IFRS Link
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In March this year, the International Accounting Standards Board (IASB) issued IFRS 3 'Business combinations' which will replace the previous standard of the same name - IAS 22. At the same time the IASB also issued revised versions of IAS 36 'Impairment of assets' and IAS 38 'Intangible assets'. In this edition of IFRS Link we look at the considerable impact these three standards will have on accounting in these often critical areas.

Background

The issue of IFRS 3 marked completion of the first phase of the IASB's project on accounting for business combinations - an exposure draft of the second stage is due later this year. As a consequence a number of transactions are excluded from the scope of IFRS 3. IFRS 3 is broadly consistent with US standards, although there are differences in respect of impairment testing of goodwill and the recognition of acquired intangible assets.

Date of application

IFRS 3 applies for business combinations where the agreement date is on or after 31 March 2004. It is permitted to apply the standard to business combinations before that date provided that the valuations and other information needed to apply IFRS 3 were obtained at the original date of acquisition and that the revised versions of IAS 36 and IAS 38 are also applied prospectively from the same date. Otherwise the revised IAS 36 and IAS 38 apply to goodwill and intangible assets acquired in business combinations for which the agreement date is on or after 31 March 2004 and for all other assets prospectively for the first annual period beginning on or after 31 March 2004.

IFRS 3 Business combinations

Scope of IFRS 3

IFRS 3 applies to all business combinations except those among entities under common control, business combinations involving mutual entities and the combining of businesses by contract alone. The excluded transactions will be considered in the second phase of the business combinations project.

The purchase method of accounting

All business combinations are required to be accounted for using the purchase method - uniting of interests is no longer permitted. As a consequence an acquirer needs to be identified in all business combinations. The IFRS contains guidance on how this identification should be achieved, but in simple terms the acquirer is the entity that obtains control of the other combining entities or businesses.

The cost of an acquisition is determined by reference to the fair values of assets given, liabilities incurred or assumed plus any direct costs of the acquisition. Where an acquisition agreement includes any contingent consideration this is also required to be included as part of the cost of acquisition so long as its payment is probable and it is capable of reliable measurement.

The acquirer is required to allocate the cost of the business combination across the fair values of identifiable assets, liabilities and contingent liabilities of the acquired business. Only those assets, liabilities and contingent liabilities that were in existence at the date of acquisition should be recognised. Restructuring provisions in respect of the acquired business can only be recognised if the acquired business had, at the date of acquisition, a liability for restructuring. Liabilities recognised on acquisition cannot include liabilities for future losses or other costs expected to arise as a consequence of the combination.

Recognition of intangible assets

Intangible assets are recognised on a business combination if they meet the criteria set out in IAS 38 'Intangible assets' which is discussed below. An intangible asset is now considered to be identifiable if it arises from contractual or legal rights or is separable. The standard makes the assumption that the carrying value of an intangible asset acquired as part of a business combination can always be measured reliably - resulting in recognition of a wide-range of assets. In particular, in process research and development is required to be recognised if it meets the definition of an intangible asset.

Some of the examples of intangibles that might be recognised, as set out in the illustrative examples within IFRS 3 are:

- Marketing related
Trademarks, internet domain names, trade dress, newspaper mastheads and non-competition agreements.

- Customer related
Customer lists, order or production backlogs and customer contracts.

- Artistic related
Plays, operas and ballets, books, musical works and pictures.

- Contract based
Licences, lease agreements, construction permits, and franchise agreements.

- Technology based
Computer software, databases and trade secrets.

Contingent liabilities

Contingent liabilities recognised at the time of acquisition are required to be re-measured at least annually. If, after initial recognition, the contingent liability becomes an obligation and the provision is higher, the liability should be increased. If, however, it is lower than the amount recorded on acquisition, it is maintained at the same level and decreased only for amortisation or on settlement. Contingent liabilities will include any payments that an entity is contractually required to make in the event of a business combination.

Goodwill

Goodwill is recognised as an asset, is not subject to amortisation but is required to be reviewed for impairment on at least an annual basis. The impairment test will be carried out in accordance with the revised IAS 36 which is discussed below and which differs from US GAAP.

In the circumstances where the fair value of the assets and liabilities acquired exceeds the cost of the business combination, IFRS 3 does not use the term negative goodwill. Where these circumstances exist, the acquiring entity must first reassess the fair values of the assets and liabilities and then recognise any remaining excess in the profit and loss account.

Where the fair values of assets and liabilities acquired can only be determined provisionally by the end of the accounting period, the business combination should be accounted for using those provisional values. Adjustments to the provisional values made within twelve months of the acquisition date will result in an adjustment to the carrying value of the associated goodwill and a restatement of comparative information to reflect the revised carrying values. Once the twelve months have elapsed adjustments should only be recognised to correct an error in accordance with IAS 8 'Accounting policies, changes in accounting estimates and errors'.

Disclosure

There are extensive disclosure requirements both in respect of acquisitions made during the financial period and also those made after the year end but before the financial statements are authorised.

IAS 38 Intangible assets

An intangible asset should be recognised if it is identifiable, the reporting entity has control of the asset, future economic benefits are expected and it is capable of reliable measurement.

To meet the identifiability criteria the asset must be either separable or arise from contractual or other legal rights, irrespective of whether those rights are transferable or separable from the entity or other rights and obligations.

In assessing whether or not an internally-generated intangible asset can be recognised the process of generating that asset should be divided into two phases:

- Research phase
- Development phase

No intangible asset arising from the research phase should be recognised. An intangible asset arising from development should be recognised if, and only if it is technically feasible to complete the asset, the entity intends to complete the asset and has the ability to do so, and the intangible asset will generate future economic benefits equal to or in excess of its carrying value.

Internally generated brands, mastheads, publishing titles, customer lists and similar items should not be recognised.

Revaluation of intangible assets

An intangible asset can be revalued to fair value if that fair value is capable of being determined by reference to an active market. Valuations are required to be kept up to date.

Useful life of intangible assets

The useful life of an intangible asset is either finite or indefinite. The rebuttable presumption of a 20 year life in the previous version of the standard has been removed and there is no restriction on the period of a finite useful life. Intangible assets with an indefinite life must be tested for impairment at least annually. Intangible assets with a finite life should be amortised over that life and it is usually assumed that the residual value is zero. The only exceptions to this assumption are where there is a commitment by a third party to buy the asset at the end of its useful life or there is an active market for the asset and the residual value can be measured by reference to this market and that the market will still exist at the end of the useful life.

IAS 36 Impairment assets

Frequency of impairment reviews

IAS 36 applies to all assets except for inventories, assets arising under construction contracts, deferred tax assets, assets arising from employee benefits, financial assets within the scope of IAS 39, investment property measured at fair value, biological assets and non-current assets held for disposal accounted for under IFRS 5. For all other assets an entity must assess at the reporting date whether there is any indication that an asset may be impaired. The standard goes into some detail on indicators of impairment which includes adverse factors affecting the entity's business and evidence of obsolescence.

Irrespective of whether there is an indication of impairment:

- all intangible assets with an indefinite useful life should be assessed for impairment annually. This review can be carried out at any time during the financial reporting period, but it must be at the same time each year; and
- goodwill is required to be tested for impairment annually.

What is required?

Where there is an indication of impairment the entity is required to consider whether the 'recoverable amount' of the asset is equal to or more than its carrying value.

Recoverable amount is the higher of an asset's or cash-generating unit's fair value less costs to sell and value in use.

Determining value in use

The following factors are required to be included in the calculation of value in use:

- An estimate of future cash flows the entity expects to derive from the asset based on reasonable and supportable assumptions consistent with the most recent budget or projections. Longer term projections should be arrived at by extrapolating those projections at a steady or declining rate and any long-term growth cannot exceed the long-term growth rate or the country or countries the entity operates in.
- Expectations about possible

variations in the amount or timing of those future cash flows.

- The time value of money.
- Other factors such as illiquidity.

The cash flow estimates must be based on the asset in its current condition and should not take account of benefits to be derived from future restructuring or improving or enhancing the asset's performance.

Recognising an impairment loss

Where the recoverable amount is less than its carrying amount, there is an impairment and the carrying value of the asset should be reduced to its recoverable amount. Unless the asset is being carried at a revalued amount, the impairment loss should be recognised immediately in the profit and loss account. Where the asset is being carried at a revalued amount, the impairment loss should be recognised against the revaluation.

Allocation to cash-generating units

Where it is not possible to estimate recoverable amount for an individual asset, the recoverable amount of the cash-generating unit to which the asset belongs should be estimated.

For the purpose of carrying out impairment reviews on goodwill, the goodwill should be allocated to each of the cash-generating units or groups of cash-generating units expected to benefit from the synergies of the combination. This allocation must be complete by the end of the first accounting period beginning after the acquisition date. Each cash-generating unit should represent the lowest level for which information about goodwill is available and should not be larger than a segment based on the entity's primary or secondary reporting format in accordance with IAS 14 'Segment reporting'. Impairment losses should be recognised firstly by reducing the carrying value of any goodwill allocated to the cash-generating unit and then to other assets pro-rata on the basis of the carrying value of the assets.

Can an impairment loss be reversed?

For assets other than goodwill a review should be undertaken to ascertain whether there is an indication that a previous impairment is no longer appropriate. The impairment can be reversed if, and only if, there has been a change in the estimates used to determine recoverable amount. An impairment recognised in respect of goodwill cannot be reversed.

Disclosure

The revised IAS 36 contains significantly more disclosure requirements than the previous version of the standard.

Transitional provisions

All three standards should be applied prospectively from 31 March 2004 subject to the following exceptions:

- Amortisation of existing goodwill should be continued until the beginning of the first annual reporting period beginning on or after 31 March 2004. From that date the carrying value of goodwill will be frozen, but an impairment review should be conducted.

- Existing intangible assets that cease to meet the recognition criteria should be reclassified to goodwill. Intangible assets previously recognised in goodwill that would meet the revised criteria are not reclassified.

- Any negative goodwill should be transferred to the opening balance of retained earnings at the beginning of the first annual reporting period beginning on or after 31 March 2004.

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