KPMG

IASBriefing

April 2004

Issue 22

This special issue of IASB*riefing* summarises the key points of IFRS 3 *Business Combinations* and the related revisions to IAS 36 *Impairment of Assets* and IAS 38 *Intangible Assets*.

Overview

The objective of the International Accounting Standards Board (IASB) in issuing a new standard in this area is to achieve convergence with US GAAP. IFRS 3 largely is consistent with the parallel US standards, although some differences remain. The most significant differences relate to impairment testing of goodwill and the recognition of acquired contingent liabilities.

All business combinations within the scope of IFRS 3 now must be accounted for using the purchase method. The uniting-of-interests method that was applicable in limited circumstances in IAS 22 *Business Combinations* is no longer allowed under IFRS 3.

Revisions also were made to IAS 36 and IAS 38. These revisions also will affect accounting for impairment and intangibles outside business combinations.

IFRS 3 is effective immediately and should be applied *prospectively* to business combinations entered into (i.e., with an agreement date) on or after **31 March 2004**. The new requirements to be applied in accounting for existing goodwill and negative goodwill are effective from the beginning of the first reporting period beginning on or after 31 March 2004. Limited retrospective application is permitted if certain criteria are met.

IFRS 3 will replace IAS 22. The main elements of IFRS 3 and changes from current practice under IAS 22, IAS 36 and IAS 38 are summarised below.

IFRS 3 *Business Combinations*

Objective, scope and definitions

IFRS 3 specifies the financial reporting by an entity when it combines with one or more other entities or businesses. Transactions among entities under common control, business combinations in which a joint venture is formed, business combinations involving mutual entities and

KPMG's bi-monthly update on International Financial Reporting Standards (IFRSs)

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the combining of businesses by contract alone currently are excluded from its scope.

IFRS 3 introduces the following important definitions:

- Business combination – the bringing together of separate entities or businesses into one reporting entity.

- Business – an integrated set of activities and assets conducted and managed for the purpose of providing (i) a return to investors, or (ii) lower costs or other economic benefits directly and proportionately to policyholders or participants.

  A business generally consists of inputs, processes applied to those inputs, and resulting outputs that are, or will be, used to generate revenues. If goodwill is present in a transferred set of activities and assets, the transferred set shall be presumed to be a business. In our view, a business does not have to be a separate legal entity.

- Business combination involving entities or businesses under common control – A business combination in which all of the combining entities or businesses ultimately are controlled by the same party or parties both before and after the combination, and that control is not transitory.

Application of the purchase method

Identifying an acquirer

In applying the purchase method, an acquirer always must be identified. The acquirer is the entity that obtains control over the combining entities or businesses. In some instances it may be difficult to identify an acquirer. IFRS 3 provides the following examples of indicators to assist in identifying an acquirer:

- when the fair values of the combining entities are significantly different, the entity with the higher fair value usually is the acquirer;

- when the cost of the acquisition is paid in cash or other assets, the entity paying cash or giving up the other assets usually is the acquirer; and

- the entity that is able to dominate the selection of the management team of the resulting combined entity usually is the acquirer.

The identification of the acquirer could result in the legal parent company being the acquiree (subsidiary) for accounting purposes (i.e., a reverse acquisition). IFRS 3 provides additional guidance on accounting for reverse acquisitions in Appendix B to the standard.

Cost of a business combination

The cost of a business combination is the aggregate fair value, at the date of exchange, of assets given, liabilities incurred and equity instruments issued by the acquirer plus any costs directly attributable to the business combination. If the business combination is achieved in stages, the date of exchange is the date of *each* exchange transaction (i.e., the date that each individual investment is recognised in the financial statements of the acquirer). IFRS 3 incorporates the existing guidance, with respect to the date of exchange, in SIC–28 *Business Combinations – "Date of Exchange" and Fair Value of Equity Instruments*.

As in IAS 22, if the business combination agreement provides for contingent consideration, the amount of the adjustment is included in the initial cost of the business combination if the adjustment is probable and can be measured reliably. Otherwise it is treated as an adjustment to the cost of the business combination when it becomes probable and the amount can be measured reliably.

Allocating the cost of a business combination to the assets acquired and the liabilities and contingent liabilities assumed

At the date of acquisition, the acquirer recognises the acquiree's identifiable assets, liabilities and *contingent liabilities* at their fair value. However, there is an exemption for non-current assets classified as held for sale under IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*, which are recognised at fair value less costs to sell. If the acquirer does not obtain all of the ownership interests in the acquiree, a portion of the fair value is assigned to minority interest. An acquirer no longer can measure minority interest at the book value of the minority's share of the assets acquired and liabilities assumed, as was permitted under IAS 22.

For most items the general recognition criteria apply (e.g., future economic benefits or outflow of resources must be probable) to determine whether an entity recognises the acquisition of assets or assumption of liabilities from the seller separately from goodwill. The standard changes the recognition criteria for intangible assets and for *contingent* liabilities (see below).

Goodwill

Goodwill acquired in a business combination is recognised as an asset and initially measured at cost. The cost of goodwill is the excess of the cost of the business combination over the acquirer's interest in the net fair values of the identifiable assets, liabilities and contingent liabilities acquired. As in current IAS 22, goodwill is recognised only to the extent of the ownership interest acquired.

After initial recognition, IFRS 3 requires that goodwill be recorded at cost less accumulated impairment charges. Goodwill no longer is amortised, as previously required under IAS 22, but instead is subject to impairment testing at least annually. Revised IAS 36 will be applied to test for impairment. The IAS 36 impairment test differs from the impairment tests applied under US GAAP.

Negative goodwill

IFRS 3 changes the accounting when there is an excess of the acquirer's interest in the net fair values of the identifiable assets, liabilities and contingent liabilities acquired over the costs paid

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(i.e., negative goodwill, although this term no longer exists under IFRS 3). Under the standard, the acquirer now must:

- reassess the identification and measurement of identifiable assets, liabilities and contingent liabilities; and
- recognise any remaining excess in profit or loss immediately on acquisition.

Intangible assets

To qualify for recognition as an intangible asset, an item must meet the definition of an intangible asset, it must be probable that the future economic benefits that are attributable to the asset will flow to the entity and the cost of the asset must be reliably measurable.

To meet the definition of an intangible asset, an item must meet the definition of an asset and be non-monetary, without physical substance and identifiable.

In IFRS 3 and IAS 38, the IASB sought to clarify the assessment of identifiability of an intangible asset, whether acquired in a business combination or otherwise. An intangible asset now is considered identifiable if it arises from contractual or legal rights or is separable either individually or together with a related contract, asset or liability. Separability was not, strictly speaking, a requirement for recognising an intangible asset under the original IAS 38. However, IFRS 3 has broadened the recognition criteria by adding contractual or legal rights as a specific alternative to separability.

Probability of future economic benefits is assumed for intangibles acquired in a business combination under IFRS 3. Therefore, an acquirer recognises an intangible item separately from goodwill at the acquisition date, if the definition of an intangible asset is met and the asset's cost (its fair value) can be measured reliably. It is assumed that normally the fair value can be measured with sufficient reliability, but this assumption can be rebutted in certain limited circumstances.

Consequently, an in-process research and development project (IPR&D) that meets the definition of an intangible asset (which is likely to be the case) and can be measured reliably should be recognised separately from goodwill. Subsequent to acquisition, this intangible asset is accounted for under the revised IAS 38. This treatment represents a difference from current US GAAP where IPR&D is recognised as an acquired asset on acquisition but written off immediately after. However, the US Financial Accounting Standards Board tentatively has agreed to converge with the IASB position when it issues its purchase method procedures exposure draft.

The Illustrative Examples in IFRS 3 include examples of intangible assets that normally should be recognised separately from goodwill on acquisition. Some of the examples include:

- marketing-related: trademarks, newspaper mastheads and non-competition agreements;
- customer-related: customer lists, customer contracts and related customer relationships and some non-contractual customer relationships;
- artistic-related: plays, books and advertising jingles; and
- technology-based: patents, computer software and unpatented technology.

Contingent liabilities

Contingent liabilities must be recognised at fair value on acquisition. This treatment differs from the previous requirements in IAS 22, under which contingent liabilities were included within the amount recognised as goodwill.

After initial recognition, if the contingent liability becomes a current obligation, and the provision required under IAS 37 is higher than the fair value recognised on acquisition, the liability is increased accordingly. If after acquisition the provision required by IAS 37 is lower than the amount recorded on acquisition (or zero), the liability is maintained at the amount recorded on acquisition and decreased only for amortisation or upon settlement.

Liabilities triggered by the business combination

A payment that an entity is contractually required to make in the event of a business combination (e.g., a so-called 'golden parachute') is a contingent liability of that entity. The business combination causes that contingent liability to become probable. Therefore, the IASB concluded that a contractual liability contingent on the business combination should be recognised as part of purchase accounting on acquisition. IAS 22 presently does not include any guidance on liabilities triggered by a business combination and practice in this area has varied.

Restructuring

In a change from IAS 22, IFRS 3 allows restructuring liabilities to be recognised on acquisition *only* when they represent a liability recognised by the *acquiree* at the acquisition date under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. An acquiree's restructuring plan that is conditional upon it being acquired is not, immediately before the business combination, a present obligation of the acquiree, nor is it a contingent liability. Therefore, under IFRS 3, such a restructuring provision would not be recognised as an assumed liability (or a cost of the acquisition). IAS 22 allowed restructuring liabilities to be recognised as part of the cost of the acquisition if certain criteria were met.

Initial accounting determined on a provisional basis

Sometimes the initial accounting for a business combination can be determined only on a provisional basis at the end of the accounting period in which the business combination occurred. In such cases, subsequent adjustments to the fair values of identifiable assets, liabilities and contingent liabilities or to the cost of acquisition are recorded against goodwill. IFRS 3 limits the period for goodwill

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adjustment to 12 months from the date of the acquisition. Adjustments are calculated as from the date of acquisition. Any resulting profit or loss effect is recognised as an adjustment to the opening balance of retained earnings in the period in which the accounting is revised. Under IAS 22, subsequent changes were allocated to goodwill if they occur within the first full annual reporting period after the acquisition. IFRS 3 incorporates the guidance previously in SIC–22 *Business Combinations – Subsequent Adjustment of Fair Values and Goodwill Initially Reported* except for restricting the period to 12 months after the date of acquisition.

The recognition of deferred tax assets acquired in a business combination does not change under IFRS 3. When a deferred tax asset that was acquired but not recognised (fully) in the initial accounting for the business combination is later recovered, IFRS 3 requires the benefits from this asset to be recognised in profit or loss when realised and goodwill to be reduced as if the deferred tax asset had been recognised at the date of acquisition. The reduction in goodwill also is recognised in profit or loss. This adjustment is *not* restricted to a period up to 12 months after the date of acquisition.

Disclosure requirements

IFRS 3 introduces new disclosures in addition to those required by IAS 22. These requirements are designed to enable users to evaluate:

- the nature and financial effect of business combinations occurring during the reporting period and after the balance sheet date;
- the financial effects of gains, losses, error corrections and other adjustments recognised in the reporting period that relates to the business combination; and
- changes in the carrying amount of goodwill during the reporting period.

Revisions to IAS 36 *Impairment of Assets*

Revisions were made to IAS 36 as part of the IASB's business combinations project. The most notable difference from the exposure draft is that the concept of 'implied fair value' is not included in the final revisions. Therefore, a difference still exists in the method of impairment testing between IFRSs and US GAAP.

Frequency of impairment tests

Previously, impairment testing was required only if a triggering event indicated that impairment might have occurred. Under revised IAS 36, an annual test for impairment is required for certain assets including:

- goodwill acquired in a business combination – goodwill must be tested for impairment annually and at any point during the year when an indicator of impairment exists; and
- intangible assets with an indefinite useful life and intangible assets not yet available for use – the recoverable amount of these assets must be measured annually, irrespective of whether there is an indication that the related assets may be impaired, as well as whenever there is any indication that they may be impaired.

With respect to cash-generating units that include intangible assets with an indefinite useful life and/or to which goodwill has been allocated, the most recent calculation of recoverable amount made in a preceding reporting period *may* be used, provided that certain criteria are met. These criteria include that the composition of the cash-generating units did not change substantially, that the recoverable amount was substantially higher than the carrying amount and that an analysis has been made in order to evaluate the likelihood that the current recoverable amount would be less than the carrying amount.

Cash-generating units – Transfer pricing

The revised standard requires that if the cash inflows generated by any asset or cash-generating unit are affected by internal transfer pricing, an entity shall use management's best estimate of future prices that could be achieved in arm's-length transactions. These arm's-length prices should be used, rather than internal transfer prices (if different), to estimate the future cash inflows used to determine the asset's or cash-generating unit's value in use and the future cash outflows used to determine the value in use of other assets or cash-generating units affected by the internal transfer pricing. This requirement applies to all impairment tests under IAS 36, not just to tests of assets recognised under IFRS 3.

Allocating goodwill to cash-generating units

The revisions to IAS 36 clarify that goodwill should be allocated to the acquirer's cash-generating unit (or group of cash-generating units) that are expected to benefit from the synergies of the business combination, irrespective of whether other assets or liabilities of the acquiree are assigned to those units. It also clarifies that the initial allocation has to be done from the acquisition date and must be completed before the end of the first annual reporting period beginning after the acquisition date (Note that this period is longer than the period for finalising the purchase price allocation under IFRS 3). Additionally, it establishes that each unit (or group of units) to which goodwill is allocated should:

- represent the lowest level within the entity for which information about goodwill is available and monitored for internal management purposes; and
- not be larger than a segment based on either the entity's primary or secondary reporting format determined in accordance with IAS 14 *Segment Reporting*.

Furthermore, if an entity disposes of an operation within a cash-generating unit (or group of cash-generating units) to which goodwill has been allocated, all or a portion of the goodwill shall be allocated to the carrying amount of the operation when calculating gain or loss on disposal.

Testing cash-generating units with goodwill for impairment

The revised standard carries forward the major concepts concerning testing of cash-generating units with goodwill for impairment. However, additional guidance regarding non-wholly-owned cash-

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generating units (or a group of cash-generating units) is provided (i.e., where a minority interest exists).

Under the revisions to IAS 36, the carrying amount of a unit (or a group of cash-generating units) is adjusted by grossing up the carrying amount of goodwill allocated to the unit (or a group of cash-generating units) in order to consider the goodwill attributable to the minority interest. This adjusted carrying amount then is compared with the recoverable amount of the unit (or a group of cash-generating units) for impairment testing purposes. However, goodwill is not measured in the financial statements at a grossed-up amount.

Timing of impairment tests for goodwill

The annual impairment test for a cash-generating unit (or group of cash-generating units) to which goodwill has been allocated can be performed at any time within an annual reporting period, provided that the test is performed at the same time every year. If the goodwill relates to a business combination that occurred during the current annual reporting period, the cash-generating unit (or group of cash-generating units) must be tested for impairment prior to the end of the current period.

Additionally, as described above, the revised IAS 36 allows the use of the most recent calculation of recoverable amount made in a preceding reporting period, provided that certain criteria are met.

Reversal of goodwill impairment losses

Reversals of impairment losses for goodwill now are prohibited.

Disclosure requirements

The revisions to IAS 36 introduce new disclosure requirements that are much more extensive than those required previously. The main additional requirements include:

- Significant portions of goodwill and intangible assets with indefinite useful lives allocated to a cash-generating unit (or a group of cash-generating units) – the reporting entity must, for each cash-generating unit (or group of cash-generating units) to which these assets have been allocated, disclose the key assumptions used to measure the recoverable amounts. It also must disclose other specified information when a reasonably possible change in a key assumption would cause the unit's (or a group of units') carrying amount to exceed its recoverable amount; and

- Non-significant portions of goodwill and/or intangible assets with indefinite useful lives allocated to multiple cash-generating units (or groups of cash-generating units) – when this occurs, it must be disclosed, along with the aggregated carrying amount of goodwill and/or intangible assets with indefinite useful lives allocated to those units (or groups of units). Additionally, certain disclosures are required if the recoverable amount of any of those units (or groups of units) are based on the same key assumptions and the aggregate carrying amount of allocated goodwill and/or intangible assets with indefinite useful lives is significant. The disclosure regarding changes in key assumptions described above also is required (if applicable).

Revisions to IAS 38 *Intangible Assets*

Revisions were made to IAS 38 as part of the IASB's business combinations project. While the changes reflect the decisions taken by the IASB as part of the development of IFRS 3, there also are some consequential effects on the accounting for intangible assets acquired outside a business combination. The following is a summary of the main changes.

Definition of an intangible asset

The definition of an intangible asset has been changed in the revisions to IAS 38 and is no longer dependent on the intended use of the asset. Previously, the definition of an intangible asset was 'an identifiable non-monetary asset without physical substance *held for use in the production or supply of goods or services, for rental to others, or for administrative purposes*'. In the revised IAS 38, the last part of this definition (*in italics*) has been removed.

The revisions to IAS 38 also clarify the identifiability criterion in the definition of an intangible asset. Previously IAS 38 stated that separability was a sufficient indication, but not a necessary condition, for identifiability. The revised standard considers an intangible asset to be identifiable if it is separable or arises from contractual or legal rights.

The Illustrative Examples in IFRS 3 list examples of items acquired in a business combination that meet the definition of an intangible asset (see the discussion of IFRS 3 above). Because the definition of an intangible asset does not depend upon the way it is acquired, these items generally can be assumed to meet the definition of an intangible asset when they are acquired individually (i.e., outside a business combination). However, recognition of these intangible assets still is dependent on meeting the other recognition criteria.

The new version of IAS 38 provides additional guidance on whether the control criterion in the definition of an intangible asset is met with regard to customer relationships. Customer relationships may qualify for recognition if exchange transactions for similar relationships provide evidence of control and of identifiability (i.e., through separability), even if they do not arise from contractual or legal rights.

Recognition criteria

As noted above the recognition criteria for intangibles acquired in a business combination no longer require an explicit assessment of the probability of future economic benefits. This change also has been applied to the recognition of intangibles acquired separately. The revised IAS 38 states that the probability recognition criterion always will be satisfied for intangibles acquired separately or in a business combination. These changes do not affect the recognition criteria for internally generated intangibles.

In-process research and development

The revisions to IAS 38 clarify the treatment of subsequent expenditure on in-process research and development projects

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acquired separately or in a business combination. The general recognition criteria for internally generated intangible assets are applied to further spending (i.e., capitalisation is limited to development costs that meet the recognition criteria).

Useful life

The rebuttable presumption that the useful life of an intangible would not exceed 20 years has been removed from IAS 38. The revision in this area requires the entity to determine whether the useful life of an intangible is finite or indefinite. Intangibles with *indefinite* useful lives must be tested for impairment at least annually, but these intangibles are not amortised. Intangibles with *finite* useful lives are amortised and must be tested for impairment under the general rules of IAS 36 (i.e., on the occurrence of a triggering event).

There is no limit to the length of finite useful lives; however, the revised standard provides additional guidance on determining useful lives (e.g., for intangibles that arise from contractual or legal rights). The requirement to test intangible assets with a useful life exceeding 20 years for impairment annually has been removed. These assets are tested for impairment under the general rules of IAS 36 only if a triggering event occurs. The carrying amounts of intangible assets which are assessed to have an indefinite useful life must be disclosed together with reasons supporting this assessment.

Disclosures

The disclosures required by the revised IAS 38 have changed only slightly as compared to the previous version. Most changes are consequential amendments as a result of the changes made with regard to useful life. Specifically, additional information is required to identify intangibles with indefinite useful lives, including the reasons supporting such a determination.

Transitional provisions

IFRS 3 and the revisions to IAS 36 and IAS 38 are to be applied prospectively from **31 March 2004** with three exemptions:

- Existing goodwill – amortisation of existing goodwill will continue until the beginning of the first annual reporting period beginning on or after 31 March 2004. At this date, the carrying value of the goodwill will be frozen and a transitional impairment test under IAS 36 must be completed;

- Intangible assets – existing intangibles that do not meet the recognition criteria should be reclassified to goodwill from the beginning of the first annual reporting period beginning on or after 31 March 2004. Any changes to recognised amounts should be accounted for according to IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. However, intangible assets included in previously recognised goodwill that would meet the revised criteria for separate recognition are not reclassified; and

- Negative goodwill – any negative goodwill existing at the adoption date is transferred to the opening balance of retained earnings at the beginning of the first annual reporting period beginning on or after 31 March 2004.

Entities are permitted to apply IFRS 3 from any date before 31 March 2004 *only* if:

- the valuations necessary to comply with IFRS 3 were obtained at the time of the initial accounting; and

- IAS 36 and IAS 38 are applied as described above from the same date.

In our view, if an entity fulfils these requirements and chooses an earlier adoption date the entity ceases amortisation of goodwill as of that date.

An entity is permitted to early adopt the revisions to IAS 36 and IAS 38 *only* if the requirements of IFRS 3 are adopted at the same time.

First-time Adoption of IFRSs

Under the general principle of IFRS 1 *First-time Adoption of International Financial Reporting Standards*, the same accounting policies are used in the opening balance sheet and throughout all periods presented in the first IFRS financial statements. Therefore, IFRS 3 will apply to all business combinations in the current and comparative periods presented by an entity that adopts IFRS from 2005. Under the business combination exemption in IFRS 1, an entity may choose not to apply IFRS 3 retrospectively to business combinations that occurred before the date of transition to IFRSs. For example, if an entity is a first-time adopter of IFRS for first-time financial statements issued for 2005, the entity applies IFRS 3 at least to all business combinations that are entered into as from the date of the opening balance sheet of the first period presented (normally, 1 January 2004 for a calendar year company).

If you would like further information on any of the matters discussed in this IASB*riefing*, please talk to your usual local KPMG contact or call any of our member firm offices.

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IASB*riefing* – Issue 22 April 2004

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