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IFRS News

Shedding light on the IASB's activities*

Business combinations supplement • August/September 2006

Business combinations phase 2 – update from the IASB

Alan Teixeira is a senior project manager at the IASB, leading the business combinations project. He talks to Michael Gaull, in PwC's Global Accounting Consulting Services team, about the progress so far and next steps.

When the business combinations phase 2 exposure draft was issued, the Board seemed surprised by the reaction to it. Do you know why?

I was also surprised at the reaction. The package might look like a radical overhaul of the standard, but in my view the changes are not as extensive as they initially appear. Take bargain purchases: the accounting outcome is no different in the ED compared with the current IFRS 3 requirements, but it looks different because it is expressed differently. It highlights just how important it is to communicate the impact of changes as part of the exposure process.

One of the difficulties seemed to be the move from the parent company to the economic entity model – conceptually quite a big shift. This wasn't exposed in itself but appeared within the ED.

Yes, this is a common theme in comment letters. But the staff hasn't asked the Board to debate the relative merits of the entity and parent perspectives. Our primary concern has been making sure that the proposals lead to information being disclosed that will help users assess the interests that the equity holders have in the reporting entity, within our framework. Our current model says that non-controlling interests are equity, but the current IFRS 3 and IAS 27 do not address some of the consequences of this classification, such as what happens when you acquire additional interests after control has been achieved. The proposals fill this gap. In my view, the portion of goodwill that you recognise is not a consequence of adopting the entity or parent perspective. So, as I say, we have simply tried to improve IFRS 3 within our current framework.

I thought that PwC's comment letter was insightful on this point. It said that the non-controlling interest is part of equity but that it is different and should be treated differently. In April the staff proposed some changes to the core disclosures about the equity of the controlling interests that reflect the particular importance of those equity holders who have an interest in the group through the parent. The IASB and FASB supported those proposals.

What were the concerns of the corporate respondents over the ED?

Most stated that they don't believe that acquisition costs should be expensed. They, and many analysts, are also concerned about the proposals for contingent consideration. They are concerned that gains would be recognised in circumstances when, if you don't meet forecasts for the business you bought, you derecognise the contingent consideration and recognise a gain. It's a difficult issue and we are working through it carefully.

What's your approach now? Are you saying that it is not very different?

We are asking the Boards to question all of the fundamental issues. For example, the proposals stated that the basic principle was to measure the fair value of the business as a whole. But the Boards have now agreed that this principle is not as helpful as it was expected to be. When there is an overpayment or a bargain purchase, the Boards have agreed that the under- or overpayment is recognised in goodwill. That means that we are placing more weight on the consideration transferred than the fair value of the business acquired. So recognising the fair value of the acquired business as a whole is no longer the fundamental principle. Despite this being expressed clearly in the public

papers for two consecutive Board meetings, it is not obvious that observers are aware of this change.

Is it back to allocation of consideration?

No, it's not about allocation; it is about measuring and recognising individual assets and liabilities.

Which presumably would come back to fair valuing the business as a whole?

Not necessarily. We still have a lot of work to do on non-controlling interests and goodwill. So far we have limited most of the debate to a 100% acquisition to make sure that we focus on the core principles in a simplified setting. Over the next few months we will be asking the Boards to have another look at non-controlling interests. The staff see this as a critical part of the redeliberation.

How did you structure the redeliberation process in light of the comment letters?

We asked the Boards to think clearly about the fundamental principles in the proposed standard first and about laying those as a foundation. We are now working through the implications of the principles and the changes from current practice that the application of those principles will lead to. When comment letters criticise part of the standard, we ask the Boards to address that and confirm if application of the principles leads to an appropriate outcome. As staff, we probably misjudged how some observers might react to this process. Our intention was to lay out the principles clearly and address implications systematically. What we didn't anticipate was that many observers view this as us having already decided what the final package will look like.

Was there some surprise when you had the first redeliberation after an edition of *IASB Update* said the Board agreed these principles?

It is possible that people haven't been following the redeliberations as closely as we thought they were. The Board published a statement in the April *IASB Update* clarifying the process we are following. This is the first joint project between the Boards that has been managed in this way. The challenge for the staff is to align the thinking processes of both Boards. That's why we are building up from basic principles, with the simplest cases, even during the redeliberation process. Once the Boards agree on these basic principles, the staff will ask them to consider the more controversial issues and the more complex transactions.

What have the Board agreed so far in their redeliberations?

They have agreed the basic principles, which includes the recognition principle and the measurement attribute, which is fair value. We have also asked them to confirm the proposed treatment of acquisition-related costs. You are probably going to ask me about goodwill because that came up quite early.

Yes, because you dealt with it through step acquisitions. The Board affirmed that 100% of goodwill should be recognised no matter what percentage had been acquired.

As a basic principle, both Boards agreed that once you control an asset, you should recognise the whole asset – that includes goodwill. There was only narrow support for this in relation to goodwill at the IASB because the Board was looking ahead to goodwill with a non-controlling interest. The staff have received a clear signal that we have more work to do on goodwill and non-controlling interests.

That debate isn't over then, despite a tentative decision?

The only vote that really matters is the one on the final standard. Until then, none of the votes are binding, but they provide the staff with direction. Our job is to identify the best solution to each problem and explain why we think it is the best solution. Different solutions have different costs and benefits; when a Board is split on an issue, it could be because the Board is facing two equally worthy solutions or because the staff haven't presented convincing enough arguments to some Board members to justify a change from current practice. If the staff can't convince the Board that a solution has merit, that can be a good signal that some constituents are also likely to be unconvinced.

Several options remain on the table. The difficulty with the current IFRS 3 and IAS 27 is that they don't address how to account for step acquisitions after control has been achieved or for divesting an interest without losing control. The staff believes that we need to improve IFRS 3.

One significant advantage of measuring goodwill only at the date that control is achieved is that it avoids the complexity of a layered approach that a cost accumulation model demands. We don't want to impose additional record-keeping costs on entities or require them to report a multi-layered amount for goodwill that is difficult to explain to users and has questionable economic relevance. We still have a lot of work to do before we take the issue back to the Boards.

Has the Board agreed to expense transactions costs?

Strictly speaking, no. What the Boards have tentatively decided is that acquisition-related costs are not part of the exchange for the acquiree and should be accounted for in accordance with other IFRSs.

What does that mean? How would you account for paying for legal fees in another transaction?

In practice, many of these costs would be expensed as they are incurred. The proposals simply make it clear that these costs are not part of the exchange for the acquiree.

I think that you can characterise acquisition costs in two ways: it's either the hole you need to step out of or it's the hurdle that you have to step over before your asset starts generating economic value for you. Expensing those costs is consistent with thinking of the costs as the amount that you need to recover. If you think of them as the hurdle, you might capitalise them. If you treat it as a hurdle, what are you going to do after that? Presumably you expense it. A clear majority on both Boards has indicated a preference for not recognising acquisition-related costs as part of goodwill.

You don't hold with the stewardship argument that transaction costs form part of the resources that companies expended to acquire this business? It includes costs paid to lawyers and accountants, for example, so that the total amount paid that we should be held accountable for is on the balance sheet?

I understand the stewardship argument. But I also think that it is consistent with the stewardship view that the day before the acquisition, the entity had assets for which it is accountable that they have now exchanged for a business and some associated services to complete the acquisition.

Did you not find many good arguments or principles to support capitalising transaction costs?

Those who argued that acquisition-related costs should be capitalised either argued that they were an important part of the outlay on which their return was going to be assessed or that writing them off was inconsistent with other IFRSs.

We agree that acquisition-related costs are an important component of a business combination. But that doesn't mean that we have to capitalise them as a separate component. We refer to the framework and ask what these costs are. The framework will say expenses. It's not that we don't think it's an important part of the outlay; but just being an important part of the transaction does not make them an asset. The Boards have both acknowledged that the proposed treatment of acquisition-related costs in business combinations is different from the way we treat them in some other standards.

How do you convince your constituents that you are listening to them when the majority said transaction costs should be capitalised?

It's always going to be difficult convincing constituents that we are listening to them and considering their arguments when the proposed treatment is not their preferred treatment.

Take the argument some constituents presented to us that you must capitalise these costs to be able to identify the total investment on which you expect a return. The staff assessment is that as soon as that acquisition has been completed, those assets and liabilities will start changing. Assets will be depreciated, inventory sold, expenses incurred, and so on. It's not clear to me how you can identify the total investment in a subsidiary in the first, or any, set of group financial statements by looking at the group balance sheet. The disclosures that we are proposing that identify the components of the business combination will provide that information. We do not set out to refute arguments constituents bring to us, but it is incumbent upon the staff to analyse those arguments when they are presented to the Boards.

What are the big issues that the Board is redeliberating?

Many of the more difficult ones, such as consideration. We think we need to do more work to draft clearer principles. We also need to look at contingent consideration, which is difficult to separate from the general issue of contingencies. We still have issues like lawsuits to deal with in the IAS 37 project, and we don't want to create new standards on business combinations while IAS 37 is still be debated. We also need to look at intangible assets and fair value measurement. And as I said earlier, we will be asking the Boards to consider how to measure non-controlling interests (NCI) at the acquisition date. In my view, it is likely to be more important than goodwill.

Will goodwill become a residual in more than an accounting sense – that is, what will the fall-out be after all your decisions up to that point?

The time to revisit goodwill is at the end. We will be asking the Boards to look at NCI first. The IFRIC has already been asked to have a look at transactions where part of an acquisition involves attaching a put or forward to the NCI. In those circumstances, the NCI has the characteristics of a liability. IAS 32 requires these instruments to be measured initially at fair value. If an NCI classified as a liability is measured at fair value on initial recognition in a business combination and all other components of equity have to be measured at fair value, we have to ask the Boards why NCI that is part of equity shouldn't be measured at fair value. I don't want to pre-judge what we will be recommending to the Board, but I think that focusing on NCI measurement is more helpful than focusing on measuring goodwill. You have to remember that, although the ED had a presumption that goodwill would be measured at fair value, it has always been an exception. The proposals have always measured goodwill as a residual.

Is the Board planning to address some of the difficult practicalities like scope-outs, dual-listed companies, common control transactions, combinations and joint ventures?

Common control and fresh-start accounting are two areas that we say we'll address later.

Although the current plan doesn't have common control as part of this project, we should at least see what would be involved. In other words, we shouldn't finish phase 2 unless we know where we're heading with any future phases. Any future phases of our project ought to be addressing some of the exceptions or

peripheral issues. I think it can be helpful to see where you are going in order to make sure that the foundation you have will serve you well when you address the remaining issues. So the staff plan to write a scoping paper to say what we're going to do with common control and fresh-start.

Will the scoping paper say, 'If we apply these re-written principles to common control, what would be the result, and is that what we want?'?

It will focus on what we need to do to extend these principles to common control. If the answer is 'a lot', we will try to identify the issues we face and we'll address them as part of another phase. We might find there is less to do than we anticipate.

Common control seems to be becoming an issue in terms of interpretation. One of the difficulties is that the definition of common control in IFRSs differs from the FASB definition. The US also has guidance built into its standard; we don't. It's something we need to think about in terms of convergence.

What was the US view of the ED and how are their re-deliberations progressing?

The proposals have a greater impact on US GAAP users than IFRS users. Some comment letters suggest that US GAAP should have converged to the current IFRS 3. Our difficulty is there are some areas where we need to improve IFRS 3 – we don't discuss what the accounting for a step-acquisition is once you've got control. We are told that there are up to five ways that people think you should account for these transactions. The proposals are designed to improve IFRS 3 and converge US GAAP and IFRS. So yes, I think FASB constituents are facing significant changes.

More so than your IFRS constituents?

For us it is principally about improvements. For example, in the US, they recognise restructuring costs as part of the acquisition; IFRS 3 does not allow you to do that. So the US is aligning with IFRS on that point. Many of their constituents don't like that change. IFRS constituents tended not to object to that proposal. Where there is a change from current practice, there are more objections from the constituents affected than where there is not a change. It's understandable. If I asked you to change your systems, you'd probably say 'convince me'. The onus is on us to explain why what we are proposing is a better solution.

People seem to think that business combinations accounting isn't working badly at the moment even if it is theoretically inconsistent. It seems that the question, 'Why go through all this change for your conceptual rigor?', is behind a lot of issues.

I still view this as an improvement project for us. It might not look particularly good that we are re-writing a standard that is only 18 months old. But you have to remember that moving straight onto phase 2 of the business combinations project was part of our programme when we published IFRS 3.

You also have to remember that we are writing a standard jointly with the FASB. The basic styles of the standards we write are not the same as those the FASB writes. Our goal is to write a standard that both Boards agree with. In doing that, we are trying to pick up the best of each others models. It's inevitable that the revised IFRS 3 will look and feel different from our current IFRS 3. But that's the same for the FASB. Statement 141R will look different from Statement 141. I suspect that's why so many people perceive that the changes are more fundamental than we think they are.

Our goal is to get this right so that any changes in the future to business combinations accounting ought to be around peripheral issues. That's the reason for having simple and clear principles as the foundation. It is the exceptions to those principles that should be the focus of any future developments. If you have sound principles and then deal with the implications, the standard is more robust.

Biography – Alan Teixeira

- **General manager, standards and quality assurance, 2004-2005, and director, research, 2003-2004 – the Institute of Chartered Accountants of New Zealand.**
- **Technical consultant – Ernst & Young, 2001-2003.**
- **Senior lecturer, department of accounting and finance – University of Auckland Business School, 1985-2003.**
- **Training, financial reporting opinions and technical consultant – PricewaterhouseCoopers, 1987-2003.**
- **PhD, accounting and finance, University of Auckland, 2001.**
- **University of Auckland Business School, department of accounting and finance, 1985-2003, including: director, bachelor of business and information management, 2000-2001; director, year one accounting and finance programmes, 1999-2001; head of financial accounting, 1998.**
- **Consultant – Ernst and Whinney, London, 1984.**
- **Consultant – McCulloch Menzies, 1982-1983.**
- **Chartered Accountant, Institute of Chartered Accountants of New Zealand.**