



corporate | IFRS 3 business combinations

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IFRS 3 significantly affects the accounting treatment of business combinations. Listed companies have been faced with this standard for a few years, however in the future these requirements may be incorporated into UK GAAP as there is an identical UK exposure draft, so it is likely to be applicable for all UK companies with time.

The major changes are:

- Companies must recognise the fair value of intangible assets acquired in a business combination.
- Amortisation of goodwill is prohibited. Goodwill is tested for impairment annually.
- Negative goodwill is not recognised in the balance sheet but is taken as an immediate profit to the income statement however, the existence of negative goodwill will be rare.
- Merger accounting is banned in most situations.

The valuation of intangible assets, including brands, customer contracts and sales orders, can be complex and will require expert valuation advice. Goodwill impairment reviews can also be complicated and difficult to perform. Due to ethical standards this work cannot be performed by a company's auditor.

valuation of intangible assets

Intangible assets fall under the following categories:

- marketing-related
 - brands
 - internet domain names
- customer-related
 - customer contracts and relationships
 - order backlogs
- contract-based
 - management contracts
 - licence agreements

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- technology-based
 - computer software
 - databases
 - trade secrets
 - patents
 - artistic-related
 - copyrights for plays, books and musical works

The valuation of the above items is not an exact science but involves a large amount of experience, expertise and judgement.

There are essentially four different ways to value intangible assets:

cost to recreate

This approach is applicable for unpatented technology and calculates the cost to recreate the technology using current costs and industry knowledge.

royalty savings

The relief-from-royalty approach is applicable for brands and patents. It is based on the concept of how much one could expect to pay a third party if one did not already own the rights to the brand in question.

excess earnings

This approach is applicable to non-compete covenants and uses the increased earnings due to such covenants.

residual earnings

This residual approach is applicable for customer relationships and takes into account the returns from the other assets recognised.

The latter three approaches use discounted cash flow forecasts to arrive at a valuation for the particular asset. These forecasts require discount rates which depend upon the assets, company and industry.

goodwill

The difference between the fair value of the consideration paid for a business and the fair value of the intangible and tangible assets and liabilities in that business is recognised as goodwill. This amount is not amortised but carried at that value and tested annually for impairment.

negative goodwill

Negative goodwill will only occur if a bargain price were achieved. In most transactions between unconnected parties this is unlikely to happen. If negative goodwill arises, it is credited immediately to the income statement.

accounting requirements of IFRS 3

IFRS 3 is only applicable to combinations of businesses. It is not applicable to group reconstructions or combinations involving the formation of joint ventures. Merger accounting is not allowed under IFRS 3, however it is still permitted for group reconstructions because they are outside the scope of the standard.

If you think IFRS 3 will affect you or you want more information then please contact your usual engagement partner or David Cox. haysmacintyre has the necessary expertise and links with experienced valuers to assist you in this complex area.

about haysmacintyre

haysmacintyre, Chartered Accountants and tax advisers, comprises 23 partners and 160 staff based in Holborn, London. It provides high quality auditing and assurance, business and personal taxation, corporate finance, financial planning and other business support services.

Around 50% of the firm's business is within the corporate sector – small and medium sized enterprises, many of which are in the property, media and entertainment, technology, sports and business services sectors. The firm acts for a number of listed companies and assists new companies raise initial funds on the capital markets and through private equity. 35% of the firm's business is for charitable and not for profit organisations and the remainder is for professional practices and private individuals – whether senior executives, entrepreneurs or those with significant land or wealth at home or overseas.

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