
Accounting (Basics) - Lecture 4

Intangible assets, business combinations and goodwill

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Recognition

- An entity shall **recognize an intangible asset** as an asset if, and only if:
 - a) it is **probable** that the expected **future economic benefits** that are attributable to the asset will flow to the entity;
 - b) **the cost or value** of the asset can be **measured reliably**;
and
 - c) **the asset does not result from expenditure incurred internally** on an intangible item.
- An entity shall **assess the probability** of expected future economic benefits using **reasonable and supportable assumptions** that represent **management's best estimate** of the economic conditions that will exist over the useful life of the asset. An entity uses **judgment to assess the degree of certainty** attached to the flow of future economic benefits that are attributable to the use of the asset **on the basis of the evidence** available at the time of initial recognition, **giving greater weight to external evidence.**

Recognition

- The probability recognition criterion is always considered satisfied for **intangible assets that are separately acquired**.
- When an intangible **asset is acquired in a business combination**, it is normally recognized as an asset because **its fair value can be measured with sufficient reliability**. However, an **intangible asset acquired in a business combination is not recognized** when it arises from **legal or other contractual rights** and its **fair value cannot be measured reliably** because the asset either
 - a) **is not separable** from goodwill, or
 - b) **is separable** from goodwill but there is no history or evidence of exchange transactions for the same or similar assets, and otherwise **estimating fair value would be dependent on immeasurable variables**.

Initial and subsequent measurement

- An entity shall measure **an intangible asset initially at cost**. The cost of a separately acquired intangible asset comprises:
 - a) **its purchase price**, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates, and
 - b) **any directly attributable cost** of preparing the asset for its intended use.
- If an **intangible asset is acquired in a business combination**, the cost of that intangible asset is its **fair value** at the acquisition date.
- If an **intangible asset is acquired in exchange for a non-monetary asset** or assets, or a combination of monetary and non-monetary assets, the cost of that intangible asset is its **fair value** unless (a) **the exchange transaction lacks commercial substance** or (b) **the fair value of neither the asset received nor the asset given up is reliably measurable**. In that case, the asset's cost is measured at the **carrying amount of the asset given up**.

Initial and subsequent measurement

- If an **intangible asset is internally generated**, the **cost of that intangible asset is not recognized**, but **there are recognized all expenditures** incurred internally for creation of that intangible item, including all expenditure for both research and development activities, unless it forms part of the cost of another asset that meets the recognition criteria in these IFRS. An entity shall **recognize expenditure on the following items as an expense** and shall not recognize such expenditure as intangible assets:
 - a) **internally generated brands, logos, publishing titles, customer lists and items similar in substance.**
 - b) **start-up activities** such as establishment costs (i.e. legal and secretarial costs incurred in establishing a legal entity), expenditure to open a new facility or business (i.e. pre-opening costs) and expenditure for starting new operations or launching new products or processes (i.e. pre-operating costs).

Initial and subsequent measurement

- c) training activities.
 - d) advertising and promotional activities.
 - e) relocating or reorganizing part or all of an entity.
 - f) internally generated goodwill.
- However, the stated above does not preclude **recognizing a prepayment as an asset** when payment for goods or services has been made in advance of the delivery of the goods or the rendering of the services.
 - **Expenditure on an intangible item that was initially recognized as an expense shall not be recognized** at a later date as part of the cost of an asset.
 - **Subsequently** an entity shall measure **intangible assets at cost less any accumulated amortization and any accumulated impairment losses.**

Amortization over useful life

- **All intangible assets shall be considered to have a finite useful life.** The useful life of an intangible asset that arises from contractual or other legal rights shall not exceed the period of the contractual or other legal rights, but may be shorter depending on the period over which the entity expects to use the asset. **If the contractual or other legal rights are conveyed for a limited term that can be renewed, the useful life of the intangible asset shall include the renewal period(s) only if there is evidence to support renewal by the entity without significant cost.**
- **If an entity is unable to make a reliable estimate of the useful life** of an intangible asset, the life shall be presumed to be ten years.
- An entity shall allocate the amortizable amount of an intangible asset **on a systematic basis over its useful life.** The amortization charge for each period shall be **recognized as an expense.**
- **Amortization begins** when the intangible asset is available for use. **Amortization ceases** when the asset is derecognized.

Amortization over useful life

- The entity shall choose an **amortization method** that reflects the **pattern in which it expects to consume the asset's future economic benefits**. If the entity cannot determine that pattern reliably, it shall use the **straight-line method**.
- An entity shall assume that **the residual value of an intangible asset is zero unless:**
 - a) there is a **commitment by a third party to purchase the asset at the end of its useful life**, or
 - b) **there is an active market for the asset and:**
 - i. **residual value can be determined** by reference to that market, and
 - ii. **it is probable that such a market will exist at the end of the asset's useful life.**

Amortization over useful life

- **Factors** such as a change in how an intangible asset is used, technological advancement, and changes in market prices may indicate that **the residual value or useful life of an intangible asset has changed** since the most recent annual reporting date. If such indicators are present, **an entity shall review its previous estimates and, if current expectations differ, amend the residual value, amortization method or useful life.** The entity shall account for the **change in residual value, amortization method or useful life as a change in an accounting estimate.**

Recoverability of the carrying amount – impairment losses

- To determine whether an intangible asset is impaired, an entity shall apply Section “Impairment of Assets”. That section explains when and how an entity reviews the carrying amount of its assets, how it determines the recoverable amount of an asset, and when it recognizes or reverses an impairment loss.

Derecognition

- An entity shall derecognize an intangible asset, and shall recognize **a gain or loss in profit or loss:**
 - a) **on disposal, or**
 - b) **when no future economic benefits are expected from its use or disposal.**

Business combinations

- **A business combination is the bringing together of separate entities or businesses into one reporting entity.** The result of nearly all business combinations is that one entity, **the acquirer, obtains control of one or more other businesses, the acquiree.** The **acquisition date** is the date on which **the acquirer effectively obtains control of the acquiree.**
- **A business combination may be structured in a variety of ways:** the purchase by an entity by means of equity of another entity, the assumption of the liabilities of another entity, or the purchase of some of the net assets of another entity that together form one or more businesses. A business combination may be effected by the **issue of equity or debt instruments, the transfer of cash, cash equivalents or other assets, or a mixture of these.**
- All business combinations shall be accounted for by applying the **purchase method** (under IFRS for SMEs, but not under

Business combinations

- full IFRS – IFRS 3 (2008) – whereby **purchase method is renamed as acquisition method**). Applying the purchase method involves the following **steps**:
 - a) **identifying an acquirer and acquisition date**;
 - b) **recognizing the assets acquired and liabilities assumed at fair value**; and
 - c) **measuring the cost of the business combination as aggregate of the fair value of assets given, liabilities assumed and equity issued including transaction costs**;
 - d) **allocating the cost of the business combination to the assets acquired and liabilities and provisions for contingent liabilities assumed**;
 - e) **recognizing any difference** between the cost of the business combination and the fair value of assets acquired and liabilities assumed. If the difference is **negative (“negative goodwill”)**, it is a **gain from bargain purchase**.

Business combinations

- Application of the purchase method starts from identification of acquirer. **An acquirer shall be identified for all business combinations. The acquirer is the combining entity that obtains control of the other combining entities or businesses.** Control is the power to govern the financial and operating policies of an entity or business so as to obtain benefits from its activities.
- Although it may sometimes be difficult to identify an acquirer, there are usually indications that one exists. For example:
 - a) if the **fair value of one of the combining entities is significantly greater than that of the other combining entity**, the entity with the greater fair value is likely to be the acquirer.
 - b) if the business combination is effected through an exchange of voting ordinary equity instruments for cash or other assets, the **entity giving up cash or other assets** is likely to be the acquirer.

Business combinations

- c) if the business combination results in the management of one of the **combining entities being able to dominate the selection of the management team of the resulting combined entity**, the entity whose management is able so to dominate is likely to be the acquirer.
- After acquirer has been identified, there is identified the **acquisition date**, which **is the date on which the acquirer obtains control of the acquiree**.
- Further the acquirer shall measure **the cost of a business combination** as the aggregate of:
 - a) **the fair values**, at the date of exchange, **of assets given, liabilities incurred or assumed, and equity instruments issued by the acquirer**, in exchange for control of the acquiree, **plus**
 - b) **any costs directly attributable** to the business combination.

Business combinations

- When a business combination agreement provides for an **adjustment to the cost of the combination contingent on future events**, the acquirer shall include **the estimated amount of that adjustment in the cost of the combination at the acquisition date if the adjustment is probable and can be measured reliably**. However, if the potential adjustment is not recognized at the acquisition date but subsequently becomes probable and can be measured reliably, the additional consideration shall be treated as an adjustment to the cost of the combination.
- The acquirer shall, at the acquisition date, **allocate the cost of a business combination by recognizing the acquiree's identifiable assets and liabilities and a provision for those contingent liabilities** that satisfy the recognition criteria at their fair values at that date. **Any difference between the cost of the business combination and the acquirer's interest in the net fair value of the identifiable assets, liabilities and provisions for contingent liabilities** so recognized shall be accounted as **'negative goodwill' or gain from bargain purchase**.

Business combinations

- The acquirer shall recognize separately the **acquiree's identifiable assets, liabilities and contingent liabilities** at the acquisition date only if they satisfy the following criteria at that date:
 - a) In the case of an asset other than an intangible asset, **it is probable that any associated future economic benefits will flow to the acquirer**, and its fair value can be **measured reliably**.
 - b) In the case of a liability other than a contingent liability, **it is probable that an outflow of resources will be required to settle the obligation**, and **its fair value can be measured reliably**.
 - c) In the case of an **intangible asset or a contingent liability**, **its fair value can be measured reliably**.
- **The acquirer's statement of comprehensive income shall incorporate the acquiree's profits and losses** after the acquisition date by including the acquiree's income and expenses based on the cost of the business combination to the acquirer.

Business combinations

- **If the initial accounting for a business combination is incomplete by the end of the reporting period in which the combination occurs, the acquirer shall recognize in its financial statements provisional amounts for the items for which the accounting is incomplete. Within twelve months after the acquisition date, the acquirer shall retrospectively adjust the provisional amounts recognized as assets and liabilities at the acquisition date to reflect new information obtained. Beyond twelve months after the acquisition date, adjustments to the initial accounting for a business combination shall be recognized only to correct an error in accordance with Section “Accounting Policies, Estimates and Errors”.**
- **An acquirer recognizes separately a provision for a contingent liability of the acquiree only if its fair value can be measured reliably. If its fair value cannot be measured reliably:**
 - a) **there is a resulting effect on the amount recognized as goodwill or accounted for; and**

Business combinations

- b) the acquirer shall **disclose the information about that contingent liability.**
- After their initial recognition, **the acquirer shall measure contingent liabilities** that are recognized separately **at the higher of:**
 - a) **the amount that would be recognized** in accordance with Section “Provisions and Contingencies”, and
 - b) **the amount initially recognized less amounts previously recognized as revenue** in accordance with Section “Revenue”.
- The acquirer shall, at the acquisition date:
 - a) **recognize goodwill acquired in a business combination as an asset**, and
 - b) **initially measure that goodwill at its cost, being the excess of the cost of the business combination over the acquirer’s interest in the net fair value of the identifiable assets, liabilities and contingent liabilities recognized.**

Business combinations

- **After initial recognition, the acquirer shall measure goodwill acquired in a business combination at cost less accumulated amortization and accumulated impairment losses. An entity shall follow the principles for amortization of goodwill as an intangible asset. If an entity is unable to make a reliable estimate of the useful life of goodwill, the life shall be presumed to be ten years. An entity shall follow Section “Impairment of Assets” for recognizing and measuring the impairment of goodwill.**
- **If the acquirer’s interest in the net fair value of the identifiable assets, liabilities and provisions for contingent liabilities recognized exceeds the cost of the business combination (i.e. there is ‘negative goodwill’), the acquirer shall:**
 - a) **reassess the identification and measurement of the acquiree’s assets, liabilities and provisions for contingent liabilities and the measurement of the cost of the combination, and**
 - b) **recognize immediately in profit or loss any excess remaining after that reassessment.**

Disclosures

- An entity shall disclose the following for each class of **intangible assets**:
 - a) the **useful lives** or the **amortization rates** used.
 - b) the **amortization methods** used.
 - c) the **gross carrying amount** and **any accumulated amortization** (aggregated with accumulated impairment losses) at the beginning and end of the reporting period.
 - d) the line item(s) in the statement of comprehensive income in which **any amortization of intangible assets is included**.
 - e) a **reconciliation of the carrying amount** at the beginning and end of the reporting period.
- This reconciliation need not be presented for prior periods.

Disclosures

- For **business combinations** an acquirer shall disclose a **reconciliation of the carrying amount of goodwill** at the beginning and end of the reporting period, showing separately:
 - a) **changes arising from new business combinations.**
 - b) **impairment losses.**
 - c) **disposals of previously acquired businesses.**
 - d) other changes.
- This reconciliation need not be presented for prior periods.