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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting: **25 May 2006, London**

Project: **Business Combinations II**

Subject: **Exceptions to the Fair Value Measurement Principle – Assets Held for Sale (Agenda Paper 2B)**

Introduction

1. The Business Combinations Exposure Draft (BC ED) proposes an exception to the fair value measurement principle for acquired non-current (long lived) assets that are classified as held for sale as of the acquisition date. The BC ED proposes that such assets be measured at fair value less cost to sell in accordance with paragraphs 7–11 of IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations* / paragraphs 34 and 35 of FAS 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*.

2. At the January 2006 Board meetings, the staff asked to bring the proposed accounting for assets held for sale back to the Boards because:

    a. the staff was concerned about the justification for the proposal as an exception to the fair value measurement principle; and

    b. it was not clear to the staff whether the Boards intended the measurement exception to relate to assets that the acquiree classified as assets held for sale before the acquisition date or whether the Board intended the measurement exception to relate to any assets acquired in the business combination that the acquirer intends to hold for sale.

3. This paper:

   a. summarises the Boards' initial deliberations;

   b. discusses respondents' concerns about the proposed accounting for assets held for sale; and

   c. asks the Boards whether they want to reaffirm the proposed measurement exception for assets held for sale.

INITIAL DELIBERATION MATERIALS AND THE BOARDS' BASIS FOR CONCLUSIONS

4. The Boards discussed the proposed measurement exception for assets held for sale at the following meetings:

   a. the FASB's 24 July and 28 August, 2002 Board meetings; and

   b. the IASB's September and October 2002 Board meetings.

5. [Paragraph omitted from observer notes]

6. During initial deliberations, the Boards decided to exempt assets held for sale from the fair value measurement principle. BC118 of the IASB's BC ED summarises the Boards' basis for this conclusion as follows (see also B144 of the FASB BC ED):

> The [IASB] was concerned that a requirement in the draft revised IFRS 3 to measure [assets held for sale] at fair value at their acquisition date would lead to the immediate recognition of a loss. Applying IFRS 5 would require expected costs to sell to be recognised immediately as an expense. The [IASB] concluded that reporting a loss in relation to those costs would not present fairly the activities of the acquirer during that period. Accordingly, the proposed IFRS requires these qualifying assets to be measured on initial recognition at fair value less costs to sell and that after initial recognition IFRS 5 will apply.

COMMENT LETTER RESPONSES

7. One respondent disagreed that assets held for sale should be an exception to the fair value measurement principle because the BC ED requires a market participant's view for valuation and measurement.

8. PWC (CL #66) stated:

> We understand the Boards' concern that recording assets held for sale at fair value may result in a loss shortly after the acquisition date since SFAS 144 and IFRS 5 would apply and require the recognition of selling costs. However, we have difficulty reconciling this view with other changes proposed by the Boards. The exposure draft refers to the proposed SFAS on Fair Value Measurements for the definition of fair value. That proposed statement would require the use of market participant data to determine fair values. Recording assets held for sale at fair value, less cost to sell, takes into consideration buyer specific intentions with regard to those assets. Under a market participant notion, buyer specific actions are not considered in the determination of fair value. This is consistent with the Boards' proposed treatment of restructuring liabilities. Therefore, we do not believe the exception for assets held for sale is consistent with the framework proposed by the Boards.

STAFF ANALYSIS AND QUESTIONS TO THE BOARDS

9. In March 2006, the Boards affirmed the following fair value measurement principle for applying the acquisition method:

> 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>.

10. Adhering to this principle means that an acquirer would measure non-current/long-lived assets held for sale at their acquisition date fair value. However, some were concerned that under IFRS 5 and FAS 144, the acquirer immediately would remeasure those assets at the lower of their carrying amount or fair value less cost to sell. Therefore, measuring assets held for sale at fair value at the acquisition date of the business combination would result in reporting an immediate loss due to a change in measurement attribute from 'fair value' to 'the lower of the carrying amount or fair value less cost to sell'. That is to say, some were concerned that a day-one gain or loss would more likely to be the result of a change in the accounting measurement attribute rather than the result of a change in the economic value of an asset.

11. The staff believes that in those cases where an IFRS or US GAAP would require an asset or liability to be remeasured at a measurement attribute other than fair value immediately after the acquisition date that might provide grounds for allowing an exception to the measurement principle. If an exception is appropriate, the asset or liability would be measured in accordance with that IFRS or US GAAP rather than at fair value.

12. The staff believes that the first step in determining whether a measurement exception is appropriate is to consider whether the classification of an asset as being held for sale is important. Classifying an asset as being held for sale imposes an entity specific designation on the asset. In the next sections of the paper the staff assesses whether that designation should be made by the acquiree, the acquirer or not at all.

Should the Designation as Held for Sale be from the Acquirer's Perspective or the Acquiree's Perspective?

13. The BC ED proposes measuring most assets acquired and liabilities assumed in a business combination at fair value but exempts assets held for sale from the fair value measurement principle. In order to qualify for the proposed measurement exception, the assets acquired must meet the criteria for recognition as held for sale set out in IFRS 5 or FAS 144 at the acquisition date.

14. It is not clear to the staff whether the Boards intended the fair value measurement exception to relate only to assets that the acquiree had designated as held for sale prior to the business combination or to any asset acquired in a business combination which the acquirer intends to sell. Some staff interpret the BC ED as exempting from the fair value measurement principle only those assets which the acquiree had designated as held for sale that the acquirer also plans to sell subsequent to the business combination because that seems to represent the class of assets for which the requirements of IFRS 5 or FAS 144 can be met at the acquisition date.

15. Some constituents expressed concerns that, in their opinion, the classification of assets as held for sale in a business combination might take into consideration buyer specific intentions. They emphasise that under a market participant notion, buyer specific intentions are not considered in the determination of fair value. The staff questions whether the designation of an asset as held for sale is even relevant in a business combination.

Acquiree's Perspective

16. Adoption of the *acquiree's perspective* would mean that only those assets which have already been designated as held for sale by the acquiree prior to the business combination could qualify for the proposed measurement exception. Other assets acquired in the business combination which the acquirer intends to sell subsequently would not qualify for the proposed measurement exception. That is because those assets would not likely meet the criteria for recognition as held for sale at the acquisition date; and thus would be measured initially at fair value. In contrast, assets which the acquiree had designated as held for sale but the acquirer does not intend to sell would be measured initially at fair value less cost to sell.[1]

17. The staff believes that once the acquirer obtains control over the acquired entity, the acquiree's earlier plans to sell an asset are irrelevant. Even if an acquiree meets the recognition criteria in IFRS 5 or FAS 144 and designates an asset as held for sale that designation should have no bearing for the acquirer because, once control is obtained, the acquirer will make its own decisions about the future use or disposal of the asset.

18. The staff believes that the objective of the accounting for business combinations should be to provide decision-useful information relevant to the status of the acquirer; thus adoption of the acquiree's perspective appears inappropriate.

[1] Under IFRS 5 an asset that ceases to be classified as held for sale shall be measured at the lower of its carrying amount before the asset was classified as held for sale (adjusted for any depreciation, amortisation or revaluations that would have been recognised had the asset not been classified as held for sale) and its recoverable amount at the date of the subsequent decision not to sell. FAS 144 measures such an asset at the lower of its carrying amount before the asset was classified as held for sale (adjusted for any depreciation or amortisation that would have been recognised had the asset not been classified as held for sale) and fair value at the date of the subsequent decision not to sell. Under both standards any required adjustments to the carrying amount must be included in income from continuing operations.

Acquirer's Perspective

19. Adoption of the *acquirer's perspective* would mean that only those assets that the acquirer plans to sell that meet the recognition criteria in IFRS 5 or FAS 144 would qualify for a measurement exception. Any designation of assets to be held for sale by the acquiree is irrelevant to the acquirer.

20. The staff believes that information about the acquirer's intentions is more relevant to users of financial statements than information about the acquiree's intentions. The acquirer is not bound to the acquiree's initial intentions to hold or dispose of an asset. Rather, the acquirer is free to make its own decisions about the future use or sale of an asset.

21. Application of the measurement principle means that recognised assets acquired and liabilities assumed in a business combination are measured at fair value at the acquisition date, which is the date the acquirer obtains control of the acquiree. FAS 144 states that for assets to be designated as held for sale, management, having the authority to approve the action, must be committed to a plan to sell the asset and that an active program to locate a buyer and other actions required to complete the plan to sell have been initiated. The criteria in IFRS 5 are similar.

22. The staff agrees with those constituents who argue that the accounting for assets held for sale should be similar to the proposed accounting for restructuring or exit activities. An acquirer would not recognize a liability for its planned restructuring activities at the acquisition date because an entity's own restructuring or exit plans are not liabilities assumed from the acquiree. The acquirers exit or restructuring plans are put in place after control is achieved. Thus, an acquirer likely could not meet the recognition criteria in IAS 37 or FAS 146 for recognising restructuring liabilities as of the acquisition date. In a similar manner the staff believes that in most cases the requirements of IFRS 5 or FAS 144 could only be met by the acquirer after control over the asset has been achieved, that is to say after the acquisition date, for assets which were previously designated as held for sale by the acquiree. That is because the acquirer is unlikely to be able to meet the recognition criteria in IFRS 5 or FAS 144 as of the acquisition date, and therefore, is unlikely to be able to recognize an asset as being held for sale at the acquisition date. The staff note that the actions of an acquiree has initiated in putting in

place an active program to locate a buyer and complete a plan to sell might allow the acquirer to meet some of the requirements of IFRS 5 or FAS 144.

23. The staff recommends that the final standard make it clear that the designation by an acquiree of an asset as being held for sale is not relevant when recognising and measuring assets acquired in a business combination. The staff believes that an acquirer should be allowed to recognise an asset as being held for sale at the date of acquisition if it can meet the criteria in FAS 144 or IFRS 5. However, the staff believes that it is unlikely that the acquirer would be able to meet those criteria as of the acquisition date.

Are there grounds for making an exception to the Fair Value Measurement Principle?

24. The staff conclusion is that neither a designation made by the acquiree nor a designation that an acquirer might make are relevant to the measurement of the assets acquired in a business combination.

25. During initial deliberations the Boards decided that there might be grounds for departing from the fair value measurement principle to avoid subsequent gains or losses arising from a change in measurement attribute. This was the basis for including the exception in the BC ED.

26. In the rare circumstance that the acquirer can meet the recognition criteria for assets held for sale as of the acquisition date, the question is whether the acquirer should recognise those assets acquired in a business combination at fair value or at fair value less costs to sell under IFRS 5 or FAS 144.

27. Although the staff believes that the fair value measurement attribute agreed to in this project is the better measure, the staff understand why the Boards would allow a measurement exception since reconsideration of IFRS 5 and FAS 144 is outside the scope of this project. However, the staff no longer believes that an exception to the fair value measurement principle is justified for assets held for sale. The staff believes that it is difficult to justify making an exception to a principle in circumstances where the exception has such limited benefits.

28. Other staff agree with the concerns that led to the proposed exception in the ED (the "day 1 loss"), but do not support an exception in the final Statement, even for those assets meeting the held for sale criteria "on the acquisition date". Those staff think that that the exception to the measurement principle proposed in the BC ED is the wrong

solution to the “day 1 loss” problem. They think the the problem should be addressed at its root—the selection of fair value less cost to sell as the measurement basis for non-current (long-lived) assets held for sale. Those staff believe that fair value should be the measurement basis for assets held for sale, whether those assets were previously held for use or acquired in a business combination. They believe that costs to sell are cost of an exiting an activity—compensation for services received in connection with the disposition of assets—that should be recognised as an expense (liability) as incurred. They recommend the Boards eliminate the exception to fair value measurement proposed in the business combination standard, clarifying instead that an acquirer shall recognise a liability for direct costs incurred for the sale of an asset when incurred through a corresponding charge to net income (profit and loss).

29. Those staff also recommend that the Boards go one step further in this project and amend IFRS 5 and FAS 144 to replace "fair value less cost to sell" with "fair value." They reject the argument that such a change is beyond the scope of the project. Rather, they see such a change as consistent with the "principles-based" approach to standard-setting discussed at the April 2006 joint meeting.

30. The main advantages of this extra step include:

    a. It would eliminate an internal inconsistency in the existing guidance—incremental direct costs of selling a long-lived asset are currently accounted for differently than other costs associated with exit or disposal activities. Eliminating that inconsistency would also improve financial reporting—costs of services would be recognised as an expense in the period the services are received.

    b. It eliminates the need to consider an exception to the fair value measurement principle in a business combination.

Do the Boards agree that the designation by an acquiree of an asset as being held for sale be ignored when recognising and measuring assets acquired in a business combination?

In the rare circumstance the acquirer can meet the recognition criteria in SFAS 144 or IFRS 5 on the acquisition date, should those assets be measured at fair value or fair value less costs to sell?

Do the Boards believe that reconsideration of IFRS 5 and FAS 144 is outside the scope of the Business Combinations Phase II project, or do the Boards wish to amend IFRS 5 and FAS 144 to replace "fair value less cost to sell" with "fair value" as part of this project?