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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting: **March 2006, London**

Project: **Business Combinations II**

Subject: **Accounting for Bargain Purchases and Overpayments (Agenda Paper 2C)**

PURPOSE OF THE MEETING

1. At the IASB's March 2006 Board meeting and the FASB's March 28, 2006 Board meeting, the staff will discuss the proposed accounting for bargain purchases and overpayments in the business combinations Exposure Draft (BC ED). As noted in the January 2006 meetings materials, the Boards considered most of the alternatives respondents raised before reaching the conclusions proposed in the BC ED. The staff reconsidered those alternatives and any new alternatives respondents raised in paragraphs 18–21 of this memorandum.

BACKGROUND

2. Two principles in the BC ED are that in a business combination, the acquirer:

(a) **Recognizes** all of the assets acquired and all of the liabilities assumed.

(b) **Measures** each recognized asset acquired and each liability assumed at its acquisition-date **fair value**.

Paragraph 20 of the BC ED states that "business combinations are usually arm's-length exchange transactions in which knowledgeable, unrelated willing parties *exchange equal* *values*. Therefore, in the absence of evidence to the contrary, the exchange price (referred to as the consideration transferred in this Statement) paid by the acquirer on the acquisition date is presumed to be the best evidence of the acquisition-date fair value of the acquirer's interest in the acquiree" (emphasis added). When a business combination is <u>not</u> an *exchange of equal values*, the following can occur:

(a) The acquirer obtains a business that is worth more than it paid for that business (that is, the consideration transferred for the acquirer's interest in the acquiree is less than the fair value of that interest)—the proposals label this as a ***bargain purchase.***

(b) The acquirer pays more for a business than that business is worth (that is, the consideration transferred for the acquirer's interest in the acquiree is more than the fair value of that interest)—the proposals label this as an ***overpayment.***

Initial Deliberation Materials for Bargain Purchases and Overpayments

3. The Boards discussed the accounting for bargain purchases and overpayments at the following meetings:

(a) The IASB's March 2003, and July 2004 Board meetings

(b) The FASB's March 17, 2003, March 26, 2003, and October 8, 2003 Board meetings

(c) The October 23, 2003 joint IASB-FASB meeting.

[Remainder of paragraph 3 not reproduced in observer notes.]

Overview of the Decisions Reached During Initial Deliberations

Bargain Purchase Decisions

4. The IASB concluded at its March 2003 meeting that when there is evidence that a business combination is a bargain purchase, a gain would only be recognized to the extent that it exceeded any goodwill. The FASB discussed this alternative at its March 17, 2003 meeting and agreed with this decision at its March 26, 2003 meeting.

Overpayment Decisions

5. The IASB decided at its March 2003 meeting that when there is evidence that an acquirer overpaid to acquire a business, that overpayment should be recognized in profit or loss at the acquisition date. That issue was briefly discussed at the FASB's March 17, 2003 meeting, but some Board members requested further analysis. The FASB staff provided the

additional analysis for accounting for overpayments to the FASB at its October 8, 2003 meeting. During that meeting, the FASB concluded that while it is conceptually appropriate to expense an overpayment on the acquisition date, practically, the amount of an overpayment would not be known on the acquisition date. Therefore, consistent with Statement 141, the amount of an overpayment would be subsumed in goodwill and subsequently tested for impairment rather than expensed on the acquisition date. The FASB reached this conclusion because it believed that the consideration transferred by the acquirer on the acquisition date is generally the best evidence of the acquisition-date fair value of the acquirer's interest in the acquiree. That is, the fair value of the business acquired is generally best measured by using the consideration transferred rather than through other valuation techniques. Consequently, an overpayment would not be known at the acquisition date, and a decision to expense an overpayment would contradict that presumption. As a result of the FASB's decision, at the October 23, 2003 joint meeting the Boards discussed their differing conclusions for overpayments, but no decisions were reached to achieve convergence. At its July 2004 meeting, the IASB agreed with the FASB's view for accounting for overpayments in the BC ED at least for purposes of the ED.

BARGAIN PURCHASES

What Is a Bargain Purchase?

6. As noted above, a "true" bargain purchase is one in which the acquirer obtains a business that is worth more than it paid for that business. That is, the fair value of the consideration transferred by the acquirer is less than the fair value of the controlling interest acquired.

7. The Boards acknowledge, however, that a business combination may initially *appear* to be a bargain purchase because of three reasons:

(a) Errors in initially estimating either the cost of the combination or the fair value of the acquiree's net assets;

(b) A requirement to measure an acquired asset or assumed liability at other than fair value; or

(c) A "true" bargain purchase (IFRS 3, paragraph 57, paraphrased).

Estimation errors (a)

8. To mitigate the concerns about the potential for inappropriate gain recognition from estimation errors, the Boards proposed that an acquirer must recheck its fair value

measurements if it initially appears that the acquirer achieved a bargain purchase (BC ED, paragraph 60, paraphrased). If an excess remains after performing those remeasurement checks, then it is assumed the excess is the result of reasons (b) or (c) above. To further mitigate those concerns, the Boards proposed that the acquirer disclose the reason it was able to achieve a bargain purchase.

Non-fair value measurement attribute (b)

9. The Boards acknowledge that an acquirer might recognize a gain because the proposals in the BC ED allow some exceptions to the principles that the acquirer *measures* and *recognizes* each asset acquired and each liability assumed at its acquisition-date fair value. (For example, assets held for sale should be measured in accordance with FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, rather than at fair value).

10. However, the Boards believe that:

(a) The proposals in the BC ED address most of the deficiencies in past GAAP that previously led to negative goodwill results—that is, a result that had the appearance but not the economic substance of a bargain purchase, such as not recognizing the acquiree's contingencies at fair value.

(b) Most business combinations will result in enough goodwill to offset any "negative goodwill" that may result from recognizing particular assets and liabilities in accordance with other standards rather than at fair value.

11. While the Boards acknowledge that a calculated gain remains a possibility because the proposals in the BC ED allow a few exceptions to the fair value measurement, they concluded that recognizing a gain on the acquisition date is a more appealing alternative than allocating the excess back to particular assets acquired. For example, an acquirer initially calculates an excess of the identifiable net assets over the consideration paid to acquire those net assets. The acquirer determines that the "excess" is the result of measuring the acquiree's deferred taxes using Statement 109 or IAS 12 rather than fair value. In that case, it would be difficult to justify allowing the excess of the fair value of the deferred taxes and the Statement 109 or IAS 12 calculated amount to be allocated back to other identifiable assets that were measured at fair value since the excess can be attributed directly to the deferred taxes.

True bargain purchases (c)

12. The Boards concluded that true bargain purchases are rare because businesses and their owners would not willingly sell assets or businesses at prices below their fair values

without reason. A bargain purchase might occur if the seller is acting under compulsion and does not have time to adequately market the business to multiple, potential buyers.

13. The Boards observed that unlike a typical acquisition of an acquiree, an economic gain is inherent in a bargain purchase. Therefore, the Boards agreed that, conceptually, an acquirer should recognize a gain at the acquisition date.

Proposed Accounting for Bargain Purchases

14. The BC ED proposes that an excess of the fair value of the acquirer's interest in the acquiree over the fair value of the consideration transferred for that interest would reduce goodwill until the goodwill related to that business combination is reduced to zero. Any remaining excess would be recognized as a gain (paragraphs 59–61, paraphrased). Therefore, the only time a gain would be recognized is if the fair value of the net identifiable assets exceeds the fair value of the consideration transferred.

15. The existing requirement in IFRS 3 for accounting for bargain purchases has the same reporting outcome as the accounting proposed in the BC ED. IFRS 3 requires gain recognition to the extent that the amounts assigned to the acquiree's recognized identifiable net assets and contingent liabilities exceed the *cost* of the combination (IFRS 3, paragraph 56, paraphrased). In contrast, Statement 141[1] requires that when the amounts assigned to the acquired net assets exceed the cost of the combination, that excess (commonly referred to as "negative goodwill") is allocated as a pro rata reduction of the amounts assigned to the acquired assets, excluding financial assets, assets to be disposed of by sale, deferred tax assets, prepaid assets relating to employee benefit plans, and other current assets. The acquirer would then recognize an *extraordinary* gain for any excess remaining after reducing the acquiree's assets to zero (paragraphs 44 and 45, paraphrased). The Statement 141 requirement is not consistent with the principle that in a business combination, the acquirer *measures* each recognized asset acquired and each liability assumed at its acquisition-date fair value.

[1] Statement 141 does not refer to the excess as a bargain purchase, but it acknowledges that, in most cases, the excess is due to measurement errors in the purchase price allocation.

16. The following example compares the reporting for bargain purchases under the BC ED, IFRS 3, and Statement 141.

AC engages an appraiser to value Target. The appraiser determines that the fair value of Target is CU200. AC acquires Target for CU175. The fair value of Target's identifiable net assets includes current assets of CU210, noncurrent assets of CU30, and liabilities of CU60.

	Proposed in BC ED	**IFRS 3**	**Statement 141**
Fair value of Target (cost basis for IFRS 3 and Statement 141)	CU200	CU175	CU175
Less: Consideration transferred	(175)	(175)	(175)
Potential gain on bargain purchase	*25*	-	-
Fair value of Target (cost basis for IFRS 3 and Statement 141)	200	175	175
Less: Fair value of acquired net assets	(180)	(180)	(180)
Potential goodwill under BC ED or potential gain under IFRS 3 and Statement 141	*20*	*5*	*5*
Amount allocated to noncurrent assets*	-	-	5
Gain	5	5	-

AC would record the acquisition of Target in its consolidated financial statements as follows:

Current assets	210	210	210
Noncurrent assets	***30***	***30***	****25***
Goodwill	-	-	-
Liabilities	(60)	(60)	(60)
Cash	(175)	(175)	(175)
Gain	***(5)***	***(5)***	-

*In accordance with Statement 141, the excess of cost over net assets is allocated to noncurrent assets.

17. The Boards decided that the limit on gain recognition is a practical way to address the problems and concerns raised about measurement errors. They also believed that reducing any positive goodwill to zero before recognizing a gain is consistent with the presumption in the BC ED that the consideration paid is generally more reliably measurable than directly measuring the business acquired.

Comment Letter Responses

18. Respondents expressed mixed views about the proposed accounting for bargain purchases. Those respondents that supported the proposal generally did not provide their rationale for their support. Some respondents that did not support the proposal were troubled

by recognizing a gain on the acquisition date. For example, one respondent stated that "[d]ue to estimates inherent in the purchase accounting process…the write-down of assets below their estimated fair value is more appropriate than gain recognition because there has not been a culmination of an earnings process to justify recognition of a gain" (The Stanley Works (CL #45)).

19. Respondents offered a number of alternatives for the Boards to consider. The staff notes that the Boards considered most of those alternatives before the BC ED was issued. Respondents also raised a few new alternatives that the Boards did not consider previously. Those alternatives are discussed below. However, the staff continues to support the principles and proposals in the BC ED.

(a) *Retain the existing accounting in Statement 141 and reduce the values assigned to other assets by the amount of the potential gain.* The Boards considered this approach before they issued the BC ED but did not choose it because it would lead to particular assets being measured at amounts other than their fair values. This approach would not result in the immediate recognition of a "gain;" however, in future periods, a disguised "gain" could be recognized in the form of lower depreciation or amortization charges.

(b) *In addition to reducing goodwill, reduce other identifiable intangible assets before recognizing a gain because intangible assets are difficult to measure and are generally measured without reference to an active market* (BB&T Corporation (CL #36) and KPMG (CL #88)). This alternative is a variant of (a) above and implies that the "excess" should be applied against any difficult to measure asset, which is similar to the model required in Statement 141 that was rejected by the Boards.

(c) *Reflect the excess in other comprehensive income rather than recognizing a gain in the income statement.* The Boards did not consider this alternative before they issued the BC ED. One could pursue this approach because the excess might not be viewed as a gain that should qualify for immediate recognition in net income. (For example, the staff notes that if the excess relates to particular assets acquired or liabilities assumed that are not measured at fair value, this approach might be appropriate.) However, the staff believes the problem with this approach becomes evident with the subsequent accounting for the excess. Depending on how the excess is "recycled" in other comprehensive income, the result could produce a gain that might be a result of accounting conventions rather than an economic gain.

(d) *Apply any excess to reduce goodwill to zero, carry forward any remaining balance as a deferred credit, and apply that credit against reorganization costs and future losses* (NACVA/IACVA (CL #25)). The Boards considered recognizing the difference as a deferred credit but did not choose this approach because it does not meet the definition of a liability. The staff notes this approach is effectively a smoothing mechanism—it is a way of reducing the income statement impact of recognizing restructuring costs as post-combination expenses.

(e) *Apply the requirements previously in IAS 22, Business Combinations* (PwC (CL #66)). The IASB considered and rejected this approach in developing IFRS 3 (see paragraphs BC143–BC156 of IFRS 3). IAS 22 required the acquirer to recognize negative goodwill:

(i) Related to the expectation of future losses and expenses identified in the acquirer's acquisition plan in income in the period in which the future losses or expenses were recognized

(ii) As a contra-account against any recognized identifiable non-monetary assets (intangible assets). The acquirer would then reduce the contra-account in income over the life of the related assets

(iii) In income immediately for any remaining excess.

20. A few respondents stated that the proposed accounting was inconsistent with the presumption in the BC ED that the fair value of the acquiree can be reliably measured when a less than 100 percent interest is acquired. That is, if the Boards believed that the fair value of a business could be measured reliably through valuation techniques other than using the consideration paid, then there is no justification for not allowing an acquirer to recognize goodwill and a gain on the same business combination. The staff disagrees with those respondents and views this as a measurement issue. The issue is what is more reliably measurable—the consideration paid or the fair value of the acquiree. In a bargain purchase, the Boards' conclusion is consistent with the presumption in the BC ED that the consideration paid is generally more reliably measurable than directly measuring the acquiree. In a less than 100 percent acquisition, the Boards concluded that the amount paid for the less than 100 percent interest might not be the best evidence of the fair value of 100 percent of the acquiree. Therefore, the fair value of the acquiree often would be measured using other valuation techniques.

21. [Paragraph 21 not reproduced in observer notes.]

Staff Recommendation for Accounting for Bargain Purchases

22. The staff recommends that the Boards:

(a) Affirm that bargain purchases can occur and that an economic gain is inherent in a bargain purchase transaction. Therefore, conceptually, the acquirer should recognize a gain on the acquisition date.

(b) Affirm the proposed accounting for bargain purchases in the BC ED.

(c) Acknowledge that the accounting for a bargain purchase is an exception to the principle that the acquirer should *recognize* all of the assets acquired and all of the liabilities assumed since any positive goodwill would be reduced to zero before recognizing a gain. (Goodwill is already an exception to the fair value measurement principle.)

(d) Acknowledge that the accounting for a bargain purchase is consistent with the overpayment decision in that it is based on the notion that the consideration paid by the acquirer on the acquisition date is generally more reliably measurable than measuring the fair value of the interest acquired using other valuation techniques.

23. *Do the Boards agree with the staff's recommendation?*

OVERPAYMENTS

Proposed Accounting for Overpayments

24. The BC ED proposes that the acquirer not recognize an expense at the acquisition date if it believes it overpaid to acquire a business because (a) an acquirer would not knowingly overpay to acquire a business so an overpayment would not be known at the acquisition date, and (b) the acquirer could not reliably measure the amount of the overpayment at the acquisition date.

25. Both Boards concluded that it is conceptually appropriate to expense an overpayment on the acquisition date. However, the FASB decided that an exception should be made on the basis that it is unlikely that the amount of an overpayment would not be known on the acquisition date. They believed that the consideration paid generally is a more reliable measure of the fair value of the business acquired than directly measuring the fair value of the business (the acquiree). Therefore, any overpayment would be addressed through subsequent impairment testing when evidence of an impairment/potential overpayment first arises. In contrast, the IASB agreed to expose this exception in the BC ED and consider its position once the comment period ends (Paragraph B183 (FASB)/Paragraph BC178 (IASB)).

Comment Letter Responses

26. Most respondents agreed with the Boards' conclusion that known overpayments rarely exist and that the amount of an overpayment cannot be reliably measured at the acquisition date.

27. A few respondents questioned the consistency of this decision in relation to the requirement to measure the fair value of the acquiree and the bargain purchase decision. For example, KPMG stated:

> We agree with the Boards' conclusion that overpayments may not be reliably measured. However, this conclusion by the Boards raises questions about the ability to reliably measure the fair value of the acquired entity and the related use of the full fair value approach. Conceptually, if fair value of the acquired entity can be reliably measured and the consideration paid can also be reliably measured, the amount of the overpayment can be easily computed. Therefore the fact that the Boards have concluded that overpayments cannot be reliably measured raises questions about the Boards' conclusion that the fair value of the acquired entity can be reliably measured in all business combinations except those when there is an overpayment. [CL #88]

28. The staff disagrees with those respondents who stated the proposed accounting for overpayments is inconsistent with the proposed accounting for less than 100 percent acquisitions. The staff views this as a measurement issue. In the BC ED, it is presumed that the consideration paid is generally the best measure of the fair value of the interest acquired. Therefore, the Boards' conclusion that an overpayment cannot be identified on the acquisition date is based on the presumption that the acquirer should use the consideration paid to measure the fair value of the acquiree. In a less than 100 percent acquisition, the Board concluded that the amount paid for the less than 100 percent interest might not be the best evidence of the fair value of 100 percent of the acquiree. Therefore, the fair value of the acquiree often would be measured using other valuation techniques.

29. The staff understands the concerns expressed by a few respondents that the proposed accounting for overpayments is inconsistent with the proposed accounting for bargain purchases. That is, the acquirer is required to recognize a gain on a bargain purchase but is precluded from recognizing an expense on an overpayment. What is consistent with both of those decisions is that the Boards are effectively relying on the presumption in the BC ED that the consideration paid is more reliably measurable than a direct measurement using other valuation techniques.

30. Further, in practice, when evidence of an impairment or potential overpayment first arises subsequent to the acquisition, the impairment test results in recognition of the overpayment that was unknown, and therefore, not recognized at the acquisition date.

Staff Recommendation for Accounting for Overpayments

31. The staff recommends that the Boards:

(a) Affirm the proposed accounting for overpayments in the BC ED.

(b) Acknowledge that the accounting for overpayments is an exception to the principle that the acquirer should *recognize* all of the assets acquired and all of the liabilities assumed since any the overpayment, which is not an asset, would be subsumed in goodwill. (Goodwill is already an exception to the fair value measurement principle.)

(c) Acknowledge that the accounting for overpayments is consistent with the bargain purchase decision in that it is based on the presumption that consideration paid by the acquirer on the acquisition date is more reliably measurable than measuring the fair value of the interest acquired using other valuation techniques.

32. *Do the Boards agree with the staff's recommendation?*

DISCLOSURE

Proposed Disclosures

33. Paragraph 72(i) of the BC ED proposes that the acquirer disclose (a) the amount of gain recognized as a result of a bargain purchase, (b) the line item in the income statement in which the gain is recognized, and (c) a description of the reasons why the acquirer was able to achieve a gain.

Comment Letter Responses

34. Respondents did not raise any new issues or concerns related to the proposed disclosure of bargain purchases.

Staff Recommendation for Disclosure

35. The staff believes the proposal for the disclosure of bargain purchases provides useful information and should ease the concerns expressed by constituents about recognizing an immediate gain as a result of a business combination. The staff recommends that the Boards affirm the proposed disclosure requirements related to bargain purchases. Please note that the staff will bring a comprehensive package of disclosures to the Boards near the end of redeliberations.

36. Do the Boards agree with the staff's recommendation?