International
Accounting Standards
Board

Financial Accounting
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INFORMATION FOR OBSERVERS

Board Meeting: **Joint IASB-FASB Meeting, 27 April 2006, London**

Project: **Business Combinations II**

Subject: **Cost incurred in connection with a business combination (IASB Agenda Paper 2B/FASB Memorandum #15)**

INTRODUCTION

1. The Business Combination Exposure Draft (BC ED) proposes the following treatment of acquisition-related costs:

> Costs the acquirer incurs in connection with a business combination (also called acquisition-related costs) are not part of the consideration transferred in exchange for the acquiree. For example, such costs include finder's fees, advisory, legal, accounting, valuation, other professional or consulting fees, general administrative costs, including the costs of maintaining an internal acquisitions department, and costs of registering and issuing debt and equity securities. The acquirer shall not include such costs in the measure of the fair value of the acquiree or the assets acquired or liabilities assumed as part of the business combination. The acquirer shall account for acquisition-related costs, separately from the business combination, in accordance with other [IFRSs/Generally Accepted Accounting Principles]. (BC ED par. 27)

2. Based on the redeliberation criteria established at the January 2006 Board meetings, the staff asks the Boards to discuss the proposed accounting for acquisition-related costs because:

    a. two IASB members expressed an alternative view in the BC ED; and

    b. most respondents were opposed to the proposal.

3. This paper:

    a. summarises the Boards' initial deliberations;

    b. analyses the principles underlying the proposed treatment of acquisition-related costs;

    c. discusses respondents' concerns about the proposed accounting for acquisition-related costs; and

    d. asks the Boards to reaffirm the proposed accounting for acquisition-related costs.

INITIAL DELIBERATION MATERIALS AND THE BOARDS' BASIS FOR CONCLUSIONS

4. The Boards discussed the proposed accounting for acquisition-related costs at the following meetings:

    a. the FASB's April 17, 2002 Board meeting; and

    b. the IASB's May 2002 Board meeting

5. [This paragraph is not reproduced for observers.]

6. During initial deliberations, the Boards decided to specify in the BC ED that acquisition-related costs are accounted for separate from the business combination accounting. BC85 of the IASB's BC ED summarises the Boards' basis for this conclusion as follows (see also B94 of the FASB ED):

> The [IASB] concluded that acquisition-related costs are not part of the fair value exchange between the buyer and seller for the business. Rather,

> they are separate transactions in which the buyer makes payments in exchange for services rendered. The [IASB] observed that these costs, whether for services performed by external parties or internal staff of the acquirer, generally do not represent assets of the acquirer, because they are consumed as the services are rendered.

7. Two IASB members expressed an alternative view on the proposed accounting for acquisition-related costs. They disagreed that acquisition-related costs are not part of the consideration transferred in exchange for the acquiree and that they should be recognised generally as an expense as incurred. AV 18 of the IASB ED states:

> …Recognising acquisition-related costs as expenses is inconsistent with accounting for purchases of assets, including investments in associated companies, whereby the direct costs form part of the carrying amount of the assets acquired, on initial recognition. It also fails to reflect the economic substance of the acquisition transaction. In order for a transaction to be justified economically, the acquirer must expect that the fair value of what is acquired is equal to, or exceeds, the total cost of acquisition (the purchase consideration plus the associated costs).

PRINCIPLES UNDERLYING THE ACCOUNTING FOR ACQUISITON-RELATED COSTS

8. In March 2006, the staff set out nine assertions, definitions, principles and presumptions on which the proposed BC ED has been developed. The Boards affirmed that those statements provide an appropriate basis for the final business combination standard. The recognition and measurement principles for applying the acquisition method were:

    a. In a business combination, the acquirer <u>recognises</u> all of the assets acquired and all of the liabilities assumed.

    b. In a business combination, the acquirer <u>measures</u> each recognised asset acquired and each liability assumed at its acquisition-date <u>fair value</u>.

9. Application of those principles means that acquisition-related costs associated with a business combination would not be accounted for as part of the business combination accounting (and, generally, would be expensed in the period they are incurred). Acquisition-related costs do not meet the recognition criteria of an asset acquired in a business combination and are not part of the fair value

measurement of recognised assets acquired and liabilities assumed in a business combination.

10. The Boards could decide to make an exception to the principles to allow entities to capitalise acquisition-related costs. At their March 2006 meetings, the Boards decided that any exceptions to the principles must be clearly identified and the reasons for allowing an exception must be explained.

Recognition Principle

11. The recognition principle requires the acquirer to recognise all of the assets acquired and all of the liabilities assumed in a business combination.

Acquisition-related costs are not part of the exchange for the acquiree

12. The Boards concluded during initial deliberations that if a transaction or arrangement is designed primarily for the economic benefit of the acquirer or the combined entity (rather than the acquiree or its former owners), that transaction or arrangement is not part of the exchange for the acquiree. Therefore, those transactions or arrangements should be accounted for separate from the business combination.

13. Acquisition-related costs are internal costs of the acquirer or transactions or arrangements between the acquirer and other third parties. The staff believe that these acquisition-related costs are incurred for the benefit of the acquirer (or the combined entity) and not for the benefit of the acquiree or its former owners. Therefore, the staff conclude that acquisition-related costs are not part of the exchange for the acquiree. They represent separate transactions in which the buyer makes payments in exchange for services rendered.

Acquisition-related costs are not assets acquired in the business combination

14. Acquisition-related costs are not assets acquired as part of the business combination.[1] Acquisition-related costs, whether for services performed by external parties or by internal staff of the acquirer, do not represent assets as of the acquisition date because the services received are consumed immediately.

Measurement Principle

15. The measurement principle is that the acquirer <u>measures</u> each recognised asset acquired and each liability assumed at its acquisition-date <u>fair value</u>.

16. The FASB's 21 October, 2005 Working Draft, *Fair Value Measurements*, defined fair value as:

> Fair value is the price that would be received for an asset or paid to transfer a liability in a current transaction between marketplace participants in the reference market for the asset or liability.

17. In December 2005, the IASB decided to adopt that definition of fair value for purposes of the IASB's fair value measurement project subject to gaining a better understanding of the concept of a reference market.[2]

18. The FASB has since redeliberated the Fair Value Measurements Exposure Draft and has revised the definition of fair value. Currently, that revised definition states:

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[1] In February 2006, the staff presented as part of the Conceptual Framework Project a revised working definition of an asset to the Boards. The staff's conclusion that acquisition costs are not an asset would not change under this revised definition:

> An asset of an entity is:
> (a) cash held by the entity;
> (b) a present right of the entity to cash;
> (c) a present right, or other present privilege of the entity to a resource that is capable of generating economic benefits to the entity, either directly or indirectly.

[2] At its March 15, 2006 meeting, the FASB decided to remove references to "reference market" from the fair value definition and elsewhere within the Fair Value Measurements Statement because it created confusion in determining how the reference market concept should be applied. Instead, the FASB decided to clarify the reference market principle in the context of the principal market or, in the

> Fair value is the price that would be received for an asset or paid to transfer a liability in a transaction between market participants at the measurement date.

19. The 1 March, 2006 Working Draft of the Fair Vale Measurement Statement states:

> When measuring the fair value of the asset or liability, the objective is to determine the price that would be received for the asset or paid to transfer the liability in a transaction between market participants to sell or otherwise dispose of the asset or transfer the liability at a measurement date. In other words, the price used to measure fair value is an exit price considered from the perspective of a market participant (seller) that holds the asset or liability. [paragraph 7]
>
> For purposes of determining the most advantageous market for the asset or liability, the price in the respective markets shall include transaction costs (the incremental direct costs to transact in the market) and/or transportation costs (the costs to access that market). However, the price used to measure the fair value of the asset or liability shall include those costs only if they are an attribute of the asset and liability. *Transaction costs are not an attribute of the asset or liability (they are an attribute of the transaction). Therefore, the price used to measure the fair value of the asset or liability shall not include transaction costs.* [Paragraph 9; emphasis added.]

20. The IASB has not deliberated the FASB's draft Fair Value Measurement Statement. However, the staff believe that the quoted paragraphs describe the implications of the adopted definition of fair value.

21. The proposed definition clearly articulates the concept of an exit price exchange from the perspective of the reporting entity. The staff believes that application of the fair value measurement principle means that acquisition-related costs are excluded from the initial measurement of the assets acquired and the liabilities assumed in a business combination.

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absence of a principal market, the most advantageous market in which the entity would sell or otherwise dispose of the asset or transfer the liability.

COMMENT LETTER RESPONSES

22. Most constituents who commented on the proposed accounting for acquisition-related costs disagreed with the proposal. Those who disagreed did so for the following reasons:

    a. many objected to the proposed treatment of acquisition-related costs because they disagreed generally with the proposed accounting for business combinations. They argued that business combinations should be accounted for using a cost accumulation approach and, therefore, should include acquisition-related costs.

    b. expensing acquisition-related costs is a significant change in practice and is contradictory to how acquisition-related costs are treated under other standards. The Boards should address the accounting for acquisition-related costs comprehensively, not just in a business combination.

    c. acquisition-related costs are an integral part of the purchase price. Every acquirer considers acquisition-related costs in determining what they are willing to pay for an acquiree, therefore, they form part of the consideration transferred and part of the fair value of the acquiree.

23. For example, PWC (CL #66) wrote:

> We do not disagree with the conceptual basis on which the Boards have proposed to exclude transactions costs from the consideration transferred in a business combination. However, we believe this is a broader issue that should be addressed more comprehensively. Current accounting under both US GAAP and IFRS requires capitalization of transactions costs related to the acquisition of a single asset or a group of assets, real estate and some financial assets. We are concerned about the disparate accounting treatment between business combinations and asset acquisitions in cases where the transactions are economically similar. We therefore recommend that the Boards address the accounting for transaction costs in a comprehensive project. Until then, we believe that the Boards should retain current accounting practice under IFRS and US GAAP that requires capitalization of transaction costs.

24. Goldman Sachs (CL #7) stated:

> We believe acquisition-related costs are part of the buyer's total purchase price of the acquiree. They are an inextricable component and essential requirement of business acquisitions. Expensing these items at the outset would inappropriately reduce current period earnings because the economic impact of the associated transaction would continue over time. We believe the proposed accounting would diverge from the economic reality of these transactions.

25. Grant Thornton (CL #20) wrote:

> Although we agree that costs are not assets, we understand that the asset to be recognised is the acquired business as a whole. Therefore, we addressed the question of how to account for acquisition-related costs by considering the basis for measuring the fair value of what the acquirer acquired – a business. We believe that the amount of direct acquisition-related costs (transaction costs) incurred in connection with a business combination represents part of the measure of the fair value of the acquired business and should be accounted for as part of the business combination.

26. A minority of respondents generally agreed with the fair value model proposed in the BC ED and that the fair value of the acquiree does not include transaction costs.

27. For example, Houlihan, Lokey, Howard & Zukin (CL #47) wrote:

> We agree that transaction costs sometimes vary and, although common, do not represent a fair value addition to the net assets acquired. You cannot, for example, turn around and sell the asset acquired for the price you paid for the asset plus the transaction costs.

28. Generally, users of consolidated financial statements have been supportive of the proposal. For example, Fitch Ratings (CL #16) stated:

> We are supportive of the notion that acquisition-related costs are not a part of the consideration transferred in exchange for the acquired business. While we understand the notion that these costs were incurred solely to consummate the transaction, we do not believe they are relevant for assessing the future financial performance of the acquired business and therefore, should be excluded from the costs of the acquired business.

STAFF ANALYSIS

Expensing acquisition-related costs is inconsistent with the treatment of acquisition-related costs in other standards

Accounting for acquisition-related costs under IFRS 3 and Statement 141

29. IFRS 3 and SFAS 141, which are both cost-based models, require the capitalisation of direct acquisition-related costs. On the other hand, direct costs incurred in an unsuccessful negotiation to acquire one or more businesses must be expensed. Indirect costs such as the costs of maintaining an acquisitions department must be expensed, too, although those costs can be attributable to a successful acquisition.

30. The accounting for issuance costs currently differs between US GAAP and IFRSs. Under IFRSs, costs of arranging and issuing financial liabilities are accounted for in accordance with IAS 39 and are included in the initial measurement of the liability. In accordance with IAS 32, the costs of issuing equity instruments reduce the proceeds from the equity issue. Under US GAAP, the accounting for issuance costs in practice is mixed. The FASB recently considered the accounting for issuance costs in its project on liabilities and equity and has tentatively agreed that those costs should be expensed when incurred.

31. Under the BC ED, any direct and indirect acquisition-related costs (including issuance costs) will be excluded from the fair value measurement. Therefore, the BC ED will create consistency in the accounting for acquisition-related costs incurred in a business combination, other than issuance costs. The accounting for issuance costs will continue to differ between IFRSs and US GAAP.

Consistent accounting for acquisition-related costs

32. Respondents generally agreed that the proposed treatment will improve consistency for the accounting for direct versus indirect acquisition-related costs. However, they were concerned that the proposed accounting differs from the treatment of acquisition-related costs in other standards. In their opinion, the BC ED might result in the same assets being measured differently depending on how

they were acquired. Respondents were troubled by the notion that the way an asset was acquired might affect its initial measurement.

33. Those comments from respondents imply that the initial measurement of assets acquired as part of a business combination and assets acquired outside of a business combination are currently aligned. IFRSs and US GAAP do not necessarily measure assets acquired as part of a business combination and assets acquired outside of a business combination the same way. The proposed expensing of acquisition-related costs only affects goodwill.

34. The staff shares respondents concerns that the proposal may be inconsistent with the accounting for acquisition-related costs in other standards. That inconsistency is primarily created because some standards use cost as their measurement attribute and some use fair value as their measurement attribute. The BC ED proposed that the measurement attribute for accounting for a business combination be fair value, which is inconsistent with the cost measurement attribute in an asset acquisition.

35. Some respondents concede that the BC ED provides a conceptually sound basis for the initial measurement of assets acquired and liabilities assumed in a business combination, but they would prefer that the Boards address acquisition-related costs as part of a more comprehensive project.

36. The staff agrees that, conceptually, the accounting for acquisition-related costs should be the same for the acquisition of an asset, a group of assets and a business. However, the Boards have agreed to limit the scope of this project to accounting for business combinations. Therefore, in our opinion the BC ED will significantly improve the accounting for acquisition-related costs in a business combination because it will create consistency for the accounting for direct and indirect acquisition-related costs. The Boards must weigh the benefits of improving the accounting for business combinations, which are a significant and important economic activity, against the benefits of consistency of accounting for acquisition-related costs, which would require a comprehensive review. The staff believes that addressing the issue of acquisition-related costs in a

comprehensive project would unduly delay the implementation of improved accounting guidance for business combinations.

Every acquirer considers acquisition-related costs in determining what they are willing to pay for an acquiree; therefore, they form part of the consideration transferred and part of the fair value of the acquiree

37. Many respondents were concerned that the proposed accounting for acquisition-related costs fails to reflect the economic substance of the exchange transaction. In their view, acquisition-related costs are an unavoidable cost of the investment. As with other investments, an acquirer intends to recover this cost through the post-acquisition operations of the business. In order for the transaction to be justified economically, the acquirer must expect that the returns on what is acquired to equal or exceed the total cost of acquisition (the purchase consideration plus the acquisition-related costs).

38. Some respondents argue, therefore, that it would be consistent with the fair value measurement principle to include acquisition-related costs in the initial measurement of assets acquired and liabilities assumed in a business combination.

39. The staff believes that those constituents are confusing <u>fair value</u> with <u>cost accumulation</u>. What they are really saying is that they would prefer that the BC ED be based on a cost accumulation notion rather than fair value.

40. The staff agrees further with the following conclusion drawn by the Boards during initial deliberations and documented in BC87 of the IASB's BC ED (see also B97 of the FASB ED):

> …The [IASB] was not persuaded that the seller of a business is willing to accept less than fair value as consideration for its business merely because a particular buyer may incur more (or less) acquisition-related costs than other potential buyers for that business. The [IASB] concluded that the intention of a buyer, including how acquisition-related costs are expected to be recovered, is distinct from fair value measurement of the acquiree.

41. The staff believes that including acquisition-related costs in the initial measurement of assets acquired and liabilities assumed in a business combination is not in accordance with the principle that in a business

combination the acquirer measures each recognised asset acquired and liability assumed at its acquisition-date fair value. However, some would argue that an exception from the measurement principle would be justified with respect to acquisition-related costs because capitalising acquisition-related costs would result in presentation of the acquirer's entire initial investment in the acquirer's balance sheet.

42. The staff believes that this exception would not improve financial reporting for business combinations. We view fair value to be the most relevant measurement attribute of assets acquired and liabilities assumed in a business combination. Including acquisition-related costs in the initial measurement of the assets acquired or liabilities assumed in a business combination would be a fundamental shift away from the fair value measurement principle to which the Boards have agreed.

43. The staff understands that users of financial statements want the ability to obtain information on the initial investment in the acquiree. However, we believe that information on the initial investment in the acquiree does not justify an exception to the fair value measurement principle and is best conveyed by footnote disclosure.

44. The proposals already require the acquirer to disclose information about the acquisition that will allow the users of its financial statements to assess the consideration transferred, the acquisition costs incurred and the fair value of the assets acquired and liabilities assumed. Users should be able to identify the total amount paid by the acquirer in relation to the acquisition and what was received in exchange from the parties involved—that is to say, the total of the acquisition-related services received and the fair values of the assets acquired and the liabilities assumed.

45. The illustration that follows highlights the type of presentation that an acquirer could make to comply with the BC proposals. The BC ED references to the left

of each item identify the paragraph in the proposals that would require that item to be disclosed.[3]

BC ED Disclosure	**Consideration**	CU
72(f)(1)	Cash	1,000
72(f)(2)	Other tangible assets	400
72(f)(4)	Debt instruments	2,000
72(f)(5)	Equity instruments	5,000
72(f)(6)	Fair value of the previously held investment in the acquiree	1,100
72(f)(3)	Additional consideration expected to be paid	500
	Total consideration transferred	10,000
72(l)	Acquisition costs	1,250
	Fair value of assets acquired and liabilities assumed[4]	
72(g)	Inventory	1,000
72(g)	Property, plant and equipment	9,000
72(g)	Financial assets	3,000
72(g)	Identifiable intangible assets	2,100
72(g)	Goodwill	2,400
		17,500
72(g)	Financial liabilities	(5,000)
72(e)	Fair value of the acquiree	12,500
	Non-controlling interest in the acquiree	(2,500)
	Fair value of the interest acquired	10,000

46. In the example above the total outlay is CU11,250, and a user can identify the assets, liabilities, non-controlling interests and acquisition-related expenses related to that outlay. The total initial outlay will only be identifiable as a consequence of the explanatory note disclosures proposed, it cannot be identified by assessing the balance sheet.

47. It is unlikely that the total initial outlay could be identified from the acquirer's financial statements in any period other than the period in which the acquisition is recognised. Capitalising acquisition costs as part of goodwill does not help a user identify or assess the total cost of the acquisition.

48. Some respondents were also concerned that the view on acquisition-related costs adopted by the BC ED might create gaming incentives. For example, the acquirer could ask the seller to pay for acquisition-related costs on its behalf and offer to consider those payments when negotiating the purchase price. The

[3] The numbers are contrived and are intended to assist Board members in interpreting the example.

disguised reimbursement effectively would be treated as part of the consideration for the business; thus the acquirer would not recognise expenses on acquisition-related costs.

49. The staff agrees that those incentives may exist. However, we think that the BC ED offers sufficient guidance to assess what is part of the exchange for the acquiree and what is not. Under the BC ED, any portion of the transaction price that is not part of the exchange for the acquiree should be accounted for separate from the business combination.

STAFF RECOMMENDATION AND QUESTION FOR THE BOARDS

50. The BC ED proposes not to include acquisition-related costs in the measure of the fair value of the acquiree or the assets acquired or liabilities assumed as part of the business combination accounting. In the staff's view, the proposed accounting is consistent with the recognition and measurement principles adopted by the Boards.

51. Acquisition-related costs do not meet the recognition principle for business combinations because they generally do not represent assets acquired or liabilities assumed in a business combination. Rather, they represent separate transactions in which the buyer makes payments in exchange for services rendered.

52. Both Boards have agreed that a fair value measure excludes transaction costs. Consequently, capitalisation of acquisition-related costs incurred in a business combination would conflict with the measurement principle.

53. In the staff's view, neither inconsistencies with the accounting for acquisition-related costs under other standards nor the argument that the acquirer considers acquisition-related costs in determining what it is willing to pay justify a departure from the recognition and measurement principles. The staff agrees with respondents that users of financial statements are interested in obtaining

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[4] The requirement in the BC ED is to disclose the aggregate fair value of each major class of asset acquired or liability assumed. The classes presented here are intended to be indicative rather than

information on the initial investment in the acquiree, but believe that information on the initial investment in the acquiree is best conveyed by footnote disclosure and should not affect the accounting for acquisition-related costs.

54. Therefore, the staff recommends the Boards affirm that the acquirer does not include acquisition-related costs in the measure of the fair value of the acquiree or the assets acquired or liabilities assumed as part of the business combination. Instead, the acquirer accounts for acquisition-related costs separate from the business combination in accordance with other IFRSs or US GAAP.

Do the Boards agree?

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prescriptive.