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International
Accounting Standards
Board

INFORMATION FOR OBSERVERS

Board Meeting: **20 July 2006, London**

Project: **Business Combinations II**

Subject: **Accounting for Restructuring Costs in a Business Combination (Agenda Paper 2B)**

Introduction

1. The Business Combinations Exposure Draft (BC ED) proposes that an acquirer recognize the acquisition-date fair value of liabilities for restructuring or exit activities acquired in a business combination *only if* they meet the recognition criteria in FASB Statement No. 146, *Accounting for Costs Associated with Exit or Disposal Activities* or IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*. Costs associated with restructuring or exit activities that do not meet the recognition criteria in Statement 146 or IAS 37 are not liabilities on the acquisition date, and thus, would be recognized as postcombination activities or transactions of the combined entity when incurred (BC ED, paragraph 37, paraphrased).

2. The BC ED does not change the accounting for restructuring costs that is currently required by IFRS 3, *Business Combinations*. The few respondents that apply IFRS supported those existing requirements, and did not identify any specific issues in applying that guidance. The remainder of this memo addresses issues raised by FASB constituents in their comment letters to the BC ED.

3. This memo:

    a. Summarizes the FASB's initial deliberations and basis for conclusions

    b. Discusses respondents' concerns about the proposed accounting for restructuring costs

    c. Asks the Boards to reaffirm the proposed accounting for restructuring costs

Initial deliberations and the FASB's basis for conclusions

4. The FASB discussed the accounting for restructuring costs at its April 17, 2002 Board Meeting. [Sentence omitted from observer notes]

5. During initial deliberations, the Board reconsidered the guidance in EITF Issue No. 95-3, "Recognition of Liabilities in Connection with a Purchase Business Combination." That guidance requires an acquirer to recognize particular costs of its plans to exit an activity of an acquiree, involuntarily terminate employees of an acquired company, or relocate employees of an acquired company (referred to in this memo as restructuring activities) as liabilities assumed at the acquisition date if specific criteria are met. Therefore, those costs would be included in the purchase price allocation process under Statement No. 141, *Business Combinations* (formerly APB Opinion No. 16, *Business Combinations*). The Board concluded that consistent with Statement No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*, costs associated with restructuring or exit activities of a newly acquired business should only be recognized as liabilities in the initial recognition of the business combination if those costs meet the recognition criteria in Statement 146 as of the acquisition date. As noted in paragraph B109 of the FASB's BC ED, the Board concluded as it did in FASB Statement No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*, that:

> Only present obligations to others are liabilities under the definition. An obligation becomes a present obligation when a transaction or event occurs that leaves an entity little or no discretion to avoid the future transfer or use of assets to settle the liability. *An exit or disposal plan, by itself, does not create a present obligation to others for costs expected to be incurred under the plan; thus, an entity's commitment to an exit or disposal plan, by itself, is not the requisite past transaction or event for recognition of a liability*. [Paragraph 4, emphasis added.]

6. Therefore, the BC ED proposes to nullify the guidance in Issue 95-3 and require that an acquirer recognize costs for restructuring *only if* they meet the recognition criteria in Statement 146.

7. The staff notes that restructuring costs were also discussed briefly at several meetings during initial deliberations in the context of determining whether the transaction price and any assets acquired or liabilities assumed were part of the exchange for the acquiree. The Boards consistently agreed that only restructuring costs that met the recognition criteria in Statement 146 or IAS 37 should be recognized as liabilities assumed in the business combination.

Principles underlying the accounting for restructuring costs

8. The Boards agreed to the following recognition principle in March 2006:

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

9. The staff believes the recognition principle provides the basis for determining whether restructuring costs should be recognized as liabilities assumed in the business combination or recognized when the costs are incurred after the acquisition date. That is, restructuring costs that do not meet the recognition criteria in Statement 146 at the acquisition date are not liabilities; therefore, the acquirer should not recognize those costs as liabilities assumed in a business combination.

Comment letter responses

10. Most respondents that commented on the proposed accounting for restructuring costs apply U.S. GAAP and disagreed with the proposal. Those respondents disagreed for the following reasons:

    a. Acquirers factor restructuring costs into the amount they are willing to pay for an acquiree. As a result, those costs should be part of the initial business combination accounting.

    b. The proposal is inconsistent with the Board's decisions regarding contingencies. That is, it is not clear why the Board decided that restructuring costs should not be recognized as liabilities assumed in the business combination when they are much more likely to be incurred than some remote contingencies that the Board proposes to recognize at fair value.

    c. Capitalizing restructuring costs as part of the business combination is consistent with guidance for other assets (such as fixed assets), where the amount capitalized is equal to the amount paid to acquire and place the asset in service.

11. Some respondents that agreed with the proposal did so for the following reasons:

a. Anticipated restructuring costs should not be recognized as liabilities assumed in a business combination since they are not liabilities at the acquisition date.

b. The proposal would eliminate the inconsistency that exists under U.S. GAAP for accounting for restructuring costs. That is, EITF Issue 95-3 allows acquirers to accrue liabilities as part of the business combination if they intend to restructure the acquiree's operations and meet particular conditions. However, acquirers are not allowed to accrue liabilities as part of the business combination if they intend to restructure their own operations as a result of the business combination. Additionally, the proposed accounting for restructuring costs in a business combination would be consistent with the requirements for accounting for restructuring costs outside of a business combination under Statement 146.

Staff Analysis

Restructuring Costs Are Factored into the Amount Acquirers are Willing to Pay for an Acquiree

12. Many respondents stated that restructuring costs, like acquisition-related costs, are factored into the price that an acquirer is willing to pay for the acquiree. As a result, the proposed accounting fails to reflect the economic substance of the business combination transaction. In their view, restructuring costs are unavoidable costs of an acquirer's investment in a business combination, and those costs should be factored into the fair value of the consideration paid. For example, Goldman Sachs (CL #7) stated:

> We do not agree with the presumption in the proposal that the fair value of the acquired business should only reflect the consideration received by the seller. In our experience, restructuring costs which are contemplated by the buyer at the time of acquisition are considered part of the total purchase price of the acquiree. They are necessary to achieve the contemplated synergies from completing the combination. Transactions in which a buyer can achieve synergies through restructuring will have a significant positive impact on both the price the buyer is willing to pay the seller, and the in-use value of the restructured business. The additional value resulting from such synergies is a determinant in the buyer's decision to engage in the purchase and related restructuring and, as noted, is used to forecast the transaction's impact on earnings, IR, and other business performance metrics. If such restructuring items are identified at the time of acquisition, and management has committed to a plan to restructure, we believe provisions should be established for such costs and included as part of the purchase price. Any unutilized provisions should be credited against goodwill.

13. Brady Corporation (CL #28) stated:

> In practice, restructuring costs that are contemplated by the acquirer at the time of the acquisition are considered part of the total cost of the acquisition of the acquiree. These types of costs are generally necessary to achieve the necessary synergies to justify the purchase price paid, thus these

> types of costs are clearly considered in determining the purchase price. To the extent that the decision to terminate employees or exit an activity is contemplated at the time of the acquisition (versus based on a decision after the fact), the related cost should be recognized as part of the cost of the acquisition as these costs were contemplated by the acquirer in determining the value to pay for the acquiree.

14. The staff agrees that any knowledgeable and willing buyer would factor a variety of costs into its decision to purchase a business. For example, a buyer would most likely consider acquisition-related costs, restructuring costs, and the price of the assets and liabilities of the acquiree as part of its purchase decision. That is, those factors will influence what the acquirer is prepared to pay for the acquiree. The staff also agrees that those costs would likely be viewed as part of the total "investment" in the acquired business. However, the acquirer does not pay the owner of the acquiree for such anticipated costs or activities, nor does the acquirer's plans to undertake those activities give rise to an obligation and associated liability at the acquisition date. The liability associated with such costs are usually incurred by the acquirer after it gains control of the business.

15. This treatment is analogous to the way an asset acquisition is accounted for under IFRSs and U.S. GAAP. For example, suppose an airline acquires a passenger aircraft from another airline. The acquirer will factor the costs of changing the logo on the aircraft and any other intended changes to its configuration to determine what it will pay for the aircraft. Other airlines bidding for the aircraft might also have plans to change the aircraft if they are the successful bidders. The extent of the plans each airline has and the costs each would incur are likely to differ.

16. Under IFRSs and U.S. GAAP none of those anticipated, post-acquisition costs are recognized at the date the aircraft is acquired. Those costs are accounted for after control of the aircraft is achieved. If those costs add to the value of the aircraft, and meet the requirements under IFRSs or U.S. GAAP, they will be recognized as assets (possibly added to the carrying amount of the aircraft). Otherwise those additional costs are likely to be expensed. The staff views the accounting proposed in the BC ED as being consistent with the accounting for an asset acquired outside of a business combination. Moreover, a restructuring outside the context of a business combination is generally undertaken to make an existing business more valuable; however, the costs of such activities are generally expensed as incurred and not recognized as assets.

17. Application of the principle and related guidance discussed in Memo #21 / Agenda Paper 2A that only the consideration transferred and the assets acquired or liabilities assumed that comprise the acquiree shall be accounted for using the acquisition method leads to the accounting proposed for restructuring costs. Other transactions should be accounted for separately based on their economic substance in accordance with other IFRSs/U.S. GAAP (that is, IAS 37/Statement 146 for restructuring costs). The staff also observes that the intention of the buyer to incur restructuring costs does not meet the definition of a liability. Therefore, unless restructuring costs meet the criteria for recognition in Statement 146 at the acquisition date, those costs are not liabilities at the acquisition date and those costs are not components of the business combination.

18. The staff notes that the BC ED states that restructuring costs that are not liabilities at the acquisition date are generally recognized "as postcombination expenses of the combined entity when incurred" (paragraph 37). That statement suggests that the expenditure is presumptively an expense. However, restructuring activities could also lead to the recognition of assets in accordance with an entity's capitalization policies after the acquisition date when the costs are incurred. The staff believes that paragraph should clarify that the expenditure should be accounted for under other IFRSs or U.S. GAAP in the postcombination period.

The Proposed Accounting for Restructuring Costs is Inconsistent with the Board's Decisions Regarding Contingencies

19. Some respondents questioned why contingencies should be recognized at fair value (and therefore included as part of the exchange for the acquiree) while restructuring costs, which are more than likely to occur, would not be considered as part of the exchange. For example, Cisco (CL #51) stated:

> …this proposal is inconsistent with other proposed requirements to recognize contingencies and other liabilities at fair value at the acquisition date. As part of an acquirer's assessment of the acquiree, decisions are made about the business, including employee and contract termination decisions, which are more than likely to occur. Under the Exposure Draft, if at the time of the acquisition, the proposed requirements have not been met, recognition of these liabilities would not be permitted, even though they are more than likely to occur…We do not believe this proposal would serve to meet the Board's objective of more reliable and transparent financial information.

20. The staff agrees with respondents that restructuring costs might often be more likely to occur than many contingencies that would be recognized at fair value under the proposals. However, the staff does not agree that the proposal produces an inconsistency between the accounting for restructuring costs and contingencies. In fact, the staff believes the proposals for restructuring costs are consistent with the Board's decisions for contingencies because in both cases, a liability is recognized when there is an obligation arising from either a contingency or restructuring activity that meets the definition of a liability as of the acquisition date. The staff believes respondents making this argument likely do not agree with the accounting for restructuring costs more generally in which liabilities are recognized only when an obligation to incur such costs occured.

21. In the IASB's June 2006 meeting, as part of the IASB's redeliberations of Proposed Amendments to IAS 37, *Provisions, Contingent Liabilities and Contingent Assets* (IAS 37 ED), the IASB staff clarified that before considering whether an item should be recognized, a potential candidate for liability recognition must first be determined to meet the definition of a liability[1]. The BC ED proposes to recognize restructuring costs and contingencies when they meet the definition of an asset or liability. The likelihood or probability of occurrence is considered in the measurement of those assets and liabilities. The staff will continue to monitor the redeliberations of the IAS 37 ED and will discuss the proposed accounting for contingencies at a future meeting.

[1] See June 2006 IASB Update and Agenda Paper 3A *IAS 37 amendments—reconsidering the probability recognition criterion*

Capitalizing Restructuring Costs as Part of the Business Combination is Consistent with Guidance for Other Assets

22. Several respondents noted that capitalizing restructuring costs related to an acquired business is consistent with existing accounting guidance for other assets where the costs incurred to bring an asset to expected service are capitalized as part of the cost of the asset. For example, Key Corp (CL #73) stated:

> Restructuring costs associated with the acquired company are generally incurred to optimize the net assets of the acquired company so that the benefits contemplated from the combined entity may be realized. Such costs are incurred to prepare the net assets of the acquired entity for their intended use. Therefore, Key contends that restructuring costs associated with the acquired company should also continue to be capitalized as an element of the acquirer's purchase price.

23. This matter was discussed in paragraphs 14 through 18. The staff believes that these constituents are confusing 'anticipated' costs with actual costs incurred. The staff believes that the Board's basis for conclusion in paragraph B109 of the FASB's BC ED explains why capitalizing anticipated restructuring costs as part of the business combination is inappropriate. Paragraph B109 states:

> The Board observed that in accordance with Statement 141, and its predecessor Opinion 16 and related interpretive guidance, particular items were being recognized in practice *as if* they were assets acquired or liabilities assumed at the acquisition date even though they did not meet the definition of an asset or a liability. That practice appears to stem from whether an item is viewed as part of the cost of (or investment in) the acquiree. For example…in accordance with existing practices particular expenses for services received in connection with a business combination were capitalized as part of the cost of the acquiree (and recognized as part of goodwill) *as if* they were an asset at the acquisition date…[t]he Board also observed that some future costs that an acquirer expected to incur often were viewed as a cost of the acquiree and recognized *as if* they were a liability at the acquisition date. The Board concluded that the representational faithfulness, consistency, and understandability of financial reporting would be improved by eliminating such practices.

24. The staff believes that restructuring costs that meet the criteria for capitalization in other IFRSs or U.S. GAAP should be capitalized when the costs are incurred in the postcombination period.

Structuring Opportunities

25. Based on the proposed approach for recognizing restructuring liabilities, the staff notes that an acquirer could structure a business combination to recognize restructuring or exit costs as liabilities assumed. For example, the acquirer could require the acquiree to implement particular exit or disposal activities prior to the acquisition date so that the recognition criteria would be met, and the acquirer would be able to recognize those costs as assumed liabilities in the business combination. The staff believes the guidance for identifying components of a business combination and assessing their economic substance, which is discussed in Memo #21/Agenda Paper 2A should reduce the risk of transactions being structured to make restructuring costs look like they are part of the liabilities assumed that comprise the acquiree at the acquisition date.

Staff Recommendation and Question for the Boards

26. The staff recommends the Boards affirm that an acquirer recognize restructuring or exit costs as liabilities assumed in a business combination only if those costs meet the recognition criteria in Statement 146 or IAS 37 as of the acquisition date. Those liabilities would be measured at fair value on the acquisition date. Therefore, restructuring or exit costs that do not meet the recognition criteria should be recognized when they occur as a substantively separate transaction from the business combination.

Do the Boards agree?