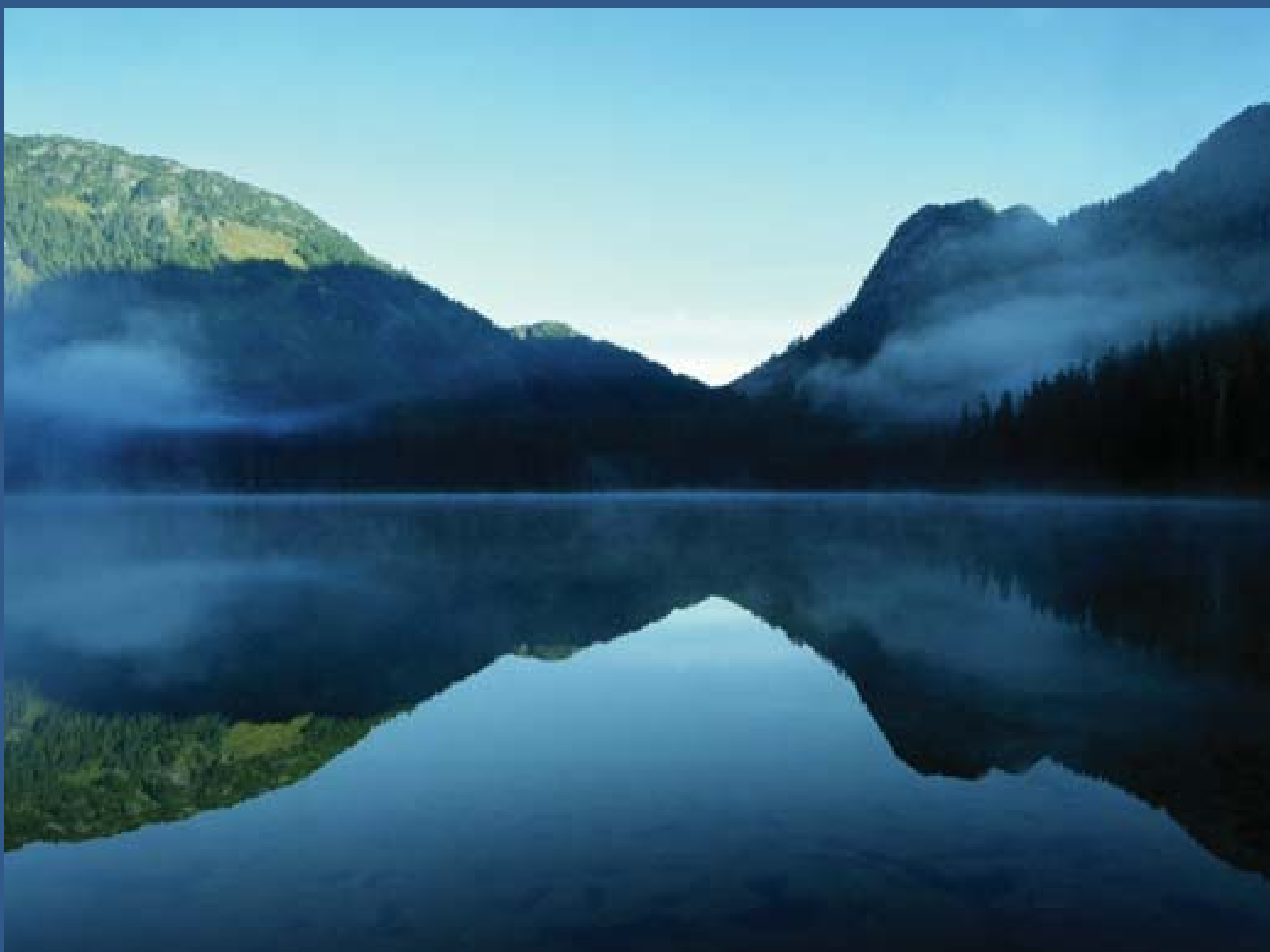
Acquisitions

Accounting and transparency under IFRS 3



April 2004

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Overview

IFRS 3 makes the accounting for business combinations a boardroom issue. The increased transparency will give the market greater insight into what has actually been acquired. They will use this to evaluate management's explanations of the rationale behind a transaction.

Changes to accounting standards may transform the way companies plan and execute their acquisition strategies. Markets will be able to judge the financial success or failure of acquisitions more quickly and accurately. Rigorous impairment testing, transparent cost allocation and extra disclosures will also require a significant investment in time and resources for each acquisition.

The changes primarily involve the financial reporting for acquisitions, but this is not a change that can be left solely to the accounting department. Senior management must understand the implications of IFRS 3 and related standards for corporate acquisition strategy and reported results of past and future acquisitions.

This publication gives you an overview of the changes and the potential impact on acquisition strategy and subsequent transparency. The changes affect all stages of the acquisition process – from planning to post-deal results.

Ian Wright
Global Corporate Reporting Leader
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Key issues for management

Results will be harder to predict

Results will be more unpredictable due to more frequent, comprehensive and rigorous impairment testing of acquired assets. Greater analysis of the target entity's business will be required in advance of a transaction, to identify potential intangible assets and to determine the risk of impairment charges.

Value will be harder to demonstrate

The financial statements will look very different following an acquisition. New assets and liabilities will appear, others will be measured on a different basis, and some existing items may disappear. The recognition and measurement requirements will make it harder to demonstrate earnings uplift from the acquisition, as more of the acquisition's costs will have to be expensed as they are incurred.

Greater transparency

Significant new disclosures are required on the cost of the acquisition, the values of the main classes of assets and liabilities and the justification for the amount allocated to goodwill. IFRS 3 creates a risk of more surprises, as it requires some expenses and losses in value to be charged immediately.

No merger accounting

Merger accounting/pooling of interests will no longer be allowed; an acquirer must be identified based on the substance of a transaction. This will represent a major change for many moving from national GAAP.

Deal structures may change

The end of merger accounting removes constraints on the structure of deal considerations. More cash deals are likely.

More work will be required

The acquisition process should become more rigorous, from planning to execution. More rigorous evaluation of targets and structuring of deals will be required, in order to withstand greater market scrutiny. Expert valuation assistance may be needed to establish values for items such as new intangible assets and contingent liabilities.

IFRS 3 – not simply an accounting change

Some questions for the board

Directors and management should consider whether they are comfortable with the answers to the following questions:

How robust is our M&A process?

- Are the right people involved?
- Is the right information obtained?
- How do we price deals?

Will there be significant goodwill write-offs in respect of past deals?

- If so, how should we communicate this to the market?
- If there is no write-off, can we satisfy the analysts that our impairment review process is robust?

Who in our organisation takes responsibility for the valuation of intangible assets?

- Do they have the skills to satisfy the requirements of the new standards?
- Do we understand what they do so that we can explain this to analysts and others who ask questions?

If not, management needs to take steps to ensure the company has access to the resources and skills it will require to successfully plan and execute acquisition strategies under IFRS 3.

Impact of the new standards

At a glance

- All business combinations are acquisitions – no more merger accounting
- An acquirer must be identified for every combination
- More intangible assets will be identified and recognised on acquisition – some will be intangible assets with indefinite lives
- Goodwill is not amortised but subject to an annual impairment test
- Negative goodwill is recognised immediately in income
- Restructuring costs are charged to income
- Contingent liabilities are recognised at fair value
- Detailed disclosures about transactions and impairment testing are required
- First-time adopters must apply new rules from day one of their IFRS track record and can choose to restate past deals

Purchase accounting must be applied to all acquisitions

Merger accounting has traditionally meant that post-transaction earnings are at least equal to the sum of the earnings of the two combining businesses less cost savings. Assets were not recorded at fair value and, as no goodwill arose, no amortisation charge was incurred. This was a clear incentive for companies to structure deals as mergers or pooling of interests.

All business combinations under IFRS 3 are acquisitions.

The identity of the acquirer is critical and may not always be clear

Purchase accounting requires an acquirer and a target (acquiree) to be identified for every business combination. Where a new company is created to acquire two or more pre-existing companies, one of the pre-existing companies must be designated as the acquirer.

The determination of the accounting acquirer is based on the facts and circumstances of the deal and will have a significant impact on the post-acquisition balance sheet. All of the acquired business' identifiable assets and liabilities, including intangible assets, must be identified and valued. The purchase price is then allocated across the fair value of these assets and liabilities with any residual allocated to goodwill.

Identification and valuation of intangibles

Purchase price allocation has not changed radically but has been made more rigorous by the new standards. All the identifiable intangible assets of the acquired business must be recorded at their fair values.

Many intangible assets that would previously have been subsumed within goodwill must be separately identified and valued. Explicit guidance is provided for the recognition of such intangible assets. An asset is identifiable when it either arises from contractual or other legal rights, or is separable. An asset is separable if it could be sold, on its own or with other assets. This will capture many more intangible assets than have typically been recognised.

IFRS 3 includes a list of assets (see the examples below) that are expected to be recognised separately from goodwill. The valuation of such assets is a complex process and may require specialist skills.

Examples of intangible assets to be separately recognised

Marketing related

Trademarks, brands, trade names, trade dress, internet domain names, newspaper mastheads, non-compete agreements

Customer related

Customer lists, order or production backlog, customer contracts and related relationships, non-contractual customer relationships

Artistic related

Plays, operas, ballets, books, magazines, newspapers, musical works, pictures, photographs, videos, films, television programmes

Contract based

Licensing, royalty and standstill agreements, contracts for advertising, construction, management, service or supply, lease agreements, construction permits, franchise agreements, operating and broadcasting rights, use rights such as drilling, water, air, mineral, timber cutting and route authorities, servicing contracts, employment contracts

Technology based

Patented technology, computer software, unpatented technology, databases, trade secrets

Poorly-performing acquisitions
will be revealed sooner
rather than later

Indefinite-lived intangible assets

Intangible assets may have an indefinite life if there is no foreseeable limit on the period over which the asset will generate cash flows. An intangible asset with an indefinite useful life is not amortised but is subject to annual impairment testing.

The criteria for indefinite lives are very strict, and relatively few assets are expected to meet them. Many will be considered long-lived assets instead.

An indefinite-lived intangible asset may seem attractive, as there will be no amortisation charges. However, the risk of impairment should be considered. A single intangible asset must be reviewed for impairment annually irrespective of whether there is any "trigger event" suggesting that impairment may have occurred.

Goodwill impairment charges

Goodwill is deemed to have an indefinite useful life and is no longer amortised. Instead, it will be subject to annual impairment tests and ad hoc testing whenever impairment is indicated. This applies to goodwill from new transactions and to goodwill from previous transactions. Additional resources or external specialists may be required to assist with the impairment reviews.

Goodwill impairment testing has always been required when a trigger event occurs. Annual impairment testing, combined with the inability to smooth transition with restructuring provisions, is likely to result in impairments on poor-performing acquisitions sooner rather than later. Goodwill impairment charges may not be reversed.

Structure of CGUs must be carefully thought through

All identifiable assets and liabilities acquired, including any goodwill, are allocated to cash generating units (CGUs) within the combined organisation. Goodwill impairment is assessed within the CGUs.

The CGU is relatively low level in the company's hierarchy, typically well below the level of an operating segment. This increases the risk of an impairment charge against goodwill, as poorly-performing units can no longer be supported by those that are performing well. As a result, the structure of CGUs must be carefully thought through.

Will earnings increase as amortisation ends?

The end of goodwill amortisation will enhance earnings of companies with significant goodwill balances. The transition rules do not require restatement of past transactions so there may be an immediate positive impact on earnings. However, more intangible assets identified in new transactions may result in more amortisation in the future, not less. Combined with the impact of new treatments for restructuring costs and negative goodwill, earnings may well move downward.

Results will be more unpredictable

Companies that made acquisitions at the top of the recent bull market may be particularly at risk of an impairment charge.

Negative goodwill disappears

The IASB has banished even the term “negative goodwill”. The new official term is “excess of acquirer’s interest in the net fair value of acquiree’s identifiable assets, liabilities and contingent liabilities over cost”, (referred to as negative goodwill in this publication). Negative goodwill implies a bargain purchase, and IFRS 3 is sceptical that bargains exist. The standard requires any negative goodwill left after a reassessment of the purchase accounting to be recognised immediately in income. Previously, negative goodwill was carried on the balance sheet and amortised over the life of the assets acquired.

The earnings cushioning-effect has been stripped out, increasing the risk of a later impairment if the acquisition turns out not to be a bargain after all.

Restructuring costs excluded

Restructuring provisions are excluded from acquisition accounting unless the target was already committed to the plan prior to the acquisition. All restructuring costs will be a charge in the income statement post-acquisition, making it harder to demonstrate that any acquisition is immediately earnings-enhancing.

Companies typically include substantial restructuring provisions in the allocated cost of an acquisition. This shelters some of the cost impact of absorbing the acquired entity. Frequently, the most visible income statement effect has been positive when provisions turn out to be overstated, and the excess is released to the income statement.

Contingent liabilities may increase goodwill

Contingent liabilities of the acquired entity will be more visible, as they must be recognised in the balance sheet at fair value. Recognition of contingent liabilities will increase the value attributed to goodwill, thus increasing the risk of impairment. The existence of contingent liabilities has always been implicitly reflected in a lower price, reflecting the risk that such liabilities would crystallise. Subsequent to initial recognition at fair value, contingent liabilities are not revalued to fair value each period but are subject to the requirements of IAS 37 and IAS 18.

More mandatory disclosures

The new standards require significantly expanded disclosures. The intent is for users to be able to understand the financial consequences of transactions.

Details of the actual costs of an acquisition (including professional fees paid to investment banks, lawyers and accountants) are required, together with details of the values ascribed to assets and liabilities and an explanation of the amount allocated to goodwill. Acquirers must also disclose the previous IFRS book value of acquired assets and liabilities to allow for comparison with fair values.

The annual disclosures required about the goodwill impairment review are detailed and onerous. Disclosures must be made at the segment or CGU level. Details of the assumptions underlying impairment reviews and an analysis of the sensitivity of the impairment review conclusion to those assumptions must be provided. Specific additional disclosures are required, driven by how recoverable amounts have been estimated.

Disclosures are intended to allow users to assess the reasonableness of management's decisions and assessments. Analysts, shareholders and other users of the financial statements will have more information about the nature and consequences of management decisions on acquisitions than they have ever had before. Directors need to be prepared for better informed questions than in the past.

Is earlier adoption an attractive alternative?

IFRS 3 is mandatory for all new transactions from 31 March 2004. Companies will cease the amortisation of goodwill in respect of previous transactions but are not required to restate assets and liabilities. The balance of goodwill arising on those transactions is tested for impairment from the beginning of the next accounting year. A company with significant goodwill in its balance sheet, particularly from higher priced transactions in the late 1990s, should assess now the potential impact of the impairment review. Any probable impairment charge should be quantified and communicated to the market in an orderly fashion to minimise negative share price movements as a result of unexpected bad news.

IFRS 3 allows for the choice of retrospective application. Provided that the necessary information is available, companies can choose to adopt retrospectively and restate prior periods.

First-time adopters

First-time adopters of IFRS must apply IFRS 3 to transactions after the date of transition but have a choice whether to restate prior acquisitions in accordance with IFRS 3. Companies will want to investigate this option carefully, as the amount of effort involved may outweigh the benefits arising from exercising this option. The option is available for all acquisitions from the date of the earliest selected for restatement; selective restatement is not permitted.

However, first-time adopters must apply the same accounting standards for all periods covered by the first financial statements. Thus a 31 December 2005 first-time adopter will apply the new standards from 1 January 2004 (transition date).

Value will be harder to demonstrate

How will IFRS 3 affect acquisitions?

The intent of the new standards is to highlight what has been acquired and how it performs. Transactions are more transparent with more detailed assignment of purchase price and far more detailed disclosures. Analysts and shareholders will have more ammunition to ask awkward questions. Good management of the communication process is needed to explain precisely what is being acquired at what price and why.

The table below highlights some of the key issues that management should consider at each stage of the transaction process.

	Structure	Evaluation	Communications	Impacts
Planning	• Identify which party is the acquirer; this may not be obvious in a complex transaction.	• Consider the composition of the opening balance sheet and impact of new rules on key ratios.	• Early identification of the key issues is vital and requires an understanding of the accounting and disclosure requirements.	• Determine the likely complexity of the purchase accounting. • Plan early communication to stakeholders of the likely financial impact of the transaction. • Identify additional resources needed to comply with recognition, valuation and disclosure requirements.
Assessing	• Consider how the target fits into the organisation. • Which parts of the business might be at risk from impairment?	• Identify and value all intangible assets and contingent liabilities of the target. • Carry out detailed analysis of all potential assets and liabilities (including those above) to determine impact on the group balance sheet and income statement post-acquisition.	• Stakeholder communications must clarify impact of IFRS 3 on particular deal, e.g. profit impact of intangible asset amortisation.	• Poor definition of CGUs might result in an impairment charge. • Use opportunities to minimise the risks of future impairment only available at the time of the transaction. • Carry out more detailed due diligence to comply with recognition and disclosure requirements. • Assess risk of impairment charges.
Closing	• Plan an appropriate structure for consideration.	• Consider purchase accounting implications of variable share prices in non-cash deals.	• Formulate communications strategy for informing the market in the light of increased transparency of disclosure. • Prepare senior management for more searching questions that may be raised by analysts and others. • Prepare market for any anticipated earnings dilution.	• The estimated value of all contingent consideration is included in the cost of the acquisition and allocated over the assets and liabilities acquired.
Post-deal		• Consider impact of impairment reviews of goodwill and indefinite-lived intangible assets. • First-time adopters consider whether to restate this or other prior transactions in accordance with IFRS 3.	• Prepare market for anticipated impairment charges.	• Impairment charges create earnings volatility. • Efforts involved in restating prior transactions may outweigh the benefits or information may not be available.

Living with IFRS 3

New skills required

- The acquisition process will need to become more rigorous, from planning to execution. Stricter evaluation of targets and structuring of deals will be required to withstand greater market scrutiny. Expert valuation assistance may be needed to establish robust values for items such as new intangible assets and contingent liabilities.
- Many companies informally carry out valuations, assessments and impairment reviews in-house. However, companies may lack the skills to satisfy the requirements of management, the Audit Committee and the auditors. Directors will want sound methodologies and analysis to support answers to analysts' and regulators' questions.

Assess now whether the necessary skills exist in-house and, if they do not, take steps to recruit or train appropriate staff. Alternatively, form relationships with external specialists to provide the services required. The best answer may be a combination of a strong in-house team supported by external specialists as needed.

Transition rules

Companies cease the amortisation of goodwill for previous transactions and test existing goodwill for impairment from the beginning of their next accounting period. Companies should assess whether they are vulnerable to impairments and communicate relevant information to the market.

Early adoption of the new standards is encouraged by the IASB. If management chooses to adopt the provisions of IFRS 3 early, it must simultaneously adopt the provisions of revised standards IAS 36 and IAS 38. IFRS 3 can only be retrospectively applied if all the necessary data on earlier acquisitions, including valuations, is available.

First-time adopters have an option to restate acquisitions prior to the transition date in accordance with IFRS 3. Companies should consider this option carefully as the effort may outweigh the benefits. The option is available for all acquisitions from a certain date; cherry-picking is not permitted.

First-time adopters will be required to apply IFRS 3 for all periods presented. Management should be sure to collect all the relevant data to allow for compliance.

What will the financial statements look like?

- The financial statements following an acquisition will look different. Many new assets will appear, others will be measured on a different basis, and some existing items may need to be removed. Financial statements are likely to include more intangible assets and to show greater volatility in earnings.
- The example below shows how different a company's financial statements might look under IFRS 3.
- Differences will remain between the financial statements prepared in accordance with IFRS 3 and those prepared in accordance with US GAAP. SEC registrants will continue to have reconciling items, even on new transactions. The Appendix to this publication (p19) shows a snapshot view of the differences that exist between accounting for acquisitions under IFRS and US GAAP at the date of publication of IFRS 3. Both regimes continue to review their standards in this area and new proposals are expected from both standard setters this year.

Company A acquires Company B for 600

Balance sheet impact			
Recorded under old GAAP		**Recorded under IFRS 3**	
Price paid	600	Price paid	600
Fair value of tangible assets	250	Fair value of tangible assets	250
Restructuring provision	-50	Fair value of intangible assets	
Goodwill	400	– Trademark/brand	50
		– Customer relationships	250
		Contingent liabilities	-75
		Goodwill	125
Purchase price allocated	600		600
Income statement impact			
EBITDA	70	EBITDA	70
Amortisation of goodwill[1]	-20	Amortisation of goodwill[2]	0
		Amortisation of Intangibles[3]	-53
		Goodwill impairment[4]	(?)
EBIT	50	EBIT	17
Interest	-30	Interest	-30
PBT	20	PBT	-13

EBITDA = earnings before interest, tax and depreciation/amortisation, EBIT = earnings before tax and interest
(1) Assumes goodwill amortisation over 20 years under old GAAP
(2) Goodwill is not amortised under IFRS 3
(3) Assumes 20 year useful life for trademark and 5 year useful life for customer relationships
(4) New annual impairment test may result in an impairment

Appendix

Major differences between IFRS 3 and FAS 141/142 as at 31 March 2004

ISSUE	IFRS 3	US GAAP (FAS 141/142 and related guidance)
Application of the purchase method		
Measurement date of consideration	Cost of a business combination measured at the date of acquisition (i.e. the date on which control passes).	Measured at the date on which the transaction is consummated (closed).
Contingent consideration	Contingent consideration included in the cost of the combination at the acquisition date if it is probable and can be measured reliably.	Generally excluded from the initial purchase price. Adjusted after the contingency is resolved and the additional consideration becomes payable (special considerations exist when there is negative goodwill).
Restructuring provisions	Recognised when the acquiree has, at the acquisition date, an existing liability for restructuring in accordance with IAS 37.	Restructuring provisions are recognised if management, at the date of the acquisition, begins to assess and formulate the plan to exit an activity or terminate or relocate employees of the acquired entity (plan must be finalised within a one-year window).
Contingent liabilities	Recognise separately the acquiree's contingent liabilities at the acquisition date as part of allocating the cost, provided their fair values can be measured reliably.	If fair value can be determined during the allocation period, the contingent liabilities are included in the allocation of purchase price. If the fair value cannot be determined, the contingent liability should be included if it is probable and reasonably estimable (following the guidance in FAS 5).
Minority interests	Any minority interest in the acquiree is stated at the minority's proportion of the net fair values of the acquiree's identifiable assets acquired and liabilities assumed.	Fair values are assigned only to the parent company's share of the net assets acquired. The minority interest is valued at its historical book value.
Negative goodwill	First reassess the identification and measurement of the acquiree's identifiable assets, liabilities and contingent liabilities and the measurement of the cost of the combination. Then recognise immediately in profit or loss any excess remaining.	Reassess whether all acquired assets and assumed liabilities have been identified and properly valued. If negative goodwill remains, acquired assets (with certain exceptions) are proportionately reduced. If all eligible assets are reduced to zero and an amount of negative goodwill still remains, the remaining unallocated negative goodwill must be recognised immediately as an extraordinary gain.

Major differences between IFRS 3 and FAS 141/142 as at 31 March 2004 (continued)

ISSUE	IFRS 3	US GAAP (FAS 141/142 and related guidance)
Goodwill Impairment		
Level of impairment testing (allocation of goodwill to cash-generating units)	Goodwill is assigned to one or more cash-generating units (CGUs). Each represents the smallest CGU to which goodwill can be allocated on a reasonable and consistent basis (i.e. the CGU should represent the lowest level at which management monitors the return on investment in assets that include goodwill). The CGU is not larger than a segment based on either the entity's primary reporting or secondary reporting format (IAS 14, Segment Reporting).	Goodwill is assigned to an entity's reporting unit (i.e. an operating segment, as defined in FAS 131) or one level below an operating segment (i.e. a component). A component of an operating segment should be deemed a reporting unit if: (1) that component constitutes a business for which discrete financial information is available, and (2) segment management regularly reviews the operating results of that component. When two or more components of an operating segment have similar economic characteristics, those components should be aggregated and deemed a single reporting unit. An operating segment should be deemed to be the reporting unit if: (1) all of its components are similar, (2) none of its components is a reporting unit, or (3) it is comprised of only a single component.
Impairment test for goodwill	The impairment test is performed under a one-step approach. The recoverable amount of the cash-generating unit (i.e. the higher of an asset's net selling price and its value in use) is compared to its carrying amount. The impairment loss is recognised as the difference. If the impairment loss exceeds the book value of goodwill, complex allocation rules must be followed.	Goodwill impairment is calculated using a two-step approach. Under Step 1, the entity compares the fair value (FV) of the reporting unit with the unit's carrying amount (CV), including goodwill. When the FV is greater than the CV, the reporting unit's goodwill is not considered as impaired, and Step 2 is not required. When the CV is greater than the FV, the reporting unit's goodwill may be impaired, and Step 2 must be completed to measure the amount of a goodwill impairment loss, if any exists. Under Step 2, the entity compares the implied fair value of the reporting unit's goodwill with the carrying amount of reporting unit's goodwill. If the carrying amount of the reporting unit's goodwill is greater than the implied fair value of its goodwill, an impairment loss must be recognised for the excess. The implied fair value of a reporting unit's goodwill is calculated in the same manner as the amount of goodwill that is recognised in a business combination would be determined under FAS 141. This process involves allocating the reporting unit's fair value (as determined in Step 1) to all of the reporting unit's assets and liabilities (both recognised and unrecognised).

Major differences between IFRS 3 and FAS 141/142 as at 31 March 2004 (continued)

ISSUE	IFRS 3	US GAAP (FAS 141/142 and related guidance)
Intangibles		
IPR&D (initial recognition and measurement)	IPR&D is recognised as an intangible asset. If is not separately recognised as an intangible asset, it is subsumed in goodwill. Subsequent expenditure on IPR&D can be capitalised if certain criteria are met (development phase).	IPR&D is charged to expense unless it has an alternative future use. Subsequent expenditure on IPR&D is expensed as incurred.
Measuring impairment of indefinite-lived intangibles	The impairment loss should be calculated as the difference between the recoverable amount (i.e. the higher of the net selling price of the value in use) and the carrying amount. Indefinite-lived intangibles could be tested as part of the CGU.	The impairment test compares the fair value of the intangible asset with the asset's carrying amount. If the fair value of the intangible asset is less than the carrying amount, an impairment loss should be recognised in an amount equal to the difference. Indefinite-lived intangibles must be tested separately from goodwill (i.e. separate from the reporting unit to which goodwill has been allocated).
Reversals of impairment losses for indefinite-lived and finite-lived intangibles	Reversals of impairment losses are allowed under specific circumstances.	Reversals of impairment losses are prohibited.

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Copies are available free on the website www.pwc.com/ifrs. For further information, send an email to the editor: joanna.c.malvern@uk.pwc.com

World Watch

Governance and corporate reporting

There is growing recognition of the importance of transparency and common business languages for financial reporting and governance. Our regular newsletter, *World Watch*, contains opinion articles, case studies and worldwide news on the many initiatives to improve corporate reporting.

Copies are available free on the website www.pwc.com/ifrs. For hard copies and further information, send an email to the editor: sarah.grey@uk.pwc.com

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