THE USE OF FAIR VALUE FOR INITIAL RECOGNITION OF BUSINESS COMBINATION

Introduction

As everybody knows, values were subject to many theoretical dissertations in accounting literature. Scholars around the world have also conducted empirical studies regarding measurement and methodology of valuation. A lot of emphasis was put on values in organizations, amongst them ethical values, corporate values, work-values and social responsibility values, which influence the performance of an entity. Business, which seriously considers creating added value for investors, does not limit its measurement activities to monetary values only. Unfortunately, a universal measurement method has not been invented yet, although scholars keep looking for a measurement method that would enable them to capture wide range of economic aspects of business transactions. Nowadays, fair value seems to be the best measurement method that incorporates monetary and economic substance of transactions in organization’s special environment. On the other hand, fair value – because if its complexity – is a focus of the recent criticism as the most controversial measurement method in modern accounting1. Business combinations are transactions whose economic substance is complex and often hard to define clearly. That is why, the article aims at presenting the scope and crucial issues of fair value measurement for initial recognition of business combinations.

1. The use of fair value in IFRS

Measurement issues are present since starting activities of International Accounting Standard Board (IASB2) in 1970s. American Financial Accounting Standard Board (FASB) has also struggled with inflation accounting measurement problem at that time. Both the FASB and IASB have conceptual frame-

2  And its predecessor body: International Accounting Standard Committee.
works but both documents lack the direct guidance on measurement. Filling gaps in frameworks and improving present standards were main objectives for joint project of IASB and FASB that has started by the Norwalk Agreement in 2002. Although work on measurement phase started in 2005, and it is not completed yet due to it controversial nature, the fair value measurement standard was issued on 12 May 2011 with effective date in January 2013\(^3\). IFRS 13 is a result of convergence objective of joint project, and provides one common fair value measurement and disclosure requirements with identical wording – in International Financial Reporting Standards and US Generally Accepted Accounting Principles.

Although fair value measurement project ended discussion whether changes in prices should be reflected in accounts, i.e. controversies about historical cost versus some form of current value\(^4\), it did not resolve the problem how these changes should be reflected\(^5\) and to what extent\(^6\). Present discussion is concerned with the question of which current value should be used\(^7\). The new definition of fair value in IFRS 13 states clearly that fair value is an exit price and it should be based on asset’s or liability’s characteristic and not entity-specific characteristic.

The *fair value* is the price that would apply in a transaction between market participants whether it is observable in an active market or estimated using a valuation technique.

**Fig. 1. Definition of fair value**


Before IFRS 113 was issued, the definition of fair value stayed almost unchanged since 1982, when the term was introduced in IAS 16 *Accounting for

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Property, Plant and Equipment. The IFRS 13 communicated the measurement objective and the role of financial reporting in serving investors in capital markets. Its objective is to provide forward-looking information, including future cash flows from a non-entity specific market perspective. The main features of broad Fair Value View (Table 1) expressed in fair value definition state that IASB and FASB have diminished analyzing the internal consistency of definitions and turned to the utility of accounting measures. It highlighted the objective of financial statements and the environment in which they are used.

### Table 1

<table>
<thead>
<tr>
<th>Usefulness for economic decision</th>
<th>The sole objective of financial reporting.</th>
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<tbody>
<tr>
<td>Current and prospective investors and creditors</td>
<td>are the reference users for general purpose financial statements.</td>
</tr>
<tr>
<td>Forecasting future cash flows, preferably as directly as possible,</td>
<td>is the principal need for those users.</td>
</tr>
<tr>
<td>Relevance</td>
<td>is the primary characteristic required in financial statements.</td>
</tr>
<tr>
<td>Reliability</td>
<td>is less important and is better replaced by representational faithfulness, which implies a greater concern for capturing economic substance, and less with statistical accuracy.</td>
</tr>
<tr>
<td>Accounting information needs ideally to reflect the future,</td>
<td>not the past, so past transactions and events are only peripherally relevant.</td>
</tr>
<tr>
<td>Market prices should give an informed, non entity specific estimate</td>
<td>of cash flow potential, and markets are generally sufficiently complete and efficient to provide evidence for representationally faithful measurement on this basis.</td>
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The Fair Value View assumes that markets are relatively perfect and complete and that, in such a setting, financial reports should meet the needs of passive investors and creditors by reporting fair values derived from current market prices.

### Table 2

| Stewardship is not a distinct objective of financial statements, although its needs may be met incidentally to others. |
| Present shareholders have no special status amongst investors as users of financial statements. |
| Past transactions and events are relevant only insofar as they can assist in predicting future cash flows. |
| Prudence is a distortion of accounting measurement, violating faithful representation. |

Cont. table 2

<table>
<thead>
<tr>
<th>Cost</th>
<th>(entry value) is an inappropriate measurement basis because it relates to a past event (acquisition) whereas future cash flow will result from future exit, measured by fair value.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value, defined as market selling (exit) price, should be the measurement objective.</td>
<td></td>
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<tr>
<td>The balance sheet is fundamental financial statement, especially if it is fair valued.</td>
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<tr>
<td>Comprehensive income is an essential element of the income statement: it is consistent with changes in net assets reported in the balance sheet.</td>
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Source: Ibid., p. 158.

Implications of Fair Value View can be observed in fair value hierarchy, which gives the highest priority to prices quoted and unadjusted that are observable in active markets for identical assets and liabilities that the entity can access at the measurement date. Unfortunately, exit prices especially in level 3, might be subject to bias and abuse\(^{10}\) as small changes in parameters can result in accounting estimates differing by several orders in magnitude\(^{11}\).

Table 3

<table>
<thead>
<tr>
<th>The Hierarchy of Fair Value Measurement</th>
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<tbody>
<tr>
<td><strong>Level 1</strong></td>
</tr>
<tr>
<td>Inputs: quoted (unadjusted) prices in active markets for identical assets or liabilities that the entity can assess at the measurement date.</td>
</tr>
<tr>
<td><strong>Level 2</strong></td>
</tr>
<tr>
<td>Inputs: other than quoted prices (included within Level 1) that are observable for the asset or liability, either directly or indirectly.</td>
</tr>
<tr>
<td><strong>Level 3</strong></td>
</tr>
<tr>
<td>Inputs: unobservable inputs for the asset or liability.</td>
</tr>
</tbody>
</table>

Source: IFRS 13. 72-75.

As quoted prices in an active market provide the most reliable evidence, IFRS 13 approach emphasizes on quoted prices in active markets primarily, then on other market information. In the absence of principal market (eg. market is not active or inputs are not observable for the full term of asset or liability), IFRS 13 requires adjustments respective to factors specific to the asset or liability. On level 3, IFRS 13 favors different valuation techniques, which aim at measurement that provides with an exit price at the measurement date from the perspective of a market participant that holds the asset or owes a liability.


All three accepted valuation techniques’ objective is to determine the price at which an orderly transaction would take place between market participants at the measurement date. IFRS 13 accepts estimations based on income, market and cost approach techniques. The objective when choosing valuation technique should be to maximize observable inputs and minimize unobservable inputs. According to this a perfect valuation would be possible if reference markets are accessible and competitive. Most often, fair value measurement would seek for the point within that range that is the most representative of fair value in the circumstances.

2. Valuation in business combination accounting

The use of fair value for initial recognition has long been required by IFRS. Fair value re-measurement of assets and liabilities was historically not so common due to reasons mentioned above. Business combinations are transactions that constitute slightly different example of fair value usage in IFRS: allocation of the cost of compound transaction. Compound transaction requires acquirer to measure the fair value of consideration given and then to allocate that cost of acquisition to the acquired net assets. The need for fair values and allocation was stated in IAS 2 Consolidated Financial Statements (1975) as well as in IAS 22 Business Combinations (1983)\(^\text{12}\). The reason for fair value use is that although business combination is a non-monetary transaction, financial statements’ disclosure requires that a monetary amount to be accompanied to it.

When assets and liabilities are acquired in a business combination, the transaction price (consideration given) usually reflects an entry price. As IFRS 13 requires fair value to be an exit price, fair value of net assets acquired in business combination might not be a transaction price. Entry and exit prices are conceptually different, and business combinations require not only initial recognition at fair value, but allocation of consideration given to assets and liabilities acquired. Because of the above, fair value estimation at the date of an acquisition requires\(^\text{13}\):

- Measurement of fair value of consideration transferred,
- Measurement of fair value of assets and liabilities acquired,
- Allocation of purchase price to net assets acquired,
- Recognition of gains from a bargain purchase or measuring goodwill.

IFRS’s requirement to value assets and liabilities at fair value might result in recognition of gains on day one, not only as a difference between a considera-


tion transferred but also as a variance between entry and exit price. Fortunately, enter price usually would reflect exit price although it might not be equal to transaction price in business combinations. The variance between consideration allocated to a specific item and its exit/enter price that might result from the changes are presented on fig. 2.

Fig. 2. Fair Value Measurement in Business Combination

Transaction costs are specific to a transaction and differ depending on how an entity enters into a transaction; they are not a characteristic of an asset or a liability. Consequently, fair value is market-oriented, and transaction costs are defined as costs of the seller, that are directly attributable to the transaction. Although transaction costs\(^{14}\) are not included in a fair value of asset acquired, from acquirer’s perspective a fair value of asset purchased would be $10. If consideration given for the asset is $8, a gain on the day of measurement should be recognized. According to IFRS 13 asset or liability measured at fair value might be a stand-alone asset (or liability) or a group of assets (or a group of liabilities), and that is why a difference between fair value and consideration given is unlikely in practice.

Because fair value is non-entity specific exit price based on the perspective of market participants, it should not be affected by an entity’s intentions towards the asset or liability\(^{15}\). Although fair value measured at exit price, is determined by other market participants, it still incorporates specific characteristic of an asset or liability if only market participants consider these characteristic when

\(^{14}\) Transaction costs do not encompass transportation costs. If location is a characteristic of the asset, the price in the principal market shall be adjusted for the cost, if any, that would be incurred to transport the asset from it current location to that market. IFRS 13.25-26.

\(^{15}\) IFRS 13.9.
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pricing them. The rule is valid even if acquirer intends not to use a specific asset acquired in a business combination or to use it in a way that is different from the way other market participants would use it. Nevertheless, the acquirer shall measure the asset at fair value determined in accordance with its use by other markets participants. This regulation is consistent with the guidance on the highest and best use premise for non-financial assets in IFRS 13\textsuperscript{16}.

As economic theory and empirical studies show that managerial disclosure decisions are influenced by the effect disclosure is expected to have on stock price\textsuperscript{17}, IFRS 13 describes minimum disclosures for each class of assets and liabilities. Information disclosed shall help users of financial statements assess:

– Valuation techniques and inputs used to measure fair value and
– The effect of the measurement on profit or loss or other comprehensive income for the period, when using significant unobservable inputs (level 3).

The level of fair value hierarchy determines fair value disclosure requirements: the greater subjectivity in fair value measurement, the more detailed disclosure required. Broad and precise disclosure requirements are important because in most cases of business combinations the values assigned to goodwill represented 50% or more of the total cost of the acquisition\textsuperscript{18}. Goodwill shall represent future economic benefits arising from other assets acquired in business combination that are not individually identified or separately recognized. As goodwill is highly unverifiable, it might be subject to aggressive accounting or misstatement.

Summary

Entities do business in markets that are imperfect and incomplete, which makes fair value measurement extraordinarily difficult. The above means that fair value is not a general, theoretically correct accounting measure that can serve all objectives of financial statements. It is a measurement method that aims at marking-to-market and assumes that managers must often use judgments when applying certain valuation techniques in order to encompass complex and vague transactions that are not explicitly addressed in IFRS. But, on the other hand, is it possible to create measurement theory in accounting that will give universal and single measurement method?

\textsuperscript{16} First Impression: Fair Value Measurement. KPMG, 2011, p. 41.
Some authors stress that IASB Framework with IFRSs contain opposing and inconsistent objectives\textsuperscript{19} while others point that internal “absolute” consistency of all accounting principles is not achievable\textsuperscript{20}. Furthermore, fair value can provide a real – world litmus – test of accounting standards. Clearly, there is room for additional improvements that should be done because fair values must be used otherwise non-cash transactions would be excluded from financial statements. That is why, fair value extend in accounting measurement seems to be a natural process; it reflects the processes of globalization and international economic integration with contemporary complexity of doing business. And, the last but not least, measurement of fair value requires not only monetary and legislation point of view. High values of accountancy professionals matter when judgments and estimations are a widespread in contemporary accounting. Fair value accounting requires also a change in managers’ perception of their role and duties to shareholders. It is a crucial issue in business combination accounting when unverifiable fair value accounting can be used for financial statements’ window dressing. Business combination accounting is a process that usually requires use of fair value measurement for huge amount of assets and liabilities at the date of acquisition. Goodwill disclosed in business combination, treated as a residual, might result from understating identifiable assets measured at fair value or overstating fair valued liabilities. The consideration transferred in the business combination shall also be measured at fair value, which makes valuation in business combination even more sensitive to all estimates made during valuation process. Because of the above, valuation at the acquisition date might be used for opportunistic reasons. Then, no matter how broad and detailed disclosure requirements are; without high professionalism of accountants any precise fair value measurement regulation would not assure high quality of financial statements, which is a basis for information usefulness for economic decisions.

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Streszczenie