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International convergence on business combinations



Business combinations have been one of the most contentious issues in the convergence of accounting standards. But Thayne Forbes, managing director of Intangible Business, finds some progress has been made.

The push to converge International and US accounting standards has seen progress recently for business combinations (the bringing together of separate companies into one reporting entity). Revisions to both the main accounting standards in this area have been issued; the International Accounting Standards Board has issued a revised IFRS 3R and the Financial Accounting Standards Board in the US has issued a revised SFAS 141R.

In fact the original two standards were already pretty similar, as the original IFRS 3 drew heavily on the original SFAS141. It plainly makes sense for consistent accounting standards particularly in areas such as business combinations for larger companies and so this move towards convergence is still a positive step.

Many of the changes have been made to make SFAS 141 more consistent with IFRS 3. I summarise the principal such changes below:

American catch-up

Recognition all acquired assets and liabilities must now be at fair value. Before some were not recognised or not recognised at fair value.

Restructuring costs must now be expensed if there is no legal obligation at the date of acquisition.

A business combination achieved in stages now recognises the full fair values of assets and liabilities, including the proportion attributable to minority shareholders.

Contingencies should now be fair valued and recognition cannot be deferred.

Negative goodwill should be taken to profit and not used to reduce the fair values of assets acquired.

Acquired R&D assets to be fair valued rather than expensed

Disclosure of the factors that make up goodwill is now required, rather than no disclosure.

In addition to this there are some relatively minor changes to both IFRS 3 and SFAS 141. After all this there still remain some differences between IFRS 3R and SFAS 141R but they are not so significant. Here I would like to focus on last of the areas of convergence which I highlighted above, the disclosure of the factors that make up goodwill.

Goodwill hunting

Research that I have carried out gives concern that companies which reported business combinations under IFRS 3 and SFAS 141 have exaggerated the amounts ascribed to goodwill. This goes against the objectives of the accounting standards which are to increase the transparency of acquisitions, and there are several possible explanations:

- To increase future profits through reduced amortisation charges on intangible assets with finite lives.
- To reduce the risk of future impairment charges on intangible assets.
- It means the possibility of overpayment for a business acquisition can be avoided.

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Goodwill is a balancing figure, derived by comparing the price paid for an acquisition with the fair values of the underlying assets. So no direct assessment of goodwill value is made. However it can be explained by factors such as acquisition synergies and assets which can't be capitalised (such as people). In the past accounting standards permitted the valuation of an assembled workforce, but resulting valuations were often quite ridiculous, being based on an agent's cost of recruiting a similar workforce! So now such valuations are outlawed. Sensible valuations of the components of goodwill, however, would be very useful in describing what is now largely a black hole.

It is therefore a very positive step that SFAS 141R has now adopted the original IFRS 3 requirement that the factors making up goodwill be described. If this is done properly it will help a reader of the accounts understand components of an acquisition better. It will make goodwill less of a black hole and reduce the risk of creative accounting by overstatement of goodwill with a corresponding understatement of the values of other intangibles recognised.

However, since the introduction of IFRS 3 in the UK there has been minimal compliance with the requirement in IFRS 3 to describe the factors making up goodwill. In its Annual report 2007, The Financial Reporting Review Panel found a significant number of companies did not adequately provide this description, either by non disclosure, or provided in identical terms and at a high level across several acquisitions. So non-compliance has been identified and is being scrutinised. I hope the response to this will be positive.

The drive for globally consistent accounting of intangible values arising on business combinations has taken a positive step forward. There are few differences remaining between IFRS 3R and SFAS 141R. Both require a description of the factors that make up goodwill, and proper compliance with this requirement will assist stakeholders greatly.

There still remain, however, many challenges as well as compliance with these accounting standards. The adequacy of the limited scope of these accounting standards still leaves much to be desired.