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AUDIT

In this edition, we discuss some challenges that may be encountered in applying the latest standard on business combinations. In addition, we highlight recent developments in the international financial reporting arena that may be of interest to Singapore companies.

In the August 2004 issue of *Financial Reporting Matters,* we highlighted significant changes in accounting for business combinations, intangibles and impairment. These changes became effective for annual financial periods beginning on or after 1 July 2004. Entities with 31 December financial year-ends will be implementing the relevant standards for the first time in the financial year ending 31 December 2005.

We believe the successful implementation of the new standard on business combinations requires better appreciation of specific issues such as the following:

- identification and valuation of intangible assets acquired in business combination;
- impairment of goodwill;
- step acquisitions;
- reverse acquisitions; and
- accounting for the business combination on a provisional basis.

We discuss the first two items in this edition and will continue our discussion of the other items in the next edition to be published in April 2005.

The last two months of 2004 were eventful months in the international financial reporting arena. The hive of activities resulted in the issuance of one new standard, amendments to two existing standards, four new interpretations and one amendment to an existing interpretation. As we believe that the Council on Corporate Disclosure and Governance (CCDG) is currently reviewing and considering these new standards and interpretations for adoption in Singapore, we also discuss the implications of relevant international changes in this edition of *Financial Reporting Matters.*

Latest Developments

On 4 February 2005, CCDG announced the adoption of FRS 40 *Investment Property* for annual periods beginning on or after 1 January 2007. Early adoption is allowed. Under FRS 40, companies are able choose to carry their investment properties at fair value or at cost less accumulated depreciation. If carried at fair value, fair value changes from period to period are taken to the profit and loss account. We will discuss further the implementation of FRS 40 in the June 2005 edition of *Financial Reporting Matters.*

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A. Recognising intangible assets in a business combination

Identifying intangible assets

The current accounting standard on business combinations before the latest FRS 103 *Business Combinations* already requires the acquirer to recognise intangible assets separately from goodwill. However, in practice, these intangible assets are subsumed within goodwill on the grounds that the assets do not meet the 'identifiable and separable' criteria set out in the current standard on intangibles.

The objective of the latest set of standards affecting business combinations is to clarify that an intangible asset is identifiable if it is separable or arises from contractual or legal rights. This clarification is now written into the revised FRS 38 *Intangible Assets* (2004), and hence it is expected that more intangible assets would meet the 'identifiable and separable' criteria. Items such as trademarks, magazine mastheads and even customer lists would therefore be recognised in a business combination. Further examples are provided in the Illustrative Examples (IE) section of FRS 103.

Determining fair value

Identifiable intangible assets acquired in a business combination are recognised initially at their estimated fair value. Fair value is the amount at which an asset could be bought or sold between a willing buyer and a willing seller other than in a forced sale or liquidation.

FRS 38 (2004) sets out a certain hierarchy for determining the fair value of an intangible asset:

- Firstly, the quoted market price of an identical intangible asset in an active market is considered to be the most reliable estimate of the fair value of an intangible asset. The appropriate market price is usually the current bid price.
- Secondly, if no active market exists for an intangible asset, observable prices of similar intangible assets in recently completed transactions may be used.
- Specific valuation techniques may be used if it is not possible to obtain the fair value using the first two methods.

In the case of an active market, it is not necessary for the intangible asset to be traded on an exchange in order for it to meet the definition. Instead, a market is considered active if the items traded in the market are homogenous, there are willing buyers and sellers at any time and the prices are available to the public. For example, we could conclude that the trading of taxi licences or fishing rights would constitute an active market because they meet the above three criteria even though they are not traded on an exchange.

However, it is unlikely that there is an active market for identical intangible assets in most instances. If prices of similar assets in recent transactions are available, an entity may estimate the fair value of the intangible asset by making reference to these prices and making the necessary adjustments. However, such a process requires detailed analysis and is likely to be highly subjective.

Our conclusion is that in most cases, the acquirer would have to use specific valuation techniques with the help of professional valuers in valuing intangible assets acquired in a business combination.

International Valuation Standards Committee-Guidance Note No 4

The standard does not set out detailed criteria for performing a valuation. However, we found some guidance in Guidance Note No 4 (GN 4) issued by the International Valuation Standards Committee, a Non-Government Organisation member of the United Nations. According to GN 4, valuation approaches for intangible assets are the 'cost to recreate', 'income capitalisation' and 'market' approaches. Factors to be considered in the valuation of intangibles include rights, privileges or conditions that are attached to the ownership interest, remaining economic life / legal life, earnings capacity, nature and history, economic outlook of relevant economies, and the condition and outlook of the specific industry.

Determining useful life - the period over which an asset is expected to generate net cash inflows to an entity

The subsequent accounting for an intangible asset depends on its useful life. An intangible asset with an indefinite useful life is not amortised but tested for impairment at least annually. An intangible asset with a finite useful life is amortised and tested for impairment only when a triggering event occurs.

When an intangible asset has an indefinite useful life, it means that the asset is able to generate net cash inflows to the entity beyond the foreseeable horizon. Indefinite does not mean infinite. Difficulties in determining the precise useful life of an intangible asset is not a basis for regarding useful life as indefinite. In such a case, we should use a best estimate for determining useful life.

When determining the useful life of an intangible asset, an entity considers:

- legal, regulatory or contractual provisions that may limit useful life;
- the effects of obsolescence, demand, competition and other economic facts such as stability of the industry, known technological advances or expected changes in distribution channels;
- the expected useful life of an asset or a group of assets of the entity to which the useful life of the intangible asset may relate to;
- the expected usage of the asset by the entity; and
- the level of maintenance expenditure required to obtain the expected future economic benefits from the asset. As with determining the useful life of property, plant and equipment, regular maintenance may be assumed, but not enhancements.

In considering whether the useful life should include the renewal period, a history of renewal without substantial cost would constitute important evidence. Without that, the renewal period should be ignored.

If the cost of renewal is significant when compared to the future economic benefits expected to flow to the entity from renewal, then this cost is considered as the cost to acquire a "new" intangible asset at the renewal date.

Reviewing useful life

The useful lives of intangible assets should be reviewed at least at each financial year-end and any change in the estimate is accounted for prospectively. It is expected that only mature products and brand names would be considered to have an indefinite life. Although an intangible asset may not currently have an indefinite life, the passage of time and other evidence could lead to a reassessment of the useful life and result in a conclusion that the useful life has become indefinite.

B. Impairment testing of goodwill

Goodwill is not amortised but tested for impairment

Under the new standard on business combinations and the revised standard on intangibles, goodwill acquired in a business combination should be recognised as an asset and initially measured at cost. However, after initial recognition, goodwill is not amortised but tested for impairment annually and when indicators of impairment occur.

Some examples of indicators of impairment are:

- adverse changes in legal factors, business climate, or regulatory environment;
- loss of key personnel; or
- unanticipated competition.

Impairment loss is recognised in the profit and loss account when the carrying amount of the cash-generating unit (CGU) to which goodwill is allocated exceeds the recoverable amount of that unit.

Selecting impairment testing dates

An entity does not have to test goodwill for impairment as of the balance sheet date. The standard allows an entity to perform the impairment test at any time during the year, provided it is performed at the same time every year. However, in the year when indicators of impairment occur other than at the impairment test anniversary date, an entity will have to test goodwill for impairment more than once. It may be possible to use the recent detailed calculation of recoverable amount provided certain criteria are met.

In addition, a different CGU to which goodwill is allocated may be tested for impairment at a different time. That being the case, we suggest that management should select goodwill impairment testing dates that will give the entity sufficient time to complete the impairment tests by the external reporting deadlines.

Sequence of impairment testing

When performing impairment testing for goodwill, there may be indicators that an asset in the CGU to which goodwill is allocated, is impaired. In such a situation, the entity tests the asset for impairment first and recognises any impairment loss for that asset before testing the CGU where goodwill is allocated for impairment. Therefore, it is possible that an entity carries out an impairment test on an individual asset at a time other than at the balance sheet date.

Illustrative example

Entity A's year-end is 31 December and it reviews goodwill for impairment annually in August. Goodwill is allocated to CGU X, Y and Z. In August 2006 when Entity A performs impairment testing of goodwill, there is indication that an asset in CGU Y may be impaired. Hence, Entity A tests the individual asset for impairment in August 2006 and recognises any impairment loss *before* proceeding to test goodwill in CGU Y for impairment.

Identifying CGU to allocate goodwill

As goodwill does not generate cash flows independently of other assets, an impairment test cannot be carried out on goodwill alone. For purposes of impairment testing, goodwill should be allocated to any CGU that is expected to benefit from the synergies of the business combination. Thus, if the acquirer's existing CGU also benefits from the acquisition, goodwill must also be allocated to that CGU even though acquired assets and liabilities are not assigned to that CGU.

The revised FRS 36 *Impairment of Assets* (2004) permits an entity to allocate goodwill to a group of CGUs as it recognises that goodwill sometimes cannot be allocated to an individual CGU without some arbitrary assumptions.

When a business combination enhances the value of all the acquirer's pre-existing CGUs, some preparers may conclude that goodwill should be tested for impairment only at the entity level. However, this conclusion is flawed. An entity should test goodwill for impairment at a level where management monitors its operations and assets, for example at the segment level. In a situation where an entity monitors its operations on a matrix basis, the CGU to which goodwill is allocated should not be larger than a segment based on either the entity's primary or secondary reporting under FRS 14 *Segment Reporting*.

Illustrative example

Retail store chain M acquired stores A and B during the year and goodwill on acquisition was recognised. Chain M has 30 other stores around the country. All the stores purchase their products through Chain M's central purchasing centre. Chain M decides pricing, marketing, advertising and human resources policies. Chain M also monitors and measures the performance of each store on an individual basis. However, all stores hire their own cashiers and sales staff.

In this case, it is likely that stores A and B are individual CGU. This is because Chain M's stores are in different cities and have different customer bases. Although the stores are managed at a corporate level, each store generates cash inflows that are largely independent of the others.

As each store represents the lowest level at which Chain M monitors its internal operations, the goodwill arising from the acquisition of stores A and B is allocated between stores A and B, assuming the existing 30 stores do not benefit from the acquisition.

Changes in CGU containing goodwill

A change in CGU happens when an entity disposes of an operation within the unit or reorganises its reporting structure in a way that changes the composition of one or more CGU. In these circumstances, the entity is required to allocate goodwill amongst the affected units.

According to the standard, the allocation of the goodwill should be *"measured based on the relative values of the operation disposed of and the portion of the CGU retained, unless the entity can demonstrate that some other method better reflects the goodwill associated with the operation disposed of"*.

The standard however, did not specify how "relative values" of the parts should be calculated. Intuitively, one might conclude that the relative carrying amounts of the assets be used. However, this is not always the case as demonstrated by the example below.

Illustrative example

Entity A acquires Entity B, which has two distinct operations, X and Y. Operation X is in a capital-intensive but "sunset" industry and Operation Y is in a growing, knowledge-based industry. If the goodwill arising from the acquisition is allocated based on carrying amounts of assets, a larger portion will be attributable to Operation X rather than Operation Y. This would not be reasonable. It is more likely that the goodwill is associated with Operation Y than Operation X.

Alternatively, the recoverable amounts of the affected units could be used. However, this means that the entity has to conduct an exercise to determine either the value in use or the fair value less costs to sell off the affected units.

The requirement to reallocate goodwill when the composition of a CGU changes may pose practical difficulties to groups that frequently reorganise their structure. When a group restructures, the ownership structure within the group may not necessary correspond to its CGU. Thus, it is important for entities to clearly identify their CGU and the basis of allocation of goodwill to them.

Testing CGU with minority interests

In the parent entity's consolidated financial statements, minority interest is stated based on the minority's proportion of the fair value of the net assets of the acquiree and goodwill is based on the parent's ownership interests. Accordingly, if there is a minority interest in a CGU to which goodwill has been allocated, the carrying amount of that CGU comprises both the parent's interest and the minority interest in the identifiable net assets of the CGU, and the parent's interest in goodwill.

However, the recoverable amount of the CGU includes the minority interest in goodwill.

When testing a non-wholly-owned CGU for impairment, an entity should gross-up the carrying amount of goodwill allocated to the CGU to include the minority interest's portion. The notionally adjusted carrying amount of the CGU is then compared with the recoverable amount to determine whether there is impairment.

If there is impairment, an entity should allocate the loss to reduce the carrying amount of any goodwill allocated to the CGU first. Any excess amount of goodwill is then allocated to the other assets in the CGU based on the relative carrying amounts.

In the case of a non-wholly-owned CGU, the impairment loss relating to the goodwill should be apportioned between the parent and the minority interest. However, only the amount attributable to the parent is recognised in the profit and loss account as impairment loss.

Impairment loss and interim financial statements

FRS 34 *Interim Financial Reporting* does not allow an entity to spread expected impairment loss for the year over the interim periods. As a CGU to which goodwill is allocated can be tested for impairment at any point in time other than at the end of the financial year, the timing for testing of impairment also has an impact on interim financial statements.

Illustrative example

Entity A and Entity B have a 31 December financial year-end and announce quarterly results. Entity A performs the annual impairment test for a CGU to which goodwill is allocated in October but Entity B performs the annual test in February. Assuming that impairment loss is recognised for each CGU, Entity A only recognises the loss in the fourth quarter whereas Entity B recognises the loss in the first quarter. Even if Entity A is comparable with Entity B in its size and operations, the different timings of their impairment tests make their quarterly results non-comparable.

Reversing an impairment loss for goodwill

Once goodwill is impaired, the standard prohibits reversal in subsequent periods.

C. Developments in International Standards and Interpretations

IFRIC 4 *Determining whether an Arrangement contains a Lease*

Effective: Annual periods from 1 January 2006

IFRIC 4 is a significant interpretation as it could potentially bring huge assets that are currently not on the balance sheets of entities, into their balance sheets. We believe that the implementation date has been pushed back one year to allow entities time to prepare for its implementation.

This interpretation addresses arrangements that do not take the legal form of a lease, but convey rights to use items for agreed periods of time in return for a payment or series of payments. Examples of such arrangements include:

- outsourcing arrangements, such as information technology management;
- suppliers of telecommunication network capacity entering into contracts to provide purchasers with rights to capacity; and
- 'take-or-pay' contracts, which require purchasers to make specified payments whether or not they take delivery of the contracted products.

IFRIC 4 provides guidance for evaluating whether such arrangements are, or contain, leases that should be accounted for under FRS 17 *Leases.* If an agreement is determined to contain a lease, then IFRIC 4 requires FRS 17 to be applied to classify and account for the lease. For further discussions on IFRIC 4, refer to the enclosed *IFRS Briefing Sheet Issue 11.*

An amendment to the scope of SIC-12 *Consolidation - Special Purpose Entities* (SPEs)

Effective: Annual periods from 1 January 2005

IFRIC has amended the scope of SIC-12 to remove the scope exclusion for equity compensation plans. With the amendment, it is likely that many employee benefit trusts would be considered to be controlled by the sponsor and therefore would have to be consolidated. As a result, treasury share accounting must be applied for shares held by a SPE that is required to be consolidated based on the criteria of SIC-12. For further discussions on this amendment to SIC-12, refer to the enclosed IFRS *Briefing Sheet Issue 8.*

A subsequent IFRIC interpretation may provide additional guidance on how to account for employee benefit trusts in the separate financial statements of a sponsor.

IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments*

Effective: Annual periods from 1 January 2005

IFRIC 2 focuses on members' shares in co-operative entities, and also provides important new guidance for debt/equity classification issues.

This interpretation focuses on members' shares in co-operative entities although it applies directly and by analogy to other classification issues.

Members' shares and similar instruments that convey to the holder the right to request redemption are classified as equity only if:

- the entity has an unconditional right to refuse redemption; or
- local law, regulation or the entity's governing charter, unconditionally prohibits redemption.

For further discussions on IFRIC 2, refer to the enclosed *IFRS Briefing Sheet Issue 10.*

Exposure drafts issued by IFRIC

During the last two months, IFRS issued the following draft interpretations, which were also issued by the CCDG as exposure drafts in Singapore.

- D10 *Liabilities Arising from Participating in a Specific Market - Waste Electrical and Electronic Equipment*
- D11 *Changes to Contributions to Employee Share Purchase Plans*

Tentative IFRIC conclusion - treasury shares and inter-group compensation plans

This tentative IFRIC conclusion, although not yet formally issued as an interpretation, is of interest to Singapore companies with inter-group compensation plans. IFRIC had tentatively concluded that the following arrangements are equity-settled arrangements:

- An entity grants options to its employees and chooses to or is required to purchase its own shares upon exercise of the options by its employees.
- A subsidiary's employees are granted rights to shares of the parent.

Other publications from the IASB and IFRIC

Other standards and interpretations published are:

Standard/Interpretations	Effective date
Amendment to IAS 39 *Financial Instruments: Recognition and Measurement - Transitional and Initial Recognition of Financial Assets and Financial Liabilities* (This amendment is limited to companies that have adopted FRS 39 early.)	Annual periods from 1 January 2005
Amendments to IAS 19 *Employee Benefits*	Annual periods from 1 January 2006
IFRS 6 *Exploration and Evaluation of Mineral Resources*	Annual periods from 1 January 2006
IFRIC 3 *Emission Rights*	Annual periods from 1 March 2005
IFRIC 5 *Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds*	Annual periods from 1 January 2006

For details relating to developments in international standards, refer to KPMG International publications enclosed with this edition:

- *IFRS in Brief* issues 8 and 9
- *IFRS Briefing Sheet* issues 7 to 17

Should you wish to discuss any matter highlighted in this publication, please contact:

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