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Foreword

The issuance of IFRS 3 Business Combinations, together with the issuance of revised standards IAS 36 Impairment of Assets and IAS 38 Intangible Assets completes one of the first major objectives of the International Accounting Standards Board (IASB) and provides a consistent framework to be used for accounting for business combinations.

IFRS 3 has been developed in order to require a methodology for accounting for business combinations that provides users with the most useful information about those transactions. An important aspect of this project has been to converge the requirements of IFRS relating to business combinations as closely as possible with those of US GAAP. While differences still exist, it is hoped that the IASB’s current Phase II project will work to eliminate many of the remaining differences.

The IASB has published a comprehensive range of illustrative examples together with the Standard. The matters addressed in this book are intended to supplement the IASB’s own guidance.

Large as this book may seem, it does not address all fact patterns. Moreover, the guidance is subject to change as new IFRS are issued or as the IFRIC issues interpretations of IFRS 3. You are encouraged to consult a Deloitte Touche Tohmatsu professional regarding your specific issues and questions.

It is our intention to use our website www.iasplus.com to update the guidance in this book as it evolves. We hope you will find this information useful in implementing IFRS 3.

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Acknowledgements
This document is the result of the dedication and quality of several members of the Deloitte team. By far the most significant contribution has come from Moana Hill, who was the main author. We also owe a special debt of gratitude to Ben Moore, Cedric Popa and Jeremy Cranford who spent many hours developing the guidance on valuation methodologies. We are grateful for the technical and editorial reviews performed by Deloitte professionals in Australia, Denmark, France, Hong Kong, South Africa, the United Kingdom and the United States. These Deloitte professionals include advisors in audit and in valuation services in order to provide you the multi-disciplinary information required to implement IFRS 3.

Abbreviations
FASB Financial Accounting Standards Board (U.S.)
GAAP Generally Accepted Accounting Principles
IAS International Accounting Standards
IASB International Accounting Standards Board
IFRIC International Financial Reporting Interpretations Committee
IFRS International Financial Reporting Standards
SFAS Statement of Financial Accounting Standards (U.S.)

All numerical examples in this publication are denominated in ‘currency units’ – abbreviated to CU.
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I. Introduction

There has been considerable debate by accounting standard-setters, users and preparers about the appropriate methodology for accounting for business combinations. IAS 22 *Business Combinations* permitted business combinations to be accounted for using either the pooling of interests method, or the acquisition method. Following consideration of decisions taken by standard setters around the world, including Australia, Canada and the United States of America, to eliminate the pooling of interests method the IASB has issued IFRS 3 *Business Combinations*. As a result, business combinations must be accounted for using the acquisition method which requires the fair value of acquired assets and assumed liabilities and contingent liabilities to be measured at the date of acquisition.

The issuance of IFRS 3 in March 2004 supersedes IAS 22 *Business Combinations* as issued in 1998, and is accompanied by the issuance of revised standards IAS 36 *Impairment of Assets* and IAS 38 *Intangible Assets*. The revisions to those documents relate primarily to accounting for business combinations.

The debate around certain aspects of business combinations is continuing. The IASB have already embarked on a Phase II project on this topic, with the intention of issuing an Exposure Draft during 2004. The Phase II deliberations include re-consideration of the appropriate treatment of contingent liabilities on acquisition, and consideration of the appropriate treatment of amounts attributable to minority interests.

Considerable judgement will be required in applying IFRS 3, including the identification and valuation of intangible assets and contingent liabilities, determination of appropriate assumptions to be used in complying with the impairment testing requirements of IAS 36, and the determination of useful lives for intangible assets in accordance with IAS 38. In addition entities will need to determine the extent to which they ought to use valuation experts in deriving the information needed to apply the standard.

IFRS 3 provides limited guidance on determining fair value. Section V of this publication outlines the most common methodologies for determining fair value and the information requirements for using those methodologies. We encourage entities to determine in advance how they will complete the required valuations, whether through recruitment and development of internal valuation expertise, or through seeking external assistance in determining fair values.

IFRS 3 also expands the disclosure requirements previously included in IAS 22. Appendix B of this document provides illustrative examples of applying the disclosure requirements of IFRS 3 in an efficient and effective manner.

This publication outlines the key features of IFRS 3 and provides illustrative examples to assist readers in applying the standard. This document aims to provide further guidance on how to apply IFRS 3 to some common transactions that currently exist. Should you require any assistance in the application of IFRS 3, you are encouraged to contact a Deloitte professional regarding your issues and specific questions.
II. Summary of IFRS 3

A. Scope

Identifying a business combination
IFRS 3 defines a business combination as the bringing together of separate entities or businesses into one reporting entity. In determining whether a transaction should be accounted for in accordance with IFRS 3 the entity should consider whether the items acquired or assumed meet the definition of a business. A business is defined in IFRS 3 as ‘an integrated set of activities and assets conducted and managed for the purpose of providing:

(a) a return to investors; or

(b) lower costs or other economic benefits directly and proportionately to policyholders or participants.’

If an entity acquires a group of assets, or a separate legal entity that does not meet the definition of a business, the transaction should not be accounted for as a business combination. The purchase of a legal entity does not, of itself, prove the existence of a business combination. Where a single asset is contained in a legal entity it is unlikely that the purchase of that entity would be considered a business combination, rather the acquisition would be treated as an acquisition of an asset.

The following types of transactions generally meet the definition of business combinations:

• The purchase of all assets, liabilities and rights to the activities of an entity;

• The purchase of some of the assets, liabilities and rights to activities of an entity that together meet the definition of a business; and

• The establishment of a new legal entity in which the assets, liabilities and activities of combined businesses will be held.

If the entity acquires a group of assets that does not constitute a business, it should allocate the cost of the acquired group of assets between the individual identifiable assets in the group based on their relative fair value. If goodwill arises on a transaction, the transaction is considered by definition to be a business combination. This requirement results in the inclusion within the scope of IFRS 3 of transactions involving certain asset and liability sets that would otherwise not meet the definition of a business combination. However where the situation arises that a transaction is considered to be a business combination only as a result of the goodwill arising, care should be taken to ensure the fair values of the assets involved have been accurately determined.

The bringing together of the entities or businesses might be effected by the payment of cash, the issuance of equity instruments, the incurring of liabilities, or the sacrifice of other assets in exchange for the acquisition of the business. The type of consideration given in exchange for the business does not alter the conclusion as to whether a transaction is considered a business combination.
Illustration A – Transaction within the scope of IFRS 3

Entity A purchases all of the assets and liabilities of the ongoing widget manufacturing operations of an entity. The transaction will be considered within the scope of IFRS 3 because the activities and assets acquired constitute a business in accordance with IFRS 3.

Illustration B – Transaction outside the scope of IFRS 3

Entity B purchases all of the hardware that comprises the computer and telephone systems of a company that is winding up. The transaction will be considered to be outside the scope of IFRS 3 because the hardware in itself is not considered an integrated set of activities and assets, and without an extensive range of other assets (software) and services (installation and ongoing servicing) cannot be used to provide a return to investors or lower costs. The transaction is accounted for as the acquisition of the assets at their respective fair values.

Scope exclusions

There are four exemptions to the general scope principle of including all transactions that meet the definition of a business combination. Firstly, IFRS 3 does not apply to business combinations in which separate entities or businesses are brought together to form a joint venture.

Secondly, IFRS 3 does not apply to business combinations involving entities or businesses that are under common control both prior to, and following, the transaction. ‘Business combination involving entities or businesses under common control’ has been defined in the standard as meaning ‘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’. In determining whether a transaction is considered to be between entities under common control all the facts and contractual arrangements involving the parties should be considered. If an entity is not included in the same consolidated financial report that does not, of itself, indicate that common control is not present. Business combinations involving entities under common control are not prohibited from applying the requirements of IFRS 3, and other accounting policies may be applied to the extent they are consistent with the requirements relating to the choice of accounting policies contained in IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors.

Illustration C – Transaction outside the scope of IFRS 3

Entity C and Entity D are both controlled by Entity E. For tax purposes Entity E reorganises its group structure, and as a result Entity C is purchased by Entity D. This transaction is subject to the scope exemption in IFRS 3 because both Entity C and Entity D were controlled by Entity E both before and after the transaction. Commonly entities would choose to effect the transfer of assets and liabilities at their carrying amounts in Entity C; however Entity D is not prohibited from applying the requirements of IFRS 3 if desired.
IFRS 3, as issued in March 2004, also excluded from its scope:

- Business combinations involving two or more mutual entities; and

- Business combinations in which separate entities are brought together to form a reporting entity by contract alone without the obtaining of an ownership interest.

In April 2004 the IASB issued an Exposure Draft *Amendments to IFRS 3 Business Combinations: Combinations by Contract Alone or Involving Mutual Entities* that proposes including such transactions within the scope of IFRS 3. The Exposure Draft provides interim solutions to applying the acquisition method of accounting to such transactions, and these solutions are expected to be revisited in the course of the Phase II Business Combinations project.

The Exposure Draft proposes that for business combinations effected by contract alone without the obtaining of an ownership interest the cost of the combination recorded by the acquirer should be the net fair value of the acquiree’s identifiable assets, liabilities and contingent liabilities.

Where the combination involves two or more mutual entities the Exposure Draft proposes that the cost of the combination be the aggregate of:

- The net fair value of the acquiree’s identifiable assets, liabilities and contingent liabilities; and

- The fair value, at the date of exchange, of any assets given, liabilities incurred or assumed, or equity instruments issued by the acquirer in exchange for control of the acquiree.

The impact of this treatment will be that the goodwill recognised will be equal to the fair value of the consideration given.

Subject to final approval, the amendments arising from the Exposure Draft are expected to have the same effective date as IFRS 3 as issued in March 2004.

**B. Method of accounting**

There has been considerable debate around the appropriate method of accounting for business combinations. The two methods that have been commonly accepted in various jurisdictions are the pooling of interests method and the acquisition method.\(^1\) Under the pooling of interests method the assets and liabilities of the combining entities are carried forward to the combined accounts at their existing carrying amounts, and the combined accounts are presented as if the entities had always been combined, subject to adjustments made to ensure uniformity of accounting policies between the entities.

Under the acquisition method of accounting, an acquirer is identified; the cost of acquisition is measured at its fair value, as are the assets, liabilities and contingent liabilities of the acquiree at the date of acquisition. These values are used to effect the business combination in the books of the combined entity. This method of accounting has significantly greater costs to implement, but ensures that at the date of combination the assets and liabilities of the acquired entity are measured at the fair value attributed to them by the acquirer in making the purchase decision.

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\(^1\) The acquisition method is also commonly known as the ‘purchase method’, and indeed that terminology has been used in IFRS 3 as issued in March 2004. However, the IASB have indicated their preference for the use of the term ‘acquisition method’ and accordingly the term ‘acquisition method’ has been used throughout this publication.
There has been considerable debate around the appropriateness of ‘fresh start’ accounting for particular transactions. The fresh start method of accounting derives from the view that a new entity (for accounting purposes) emerges as a result of the business combination. Fresh start accounting is effected by measuring the fair values of the assets and liabilities of all entities involved in the business combination at acquisition date, and using those values as the opening values in the books of the newly combined entity. Research into the appropriateness of such a requirement is continuing, and the Board is expected to further debate the application of this methodology as part of their Phase II business combinations project.

IFRS 3 requires that the acquisition method of accounting be applied to business combinations within the scope of the standard without exception.

C. Application of the acquisition method

Identifying the acquirer

The superseded IAS 22, states that in virtually all business combinations one of the combining entities obtains control over the other combining entity, thereby enabling an acquirer to be identified (and therefore the acquisition method of accounting should be applied). IFRS 3 however mandates that the acquisition method of accounting be used and accordingly an acquirer must be identified for all transactions within the scope of IFRS 3.

An entity might have obtained control of another entity if, as a result of the business combination, it obtains the power to govern the financial and operating policies of the other entity, such power would be indicated by the entity having some or all of the following:

- More than half the voting rights in the combined entities;
- The power to appoint or remove the majority of members of the Board;
- The power to cast the majority of votes at meetings of the Board of Directors; and
- The ability to determine the selection of the combined entity’s management team.

Where an entity has acquired more than half of the other entity’s voting rights that entity is presumed to be the acquirer unless it can be demonstrated (for example using the factors above) that such ownership does not constitute control.

In some circumstances the entity may have more than half the voting rights without necessarily having control of the combined entity. Certain unusual voting arrangements may mean that in effect the entity does not have control. Items to be considered when assessing the impact of any unusual or special voting arrangements on the identification of the acquirer include:

- The remaining term of the arrangement;
- The specific voting rights provided – for example, do voting rights provided apply to all or only selected matters;
- The conditions, if any, wherein the arrangement can be terminated or modified; and
- Any statutory requirement that may impact the operation of the arrangement.
Furthermore, the determination of which entity has control is made more difficult where options, warranties or securities are on issue. Consideration must be given to whether the existence of these instruments alters the conclusions about which entity gains control of the combined entity. Considerations to be taken when assessing the impact of options, warrants, or convertible securities include:

- The length to maturity of the security, if applicable;
- The number of voting rights provided by the security either currently or upon conversion; and
- The likelihood of exercise/convert (that is, the degree to which the security is “in the money”) and timing of such.

Where one entity gains, or appears to gain, control over the composition of the governing body of the combined entity this may indicate that this entity is the acquirer. When analysing the composition of the governing body the following questions should be considered:

- What will be considered to be the governing body of the combined entity?
- How will the governing body be elected or appointed?
- How, if at all, do statutory requirements impact any agreement in place governing such election or appointment?
- How long after the consummation of the business combination will the ability of one party to elect or appoint some or all of the members of the governing body of the combined entity, be in place?

Sometimes it may be difficult to identify an acquirer, but there are usually indications that one exists, such as:

- If the fair value of one of the combining entities is significantly greater than that of the other combining entity, the entity with the greater fair value is likely to be the acquirer;
- If the business combination is effected through an exchange of voting ordinary equity instruments for cash or other assets, the entity giving up cash or other assets is likely to be the acquirer; and
- If the business combination results in the management of one of the combining entities being able to dominate the selection of the management team of the resulting combined entity, the entity whose management is able to so dominate is likely to be the acquirer.

The determination of which entity is the acquirer may be subjective and should be based on the collective weight of the factors considered above and the application of professional judgment where necessary. The factors to be considered are structured to be individually determinative if all other factors are considered equal. In situations where individual factors may provide conflicting indications as to the acquiring entity, judgment should be applied in reaching an overall conclusion as IFRS 3 provides no hierarchy to use when resolving such conflicts.
The entity that is identified as the acquirer for accounting purposes may differ from that specified by the legal form of the transaction resulting in a reverse acquisition. The IASB have provided comprehensive guidance on accounting for reverse acquisitions in Example 5 of the Illustrative Examples to IFRS 3.

Where a new entity is formed to issue equity instruments to effect a business combination, one of the entities that existed before the business combination must be identified as the acquirer. That is, the entity that was established to legally acquire the combining businesses cannot for accounting purposes be considered to be the acquirer. In such circumstances an entity should consider which of the pre-existing entities is the acquirer based on all of the information available using the factors cited above. Persuasive evidence includes factors such as the relative size of the entities prior to the business combination, or which entity was the initiator of the business combination transaction.

**Illustration D – Identification of an acquirer under IFRS 3**

Entity D and Entity E enter into a business combination transaction. The terms of the transaction are as follows:

- A new entity, Entity F is created.
- The previous shareholders of Entity D hold 55% of the interests in Entity F.
- The previous CEO and CFO of Entity D hold those respective positions in Entity F.
- The fair value of the net assets of Entity D at acquisition was CU1m.
- The fair value of the net assets of Entity E at acquisition was CU0.9m.

Based on these facts, and absent other facts to the contrary, Entity D would be considered to be the acquirer. Accordingly, the assets, liabilities and contingent liabilities of Entity E must be measured at fair value for their initial inclusion in the combined accounts.

**Illustration E – Identification of an acquirer under IFRS 3**

Entity E (a listed entity) and Entity F enter into a business combination transaction. The terms of the transaction are as follows:

- Entity E acquires 100% of the ordinary share capital of Entity F.
- The previous shareholders of Entity F are issued with new shares making up 75% of the voting shares in Entity E.
- The previous CEO and CFO of Entity F take up those positions in Entity E.
- The fair value of the net assets of Entity E at the date of acquisition was CU1m.
- The fair value of the net assets of Entity F at the date of acquisition was CU3m.

In this example Entity F is considered to be the acquirer for accounting purposes, irrespective of the fact that from a legal perspective Entity E is considered to be the acquirer, and the requirements relating to reverse acquisitions are applied.
Once an acquirer has been identified, the financial report of the combined entity is prepared as though it represents the ongoing financial reporting of the acquirer. Resultantly, the accounting policies of the acquirer are applied in the accounts of the combined entity.

**Cost of a business combination**

The acquirer measures the cost of the business combination as the aggregate of the fair values at date of exchange of assets given, liabilities incurred or assumed and equity instruments issued by the acquirer in respect of a business combination plus any costs directly attributable to the business combination. When a business combination is achieved in a single transaction, the date of exchange is the acquisition date, which is the date on which the acquirer effectively obtains control of the acquiree.

Where the acquirer issues equity instruments as part of the cost of acquisition, the market price of those equity instruments at the date of exchange provides the best evidence of fair value. Where the acquisition agreement specifies a number of equity instruments to be issued, the fair value of the equity instruments to be issued may rise or fall from that envisaged at the time of developing the agreement. As the effective date of obtaining control may be delayed (e.g. as a result of regulatory approval requirements) the actual cost of acquisition may differ from that first estimated by the acquirer as a result of movements in the value of the acquirer’s equity.

In rare circumstances the entity may consider that the market price of the equity instruments does not provide a reliable indicator of the instrument’s fair value – however the Standard specifies that market price can only be considered to be an unreliable indicator where the market price has been affected by the thinness of the market. In such cases, or where the instruments are not traded on an organised market, other valuation techniques are used. Further guidance on determining the fair value of equity instruments is found in IAS 39 *Financial Instruments: Recognition and Measurement.*

Amounts that would ordinarily be classified as expenses that are incurred by the acquirer solely for the purpose of executing the business combination transaction (such as accounting and legal fees) are included in the cost of acquisition. Such amounts can only be included in the cost of the acquisition to the extent they are directly attributable to the acquisition, therefore an entity cannot, for example, allocate a portion of general administration costs, to be included in the cost of the business combination. Where a business combination is not completed such costs are expensed at the time that it is determined the transaction will not proceed. Future operating losses expected to arise as a result of the business combination cannot be included in the cost of the business combination.

In some circumstances, the acquirer will need to extend or alter the terms of their financing arrangements in order to execute a business combination. In accordance with IAS 39 the costs of arranging and issuing the financial liability are to be recognised on the initial recognition of the financial liability, rather than as a cost of the business combination. Similarly, the costs of issuing equity instruments as part of the business combination should be treated as part of the issuance of equity, in accordance with IAS 32, rather than as a cost of the business combination.
Illustration F – Cost of a business combination

Entity F acquires Entity G. The outflows of economic benefits from Entity F in respect of this transaction are as follows:

- Entity F issues 1,000 new shares to the shareholders of Entity G with terms equivalent to those traded on the market, and the market price of Entity F’s shares is CU4.
- Entity F pays CU1,000 in cash to the previous shareholders of Entity G.
- Entity F incurs a liability of CU500 to a customer of Entity G in respect of termination of a supply agreement that was necessitated by the business combination.
- Entity F pays accounting fees in relation to the transaction of CU200 and legal fees of CU200.
- Entity F extends the terms of its finance arrangements in order to obtain the cash required for the transaction. The cost of the extension is CU50.
- Entity F has an acquisitions department, which incurred CU200 in running costs over the period of completing the business combination. Staff in the department estimate they have spent 25% of their time on the acquisition of Entity G over this period.
- Entity F will incur expenditure of CU200 on updating Entity G’s accounting systems to be consistent with those used by Entity F.

The following items would be included in the cost of acquisition:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount (CU)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity instruments issued</td>
<td>4,000</td>
</tr>
<tr>
<td>Cash</td>
<td>1,000</td>
</tr>
<tr>
<td>Liability</td>
<td>500</td>
</tr>
<tr>
<td>Accounting Fees</td>
<td>200</td>
</tr>
<tr>
<td>Legal Fees</td>
<td>200</td>
</tr>
<tr>
<td><strong>Total cost of acquisition</strong></td>
<td><strong>5,900</strong></td>
</tr>
</tbody>
</table>

The liability extension costs would be included in the measurement of the liability that Entity F takes out to finance the acquisition. The CU50 share of the acquisition department expenses and the future systems expenditure of CU200 are expensed when incurred.²

² Note that for the purposes of simplicity, the impact of deferred taxes has been excluded from the numeric examples in this publication.
In some circumstances, the cost of acquisition will be contingent on future events, for instance future profitability of the acquired business. Where this is the case the contingency is included in the cost of acquisition if the contingent payment is probable and it can be reliably measured. Such contingencies are included in the cost of acquisition irrespective of whether their impact is to increase or decrease the cost of acquisition (and consequently goodwill). Subsequent changes to the assessment of whether a contingency is probable and can be reliably measured are treated as amendments to the cost of the business combination.

**Illustration G – Contingent cost of acquisition**

Entity G acquires Entity H. If the average profitability of Entity H exceeds CU1m per year for the next three years then an additional payment of CU300,000 will be made to the previous owners of Entity H. Entity H has historically made profits between CU900,000 and CU1,200,000. Unless there is evidence to the contrary (such as an intended significant change in the business model employed by Entity H), it would seem probable that the payment will be made, and the amount of CU300,000 is reliably measurable, the CU300,000 is included in the cost of acquisition.

Subsequent to acquisition if Entity H makes profits of only CU500,000 in the first year, it is likely that the payment will no longer be considered probable (as in each of the remaining two years of the agreement a profit of CU1,250,000 which exceeds the historical profit range would be needed for the payment to be required). Accordingly the cost of acquisition will be adjusted for the CU300,000 contingent payment no longer expected to be made, resulting in a CU300,000 decrease in recognised goodwill.

In some transactions, the acquirer agrees to make additional payments to the acquiree to compensate for a reduction in the value of consideration given. For example, an acquirer may agree to issue further equity instruments if the fair value of the equity instruments given in consideration falls below a certain amount. Where this occurs no increase in the cost of the business combination is recognised because the fair value of the equity instruments issued is offset by a reduction in the value of the equity instruments initially issued.

**Illustration H – Guaranteed value of consideration**

Entity H a listed entity acquires Entity I. The combination is effected by Entity H issuing the previous owners of Entity I with 1,000 shares, with a value of CU5 each. The acquisition agreement has a clause that if the market price of Entity H’s shares has fallen below CU 5 six months after the date of acquisition, Entity H will issue further shares such that the market value of shares in Entity H held by the previous owners of Entity I six months after the acquisition cannot fall below CU5,000.

Six months after the date of acquisition, the market price of shares in Entity H has fallen to CU4. In accordance with the agreement, Entity J issues a further 250 shares. 

\[ ((5,000 – 1,000*4)/4) \]

The entity may record a journal entry as follows:

| Dr | Equity (shares issued at date of acquisition) | 1,000 |
| Cr | Equity (new instruments issued) | 1,000 |

As a result no change in the recognised cost of the business combination is recorded.
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. (Contingent assets are not included in the allocation of the cost of a business combination). However, where an acquired asset is classified as held for sale in accordance with IFRS 5 Non-Current Assets Held for Sale and Discontinued Operations the acquired asset should be measured at fair value less costs to sell. Any difference between the total of net assets acquired and cost of acquisition is treated as goodwill or an excess of the acquirer’s interest in the net fair value of the acquiree’s identifiable assets, liabilities and contingent liabilities over cost (a detailed discussion of the accounting treatment for goodwill is provided later in this section). Appendix B to the Standard includes guidance on identifying the fair value of specific assets and liabilities. Where necessary the services of appropriately qualified valuation experts should be engaged.

Illustration I – Allocation of the cost of a business combination

Entity F acquires Entity G as illustrated in illustration F. The cost of acquisition is CU5,900. At the date of acquisition the assets, liabilities and contingent liabilities of Entity G are as follows:

<table>
<thead>
<tr>
<th></th>
<th>Book Value CU</th>
<th>Fair Value CU</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>1,200</td>
<td>1,200</td>
</tr>
<tr>
<td>Receivables (net)</td>
<td>300</td>
<td>300</td>
</tr>
<tr>
<td>Inventory</td>
<td>1,300</td>
<td>1,600</td>
</tr>
<tr>
<td>Property, plant and equipment</td>
<td>1,500</td>
<td>1,800</td>
</tr>
<tr>
<td>Land</td>
<td>900</td>
<td>900</td>
</tr>
<tr>
<td>Accounts Payable</td>
<td>(1,249)</td>
<td>(1,249)</td>
</tr>
<tr>
<td>Unrecognised contingent liability</td>
<td>(51)</td>
<td></td>
</tr>
<tr>
<td><strong>Total fair value of net assets acquired</strong></td>
<td></td>
<td><strong>4,500</strong></td>
</tr>
<tr>
<td><strong>Total cost of acquisition</strong></td>
<td></td>
<td><strong>5,900</strong></td>
</tr>
<tr>
<td><strong>Goodwill recognised on acquisition</strong></td>
<td></td>
<td><strong>1,400</strong></td>
</tr>
</tbody>
</table>

The variations between recognised values and fair values are not required to be recognised by the acquiree, although the acquiree may be able to recognise the increase in the value of property, plant and equipment through a revaluation reserve.
Only those assets, liabilities and contingent liabilities of the acquiree that exist at the acquisition date are recognised as part of the business combination transaction. Assets, other than intangible assets, are only recognised if their fair value can be measured reliably and it is probable that any associated future economic benefits will flow to the acquirer. Liabilities, other than contingent liabilities, are only recognised if their fair value can be measured reliably and it is probable that an outflow of economic benefit will be required to settle the obligation. Intangible assets and contingent liabilities are only recognised if their fair values can be measured reliably.

If a restructuring will occur as a result of the business combination, but the related liability does not meet the IAS 37 recognition criteria in the books of the acquiree at acquisition date, it cannot be recognised as part of the business combination transaction. Therefore, if the restructuring is recognised only as a result of the business combination the effects of the restructuring will be recognised as an expense in the period following the acquisition rather than as a liability on acquisition. This represents a significant change from the superseded IAS 22 which allowed the separate recognition as part of allocating the cost of the business combination of provisions for restructuring that were not previously recognised in the books of the acquiree provided certain stringent conditions were met.

IFRS 3 also specifically notes that an acquiree’s restructuring plan that has as a condition of its execution the consummation of a business combination, may not be recognised in allocating the cost of the business combination, because the effects of the plan are not a liability of the acquiree prior to the business combination. In addition, IFRS 3 clarifies that such a contingent restructuring plan does not meet the definition of a contingent liability of the acquiree prior to the business combination because it is not a possible obligation arising from a past event whose existence will be confirmed only by the occurrence or non-occurrence of on or more uncertain future events not wholly within the control of the acquiree. Therefore such amounts cannot be recognised as contingent liabilities in allocating the cost of the business combination.

However, in circumstances where the entity has a contractual obligation to make a payment in the event that it is acquired in a business combination, this is a present obligation that is considered as part of the cost of the business combination. For example, where an entity is contractually required to make a payment to employees should a combination occur, then when the combination occurs the liability is triggered and should be included as part of the allocation of the cost of the business combination.

**Illustration J – Recognition of provisions for restructuring**

Entity F acquires Entity G. As part of the acquisition, Entity F announces a plan to restructure the activities of Entity G, including terminating the employment contracts of 50% of the existing employees of Entity G. In accordance with IFRS 3 Entity F is not permitted to recognise the related restructuring costs as an acquired liability. However, if, prior to the acquisition, the restructuring provision met the recognition criteria in the books of Entity G, Entity F should include the provision in the allocation of the cost of acquisition.
Illustration K – Recognition of provisions for restructuring

Entity F acquires Entity G. Prior to the date of acquisition, Entity G has entered into a retrenchment package for directors, such that if the entity is acquired by another party the directors will become entitled to a one-off aggregate payment of CU50. In addition a restructuring plan with a total cost of CU115 would be implemented. In allocating the cost of the business combination Entity F recognises the liability of CU50 to the directors, because this represents a contractual obligation of Entity G that has become probable by virtue of the consummation of the business combination, but does not recognise the liability for the restructuring of CU115 – this amount would be recognised as an expense when the recognition criteria in IAS 37 are met.

In allocating the cost of a business combination intangible assets must be recognised separately from goodwill when those assets meet the definition of intangible assets in IAS 38 and their fair values can be measured reliably. Under IAS 38, the probability recognition criterion is always considered to be satisfied for intangible assets acquired in a business combination. Where an intangible asset cannot be measured reliably, the value of that intangible is effectively included in the goodwill number recognised. Section IV of this document provides more information on initial and subsequent accounting for intangible assets acquired in a business combination.

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. Such a valuation would take into account the range of likely outcomes of the contingency, rather than a single best estimate. Where a contingent liability is recognised on acquisition it is outside the scope of IAS 37 Provisions, Contingent Liabilities and Contingent Assets. However for each contingent liability acquired the acquirer must disclose in respect of that contingency the information required to be disclosed in respect of each class of provision by IAS 37.

The IASB have required the recognition of contingent liabilities in a business combination, on the basis that the existence of such a contingent liability will depress the purchase price an acquirer is willing to pay for the acquiree. The IASB have tentatively indicated their intention that the Standard arising from the Phase II Business Combinations project will not require or permit the recognition of contingent liabilities when allocating the cost of a business combination.
Illustration L – Recognition of contingent liabilities on acquisition

Entity F acquires Entity G. In completing the transaction, two legal proceedings against the company are identified. The first is a personal injury claim, notice of which has only just been given to Entity G. Entity G’s lawyers are considering the merits of the claim, and the most appropriate means of dealing with the claim. The second is a warranty claim, for which negotiations are in advanced stages. Entity G’s lawyers have indicated that there is a 60% chance the company will have to pay nothing, a 15% chance they will have to pay CU90 and a 25% chance they will have to pay CU150. No contingent liability is recognised on the personal injury claim because the fair value of such a liability could not be measured reliably. A contingent liability of CU51 \( [(60\% \times 0) + (15\% \times 90) + (25\% \times 150)] \) is discounted to its present value and recognised in respect of the warranty claim, taking account of the range of probable outcomes.

Although IFRS 3 does not refer specifically to the use of a specialist, entities should consider what evidential matter is necessary to support the fair value measurements required to perform the allocation of the cost of the acquired entity under IFRS 3. Use of internal and external specialists and in what specific capacity is expected to vary by entity and by the specific fair value measurement required. Whether a particular fair value measurement is prepared internally or with the assistance of a third-party specialist, the level of evidential matter necessary to support the conclusions of the entity is expected to be similar.

Accounting for a minority interest

Any minority interests in the acquiree are recorded by reference to their share of the fair value of the assets, liabilities and contingent liabilities of the acquiree at acquisition date. Under IAS 22, the benchmark treatment was to measure each item at its fair value to the extent of the acquirer’s interest, and at its pre-combination carrying amount to the extent of the minority interest. This treatment is no longer permitted.

Illustration M – Business combination involving a minority interest

Entity F acquires Entity G as illustrated in Illustration F. However, Entity F acquires only 80% of Entity G. Assume cost of acquisition (CU5,900) remains unchanged. The following amounts would be recorded.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair Value of share of assets acquired (4,500*0.8)</td>
<td>3,600</td>
</tr>
<tr>
<td>Minority interest in fair value of assets (4,500*0.2)</td>
<td>900</td>
</tr>
<tr>
<td>Goodwill arising on acquisition (5,900 – 3,600)</td>
<td>2,300</td>
</tr>
</tbody>
</table>

The assets, liabilities, and contingent liabilities will be recorded at their total fair values as illustrated in Illustration I.
Subsequent accounting treatment

Subsequent to the acquisition date the acquirer recognises income and expenses based on the cost of the business combination to the acquirer. For example, depreciation expense relating to the acquiree included in the acquirer’s income statement is based on the fair values determined at the date of acquisition rather than the carrying amounts in the books of the acquiree prior to the date of acquisition.

Illustration N – Subsequent depreciation of acquired assets

Entity F acquires Entity G as illustrated in Illustration F. The book value of property, plant and equipment in the books of Entity G is CU1,500, however the fair value at the date of acquisition was CU1,800. The property, plant and equipment is depreciated over ten years, is five years into its useful life, and there is no reason at acquisition date to believe that the remaining useful life should be reassessed. Entity G has chosen not to revalue the assets in its own books. Accordingly Entity G recognises depreciation expense of CU150 in its stand alone accounts for the year ended 31 December 20X5. On consolidation, Entity F recognises an additional depreciation charge of CU60 ((1,800-1,500)/5) to reflect the appropriate depreciation expense for the consolidated carrying amount of the assets.

Contingent liabilities recognised as a result of a business combination are subsequently recognised at the original value recognised (less any cumulative amortisation recognised in revenue in accordance with IAS 18 Revenue) whilst they remain outstanding as contingent liabilities. Where the contingency subsequently results in a liability being incurred that meets the recognition criteria in other standards, the contingency should be reclassified as a liability and accounted for in accordance with that other standard (for example, IAS 37). Where the contingency is subsequently found not to result in an outflow of future economic benefits the contingency is derecognised with the result of that derecognition being recognised in profit and loss. If the accounting for the business combination has only been completed on a provisional basis, as discussed below, an adjustment to the value of the contingent liability may be able to be adjusted against goodwill.

Illustration O – Re-measurement of a recognised contingent liability

The contingent liability in Illustration L above was recognised because the range of likely outcomes indicated that the fair value of this liability was CU51. During the year ended 31 December 20X5, the likely settlement amount of this liability should it come to fruition has increased to CU60. Because the sacrifice of future economic benefits is still not considered probable, no amount would be recognised for this under IAS 37, and accordingly the liability continues to be measured at CU51. If during the year events had taken place triggering the recognition criteria in IAS 37, the contingent liability would be classified as a provision and remeasured to CU60.

Initial accounting determined on a provisional basis

In some circumstances the fair values of recognised assets and liabilities can be recognised only provisionally at the date of acquisition. Where this is the case the acquisition should be accounted for using the provisionally determined values. If a financial reporting date occurs between the date of the business combination and the date of finalisation of the accounting entries, the financial
report for that period must disclose that the business combination amounts have been determined on a provisional basis and an explanation of why this is the case. The acquirer recognises any amendments to those values within twelve months of acquisition date, with retrospective effect to acquisition date. This means that for example, depreciation on property, plant and equipment between the date of acquisition and the date of the amendment should be remeasured as the depreciation expense that would have been recognised had the items always been recognised at their correct amounts. The comparative information presented before the initial accounting for the combination was completed shall be presented as if the initial accounting had been completed at the acquisition date.

Illustration P – Initial accounting determined on a provisional basis

Entity F acquires Entity G as illustrated in Illustration F. At the date of acquisition, Entity F is unable to finalise the determination of the fair value of the property, plant and equipment and records the fair value as being CU1,800. Three months after acquisition, the fair value is finally determined as being CU1,900. The acquisition entries are changed so that the property, plant and equipment is recognised at CU1,900 and the goodwill is reduced from CU1,400 to CU1,300. An additional depreciation charge is processed of CU2.5 (100/10 years*3/12) to ensure the depreciation expense is as it would have been if the assets had been recorded at the correct value at acquisition date.

Once the initial accounting is considered to be complete (limited to twelve months after the date of acquisition) subsequent changes to the acquisition values are only made to correct an error. Such changes are accounted for in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors. Changes to the initial recognition of the assets, liabilities and contingent liabilities are not made for changes in accounting estimates.

Where on acquisition a deferred tax asset is not recognised due to not meeting the recognition criteria, but is subsequently realised, the change shall be accounted for as a reduction in goodwill. This reduction is recorded as an expense with an offsetting reduction in income tax expense having been recognised in the profit and loss statement. An adjustment made in accordance with this requirement can be made only where it does not result in the recognition of, or an increase in a previously recognised, gain on acquisition. Where the treatment would result in the recognition of, or an increase in gain on acquisition, no adjustment is made to the business combination for the realisation of unrecognised deferred tax losses. The IASB has indicated their intention to reconsider this treatment as part of the Phase II project on business combinations.

Goodwill

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. Subsequent to initial recognition goodwill is measured at cost less any accumulated impairment losses recognised in accordance with IAS 36 (the relevant requirements of IAS 36 are discussed in section III of this document). Goodwill is no longer amortised, but is tested for impairment annually, or more frequently if events or changes in circumstances indicate that it might be impaired. This represents a significant change from the accounting required under IAS 22 as amortisation of goodwill is no longer required or permitted. Assets or liabilities that are not recognised at acquisition because they do not meet the recognition criteria are, in effect, included in the value of the goodwill recognised.
**Discount on acquisition (previously termed negative goodwill)**

If the acquirer's interest in the fair values of the assets, liabilities and contingent liabilities exceed the cost of acquisition (discount on acquisition), the acquirer should reassess the fair values determined, and the measurement of the cost of acquisition. Having reassessed this information any excess remaining is recognised immediately in profit or loss for the period. This represents a significant change from existing accounting practice which has varied from allocation across non-monetary assets, amortisation over a period and various other methodologies.

**Illustration Q – Discount on acquisition**

Entity F acquires Entity G as illustrated in Illustration F, however the cost of acquisition differs from that in Illustration F, and is CU3,900. Fair value of net assets acquired is still CU4,500. Entity F would reassess the fair values of the assets, liabilities and contingent liabilities acquired, and the cost of acquisition. Examples of activities that could be undertaken in reassessing the valuation include:

- Obtaining independent valuations for those items which have not been previously valued by an independent valuer.
- Reassessing the assumptions used in valuation reports.

If, after the reassessment, the fair values were considered to be correct, a gain of CU600 would be recognised in the profit and loss statement in the period of the business combination.

**Business combinations achieved in stages**

Where a business combination is effected through a number of transactions, each exchange transaction is treated separately, and the fair values of the assets, liabilities and contingent liabilities are remeasured at each exchange date in order to accurately measure the effects of each transaction. If the entity chooses to remeasure the previously acquired share of the acquiree's assets and liabilities at a subsequent exchange date this remeasurement is accounted for as a revaluation, however such a remeasurement does not imply that the entity should be considered to have an accounting policy of revaluation.

IFRS 3 provides two definitions, acquisition date and date of exchange, for determining when a business combination should be recognised. Acquisition date is defined as the date on which the acquirer effectively obtains control of the acquiree, and is the date from which the acquisition takes effect for accounting purposes (this may differ from the legal date of acquisition). Where a business is acquired in a single transaction this will be the same as the date of exchange. Where a business is acquired through multiple transactions, each date of exchange is the date that the individual transactions are recognised in the financial statements of the acquirer.
D. Transitional provisions and effective date

Existing IFRS users

IFRS 3 is effective for business combinations for which the agreement date is on or after 31 March 2004. IFRS 3 defines agreement date as ‘The date on which a substantive agreement between the combining parties is reached and, in the case of publicly listed entities, announced to the public. In the case of a hostile takeover, the earliest date that a substantive agreement between the combining entities is reached is the date that a sufficient number of the acquiree’s owners have accepted the acquirer’s offer for the acquirer to obtain control of the acquiree’.

Where goodwill has been previously recognised in business combination transactions an entity should from the beginning of the first annual period beginning on or after 31 March 2004:

- Discontinue the amortisation of goodwill;
- Eliminate the carrying amount of accumulated goodwill amortisation against the carrying amount of goodwill; and
- Test the carrying amount of goodwill for impairment in accordance with IAS 36 Impairment of Assets.

Where entities have recognised amortisation or impairment losses in relation to goodwill in previous periods these amounts are not reversed on initial adoption of IFRS 3 and IAS 36 (revised).

Where an entity has previously recognised intangible assets as part of a business combination that do not meet the recognition criteria in IAS 38 Intangible Assets these assets are reclassified as part of goodwill from the beginning of the first annual reporting period beginning on or after 31 March 2004 if they do not meet the identifiability criterion contained within IAS 38 at that date. However, where an entity has previously subsumed in goodwill an item that meets the criteria for recognition as an intangible asset as part of the business combination (for example, in-process research activities), that asset may not be separately recognised on adoption of IFRS 3, unless the requirements of IFRS 3 are being early adopted with application to the date of the business combination in question, or an earlier date.

Entities may choose to apply the standard from any date prior to 31 March 2004 providing they have the valuations and other information needed to apply IFRS 3 to past business combinations, and they also apply the revised versions of IAS 36 and IAS 38 from the same date. The valuations and other information needed to apply the standard to past business combinations must have been obtained at the date the past acquisition was accounted for in order to be acceptable for use in retrospectively applying the requirements of IFRS 3. In addition, the valuations and information required to apply IAS 36 and IAS 38 must have been obtained at that prior date, so as to remove the need to determine estimates that would need to have been made at a prior date.
The practical implications of applying IFRS 3 retrospectively can be onerous. These implications include:

- Restatement of any poolings of interest after that earlier date;
- Obtaining the relevant information current at the date of the past transactions;
- Re-determining the cost of acquisition;
- Re-allocating the cost of acquisition amongst the fair values of assets, liabilities and contingent liabilities at the date of the transaction;
- Separate identification and recognition of intangible assets; and
- Performance (or re-performance) of impairment tests in accordance with IAS 36 from that earlier date.

**Illustration R – Transition for entities with recognised goodwill**

Entity R acquired Entity S on 1 January 2002. Goodwill of CU2,000 was recognised on the acquisition, and was amortised on a straight line basis over 20 years. In the business combination an intangible asset of CU200 was recognised that did not meet the identifiability criteria in IAS 38, with an assessed useful life of six years. At 1 January 2005 the goodwill is carried at CU2,000 less accumulated amortisation of CU300, and the intangible asset is carried at CU100. No impairment losses have been recognised. On 1 January 2005 Entity R:

- ceases amortising the goodwill;
- transfers the CU100 intangible asset to goodwill;
- writes off the accumulated goodwill amortisation against the carrying amount of goodwill; and
- tests the carrying amount of goodwill (CU2,000 – CU300 + CU100 = CU1,800) for impairment in accordance with IAS 36.

**Illustration S – Transition for Entities with recognised negative goodwill**

Entity S acquired Entity T on 1 January 2002. On acquisition negative goodwill of CU2,000 was recognised that was not attributable to identifiable expected future operating losses. In accordance with IAS 22 the negative goodwill was recognised and amortised over the remaining useful lives of the acquired non-monetary depreciable assets. The average remaining useful lives of the acquired assets was assessed to be 10 years at the date of acquisition. At 1 January 2005 the remaining unamortised balance of CU1,400 is derecognised with the corresponding entry to retained earnings.
The requirements of IFRS 3 must be applied in accounting for the goodwill or negative goodwill arising on equity accounted investments. The transitional provisions relating to equity accounted investments are similar to the requirements for controlled entities and businesses. That is:

- Amortisation of goodwill arising on equity accounted investments is no longer included in the determination of the entity’s share of gain or loss on equity accounted investments;

- Any negative goodwill included in the carrying amount of the investment at the date of adopting the standard is derecognised; and

- Any excess of acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities over cost arising on acquisitions subsequent to the date of adopting the standard is recognised in the determination of the entity's share of the investee's profits or losses in the period in which the investment is acquired.

**First time adoption of IFRS**

If an entity applies IFRS 3 as part of its first time application of International Financial Reporting Standards in accordance with IFRS 1 *First-time Adoption of International Financial Reporting Standards* the entity must apply the requirements of IFRS 1 that apply to the transition from another reporting framework to IFRS.

In accordance with IFRS 1, an entity uses accounting policies that comply with each IFRS effective at the reporting date for its first IFRS financial statements in its opening IFRS balance sheet and throughout all periods presented in its first financial statements. The practical implication of this is that for those entities adopting IFRS as their reporting framework with their first IFRS reporting date being after 31 March 2004, IFRS 3 must be applied to all reporting periods presented in that financial report.

In accordance with IFRS 1 an entity may elect to apply IFRS 3 retrospectively to any business combination, providing that the entity applies IFRS 3 to all business combinations occurring after the date of the business combination selected. The entity must also apply IAS 36 (revised) and IAS 38 (revised) with effect from the same date.

If an entity elects not to re-state its past business combinations on initial adoption of IFRS 3, the business combination is carried forward into the accounts prepared under IFRS in the same manner as it was carried under previous GAAP, with some limited amendments.

The entity excludes from its opening IFRS balance sheet any item recognised under previous GAAP that does not qualify for recognition as an asset or liability under IFRS. The resulting changes are accounted for as follows:

- An intangible asset recognised in a past business combination that does not qualify for recognition as an asset under IAS 38 is reclassified as part of goodwill (unless the entity deducted goodwill directly from equity under previous GAAP in which case the intangible is derecognised with the adjustment being recognised in retained earnings); and

- All other resulting changes are recognised directly in retained earnings.
IFRS require subsequent measurement of some assets and liabilities on a basis other than original cost, such as fair value. The entity measures these assets and liabilities on that basis in its opening IFRS balance sheet, even if they were acquired or assumed in a past business combination. It shall recognise any resulting change in the carrying amount by adjusting retained earnings (or, if appropriate, another category of equity) rather than goodwill.

If an asset acquired, or liability assumed, in a past business combination was not recognised under previous GAAP, it does not have a deemed cost of zero in the opening IFRS balance sheet. Instead, the acquirer shall recognise and measure it in its consolidated balance sheet on the basis that IFRS would require in the separate balance sheet of the acquiree.

**Illustration T – Finance lease not capitalised under previous GAAP**

Entity T’s date of transition is 1 January 2004. Entity T acquired Entity U on 15 January 2001 and did not capitalise Entity U’s finance leases entered into prior to 15 January 2001. If Entity U prepared separate financial statements under IFRS, it would recognise finance lease obligations of 750 and leased assets of 625 at 1 January 2004.

In its consolidated opening IFRS balance sheet, Entity T recognises finance lease obligations of 750 and leased assets of 625, and the net resulting change of 125 is recognised in retained earnings at that date.

The carrying amount of goodwill in the opening IFRS balance sheet shall be its carrying amount under previous GAAP at the date of transition to IFRS, adjusted as follows:

- Increased for the reclassification of an item that was recognised as an intangible asset under previous GAAP into goodwill under IFRS;
- Decreased for the reclassification of an intangible asset subsumed into goodwill under previous GAAP as a separate intangible asset under IFRS;
- Altered to reflect the resolution of any contingencies taken into account in accounting for a business combination under previous GAAP that have been resolved before the date of transition to IFRS; and
- Decreased for the results of an impairment test for goodwill based on conditions at the date of transition to IFRS.

If the entity recognised goodwill under previous GAAP as a deduction from equity:

- It does not recognise that goodwill in its opening IFRS balance sheet. Nor does it transfer that goodwill to the income statement if it disposes of the subsidiary or if the investment in the subsidiary becomes impaired; and
- Any adjustments resulting from the subsequent resolution of a contingency affecting the cost of acquisition shall be recognised in retained earnings.
In some jurisdictions a carrying amount of negative goodwill from business combinations agreed to prior to 31 March 2004 will be included in the balance sheet. Such amounts will be 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.

Under previous GAAP, the entity may not have consolidated a subsidiary acquired in a past business combination (for example, because the parent did not regard it as a subsidiary under previous GAAP or did not prepare consolidated financial statements). The entity shall adjust the carrying amounts of the subsidiary’s assets and liabilities to the amounts that IFRS would require in the subsidiary’s separate balance sheet. The deemed cost of goodwill equals the difference at the date of transition to IFRS between:

- The parent’s interest in those adjusted carrying amounts; and
- The cost in the parent’s separate financial statements of its investment in the subsidiary.

IFRS 1 specifically states that when an entity elects not to retrospectively apply IFRS 3 on first time adoption the following prior accounting treatments are not amended:

- The classification of the transaction as an acquisition, reverse acquisition or pooling of interests;
- The derecognition of non-derivative financial assets and financial liabilities under previous GAAP;
- The inclusion of in-process research and development acquired in the business combination as part of the carrying amount of goodwill;
- The effects of prior period amortisation of goodwill; and
- The effects of any adjustments to goodwill made under previous GAAP that would not have been permitted by IFRS 3.

The alternative not to fully re-state past business combinations may be equally applied to accounting for past acquisitions of investments in associates and joint ventures.

The implementation guidance to IFRS 1 provides comprehensive examples of the application of the exemption from fully re-stating business combinations.
III. Impact of revised IAS 36

A. Overview of the impairment test

IAS 36 Impairment of Assets (revised March 2004) requires the recoverable amount of an asset to be measured whenever there is an indication of impairment, with the additional requirement that the following items must be assessed for impairment annually:

- intangible assets with indefinite useful lives;
- intangible assets not yet available for use; and
- goodwill acquired in a business combination.

An impairment loss is considered to exist when the asset's carrying amount exceeds its recoverable amount. An asset's recoverable amount is the higher of its value in use (the present value of the future cash flows expected to be derived from the asset) and its fair value less costs to sell\(^3\) (the amount obtainable from the sale of an asset in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal).

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\(1\) The term ‘fair value less costs to sell’ replaces the term ‘net selling price’. This is a consequential amendment to IAS 36 arising from the completion of IFRS 5 Non-current Assets Held for Sale and Discontinued Operations.
The 2004 revisions to IAS 36 relate only to the aspects of impairment testing that are relevant to accounting for business combinations, rather than a revision to the general impairment requirements. As a consequence the revisions were primarily concerned with the impairment test for goodwill. Because goodwill in itself does not have an independent value in use (as cash flows cannot be directly attributed to it) or a fair value less costs to sell (because it cannot be sold independently of the other assets that make up the business), goodwill is allocated to cash-generating units in order to assess its recoverability.

B. Identification of a cash-generating unit
A cash-generating unit is 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. Cash-generating units are used to assess the recoverability of any assets for which it is not possible to estimate the recoverable amount of the individual asset. Common examples are goodwill and corporate assets.

In identifying a cash-generating unit, an entity considers those inflows of cash and cash equivalents that flow from parties outside the entity. To determine whether the cash flows are largely independent of other cash flows the entity considers matters such as the method of managing cash flows in relation to an operation, and how the results of those operations are reported to management. If an active market exists for the output produced by an asset or group of assets the asset or group of assets is identified as a cash-generating unit, irrespective of whether some or all of the output of the entity is used internally.

If internal transfer pricing policies affect the calculated cash flows of a cash-generating unit the entity uses the best estimate of future prices that could be achieved in an arm’s length transaction to assess recoverable amount. The entity uses this estimate in calculating the recoverable amount of both the cash-generating unit providing the services (expected future cash inflows are determined using arm’s length prices) and the cash-generating unit receiving the services (expected future cash outflows are determined using arm’s length prices).

Illustration U – Identification of a cash-generating unit
Entity U operates a grocery wholesale business. The business includes the operation of an integrated distribution business that ensures goods are delivered to Entity U’s clients as and when required. All activities undertaken by the distribution arm are related to the distribution of groceries to customers. Prior to acquiring the distribution business, Entity U used a number of external service providers who were able to satisfy Entity U’s distribution requirements. In this case, the distribution arm will be considered to be a cash-generating unit because, although Entity U uses all of the outputs, an active market for the services provided exists. In determining the recoverable amount of the distribution business Entity U uses the best estimate of distribution revenue that would be earned by supplying distribution services to other entities, irrespective of the fact that the internal transfer prices actually used may be different.
Illustration V – Identification of a Cash-generating unit

Entity V is a manufacturer of electronic equipment. As part of the manufacturer’s operations, a specialist division has been established to manufacture microchips for use in Entity V’s products. Due to the specialised design of these microchips, they are incompatible with other manufacturer’s products and accordingly Entity V is unable to sell them to other parties. Because there is no active market for the microchips, and the microchips do not generate cash inflows for V, the microchip manufacturing division is not considered to be a cash-generating unit.

Cash-generating units shall be identified consistently from period to period unless the entity can justify a change in the determination of cash-generating units. Where a change in the assessment of the cash-generating units occurs, certain disclosures are required.

Illustration W – Change in the identification of a cash-generating unit

Entity V (as described in Illustration V above) noted that there is an absence of similar microchips in the market, and begins to market these microchips to external parties. As a result of this exercise a number of other entities have identified that specifications of the micro-chips manufactured by Entity V would be useful in their own products, and accordingly have modified their own designs to take advantage of the technology developed by Entity V. Entity V sell 90% of the microchips they manufacture to external parties. Forecasts indicate similar levels of activity in the foreseeable future. In these circumstances Entity V would change the microchip manufacturing department’s status so that it is considered a cash-generating unit in the current and future reporting periods, and reallocate the goodwill in the larger unit between the other operations of Entity V and the microchip manufacturing operations based on respective values of the businesses.

C. Assessment of recoverable amount

In order to determine whether the recognition of an impairment loss 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 and value in use. In some circumstances it will not be necessary to determine both amounts. For instance, if a cash-generating unit’s value-in-use is greater than its carrying amount, determining the fair value less costs to sell is an academic exercise because it will not result in the recognition of an impairment loss. In other circumstances it will be difficult to determine both amounts, for instance where the amount that a willing buyer and willing seller would agree to transact for in an arm’s length transaction is not readily determinable.
Fair value less costs to sell

IAS 36 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 at which 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 often 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 the balance sheet date that reflects the amount the entity could obtain for disposal in an arms length transaction between a willing buyer and a willing seller. In determining this amount management make use of all available information at the balance sheet date, particularly information relating to recent transactions for the disposal of similar assets or cash-generating units.

Illustration X – Determination of fair value less costs to sell for a cash-generating unit

Entity X is assessing the recoverable amount of its distribution business, Entity Y, in order to ensure the goodwill recognised on acquisition of Entity Y is not impaired. Entity X has no current intention to sell Entity Y, and no active market for a distribution business of this size exists. If Entity X was able to obtain sufficient information about a recent sale of a similar cash-generating unit to make an assessment as to the fair value less costs to sell of Entity Y, they should do so. Often, sufficient information to perform this assessment will not be made publicly available. Even if the information required is publicly available, Entity X would need to assess how they should adjust for the differences between the turnover, assets, debts and profitability of the businesses. In some circumstances the differences between the two businesses may be so great as to prevent an analogy between the transaction and the recoverable amount of Entity Y. In such circumstances Entity X is likely to choose the method of determining the recoverable amount of Entity Y for which the information is most readily available – that is, value in use. Only if the value in use calculation derived a recoverable amount of less than carrying amount would Entity X be likely to endeavour to determine fair value less costs to sell in respect of Entity Y.

Incorporated in the determination of fair value less costs to sell are the expected incremental costs of disposal that have not been recognised as liabilities are deducted to determine the cash-generating unit’s recoverable amount. Costs of disposal include legal costs, transaction taxes, removal costs and costs of making the asset ready for sale.

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5 Where a binding sale agreement does exist the cash-generating unit would be treated as a disposal group classified as held for sale in accordance with IFRS 5 Non-Current Assets Held for Sale and Discontinued Operations.
Illustration Y – Incremental costs to sell

Cash-generating Unit Y is to be sold after year end, and the expected sale price based on recent similar market transactions is CU1,000. The entity has identified the following costs to be incurred in respect of Unit Y up to the date of disposal:

- Stamp duty CU25.
- Legal fees on transaction finalisation CU10.
- Legal fees on warranty claim within Unit Y CU15.
- Net operating cash outflow from operation CU40.

The entity would determine that the fair value less costs to sell of Y is CU965 (1,000 – 25 – 10). The legal fees on an existing claim and expected future operating cash outflows do not form an incremental part of the sale transaction and are therefore excluded from the calculation of fair value less costs to sell.

Value in use

In some circumstances fair value less costs to sell for a cash-generating unit that is not about to be sold may not be readily determinable. Where this is the case, the recoverable amount of the cash-generating unit is determined by reference to its value in use. That is, an assessment is made of the present value of the future cash flows of the operation, and whether the value derived indicates that the carrying amount of the cash-generating unit will be recovered through future use and ultimate disposal.

In making that assessment of the present value of the operation’s future cash flows, the following factors are considered:

- estimates of future cash flows expected to be derived from the cash-generating unit (both from continuing use and eventual disposal);
- expectations about possible variations in the timing or amount of those future cash flows;
- the time value of money (represented by the current market risk-free rate of interest);
- the price for bearing the uncertainty inherent in the cash-generating unit; and
- any other factors that market participants would reflect in pricing the future cash flows the entity expects to derive from the cash-generating unit (such as illiquidity).

The model an entity uses for assessing recoverable amount must take into account all of the above factors to ensure that cash-generating units are assessed in accordance with IAS 36. Entities will need to determine how they will identify the information above, and for the more subjective items, how they will factor these into their calculations.
Cash flow projections used in determining value in use should be based on the most recent financial budgets/forecasts approved by management. As a check on the reliability of management budgets the entity should consider past variations between budgeted cash flows and actual cash flows and determine whether the causes of those variations are relevant to the current period. If they do appear to be relevant (such as consistent over-estimation of cash inflows) then the management approved forecasts should be adjusted for those factors. 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.

Unless there is evidence to justify the use of a longer period, the entity uses budgets/forecasts for a maximum of the next five years in determining recoverable amount. Appropriate support for using a longer period would take the form of historical evidence that management's long term budgets are reliable. The cash flows for the period beyond five years are then estimated using a steady or declining growth rate.

Where the budgets and forecasts approved by management do not extend out to five years, the entity may extrapolate the approved budgets over the permitted five-year period using either a steady or declining growth rate to estimate cash flow projections beyond the period covered by the budgets and forecasts. An increasing growth rate is only used where it can be specifically justified. The growth rate used cannot exceed the long-term average growth rate for the products, industries, country or countries in which the entity operates unless specific justification for a higher rate can be made.

In determining future cash flows the following items are included:

- projections of cash inflows from the continuing use of the cash-generating unit;
- projections of cash outflows that are necessarily incurred to generate the cash inflows from the continuing use of the cash-generating unit that can be directly attributed, or allocated on a reasonable and consistent basis, to the cash-generating unit (including future capital expenditure necessary to bring the asset to a state where it is held ready for use); and
- net cash flows to be paid or received on the eventual disposal of the cash-generating unit.

In determining future cash flows for the purposes of the impairment test entities must exclude cash inflows or outflows arising from:

- financing activities;
- capital expenditure that extends or enhances the cash-generating unit’s performance;
- a future restructuring to which the entity is not yet committed; and
- income tax receipts or payments.
Illustration Z – Identification of cash flows to include in recoverable amount testing

Cash-generating Unit Z is being assessed for recoverable amount based on its value in use. Management intend to extend the plant at the end of Year 3, and anticipate they will be able to double their capacity, and their sales without impacting their profit margin, as demand in the industry will continue to outstrip supply. Management have an extensive seven year budgeting process, which has identified cash flows as follows:

<table>
<thead>
<tr>
<th>Without capital expenditure</th>
<th>With capital expenditure</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>CU</strong></td>
<td><strong>CU</strong></td>
</tr>
<tr>
<td>Year 1</td>
<td>100</td>
</tr>
<tr>
<td>Year 2</td>
<td>110</td>
</tr>
<tr>
<td>Year 3</td>
<td>121</td>
</tr>
<tr>
<td>Year 4</td>
<td>133</td>
</tr>
<tr>
<td>Year 5</td>
<td>146</td>
</tr>
<tr>
<td>Year 6</td>
<td>161</td>
</tr>
<tr>
<td>Year 7</td>
<td>177</td>
</tr>
<tr>
<td>Total</td>
<td>948</td>
</tr>
</tbody>
</table>

An analysis of management’s past budgeting experience indicates that while they continue to budget for 10% growth in the unit, they generally experience 5% growth. Management acknowledge this, but continue to set the budgets at 10% growth to encourage sales staff to aim higher. Unit Z’s licence to operate expires at the end of Year 5 and there is no guarantee it will be renewed.

In determining the cash flows to be used in assessing recoverable amount, the budgeted figures should be amended for the actual expected growth rate, and the results beyond year 5 should be disregarded, as there is no certainty as to whether any cash flows will be received. The expected cash inflows and outflows from the capital expenditure are not included in the determination of recoverable amount.

The following cash flows would be included in the value in use calculation:

<table>
<thead>
<tr>
<th><strong>CU</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
</tr>
<tr>
<td>Year 2</td>
</tr>
<tr>
<td>Year 3</td>
</tr>
<tr>
<td>Year 4</td>
</tr>
<tr>
<td>Year 5</td>
</tr>
<tr>
<td>Year 6</td>
</tr>
<tr>
<td>Year 7</td>
</tr>
<tr>
<td>Total</td>
</tr>
</tbody>
</table>

(1) Expected cash flows are increased by only 5% being the actual anticipated growth rate rather than the budgeted rate used to motivate employees.

(2) Cash inflows and outflows arising from the future capital expenditure are disregarded.

(3) The doubling of cash inflows arising from the future capital expenditure is disregarded.

(4) Cash flows beyond year 5 are disregarded because there is no guarantee that the licence will be renewed.
Having identified the expected cash flows, the cash flows are discounted using a pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the asset for which the future cash flow estimates have not been adjusted.

Carrying amount of the cash-generating unit
The carrying amount of a cash-generating unit to be compared with the assessed recoverable amount includes the carrying amount of all assets that can be attributed directly, or allocated on a reasonable basis, to that cash-generating unit. The assets allocated to the cash-generating unit are those that will generate the future cash inflows estimated in determining the cash generating unit’s recoverable amount. The carrying amount of the cash-generating unit does not include the carrying amount of any recognised liabilities unless the recoverable amount of the cash-generating unit cannot be determined without considering the liability. For example, if a cash-generating unit has been assessed for recoverable amount by reference to its fair value less costs to sell, and the buyer will be obliged to assume the obligation when purchasing the business.

Illustration AA – Carrying amount of the cash-generating unit

Cash-generating Unit Y as described in Illustration Y is being assessed for recoverable amount based on its fair value less costs to sell. The cash-generating unit has the following assets and liabilities (stated at their carrying values):

<table>
<thead>
<tr>
<th></th>
<th>CU</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property, plant &amp; equipment</td>
<td>500</td>
</tr>
<tr>
<td>Allocated goodwill</td>
<td>300</td>
</tr>
<tr>
<td>Payables</td>
<td>100</td>
</tr>
<tr>
<td>Provisions (warranty claims)</td>
<td>100</td>
</tr>
</tbody>
</table>

The cash-generating unit’s carrying amount of CU800 is determined by summing the value of the assets, including allocated goodwill. This amount will then be compared with the recoverable amount determined in Illustration Y, of CU965, assuming in this example, that the amount determined in Illustration Y related to the disposal of the business without the liabilities.

Illustration BB – Inclusion of liabilities

The owners of Unit Y (as discussed in Illustration Y) intend to divest Unit Y. The owners of Unit Y have determined that they should settle the accounts payable by Unit Y, but that any purchaser should assume the warranty claims of Unit Y. Assuming in this example that the like transaction considered in determining recoverable amount included the disposal of similar warranty provisions, carrying amount against which the recoverable amount is compared is CU700 (total assets, less the provisions that will be acquired by the purchaser).
D. Allocation of goodwill to cash-generating units

At the date of acquisition goodwill is allocated to the cash-generating units (including, where appropriate, the pre-existing cash-generating units of the acquirer) that are expected to benefit from the synergies arising from the business combination. This allocation occurs irrespective of whether the identifiable assets and liabilities acquired are allocated to the same cash-generating unit. The units to which goodwill is allocated must represent the lowest level for which information about goodwill is available and monitored for internal management purposes, and cannot be larger than a segment determined in accordance with IAS 14 Segment Reporting. It is possible that some businesses that appear to have independent cash flows will not be a cash-generating unit to which goodwill can be allocated because management does not gather or monitor the information about goodwill at that level. In such a situation goodwill is tested at a cash-generating unit level that may incorporate a number of apparently independent but related businesses, but in any case cannot be larger than a segment.

**Illustration CC – Allocation of goodwill**

Entity C has three cash-generating units D, E & F. Each of these units has distribution activities; however Unit D needs its own trucks. The entity acquires Entity G primarily for the purposes of getting trucks for Unit D, but also takes advantage of the transaction by implementing the distribution tracking system owned by unit G across all units. Entity C monitors the performance of goodwill for each cash-generating unit as specified above. In this case the trucks will be allocated to unit D, but the computer system and the goodwill should be allocated across units D, E & F.

Where the allocation of goodwill to cash-generating units is not completed before the end of the annual reporting period, the disclosures required by paragraph 133 of IAS 36 must be made. In any event, the allocation of goodwill to cash-generating units must be complete by the end of the first annual reporting period beginning after acquisition date. This requirement is less stringent than the requirement to complete the initial acquisition accounting, which must be completed within twelve months of acquisition. The time lag between the requirement to complete initial accounting and the requirement to allocate the goodwill are indicative of the IASB’s view that allocation of goodwill may be a complex task, which in any case cannot be completed prior to the completion of initial accounting.

When an operation within a cash-generating unit is disposed of, the goodwill allocated to that unit must be included in the carrying amount of the operation when determining gain or loss on disposal. Generally, this allocation is done using the relative values of the cash-generating unit and the operation disposed of, unless the entity can provide evidence of a better methodology. Similarly, if an entity restructures its operations, goodwill is reallocated between cash-generating units on the basis of the relative values of those units.
Illustration DD – Allocation of goodwill on partial disposal

Cash-generating Unit D has been allocated CU100 of goodwill. The entity sells part of the cash-generating unit for CU1,150. In the recoverable amount testing the assets of the cash-generating unit (excluding goodwill) have been assessed as having a value of CU10,000 and the value of the assets disposed CU1,000. The profit on disposal is calculated as CU140 (1,150 – 1,000 – ((1,000/ 10,000)*100)). The following journal entry would be recorded:

<table>
<thead>
<tr>
<th>Dr</th>
<th>Cash</th>
<th>1,150</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cr</td>
<td>Cash</td>
<td>1,000</td>
</tr>
<tr>
<td>Cr</td>
<td>Goodwill</td>
<td>10</td>
</tr>
<tr>
<td>Cr</td>
<td>Profit on disposal</td>
<td>140</td>
</tr>
</tbody>
</table>

E. Impact of a minority interest

Where a minority interest in a cash-generating unit that contains goodwill exists, the recoverable amount of that cash-generating unit will include an amount that relates to the unrecognised goodwill that is theoretically attributable to the minority interest. In order to ensure that minority interests do not effectively provide a buffer against impairment losses, the standard requires that a notional amount of goodwill attributable to the minority interest be included in the carrying amount of the cash-generating unit when testing for impairment.

Illustration EE – Impairment testing of cash-generating unit with a minority interest

Company E acquired 80% of Company F for CU8,000. Company F is considered to be a cash-generating unit. The aggregate net fair value of the assets, liabilities and contingent liabilities for Company F at the date of acquisition was CU7,000.

Company F interest 5,600
Minority interest 1,400
Goodwill recognised on acquisition (8,000-5,600) 2,400
Notional goodwill of minority interest (2,400*20/80) 600

At the balance date, the carrying amount of company F is CU9,000. The recoverable amount is calculated to be CU9,200.

In completing the impairment testing of Company F, Company E must add to the carrying amount of Company F an additional CU600 of goodwill. Therefore at balance date the carrying amount to be tested for impairment is CU9,600. Accordingly, there is an impairment loss of CU400. Of the CU400, CU80 (CU400*20%) is attributable to the minority interest, and is not recognised. The remaining CU320 is recognised in profit and loss as an impairment of goodwill.
F. Practical issues
Where goodwill has been allocated to a cash-generating unit the cash-generating unit must be tested annually for impairment. For an individual unit the impairment testing must be completed at the same time each year, but each cash-generating unit can be tested at a different time during the year. However, it should be noted that there are some practical limitations to the ability to test at different times during the year. For instance, if budgets for future reporting periods only become available toward the end of the current reporting period, the impairment testing will have to be done in between the time when the budgets become available and the end of the reporting period. When determining the time of year when impairment testing will be carried out companies must have regard to the availability of information, and any other practical limitations on their resources which will limit the available options.

Illustration FF – Timing of impairment assessments
Entity F currently owns three operating cash-generating units, G, H & I to which goodwill has been allocated, which were assessed for impairment in December of the previous financial year. During the current reporting period, Entity F acquires Unit J, a cash-generating unit. Due to resource issues, Entity F would like to spread the impairment testing over a couple of months. Units G, H & I must be tested for impairment in December because that is when they were tested for impairment in the prior year. However, Entity F may elect a date at which to conduct the impairment test of unit J, save that the test must be conducted prior to conclusion of the current reporting period and at the same date in the next reporting period. In addition to the annual testing, Entity F is also required to test the cash-generating units whenever there is an indication of possible impairment.

Where there is an indication that an asset within a cash-generating unit is impaired, that asset must be tested for impairment prior to the testing of the cash-generating unit as a whole. This methodology is necessary because the standard states that when testing a cash-generating unit for impairment, any impairment loss must be first applied against goodwill. As a result, it is essential that individual assets that show indications of being impaired are tested first, to ensure the impairment loss attributable to them is not subsumed into an impairment loss recognised in respect of goodwill.

Illustration GG – Order of impairment testing
Cash-generating Unit G has a carrying amount of CU1,000 and contains goodwill of CU50. The unit also contains land (book value CU200) in an area in which property prices have fallen markedly in the reporting period due to the discovery of potentially harmful chemicals permeating the ground. To complete the required impairment testing the land is first assessed for its recoverable amount. The land is found to have a recoverable amount of CU170. The land is written down to CU170. The remaining carrying amount of the cash-generating unit (CU970) is then tested for impairment. Any additional impairment losses identified from testing the cash-generating unit for impairment will be applied first against the goodwill of the cash-generating unit.
Where a detailed calculation was made in prior reporting periods to support the recoverable amount of a cash-generating unit, that calculation may be used in the current period impairment testing if a number of stringent conditions are met. The conditions are as follows:

- The assets and liabilities within the unit have not changed significantly since the most recent detailed calculation;
- The most recent calculation resulted in an amount that exceeded the carrying amount of goodwill by a substantial margin; and
- No events have occurred or circumstances changed that would cause one to believe that a more up to date detailed calculation would result in a requirement for the recognition of an impairment loss.

**Illustration HH – Recalculation of recoverable amount**

Entity H assessed operating unit I for impairment in the prior period. At that time operating unit I had assets with a carrying amount of CU1,000 and a recoverable amount of CU1,500. During the year there has not been significant additions or disposals of assets within the cash-generating unit. The discount rate that was used has not changed and the business has been operating substantially in line with budget. Entity H is not required to re-perform a detailed calculation to determine the recoverable amount of operating Unit I and may use the previously obtained recoverable amount (CU1,500) for the purposes of the impairment test.

**Illustration II – Recalculation of recoverable amount**

Entity I assessed operating unit J for impairment in the prior period. At that time operating unit J had assets with a carrying amount of CU1,000 and a recoverable amount of CU1,100. During the year there has not been significant additions or disposals of assets within the cash-generating unit. The discount rate that was used has not changed but the unit has consistently been earning net cash flows at a rate 20% below budget. Entity I is required to re-perform a detailed calculation to determine the recoverable amount of operating Unit J. Entity I may carry forward many of the assumptions in the original calculation (such as the discount rate) however, where more up to date information is available that must be used in the new calculation.

**G. Mechanics of impairment loss recognition and reversal**

An impairment loss is generally recognised in the profit and loss statement in the period in which it is identified. In circumstances where an impairment loss related to a cash-generating unit has been identified, the impairment loss is first allocated to any recognised goodwill within the cash-generating unit.

Any additional impairment loss (in excess of the goodwill) to be recognised is then allocated on a pro rata basis to the other assets within the cash-generating unit. In performing this allocation, no asset may be written down below the higher of its fair value less costs to sell, its value in use, or zero. The additional impairment losses are treated as impairments of the individual assets.
Where the assets concerned have been previously revalued the previous revaluation is reversed to the extent of the impairment loss. Any remaining impairment loss once the prior revaluation has been reversed must be recognised in the profit and loss statement. Therefore impairment losses are processed through profit and loss except to the extent they reverse a revaluation surplus previously credited to equity.

**Illustration JJ – Impairment loss**

Entity J assesses cash-generating unit K for impairment.

Unit K has the following assets recorded in its books:

<table>
<thead>
<tr>
<th>CU</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property, plant and equipment</td>
</tr>
<tr>
<td>Licences</td>
</tr>
<tr>
<td>Land (at revalued amount)</td>
</tr>
<tr>
<td>Goodwill</td>
</tr>
<tr>
<td><strong>Total</strong></td>
</tr>
</tbody>
</table>

Unit L is found to have a recoverable amount of CU550.

The CU50 goodwill is written off, and cannot be reversed.

The entity then analyses the remaining assets. The theoretical write-down arising from a pro-rata allocation is as follows:

<table>
<thead>
<tr>
<th>CU</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property, plant and equipment</td>
</tr>
<tr>
<td>Licences</td>
</tr>
<tr>
<td>Land</td>
</tr>
</tbody>
</table>

However, on further analysis, the entity determines that the licences, which are taxi licences for which there is an active market, are fully recoverable. The CU8 that would be allocated to the licences is re-allocated to the remaining items. The result is that property, plant and equipment is written down by CU34 and land by CU66.

Because the land was previously revalued, the CU66 impairment loss is taken as a reduction in the asset revaluation reserve. The CU34 impairment loss in respect of property, plant and equipment is taken to profit and loss. The impairment losses in respect of property, plant and equipment and land may be reversed in the future if there is a change in the estimates that led to the write-down.
Where prior period impairment losses have been recognised, at each reporting date the entity must assess whether or not any indicators exist that would suggest that the impairment loss previously assessed may have reduced. If such an indicator exists the entity must make a recoverable amount assessment in respect of that asset. An impairment loss is only reversed if the estimates used to determine the asset’s recoverable amount at the time of the initial impairment are changed. Accordingly, the mere unwinding of the discount rate as the future cash inflows become closer does not give rise to a reversal of an impairment loss.

Where an impairment loss is recognised in respect of goodwill that impairment loss cannot ever be reversed. Where a prior period impairment loss has been recognised in relation to a cash-generating unit, the reversal of that impairment loss is allocated to the assets, other than goodwill, pro rata with the carrying amounts of the assets. This allocation must not result in any asset being carried at greater than the lower of its recoverable amount and the carrying amount that would have been determined had no prior period impairment loss been recognised. That is, the amount recognised following the reversal of the impairment loss cannot exceed the net carrying amount that, absent any prior impairment losses, would have been recognised in the financial statements. The reversal is recognised in profit and loss unless the asset is carried at a revalued amount in which case the reversal is treated as a revaluation increase in accordance with the requirements of the standard under which the asset is carried at fair value.

Once a reversal of an impairment loss has been completed, depreciation in future periods is adjusted to ensure the revised carrying amount (less any residual value) is allocated on a systematic basis over the asset’s remaining useful life.

### Illustration KK – Reversals of impairment losses

In the prior reporting period, Operating Unit K processed the following impairment losses.

<table>
<thead>
<tr>
<th>Asset</th>
<th>Amount (CU)</th>
<th>Note</th>
</tr>
</thead>
<tbody>
<tr>
<td>Goodwill</td>
<td>50</td>
<td>(profit and loss)</td>
</tr>
<tr>
<td>Land</td>
<td>15</td>
<td>(revaluation reserve)</td>
</tr>
<tr>
<td>Property, plant and equipment</td>
<td>20</td>
<td>(profit and loss)</td>
</tr>
</tbody>
</table>

The property, plant and equipment had a remaining useful life of 5 years at the date of the write-down. As a result of favourable changes in the market in which the operating unit operates, the management believe the impairment may have reversed and accordingly in the current reporting period a recoverability assessment on operating Unit K is performed.

The assessment shows that the amount of expected future cash flows has changed so markedly that the carrying amounts that would have been recorded if the prior period impairment loss had not been recorded are recoverable. The entity records a reversal of an impairment loss through profit and loss of CU16 (20 original write-down – 4 depreciation that should have been expensed in relation to that amount during the period), a revaluation of CU15 in respect of the land, and no reversal in respect of the goodwill. In each of the following four years an additional depreciation charge of CU4 is recognised to ensure the revised carrying amount of property, plant and equipment is appropriately depreciated over the remaining useful lives of those assets.
### H. Transitional provisions and effective date

The effective dates of IAS 36 are as follows. The standard should be applied to:

- goodwill and intangible assets acquired in a business combination for which the agreement date is on or after 31 March 2004 from that date; and

- all other assets prospectively from the beginning of the first annual reporting period beginning on or after 31 March 2004.

Entities may apply IAS 36 (revised) earlier than the effective dates cited in the standard providing that the entity also applies IFRS 3 and IAS 38 (revised) with the same effective date, and that the information required to apply IAS 36 was available at the date from which the standard is to be applied.

### Reverse prior period write-downs?

<table>
<thead>
<tr>
<th>Asset</th>
<th>Reverse prior period write-downs?</th>
<th>Treatment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Goodwill</td>
<td>No</td>
<td>N/A</td>
</tr>
<tr>
<td>Other assets – revalued</td>
<td>Yes</td>
<td>Treated as a revaluation increase</td>
</tr>
<tr>
<td>Other assets – carried at cost</td>
<td>Yes</td>
<td>Recognised in profit and loss</td>
</tr>
</tbody>
</table>

### A guide to IFRS 3 Business combinations

- Business combinations
IV. Impact of revised IAS 38

A. Overview of IAS 38 requirements

IAS 38 Intangible Assets (revised March 2004) requires that an intangible asset be recognised at cost on acquisition, with the cost being the fair value determined as part of the acquisition accounting exercise. Subsequent to recognition, those intangible assets must:

- For assets with determinable useful lives, be amortised over their expected useful lives, and be assessed for impairment where an indicator of impairment exists;
- For assets with indefinite useful lives and assets not yet available for use, be assessed for impairment annually; and
- Where an active market exists the intangible asset may be revalued by reference to that market.
The 2004 revisions to IAS 38 relate to the aspects of accounting for intangible assets that are relevant to accounting for business combinations, rather than an overall reconsideration of the requirements relating to accounting for intangible assets. The changes made include extension of the guidance on the ‘identifiability’ criterion as it relates to intangible assets, requirements relating to the useful life and amortisation of intangible assets, and the accounting for in-process research and development projects acquired in business combinations. The pertinent sections of IAS 38 to business combinations are those requirements relating to the identification and recognition of intangible assets on the acquisition of a business. However, amendments to the subsequent treatment of intangible assets in terms of when amortisation and impairment testing are required, apply equally to intangible assets acquired separately.

B. Recognition and measurement at date of acquisition
Where an entity acquires an intangible asset as part of a business combination the intangible asset is recognised separately if the asset meets the following criteria:

- It is separately identifiable;
- It is a resource that is controlled by the entity;
- It is a probable source of future economic benefits; and
- The fair value of the asset is reliably measurable.

An intangible asset meets the separately identifiable criterion if it is capable of being separated or divided from the entity or arises from contractual or other rights. Ways in which an asset can be separated from the entity include where it can be independently sold, leased, rented or exchanged – either on its own or together with a related contract, asset or liability. Where the separate identifiability is justified by reference to the legal rights, those legal rights are not required to be separable from the entity or from other rights and obligations of the entity. However legal enforceability of a right is not a necessary condition of control.

The control criterion is most commonly considered to be met 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.

Not all items that add value to a business combination are eligible for separate recognition as an intangible asset. In determining the amount they are willing to pay for the acquisition of a business the purchaser will take account of a number of factors, not all of which are eligible for recognition as an asset separable from goodwill, because the entity does not control the resource in question – for example, an assembled workforce. Skills or resources embodied in particular persons, or groups of persons, do not usually meet the definition of an intangible asset because the entity often has insufficient control over the actions of that person to recognise those skills or resources as a separate asset.
Illustration LL – Identification of intangible assets

Entity L acquires a vineyard and winery. In determining the purchase price, Entity L takes account of the following items that are not tangible assets of the acquiree:

- The skills and experience of the winemaker.
- The brand name attaching to wines originating from the vineyard.
- The patent on the special bottling technique used by the vineyard.

The skills and experience of the wine maker cannot be recognised as a separate intangible asset because the entity does not have sufficient control over the winemaker for his skills and experience to be considered an asset of the entity. The winemaker may choose to resign at any time.

The brand name attaching to wines originating from the vineyard can be recognised (subject to being able to reliably measure fair value). Although the brand name cannot be separated from the physical assets, it is separable from the other assets of the entity, in that alone the brand name and vineyard could be sold or leased together.

The patent on the special bottling technique used by the entity would be recognised (subject to being able to reliably measure fair value), as the patent arises from legally enforceable rights of the entity.

In some circumstances, an intangible asset exists that is not separable from other assets of the entity (such as the value of the brand name in illustration LL). In such circumstances that intangible asset is still recognised separately from goodwill providing that its fair value can be reliably measured. Where the fair value of the related asset cannot be measured, the related asset and the intangible asset can be recognised together as a single asset.

Illustration MM – Recognition of intangible assets

Entity M acquires a manufacturing business. The manufacturing business includes land and water rights. The water rights are not able to be sold or otherwise disposed of without also disposing of the land. Irrespective of the fact that the water rights cannot be separately disposed; the entity should still recognise these rights separately as an intangible asset (subject to being able to determine their fair value) in the initial accounting for the business combination, because they represent an identifiable intangible asset acquired in the transaction.

IAS 38 provides extensive examples of recognisable identifiable intangible assets, with comprehensive discussions of marketing-related intangible assets, customer related intangible assets, artistic-related intangible assets, contract-based intangible assets and technology-based intangible assets to be found in the Illustrative Examples to IFRS 3.
On initial recognition as part of the acquisition transaction, the cost of an intangible asset is measured at fair value at the date of acquisition. This treatment may mean that items, such as in-process research and development that were ineligible for recognition in the books of the acquiree may have to be recognised separately by the acquirer on acquisition.

In-process research and development of the acquiree is recognised in a business combination if it meets all of the recognition criteria specified by IAS 38. There are no specific requirements in IFRS 3 relating to the acquisition of such intangibles, and the Board have clarified in the Basis for Conclusions that they believe such assets should be recognised using the criteria for recognising intangibles generally. However, IAS 38 does clarify that an identifiable intangible asset acquired as part of a business combination, for which the fair value can be reliably measured, will always satisfy the probability criterion for recognition as an asset.

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.

IAS 38 specifically notes that generally the fair value of an intangible asset acquired in a business combination can be measured reliably. Furthermore, IAS 38 includes a rebuttable presumption that where an intangible asset has a finite future life its fair value can be measured reliably. Resultantly, it is only in rare circumstances that an identifiable intangible is not separated from goodwill on acquisition because its fair value cannot be measured reliably. This could only occur where an intangible asset arises from legal or contractual rights and is either not separable, or is separable but there is no history of exchange transactions for similar assets. Such situations are expected to occur very rarely in practice. Guidance on determining fair value is found in section V of this document.

C. Measurement subsequent to date of acquisition

Subsequent to acquisition, identifiable intangible assets with a finite useful life must be amortised over that useful life, and assessed for impairment whenever an indicator of impairment is identified. Amortisation is discontinued at the date the asset is classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with IFRS 5 Non-Current Assets Held For Sale and Discontinued Operations or at the date the asset is derecognised.

In determining the depreciable amount of the asset, the residual value is assumed to be zero unless there is a commitment by a third party to purchase the asset at the end of its useful life, or there is an active market for the asset and the residual value can be determined by reference to that market and it is probable that such a market will exist at the end of the asset’s useful life.

As a minimum, the amortisation period and method must be reassessed at every financial year-end. If the amortisation period and/or method are found not to be reflective of the expected consumption of future economic benefits, the period and/or method (as appropriate) should be changed to reflect the change in the expected timing/pattern of consumption. Such changes are accounted for as changes in accounting estimates in accordance with IAS 8.

Identifiable intangible assets with an indefinite useful life shall not be amortised and must be assessed for impairment in accordance with IAS 36 at least annually and more frequently if an indicator of impairment is identified.
Intangible assets are carried at cost less accumulated amortisation, unless the entity chooses to carry them at a revalued amount. The option to carry the asset at a revalued amount is only available where the fair value of the asset can be identified with reference to an active market. The characteristics of an active market include homogenous items, readily available and willing buyers and sellers and publicly available prices. Active markets for intangible assets are rare, but can exist where items are traded on a regular basis – for example taxi licences in certain jurisdictions. If an asset is carried at a revalued amount and the active market for that asset ceases to exist the asset is carried at the last valuation determined with reference to an active market, less accumulated amortisation. Where an indicator of impairment exists, in accordance with IAS 36 impairment testing must be undertaken.

Where an intangible asset that is not yet available for use is acquired or developed internally, that intangible must be assessed for impairment in accordance with IAS 36 annually until the asset is available for use, irrespective of whether an indicator of impairment is identified.

Subsequent expenditure on the research phase of an acquired in-process research and development project must be expensed when it is incurred. The research phase of a project is characterised by the search for new knowledge or techniques, and commonly the likely outcomes of this phase of a project are not predictable. Subsequent expenditure on the development phase may be recognised as an asset providing the entity can demonstrate the following:

- The technical feasibility of completing the intangible asset so that it will be available for use or sale;
- The intention to complete the intangible asset and use or sell it;
- The ability to use or sell the intangible asset;
- The method by which the intangible asset will generate probable future economic benefits;
- The availability of adequate technical, financial and other resources to complete the development to use or sell the intangible asset; and
- The ability to measure reliably the expenditure attributable to the intangible asset during its development.

The development phase is characterised by development of knowledge obtained in the research phase into an intangible asset that will deliver probable future economic benefits to the entity.
Illustration NN – Accounting for in-process research and development

Entity N acquires a research laboratory. The lab is involved in the development of medical research techniques. At the date of acquisition, the entity has two projects in process. One is the development of a proven cure for a common disease into a commercially viable drug, and the second is research into the curative characteristics of a particular chemical compound. On initial acquisition the intangible assets arising from these projects are measured at their fair value and recognised as assets acquired in the business combination.

In subsequent years, providing the IAS 38 recognition criteria are met, development expenditure directly attributable to the first project is capitalised, and the asset tested for impairment if any indicators of impairment are considered to exist. All subsequent expenditure attributable to the second project is expensed when incurred, until such time as the project meets all the criteria in the standard for recognition as a development asset. Once the criteria are satisfied, expenditure that has been previously expensed cannot be reinstated into the development asset.

D. Transitional provisions and effective date

The standard applies to all intangible assets acquired in business combinations with an effective date of on or after 31 March 2004, and to the accounting for all other intangibles in the first financial reporting period beginning on or after 31 March 2004. The Standard must be adopted early if an entity has elected to apply IFRS 3 and IAS 36 (revised) with the same effective date.

On initial adoption of the revised IAS 38, the useful lives of all intangible assets must be reassessed. This reassessment includes consideration of the appropriateness of the classification as an asset with a finite useful life or an indefinite useful life. If the result of this reassessment is a change in the estimated useful life of an asset, the effects of that change are accounted for as a change in accounting estimate in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors.
V. Determining fair value for the purpose of accounting for business combinations

A. Determining the fair value of intangible assets
In its discussions regarding the adoption of IFRS 3 and of the revised IAS 38, the IASB has noted in the Basis for Conclusions that, despite the intentions of IAS 22, companies did not identify a significant number of assets separately from goodwill when they made acquisitions. The changes in these accounting standards are aimed at increasing the frequency and the number of intangible assets identified in acquisitions, in order to ensure that subsequent accounting treatment is appropriate in an accounting model where goodwill is no longer amortised.

The intentions of the IASB are emphasised in paragraph 67 of IFRS 3, which states that “the acquirer shall disclose the following information for each business combination that was effected during the period: [...] (h) a description of the factors that contributed to a cost that results in the recognition of goodwill – a description of each intangible asset that was not recognised separately from goodwill and an explanation of why the intangible asset’s value could not be measured reliably”.

Hence, an implication of IFRS 3 is the likelihood of increased recognition of different intangible assets apart from goodwill. On acquisition these will need to be identified and their fair value assessed. A guide to examples of the potential intangible assets is provided in paragraph 119 of IAS 38 and the IFRS 3 examples also provide a list of intangibles which is similar to the list of intangibles included in SFAS 141 Business Combinations.

IAS 39 contains a fair value hierarchy which generally requires the use of a quoted price in an active market where one is available, or valuation techniques where such a price is not available. However, the description of that hierarchy is more useful for valuing financial instruments – not necessarily valuing businesses or intangible assets. In the course of their deliberations on Phase II of business combinations the IASB has tentatively approved the following hierarchy for determining fair value:

- **Level 1** – if observable prices for market transactions for identical assets or liabilities at or near the measurement date are available, fair value should be estimated by reference to these prices;

- **Level 2** – if observable prices for market transactions for similar assets or liabilities at or near the measurement date are available, fair value should be estimated by reference to these prices, making the necessary adjustments; and

- **Level 3** – if Level 1 and 2 do not apply, use other valuation methodologies.
The IAS 39 hierarchy also permits the use of adjusted market prices (as in level two above) where appropriate. Accordingly the fair value hierarchy in paragraphs AG69-AG84 of IAS 39 is not considered inconsistent with the hierarchy cited above.

In the majority of cases, there are unlikely to be identical assets (Level 1) with observable prices which can be relied upon to estimate the fair values of the intangible assets of the business being acquired. Some examples of assets where there may be directly comparable prices which could be relied on include taxi licences and fishing rights in some markets.

Other assets can be considered similar under Level 2 methods by reference to their legal nature (e.g. patents, licences), intended uses, useful economic life, pattern of cash flows, risks and opportunities, etc. However, identifying similar assets for which observable prices exist can also be difficult, since there are few markets for intangible assets and a majority of asset acquisitions are ‘private’ transactions, hence information is not publicly available. In addition, making adjustments to the observable prices so that they may be used to assess the value of the asset in question can be highly subjective and requires detailed analysis.

Accordingly, in a majority of cases, it should be expected that intangible asset valuations will need to be performed using other valuation methodologies (Level 3) for the purposes of IFRS 3. There is a broad range of other valuation techniques that might be appropriate to adopt for the purposes of assessing the fair value of intangible assets, which we discuss below.

Where possible, more than one of the valuation techniques may be applied to arrive at fair value. This approach is designed to provide additional support, by way of a cross-check, for the fair value assessment made.

Valuation techniques for the purposes of assessing the fair value of intangible assets
When applying valuation techniques for the purposes of assessing the fair value of intangible assets, the objective of fair value measurement must be considered. Accordingly, the assumptions used should reflect market assumptions.

The most common generally accepted valuation methodologies for the purposes of assessing the fair value of intangible assets include:

- Market methods – value intangible assets by reference to transactions, or benchmarks, involving similar assets that have occurred recently in similar markets (these correspond to Level 1 and Level 2 methodologies); and

- Income methods – value intangible assets on the basis of the future economic benefits derived from ownership of the asset. The main income methods include, Relief from royalty, and Excess earnings (or the related method, Premium profits).

Note: cost-based methods\(^6\) are sometimes, though not often, used in intangible asset valuations. However, paragraph BCZ 29 of IAS 36 (Basis for Conclusions) states that “IASC believed that replacement cost techniques are not appropriate to measuring the recoverable amount of an asset”.

\(^6\) Cost-based methods value intangible assets by aggregating the cost of developing the asset to its current condition, or replacing that asset.
There is a further category of ‘hybrid’ methods which use elements from more than one method above. These have been included in the category to which they are most closely related (e.g. relief from royalty and avoided cost under income methods, replacement cost plus lost profits under cost-based methods).

The standards do not set out detailed criteria for performing a valuation. However, listed below are some key criteria, based on common valuation practice, that need to be considered in undertaking a valuation of an intangible asset:

- **Credibility** – the valuation methodology should be credible and generally accepted from both a theoretical and commercial perspective;

- **Objectivity** – the choice of methodology may necessitate a trade-off between the intellectual rigour of the methodology and the inherent degree of subjectivity. The valuer must be guided by the quality and quantity of objective information available;

- **Versatility** – credibility will be enhanced if standard approaches can be applied across companies, industries and classifications of intangible assets;

- **Consistency** – the methodologies should be applicable on a consistent basis year on year, and thus facilitate the updating of the valuation;

- **Reliability** – the valuation should be verifiable, such that other valuers may replicate the process using similar measurement principles;

- **Relevance** – the valuation basis and methodology selected should be relevant to the requirements of the user; and

- **Practicability** – the methods and underlying parameters should be clear and relatively easy to apply in practice.

One of the key elements of any valuation exercise is a thorough understanding of the business which is the subject of the transaction. Having done this a valuer will have a better appreciation of the approach that may be adopted for the purposes of the valuation exercise and be able to identify the intangible assets that are important to the business. This will assist in applying the appropriate valuation methodology and assessing the information that will be required, subject to availability. In addition it will help in assessing the lives of the intangible assets that are in existence by understanding their nature and importance to the business.

**The process of assessing the fair value of intangible assets**
The approaches set out above include a number of steps that identify and collate the information to enable the valuer to make an assessment of the fair value of the intangible assets.
These steps may be summarised as follows:

**Figure 1: Intangible asset valuation approach for an identified entity**

- **Background research**
  - Overview: industry and countries of operation.
  - Company: operations, financing, clients, suppliers.
  - Client information: forecasts, internal documentation, legal documentation.

- **Intangible asset identification**
  - Reasons for acquisition.
  - Available documents (board presentations, acquisition agreement).
  - Are recognition and identification criteria met?
  - Do accounting standards provide specific guidance on this type of intangible asset?

- **Select valuation methodology**
  - IAS 36/IAS 38/IFRS 3 guidelines.
  - Information available.
  - Commercial practice/valuer experience.
  - Alternative methodology available?

- **Market methods (identical/comparable IA)**
  - Comparable companies and transactions
  - Relief from royalty

- **Income methods**
  - Excess earnings
  - Lost profits + cost
  - Avoided cost

- **Cost**
  - Integration of financial and market data.
  - Estimate useful life: finite/indefinite.
  - Application of selected valuation methodology.
  - Additional/specific research: data sources.
  - Sensitivity analysis on projections/analyses.
  - Reporting/presentation.

- **Value the asset**
  - Other valuation method.

- **Cross-checks**

(7) Note that replacement cost methodologies are not generally considered to be appropriate.
Market value method
Under the comparable market value methodology, the value of an intangible asset is determined by reference to the prices obtained for comparable assets in recent transactions. The methodology is, therefore, theoretically attractive: it is credible, objective and, since the valuation basis is fair value, relevant.

As per the IASB discussions, appropriate adjustments for entities using this method should be made by reference to known, quantifiable differences between the transaction being accounted for and the comparable transaction. (If the differences between the transactions are not capable of quantification, an entity should proceed to Level 3 measurement techniques).

The main issues with this methodology are that:

- Its use in practice is often limited by the scarcity of comparable transactions and publicly disclosed information on any such transactions; and

- It can be difficult to ensure that the asset under consideration and the market transaction are sufficiently comparable.

Transactions in the shares of companies owning similar assets are more frequent. In the majority of these circumstances, separation of the value attributable to the intangible asset from the underlying assets of the business will not be straightforward, particularly for those not party to the transaction. However, the valuer will often find the component parts of the transaction data useful. For example, the multiple of earnings at which the business is sold may be an important reference point when determining an appropriate rate at which to capitalise the intangible asset’s earnings.

Income methods
The economic/income-based valuation of any intangible asset has two distinct components:

- Identification, separation and quantification of the cash flows (or earnings) attributable to the intangible asset; and

- Capitalisation of those cash flows (or earnings).

The main income methods are:

- Relief from royalty; and

- Excess earnings or the related method, Premium profits.
Relief from royalty

**Principle:** the value of an intangible asset to a company is what it would pay to use it under a licence if it did not own it, or the cost savings of not having to pay a royalty.

**Generally applicable to:** patented technology, unpatented technology (know-how), brands.

**Steps**

- Research licensing transactions with comparable assets to establish a range of market levels for royalty rates.
- Analyse the strength and importance of the asset and its contribution to the overall economics of the owning entity to determine an applicable royalty rate.
- Select a royalty rate or range of royalty rates.
- Apply the selected royalty rate to the future revenue stream attributable to the asset.
- Use the appropriate marginal tax rate to arrive at an after-tax royalty rate; and
- Discount the resulting cash flow stream to the present at an appropriate risk-adjusted discount rate.

**Issues**

- The value of alternative uses of an owned asset and the different risks of ownership must be considered.
- The process of selecting an appropriate royalty rate range based on market evidence needs to be rigorous, as the value implications of a small change in the royalty rate can be significant.
- Factors to consider in establishing the appropriate royalty rate range include the asset’s strengths and weaknesses, competing assets, etc.
- What discount rate to use:
  - Company-specific?
  - Cash-generating unit-specific? (this may include an additional premium linked to the size of the cash-generating unit).
  - Asset-specific? (this may include an additional premium due to the higher risks of an intangible asset compared to a business as a whole).

Excess earnings and premium profits

**Principle:** the value of an asset is the capitalised amount of incremental profits achievable through use of the intangible asset as compared with the profits of the same business not using it, or the value of an asset is the capitalised amount of earnings relating to that asset less the returns on all other assets that contribute to that earnings stream.

**Generally applicable to:** customer relationships, patented technology, unpatented technology, (know-how), brands.
Two approaches

- Profit and loss based (forecasting profits in excess of ‘normal’ profits that would be obtained by a business producing a similar good or rendering a similar service, without the use of this intangible asset); and

- Balance sheet based (comparing the return on capital of the cash-generating unit using the intangible asset with the return on capital of businesses not using the respective intangible asset).

Steps

- Forecast a normalised level of income for the cash-generating unit.

- Apply an appropriate or risk-adjusted rate of return to the net asset base to compute the economic income attributable to the tangible and the other intangible assets of the cash-generating unit.

- Subtract the fair return on assets from the normalised level of economic income for the cash-generating unit to arrive at the excess earnings; and

- Capitalise the resulting excess earnings using an appropriate risk-adjusted discount rate to calculate fair value.

Issues

- Difficult to find relevant companies which do not own/use a similar intangible asset.

- Estimation of discount rate.

- If a business has several intangible assets, how should ‘premium profits’ value be allocated amongst them?

- What is an appropriate rate of return on other intangible assets?

Some useful information sources used for intangible asset valuations

For the purposes of valuing intangible assets there are a number of sources that can be used for certain elements of the exercise including:

- Third-party licensing agreements;

- http://www.royaltysource.com/ (a fee is charged for this service);

- In respect of franchise fees:
  - www.minorityfranchising.com
  - www.franchisingamerica.com

- SEC EDGAR database for any information filed by comparable companies.
B. Determining the recoverable amount of a cash-generating unit

Assessing a cash-generating unit's recoverable amount
In accordance with the impairment testing requirements under IAS 36, the approach which should be adopted for the purposes of the Standard is to compare the carrying amount of the cash-generating unit with its recoverable amount. The recoverable amount is the greater of fair value less costs to sell and value in use.

This section sets out the generally accepted approaches to assessing fair value and value in use.

The guidance in IAS 36 applies to both asset impairment and goodwill impairment. For purposes of this summary most of the concepts apply primarily to goodwill impairment but many can be used for asset impairment as well.

Valuation techniques for the purposes of assessing a cash-generating unit's recoverable amount
It is a fundamental principle of valuation that the value of an asset is a function of (a) the future cash returns to the owner of the asset, (b) the timing of those returns and (c) the risks associated with the realisation of the anticipated returns in the expected timeframe.

The two principal and internationally recognised techniques which may normally be employed in assessing the recoverable amounts of a cash-generating unit are:

1. earnings capitalisation (the market approach); and
2. income approach – discounted cash flows (“DCF”).

Using more than one valuation approach is generally recognised as providing supporting evidence as to the most likely value of an asset or business. Whenever possible, more than one valuation approach should always be considered.

A market approach is appropriate for determining fair value less costs to sell and an income approach is appropriate for assessing value in use. The market approach and income approach are discussed below.

The market approach
This approach is a practical means of capturing the fundamental elements of value in assets, namely the expected future financial return on investment, the timing of realisation of those returns and the risks associated with realising those anticipated returns in the expected time frame.

Under this approach, the value of a business or cash-generating unit is obtained by multiplying its estimated sustainable earnings by an appropriate market earnings multiple. The terms earnings multiple and capitalisation factor can be used interchangeably.
The method requires the assessment of two key inputs that are specific to the entity being valued:

1. The earnings that can be maintained in the future (i.e. maintainable earnings); and

2. The capitalisation factor appropriate to those earnings, such a factor reflecting the rate of return on investment required by the market (incorporating risk and growth potential) for such a business.

The assessment of both these parameters requires a degree of professional judgement in addition to knowledge of finance and accounting. A traditional method of assessing maintainable earnings is to focus on the latest reported results and latest estimates of current performance. Such results can often provide a reliable indication of present performance and a meaningful basis for predicting future performance, although this will not always be the case if the results of the business reflect exceptional or non-recurring items, or are likely to be significantly affected by factors that did not occur historically (or are not expected to be ongoing).

One of the main differences between the cash flows of a business and its accounting profits is a difference in timing. But ultimately accounting profits of both a revenue and capital nature are turned into cash flows for the shareholders (in the form of dividends, returns of capital, gains on sale), so it is often considered reasonable to examine accounting profits or earnings as a surrogate for cash-flows and thus as a basis for valuing a business enterprise.

The value of the cash-generating unit is then assessed by applying the rate of return a potential investor in the market would require in relation to expected future earnings. To establish this, earnings multiples (for example, Sales, EBITDA, EBIT and PE multiples) derived from similar companies quoted on Stock Exchanges, and multiples paid in merger and acquisition activity involving similar companies (comparable transactions), are considered. These multiples, all else being equal, reflect both the rate of return on investment required by the market for investments in similar businesses, and the expected future growth in the earnings of those businesses. Care should be taken in selecting the multiples however, to ensure that the figures on which they are based are derived consistently between the entities being analysed.

However it is unlikely that the companies used to derive the earnings multiples above will be directly comparable to the cash-generating unit in question. Both the selection to the type of multiple (i.e. Sales, EBITDA, EBIT or PE multiples) and the magnitude of the multiple needs to be considered. In addition, appropriate adjustments to reflect relative differences in, inter alia, the expected growth and risks associated with each company should be made to the earnings multiples to make them comparable.

Consideration also needs to be given to factors which may have impacted the current prices of listed companies and the amount that was paid in comparable transactions. For example, is the current listed price of a company impacted by bid speculation, or did the amount ultimately paid in a transaction reflect a competitive bid or ‘special purchase’ by the acquirer?

Hence, in using the market approach significant analysis needs to be undertaken in order to assess an appropriate earnings multiple for the cash-generating unit being valued.
The income approach

The most widely used income approach is the DCF method. IAS 36 provides general guidance as to the methodologies that are preferred including the traditional DCF method.

The principles underlying the DCF approach include, inter alia:

1. It is based on cash flows rather than accounting profits (generally referred to as “earnings”). Accounting earnings typically contain non-cash items (e.g. depreciation) whereas cash flows represent the free (net) cash flows available for distribution to the capital providers of the business.

2. It recognises the time value of money by placing future revenues and costs on a present value basis reflecting the uncertainty (risk) associated with forecasting the future financial performance of the business.

IAS 36, Appendix A lists the main components of present value measurement under an income approach:

a) “An estimate of the future cash flow, or in more complex cases, series of future cash flows the entity expects to derive from the asset;

b) Expectations about possible variations in the amount or timing of those cash flows;

c) The time value of money, represented by the current market risk-free rate of interest;

d) The price for bearing the uncertainty inherent in the asset; and

e) Other, sometimes unidentifiable, factors (such as illiquidity) that market participants would reflect in pricing the future cash flows the entity expects to derive from the asset.”

Appendix A to IAS 36 clarifies that there are two approaches to computing present value in a DCF method:

- “Under the ‘traditional’ approach, adjustments for factors (b) – (e) are embedded in the discount rate”; and

- “Under the ‘expected cash flow’ approach, factors (b), (d) and (e) are taken into account in risk-adjusted expected cash flows”.

Estimating future cash flows

IAS 36 includes a series of requirements on estimating future cash flows, including amongst others:

1. Cash flows should be based on reasonable and supportable assumptions that represent management’s best estimate of the range of economic conditions that will exist over the remaining useful life of the asset/cash-generating unit;

2. Greater weight must be given to external evidence in selecting the assumptions for the cash flow estimates (although these should based on the most recent budgets/forecasts prepared by management);

3. Projections should normally cover a maximum period of five years;
4. The growth rate beyond the detailed projections should be steady or declining and should not exceed the long-term average growth rate for the relevant products, industry, country or countries; and

5. Cash flow estimates shall exclude any future cash inflows or outflows expected to arise from future restructurings or from improving or enhancing the asset’s performance.

This last point is likely to result in the need for careful consideration as to what it is reasonable and appropriate to include in the cash flow estimates.

**Discount rate**

The discount rate used to discount the expected cash flows should reflect the time value of money and the risks specific to the asset for which the future cash flow estimates have not been adjusted. Whichever approach (‘traditional’ or ‘expected cash flow’) an entity adopts for measuring the value in use of an asset, discount rates should not reflect the effects of any risk for which the cash flows have been adjusted (otherwise the effect of some assumptions will be double-counted).

The discount rate should be calculated on a pre-tax basis. The discount rate should be an estimate of the rate that investors would require on an investment generating cash flows of similar amounts and timing, and with a similar risk profile, as those the entity expects to derive from the asset (or cash-generating unit).

Estimates of this rate may be made by reference to:

- The rate implicit in current market transactions for similar assets;
- The weighted average cost of capital (“WACC”) of a listed entity that has a single asset (or portfolio of assets) similar in terms of service potential and risks to the asset under review; or
- The WACC for the entity, but only if adjusted for the particular risks associated with the cash-generating unit.

**Converting from a post-tax to a pre-tax discount rate**

A pre-tax discount rate is simply the discount rate which will give the same results when discounting pre-tax cash flows as the results obtained by discounting post-tax cash flows at a post-tax discount rate.

Because the tax consequence of different cash flows may be different, the pre-tax discount rate is not always the post-tax discount rate grossed up by a standard rate of tax. Instead, the pre-tax discount rate is the post-tax discount rate adjusted to reflect the specific amount and timing of future cash flows.

Two difficulties are that:

1. Benchmark discount rates, such as WACC, are generally post-tax rates; and

2. Where a company has conducted an impairment test on a post-tax basis, it will expect an impairment test on a pre-tax basis to give a consistent result.
In practice, estimating a suitable pre-tax rate is far from straightforward. A simple ‘grossing-up’ of the post-tax rate is only likely to be reliable where the pattern of tax cash flows is similar to the pattern of pre-tax operating cash flows. An assessment of a pre-tax rate must therefore take into account the tax status of the assets in an cash-generating unit and the timing of tax cash flows.
VI. Frequently asked questions

Attention: This section is intended to highlight criteria that may be used to determine the appropriate accounting under IFRS 3. This Section should not be used as an alternative to seeking professional guidance on your specific fact pattern.

Question 1: Distinction between shares issued as compensation for services and shares issued as purchase price consideration

Question
What factors should be considered to determine whether an agreement to issue fully vested shares to employees of the acquiree at the end of a 12-month period following on from a business combination is within the scope of IFRS 2 or subject to the scope exemption for shares issued in a business combination?

Response
The determination of whether equity instruments issued for contingent consideration in a purchase combination are compensation to current employees or part of the purchase price to the former owners is a matter that requires a full assessment of the facts and careful judgement.

The following criteria may be used to determine whether contingent consideration should be accounted for as (1) an adjustment of the purchase price of an acquired enterprise under IFRS 3 or (2) compensation for services or other in accordance with IFRS 2. This list of factors or indicators is not all-inclusive.

- Factors involving continued employment, such as:
  - **Linkage of continued employment and contingent consideration** – arrangements in which the contingent payments are not affected by employment termination may be a strong indicator that the contingent payments are additional purchase price rather than compensation.
  - **Duration of continued employment required** – If the length of time of required employment coincides with or is longer than the contingent payment period, that fact may indicate that the contingent payments are, in substance, compensation.
  - **Level of compensation** – Situations in which employee compensation other than the contingent payments is at a reasonable level in comparison to that of other key employees in the combined enterprise may indicate that the contingent payments are additional purchase price rather than compensation.
Factors involving components of a shareholder group:

- **Contingent payout is the same for former shareholders independently of whether they are employees** – The fact that selling shareholders who do not become employees receive the same contingent payments on a per share basis from what the selling shareholders who become employees of the combined enterprise receive, may indicate that the incremental amount of contingent payments to the selling shareholders who become employees may not be compensation.

- **Relative amount of shares owned by the selling shareholders who remain as key employees** – If selling shareholders who owned substantially all of the shares in the acquired enterprise continue as key employees, that fact may indicate that the arrangement is, in substance, a profit-sharing arrangement intended to provide compensation for post combination services.

Understanding the rationale for the inclusion of a clause for contingent payments in the acquisition agreement may be helpful in assessing the substance of the arrangement. For example, if the initial consideration paid at the acquisition date is based on the low end of a range established in the valuation of the acquired enterprise and the contingent formula relates to that valuation approach, that fact may suggest that the contingent payments are additional purchase price. Alternatively, if the contingent payment formula is consistent with prior profit-sharing arrangements, that fact may suggest that the substance of the arrangement is to provide compensation.

The formula used to determine the contingent payment might be helpful in assessing the substance of the arrangement. For example, a contingent payment of five times earnings may suggest that the formula is intended to establish or verify the fair value of the acquired enterprise, while a contingent payment of 10 percent of earnings may suggest a profit-sharing arrangement.

The provision for payment only upon completion of an employment period is a strong indicator that the agreement should be accounted for as compensation, and therefore a presumption would exist that such an arrangement would be included within the scope of IFRS 2.
Question 2: Accounting for direct acquisition costs when the acquisition of the business combination is uncertain

Facts
Entity X is in the process of negotiating the purchase of Entity Y at 31 December 20X5. At that date Entity X has incurred CU500,000 of direct costs such as due diligence and legal fees that will be eligible for inclusion in the cost of acquisition if the acquisition goes ahead.

Question
At 31 December 20X5 how should the CU500,000 be treated in Entity X’s financial statement?

Response
Entity X should make an assessment at 31 December 20X5 as to whether the CU500,000 meets the criteria for recognition of an asset. This will involve consideration of the probability of the proposed business combination transaction being consummated. If the entity is in the initial stages of researching the viability of the transaction, or considering a number of alternatives, the probability criterion may not be met. If the entity has made a tentative decision to proceed with the business combination, has discontinued exploration of other alternatives and is in the final stages of due diligence type activities the probability criterion may be met. If the transaction is considered probable the CU500,000 should be deferred until the outcome of the negotiations is certain. If a decision is made not to proceed the costs should be expensed immediately following this decision.

Question 3: Assigning amounts to inventory

Question
What general principles should be applied when assigning amounts to inventories of a manufacturing entity?

Answer
An acquired entity may hold three different classes of inventory: finished goods, work in process, and/or raw materials. The general principle to be followed when assigning amounts to these three classes of inventory is to ensure that the acquirer will recognise in future periods only profits associated with value added to the acquired inventory subsequent to the acquisition date. Accordingly, in assigning the purchase price to finished goods and work in process inventories, valuations should be based on the selling price less the sum of:

- Costs to complete, if applicable;
- Costs of disposal; and
- A reasonable profit allowance for the selling effort, and the post acquisition completion effort.

Generally, it is not appropriate to assign the acquiree’s carrying amount to the cost of acquired inventories, because the acquiree’s cost does not reflect the manufacturing profit that is recognised by the acquiree through the normal selling process. This manufacturing profit should be considered as part of the fair value assigned to the inventory.

Raw materials should be valued at replacement cost as of the date of the acquisition, because no value has been added to the raw materials through manufacturing or holding. Replacement cost of raw materials inventories should be determined as of the business combination acquisition date.
Care should be taken in evaluating the various types of inventory to assure that inventories are valued according to their appropriate classification: finished goods, work in process, or raw materials.

**Question 4: Determining costs to complete, costs of disposal, and reasonable profit allowances**

**Question**
How should the cost to complete, cost of disposal and reasonable profit allowance for the selling effort associated with acquired inventory be determined?

**Answer**
The valuation of finished goods and work in process inventory requires a determination of the (a) costs to complete, if applicable, (b) costs of disposal, and (c) a reasonable profit allowance for the selling effort and the post acquisition completion effort. In making such determinations, the following factors should be considered:

- The nature of the inventory and the nature of the acquiree’s production processes.
- The historical turnover rate for inventories of the acquiree and for the acquiree’s industry.
- Industry statistics for normal profit allowances and turnover rates.
- Nature of the selling network and marketing techniques employed by the acquiree or that will be employed by the acquirer, if significantly different.

In the case of retail operations, costs to dispose may include inventory stocking costs and warehousing and distribution costs for the acquired inventory. However, it is inappropriate to allocate general and administrative overhead costs to finished goods inventory in the acquisition.

**Question 5: Valuation of purchased intangible assets for which no active market exists**

**Question**
What would be an example of a technique that is used for estimating the fair value of intangible assets when no active market exists?

**Answer**
An example can be found in the publishing industry. Because each masthead is unique, no active market exists for mastheads. However, mastheads are often bought and sold with the sales price based on a multiple of the current year’s operating profit. The multiple is based on the industry or geographic segment in which the masthead operates. Imagine that a multiple of 11 can be assigned to a masthead and that the newspaper is generating 1 million operating profit before it is purchased through an acquisition. In this simplistic example, the fair value of the masthead could be estimated to be 11 million. However, careful consideration should be given to the appropriateness of the multiples and the basis to which they are applied. In determining the fair value of intangible assets for which no active market exists an entity should make use of appropriately qualified valuation experts.
Question 6: Evaluating the useful lives of intangible assets each reporting period

Question
What procedures should an entity perform each reporting period in respect of intangible assets with both finite and indefinite lives?

Answer
Subsequent to the determination of useful life for all intangible assets, an entity must perform the following activities in each financial year:

For intangible assets with a finite useful life

- Evaluate the remaining useful life to determine whether events or circumstances warrant a revision to the remaining amortisation period.

- If the intangible asset is determined to have an indefinite useful life, the intangible asset shall be tested for impairment.

- Intangible assets determined in this evaluation to have an indefinite useful life shall no longer be amortised and shall be accounted for in the same manner as other intangible assets that are not subject to amortisation.

- If the intangible asset is determined to have an indefinite useful life, previous amortisation of that asset, if any, is not reversed.

For intangible assets with an indefinite useful life

- Evaluate whether events or circumstances continue to support an indefinite useful life.

- If the intangible asset still has an indefinite useful life, it shall be tested for impairment once year, at the same time during the reporting period.

- If the intangible asset is determined to have a finite useful life, the intangible asset shall be tested for impairment.

- Intangible assets determined in this evaluation to have a finite useful life shall then be amortised over their estimated remaining useful life and accounted for in the same manner as other intangible assets that are subject to amortisation, including the completion of impairment testing where indicators of impairment exist.

The determination of useful life for each intangible asset requires a comprehensive consideration of all pertinent factors surrounding the assets. Subsequent to the initial determination of useful life, entities must establish sufficient procedures to appropriately identify and evaluate those events or circumstances that, if occurring or changed from the initial determination, may impact the remaining useful life. Some events or circumstances will represent both discrete and readily identifiable events to which the entity should readily respond (i.e., a change in regulation). Other events or circumstances may develop more gradually over time but, nevertheless, must be monitored and given appropriate consideration by the entity (i.e. obsolescence, competition, and demand). Given the varying nature of the intangible assets and each entity’s unique facts and circumstances, procedures employed by entities each reporting period to evaluate useful lives of intangible assets are expected to vary.
Question 7: Goodwill related to equity method investments

Question
How should goodwill related to equity method investments be accounted for?

Answer
The portion of the difference between the cost of an investment and the amount of the underlying equity in net assets of an associate that is recognised as goodwill in accordance with IAS 28 should not be amortised. However, because goodwill included in the carrying amount of an equity accounted investment is not separately recognised, it is not tested for impairment separately by applying the requirements for impairment testing goodwill in IAS 36. Instead, the entire carrying amount of the investment is tested under IAS 36 for impairment, by comparing its recoverable amount with its carrying amount whenever application of the requirements in IAS 36 indicates that the investment may be impaired.

Question 8: Acquisition of an intangible asset which will not be used

Question
A company acquired a trademark as part of a business acquisition. The trademark involved the logo of one of its direct competitors. When acquired, the company has no intention to use this logo anymore.

Can the company recognise the logo as a separate intangible asset?

Answer
Yes. The logo is separable by itself as it can be for example licensed and arises from legal rights. In acquiring the logo, the entity makes sure that future economic benefits will inflow, and increase, as the entity stops or reduces the business of its competitors. The criteria of IAS 38.12 and IAS 38.21 are met; therefore an intangible asset should be recognised.

However, if the entity has no intention to use the logo after the acquisition it seems unworkable to allocate the logo to existing cash generating units and should be identify as a cash-generating unit by itself as the management intends to exclude the logo from the operating process. The cash inflows related to the logo are nil, however immediately after acquisition it would appear reasonable that the fair value less costs to sell are not significantly different from the amount recognised, and accordingly an impairment loss is not recognised. However the asset must be amortised over its useful life. The useful life to the entity is the length of time for which holding the logo will be effective in discouraging competition, which would be likely to be a fairly short period, as an unexploited logo loses value very quickly. As the entity acquired the asset with the express intention of denying others the opportunity to use the asset, it appears unlikely that the asset will be sold in the future, and accordingly the residual value is zero. Resultantly an amortisation charge for the full carrying amount of the asset is recognised over the useful life (which may be as short as a single accounting period).
**Question 9: Transition to IFRS 3 on first time adoption of IFRS**

**Question**

Which transactions must be accounted for in accordance with IFRS 3 for inclusion in the financial report for the year ended 31 December 2005?

**Answer**
The business combinations involving Company C and Company D must be restated, as all business combinations after the date of transition (1 January 2004) must be accounted for in accordance with the accounting requirements in force at the company's first IFRS reporting date (31 December 2005). The purchase of Company E will be accounted for in accordance with IFRS 3 when it occurs as the purchase is subsequent to the date of application of IFRS.

The purchase of Company B may also be restated providing Company A applies the requirements of IAS 36 and IAS 38 with effect from the same date, and the valuation and other information required to apply IFRS 3, IAS 36 and IAS 38 was obtained at the date of acquisition of Company B. If Company A does not wish to restate the purchase of Company B the requirements of Appendix B to IFRS 1 must be applied to the transaction in the first financial report prepared in accordance with IFRS.

**Question 10: Transition to IFRS 3 – existing IFRS user**

**Question**
Company A is an existing IFRS user that has elected not to early adopt the requirements of IFRS 3. The company purchases Company B on 31 October 2003, Company C on 15 March 2004 and Company D on 17 July 2004.

Which business combinations must be accounted for in accordance with IFRS 3 for inclusion in the financial report for the year ended 31 December 2004?

**Answer**
The business combination involving Company D must be accounted for in accordance with IFRS 3 in the financial report for the year ended 31 December 2004. As Company A has chosen not to early adopt IFRS 3, the transitional accounting changes, such as the cessation of amortisation of goodwill and the write-off of accumulated goodwill amortisation will be effected for prior business combinations in the year beginning 1 January 2005.
VII. Comparison of IFRS and US GAAP

One of the overall objectives of the IASB’s business combinations project has been to move toward international convergence, particularly with the United States, in accounting for business combinations. As a result, the affect of IFRS 3, and revised IAS 36 and IAS 38, is to eliminate a number of differences that existed between US GAAP and IFRS in accounting for business combinations.

While IFRS 3 and SFAS 141 Business Combinations and SFAS 142 Goodwill and Other Intangible Assets are similar, there remain some significant differences, which the IASB and FASB are addressing as part of a continuing convergence project. This section illustrates some of the remaining significant differences between US GAAP and IFRS.

A. Definition of a business

The definition of a business under IFRS 3 differs from that contained in US GAAP. The IASB considered the definition in US GAAP and determined that it did not capture all of the sets of activities and assets that the IASB believed should be considered a business. The following requirements give rise to businesses being identified under IFRS 3 that would not be identified as a business under US GAAP:

- The presumption in IFRS 3 that transactions on which goodwill arises must involve the transfer of a business;
- The absence of a requirement in IFRS 3 that a business be self-sustaining; and
- The absence of a requirement in IFRS 3 that a developed set of activities that has not commenced principal planned operations is not presumed to be a business.

B. Application of the acquisition method

Date of measurement of the cost of a business combination

In accordance with SFAS 141, the cost of a business combination must be measured at the date of announcement. Conversely, under IFRS the cost of the business combination is measured at the date of acquisition (that is, the date the acquirer obtains control of the acquiree), or, where there are multiple transactions to effect the business combination, the date of exchange of each transaction. This distinction will create variances in the cost of the business combination under IFRS and US GAAP, particularly where publicly traded equity instruments are issued as part of the consideration, because the fair value of equity instruments issued will commonly change between the date the transaction is announced and the date the acquirer obtains control. This difference will be addressed during the Phase II Business Combinations project, and the FASB have announced their intention to converge with the date of acquisition requirements contained in IFRS 3.
**Allocation of the cost of a business combination**

Where an entity acquires in-process research and development in the course of a business combination, that in-process research and development must be included in the allocation of the cost of acquisition under both US GAAP and IFRS. In accordance with US GAAP the amount recognised must be written off immediately, irrespective of how, if at all, the entity intends to use the asset. Under IFRS 3 the amount recognised continues to be carried in the books of the combined entity and is amortised over its useful life (and subjected to impairment testing when considered necessary, and on an annual basis prior to the asset being considered available for use).

**Illustration OO – Recognition of in-process research and development**

Entity O acquires entity P. The fair value of the net assets of Entity P at acquisition date is CU500. In addition, in-process research and development with a fair value of CU10 will be acquired. The cost of acquisition is CU550. The following difference would arise:

<table>
<thead>
<tr>
<th>Description</th>
<th>IFRS CU</th>
<th>US GAAP CU</th>
</tr>
</thead>
<tbody>
<tr>
<td>In-process research and development asset recognised</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>Goodwill recognised</td>
<td>40</td>
<td>40</td>
</tr>
<tr>
<td>Immediate expense related to IPR &amp; D</td>
<td>–</td>
<td>10</td>
</tr>
</tbody>
</table>

The CU10 in-process research and development recognised must be expensed immediately under US GAAP. This results in net assets recognised after effecting all business combination transactions as CU550 under IFRS and CU540 under US GAAP.

In accordance with EITF 95-3 **Recognition of Liabilities in Connection with a Purchase Business Combination** certain liabilities that are not liabilities of the acquiree at acquisition date may be recognised on initial acquisition provided certain stringent conditions are met. Restructuring provisions (including those relating to employee terminations and relocations) may be recognised providing certain conditions about the nature, timing and detail of the plan for that restructuring are met. The amounts recognised must either be a cost with no future economic benefit to the company arising from the plan, or an item that arises from the contractual obligations of the acquiree that will not provide a future economic benefit to the company. Consequently, US GAAP would allow the recognition of some restructuring provisions on initial acquisition that would not be recognised in accordance with IFRS 3.
Minority interests
Under US GAAP, an entity fair values only the proportion of the asset attributable to the acquirer. In accordance with IFRS 3, an entity must recognise the fair value of the entire asset, with a corresponding increase to minority interest for the proportion of the asset attributable to those interests.

Illustration PP – Recognition of minority interests
Entity P acquires 60% of Entity Q. The carrying amount of the net assets of Entity Q at acquisition date is CU1,000, and the fair value is determined to be CU1,200. The respective treatments are as follows:

<table>
<thead>
<tr>
<th></th>
<th>IFRS</th>
<th>US GAAP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net assets recorded</td>
<td>1,200</td>
<td>1,120</td>
</tr>
<tr>
<td>Minority interest</td>
<td>480</td>
<td>(40% * 1,200)</td>
</tr>
</tbody>
</table>

Accounting for negative goodwill
Under SFAS 141 the excess of acquirer's interest in the net fair value of acquiree's identifiable assets, liabilities and contingent liabilities over cost is accounted for by reducing the carrying amounts of certain non-monetary assets and liabilities proportionately. Having completed this exercise any remaining discount is taken to the profit and loss statement as an extraordinary gain. The carrying amounts of the following types of assets are not adjusted in this accounting entry:

- Financial assets (other than investments accounted for using the equity method);
- Assets acquired with the intention of near term disposal;
- Deferred taxes;
- Pre-paid pension assets; and
- Other current assets.

In contrast, IFRS 3 requires the fair values of the elements of the business combination to be reassessed, and any remaining excess following on from that reassessment is recognised immediately in profit and loss.
C. Impairment testing requirements

Identification of cash-generating units
The requirements in IAS 36 in relation to the identification of cash-generating units for the purposes of impairment testing goodwill may result in the identification of more cash-generating units under IAS 36 than reporting units that would be identified under SFAS 142. SFAS 142 limits a reporting unit to be no lower than an operating segment (referred to as a component). IAS 36 does not contain this limitation, and accordingly cash-generating units may be identified at a lower level than reporting units under US GAAP. As a result, application of the cash-generating unit definition in IAS 36 may result in the identification of units to be tested for impairment at a lower level than would be permitted under SFAS 142. Under SFAS 142 reporting units that constitute businesses with similar characteristics are aggregated and treated as single units, irrespective of whether or not management monitor them independently for internal reporting purposes. Both SFAS 142 and IAS 36 do not allow reporting units/cash-generating units to be at a higher level than reportable segments.

Illustration QQ – Identification of cash-generating units to be tested for impairment

Entity Q is a diversified magazine publisher. For segment reporting purposes they have a ‘sports magazine’ segment. For the purpose of internal reporting to the Board reports are prepared for each major sporting segment such as cycling. As noted by the IASB in their illustrative example to the amended IAS 36, under IAS 36 each magazine title within the cycling segment would ordinarily be expected to form a cash-generating unit. Under FAS 142 the cycling magazines in aggregate would form the reporting unit to be tested for impairment. Under IAS 36, it is possible that goodwill would be tested for impairment at the magazine title level if the goodwill were managed at that detailed level.

Impairment test for goodwill
The methodology for impairment testing of goodwill in accordance with SFAS 142 differs significantly from that required by IAS 36. Under SFAS 142 a two step process is required. In the first step, the fair value of the reporting unit is determined (similarly to under IFRS). The fair value of the reporting unit is compared with the carrying amount of the reporting unit (including the liabilities). If the carrying amount of the reporting unit exceeds its fair value, step two of the impairment testing is performed.

In step two, fair values are attributed to all assets and liabilities of the entity as they would be on initial recognition of a business combination, to determine the implied fair value of goodwill. In completing this exercise an entity may take into account unrecognised assets and impairment losses on other items; however the mere completion of this test does not give rise to the requirement to recognise such assets or to recognise such impairment losses. The implied fair value of goodwill is then compared with the carrying amount to determine if an impairment loss should be recognised.
The following are the main differences that would be noted if an impairment calculation were completed under IFRS (for the purposes of this analysis assume that the reporting unit under US GAAP is equivalent to the cash-generating unit for IFRS):

1. The liabilities of the cash-generating unit would not be included in the calculation of the carrying amount of the cash-generating unit, unless they were unable to be factored out of the recoverable amount calculation (as discussed in Part C of Section III of this document).

2. IFRS would not proceed to step 2, the write-down would be calculated at the completion of Step 1. Prima facie, this would give a write-down of 300 (Carrying amount of 1,500 (liabilities excluded as noted in point 1) less the fair value of the cash-generating unit of 1,200) however, the fair value is likely to be different because the fair value determined for the purposes of IFRS would not take into account the effect of the existence of the liabilities.

3. In Step 2 the US GAAP approach requires an entity to determine the fair value of the CGU by determining the fair values of all the assets and liabilities that would be recognised if the CGU was acquired in a business combination at the date of the impairment assessment, hence the unrecognised trademark is factored into the calculation. This amount would be omitted from the calculations in accordance with IFRS.
Impairment testing of amortisable intangible assets
SFAS 144 Accounting for the Impairment or Disposal of Long-lived Assets requires the use of undiscounted cash flows when testing assets within its scope. These include intangible assets with finite useful lives as well as long-lived physical assets. In accordance with IFRS 3, if an indicator of impairment exists for a particular asset, that asset must be tested for impairment in accordance with IAS 36 which, where relevant, would require the use of discounted cash flows in determining value in use. The practical impact of this is that where an indicator of impairment exists the recognition of an impairment loss is more likely to be required under IFRS than under US GAAP.

Reversals of impairment losses
IAS 36 allows impairment losses, other than those relating to goodwill, to be reversed where there is an indicator that the impairment may have reversed, and the resultant reversal is the result of a change in the estimates used to determine recoverable amount since the original impairment write-down. US GAAP does not permit the reversal of impairment losses in any circumstance.
Appendix A: Disclosure checklist

IFRS 3 increases the level of disclosures previously required in relation to business combinations. Illustrative examples are provided in Appendix B. IFRS 3 requires that sufficient information be disclosed to satisfy the following disclosure objectives. The financial statements should enable users to evaluate:

- The nature and financial effect of business combinations that were effected
  - During the period, and
  - After the balance sheet date but before the financial statements are authorised for issue.
- The effects of gains, losses, error corrections and other adjustments recognised in the current period that relate to business combinations that were effected in the current or in previous periods; and
- Changes in the carrying amount of goodwill during the period.

To give effect to these principles, IFRS 3 requires extensive disclosure of information in relation to current and past business combinations. The following serves as a checklist and summary of the required disclosures. However, where compliance with the disclosures noted below does not satisfy the disclosure objectives above, additional information should be provided to ensure those objectives are satisfied.

<table>
<thead>
<tr>
<th>IFRS 3 Reference</th>
<th>IFRS 3 Disclosure checklist</th>
<th>Yes/No/N/A</th>
</tr>
</thead>
<tbody>
<tr>
<td>67(a)</td>
<td>Have the names and descriptions of all the entities involved in the business combination been disclosed?</td>
<td></td>
</tr>
<tr>
<td>67(b)</td>
<td>Has the acquisition date been disclosed?</td>
<td></td>
</tr>
<tr>
<td>67(c)</td>
<td>Has the percentage of voting equity instruments acquired been disclosed?</td>
<td></td>
</tr>
<tr>
<td>67(d)</td>
<td>Has the cost of the combination, and a description of the components of that cost of combination, including costs directly attributable to the business combination been disclosed?</td>
<td></td>
</tr>
</tbody>
</table>

Where equity instruments have been issued or become issuable as part of the cost of the combination has the following information been disclosed?

- The number of equity instruments issued or issuable.
- The fair value of those instruments and the basis for determining that fair value. If a published price for the instruments doesn’t exist at the date of exchange, the significant assumptions used to determine fair value. If a published price does exist but is not used, the reasons for not using the quoted price, the significant assumptions used in determining fair value, and the aggregate variance between published market price of the instruments issued and recognised cost attributed to the instruments issued.
<table>
<thead>
<tr>
<th>IFRS 3 Reference</th>
<th>IFRS 3 Disclosure checklist</th>
<th>Yes/No/N/A</th>
</tr>
</thead>
<tbody>
<tr>
<td>67(e)</td>
<td>Have the details of any operations the entity has decided to dispose of as a result of the business combination been disclosed? Such details could include the nature of the operations, recent results from operations and expected timing of the disposal.</td>
<td></td>
</tr>
<tr>
<td>67(f)</td>
<td>Have the amounts recognised at acquisition date for each class of the acquiree’s assets, liabilities and contingent liabilities, and if practicable their book value prior to the acquisition been disclosed? If the latter disclosure is not practical that fact must be disclosed together with an explanation of why not.</td>
<td></td>
</tr>
<tr>
<td>67(g)</td>
<td>Has the amount of any excess on acquisition recognised in the financial statements, and the line item in the profit and loss in which that excess is recognised been disclosed?</td>
<td></td>
</tr>
<tr>
<td>67(h)</td>
<td>Has a description of the factors that contributed to a cost that results in the recognition of goodwill, including a description of each intangible asset that was not recognised separately from goodwill and an explanation of why the intangible asset’s fair value could not be measured reliably, or a description of any excess recognised in profit or loss been disclosed?</td>
<td></td>
</tr>
<tr>
<td>67(i)</td>
<td>Has the amount of the acquiree’s profit or loss since the acquisition date included in the acquirer’s profit or loss for the period been disclosed if practicable? If this disclosure is not practicable an explanation of why not must be disclosed.</td>
<td></td>
</tr>
<tr>
<td>68</td>
<td>The information listed above may be disclosed in aggregate for business combinations effected during the period that are individually immaterial. The information should, where practical, be disclosed for business combinations occurring after the balance sheet date but before the financial statements are authorised for issue.</td>
<td></td>
</tr>
<tr>
<td>69</td>
<td>If the initial accounting has been determined only provisionally has that fact been disclosed together with an explanation of why this is the case?</td>
<td></td>
</tr>
<tr>
<td>70</td>
<td>Has the following information been disclosed if practicable? • The revenue of the combined entity for the period as though all the business combinations effected during the reporting period had been effected at the beginning of the period. • The profit or loss of the combined entity for the period as though all the business combinations effected during the reporting period had been effected at the beginning of the period. If these disclosures are not practicable an explanation of why not must be disclosed.</td>
<td></td>
</tr>
<tr>
<td>73(a)</td>
<td>Has the amount, and an explanation of any gain or loss recognised in the current reporting period that is of such a size, nature or incidence that disclosure is relevant to an understanding of the combined entity’s financial performance that relates to the identifiable assets acquired or liabilities or contingent liabilities assumed in a business combination that was effected in either the current or a previous reporting period been disclosed?</td>
<td></td>
</tr>
<tr>
<td>IFRS 3 Reference</td>
<td>IFRS 3 Disclosure checklist</td>
<td>Yes/No/N/A</td>
</tr>
<tr>
<td>------------------</td>
<td>----------------------------</td>
<td>------------</td>
</tr>
<tr>
<td>73(b)</td>
<td>Have amounts and explanations of adjustments to provisional values recognised in relation to business combinations effected in the prior period been disclosed?</td>
<td></td>
</tr>
<tr>
<td>73(c)</td>
<td>Has the information required to be disclosed about error corrections by IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors for any of the acquiree’s identifiable assets, liabilities or contingent liabilities, or changes in values assigned to those items, recognised in the current period been disclosed?</td>
<td></td>
</tr>
</tbody>
</table>
| 75               | Has a reconciliation of the carrying amount of goodwill at the beginning and end of the period been disclosed? Showing separately:  
  • The gross amount and accumulated impairment losses at the beginning of the period.  
  • Additional goodwill recognised during the period, except where that goodwill is included in a disposal group that is classified as held for sale in accordance with IFRS 5.  
  • Adjustments resulting from the subsequent recognition of deferred tax assets during the period.  
  • Goodwill derecognised during the period on the disposal of the business to which it relates.  
  • Impairment losses recognised during the period.  
  • Net exchange differences arising during the period.  
  • Any other changes in the carrying amount during the period.  
  • The gross amount and accumulated impairment losses at the end of the period. |            |
B: Illustrative disclosure

Note 20: Business Combinations

Financial Report for the Year ended 31 December 20X5

<table>
<thead>
<tr>
<th>Names of businesses acquired</th>
<th>Principal activity</th>
<th>Date of acquisition</th>
<th>Proportion of shares acquired %</th>
<th>Cost of acquisitionCU'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Finance Limited</td>
<td>Financial</td>
<td>15/12/05</td>
<td>100</td>
<td>549</td>
</tr>
<tr>
<td>Minus Limited</td>
<td>Distribution</td>
<td>30/05/05</td>
<td>100</td>
<td>1,122</td>
</tr>
</tbody>
</table>

1,671

As a result of the acquisition of a comprehensive distribution business, the distribution operations of the widget manufacturing operation are now considered to be superfluous to requirements, and will be disposed of. The disposal is expected to be completed by 30 June 20X6.

<table>
<thead>
<tr>
<th>Components of the Cost of Acquisition</th>
<th>Minus CU'000</th>
<th>Finance CU’000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>100</td>
<td>400</td>
</tr>
<tr>
<td>Land and Buildings</td>
<td>300</td>
<td>–</td>
</tr>
<tr>
<td>Equity Instruments issued (1)</td>
<td>710</td>
<td>141</td>
</tr>
<tr>
<td>Directly attributable acquisition costs (2)</td>
<td>12</td>
<td>8</td>
</tr>
</tbody>
</table>

1,122
549
### Net assets acquired

<table>
<thead>
<tr>
<th></th>
<th>Minus</th>
<th>Finance</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Fair Value CU’000</td>
<td>Fair Value CU’000</td>
</tr>
<tr>
<td><strong>Book Value prior to</strong></td>
<td><strong>acquisition CU’000</strong></td>
<td><strong>acquisition CU’000</strong></td>
</tr>
<tr>
<td>Current assets:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>300</td>
<td>150</td>
</tr>
<tr>
<td>Receivables</td>
<td>492</td>
<td>50</td>
</tr>
<tr>
<td>Non-current assets:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investments</td>
<td>–</td>
<td>300</td>
</tr>
<tr>
<td>Intangible Assets</td>
<td>50</td>
<td>–</td>
</tr>
<tr>
<td>Property, plant and equipment</td>
<td>404</td>
<td>100</td>
</tr>
<tr>
<td>Current Liabilities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Payables</td>
<td>(96)</td>
<td>(50)</td>
</tr>
<tr>
<td>Provisions</td>
<td>(37)</td>
<td>(10)</td>
</tr>
<tr>
<td>Non-current liabilities:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Contingent liability</td>
<td>(15)</td>
<td>(27)</td>
</tr>
<tr>
<td>Borrowings</td>
<td>(58)</td>
<td>–</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net assets acquired</td>
<td>1,040</td>
<td>513</td>
</tr>
<tr>
<td>Goodwill on acquisition (3)</td>
<td>82</td>
<td>–</td>
</tr>
<tr>
<td>Discount on acquisition (4)</td>
<td>–</td>
<td>36</td>
</tr>
<tr>
<td></td>
<td>1,122</td>
<td>549</td>
</tr>
</tbody>
</table>

(1) In the acquisition of Minus Limited 50,000 ordinary shares were issued at a fair value of CU14.20 per share. In the acquisition of Finance Limited 10,000 ordinary shares were issued at a fair value of CU14.10 per share. In both acquisitions the fair value was determined by taking the he closing market price per ordinary share on acquisition date.

(2) Directly attributable acquisition costs included in the cost of acquisition are the direct legal and accounting costs incurred in developing the acquisition contracts and performing due diligence activities.

(3) Goodwill arose on acquisition of Minus Limited. The goodwill reflects the following factors:
- The entity placed significant emphasis on the value of Minus’ assembled work force in making the decision to acquire, however this is not a recognisable intangible asset in accordance with International Financial Reporting Standards.
- The entity placed considerable value on the integrated nature of Minus’ distribution systems. While the tracking software owned by Minus was able to be recognised, the value attributable to having that system across the whole business was unable to be reliably measured.

(4) The excess of CU36,000 recognised on acquisition of Finance Limited is included in the ‘Other revenue’ line item in the profit and loss statement.

Minus Limited has made a profit of CU155,000 since the date of acquisition. Finance Limited has made a profit of CU23,000 since the date of acquisition. If the acquisitions of both Minus Limited and Finance Limited had taken effect on 1 January 2005 the consolidated entity would have recorded total revenues of CU2,000,000 and net profit of CU768,000.

The initial accounting for the acquisition of Finance Ltd has not been finalised. This is the result of significant uncertainties surrounding the valuation of property, plant and equipment at acquisition date. These uncertainties are expected to be resolved by 30 April 20X6.
In future periods additional information may need to be disclosed in respect of these business combinations. The following disclosure requirements should be considered at each future reporting date to determine whether they have been triggered by events during that reporting period:

- The amount, and an explanation of, any gain or loss recognised in the current reporting period that is of such a size, nature or incidence that disclosure is relevant to an understanding of the combined entity's financial performance that relates to the identifiable assets acquired or liabilities or contingent liabilities assumed in a business combination that was effected in either the current or a previous reporting period;

- The amounts of, and explanations for, adjustments to provisional values recognised in relation to business combinations effected in the prior period; and

- The information required to be disclosed about error corrections by IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors for any of the acquiree's identifiable assets, liabilities or contingent liabilities, or changes in values assigned to those items, recognised in the current period.
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