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International
Accounting Standards
Board

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These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting:	**17 October 2006, London**
Project:	**Business Combinations II**
Subject:	**Measurement Period Adjustments (Agenda Paper 2D)**

INTRODUCTION

1. If the acquisition date is towards the end of the acquirer's reporting period or the acquired enterprise is very large or complex, it is often not possible for the acquirer to obtain all of the information necessary to complete the initial accounting for a business combination before its financial statements are issued. Therefore, the BC ED proposes to allow the acquirer reasonable time after the acquisition date to finalise the business combination accounting, including identification, recognition and measurement of the assets acquired and the liabilities assumed.

2. Paragraphs 64 and 67 of the BC ED state:

> During the measurement period, the acquirer shall adjust the provisional amounts recognised at the acquisition date to reflect any new information obtained about facts and circumstances that existed as of the acquisition date that, if known, would have affected the measurement of

> the amounts recognised as of that date. During the measurement period, the acquirer also shall recognise additional assets or liabilities if new information is obtained about facts and circumstances that existed as of the acquisition date and, if known, would have resulted in the recognition of those assets and liabilities as of that date.
>
> The acquirer shall recognise any adjustments to the provisional values during the measurement period as if the accounting for the business combination had been completed at the acquisition date. Thus, comparative information for prior periods presented in financial statements shall be adjusted, including any change in depreciation, amortisation, or other profit or loss effect recognised as a result of completing the initial accounting.

3. At the January 2006 Board meetings, the Boards agreed that the only issue they would address as part of redeliberations is whether an acquirer should recognize measurement period adjustments prospectively or retrospectively because this was an area of significant concern for respondents.

4. This paper:

    a. summarises the Boards' initial deliberations;

    b. analyses the principles underlying the proposed recognition of measurement period adjustments;

    c. discusses respondents' concerns about the proposed recognition of measurement period adjustments; and

    d. asks the Boards whether measurement period adjustments should be recognised prospectively or retrospectively.

INITIAL DELIBERATION MATERIAL AND THE BOARDS' BASIS FOR CONCLUSIONS

5. The Boards discussed the proposed recognition of measurement period adjustments at the following meetings:

    a. the FASB's 12 December 2001 and 8 October 2003 meetings

b. the joint 23 October 2003 meeting.

The material and the minutes for those meetings can be accessed from the FASB's intranet, the IASB's intranet or will be made available in hard copy form upon request.

6. IFRS 3 and some current practices under SFAS 141 might currently diverge on the accounting for measurement period adjustments. IFRS 3 requires retrospective recognition of measurement (allocation) period adjustments. Paragraph 62 of IFRS 3 states:

> If the initial accounting for a business combination can be determined only provisionally by the end of the period in which the combination is effected, because either the fair values to be assigned to the acquiree's identifiable assets, liabilities or contingent liabilities or the cost of the combination can be determined only provisionally, the acquirer shall recognise any adjustments to those provisional values as a result of completing the initial accounting:
>
> (a) within twelve months of the acquisition date; and
>
> (b) from the acquisition date. Therefore:
>
> (i) the carrying amount of an identifiable asset, liability or contingent liability that is recognised or adjusted as a result of completing the initial accounting shall be calculated as if its fair value at the acquisition date had been recognised from that date.
>
> (ii) goodwill or any gain recognised in accordance with paragraph 55 [of IFRS 3] shall be adjusted from the acquisition date by an amount equal to the adjustment to the fair value at the acquisition date of the identifiable asset, liability or contingent liability being recognised or adjusted.
>
> (iii) comparative information presented for the periods before the initial accounting for the combination is complete shall be presented as if the initial accounting had been completed from the acquisition date. This includes any depreciation, amortisation or other profit or loss effect recognised as a result of completing the initial accounting.

7. Paragraph B183 of SFAS 141, which is a direct quote from FASB Statement No. 38, *Accounting for Preacquisition Contingencies of Purchased Enterprises*, states:

> If a business combination is consummated toward the end of an acquiring enterprise's fiscal year or the acquired enterprise is very large or unusually complex, the acquiring enterprise may not be able to obtain some of the data required to complete the allocation of the cost of the purchased enterprise for inclusion in its next annual financial report. In that case, a tentative allocation might be made using the values that have been determined and preliminary estimates of the values that have not yet been determined. *The portions of the allocation that relate to the data that were not available subsequently are adjusted to reflect the finally determined amounts, usually by adjusting the preliminary amount with a corresponding adjustment of goodwill.* [Emphasis added.]

8. While that paragraph is ambiguous, some constituent believe that it requires retrospective adjustment. Even so, this paragraph is in the basis for conclusions and not in the standards section of SFAS 141. Therefore, some constituents may not be aware of this guidance. In addition, based on discussions with resource group members, acquirers do not appear to be recognising *all* allocation period adjustments prospectively. Current practice seems to be that immaterial adjustments are recognised prospectively while significant adjustments are recognised retrospectively because they are viewed to be more like errors.[1]

9. During initial deliberations, the FASB observed that the IASB guidance better reflected the principle that assets acquired and liabilities assumed should be measured at their acquisition date fair values and decided to adopt the IASB guidance.

10. The FASB acknowledged concerns about the costs of retrospective measurement period adjustments. Some FASB members stated that for cost-benefit reasons they would prefer not to require retrospective adjustment. Other FASB members believed that there would be no significant additional cost to retrospective application.

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[1] SFAS 141 uses the term "allocation period," which is defined as follows:

> **Allocation Period**
> The period that is required to identify and measure the fair value of the assets acquired and liabilities assumed in a business combination.

SFAS 141 requires acquirers to disclose "…the nature and amount of any material adjustments made to the initial allocation of the purchase price…" and presumably a similar disclosure would be required if the Boards required prospective adjustment (paragraph 51(h)). Since the effect of any adjustments on the financial statements would need to be determined anyway, those FASB members believed there would be no significant cost to retrospective adjustment. As a result, a majority of the FASB members supported retrospective adjustment on the basis that the benefits of improved comparability and convergence with IFRSs outweigh the potential costs of retrospective measurement period adjustments.

11. However, the FASB did request that the Notice to Recipients/Invitation to Comment solicit feedback on this issue. Therefore, Question 13 asked constituents whether they agreed that measurement period adjustments should be recognized retrospectively.

PRINCIPLES UNDERPINNING THE ACCOUNTING FOR MEASUREMENT PERIOD ADJUSTMENTS

12. The measurement period is intended to provide the acquirer with a reasonable time to obtain the information required to identify, recognise and measure the acquired assets, the assumed liabilities and the consideration transferred for the acquiree. During the measurement period, the acquirer adjusts the provisional amounts recognised at the acquisition date to reflect any new information obtained about facts and circumstances that existed as of the acquisition date. Therefore, the measurement period provides preparers of financial statements reasonable time to appropriately comply with the recognition and measurement principles of the standard.

13. It follows from the recognition and measurement principles for business combinations that measurement period adjustments should be recognised retrospectively, that is, as if the accounting for the business combination had been completed at the acquisition date. To illustrate:

Assume AC acquires TC on 1 July 20X1. Assets and liabilities assumed in the business combination are recognised and measured on a provisional basis. TC's machinery has been measured provisionally at CU 500,000. The machinery's useful life is estimated to be 5 years.

In AC's 31 December 20X1 financial statements the asset is reported at CU 450,000. AC has incurred depreciation expense of CU 50,000 in 20X1.

On 30 June 20X2 AC learns about facts and circumstances which existed at the acquisition date indicating that the machinery's fair value as of 1 July 20X1 was CU 600,000 and not CU 500,000. Because the measurement period is still open, the adjustment is accounted for by retrospectively adjusting the initial accounting for the business combination.

A retrospective measurement period adjustment means that the asset is accounted for as if it had been measured at CU 600,000 at 1 July 20X1. In AC's 31 December 20X2 financial statements the asset is reported at CU 420,000. Depreciation expense for 20X2 is CU 120,000. Prior years comparatives are restated to CU 540,000 for the asset and CU 60,000 for the depreciation expense. Goodwill for 20X1 is reduced by CU 100,000.

14. If measurement period adjustments are accounted for retrospectively:

    a. all and only the assets acquired and liabilities assumed that meet the recognition criteria as of the acquisition date are recognized at that date; and

    b. those assets and liabilities are measured at their acquisition date fair value (or other required measurement basis).

15. Sometimes the measurement period spans more than one reporting period. Accounting for measurement period adjustments retrospectively would require that in those cases the acquirer adjust its comparatives for prior years.

16. The staff notes that the measurement period is only intended to allow for adjustments to the initial accounting for a business combination for facts and circumstances that *existed as of the acquisition date*. Events occurring after the acquisition date that

change the value of acquired assets and assumed liabilities assumed or incurred are not measurement period adjustments. Rather, those are post-combination events that an acquirer should recognize in its post-combination financial statements. For example, changes in the value of an obligation to deliver additional consideration resulting from post-combination events (contingent consideration) are not adjustments to provisional values to be treated as measurement period adjustments.

COMMENT LETTER RESPONSES

17. The majority of respondents disagreed with the proposed treatment of measurement period adjustments. Constituents who disagreed with the proposal likened measurement period adjustments to changes in estimate. Those constituents stated that FASB Statement No. 154, *Accounting for Changes and Error Corrections,* and IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* require retrospective adjustment only for changes in accounting policy or restatement for errors. Since measurement period adjustments are neither a change in accounting policy nor an error, those constituents did not understand why the Boards would propose retrospective adjustment for measurement period adjustments. Additionally, constituents who supported recognising measurement period adjustments prospectively pointed out that "restatements" are confusing to users, imply that the company's financial statements are wrong, and therefore, undermine users' confidence in the company's financial statements.

18. For example, Fitch (CL #16) stated:

> We believe that financial statements by their general nature consist of estimates. Unless an error exists changes in estimates should be handled prospectively and this should include changes in purchase price allocation. A more useful approach would be to provide clear disclosures to the users of the financial statement with adequate information on changes in assumptions and pro forma cash flow information where possible. This will allow the analysts to evaluate not only management's ability to make reliable forecasts but also cash flow information to perform a thorough analysis. Ability to predict actual cash

> flows is vital to the users of the financial statements especially the credit analysts.

19. KPMG (CL #88) wrote:

> We disagree that comparative information for prior periods presented in the financial statements should be restated as a result of measurement period adjustments. We believe that measurement period adjustments should be reported in the period those adjustments are made consistent with the accounting for a change in estimate.
>
> IAS 8 and Statement 154 distinguish between corrections of errors and changes in estimates. The Exposure Drafts appear to treat the measurement period adjustments as if they were errors. However, if the provisional fair values were estimated on a reasonable basis, the measurement period adjustments would not meet the definition of "prior period errors" in IAS 8 and Statement 154. We therefore, would expect such adjustments to be treated as changes in estimates.

20. Anglo American (CL #176) wrote:

> We agree with the principle underlying the proposal but believe there are significant practical and commercial considerations which make the ED proposals inappropriate:
>
> - "Restating" financial information has adverse connotations to most readers of accounts and therefore should be avoided where the restatement would be the result of a requirement in an accounting standard. It would be confusing for readers to see regular restatements where, in reality the financial information was correct (to the best of the company's knowledge) at the date of publication;
>
> - Practically there are several issues for companies in restating information: not only could groups with an active acquisition programme end up "restating" every year, but the logistics of manipulating financial records to adjust for these changes in a previous, "locked" period would be complex.

STAFF ANALYSIS AND QUESTIONS FOR THE BOARDS

21. The majority of respondents believe measurement period adjustments are changes in estimate that should be accounted for prospectively. Paragraphs 32–34 of IAS 8 describe a change in estimate as follows:

> As a result of the uncertainties inherent in business activities, many items in financial statements cannot be measured with precision but can only be estimated. Estimation involves judgements based on the latest available, reliable information. […]
>
> The use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability.
>
> An estimate may need revision if changes occur in the circumstances on which the estimate was based or as a result of new information or more experience. By its nature, the revision of an estimate does not relate to prior periods and is not the correction of an error.

22. If a measurement period adjustment was recognised prospectively, similar to a change in estimate, the example in paragraph 12 of this paper would be modified as follows:

> AC acquires TC on 1 July 20X1. Assets and liabilities assumed in the business combination are recognised and measured on a provisional basis. TC's machinery has been measured provisionally at CU 500,000. The machinery's useful life is estimated to be 5 years.
>
> In AC's 31 December 20X1 financial statements the asset is reported at CU 450,000. AC has incurred depreciation expense of CU 50,000 in 20X1.
>
> On 30 June 20X2 AC learns about facts and circumstances that existed at the acquisition date indicating that the machinery's acquisition date fair value as of 1 July 20X1 was CU 600,000 and not CU 500,000.
>
> A prospective measurement period adjustment means that in AC's 31 December 20X2 financial statements the asset is reported at CU 427,778. Depreciation expense for 20X2 is CU 122,222.[2] In addition, goodwill as of 31 December 20X2 would be adjusted for CU 100,000. Prior year comparatives are not restated.

[2] Calculated as (CU 500,000 ÷ 5 useful life at initial recognition) + (CU 100,000 adjustment ÷ 4.5 remaining useful life).

23. The relation between measurement period adjustments and changes in estimates is addressed in the basis for conclusions of the superseded SIC 22 *Business Combinations – Subsequent Adjustment of Fair Values and Goodwill Initially Reported*. The interpretation emphasises that estimates must be based on reliable information. Because the recognition and measurement of provisional amounts in a business combination stems from the acquirer's inability to obtain reliable information as of the acquisition date, provisional amounts do not meet the definition of an estimate. Therefore, measurement period adjustments should not be compared to changes in estimate. Paragraph 11 of the basis for conclusions of SIC 22 states:

> IAS 22.93 requires disclosure if the fair values of identifiable assets and liabilities can only be determined on a provisional basis. This implies that in such circumstances, the enterprise is aware that reliable estimates cannot yet be made and therefore the adjustment is not accounted for as a change in estimate addressed in paragraphs 23 through 30 of IAS 8 (revised 1993).

24. Some staff members disagree with this view. They believe that in order to determine a purchase price in a business combination, the acquirer must have some information upon which to develop an estimate. They, therefore, disagree with the basis for conclusions of SIC 22. The staff believes that measurement period adjustments are more like "*adjusting events after the balance sheet date*" according to IAS 10 *Events after the Balance Sheet Date* and "*type 1 subsequent events*" according to AU Section 560 *Subsequent Events.* Those standards require an entity to adjust the financial statements for facts discovered after the balance sheet date that existed as of (or before) the balance sheet date.

25. The measurement period provides an acquirer time to obtain information about facts and circumstances that exist at (or before) the acquisition date. With or without the measurement period guidance, an acquirer would be required to adjust the financial statements to reflect information about *adjusting events after the balance sheet date/type I subsequent events* obtained through the date of issuance of the financial statements. Those *events* are not changes in estimate under existing GAAP or IFRSs.

The proposal to require retrospective recognition of measurement period adjustments might be viewed as extending the *adjusting events after the balance sheet date/type I subsequent events* approach beyond the date that the financial statements are issued (or authorized for issue) to a period not to exceed one year.

26. The staff believes that the changes in estimate that IAS 8 and SFAS 154 generally refer to are not same phenomenon that is being covered in a business combination. That is because changes in estimate are related to the need to update estimates for changes in facts and circumstances that affect an estimate (such as a change in technology impacting the useful life of an asset or a residual).

27. If the Boards should decide to retain the proposed retrospective treatment of measurement period adjustments, the staff proposes including a paragraph in the basis for conclusions of the final standard clarifying the Boards' basis for choosing retrospective adjustment so that constituents do not continue to compare measurement period adjustments to changes in estimate.

28. The staff notes that prospective recognition of measurement period adjustments conflicts with the business combination recognition and measurement principles as follows:

    a. an asset acquired or a liability assumed in a business combination would not be recognised at the acquisition date despite the recognition criteria being met at the acquisition date;

    b. an asset acquired or a liability assumed in a business combination would be recognised at the acquisition date despite the recognition criteria not being met at the acquisition date; or

    c. assets acquired or liabilities assumed in a business combination would not be measured at their acquisition date fair values.

29. In addition, the staff notes that prospective recognition of measurement period adjustments might create incentives to understate or overstate provisional amounts at the acquisition date. The subsequent remeasurement of the provisional amounts would result in deferring gains or losses to later reporting periods.

30. Many constituents stated that the costs of retrospective adjustments do not outweigh the benefits. The staff believes that constituents use the term “costs” to mean two different things.

31. The first is the actual cost that will be incurred for retrospectively adjusting the financial statements in those situations in which the measurement period falls into more than one reporting period and, thus, prior year comparatives must be adjusted. However, if the Boards were to require prospective adjustment, presumably the acquirer would be required to disclose the effects of those adjustments similar to the existing requirements in SFAS 141. Therefore, the effects would need to be determined anyway and there would be no significant cost to retrospective adjustment.

32. The second cost is the negative impression that results from retrospectively adjusting financial statements. Many constituents who supported recognising measurement period adjustments prospectively pointed out that “restatements” are confusing to users, imply that the company’s financial statements are wrong, and therefore, undermine users’ confidence in the company’s financial statements. The staff points out that we intentionally avoided the term “restatement” and used “retrospectively adjust” when we described in the BC ED how acquirers should present measurement period adjustments. However, based on the comment letters received, it is clear that constituents view any prior period adjustment as a “restatement” and they do not differentiate between “restatement” and “retrospectively adjust.”

33. Overall, the staff agrees with the Boards’ decision to require retrospective adjustment on the basis that the overall benefits of improved comparative information that result outweigh the potential costs of retrospective application. Therefore, the staff

recommends affirming retrospective recognition of measurement period adjustment as proposed by the BC ED. The staff does have sympathy for constituents who are concerned that any type of prior-period adjustment will be viewed negatively by users of their financial statements. The staff acknowledges that a negative market perception cannot be fully mitigated by note disclosure.

Do the Boards believe that measurement period adjustments should be recognised prospectively or retrospectively? Please explain the basis for your view.