VALUATION BRIEF

International Financial Reporting Standards
January 2006

Harmonization of the U.S.'s generally accepted accounting principles (GAAP) and international accounting regimes, particularly those in Europe, has long been a challenge. However, some progress has been made, albeit in very small steps that have taken years and arduous consultations that have been fraught with frustration. The latest move by the International Accounting Standards Board (IASB) has been an attempt to bring international accounting standards more in line with GAAP with respect to business combinations (SFAS 141) and the treatment of goodwill and other intangible assets (SFAS 142). The latest changes have been embodied in the draft version of International Financial Reporting Standards (IFRS) 3—a hotly debated change in accounting for business combinations written jointly by the IASB and the U.S. Financial Accounting Standards Board that has faced stiff opposition from accountancy firms, industry groups, and businesses alike.

Currently, some intangibles are separable from the business entity whilst some are not. Those that are not separable include intangibles as non-compete agreements, customer lists, patents, etc. The IASB allows some intangibles to be combined with related intangible assets if this will make the aggregate of the intangibles separable. For example, a luxury hotel name and its guest history may be inseparable as may be a website and its subscriber database.

IFRS3 focuses on recognizing more acquired intangibles associated with the target of an acquisition. The proposed IFRS3 suggests that there is more than just the goodwill associated with an acquisition in a business combination. Goodwill calculations would be based on the full fair value of the acquired company not just the price paid by the acquirer. IFRS3 eliminates the amortization of goodwill but subjects the goodwill value to an annual impairment test. In addition, there is a focus on greater accounting for contingent liabilities associated with the acquired firm. Contingent liabilities such as lawsuits or environmental issues must be recognized at fair value, the value at which a third party would pay to assume them.

In addition, actuarial gains and losses (not necessarily required to be recognized under IAS19 [Employee Benefits]) must be accounted for following

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the transaction, and tax deferred assets associated with tax losses of the target of the acquisition must be recognized following the acquisition. As such, IFRS3 is seen as a move towards a fair value standard of accounting for business combinations, where all assets and liabilities are shown at market value or their equivalent.

There are two key IFRS3 assumptions that stem from the greater recognition of intangible assets. First, IFRS3 assumes that the future economic benefits associated with the intangible asset will ultimately accrue to the acquirer of the operating entity that is being acquired. Second, intangibles with a finite useful life can be measured reliably and subsequently depreciated over the estimated useful life. This move towards a fair value standard would impact earnings per share following a transaction.

To illustrate the potential impact upon earnings, consider the following two scenarios. Under Scenario 1, Triumvirate Industries acquires XYZ Corporation for $100 million. With $60 million determined to be goodwill (calculated as the difference between the purchase price and the market value of the tangible assets), the annual amortization charge is $3 million.

Triumvirate Industries	
Scenario 1	
Purchase Price	$100,000,000
Tangible Assets	$40,000,000
Goodwill	$60,000,000
Amortization Period	20
Annual Amortization Charge	$3,000,000
Income Statement	
Sales	$75,000,000
Net Operating Profit	$15,000,000
Depreciation	$2,500,000
Goodwill	$3,000,000
Net Income	$9,500,000

Under the proposed IFRS3, the net income of the firm would be negatively impacted by the identification of intangible assets other than goodwill. In Scenario 2, $40 million of the original $60 million goodwill is identified as a separate intangible asset with an estimated useful life of ten years. As a result, the following table illustrates this impact upon Triumvirate Industries' profitability.

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Triumvirate Industries	
Scenario 2	
Purchase Price	$100,000,000
Tangible Assets	$40,000,000
Goodwill	$20,000,000
Intangibles	$40,000,000
Useful Life	10
Depreciation	$4,000,000
Income Statement	
Sales	$75,000,000
Net Operating Profit	$15,000,000
Depreciation (Original)	$2,500,000
Depreciation (Intangibles)	$4,000,000
Net Income	$8,500,000

Of course, the profitability of Triumvirate Industries could be further negatively impacted by one time impairment charges to the goodwill on the balance sheet.

IFRS3 also has several other implications for international public companies. For example, there is an impact upon accounting for pre-acquisition dividends. Whereas pre-acquisition dividends were previously treated as income, realized, and then available for distribution, IFRS3 does not allow pre-acquisition dividends to be treated as income. Therefore, there is nothing available for distribution under company law. In some countries such as the United Kingdom, additional reporting requirements have resulted in directives on dividends that inadvertently apply to private companies to which IFRS do no apply.

It should be clear that many businesses and industry groups are likely to strongly oppose IFRS3 for a variety of reasons. Beyond the obvious reasons for opposition, many feel that the IASB and FASB want to reinvent financial reporting rather than just harmonize standards that vary between countries. Undoubtedly, the battle over IFRS3 has only just begun. Owners of international privately-held businesses and their advisors should be aware of the developments surrounding IFRS3 and prepare for possible implementation of standards that may have a significant impact upon cross-border mergers and acquisitions.[1]

[1] The articles referenced for this article include the following:

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“Some unexpected impacts of IFRS on acquisition,” Anthony Carey, *The Financial Times*, September 15, 2005.

“Dividend payments feel IFRS effect,” Robert Bruce, *The Financial Times*, September 29, 2005.

“Opposition mounts to IFRS3 draft,” Barney Jopson, *The Financial Times*, October 24, 2005.

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