

# Accounting Alert

Analysis of the latest accounting developments delivered to you via e-mail

## IASB issues standards on business combinations, intangibles and impairment

The International Accounting Standards Board (IASB) has released new or revised standards on business combinations, intangibles and impairment.

The Australian Accounting Standards Board (AASB) is expected to issue equivalent standards to IFRS 3 *Business Combinations* and the revised versions of IAS 36 *Impairment of Assets* and IAS 38 *Intangible Assets* in due course.

This Accounting Alert provides an overview of these developments.

### Overview

From an Australian perspective, the main impacts of these new and revised standards will often not arise from business combinations themselves, but in the areas of impairment and intangible assets.

Significant Australian impacts include:

- the implementation of a rigorous impairment testing regime for all assets, including a requirement to reverse past impairment losses in some cases
- strict criteria for the recognition and measurement of intangible assets, including a prohibition on the revaluation of intangibles unless there is an 'active market'
- the requirement to separately recognise and measure intangibles that meet specific criteria when they are acquired in a business combination
- no amortisation of goodwill and intangibles with indefinite useful lives, but a more rigorous impairment test based on an allocation of these assets to individual cash-generating units
- significantly expanded disclosure requirements in relation to recoverable amount and impairment, including information about key assumptions and in some cases sensitivity analyses
- new requirements in relation to accounting for business combinations – recognition of contingent liabilities acquired, a more rigorous recognition criterion for restructure provisions and the treatment of some acquisitions as 'reverse acquisitions'.

*Main impacts from Australian perspective in areas of impairment and intangibles*

# Significant differences from the original proposals

The final standards are mostly consistent with the proposals in ED 3 (see *Accounting Alerts 2002/17* and *2002/13*).

However, the following is a brief summary of some of the significant differences from ED 3:

*There are a number of important changes from the original proposals*

- the measurement and allocation of impairment losses in relation to goodwill has been amended and simplified to a 'goodwill first' approach, with any excess allocated to other assets on a pro-rata basis
- the subsequent measurement of contingent liabilities recognised in a business combination is based on IAS 37 and the amount recognised, not fair value as originally proposed
- goodwill can be allocated to a cash-generating unit not larger than either an entity's primary or secondary segment reporting format
- value in use calculations do not *require* an assessment of management's ability to forecast cash flows in the past
- reduction in the disclosures surrounding recoverable amount and impairment to address cost and commercial concerns
- removal of the proposal that, with the exception of an assembled workforce, sufficient information should always exist to measure reliably the fair value of an intangible asset acquired in a business combination.

## Business combinations

The requirements of IFRS 3 are largely consistent with current Australian requirements in major conceptual areas such as prohibiting the use of the 'uniting of interests' method and the allocation of fair values.

However, the following areas will in many cases lead to significant differences from current Australian practice:

*Some areas can lead to significant differences to past Australian practice*

- non-amortisation of goodwill and indefinite useful life intangibles
- recognition of acquired contingent liabilities at their fair values
- limiting reassessment of fair values arising from changes in estimates to a 12 month period
- limiting restructure provisions conditional on the business combination other than those that the acquiree is contractually required to make
- requiring the 'acquirer' to be other than the legal acquirer in some cases, e.g. reverse acquisitions, mergers, etc
- not treating some legal acquisitions as business combinations, e.g. acquisitions of entities with single-assets that are not considered 'businesses'
- immediate recognition of revenue for amounts previously treated as a 'discount on acquisition'
- use of a 'rules based' determination of fair value for various items.

### **Proposed AASB amendments for entities and business under common control**

The Australian Accounting Standards Board (AASB) is proposing an amendment to the scope section of the Australian equivalent to IFRS 3, AASB 3 *Business Combinations*.

*The AASB is proposing to amend the scope of AASB 3 bringing internal reconstructions within the business combination criteria*

This amendment, considered at the AASB's meeting late last week, would remove the scope exclusion in IFRS 3 for business combinations involving entities or businesses under common control, forcing these transactions into the scope of AASB 3. Non-reporting entities outside the scope of the *Corporations Act 2001* would be permitted to recognise these transactions at book values.

Although such an amendment will retain the status quo in Australia, we believe that this amendment has the potential to undermine the IFRS convergence project. Transactions will be required to be treated as business combinations under AASB 3 that are not considered business combinations under IFRS 3. The potential for differences in interpretation in areas such as the creation of new holding companies or interposed entities may result in materially different outcomes between AASB 3 and IFRS.

## Impairment testing

The introduction of an Australian standard equivalent to the revised version of IAS 36 will result in a significant increase in the complexity and rules surrounding the assessment of impairment.

### Impacts on current Australian practice

IAS 36 is much stricter in its application than current recoverable amount tests in Australia. Impacts include:

- removal of the ability to assess recoverable amount on an undiscounted basis
- not permitting the impacts of expected future capital expenditure in value in use calculations
- strict requirements for the allocation and testing of goodwill, intangibles and corporate assets
- goodwill in relation to partly-owned subsidiaries will be required to be 'grossed up' to 100% when assessing impairment
- vastly expanded disclosures in relation to impairment, intangibles and goodwill
- flow on impacts from other IFRS convergence adjustments, such as the separate recognition of derivatives on the balance sheet, and the resultant exclusion of cash flows associated with them from value in use calculations or inclusion of their carrying value in total carrying amount tested for impairment.

### Process of testing impairment

In overview terms, the following process is required:

- impairment must be assessed annually for goodwill, intangibles with indefinite useful lives, and other intangibles that are not yet available for use
- impairment of all other assets are assessed if there is an indication of impairment
- assets are assessed for impairment individually or as part of a cash-generating unit (CGU), depending on the circumstances
- goodwill must be allocated to individual CGUs or groups of CGUs and assessed on that basis, after any impairment losses have been recognised in relation to the assets or CGUs themselves before the allocation
- impairment losses arising in a CGU with allocated goodwill are used firstly to reduce any allocated goodwill, then on a pro-rata basis to other assets.

The appendix contains a flow chart that outlines the process of impairment testing for individual assets, CGUs and goodwill.

### Cash-generating units

A 'cash-generating unit' (CGU) is defined as the 'smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets'.

The identification of CGUs can be complex and must be consistent from period to period unless a change is justified.

*Impairment will be a major IFRS convergence area for some entities*

*The process for testing impairment is complex and rigorous*

*The determination of cash-generating units can be onerous*

Recoverable amount is the higher of an asset's (or CGU's) fair value less costs to sell and value in use

### Determining recoverable amount

Recoverable amount is determined as the higher of an asset's (or CGU's) 'fair value less costs to sell' and 'value in use'. If one of these measures is determined to be higher than the asset's (or CGU's) carrying amount, no impairment loss results and the other measure is not required to be calculated.

The determination of the fair value less costs to sell for an asset is by way of a hierarchy with the best evidence being a price in a binding sales agreement.

There are strict requirements on the determination of value in use, including what cash flows are taken into account, the measurement of future cash flows and the treatment of future capital expenditure. A summary of some of these requirements are outlined in the following table.

### Measuring value in use

The following table outlines the items that must be included and excluded in the measurement of value in use. The items in parentheses indicate the paragraph reference in IAS 36.

Included	Excluded
Cash inflows from the continuing use of the asset (39(a))	Cash flows from assets that are largely independent of the asset under review, e.g. financial assets such as receivables (43(a))
Cash outflows necessarily incurred to generate cash inflows from the continuing use of the asset (39(b))	Cash outflows related to recognised liabilities (43(b))
Net cash flows arising from the disposal of the asset at the end of its useful life (39(c))	Cash inflows and outflows expected to arise from a future restructuring (44(a))
Cash outflows necessary to maintain the level of economic benefits expected to arise from the asset in its current condition (49)	Cash inflows and outflows from improving or enhancing the asset's performance (44(b))
	Cash flows from financing activities (50(a))
	Income tax receipts and payments (50(b))

Sometimes the measurement of future cash flows will require the inclusion of some items noted above to be excluded, e.g. cash outflows required to satisfy a restoration obligation that cannot be separated from the other cash flows. In these cases, the carrying amount of the CGU is adjusted so that the value in use calculation and carrying amount are determined on the same basis.

However, this does not extend to future capital expenditures and restructurings which can never be taken into account in the value in use calculation.

## Intangible Assets

The introduction of an Australian standard equivalent to the revised IAS 38 *Intangible Assets* will see specific requirements in relation to intangibles for the first time in the Australian context.

Major Australian impact areas include:

- mandatory recognition of intangibles acquired in a business combination separately from goodwill (see below)
- non-amortisation of intangibles with an indefinite (not infinite) useful life
- prohibition on the revaluation of intangible assets except in the rare circumstances where an active market exists
- prohibition on the capitalisation of start-up costs, including research, training, advertising or promotional activities, relocations and reorganisations.

## Intangible assets acquired in business combinations

The following groups of intangibles would ordinarily be expected to meet the definition of an intangible asset where they arise in a business combination:

<b>Marketing-related intangible assets</b> <ul style="list-style-type: none"><li>– Trademarks, trade names, service marks, collective marks and certification marks</li><li>– Internet domain names</li><li>– Trade dress (unique colour, shape or package design)</li><li>– Newspaper mastheads</li><li>– Non-competition agreements</li></ul>	<b>Customer-related intangible assets</b> <ul style="list-style-type: none"><li>– Customer lists</li><li>– Order or production backlog</li><li>– Customer contracts and related customer relationships</li><li>– Non-contractual customer relationships</li></ul>	<b>Contract-based intangible assets</b> <ul style="list-style-type: none"><li>– Licensing, royalty and standstill agreements</li><li>– Advertising, construction, management, service or supply contracts</li><li>– Lease agreements</li><li>– Construction permits</li><li>– Franchise agreements</li><li>– Operating and broadcasting rights</li><li>– ‘Use’ rights such as drilling, water, air, mineral, timber-cutting and route authorities</li><li>– Servicing contracts such as mortgage servicing contracts</li><li>– Employment contracts below current market value</li></ul>
<b>Artistic-related intangible assets</b> <ul style="list-style-type: none"><li>– Plays, operas and ballets</li><li>– Books, magazines, newspapers and other literary works</li><li>– Musical works such as compositions, song lyrics and advertising jingles</li><li>– Pictures and photographs</li><li>– Video and audiovisual material, including films, music videos and television programs</li></ul>	<b>Technology-based intangible assets</b> <ul style="list-style-type: none"><li>– Patented technology</li><li>– Computer software and mask works</li><li>– Unpatented technology</li><li>– Databases</li><li>– Trade secrets such as secret formulae, processes or recipes</li></ul>	

AASB 1 has an optional exemption from restatement for past business combinations but it must be applied with care

## First-time adoption

Under AASB 1 *First-time Adoption of Australian International Financial Reporting Pronouncements*, entities have the choice to not restate past business combinations in accordance with the requirements of the new standards, or to only restate business combinations that occurred after a particular date.

It is expected that many entities may choose to take advantage of the option in AASB 1. However, entities wishing to do so should be aware of the potential for significant issues to arise in such areas as:

- the reallocation of items to and from previously recognised goodwill will be restricted to very limited circumstances
- prior goodwill amortisation will not be able to be reversed
- the recognition of deferred taxes arising in past business combinations will impact opening retained earnings rather than goodwill, potentially severely impacting net assets.

## Future developments

These revised standards are the first phase of the IASB’s business combinations project. Further amendments are expected as a result of phase II of the project.

In particular, the IASB is expected to shortly release proposed amendments to the scope and treatment of IFRS 3 in relation to mutual entities and dual-listed entities. Further exposure drafts can be expected as the phase II project progresses.

## Further information

The requirements of IFRS 3, IAS 36 and IAS 38 and their associated implementation guidance and bases for conclusion run to nearly 500 pages.

For more information about these developments, visit our international web site on IFRS, IAS Plus, at [www.iasplus.com](http://www.iasplus.com). An in-depth publication on business combinations is expected to be made available in the coming weeks.

IAS Plus also has summaries of IASB pronouncements, publications, analyses, chronologies and other useful information about IFRS.

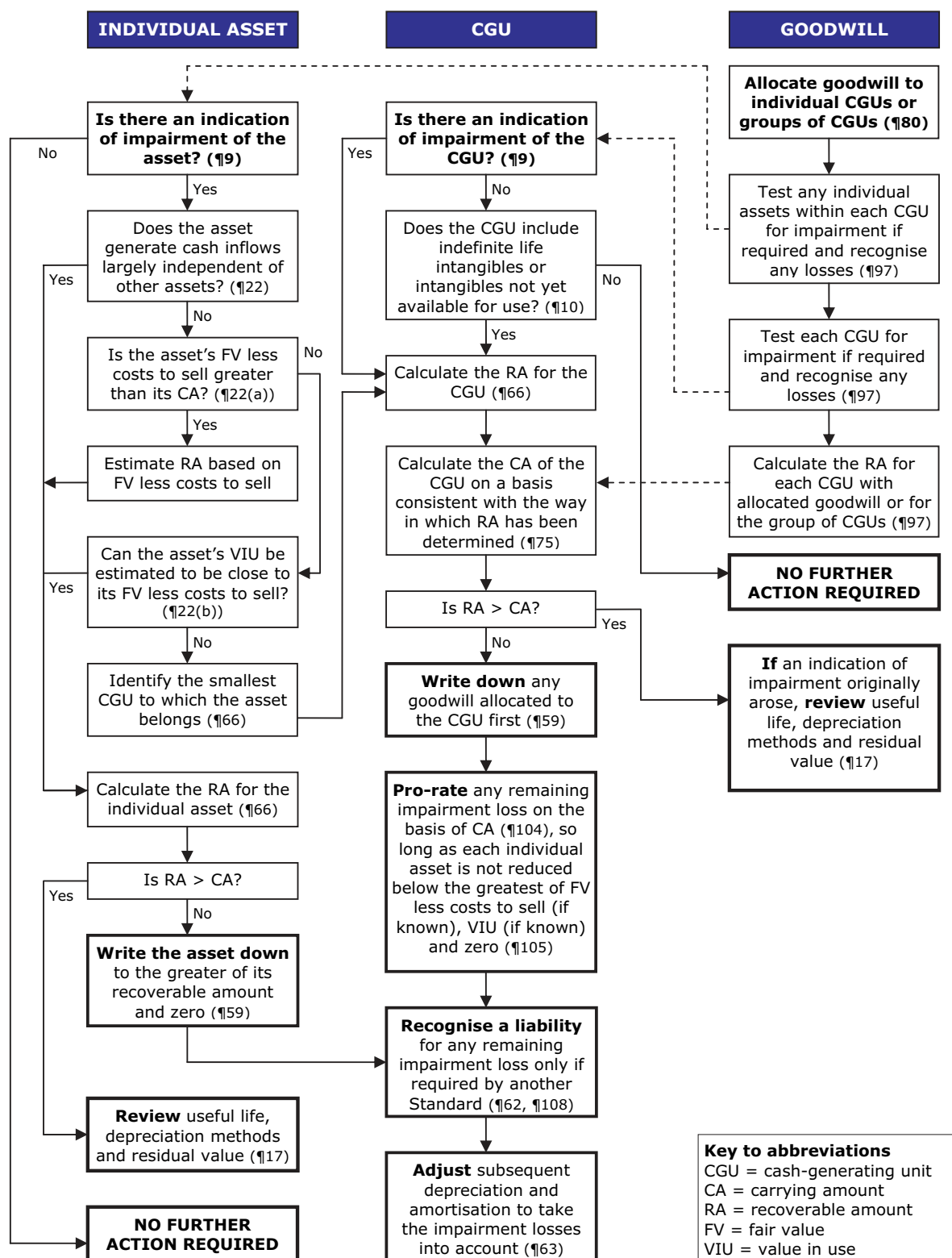
## Feedback and assistance

We welcome your feedback on the matters covered in this *Accounting Alert* – please email your comments to [accounting\\_alerts@deloitte.com.au](mailto:accounting_alerts@deloitte.com.au).

For assistance in determining the impact of the requirements on your organisation, please contact your local Deloitte office or contact our Lead National Technical Partner, Bruce Porter on (03) 9208 7490, or by email to [bruporter@deloitte.com.au](mailto:bruporter@deloitte.com.au).

The Deloitte global IFRS site has substantially more information on these developments and on IFRS in general

# Appendix: Overview of impairment testing process



This and other Deloitte publications are available on the Deloitte website at [www.deloitte.com.au](http://www.deloitte.com.au). This Accounting Alert is of a general nature only and is not intended to be relied upon as, nor to be a substitute for, specific professional advice. No responsibility for loss occasioned to any person acting on or refraining from action as a result of any material in this publication can be accepted. The liability of Deloitte Touche Tohmatsu is limited by, and to the extent of, the Accountants' Scheme under the Professional Standards Act 1994 (NSW). © 2004 Deloitte Touche Tohmatsu. All rights reserved. Produced in Australia.