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IFRS 3 - Accounting Implications

A digest of accounting implications arising from IFRS 3 Business Combinations, which is a controversial and difficult area of accounting.

Introduction to IFRS 3

Values of all acquired assets must be separately identified for balance sheet reporting under IFRS 3 Business Combinations. IFRS 3 is a complex standard, particularly concerning intangible assets. It requires technical expertise to ensure its application conforms to regulator guidelines and also has the best interests of the company at heart. There are a number of issues to consider with potentially significant implications going forward for the company's balance sheet and income statement, which this article will discuss.

Valuation of intangible assets

IFRS 3 states that all separately identifiable and measureable intangible assets must be valued and placed within marketing, customer, artistic, contract or technology related categories. Valuations must be carried out by a company independent of the business and auditors and be at 'the amount for which an asset could be exchanged or a liability settled, between knowledgeable, willing parties in an arm's length transaction' – fair value. Valuation methods include economic income approach, market approach and the cost creation or recreation approach.

Potential for double-counting under fair values

Valuations of some assets such as intangibles, real estate and inventory may double-count elements of value. This can occur where valuations are based on future income which is generated by more than one asset. This means that valuations of different classes of assets need to be fully understood and analysed to ensure that there is no inappropriate double- counting of value.

Associated tax liabilities

Acquisitions have considerable tax implications which require careful consideration during the purchase price allocation (PPA) process. The PPA process results in uplifts to net asset values and the recognition of intangible assets in the financial statements of the acquired company which has potential tax implications. Adjustments for consequent tax need to be considered.

Profit implications of the PPA

The PPA can impact on reported profit of the acquired company post-acquisition. For instance, a fair value uplift in the value of plant, property and equipment increases the subsequent depreciation charge in the income statement. Also, an uplift on inventory increases the cost of goods sold until the inventories acquired are consumed. If the acquired entity carried extensive inventory for which the fair market value is near its sale price, it may record losses for a period post acquisition.

Profit implications of intangible asset values

Intangible assets with finite lives are amortised over their useful lives. The estimate of useful life may have a significant impact on profit reported post-acquisition. Intangible assets with indefinite lives are subject to an annual impairment test. If an intangible asset is found to be impaired, this results in a corresponding write-down of reported profits. If values are found to have increased there can be no recognition upwards. In practice this encourages the recognition of the lowest defensible figure.

Profit implications of goodwill value

As goodwill is a residual, the value of intangible assets recognised within the PPA reduces the value of goodwill on the acquisition. This is important because impairment losses on goodwill cannot be reversed, whereas impairment losses on other assets can be reversed in certain circumstances. The acquiring company will seek to ensure that provisions are made where there is a present obligation from a past event at the acquisition date to ensure that post-acquisition profit is not restricted when expenditure is subsequently incurred.

Impairment testing of assets

IAS 36 Impairment of Assets defines the methodology for calculating impairment losses on non-current assets, including goodwill. Where possible, individual assets should be tested for impairment separately. However, where cash flows are generated by a combination of assets, assets are grouped within cash-generating units (CGUs) for the purpose of impairment testing. A CGU is defined as 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."

IFRS 3 treats goodwill as an asset with an indefinite life and requires tests to be performed annually to determine whether it is impaired. An impairment charge is recognised in the income statement where the carrying value of goodwill is greater than its recoverable amount. The impact is that impairment charges will be raised on an irregular basis when economic factors impact the recoverable value of goodwill. As a consequence reported profits are likely to be considerably more volatile than under the amortisation of goodwill method.

Allocation of impaired goodwill

IAS 36 Impairment of Assets states that goodwill should be allocated to CGUs for the purpose of impairment testing. Goodwill represents the future economic value of assets which cannot be individually identified and separately valued. It does not generate cash flows on its own and may contribute to the cash flows of a number of separate CGUs. Consequently, goodwill is allocated to the CGUs which are expected to benefit from the synergies arising from the business combination.

Defining CGUs

Determining CGUs is a subjective process. Since cash flow forecasts are required to perform impairment tests, identifying too many CGUs increases complexity, whilst a small number of large CGUs may conceal poorly performing operations. IFRS 3 addresses this issue by stating that goodwill is allocated to:

- the lowest level at which goodwill is monitored for internal management purposes; and that
- this must not be larger than an operating segment determined in accordance with IFRS 8 Operating Segments.

Testing CGUs for impairment

CGUs to which goodwill has been allocated must be tested annually and whenever there is an indication that a CGU may be impaired. External indicators include adverse changes in market values, regulatory environment, market conditions or discount rates. Internal indicators include deterioration of cash flows, restructuring and reorganisation. When an impairment loss is identified in a CGU, it must be apportioned initially against goodwill and any excess against the other assets within the CGU on a pro rata basis. However, the value of any individual asset within the CGU should not be reduced below its recoverable amount, if determinable, or zero.

Inventory step-up

Inventory step-up represents the mark-up applied to the cost of finished goods. IFRS 3 (2004) states that the fair value "for inventories of (i) finished goods and merchandise the acquirer shall use selling prices of finished goods less the sum of (1) cost of disposal and (2) a reasonable profit allowance for the selling effort of the acquirer based on profit for similar finished goods and merchandise." IFRS 3 (Revised 2008) is however silent on how the fair value of inventory should be calculated in an acquisition. The key implications are that inventory values could be overstated or understated and the value of inventory may be susceptible to manipulation. This highlights the need for advice and strong technical analysis, to help apply IFRS 3 appropriately to determine the fair value of inventories.

Cost efficiency

IFRS 3 raises many potentially complex and costly issues. It is necessary to have a good handle on what is reasonable and proportionate in terms of resource, so that the accounting implications are fully understood and the associated costs are not disproportionate.

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