inputs and lowest priority to internal estimates and assumptions and is based on three 'levels' (in order of priority):

- Level 1 estimates – unadjusted quoted market prices for identical assets or liabilities in active markets to which an entity has immediate access
- Level 2 estimates – estimated using quoted market prices for similar assets or liabilities in active markets, adjusted as appropriate for differences
- Level 3 estimates – estimated using multiple valuation techniques consistent with the market approach, income approach, and cost approach, with an emphasis on market based inputs.

The stress on market based fair value determination may infer that expert valuers may be involved more often in the accounting for business combinations. This may lead to increased transaction costs – which of course would also be expensed rather than being capitalised under the proposals.

Intangible assets

All intangibles must be recognised and fair valued – it will no longer be possible to argue that intangible assets cannot be reliably measured

The phase II proposals also include amendments to the treatment of intangible assets. Consistent with the approach under current US-GAAP, all items that meet the definition of an 'intangible asset' are required to be recognised, other than in respect of an assembled workforce. In other words, there will no longer be a 'reliable measurement' excuse for not recognising an intangible asset separately from goodwill.

The identification and measurement of intangible assets is one of the most difficult areas of the current business combination requirements. In some cases, the 'reliable measurement' hurdle currently allows some difficult to measure intangible assets to be subsumed within goodwill, particularly where there is limited market based evidence of transactions for the separate asset. These new proposals will require a reassessment of the approach taken to accounting for the majority of business combinations.

Acquisition related costs

Acquisition related costs are generally expensed

The phase II proposals make it clear that costs incurred in connection with a business combination are not part of the 'consideration transferred' in exchange for the acquiree. The proposals include examples such as finder's fees, advisory, legal, accounting, valuation, other professional fees and general administrative costs.

Because these costs do not form part of the 'consideration transferred' for a combination, they will be treated in accordance with other Standards – which in most cases means that they will be expensed through the profit and loss as incurred. The IASB has noted that this also creates a difference in the treatment of these costs between purchases of assets (capitalise) and businesses (expense).

Will stamp duties be expensed as an acquisition related cost?

In the Australian context, the question of the treatment of stamp duty arising in business combinations appears somewhat uncertain. Stamp duty is an unavoidable cost that must be paid by any buyer, so is conceptually different from the examples noted above as those vary from buyer to buyer and are paid in exchange for services received (which are the basis of some of the arguments for treating these separately from the business combination noted by the IASB).

Stamp duty is also necessarily incurred as part of the 'consideration transferred' in exchange for the acquiree and economic theory may indicate that the fair value of businesses might increase in the absence of stamp duties. Furthermore, stamp duties cannot be avoided and there is no 'service received' (in a normal sense) from the payment of stamp duty.

Therefore, there may be differing views as to whether stamp duties should be considered 'acquisition-related costs' (and so expensed) or as part of the 'consideration transferred' (and so taken into account in determining the fair value of the acquiree).

We intend to seek clarification of the treatment of stamp duty and other transaction taxes or government imposts in our submission to the AASB on the exposure drafts.

When are these changes proposed to take effect?

The changes are proposed to commence from 1 January 2007

The phase II changes are proposed to commence with effect from 1 January 2007. The requirements will be largely prospectively applied, other than specific transitional adjustments in the following areas:

- deferred tax assets – adjustments to goodwill can only be made in line with the new requirements, i.e. a presumption that adjustments within 12 months should be made to goodwill, but after that time no adjustments to goodwill would be permitted
- contingent liabilities in relation to past business combinations would be reassessed in light of the new requirements with any adjustments recognised by adjusting goodwill.

Why consider these proposals now?

The question then becomes 'why consider this now?' The answer lies in understanding the new requirements and planning for their implementation – acquisitive groups in particular need to fully understand these changes so that acquisition metrics take them into account.

The AASB has sought comments on the exposure drafts by 23 September 2005, to allow the AASB to consider constituent's comments in formulating its own comments to the IASB which are due by 28 October 2005. Therefore, entities that wish to make submissions on the proposals will need to respond within these timeframes. We would also welcome your feedback and comments on the proposals.

Feedback and assistance

We welcome your feedback on the matters covered in this *Accounting Alert* – please email your comments to **accounting_alerts@deloitte.com.au**

For assistance in applying the requirements outlined in your organisation, please contact your local Deloitte office or contact our Lead National Technical Partner, **Bruce Porter** on **+61** (**0) 3 9208 7490**, or by e-mail to **bruporter@deloitte.com.au**

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