



International Accounting Standards Board®

Press Release

5 December 2002

IASB PUBLISHES PROPOSALS ON ACCOUNTING FOR BUSINESS COMBINATIONS

The International Accounting Standards Board (IASB) today published for public comment proposals on the accounting for business combinations. The proposals are set out in exposure draft ED 3 *Business Combinations*, and an Exposure Draft of Proposed Amendments to IAS 36 *Impairment of Assets* and IAS 38 *Intangible Assets*. The IASB invites comments on the Exposure Drafts by 4 April 2003.

The IASB announced in July 2001 that it would undertake a project on Business Combinations as part of its initial agenda, with the objective of improving the quality of, and seeking international convergence on, the accounting for business combinations. The project has two phases. ED 3 and the Exposure Draft of Proposed Amendments to IAS 36 and IAS 38 have been published as part of phase I.

The main features of the IASB's proposals are:

- all business combinations within the scope of ED 3 would be accounted for using the purchase method. The pooling of interests method would be prohibited.
- costs expected to be incurred as a result of a business combination to restructure the acquired entity's (or acquirer's) activities would be treated as post-combination expenses, unless the acquired entity has a pre-existing liability for restructuring its activities
- acquired intangible items would be recognised as assets separately from goodwill if they meet the definition of an asset, and are either separable or arise from contractual or other legal rights
- identifiable assets acquired, and liabilities and contingent liabilities assumed, would be initially measured at fair value
- there would be no amortisation of goodwill or intangible assets with indefinite useful lives. Instead they would be tested for impairment annually, or more frequently if events or changes in circumstances indicate a possible impairment.

One of the primary objectives of phase II of the project will be to eliminate remaining differences between International and national standards on business combinations. Matters to be addressed include:

- issues related to applying the purchase method of accounting. This is being run as a joint project with the US Financial Accounting Standards Board (FASB)
- the accounting for formations of joint ventures and business combinations involving entities under common control
- possible applications for ‘fresh start’ accounting.

Introducing the Exposure Drafts, Sir David Tweedie, IASB Chairman, said:

“Accounting for business combinations diverges substantially across jurisdictions. These proposals mark a significant step toward achieving high quality standards in business combination accounting, and in ultimately achieving international convergence in this area. Although many of the proposals are consistent with standards issued in Canada and the United States during 2001, the IASB has drawn on requirements in other jurisdictions when it believed a higher quality solution existed. This project is a good example of how convergence can and should work—for instance, the FASB has agreed to reconsider its own standards on the treatment of restructuring costs that are expected to be incurred as a result of a business combination.”

Copies of ED 3 and the Exposure Draft of Proposed Amendments to IAS 36 and IAS 38 (ISBN 1-904230-06-7) are available, at £20 for the two exposure drafts (€32/US\$31) including postage, from:

IASB Publications Department, 30 Cannon Street, London EC4M 6XH, United Kingdom.

Tel: +44 (0)20 7246 6410, Fax: +44 (0)20 7332 2749,

email: publications@iasb.org.uk. Web: www.iasb.org.uk

Subscribers to the IASB’s *Comprehensive Subscription Service* can view the exposure draft from the secure online services area of the IASB’s Website. From 16 December the complete text of the exposure draft will be freely available from the Website.

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NOTES TO EDITORS

The Proposals

1. The proposals in ED 3 deal with the accounting for business combinations and the ongoing accounting for goodwill acquired in business combinations—they would replace the requirements in IAS 22 *Business Combinations*. The changes proposed in the Exposure Draft of Proposed Amendments to IAS 36 and IAS 38 are primarily concerned with:
 - the impairment test for goodwill;
 - the accounting for intangible assets, including in-process research and development projects, acquired in business combinations; and
 - determining the useful life and amortisation of intangible assets.

The IASB's intention in developing these proposals was *not* to reconsider all of the requirements in IAS 36 and IAS 38.

2. In December 1998, the IASC (the IASB's predecessor body), along with other members of the G4+1,* published for public comment a Position Paper *Methods of Accounting for Business Combinations: Recommendations of the G4+1 for Achieving Convergence*. The Paper argued that the use of a single method of accounting for business combinations is preferable to two or more methods, and that the appropriate method is the purchase method. The Paper noted that its recommended approach was consistent with standards in Australia and proposed (now existing) standards in New Zealand, and recommended that the IASC and other G4+1 members should consider amending their standards. In June 2001, the FASB issued Statement of Financial Accounting Standards No. 141 *Business Combinations*, and the Canadian Accounting Standards Board issued Section 1581 *Business Combinations*. Both those Standards prohibit the use of the pooling of interest method of accounting for business combinations, and instead require all business combinations to be accounted for by applying the purchase method. In July 2001, the IASB, after consulting its Standards Advisory Council (SAC), decided that a project to achieve convergence of existing standards on business combinations should be added to the Board's agenda.

* The G4+1 comprised members of the national accounting standard-setting bodies of Australia, Canada, New Zealand, the UK and the US, and IASC.

3. The main proposals in ED 3 are:
 - (a) consistently with the prohibition of the pooling of interests method in Australia, Canada, New Zealand and the United States, all business combinations within the scope of ED 3 should be accounted for using the purchase method.
 - (b) in applying the purchase method, an acquirer should not recognise provisions for future losses or other costs expected to be incurred as a result of the business combination. Therefore, unless an acquired entity has, at the acquisition date, an existing liability for restructuring its activities, costs expected to be incurred as a result of the business combination to restructure the activities of the acquired entity (or the acquirer) should be treated as post-combination expenses. This is consistent with the requirements of UK Financial Reporting Standard FRS 7 *Fair Values in Acquisition Accounting*.
 - (c) in applying the purchase method, an intangible item acquired in a business combination, including an in-process research and development project, should be recognised as an asset separately from goodwill if it meets the definition of an asset, and is either separable or arises from contractual or other legal rights. Except for the treatment of in-process research and development projects, this is consistent with requirements in Canadian and US standards.
 - (d) to remove the option that currently exists in IAS 22 for initially measuring the acquired identifiable net assets. Under that option, an acquirer can elect to measure an acquired identifiable item at its fair value, or at a mixture of its fair value and pre-combination carrying amount. For example, assume entity A acquires a 60% ownership interest in entity B, and that one of entity B's assets is a building with a carrying amount of 1,000 and fair value of 2,000. Under IAS 22, A can elect to initially measure the building at 2,000 (fair value), or at 1,600 (fair value for the 60% ownership interest acquired, plus pre-combination carrying amount for the 40% ownership interest that continues to be held by parties other than A). ED 3 proposes to require the acquired identifiable net assets to be measured initially by the acquirer at their fair values at the acquisition date.
 - (e) consistently with requirements in Canadian and US standards, goodwill acquired in a business combination should not be amortised. Instead it should be tested for impairment annually, or more frequently if events or changes in circumstances indicate that it might be impaired.
 - (f) if the acquirer's interest in the net fair value of the acquired identifiable net assets exceeds the cost of the business combination, that excess (sometimes referred to as negative goodwill) should be recognised immediately in the income statement as a gain.
4. The IASB and the FASB, through their joint phase II Business Combinations project, are working to eliminate remaining differences in the application of the purchase method between International Financial Reporting Standards and US accounting standards. As a result of those efforts, the FASB has tentatively agreed to amend its standards to converge with the proposals outlined in 3(b), (d) and (f) above. The FASB is also reconsidering whether it should review US requirements for the treatment of in-process research and development projects acquired in a business combination.
5. The main proposals in the Exposure Draft of Proposed Amendments to IAS 36 and IAS 38 are:
 - (a) if a cash-generating unit within an entity is impaired (in other words, the unit's recoverable amount is less than its carrying amount), an assessment should be

made of the *extent* to which the impairment loss relates to any goodwill in that unit. This would involve comparing the carrying amount of the goodwill in the unit with its implied current value. The implied current value of the goodwill would be measured consistently with the way that goodwill is measured in a business combination—the recoverable amount of the unit would be treated as though it were the ‘purchase price’, and the net fair value of the identifiable net assets of the unit on the date of the impairment test would be deducted from that amount.

- (b) reversals of impairment losses for goodwill should be prohibited. This is consistent with Canadian and US requirements.
- (c) an intangible asset should be treated as having an indefinite useful life when, based on an analysis of all relevant factors, there is no foreseeable limit on the period over which the asset is expected to generate net cash inflows for the entity. An intangible asset with an indefinite useful life would not be amortised, but would instead be tested for impairment at the end of each annual reporting period, or more frequently if events or changes in circumstances indicate that it might be impaired. This is consistent with requirements in Canadian and US standards.
- (d) to require disclosure of a range of information for each segment that includes within its carrying amount goodwill or intangible assets with indefinite useful lives. That information is concerned primarily with:
 - the key assumptions used to measure the recoverable amounts of the cash-generating units in the segment that include within their carrying amounts goodwill or intangible assets with indefinite useful lives; and
 - the sensitivity of the recoverable amounts of those units to changes in the key assumptions.

The non-amortisation of these assets increases the reliance that must be placed on their impairment tests. However, the nature of impairment tests means that the carrying amount of a non-amortised asset, and the related assertion that the asset is not impaired, would often be supported only by managements’ projections. The IASB has therefore included these disclosure requirements in the proposals in order to improve the transparency and reliability of impairment tests for goodwill and intangible assets with indefinite useful lives.

Form of Publication

- 6. As with EDs 1 and 2, the IASB is publishing ED 3 as three separate booklets. The first contains the requirements of the proposed standard; the second contains the Basis for Conclusions, which sets out the IASB’s reasoning behind its proposals; and the third consists of draft illustrative examples.

The IASB

- 7. The IASB, based in London, began operations in 2001. It is funded by contributions collected by its Trustees, the IASC Foundation, from the major accounting firms, private financial institutions and industrial companies throughout the world, central and development banks, and other international and professional organisations. The 14 IASB members (12 of whom are full-time) reside in nine countries and have a variety of professional backgrounds. The IASB is committed to developing, in the public interest,

a single set of high quality, global accounting standards that require transparent and comparable information in general purpose financial statements. In pursuit of this objective, the IASB cooperates with national accounting standard-setters to achieve convergence in accounting standards around the world.