Convergence of Business Combinations

Introduction

The merger and acquisition of business entities (business combinations) has been a reoccurring theme in the business community. It represents the combining of two or more entities consistent with business strategies, economic necessities, regulatory requirements, and numerous other reasons. The accounting for the combination of business entities has been a subject of debate for years and had generally evolved into two basic approaches—pooling of interest and purchase accounting. Pooling of interest views the transaction from the perspective of the shareholder and occurs when the assets and liabilities of the two entities are combined at book values. Purchase accounting views the event from a buyer/seller perspective and occurs when the acquired company’s assets and liabilities are restated at current values and any difference between the current value of the net assets and the purchase price is recorded as goodwill, an intangible asset, on the acquiring company’s books.

Goodwill is a significant asset on many companies’ financial statements (Jerman & Manzin, 2008). Additionally, other intangible assets play an important role in a business’ operations and ability to compete. Over the last several decades, the amount of intangible assets has grown requiring better information to measure the significance to future predicative capabilities of operational abilities. These intangible assets are bundles of future benefits that will provide increased revenues or decreased costs in subsequent accounting periods. Consequently, they need to be identified, measured, and allocated to the appropriate accounting period to which they provide a benefit.

Issues

Before the issuance of the current accounting standards, business combinations were accounted for under two different methods. Consequently, similar situations could be accounted for differently resulting in significantly different financial results (Jerman & Manzin, 2008). Comparability was therefore jeopardized. Despite the many different reasons for a business combination, it appears that no basis exists to support accounting for such a transaction using the pooling of interest method (Wahlen, Boatsman, Herz, Jennings, & et al, 1999). The justification for use of pooling of interest relates to the role of the shareholder and the risks and rewards attributable to the shareholder. Studies have indicated that the shareholder is seldom involved. Rather it is management that heads the efforts for a business combination with the shareholder relegated to participant rather than initiator (Wahlen et al., 1999). This finding does not support a pooling of interest approach to the recording of the transaction. Additionally, under the pooling of interest, any premium paid for the acquired company is not reflected in the financial records of the acquiring company, therefore limiting information to the reader of the financial statements as to the excess purchase price over the net assets acquired.

On the other hand, purchase accounting is more in line with the concept of acquisition of assets and allows for more comparability to other types of capital asset acquisition activities (Wahlen et al., 1999). Studies have shown that readers of financial statements are interested in the cost of the acquisition and the excess, if any, paid for a
business combination. Purchase accounting allows for the measurement of the excess through the creation of Goodwill—the excess of the purchase price over the fair value of the net assets acquired. Investors monitor the benefit of the excess paid by determining if the future benefits will exceed the excess paid when the combination was first originated (Wahlen et al., 1999). The impairment approach to valuing goodwill as required by SFAS 142 is considered an assessment of management’s decision to spend the premium. Should the premium be impaired prior to when anticipated, an investor could evaluate the reasonableness of paying the price for the business (Wahlen et al., 1999). Without this information, one could argue that the financial information is less relevant and reliable, key concepts of accounting standards.

The requirements of the new standards also create some issues. Though the objective of the new standards is to provide transparency regarding the economic substance behind business combinations and the future benefit of the premium paid for the business (goodwill), the new accounting approach requires subjectivity in the determination of fair value. This subjectivity can lead to creative accounting and potentially reduce the usefulness of financial information for which the new standards were designed to provide (Jerman & Manzin, 2008).

Accomplishments to date

Because of the issues related to the use of two different approaches to recording of a business combination, FASB issued SFAS 141 and SFAS 142 in 2001 eliminated the use of pooling of interest and established the impairment approach to valuing goodwill. In 2004 the IASB issued IFRS 3 which generally followed SFAS 141 and SFAS 142 with some exceptions. The convergence of accounting for business combinations was generally completed in 2009 and created more consistency and comparability in financial reporting worldwide (Jerman & Manzin, 2008). Both standards eliminated negative goodwill and required the recognition of the amount of the purchase price that was less than fair value of net assets acquired in the income statement as a gain. Additionally, both sets of standards required the identification of intangible assets other than goodwill, valuation at fair values where appropriate, with any non-valued amounts going to goodwill. Intangible assets, other than goodwill, would be amortized over their estimated service life.

Remaining differences between IRFS and U.S. GAAP

A main objective of the IASB when it issued IFRS 3 was to move towards convergence with U.S. GAAP. In issuing IFRS 3, it reduced a significant number of differences in dealing with business combinations, but some issues still remain. One of the differences is the identification of reporting units. Under IFRS 3, there are more possible reporting units (called cash-generating units in IFRS 3) than in SFAS 142. U.S. GAAP does not go below the operating segment whereas IFRS has no such limitation. Another difference is the impairment test. In SFAS 142, a two-step approach is followed with the first step identifying the fair value of assets and liabilities and the second step determining the write-down, if applicable. Under IFRS 3, only the first step is followed ignoring the fair value of any liabilities (Jerman & Manzin, 2008). Another difference
relates to reversals of impairment losses on intangible assets other than goodwill. IFRS 3 allows for reversals on intangible assets, SFAS 142 does not permit any reversals. Other than these remaining differences, the two standards are quite similar.

Conclusion

The impairment approach to goodwill has been criticized by many because of the opportunity for management’s discretion in developing the testing parameters for impairment (Schultze, 2005). However, the approach also lends to performance measures that provide useful information about value creation for shareholders (Schultze & Weiler, 2010). At least with the issuance of IFRS 3, convergence with U.S. GAAP grew closer to reality and the discussions are now centered on more than one area of the world. The convergence efforts continue with joint projects scheduled in the future. One day, there just may be one set of accounting standards for the world.
References


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