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COMMENTARY

Commentary on the IASB's Exposure Draft on Business Combinations

AAA Financial Accounting Standards Committee

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INTRODUCTION

The Financial Accounting Standards Committee of the American Accounting Association (the Committee) is charged with responding to requests for comment from standard setters on issues related to financial reporting. The Committee is pleased to respond to the IASB (hereafter the Board) Exposure Draft on Business Combinations (hereafter the ED). The comments in this letter reflect the views of the individuals on the Committee and not those of the American Accounting Association.

IAS No. 22, *Business Combinations* (IASB 1994), currently permits business combinations to be accounted for using either the pooling of interests or purchase method. Although IAS No. 22 restricts the pooling of interests method to cases in which the acquirer cannot be identified, constituents of the Board raised concerns that allowing two methods impaired comparability of financial statements (ED, para. 1). Accordingly, due to these comparability concerns, as well as the recent prohibition of pooling of interests in the United States, the Board reconsidered financial reporting for business combinations and issued the ED. The ED's key features are:

1) All business combinations within its scope must be accounted for by the purchase method.
2) An acquirer must be identified for every business combination within its scope.
3) The acquirer must recognize all identifiable assets, liabilities, and contingent liabilities of the acquiree at the date of acquisition, regardless of whether the acquiree had previously recognized them. However, the ED specifically prohibits recognition of "acquisition liabilities" not previously recognized on the acquiree's books.
4) The ED prohibits amortization of goodwill, and instead requires that goodwill be tested for impairment.
5) The ED requires disclosure of the effects of business combinations occurring prior to, during, and subsequent to the reporting period.
6) The ED requires disclosures to enable users to evaluate changes in goodwill during the reporting period.

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We present our response to the ED in several parts. We describe our perspective on the desired attributes of a general business combinations standard followed by an overall evaluation of the ED from this perspective. We also provide our comments and recommendations on the specific proposals in the ED. We summarize relevant academic accounting research findings that form the basis for our views. We note that much of this research does not directly investigate issues relating to the purchase method of accounting for business combinations. Given the lack of direct research on purchase method accounting, we base our opinion on inferences from related research, as well as our understanding of the IASB's "Framework for the Presentation and Preparation of Financial Statements" (IASB 2002) (hereafter the Framework). The final section summarizes our position.

OVERALL EVALUATION

Preferred Characteristics of a Business Combination Standard

The committee favors standards that are conceptually sound and based on economic principles. We support the Board's stated preference for principles-based standards. We maintain that a principles-based standard should exhibit the following characteristics (AAA FASC 2003):

1) The economic substance, not the form, of a given transaction or event should guide its financial reporting. The Framework defines the elements of financial statements and provides recognition and measurement criteria to guide the reporting process. These principles serve as the foundation for ensuring that financial reports reflect the economic substance of the underlying transactions.
2) The standard should include a description of the particular transaction or event that is the subject of the standard. This description should encompass the underlying economics of the transaction or event in order to provide a common, explicit understanding of these economics.
3) The standard should include a general discussion of the mapping between the economics of the transaction or event and the financial statements, using the Framework to guide classification and measurement issues associated with this mapping.

The Committee believes that a business combinations standard should follow from the Framework. Covered transactions or events, procedures for identifying the acquirer and target, and measurement rules should be consistent with the Framework. The standard should include a description of a business combination and its underlying economics. The standard should contain no detailed rules beyond the broad principles outlined therein. There should be no scope exceptions.

Professionals may differ in their interpretation and application of principles-based standards. Preparers will exercise professional judgment to determine whether a business combination, as defined, has occurred, and to identify the controlling party. In addition, preparers will forecast future events in the course of applying the measurement rules to the transaction. These forecasts of future events may differ among individuals. These potential differences in application of the standard underscore the importance of disclosure to making the standard useful to users of financial statements.

Evaluation of the ED Relative to the Preferred Characteristics

A standard on business combinations should apply to all transactions fitting the definition of a business combination. The ED defines a business combination as "the bringing together of separate entities or operations of entities into one *reporting entity*" (emphasis added). Excluded from the scope of the ED are "joint ventures" and "entities under common control." Explicitly included within the scope of the ED are "true mergers," in which a business combination occurs without one entity obtaining control of another.

We believe the absence of an economic definition of a business combination is a major weakness of the ED. The ED defines a business combination as the creation of a reporting entity. This

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definition does not require that an economic transaction or event take place; the financial reporting appears to determine the definition of the transaction rather than the reverse.

Because the current definition does not entail any concept of ownership or control, absent scope exceptions, the ED applies to joint ventures, combinations of entities under common control, and "true mergers." The ED might even justify "new basis" reporting for the operations identified in the creation of a tracking stock. All seem to satisfy the definition of a business combination presented in the ED.

The Board's decision to provide scope exceptions for joint ventures or entities under common control is inconsistent with a principles-based standard. Furthermore, while the Board exhibits some ambivalence about whether "true mergers" exist, guidance in the current ED says that the standard applies, albeit temporarily, to "true mergers." Meanwhile, the Board will determine whether there is an economically distinct "true merger," and whether to exempt such transactions. If it determines that "true mergers" exist and should be exempted, then the Board will create a third scope exception. Moreover, we anticipate that the Board would institute a fourth scope exception were an entity to apply the standard in the creation of a tracking stock.

Notwithstanding its definition of a business combination as the creation of a reporting entity, the ED addresses transactions between two entities in which control over one of the entities changes hands. The ED states that all business combinations within its scope consist of an acquirer that obtains control over the operations of the acquiree. For the time being, the ED includes within its scope combinations in which one of the combining entities does not obtain control of the other combining entity. It appears that the controlling entity in such a case is to be identified by sheer willpower: "[A]n acquirer shall be identified for all business combinations within the scope of this IFRS" (ED, para. 17).

The Committee believes that the definition of a business combination should suffice in determining the covered transactions. We recommend the ED define a business combination in terms of its underlying economics. The Committee suggests that the ED define the covered transactions as those in which one entity obtains control over another. The change in control is a transaction with economic consequences that financial statements should reflect. Joint ventures, combinations of entities under common control, "true mergers," and tracking stocks would presumably fall outside the scope of a standard based on this definition.

Defining covered transactions as those in which one entity obtains control over another would eliminate a major inconsistency in the ED, which suggests that some business combinations may not have a controlling party and yet requires preparers to identify the controlling party. Limiting the ED to transactions involving a change in control would not resolve the problem of identifying and accounting for "true mergers." However, given the skepticism of the Board that such "true mergers" exist ("true mergers, assuming they exist, are likely to be relatively rare" [ED, Basis for Conclusion, para. 28]), the failure to resolve these accounting issues may be a minor issue.

A redrafted ED would require preparers to exercise judgment in determining whether control of an entity has changed. Entities engaging in transactions in which control did not change hands should be required to disclose the facts supporting that conclusion. A principles-based standard should not incorporate bright-line rules defining covered transactions. The existence of rigid or detailed rules increases the complexity of the standard and provides firms with an opportunity to engineer transactions to obtain desired reporting outcomes. Such opportunities do not appear desirable in high-quality reporting standards.

RESPONSES TO SPECIFIC QUESTIONS

Q1: Scope

The ED includes scope exceptions for joint ventures and entities under common control. As argued above, we believe the ED should define transactions within its scope in terms of the underlying

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economics. If the ED covered only transactions between entities in which there was a change in control, joint ventures and business combinations involving entities under common control would not fall within the scope of the ED. Under a revised ED, no scope exceptions would be necessary.

Q2: Method of Accounting for Business Combinations

The ED proposes to eliminate the use of the pooling of interests method and to require use of the purchase method. Assuming the ED applies only to transactions in which there is a change in control, we support the Board's decision to eliminate pooling of interests accounting. As we suggested above, we believe the ED should apply to all transactions in which one entity acquires control of another.

In a response to the FASB, the Committee noted that neither anecdotal evidence nor research supports the view that certain business combinations conform to the description of a "true merger" (AAA FASC 1999). Furthermore, research suggests that acquisition premiums have been largest in transactions accounted for as a pooling of interest (Ayers et al. 2002; Robinson and Shane 1990). One interpretation of that finding is that both "purchase" and "pooling" combinations are economic transactions in which one entity pays to acquire control over another. Absent evidence that a business combination did not entail a change in control, the Committee believes that pooling of interests accounting would allow preparers to ignore the costs of acquiring control in the subsequent accounting.

Q3: Reverse Acquisitions

The ED modifies the circumstances in which a business combination could be regarded as a reverse acquisition. It clarifies that for all business combinations effected through an exchange of equity interests, the acquirer is the combining entity with the power to govern the financial and operating policies of the other entity (or entities) so as to obtain benefits from its (or their) activities. The ED also proposes additional guidance on the accounting for reverse acquisitions.

The Committee agrees with conclusions of the ED that the economic substance of the transaction should dictate the accounting. If the legal subsidiary is the controlling entity, it should be the acquirer for accounting purposes.

Q4: Identifying the Acquirer When a New Entity Is Formed to Effect a Business Combination

The ED proposes that when a new entity is formed to issue equity instruments to effect a business combination, one of the combining entities that existed before the combination should be adjudged the acquirer on the evidence available.

Consistent with our previous comments, the Committee believes this prescription for identifying the acquirer in a business combination will be unnecessary if covered transactions include only those in which control changes hands.

Q5: Provisions for Terminating or Reducing the Activities of the Acquiree

The ED proposes that an acquirer should recognize a restructuring provision as part of allocating the cost of a business combination only when the acquiree has, at the acquisition date, an existing liability for restructuring recognized in accordance with IAS No. 37, *Provisions, Contingent Liabilities, and Contingent Assets* (IASB 1998). Furthermore, the ED does not allow future losses or other costs expected to be incurred as a result of the combination to be included as part of the cost of the combination.

The Committee supports this position. It follows directly from the Framework's definition of a liability, and is consistent with IAS No. 37. We note that there may be circumstances in which the restructuring liability post-acquisition will differ from that in the acquiree's books. For example, the acquiring firm may have a restructuring plan as part of the acquisition that runs counter to, or is distinct from, the plan contemplated by the acquiree. In such circumstances, the Committee recommends that adjustments to the liability should be made in the acquirer's books subsequent to

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the acquisition in accordance with IAS No. 37. More importantly, we recommend that footnotes clearly disclose and explain such post-acquisition adjustments.

Q6: Contingent Liabilities

The ED proposes that an acquirer should recognize separately the acquiree's contingent liabilities at the acquisition date as part of allocating the cost of a business combination, provided their fair values can be measured reliably.

The Committee does not agree with the position of the ED. It is inconsistent with the measurement criteria for recognition of a liability in the Framework. The Framework states "a liability is recognized in the balance sheet when it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably." If the liability does not exist on the acquiree's books at the date of the acquisition, then management has judged it to be not probable or not measurable. We see no basis for the assumption that a business combination will affect either of those judgments.

The ED also is inconsistent with IAS No. 37, which requires that provisions for contingent liabilities be recognized in the balance sheet when, and only when: (1) an enterprise has a present obligation (legal or constructive) as a result of a past event; (2) it is probable (i.e., more likely than not) that an outflow of resources embodying economic benefits will be required to settle the obligation; and (3) a reliable estimate can be made of the amount of the obligation. Under IAS No. 37, a contingent liability should already be recorded in the acquiree's book at the date of acquisition, if probable and reliably estimable.

The Board proposes to revisit the role of probability in the Framework as part of a future Concepts project. Until a revised Framework articulates different standards for the recognition of contingent liabilities, we do not believe contingent liabilities should be recognized in the business combination unless they would be recognized in the acquiree's books absent the combination.

Differences of opinion regarding the probability and fair value of contingent liabilities may arise at the time of the acquisition, and/or the probability or fair value may change as a result of the acquisition. In such circumstances, we believe there is justification for substituting the acquirer's assessments for the acquiree's assessment. Nevertheless, the ED should require disclosure to document why the probability and fair value of the contingent liability differ from those reflected in the acquiree's books.

Finally, the Committee notes with concern that permitting revaluation of contingent liabilities at acquisition creates the opportunity for earnings management. Because increasing contingent liabilities results in an equivalent increase in goodwill and the ED no longer allows goodwill amortization, *ceteris paribus*, overstating the liabilities at acquisition does not result in additional expenses in the current or future periods.[1] However, subsequent reversal of any excess contingent liabilities recorded at the acquisition date would increase future income (ED, para. 46). This creates the opportunity to create cookie jar reserves through "over-identification" of contingent liabilities at acquisition date.[2] The potential for earnings management underscores the need for full disclosure of adjustments at the time of, and subsequent to, the acquisition.

Q7: Measuring the Identifiable Assets Acquired and Liabilities and Contingent Liabilities Assumed

The ED requires the acquirer to allocate the cost of the acquisition by recognizing the acquiree's identifiable assets, liabilities, and contingent liabilities at their fair values at the acquisition date.

[1] This is not strictly true, as goodwill may be impaired in the future, which would result in a charge.

[2] The potential for earnings management via creation of excess contingent liabilities exists in situations other than business combinations. However, in those situations, the ability to recognize a gain in future periods under IAS No. 37 is limited to the amount of the expense recognized when the contingent liability is created. For business combinations, the company obtains the potential to reverse an excess contingent liability without ever recognizing an expense.

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Therefore, any minority interest in the acquiree will be stated at the minority's proportion of the net fair values of those items.

The Committee believes that measuring all assets and liabilities at fair value would be consistent with the underlying economic transaction, assuming the ED covers transactions in which there is a change in control.

Q8: Goodwill

The ED proposes that goodwill acquired in a business combination be recognized as an asset and not amortized. Instead it should be accounted for after initial recognition at cost less any accumulated impairment losses.

We agree that goodwill meets the conceptual definition of an asset. We also agree that the measurement problems associated with estimation of the fair value of net assets and of overpayment at the time of the acquisition are not so severe as to prevent recognition of goodwill on the balance sheet.

We do not agree with the Board's arguments for prohibiting the periodic amortization of goodwill. The Board's position is that amortization does not provide useful information when firms cannot recognize the internally generated goodwill that replaces the amortized goodwill. We note, however, that the Board does not permit explicit recognition of internally generated goodwill. The combined effect of the Board's rulings is that internally generated goodwill is implicitly recognized for firms with acquired subsidiaries, but not otherwise.

To resolve this inconsistency, the board would have to permit recognition of internally generated goodwill, or require systematic amortization of acquired goodwill. If the board believes that valuation of goodwill subsequent to acquisition is sufficiently reliable to perform impairment tests, then valuation methods should be sufficiently reliable to value internally generated goodwill. However, we do not believe the Board has made a compelling case for the reliability of the valuation tests, and we do not support recognition of internally generated goodwill (AAA FASC 2001). Absent this recognition, we believe systematic amortization of acquired goodwill should be permitted.

Q9: Excess over the Cost of a Business Combination of the Acquirer's Interest In the Net Fair Value of the Acquiree's Identifiable Assets, Liabilities, and Contingent Liabilities ("Negative Goodwill")

The ED suggests that such excess could potentially be due to errors in measuring the fair value (ED, para. 56). The ED then proposes that when such an excess exists, the acquirer should:

1) reassess the identification of the acquiree's identifiable assets, liabilities, and contingent liabilities and the measurement of the cost of the combination; and
2) recognize immediately in profit or loss any excess remaining after that reassessment.

The Committee takes the position that an excess of fair value over cost is evidence that the fair values of the acquired assets and liabilities were not measured correctly. In most cases, we believe the excess should be allocated to the fair value of the assets and liabilities acquired. The difference should be recorded in income only when the net assets cannot be written down further without violating another standard.

Q10: Completing the Initial Accounting for a Business Combination and Subsequent Adjustments to That Accounting

The ED proposes that:

1) If the initial accounting for a business combination can be determined only provisionally by the end of the reporting period in which the combination occurs 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, then the acquirer should account for the combination using those provisional values. Any adjustment to those values as a result of completing the initial accounting is to be recognized within 12 months of the acquisition date.

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2) With some exceptions carried forward as an interim measure from IAS No. 22, adjustments to the initial accounting for a business combination after that accounting is complete should be recognized only to correct an error.

The Committee recognizes that in some cases the cost of the business may be provisional at the date of the combination. In the event that the acquisition cost changes post-acquisition, we recommend that the offsetting entry be made to goodwill.

The Committee is less comfortable endorsing the ED's position regarding post-acquisition adjustments to the fair value of identifiable assets, liabilities, and contingent liabilities acquired. We believe that even sophisticated financial statement users often neither detect nor understand these adjustments.

Although prohibiting such adjustments may have unforeseen consequences, we recommend that the Board consider this alternative, particularly for adjustments that increase goodwill. The acquiring company performed due diligence prior to the acquisition, and presumably estimated the fair values of the net assets. We believe one could reasonably argue that any subsequent reduction in the fair value of the identifiable net assets is evidence of overpayment for the acquired company, and should be recognized in income.

Assuming post-acquisition adjustments are not prohibited, it is nonetheless the committee's view that subsequent adjustments to the provisional numbers should be exceptional. Adjustments should be triggered only by the receipt of new factual information regarding the values of the net assets at the date of acquisition (for example, an audit of acquired pension assets). Adjustments made under these circumstances should be clearly disclosed. The acquiring firm should quantify the impact of the adjustment on the balance sheet and the income statement for the current and subsequent periods.

Finally, the Committee believes that allowing the acquiring firm 12 months to finalize the purchase price allocation is excessive. It opens the possibility that events subsequent to the acquisition date will inappropriately influence the estimate of fair value as of the acquisition date. We recommend that all adjustments should be made by the end of the first full quarter after the acquisition.

IMPLICATIONS OF RESEARCH FOR A BUSINESS COMBINATIONS STANDARD

The empirical accounting literature has a striking absence of research relating to the application of purchase method accounting. However, we note that the research that does exist supports the ED's decision to eliminate the creation of purchase liabilities. We also believe that related research supports the increased disclosure requirements of the ED. Research supports the recognition of goodwill as an asset, and one recent empirical test supports the ED's prohibition on the amortization of goodwill. However, the latter study covers only five years, and the results may not be robust to other time periods.

Purchase Method Procedures

Recent research suggests that the ED's proposal to eliminate goodwill amortization will not reduce the information content of earnings or book values. Barth and Clinch (1996), Jennings et al. (1996), and McCarthy and Schneider (1995) report evidence showing that investors price goodwill as an asset. Henning et al. (2000) report that investors value different components of reported goodwill differently. In particular, they report that the component attributable to over- (under-) payment for the target's assets is not valued, while "core goodwill" is valued positively. (See Johnson and Petrone [1998] for a discussion of the components of reported goodwill.) Hirschey and Richardson (2002) report that public announcements of goodwill write-offs trigger negative and significant stock price reactions. Jennings et al. (2001) and Jennings et al. (1996) report that earnings before goodwill amortization explain significantly more of the cross-sectional difference in share prices than earnings

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after goodwill amortization. Moehrle et al. (2001), in cross-sectional regressions of annual returns on annual earnings, find no difference in the explanatory power of reported earnings and earning before amortization of goodwill. Taken together these results provide some support for the Board's decision to eliminate goodwill amortization. We caution, however, that these results may not be generalizable to an environment in which it is known at the time of acquisition that goodwill need not be amortized.

Brown et al. (2000) find evidence that provision-taking in business combinations is associated with declining accounting and market-adjusted stock price performance over the three-year period following the fiscal year of the acquisition. Their results are consistent with the hypothesis that the companies that took larger provisions used the provisions to insulate accounting earnings from the effects of declining cash flows. The market belatedly reacted to these firms' declining fortunes when net income was no longer inflated by provision reversals. We believe this evidence supports the ED's decision to disallow the creation of liabilities in the purchase price allocation.

Moehrle (2002) presents evidence that firms opportunistically reverse restructuring reserves in order to meet certain earnings targets. Using a sample of 121 reversals recorded between 1990 and 1999, he finds that some firms record reversals to beat analysts' forecasts, to avoid reporting net losses, and to avoid earnings declines. While the evidence relates to restructuring provisions taken outside business combinations, the evidence may generalize to such provisions taken in a business combination.

Evidence in the literature suggests that restructuring charges create uncertainties for analysts, and that enhanced disclosure of the components of the charges helps resolve some of the uncertainties. Chaney et al. (1999) provide evidence that analyst forecast accuracy is impaired by restructurings. Lopez and Clement (2000) conclude that restructurings create uncertainty for analysts for at least two years subsequent to the announcement of the event. Lopez (1999) presents evidence suggesting that analysts benefit from enhanced disclosures in connection with restructuring charges. He finds the components of the restructuring charge required by EITF 94-3 provide incremental information over the aggregate charge in explaining analysts' earnings forecast revisions. Although these results do not bear directly on business combinations, they provide some tangential support for the disclosure requirements proposed in the ED.

Purchase Method versus Pooling of Interests

Empirical research provides support for the ED's operational stance that "pooling" and "purchase" method transactions are economically similar events. Vincent (1997) compares investors' responses to firms' choice of pooling or purchase method accounting. She reports that investors appear to adjust firms' reported accounting numbers so that purchase and pooling firms are valued on an equivalent basis. Although the results indicate that pooling firms enjoy some price advantage over purchase firms, the price difference is not associated with accounting differences.

Aboody et al. (2000) find that managers choose opportunistically between pooling and purchase method in response to their private economic incentives. The authors present evidence that the accounting choice is jointly determined by the premium paid over the book value of the acquired firm and the managers' economic benefits derived from accounting-based contracts. They report that when the business combination involves a target firm with the book value of net assets significantly below the fair value (i.e., cases that require large step-up to the target's net assets), CEOs with earnings-based compensation plans are more likely than others to incur the costs of qualifying for pooling and avoid the earnings penalty associated with the purchase method. However, they find no association between stock-based compensation and the purchase-pooling choice, suggesting managers are not concerned about implications of large step-ups for firms' equity values.

Although Vincent's (1997) results suggest that markets eventually price firms similarly, Hopkins et al. (2000) present evidence suggesting that using different methods to report economically equivalent

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events increases analysts' cognitive costs of processing financial statement information. Specifically, their results show that analysts assign a lower post-combination value to a purchase combination in which the parent company records and amortizes an acquisition premium, compared to either a purchase combination in which the parent expenses the entire premium as in-process research and development or a pooling-of-interests combination. In addition, when the parent company records and amortizes an acquisition premium in a purchase-method business combination, analysts' stock-price judgments are significantly lower if the business combination occurred three years ago as compared to one year ago.

Joint Ventures

The literature has limited evidence supporting the ED's position that joint ventures should be excepted from the current standard because they differ in important economic ways from other business combinations. Hauswald and Hege (2002) present theoretical arguments suggesting that for many joint ventures the absence of a controlling party is an important feature of the economic arrangement. They argue that when the parent firms have complementary resources and neither has industry or geographical dominance over the other, 50/50 ownership is optimal. The resource complementarity eliminates moral hazard in parent contributions so that ownership provides sufficient incentives for optimal investments. However, majority ownership by one parent creates the opportunity for it to extract rents from the other owner, making a 50/50 stake the optimal structure under these circumstances. The authors report evidence consistent with their theoretical model. In particular, they find that 50/50 joint ventures are more common when the parent firms have complementary resources, and neither has a dominant position with respect to the joint venture. Majority ownership and control by one parent is more common when only one of the parent firms shares the industry or country of origin with the joint venture.

CONCLUSION

The Committee views the Exposure Draft as flawed, primarily due to its lack of an economic description of a business combination. We believe the Board could eliminate the ED's scope exceptions if it defined transactions within its scope as economic, rather than reporting, events. In particular, we note that the ED covers only transactions in which one firm acquires control over another, and we suggest that the ED should define the economic transaction in terms of control. We also propose that the ED eliminate the inconsistency between the IASB Framework and the ED's guidance regarding recognition of contingent liabilities in a business combination at fair value. We endorse the ED's disclosure provisions, and believe these will aid investors and analysts in assessing the economic consequences of business combinations.

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