Valuation Researcher

Alert

February 2008

IASB Issues Business Combinations Statement

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In its first major joint project with the US accounting standards setter, the International Accounting Standards Board (IASB) has issued two new statements, IFRS 3(R), *Business Combinations* and IAS 27(R), *Consolidated and Separate Financial Statements*. The IASB's announcement comes on the heels of FASB issuing SFAS 141(R), *Business Combinations*, and SFAS 160, *Noncontrolling Interests in Consolidated Financial Statements*, thereby completing the second phase of both standards setters' business combination projects. The IASB began the first phase of its business combination project in 2001, following the release of SFAS 141 and SFAS 142 in the US. The result of the IASB's phase one project, IFRS 3, *Business Combinations*, was issued in April 2004.

Commenting on the release of the new international standards, IASB Chairman Sir David Tweedie said, "...comparing financial statements is more difficult when acquirers are accounting for acquisitions in different ways, whether those differences are a consequence of differences between US GAAP and IFRSs or because IFRSs or US GAAP are not being applied on a consistent basis. Now the accounting requirements in IFRSs and US GAAP will be substantially the same."

Among the more significant changes from the prior international accounting requirements are the following:

Contingent consideration. Under the prior standard, contingent consideration was only measured if payment was probable and it could be reliably measured. Under IFRS 3(R), contingent consideration is recognized at fair value at the acquisition date. Further, if the contingent consideration is a liability (rather than equity), it will be remeasured to fair value at each reporting period, with any change in value recorded as income or expense. This new approach to contingent consideration is the same as the US accounting model under SFAS 141(R).

Transaction costs. Like the new US accounting standard, IFRS 3(R) requires that transaction costs, such as legal fees, banking fees, accounting fees, and fees for valuation services, be expensed when they are incurred. These costs will no longer be capitalized as part of the acquisition's purchase price.

Minority interests. When a company obtains control of a business by purchasing less than 100% of the ownership interests, the minority (or non-controlling) interest owned by a third party needs to be recorded in the consolidated financial statements. Under IFRS 3(R), the acquirer is permitted to record a non-controlling interest in the acquired entity at fair value. Alternatively, the acquirer may record the non-controlling interest at the third party's proportionate share of the net assets of the acquired business, consistent with the existing international accounting standard. The new US accounting standard does not permit this alternative accounting treatment.

Acquisitions that do not result in a change of control. When a company's ownership interest changes without a change in control (for example, Parent owns 85% of Subsidiary A and either purchases or sells a 10% interest), no gain or loss is recognized. Any difference between the fair value

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of the consideration paid or received by the company and the change in the non-controlling interest for the subsidiary is reported as a direct adjustment to the parent's equity. Previously, the international accounting literature provided no guidance on how to account for such transactions.

"The new accounting rules further increase the need for valuation services in connection with a business combination."

IAS VS. US

With the release of the new business combinations statements from the IASB and FASB, US and international accounting standards are more closely aligned but some differences remain. The following are the some of the major differences between IFRS 3(R) and SFAS 141(R):

Fair value definition. The revised international business combinations statement retains the definition of fair value from IFRS 3, i.e. fair value is, "the amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arm's length transaction." Conversely, FASB's definition of fair value is based on the exit price, i.e. "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."

Contingent liabilities. Perhaps the most significant difference in approach relates to the way in which contingent liabilities assumed in a business combination, such as warranties and litigation, are reported. Under IFRS 3(R), a contingent liability is recognized at the acquisition date if its fair value can be reliably measured. In contrast, there are two accounting models for contingencies assumed in a business combination under SFAS 141(R): one model for contractual contingencies, such as warranties, and a second model for non-contractual contingencies, such as a patent infringement lawsuit. Contractual contingencies are measured at their estimated fair value as of the acquisition date. Non-contractual contingencies are measured at fair value only if it is determined that a liability is *more likely than not* to exist (i.e. probability of greater than 50%) as of the acquisition date.

Non-controlling interests. As noted above, the international standards will permit a non-controlling interest to be measured as a proportionate share of net identifiable assets rather than at fair value. Entities will be able to decide which accounting approach to follow on a transaction by transaction basis. The US standard will permit no flexibility: it requires companies to measure an acquisition of a non-controlling interest at fair value.

EFFECTIVE DATE

The new accounting rules further increase the need for valuation services in connection with a business combination. IFRS 3(R) and IAS 27(R) take effect on July 1, 2009, although entities are allowed to adopt the requirements earlier. Both SFAS 141(R) and SFAS 160 are effective for fiscal years beginning after December 15, 2008. For more information contact your Valuation Research representative or Bill Hughes at 312-957-7504. **VR**

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Boston	617.342.7366
Chicago	312.957.7500
Cincinnati	513.579.9100
Milwaukee	414.271.8662
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