Accounting Alert

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Business Combinations Exposure Drafts Issued

On 5 December 2002, the International Accounting Standards Board (IASB) and the Australian Accounting Standards Board (AASB) concurrently released exposure drafts on business combinations. This *Accounting Alert* provides an outline of the major Australian impacts resulting from the proposals included in these exposure drafts.

Overview

No amortisation of goodwill and indefinite life intangibles

Implementation of the IASB proposals will have a wide reaching impact on Australian financial reporting including,

- Goodwill would be allocated to business sub-units and measured on an impairment basis, rather than being amortised;
- Acquired intangible assets would only be recognised separately from goodwill if they meet the definition of an asset and are either separable or arise from contractual or other legal rights; and
- Intangibles that have an indefinite useful life would be accounted for on an impairment basis.

However, much of the devil is in the detail or the associated changes to accounting for intangible assets and impairment testing. There will be many potential issues for Australian entities undertaking the transition to the proposals outlined in the exposure drafts.

The following sets out a high-level summary of the major Australian impacts of the proposals. This includes an overview of some initial issues arising from the proposed changes to be considered in each of the significant areas.

Goodwill

Goodwill is allocated to individual operations and tested for impairment only, with no amortisation

Key Impacts

- Goodwill acquired in a business combination must be allocated to the smallest individual 'cash generating units' ('CGUs') by the end of the first annual reporting period beginning after acquisition date;
- Goodwill will not be amortised, but will be subject to a 'two-step' impairment test as part of the impairment test for the CGU to which it relates; and
- Impairment losses recognised in relation to goodwill cannot be reversed in a subsequent period.

Preliminary Issues

- Because the impairment test is applied to each CGU, the excess 'value' from one CGU cannot be used to support the carrying amount of other CGUs.
- Where changes in circumstances change the recoverable amount of individual 'cash generating units', entities will be required to recognise an impairment loss expense. This may lead to more 'lumpy' net profit or losses, as impairment losses might be expected to only occur irregularly.

Goodwill allocation may cause some problems with impairment testing, but there are some 'buffers' in the test applied

- The impairment test will include the value of 'internally generated goodwill' in the recoverable amount calculation, particularly as the time between the test date and acquisition date gets longer.
- The recoverable amount of the cash-generating unit as a whole is used in the test. The increases in fair values of other assets in the CGU will tend to act as a 'buffer' against any prima facie reduction in the recoverable amount of goodwill itself.
- The profit or loss recognised on the disposal of a CGU (or part thereof) will be impacted by the level of goodwill attributed to that CGU.

Points to Consider

- What amount of goodwill is currently recognised?
- What impact will its non-amortisation have on future profits?
- How does the definition of a CGU relate to the structure of the entity?
- How will goodwill be allocated to individual CGUs?

Intangible Assets

Key Impacts

Many more intangibles would be recognised, but there would be restrictions on revaluations, internally generated assets and a prohibition on the capitalisation of start-up costs

- Intangibles (including those acquired in a business combination) must be recognised where they meet the 'identifiability' criterion – either the asset is 'separable' or arises from contractual or legal rights;
- Non-amortisation of intangible assets that have an indefinite (not infinite) useful life – intangibles can qualify for non-amortisation where legal rights can be renewed without significant cost;
- A prohibition on the recognition of internally generated brands, mastheads, publishing titles, customer lists and similar items as assets;
- Revaluations of intangible assets would be restricted to fair values determined by reference to an active market (ie: without an active market, no revaluation is permitted); and
- A prohibition on the capitalisation of expenditure (outside of a business combination) related to start-up, training activities, advertising, promotional, relocation and other similar activities.

Preliminary Issues

Intangibles recognised may require amortisation

- A wide range of intangible assets will meet the recognition criteria – trademarks, customer lists, musical works, patents, software, etc;
- Intangibles that meet the 'identifiability' criteria will be required to be recognised separately from goodwill and could lead to amortisation being recognised where their useful lives are not 'indefinite'; and
- Many Australian entities will be required to derecognise assets such as internally generated brands, assets revalued without reference to an active market and certain prohibited capitalised expenditure.

Points to Consider

- What intangible assets are currently recognised?
- Will we be required to derecognise any intangibles (those not meeting the definition or having been revalued without reference to an active market)?
- Do any of our intangibles have indefinite useful lives and so qualify for non-amortisation?
- What types of intangible assets would be expected to arise in a business combinations in our industry? Would these intangibles have indefinite useful lives, or would they need to be amortised under the proposals?

Impairment Testing

Key Impacts

- Other than for goodwill and intangible assets with indefinite useful lives, recoverable amount will only need to be determined where there is an indication of impairment – various internal and external sources of information are specified as the minimum to be considered.
- Recoverable amount is determined as the higher of an asset's 'net selling price' and 'value in use'.

Recoverable amount based on the higher of net selling price and value in use

- When determining an asset's value in use:
  - future cash flows **must** be discounted – the discount rate is determined on a pre-tax basis and future cash flows are also determined on a pre-tax basis; and
  - there are many restrictions on what information and assumptions can be used when determining future cash flows – particularly in relation to future capital expenditure and growth rates used.

- If it is not possible to estimate recoverable amount of the individual asset, the entity determines the recoverable amount of the CGU to which the asset belongs.
- Impairment losses (other than for goodwill) **must** be reversed in certain circumstances.

Preliminary Issues

- The proposals would implement a more prescriptive impairment test than current Australian standards specifically in relation to determining future cash flows and the identification of CGUs.

Undiscounted cash flows not permissible

- Carrying value of assets will no longer be supportable using undiscounted cash flows.
- When net selling price is higher than value in use and costs of disposal are not negligible, assets carried at fair value may be impaired.

Points to Consider

- What are our current practices in relation to the determination of recoverable amount?
- Do we currently use undiscounted cash flows or assume future capital expenditure in supporting the carrying amount of assets?

Acquisition Accounting Generally

Key Impacts

Requirements in relation to restructuring provisions tightened, contingent liabilities and IPR&D recognised

Reverse acquisitions permitted, negative goodwill immediately recognised as revenue

- Removal of the existing concessions in relation to the recognition of restructuring provisions in relation to a business combination (other than those triggered by the business combination under pre-existing contractual obligations);
- Contingent liabilities assumed in an acquisition must be initially recognised at their fair value at acquisition date and at each subsequent reporting date;
- In-process research and development (IPR&D) to be recognised as an asset when acquired as part of a business combination;
- 'Reverse acquisition' accounting would be required in some circumstances; and
- 'Negative goodwill' (discount on acquisition) recognised immediately in net profit or loss.

Preliminary Issues

Changes to the allocation of fair values will impact profitability

- Restructuring costs relating to a business combination will be recognised as a post acquisition expense unless there is a pre-existing liability of the acquired entity at the date of acquisition;
- Reverse acquisition accounting will allow certain acquisitions to be accounted for with a reduced level of goodwill; and
- The proposals to recognise the fair value of contingent liabilities and in-process research and development will change the allocated fair values in an acquisition and may lead to differences in reported profitability.

Points to Consider

- How will the proposed changes to the recognition of restructuring provisions impact us? Have past acquisitions resulted in restructuring provisions? Will the changed approach impact planned or anticipated acquisitions?
- Does our industry tend to have a lot of contingent liabilities? How would we determine the 'fair value' of these contingent liabilities in an acquisition situation? What impacts would this have on future planned or anticipated acquisitions?

Disclosures

Key Impacts

- Disclosures already required under International Standards will be significantly more onerous than existing Australian requirements – the exposure drafts also propose further disclosures;

Many more disclosures than currently required under Australian Standards

- Excess of recoverable amount over carrying amount, significant assumptions, sensitivity analyses and justifications for assumptions used would be required in relation to the impairment testing for goodwill and intangibles;
- Pro-forma information would be required, unless such disclosure would require undue cost or effort, for business combinations as though acquisitions during the period had occurred at the beginning of the period; and
- Movement schedules (with comparatives) would be required for goodwill and intangibles.

Preliminary Issues

- Entities with significant balances of goodwill and intangibles would disclose information that may be considered commercially sensitive; and

Information may be commercially sensitive and include forward looking statements

- Many of the proposed disclosures relate to forward-looking information or relate to the period before an entity was controlled, and therefore have the potential to create significant issues for directors and auditors.

Points to Consider

- What impact will the proposed disclosures have? Will commercially sensitive information be required to be disclosed? What assumptions will we need to disclose?
- How will we obtain the necessary comfort on the assumptions and other disclosures to enable the directors and auditors to sign the financial report?

Other Areas

Key Impacts

- Equity accounting would be adjusted to be consistent with the business combinations proposals (no amortisation of goodwill, recognise negative goodwill as revenue, etc); and
- Transitional provisions would apply to most requirements on a prospective basis only.

Implementation in Australia

The AASB has signalled its intention to issue AASB Standards equivalent to the IASB Standards at the same time as they are issued by the IASB. The AASB Standards will contain some additional material dealing with not-for-profit entities and transitional provisions.

Mandatory application in Australia from 1 January 2005, with early adoption permitted – but only if all requirements adopted simultaneously

The AASB Standards will have mandatory application to reporting periods beginning on or after 1 January 2005, to coincide with the move to IFRS in Australia from that date.

The IASB and AASB Standards are expected to be issued during 2003 and Australian entities will have the option of early adopting their requirements. However, all three Standards (ie: business combinations, intangible assets and impairment of assets) will need to be implemented at the same time.

Early adoption may not be as attractive as first glance may indicate

The early adoption mechanism may appeal to many entities, particularly in relation to the non-amortisation of goodwill and other intangibles. However, entities will need to consider the wider implications of the proposals in their entirety before making the decision to adopt early.

Future Developments

The exposure drafts are also only the implementation of 'Phase I' of the business combinations project – 'Phase II' is intended to address other contentious matters in relation to business combinations.

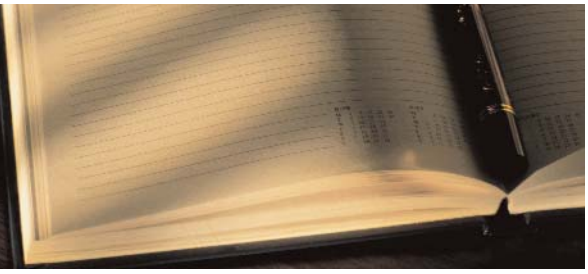
The Financial Accounting Standards Board (FASB) from the United States is partnering the IASB on some aspects of Phase II of the project, which will deal with topics that include the following:

Phase II will consider the more contentious areas of accounting for business combinations

- issues related to applying the purchase method of accounting;
- accounting for formations of joint ventures and business combinations involving entities under common control; and
- possible applications for 'fresh start' accounting.

The existing FASB requirements may be revised

The FASB has also agreed to reconsider certain aspects of the current United States requirements in relation to the matters covered by the exposure drafts in order to move towards globally harmonised accounting standards in this area.



Other Resources

Copies of the AASB documents mentioned in this *Accounting Alert* can be found at www.aasb.com.au. Copies of the IASB documents can be obtained from www.iasb.org.uk.

Deloitte maintains a comprehensive web site resource on IFRS at www.iasplus.com.

Accounting Alerts 2002-13 'Current Developments in Accounting for Business Combinations' and 2002-03 'AASB Releases Revised Exposure Draft on Impairment of Assets' provide more detailed analyses of some aspects of the IASB's Business Combinations project and can be obtained from the Deloitte web site: www.deloitte.com.au

Feedback and Assistance

We welcome your views on the business combinations exposure drafts - please email your comments to accounting_alerts@deloitte.com.au

For assistance in identifying the major impact areas for 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