

# FACT SHEET

## Retrospective Application of IFRS 3, Business Combinations

### Introduction

All European quoted companies are required to prepare financial statements in accordance with International Financial Reporting Standards (IFRS) including International Accounting Standards (IAS) from 2005. Companies in a number of other jurisdictions, notably Australia, Canada and New Zealand, will also adopt IAS in a similar timeframe.

One standard, IFRS1 deals with the first time adoption of IFRS financial statements by companies, while IFRS 3 deals with Business Combinations.

When companies adopt IFRS for the first time, they may elect to apply IFRS 3 either from the date of adoption of all IFRS or retrospectively from an earlier date.

### Who Should Consider Retrospective Adoption of IFRS 3

Some companies will recognise significant benefits by electing to adopt IFRS 3 retrospectively. You should seriously consider this election if:

- Intangible assets, particularly brands, are key business drivers.
- Your intangible assets are not currently reported on the balance sheet
- You made significant acquisitions of brands or other intangible assets in recent years
- You have good historic records

### Advantages of Retrospective Adoption

Business combinations completed in the recent past will have been accounted for under local GAAP rules then in force. For instance for UK companies this includes the recognition of goodwill on acquisition and its amortisation, usually over 20 years, in accordance with FRS 10. Prior to the introduction of FRS 10, in 1998, goodwill was commonly written off against reserves.

For acquisitive companies, goodwill frequently represents a significant proportion of total net assets but it is a poorly defined and understood asset. Amortisation over an arbitrary period has been required, but this has no impact on cash flows and is routinely ignored by analysts and investors.

Retrospective adoption of IFRS 3 allows companies to restate previous business combinations as if IFRS 3 had been applicable at the date of acquisition. Companies can recognise intangible assets previously included in goodwill. In the case of brands, they may determine that they have indefinite lives and require no amortisation. Much of a company's goodwill can be reclassified as more meaningful, albeit intangible, assets that analysts and investors can understand and recognise.

Where intangible assets, such as brands, are key drivers of a company's business, their recognition on the balance sheet sends a powerful message to the investment community. Where a competitor already recognises intangible assets, comparability is improved.

Goodwill amortisation can be reversed and goodwill previously written off on acquisition can be reinstated, thereby increasing a company's net assets. This may improve credit ratings and enable companies to negotiate additional financing, and even lower interest rates.



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For multinational groups, intangible assets recognised as a result of the retrospective application of IFRS 3 may be in different functional currencies to the goodwill they replace. This may assist in providing suitable assets for hedging purposes under IAS 39.

Recognition of intangible assets on the balance sheet will increase management's focus on these business drivers.

### Retrospective Adoption in Practice

Retrospective adoption of IFRS 3 is onerous and time consuming and many companies will decide that the costs outweigh the benefits. However, some companies will recognise the opportunity of real benefits.

Companies may elect to apply IFRS 3 from any chosen date, but must apply it consistently to all business combinations after that date. IAS 36, Impairment of Assets and IAS 38, Intangible Assets must both be applied from the same date as IFRS 3. The adoption process must, of course, be audited.

All of the provisions of IFRS 3 must be followed to each business combination, so that fair value adjustments to a variety of acquired assets and liabilities, such as stocks, fixed assets, pension liabilities and deferred tax must all be determined. Frequently the fair values under IFRS will not vary materially from those under local GAAP and can be ignored.

The fair values of assets must be determined using contemporaneous information collected at the time when the acquisitions were originally accounted for. Compliance with IAS 36 and IAS 38 must also use historic information. In practice, this requirement makes adoption progressively more difficult the further back a company elects to go. The most suitable adoption date is likely to be determined by the availability of historic records to support the process.

For instance, for the impairment testing of any remaining goodwill, the asset value would normally be compared to the net present value of future cash flows. These forecasts of future cash flows must be based upon information available as at the date of the test without the benefit of hindsight. In practice this means that companies need to be able to access budgets, forecasts and strategic plans prepared at the time. As goodwill impairment cannot be reversed, it is necessary to carry out the impairment tests at each balance sheet date subsequent to the date of application of IFRS 3.

For intangibles other than goodwill, reversal of impairment is permitted under IFRS and therefore, it is only necessary to test for impairment at the latest balance sheet date.

### Timing

Retrospective adoption of IFRS 3 is only permitted when a company adopts IFRS for the first time, in accordance with IFRS 1. Precise timing depends on the company's year end reporting date and implementation must be completed for the first reporting under IFRS, normally interim financial statements. Thus for a company with a December year end, the first IFRS reporting will be for their interim statements for the six months to 30th June 2005, while a company with a September year end will report the six months to 31st March 2006.

*Allan Caldwell, Intangible Business*

*Intangible Business Ltd*

