



16

Givers and shakers: why do the world's top business leaders engage in philanthropy?



12

Demi-d lies and statistics: the dark arts of presenting information on consumer packaging.



29

Hobbits wanted: what can a fresh start in **New Zealand** offer an adventurous CIMA member or student?

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financial management

Wandering star
Why Martyn Cuff of Allianz Global Investors has ditched his desk

Technical matters

Outsourcing finance
Shared service centres
IFRS3 and FAS141
Money-laundering
Book reviews

Study notes

Paper P10 TOPCIMA
Paper P6 Management Accounting
– Business Strategy

CIMA

>technical matters

IFRS3 AND FAS141

Stuart Whitwell analyses changes to the FASB's and IASB's standards on business combinations and considers how close they are to convergence.

In December 2007 and January 2008 respectively, the US Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) issued revised standards on business combinations. These revised standards take significant steps toward the standard-setters' declared goal of convergence.

This achievement should not be underestimated, as a set of common global standards was always going to be the primary objective, whatever the shortcomings of those standards. It seems that common sense has prevailed, with the best of both standards being adopted without either party stubbornly defending its existing standard.

The two boards are to be applauded for their efforts and encouraged to go the last mile to complete convergence urgently. Only then, I suspect, will there be an appetite to address the weaknesses that remain.

Application of the revised international standard

The good news for firms reporting under International Financial Reporting Standard 3: "Business combinations" (IFRS3) is that the revised standard makes few changes and some of these are of limited application. Many business combinations will not involve contingent consideration or step acquisitions. The only change that will affect all business combinations is that the costs of the acquisition must now be expensed instead of being included in the purchase price.

For US-listed companies, the changes to Statement of Financial Accounting Standards No 141: "Business combinations" (FAS141) are more substantial, but they all serve to eliminate treatment differences between US Gaap and IFRS, and so reduce workloads.

I would urge companies to pay more attention to applying the existing standard well, particularly to ensure that their intangible assets are realistically valued and disclosed. But I believe that there is a need to monitor and enforce compliance, other than the external audit, as the Securities and Exchange Commission (SEC) does in the US.

The components of goodwill must be disclosed in published accounts – a requirement widely ignored in the early days of IFRS3. I believe that it's good practice to prepare a full-value analysis of the components of goodwill to support the amount reported in the purchase price allocation. Ultimately, this should form part of the accounting standard. This would require companies to be more open and realistic about the amount reported as goodwill.

The changes and remaining differences

FAS141 covers all business combinations initiated after June 30, 2001. IFRS3 had an effective date of March 31, 2004, although many jurisdictions adopted IFRS later than this.

In December 2007 the FASB issued a revised FAS141 (FAS141R), which is mandatory from the annual reporting period starting on or after December 15, 2008. Entities are not permitted to apply the new standard early.

The revised IFRS3 (IFRS3R) was issued in January 2008 and is effective for accounting

periods starting on or after July 1, 2009. Unlike FAS141R, it may be applied earlier.

The table below summarises the main changes to FAS141 that bring it into line with IFRS3. The table on the bottom of the next page summarises the changes made to both standards. No changes affect IFRS3 alone.

Remaining differences

Saint Augustine said: "Give me chastity and continence, but not yet," and the boards seem to have taken a similar approach. While striving for convergence, they have decided to issue new standards that still differ, although they will consider most of the differences in future convergence projects. This is disappointing because, at best, it delays completion of the convergence process. Could they not have gone the extra mile to finish the job?

Having said that, the first big difference listed by the FASB is in the definition of the acquirer and identifying the acquirer. The reason cited for a continuing difference is the absence in IFRS of any guidance equivalent

Changes to FAS141

New treatment	Previous treatment
Recognition of all acquired assets and assumed liabilities at fair value at the acquisition date	Some assets and liabilities not recognised – and some not at fair value
Restructuring costs, expected but not obligated to incur, to be expensed	Included in cost of acquisition
Recognition of the full fair values of acquired assets and assumed liabilities in a business combination achieved in stages	Only the proportion of assets attributable to the acquirer were fair-valued, with minority interest based on book values
Assets and liabilities arising from contractual contingencies to be recognised at their fair value at the acquisition date	Deferred recognition was permitted
Negative goodwill resulting from a bargain purchase is taken to profit	Fair values of acquired assets were reduced pro rata
Acquired R&D assets to be reported at fair value	R&D assets with no alternative use immediately charged to expense
Disclosure of the factors that make up goodwill	No disclosure required

to that legend of obfuscation, FASB Interpretation No 46 (Revised) "Consolidation of variable interest entities" (FIN46R).

While the issues that FIN46R attempts to address are only too real – off-balance sheet vehicles beloved of Enron and others – it is the worst example I have ever seen of detailed accounting rules trying to corral the excesses of creative accounting. You might as well try to nail blancmange to a wall. If ever there were an area where principles-based standards were required, this is it. Agreement between FASB and IASB on this will need a lot of work.

The other significant remaining differences are summarised in the table on the right.

Where do we go from here?

Clearly, there is a commitment to achieve further convergence, but this falls short of what should be the short-term objective. The next step must be a common standard for business combinations – the boards should say so unequivocally and set a target date for achieving this.

We need to stand back and take a good look at how business combinations are reported to stakeholders and how well stakeholders' needs are served. We must get past convergence in order to address two bigger issues: the shortcomings common to both standards and the effectiveness of the standards' application.

Research by my firm into reporting by FTSE-100 companies applying IFRS3 for the first time, and by the largest US corporations in the first five years of FAS141, indicates that many firms have either failed to identify and report intangible assets in acquired entities or undervalued them. This has resulted in a corresponding overstatement of goodwill. For example, Standard Chartered Bank would have us believe that the combined value of the brand name and customer relationships

The other significant remaining differences

	FAS141R	IFRS3R
Minority interests	Must be measured at fair value	May be measured at fair value or as a proportionate share of net assets
Operating leases	Requires recognition of an intangible asset, or liability, if the lease terms are other than market terms	No recognition required
Contingent assets and liabilities	Recognise contractual, and some non-contractual, contingencies	Recognise contingent liabilities for present obligations arising from past events – that can be measured reliably
Goodwill disclosure	Disclosure by reportable segment for each business combination	Not required

of Korean First Bank was only £100m on its acquisition in 2005, while the reported goodwill was £1.7bn. This purchase price allocation seems to undervalue the driving forces behind the acquisition. In the same year, Aviva acquired the RAC and reported the values of brand and customer relationships at £400m, with goodwill of £1.1bn. Again, I believe that the intangible assets were substantially undervalued.

Company filings in the US are subject to scrutiny by the SEC, which strikes fear into the hearts of reporting entities and auditors alike, but there is no equivalent for companies reporting under IFRS. With the Financial Reporting Review Panel, the auditors are the main safeguard of compliance. This is clearly not enough, because many UK firms have been able to report business combinations without explaining the components of goodwill, in clear breach of IFRS3's disclosure requirements. If the rules are there, they must be applied. Compliance needs to be monitored and enforced more strongly.

I have focused mainly on intangible assets because these are so often the elephant in

the living room. They drive most of the value of businesses in many sectors, but the only time their value is considered for reporting purposes is after a business combination. I believe that the standards could be strengthened to impose more realistic valuations on reporting entities and their auditors. The fact that FAS141R includes a requirement to disclose the factors that make up goodwill, such as synergies and intangible assets that cannot be recognised separately (such as an assembled workforce), is welcome. I only hope that firms comply with it more strictly than the FTSE-100 companies that reported under IFRS3 for the first time. The early indications are that reporting standards among the biggest UK companies are improving on the second time around.

It may be inappropriate to beef up the disclosure requirements for goodwill any further because of commercial confidentiality considerations, but acquirers should be obliged to quantify the fair values of the identified elements of goodwill, which could then be audited. This would produce better information on the probability of material overpayments for acquisitions at a much earlier stage. It would be similar to an impairment test of the goodwill on each acquisition and would be much tougher than the present, aggregated impairment testing of goodwill. The shareholders of eBay might have been glad of such a requirement before the online auction firm acquired Skype.

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Changes to FAS141 and IFRS3

New treatment	Previous treatment
Costs of acquisition to be expensed	Included in cost of acquisition
Contingent consideration to be recognised at fair value at the acquisition date	Recognised only when additional consideration became payable
Re-measure fair value of previously held equity interests in a step or partial acquisition	Changes in fair value treated as a revaluation