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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting:	**25 May 2006, London**
Project:	**Business Combinations II**
Subject:	**Reasons for Making Exceptions to Either the Fair Value Measurement Principle or the Recognition Principle (Agenda Paper 2A)**

Purpose of this memo

1. The primary objective of the business combinations project is to develop a single high-quality standard for accounting for business combinations that:

   a. reflects a common set of principles that provides decision-useful information (that is, improve the completeness, relevance, and comparability of financial information about business combinations), and

   b. minimizes exceptions to those principles.

   The Boards have decided on a **recognition principle** and a **fair-value measurement principle** that are intended to achieve that objective.

2. At this meeting the staff is asking the Boards to consider three papers that address possible exceptions to those principles. The three topics are:

   a. assets held for sale (Agenda Paper 2B);
   b. assets or liabilities related to employee benefit plans (Agenda Paper 2C); and
   c. assets and liabilities related to operating leases (Agenda Paper 2D)

3. The staff is asking the Boards to make tentative decisions on the accounting for those items in a business combination.

4. The staff believes that there are valid reasons the Boards might make exceptions to those principles. The staff believes that if the Boards want to develop a principle-based standard for accounting for business combinations, it is important to explain clearly those reasons for making exceptions. The staff believes that a standard is more understandable when the reason for an exception is explained and the grounds for making an exception are applied consistently in similar circumstances.

5. The staff has been developing a framework that it believes will help the Boards make decisions on when to make exceptions to, or develop guidance for, the principles. The staff has incorporated its thinking in the analysis presented in Agenda Papers 2B, 2C and 2D, but is not ready to present a formal framework to the Boards.

6. The staff will bring its framework for assessing exceptions and guidance to future Board meetings. If at any point the framework suggests that any of the decisions on exceptions and guidance made at this meeting should be revisited the staff will also bring those issues back to the Boards.

The recognition and measurement principles

Recognition principle

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

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

8. Application of the recognition principle means that the acquirer would recognize *all of* and *only* the assets acquired and liabilities assumed on the acquisition date. As a consequence, an acquirer would recognize the assets or liabilities (or both) in a business combination associated with operating leases, all intangible assets including an assembled workforce and in-process research and development, contingencies (and contingent consideration), asset retirement obligations, service concessions and emission rights. In the development of the ED, however, the Boards agreed to some exceptions to the recognition principle.

9. In addition, application of the recognition principle is consistent with the Boards' decision that acquisition-related costs should **not** be recognized as part of the business combination accounting (generally expensed as incurred) because they are not assets acquired in a business combination.

Fair value measurement principle

10. The Boards agreed to the following fair value measurement principle in March 2006:

> In a business combination, the acquirer **measures** each recognized asset acquired and each liability assumed at its acquisition-date **fair value**.

11. Application of this principle means that the initial measurement of each recognised asset acquired and each liability assumed in a business would be measured at its acquisition-date fair value. As a consequence, tangible, financial, and intangible assets (including goodwill and deferred tax assets)

would be measured at fair value, as would all liabilities (such as financial instruments, post-employment benefit obligations, contingencies, deferred tax liabilities.) In the development of the ED, the Board decided to make exceptions to the fair value measurement principle for some of those assets and liabilities.

12. The BC ED had a combined recognition and measurement principle, so it did not discuss whether each of those exceptions was an exception to fair value measurement or to recognition. Now that the principles have been separated into measurement and recognition, the remainder of this memo discusses the exceptions as being either an exception to the fair-value measurement principle or to the recognition principle (or both). The staff believes this will help organize our thinking about why those exceptions were proposed or about whether an exception might be appropriate.

Application of those principles

13. Even though the staff believes that the application of those principles will result in the reporting of decision-useful information about business combinations, this memo considers the circumstances when the Boards should analyze further the application of the principles. There might be narrowly defined circumstances when the Boards believe that it should depart from a principle even if such a departure might reduce the decision-usefulness of the information reported about acquired assets and assumed or incurred liabilities. For example, application of the principles might result in the accounting for some assets or liabilities being fundamentally different to that required by an existing IFRS or US GAAP. The Boards might decide that it is better to depart from a principle—create an exception within the accounting for a business combination—because they believe that consistency of the accounting justifies such a departure.

14. A difference could occur because of other IFRS or US GAAP requirements (for example, income taxes and employee benefit obligations) or because the asset acquired or liability assumed in a business combination is not subject to another

IFRS or US GAAP requirement. In the latter case the accounting for that asset or liability might differ from current practice.

15. The staff believes that application of the recognition principle is likely to merit further analysis if an IFRS or US GAAP prohibits the recognition (or separate recognition) of an asset or a liability related to a transaction. That prohibition could be because that requirement states that the asset or liability cannot be measured reliably or for some other reason (even though the amounts can be measured reliably). Generally, when an asset or liability is not recognised separately it will be recognised and measured as part of goodwill. When the staff presents its detailed analysis at future Board meetings the emphasis will be on considering whether the financial statements of an acquirer are likely to be more complete, relevant and comparable if an item is recognised separately from goodwill. In making that assessment the staff will assess the costs and benefits of the requirement.

16. For measurement matters, the staff will pay particular attention to those circumstances where an entity reporting under IFRSs or US GAAP would report a gain or loss as a result of the change in the accounting measurement attribute and not as a result of a change in the economic condition of the asset or liability.

17. The staff also intends to analyze further transactions that:

    a. respondents have identified that they believe should not be accounted for in accordance with the principles proposed; or

    b. were characterized in the BC ED as exceptions (assets held for sale, deferred taxes, assets and liabilities related to operating leases, assets or liabilities related to employee benefit plans and goodwill).[1]

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[1] The staff believes that it is appropriate to consider goodwill separately from the other exceptions. The BC ED defines goodwill as 'the future economic benefits arising from assets that are not individually identified and separately recognised'. This definition means that goodwill is a residual, and the BC ED proposes that it be measured as a residual. Accordingly, the staff does not intend to use the framework described here in assessing whether it might be appropriate to consider allowing goodwill to be measured on some basis other than fair value. Over the next few months, the staff will bring back issues related to measuring goodwill and our recommendations for how to measure goodwill.

18. By taking this approach the staff is also highlighting some areas where applying the principles might result in a material change from current practice. The purpose in doing this is to ensure that the Boards are aware of the implications of the principles. For example, many entities reporting under IFRSs operate in jurisdictions where the rights and obligations associated with emitting identified pollutants are managed through emission rights schemes. Any assets or liabilities associated with those schemes would be recognised in a business combination and measured at their acquisition-date fair values. This might be a change from current practice. The staff is not suggesting that a material change from current practice is an appropriate reason for making an exception to the principles. The staff is only highlighting those changes to the Boards and to constituents so that the implications are clear before the business combinations standard is finalized.

19. ***Do the Boards agree with the approach the staff is taking to identify the circumstances when the Boards should consider further whether the application of a principle is improving the completeness, relevance, and comparability of financial information about business combinations that is reported in financial statements?***

Assessing the implications

20. Having identified which assets and liabilities might be considered further, the next step is to identify the factors that would lead the Boards to allow an exception to a principle or to provide additional guidance on how those principles should be applied.

21. Although the staff is still developing a framework for assessing the relative costs and benefits of applying the principles and allowing departures from those principles it does not believe that the absence of a formal framework prevents the Boards from considering the matters presented in Agenda Papers 2B, 2C and 2D. As the staff has indicated, its current thinking is reflected in those Papers and the staff will assess any decisions made at this meeting in the light of the exceptions framework the Boards decide on.