

# IAS Plus.

Published for our clients and staff throughout the world

## Deloitte global IAS leadership team

### IAS global office

Global IAS Leader

Ken Wild

kwild@deloitte.co.uk

### IAS centres of excellence

#### Americas

D. J. Gannon

iasplusamericas@deloitte.com

#### Asia-Pacific

Stephen Taylor

iasplus@deloitte.com.hk

#### Europe-Africa

##### Johannesburg

Graeme Berry

iasplus@deloitte.co.za

##### Copenhagen

Stig Enevoldsen

dk\_iasplus@deloitte.dk

##### London

Veronica Poole

iasplus@deloitte.co.uk

##### Paris

Laurence Rivat

iasplus@deloitte.fr

### IAS plus website

Over 480,000 people visited our [www.iasplus.com](http://www.iasplus.com) web site in 2003 (compared to 267,000 in 2002 and 89,000 in 2001). Our goal is to be the most comprehensive source of news about IFRS on the Internet. Please check in regularly during 2004.

## IASB publishes IFRS 3 Business Combinations

The International Accounting Standards Board (IASB) has issued International Financial Reporting Standard (IFRS) 3 Business Combinations that will require all business combinations within its scope to be accounted for using the purchase method of accounting. As part of this project the IASB has also issued revised versions of IAS 36 Impairment of Assets and IAS 38 Intangible Assets. In reissuing these standards the IASB limited its considerations to only those aspects of the standards that affect accounting for business combinations. IFRS 3 is based on its preceding exposure draft, ED3, but there have been important changes, especially in the provisions relating to impairment testing.

The following table illustrates the major areas of accounting for business combinations that will be affected by the issuance of IFRS 3.

### Significant changes in IFRS 3

Method?	→	Must be accounted for using the purchase method.
Assets and liabilities acquired?	→	Recognition of more intangible assets and contingent liabilities at fair value at acquisition date.
Goodwill?	→	Not amortised but tested for impairment at least annually.
Negative goodwill?	→	Recognised in profit or loss immediately.
Restructuring costs?	→	Only recognised to the extent a liability of the acquiree exists at acquisition date.

### Scope

IFRS 3 defines a business combination as the bringing together of separate entities or businesses into one reporting entity, and requires the purchase method of accounting to be applied to all such transactions, with limited exceptions, for example business combinations between entities under common control and combinations involving two or more mutual entities.

Under the purchase method of accounting the acquiree's identifiable assets and liabilities must be measured at their fair value at acquisition date.

## Method of accounting

In many jurisdictions the pooling of interests method of accounting (also known as uniting of interests or merger accounting) has been permitted under national GAAP, and indeed, by IAS 22 where an acquirer could not be identified. Under the purchase method of accounting the acquiree's identifiable assets and liabilities should be measured at their fair value at acquisition date, a method that requires significantly more effort than the pooling of interests method and will usually result in the recognition of goodwill or negative goodwill on acquisition.

IFRS 3 states that an acquirer, being the entity that obtains control of the combined entity, shall be identified. The IASB has included in the Standard substantial guidance on the identification of the acquirer, in acknowledgement that in many business combinations, particularly those purported to be a 'merger', the acquirer may not be immediately obvious. The Standard specifies that the acquirer for accounting purposes may be different from the legal acquirer, and provides extensive guidance on the application of IFRS 3 to such a situation (also known as 'reverse acquisitions').

## Cost of a business combination

The acquirer measures the cost of the business combination as the total of the fair values at date of exchange of assets given, liabilities incurred and equity instruments issued by the acquirer in exchange for control of the acquiree and any costs directly attributable to the business combination incurred by the acquirer. If equity instruments are issued as consideration for the acquisition the market price of those equity instruments at the date of exchange is considered to provide the best evidence of fair value. Where a market price does not exist, or is not considered reliable evidence of fair value, other valuation techniques are used to determine fair value.

## Allocating the cost of a business combination

At acquisition date, the acquirer must allocate the cost of the business combination by recognising, at fair value, the identifiable assets, liabilities and contingent liabilities of the acquiree. Any proportion of the identifiable assets, liabilities and contingent liabilities of the acquiree attributable to minority interests is also recognised at fair value. Any difference between the total of net assets acquired and cost of acquisition is treated as goodwill or negative goodwill.

Where an entity acquires an intangible asset as part of a business combination the intangible asset is recognised separately if it meets the following criteria:

- separately identifiable;
- controlled by the entity;
- a source of future economic benefits; and
- the fair value can be measured reliably.

Items, such as in process research and development, that were ineligible for recognition in the books of the acquiree, may be recognised by the acquirer on acquisition.

In determining the amount they are willing to pay for the acquisition of a business, purchasers will take account of a number of factors, not all of which are eligible for recognition as an asset because the entity does not control the resource in question – for example, an assembled workforce. Control is most commonly considered to exist where there are legal rights attaching to the resource in question that would be enforceable in a court of law. For instance, technical knowledge may be protected by licences or trademarks, giving the entity legal enforceability of their control over the knowledge. Skills or resources embodied in particular persons, or groups of persons, do not usually meet the definition of an intangible asset because the entity has insufficient control over the actions of that person to recognise those skills or resources as a separate asset.

On initial recognition as part of the acquisition transaction, the cost of the intangible is measured as the fair value at the date of acquisition. The fair value of an intangible asset is the amount the entity would have paid for the asset at the acquisition date in an arm's length transaction between knowledgeable and willing parties, on the basis of the best information available. In determining fair value the advice of an independent valuer with experience in the market may be sought.

A contingent liability is recognised in the course of a business combination if its fair value can be measured reliably. The amount recognised is based on the amount a third party would charge to assume that contingent liability. In determining the amount to be recognised an entity should take into account the range of likely outcomes of the contingency, rather than a single best estimate.

### Accounting for goodwill/discount on acquisition

At acquisition date, the acquirer recognises goodwill acquired in a business combination as an asset. The asset recognised is measured as the excess of the cost of acquisition over the acquirer's interest in the fair values of assets, liabilities and contingent liabilities acquired. On an ongoing basis the goodwill is measured at cost, and is assessed for impairment in accordance with IAS 36 at least annually. This represents a significant change from the accounting required under IAS 22 as amortisation of goodwill is no longer required or permitted.

If the fair value of the assets, liabilities and contingent liabilities exceed the cost of acquisition, the acquirer should reassess the fair values determined, and the measurement of the cost of acquisition. Having reassessed this information any excess remaining (also known as negative goodwill) is recognised immediately in profit or loss for the period. This represents a significant change from existing accounting practice which consisted of a range of policies such as allocation of the negative goodwill across non-monetary assets and amortisation of negative goodwill over a period.

### Impairment testing in accordance with IAS 36

In determining whether goodwill arising on a business combination is considered to be impaired, goodwill is allocated to a cash-generating unit. In order to determine whether an impairment write-down is required, the recoverable amount of a cash-generating unit is compared with its carrying amount. The recoverable amount is determined as the higher of fair value less costs to sell or value in use. In some circumstances it will not be necessary to determine both figures. For instance, if a cash-generating unit's value in use is greater than its carrying amount, fair value less cost to sell is academic because it will not result in a write-down.

The standard states that the best estimate of a cash-generating unit's fair value less costs to sell is a price agreed in a binding sales agreement for that cash-generating unit in an arm's length transaction, adjusted for incremental costs attributable to the disposal. For individual assets, where no binding sale agreement exists, the fair value less costs to sell is normally considered to be the bid price when that asset is traded in an active market. Generally no active market exists for entire cash-generating units, and accordingly fair value less costs to sell cannot be readily determined by reference to an active market. In the absence of a binding sale agreement, or an active market, fair value less costs to sell is determined based on the best available information at balance date that reflects the amount the entity could obtain for disposal in an arms length transaction between a willing buyer and a willing seller. Having arrived at fair value less costs to sell, the expected incremental costs of disposal that have not been recognised as liabilities are deducted to determine the cash-generating unit's recoverable amount

As discussed above, it is quite rare for a cash-generating unit that is not about to be sold to have a readily determinable fair value less costs to sell and therefore it is expected that commonly the recoverable amount of the cash-generating unit will be determined by reference to its value in use. Cash flow projections used in determining value in use should be based on the most recent financial budgets/forecasts for the following five years as approved by management. The cash flows used in assessing the recoverable amount do not include the effects of future cash inflows and outflows arising from future restructurings or capital expenditure. However, future cash inflows and outflows arising from maintaining the existing capacity of the asset are included. Where the budgets and forecasts approved by management do not extend out to five years or cash flows are expected beyond five years, the entity may extrapolate the approved budgets using either a steady or declining growth rate.

When a recoverable amount write-down is required that write-down is taken through the profit and loss statement in the period in which it is identified. In circumstances where the need for a recoverable amount write down in a cash-generating unit has been identified, that write-down is first allocated to any recognised goodwill within the cash-generating unit. This differs from the approach proposed in ED 3 which was similar in nature to the two step approach required by US GAAP. Any additional write-down that is required is then allocated on a pro rata basis to the other assets within the cash-generating unit.

In determining whether goodwill arising on a business combination is considered to be impaired the goodwill is allocated to a cash-generating unit.

## Effective date and transitional provisions

IFRS 3 is effective for business combinations for which the agreement date is on or after 31 March 2004. Entities may choose to apply the standard from any date prior to 31 March 2004 to all business combinations occurring on or after the chosen application date providing that they have sufficient information to apply the standard to past business transactions (that information having been obtained at the date of initially accounting for the business combination in question), and that they also apply the revised versions of IAS 36 and IAS 38 with the same effective date.

Where goodwill has been previously recognised in business combination transactions an entity is required to:

- Discontinue amortising goodwill in the first period beginning on or after 31 March 2004.
- Eliminate the carrying amount of accumulated goodwill amortisation against the carrying amount of goodwill at the beginning of the first reporting period beginning on or after 31 March 2004.
- Test the carrying amount of goodwill for impairment in accordance with IAS 36 from the beginning of the first annual reporting period beginning on or after 31 March 2004.

In some jurisdictions a carrying amount of negative goodwill from business combinations agreed prior to 31 March 2004 will be included in the balance sheet. Such amounts are derecognised at the beginning of the first reporting period beginning on or after 31 March 2004 with the corresponding adjustment being made to the opening balance of retained earnings.

For first time adopters of IFRS, IFRS 3 must be applied at the date of transition. There is no requirement to re-state business combinations that occurred prior to that date, however if an entity chooses to re-state a particular past business combination they must re-state any past business combinations that have occurred in between the date of the first combination they re-state and their date of transition. Certain limited amendments must be made to amounts recognised in all previous business combinations – for example the derecognition of assets recognised that do not qualify for recognition under IFRS. Any negative goodwill recognised in the balance sheet is eliminated against retained earnings at the date of transition.

The requirements of IFRS 3, IAS 36 and IAS 38 represent significant accounting changes in many jurisdictions. Entities should ensure that they obtain all the information necessary in order to account for each business combination both at date of acquisition and subsequent to that date. For further information or assistance in applying IFRS 3, IAS 36 and/or IAS 38 please contact your nearest Deloitte office.

For more information on Deloitte Touche Tohmatsu please access our website at [www.deloitte.com](http://www.deloitte.com).

Deloitte Touche Tohmatsu is one of the world's leading professional services organizations. The member firms of Deloitte Touche Tohmatsu deliver world-class assurance and advisory, tax, and consulting services. With more than 119,000 people in over 140 countries, the member firms serve over one-half of the world's largest companies, as well as large national enterprises, public institutions, and successful, fast-growing global growth companies. Our internationally experienced professionals strive to deliver seamless, consistent services wherever our clients operate. Our mission is to help our clients and our people excel.

Deloitte Touche Tohmatsu is a Swiss Verein, and each of its national practices is a separate and independent legal entity.

This publication contains general information only and is not intended to be comprehensive nor to provide specific accounting, business, financial, investment, legal, tax or other professional advice or services. This publication is not a substitute for such professional advice or services, and it should not be acted on or relied upon or used as a basis for any decision or action that may affect you or your business. Before making any decision or taking any action that may affect you or your business, you should consult a qualified professional advisor.

Whilst every effort has been made to ensure the accuracy of the information contained in this publication, this cannot be guaranteed and neither Deloitte Touche Tohmatsu nor any related entity shall have any liability to any person or entity who relies on the information contained in this publication. Any such reliance is solely at the user's risk.

© Deloitte Touche Tohmatsu 2004. All rights reserved.

Deloitte Touche Tohmatsu, 1633 Broadway, New York, NY 10019-6959, United States.

Designed and produced by The Creative Studio at Deloitte, London.