NEW IASB STANDARD TO SWAP GOODWILL FOR INTANGIBLES

The IASB has been putting the finishing touches on its IFRS 3 *Business combinations*, with publication expected by the end of March. The final standard, expected to be largely unchanged from the preceding ED 3 *Business combinations*, will greatly impact accounting for acquisitions and the earnings of acquisitive companies.

Anticipated requirements

Merger accounting will no longer be permitted and will be replaced by the 'purchase' method. Companies will no longer be able to allocate the excess of purchase price above fair value to goodwill.

Companies will be required to complete a Purchase Price Allocation for the assets and liabilities acquired in a business combination. They will have to value intangible assets separately and record them separately in the balance sheet. Intangible assets include brands and trademarks, customer contracts, licenses and patents, software and customer relationships.

The valuation approach used for each type of intangible asset will vary. For example, software will typically be valued at cost, while an income basis using a cash-flow model will be used for customer contracts and patents. "It will be important to ensure that the treatment is appropriate and consistent with that used in the sector," says Andreas Mackenstedt, a partner at PricewaterhouseCoopers in Germany and a business combinations accounting specialist. "There will be an evolving consensus of what is acceptable. There is no valuation cookbook," says Mackenstedt.

Intangible assets other than goodwill will either be amortised over their 'useful life' or, if appropriate, assigned 'indefinite lives'. Assets with such indefinite lives must undergo an annual impairment test.

The useful lives of intangible assets are typically expected to be:

- **Brands/trademarks**
20 years or indefinite life
- **Customer contracts**
Life of contract
- **Licenses/patents**
Life of agreement
- **Software**
3-5 years
- **Customer relationships**
5-10 years

Residual goodwill will not be amortised but will be subject to a more stringent annual impairment test. If goodwill is impaired, an immediate charge will be taken to the profit and loss account.

The impairment tests on goodwill and any intangible assets with indefinite lives must be conducted at the level of a cash-generating unit (CGU). The CGU's recoverable amount (the higher of net selling price and value in use) should be compared against the carrying amount. Any shortfall in recoverable amount should be treated as impairment and allocated first to goodwill; any remaining shortfall should then be allocated to the other assets on a pro-rata basis (based on the carrying amount of each asset).

Restructuring costs will be recorded against post-acquisition earnings.

Impact of IFRS 3

The removal of goodwill amortisation and the introduction of intangible amortisation will impact earnings. Short-term EPS may fall in some cases as a result of the increased number of short-lived intangible assets, which may lead to higher amortisation charges in the early years after an acquisition. Earnings may also be more volatile as the predictable old annual goodwill amortisation charge is replaced by periodic impairment reviews.

Also note that impairments are most likely to occur in years of already poor financial performance, when market and economic values are more depressed, further depressing profits in years that are already difficult.

Companies applying the standard from January 2005 will need to provide comparative figures for 2004, which means that the standard will have to be applied to all acquisitions made from 1 January 2004.

Transparency

IFRS 3 will increase transparency in relation to acquisitions. The increased information disclosed about the value of components that make up the purchase price will give analysts a more immediate indication of whether companies overpaid for their acquisitions. "By decomposing the goodwill blob, the new reporting will give a good image of what's going on," says Richard Winter, a partner at PricewaterhouseCoopers. "Similarly, the compulsory impairment test will highlight the success – or failure – of acquisitions." Any loss of value in goodwill will be expensed immediately to the P&L.

The increased disclosure requirements in IFRS 3 will give analysts and shareholders more information with which to challenge the performance of management. Therefore, PwC recommends that management teams consider the financial impact of proposed acquisitions thoroughly so that they will be able to answer probing questions effectively. "Most companies are not taking this [ED 3] into consideration in their due diligence for acquisitions,"says Mackenstedt. "That's not helpful, because they need to know if the acquisitions are earnings-neutral, enhancing or dilutive."

Mistakes can be made by companies and banks in assessing the impact of an acquisition. For example, PwC analysed one potential acquisition and concluded that the value of intangibles was twice as high as the figure estimated by an investment bank's high-level analysis. This meant the deal would not enhance EPS until 2005 – a year later than the bank's analysis suggested.

Note: At the time of going to press it was not possible to guarantee that IFRS 3 would be similar to ED 3 in the elements discussed above.

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Useful links

- **ED 3 can be found on the IASB's website at *www.iasb.org/uploaded_files/documents/8_38_ed3.pdf***
- **PwC's analysis of the impact of ED 3 is at *www.pwcglobal.com/pl/eng/about/svcs/abas/ias/iss1ed3.html#01***