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IP for Innovation

STUDENTS HANDBOOK

Intellectual Property Accounting and Controlling

Module 4.:

Intellectual Property Accounting and Controlling

„The accounting profession itself is increasingly aware of the necessity to confront the knowledge-driven economy and recognizes that reporting systems have to be developed that reflect the increasing importance IP has.“

Roya Ghafele, Associate Economic Officer, WIPO (2007)

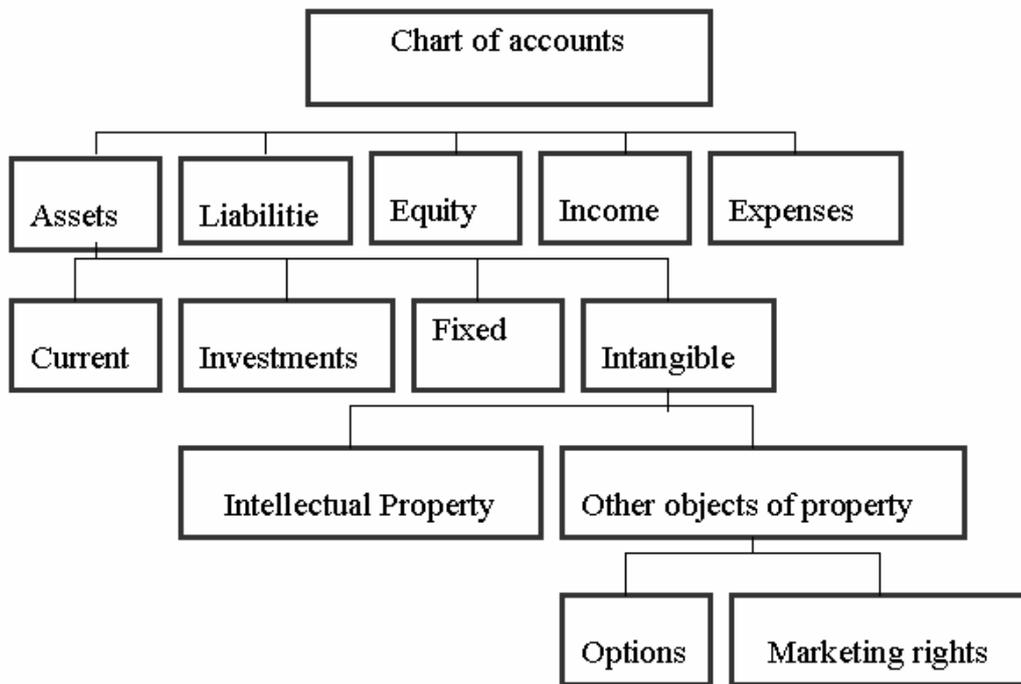
The periodic accounts statement of a company provides a numbers-based understanding of its performance. The analysis of its reports indicates whether it is meeting its objectives, in terms of return on investment, profits and market share. Accounting continuously documents the financial situation of a company and hence affects its valuation as a business.

In today's increasingly knowledge-driven economy, the key economic resources underlying wealth production are no longer based on competitive advantages in access to and use of land, labour and/or capital. Rather competitive advantages relate to access to and use of intangible assets, especially IP. In recent years, changes in regional accounting standards to address this issue are beginning to appear. Harmonisation of these standards and changes are a goal for the near future.

Chart of accounts

A **Chart of accounts** is a list of all accounts tracked by a single accounting system, and should be designed to capture financial information to make good financial decisions. Each account in the chart is assigned a unique identifier, typically an account number. Each account in the Anglo-Saxon chart is classified into one of the five categories: Assets, Liabilities, Equity, Income and Expenses.

The overview of the chart of account is pictured by the following figure.



Assets

Probably the most accepted accounting definition of an asset is the one used by the International Accounting Standards Board. The following is a quotation from the IFRS Framework (see later): "An asset is a resource controlled by the enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise."

Assets are economic entities that give rise to future economic benefit and are controlled by the entity as a result of past transaction or other events. It is probable that the future economic benefit will eventuate and the amount of asset can be measured with reliability from source document, which makes it representationally faithful. Examples include cash, equipment, buildings, and land.

Assets have three essential characteristics:

- They embody a future benefit that involves a capacity, singly or in combination with other assets, in the case of profit oriented enterprises, to contribute directly or indirectly to future net cash flows, and, in the case of not-for-profit organizations, to provide services;
- The entity can control access to the benefit; and,
- The transaction or event giving rise to the entity's right to, or control of, the benefit has already occurred.

Classification of assets

Assets may be classified in many ways. In a company's balance sheet certain divisions are required by generally accepted accounting principles (GAAP), which vary from country to country.

- a) Current assets are cash and other assets expected to be converted to cash, sold, or consumed either in a year or in the operating cycle.
- b) Investments are to be held for many years and are not intended to be disposed in the near future.
- c) Fixed assets, also referred to as PPE (property, plant, and equipment), or tangible assets, these are purchased for continued and long-term use in earning profit in a business. This group includes land, buildings, machinery, furniture, tools, and certain wasting resources e.g., timberland and minerals. They are written off against profits over their anticipated life by charging depreciation expenses (with exception of land). Accumulated depreciation is shown in the face of the balance sheet or in the notes.
- d) Intangible assets lack physical substance and usually are very hard to evaluate. They include patents, trademarks, copyrights, franchises, goodwill, etc.

Intangible assets are defined as those non-monetary assets that cannot be seen, touched or physically measured and which are created through time and/or effort. There are two primary forms of intangibles

- Legal intangibles (such as trade secrets (e.g., customer lists), copyrights, patents, utility models, designs, trademarks, and goodwill) and
- Competitive intangibles (such as knowledge activities (know-how, knowledge), collaboration activities, leverage activities, and structural activities).

How do current regional accounting standards approach IP?

International Financial Reporting Standards (IFRS)

International Financial Reporting Standards (IFRS) are standards and interpretations adopted by the International Accounting Standards Board (IASB) serving to standardise valuation rules, presentation of results and the contents of annual reports. Their purpose is to make balance sheets, income statements and notes of annual reports **comparable internationally**.

Many of the standards forming part of IFRS are known by the older name of International Accounting Standards (IAS). Nearly 100 countries, including the member states of the EU currently require, permit the use of, or have a policy of convergence with IFRS.

IAS 38 deals with accounting of intangible assets that are not dealt with specifically in another IAS. The Standard requires an enterprise to recognise an intangible asset if, and only if, certain criteria are met. The Standard also specifies how to measure the carrying amount of intangible assets and requires certain disclosures regarding intangible assets (see Appendix).

There is no law that enforces IFRS-rules in reporting, but investors and the media ask more and more for presentations that are drawn up according to these rules. As these rules are issued by the International Accounting Standards Board they always represent a compromise between the interpretations in different countries. This compromise is usually regarded as the minimum standard.

Expense recognition - General standards

The Financial Accounting Standards Board (FASB) offers some guidance as to how intangible assets should be accounted for in financial statements. (For more detail see Appendix)

In general, intangibles that are developed internally are not recognised and intangibles that are purchased from third parties are recognised. However intangible assets developed in-house can be recognised using a well developed accounting scheme. As with all assets, the intangible asset also has to contribute to generate future benefit. Until this can be proved, expense recognition is postponed. Therefore, every cost related to an R+D project has to be collected on a **special ledger** called “**unfinished investments**”.

In the event that the research is completed, product development made and commercialisation started, the costs gathered under the unfinished investments account can be **activated**. Activation means cost recognition, from which moment expenses can be depreciated.

Depreciation is a term used in accounting, economics and finance with reference to the fact that assets with finite lives lose value over time.

In accounting, depreciation is a term used to describe any method of attributing the historical or purchase cost of an asset across its useful life, roughly corresponding to normal wear and tear. It is of most use when dealing with assets of a short, fixed service life, and which lose value over that life.

The use of depreciation affects the financial statements and the taxes of companies and individuals. The recording of depreciation will cause an expense to be recognised; thereby lowering stated profits on the income statement, while the net value of the asset (the portion of the historical cost of the asset that remains to provide future value to the company) will decline on the balance sheet. Depreciation reported for accounting and tax purposes may differ substantially.

Depreciation and its related concept, amortization (generally, the depreciation of intangible assets), are non-cash expenses. Neither depreciation nor amortization will directly affect the cash flow of a company, as both are accounting representations of expenses attributable to a given period. Depreciation recognised for tax purposes will, however, affect the cash flow of the company, as tax depreciation will reduce taxable profits. There is generally no requirement that treatment of depreciation for tax and accounting purposes be identical. Where depreciation is shown on accounting statements, the figure usually does not relate to depreciation for tax purposes.

Thus costs of in-house R+D activity can be depreciated when they start to generate profit. Activation is the baseline for costs related to a R+D project to be recognised and depreciated. Until activation is not possible, costs incurred are accounted on a special ledger called “unfinished investments”.

Intangible assets are typically expensed according to their respective life expectancy and are characterised as having either an identifiable or indefinite useful life. Intangible assets with identifiable useful lives are amortized on a straight-line basis over their economic or legal life, whichever is shorter. Examples of intangible assets with identifiable useful lives include copyrights and patents. Intangible assets with indefinite useful lives are reassessed each year for impairment. If an impairment has occurred, then a loss must be recognised. An impairment loss is determined by subtracting the asset's fair value from the asset's book value. This impairment loss may only be reversed under certain circumstances.

Trademarks and goodwill are examples of intangible assets with indefinite useful lives, thus amortization of them is forbidden.

Valuations of intangible assets in accounting

A company may argue that it has **two kinds of intangible assets** (e.g. brands), those that it purchased from other companies and those that it develops internally (home grown). The valuation procedures differ radically.

Those that were acquired through purchase can be valued at their purchase price, although it may prove difficult to allocate a specific sum to one intangible asset from the price paid to acquire the entire company.

The major valuation problem surrounds the homegrown intangible assets that grow in value over many years. Two methods may be used:

Historic Cost

This method requires that all costs spent in developing and maintaining the intangible asset be capitalised. Previously written-off costs such as marketing, advertising, etc. associated with the intangible asset are "written-back" into the financial statements. Because this action does not affect the current year's profit and loss account the adjustment is made through the reserves.

The shortcomings of historic cost recognition model are as follows:

- It fails to reflect the correct amount of depreciation on up-to-date asset values
- Balance sheets are understated because assets are valued at historic cost rather than replacement cost, in most circumstances a more relevant basis for managerial decision.

Imagine the use of historic cost model for valuating an 18-year-old patent:

Based on the historic cost model, the value of a patent is composed of all the cost related to obtaining and maintaining the patent. It is easy to see, that significantly lower cost had been spent on a newly acquired patent with great business opportunity compared to an old, technologically obsolete patent. Thus the historic cost model does not reflect the real business value of intellectual property.

Furthermore, as the value of a patent is composed of all the cost related to obtaining and maintaining, the followings are accounted:

- Cost of patent attorney of filing
- Application fee
- Maintenance fee
- Cost of purchase/royalty
- Costs of enforcement
- Mitigation costs paid

Therefore, a badly formulated patent with a weak position (e.g. the scope of the patent being too broad, thus continuously attacked by competitors) has a much higher historic cost than a well prepared one.

Additionally, a dependent patent's historic cost contains the fee requested by the patent holder of the original patent for secondary application in contrast to a real novel technology where such cost does not exist.

Earnings Method

In contrast to the historic cost model that looks back, the earnings method looks forward. Under this method management must attempt to attribute the actual earnings of the company to a specific intangible asset and then apply a multiplier to this figure which reflects the intangible asset strength (i.e. future stability, development, growth, profit contribution etc.) over the foreseeable future. However, this method is based very much on subjectivity.

Areas of controversy are presently the subjects of vigorous debates within the accounting profession:

- **Goodwill** - the difference between the fair value of net assets acquired in a corporate acquisition and the price paid for these assets. It is far from clear what the best accounting policy is for this amount and companies currently select a variety of treatments, each of which has a different impact on earnings.
- **Brands** - one specific component of goodwill associated with the image and market potential of certain products. Some companies have been keen to put brands on their balance sheets but financial commentators wait with interest how they will account for the brands' diminution in value.

First of all, IFRS-rules want to show a **true and fair view** of the company. This is also one of the purposes of **US-GAAP**. However, within the IFRS the valuation and presentation rules are not as rigid as in US-GAAP and the idea of protecting the creditors is valued higher than in US-GAAP.

Like US-GAAP, IFRS rules are also not made to replace managerial accounting as they are designed for the reporting to shareholders and not for the direct control of operations within the company and the market.

US-GAAP (United States Generally Accepted Accounting Principles)

In the United States, generally accepted accounting principles are accounting rules used to prepare, present, and report financial statements for a wide variety of entities. Companies that are willing to quote their shares in US stock exchange markets must follow these valuation- and presentation principles. This is mainly in the interest of big internationally acting corporations as they can enter the biggest market for equity worldwide.

When valuing assets on the balance sheet, there are only little differences between European (IFRS) and US reports. According to US-GAAP, assets may not be valued higher than the historical cost at the time of the acquisition of the assets (**historical cost principle**). But the value of the stock is to be calculated including the appropriate parts of structure costs for warehousing and the buying department, for manufacturing overheads as well as the appropriate pads of depreciation and interest and special direct costs of manufacturing (**full cost principle**).

The Income statement (**profit and loss statement**) has to be structured following the **cost of sales** method but there are no more detailed prescriptions. Where as in the usual continental European structure of a pal statement, where the different expense-types are deducted from sales, in US-GAAP a rough **cost centre grouping** is the standard. From revenue, the costs of goods sold are deducted which results in the gross margin. These costs of goods sold are the full costs of the whole works (defined as one big cost centre), but only after respecting the changes in the value of half-finished and finished goods, as well as work in process. Then the cost for research & distribution, marketing and sales cost and administration have to be subtracted from gross margin to arrive at the profit before taxes.

As far the income statement does not show all the important information additional insight have to be given in the notes.

Also part of the income statement is information about **earnings per share (EPS)** and the development of the equity. 'This is to be done under the income statement or in an extra statement of retained earnings.

Additionally, following US-GAAP, a statement of cash flow - a statement of changes in financial position - is part of the annual report. In this statement cash flows are divided in three positions:

- Cash flow from operations
- Cash flow from investment and disinvestments
- Cash flow from financial activities.

Following the **accrual principle**, companies working with long-range orders (duration more than one year), may also show the respective part of revenues in the income statement which leads to higher results in periods when the order is not finished yet. This is the **percent of completion method**.

FAS 141 & 142¹

Before the introduction of FAS 141 and FAS 142 in the US GAAP, **goodwill** was the only vocabulary used by the accounting profession to speak about IP. These important steps towards the recognition of IP mean that companies now have the possibility to discern the assets lumped together under "goodwill", including IP and value them separately. Companies need now to review, on an annual basis, the acquired IP and conduct an **'impairment test'**.

These recent regulatory changes have already had a significant impact on current market practices. For example, in Germany, they have created high demand for the valuation of brands. Since German companies registered in the US (notably most DAX listed firms) can make their income statement under US GAAP, incentives have been strong to report adequately valued trademarks on the balance sheet.

These modifications may be considered as important first steps towards a true and fair appreciation of IP, but further adaptations will be necessary to adequately reflect IP on the balance sheet. Under FAS 141 and FAS 142, IP can be accounted for if it qualifies as intangible assets. Much of the IP held in a company will, however, hardly pass that test.

In the US-GAAP, internally generated IP is treated as an immediate expense. The same applies to Research and Development (R&D) related to the creation of IP. This means that the balance sheet offers distorted information on how IP is made. The costs incurred for the creation of IP are reported at **one single point in time**, while the IP is accounted for only in the context of a commercial transaction. However, this approach is not exclusively reserved for IP, but reflects the general way in which the accounting profession approaches a business.

Unlike internally generated IP, acquired IP is reflected on the balance sheet; for example, according to US GAAP, IP is valued at its acquisition cost and amortized over a maximum period of 40 years. However, this may lead to serious confusion; whereas internally generated IP is considered to be worth nothing, the IP that change hands may be worth hundreds of millions of Dollars. Thus, a company which decides to sell or license internally generated IP appears to create profits virtually out of nothing, as the IP that generated these profits does not appear on its balance sheet.

¹ Roya Ghafele (2007), WIPO website

APPENDIX 1

IAS standard on intangible asset accounting

SUMMARY OF IAS 38²

Objective

The objective of IAS 38 is to prescribe the accounting treatment for intangible assets that are not dealt with specifically in another IAS. The Standard requires an enterprise to recognise an intangible asset if, and only if, certain criteria are met. The Standard also specifies how to measure the carrying amount of intangible assets and requires certain disclosures regarding intangible assets.

Scope

IAS 38 applies to all intangible assets other than: [IAS 38.2-3]

- financial assets
- mineral rights and exploration and development costs incurred by mining and oil and gas companies
- intangible assets arising from insurance contracts issued by insurance companies
- intangible assets covered by another IAS, such as intangibles held for sale, deferred tax assets, lease assets, assets arising from employee benefits, and goodwill. Goodwill is covered by IFRS 3.

Key Definitions

Intangible asset: An identifiable nonmonetary asset without physical substance. An asset is a resource that is controlled by the enterprise as a result of past events (for example, purchase or self-creation) and from which future economic benefits (inflows of cash or other assets) are expected. Thus, the three critical attributes of an intangible asset are: [IAS 38.8]

- identifiability
- control (power to obtain benefits from the asset)
- future economic benefits (such as revenues or reduced future costs)

Identifiability: An intangible asset is identifiable when it: [IAS 38.12]

- is separable (capable of being separated and sold, transferred, licensed, rented, or exchanged, either individually or as part of a package) or
- arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

² www.deloitte.com

Examples of possible intangible assets include:

- computer software
- **patents**
- **copyrights**
- motion picture films
- customer lists
- mortgage servicing rights
- **licenses**
- import quotas
- **franchises**
- customer and supplier relationships
- **marketing rights**

Intangibles can be acquired:

- by separate purchase
- as part of a business combination
- by a government grant
- by exchange of assets
- by self-creation (internal generation)

Recognition

Recognition criteria. IAS 38 requires an enterprise **to recognise an intangible asset**, whether purchased or self-created (at cost) **if, and only if:** [IAS 38.21]

- **it is probable that the future economic benefits that are attributable to the asset will flow to the enterprise; and**
- **the cost of the asset can be measured reliably.**

This requirement applies whether an intangible asset is acquired externally or generated internally. IAS 38 includes additional recognition criteria for internally generated intangible assets (see below).

The probability of future economic benefits must be based on reasonable and supportable assumptions about conditions that will exist over the life of the asset. [IAS 38.22] The probability recognition criterion is always considered to be satisfied for intangible assets that are acquired separately or in a business combination. [IAS 38.33]

If recognition criteria not met. If an intangible item does not meet both the definition of and the criteria for recognition as an intangible asset, IAS 38 requires the expenditure on this item to be recognised as an expense when it is incurred. [IAS 38.68]

Business combinations. There is a rebuttable presumption that the fair value (and therefore the cost) of an intangible asset acquired in a business combination can be measured reliably. [IAS 38.35] An expenditure (included in the cost of acquisition) on an intangible item that does not meet both the definition of and recognition criteria for an intangible asset should form part of the amount attributed to the goodwill recognised at the acquisition date. IAS 38 notes, however, that non-recognition due to measurement reliability should be rare: [IAS 38.38]

The only circumstances in which it might not be possible to measure reliably the fair value of an intangible asset acquired in a business combination are when the intangible asset arises from legal or other contractual rights and either:

- (a) is not separable; or
- (b) is separable, 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.

Reinstatement. The Standard also prohibits an enterprise from subsequently reinstating as an intangible asset, at a later date, an expenditure that was originally charged to expense. [IAS 38.71]

Initial Recognition: Research and Development Costs

- **Charge all research cost to expense.** [IAS 38.54]
- **Development costs are capitalised only after technical and commercial feasibility of the asset for sale or use have been established.** This means that the enterprise must intend and be able to complete the intangible asset and either use it or sell it and be able to demonstrate how the asset will generate future economic benefits. [IAS 38.57]

If an enterprise cannot distinguish the research phase of an internal project to create an intangible asset from the development phase, the enterprise treats the expenditure for that project as if it were incurred in the research phase only.

Initial Recognition: In-process Research and Development Acquired in a Business Combination

A research and development project acquired in a business combination is recognised as an asset at cost, even if a component is research. Subsequent expenditure on that project is accounted for as any other research and development cost (expensed except to the extent that the expenditure satisfies the criteria in IAS 38 for recognising such expenditure as an intangible asset). [IAS 38.34]

Initial Recognition: Internally Generated Brands, Mastheads, Titles, Lists
Brands, mastheads, publishing titles, customer lists and items similar in substance that are internally generated should not be recognised as assets. [IAS 38.63]

Initial Recognition: Computer Software

- Purchased: capitalise
- Operating system for hardware: include in hardware cost
- Internally developed (whether for use or sale): charge to expense until technological feasibility, probable future benefits, intent and ability to use or sell the software, resources to complete the software, and ability to measure cost.
- Amortisation: over useful life, based on pattern of benefits (straight-line is the default).

Initial Recognition: Certain Other Defined Types of Costs

The following items must be charged to expense when incurred:

- internally generated goodwill [IAS 38.48]
- start-up, pre-opening, and pre-operating costs [IAS 38.69]
- training cost [IAS 38.69]
- advertising cost [IAS 38.69]
- relocation costs [IAS 38.69]

Initial Measurement

Intangible assets are initially measured at cost. [IAS 38.24]

Measurement Subsequent to Acquisition: Cost Model and Revaluation Models Allowed

An entity must choose either the cost model or the revaluation model for each class of intangible asset. [IAS 38.72]

Cost model. After initial recognition the benchmark treatment is that intangible assets should be carried at cost less any amortisation and impairment losses. [IAS 38.74]

Revaluation model. Intangible assets may be carried at a revalued amount (based on fair value) less any subsequent amortisation and impairment losses only if fair value can be determined by reference to an active market. [IAS 38.75] Such active markets are expected to be uncommon for intangible assets. [IAS 38.78] Examples where they might exist:

- Milk quotas.
- Stock exchange seats.
- Taxi medallions.

Under the revaluation model, revaluation increases are credited directly to "revaluation surplus" within equity except to the extent that it reverses a revaluation decrease previously recognised in profit and loss. If the revalued intangible has a finite life and is, therefore, being amortised (see below) the revalued amount is amortised. [IAS 38.85]

Classification of Intangible Assets Based on Useful Life

Intangible assets are classified as: [IAS 38.88]

- **Indefinite life:** No foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity.
- **Finite life:** A limited period of benefit to the entity.

Measurement Subsequent to Acquisition: Intangible Assets with Finite Lives

The cost less residual value of an intangible asset with a finite useful life should be amortised over that life: [IAS 38.97]

- The amortisation method should reflect the pattern of benefits.
- If the pattern cannot be determined reliably, amortise by the straight line method.
- The amortisation charge is recognised in profit or loss unless another IFRS requires that it be included in the cost of another asset.
- The amortisation period should be reviewed at least annually. [IAS 38.104]

The asset should also be assessed for impairment in accordance with IAS 36. [IAS 38.111]

Measurement Subsequent to Acquisition: Intangible Assets with Indefinite Lives

An intangible asset with an indefinite useful life should not be amortised. [IAS 38.107]

Its useful life should be reviewed each reporting period to determine whether events and circumstances continue to support an indefinite useful life assessment for that asset. If they do not, the change in the useful life assessment from indefinite to finite should be accounted for as a change in an accounting estimate. [IAS 38.109]

The asset should also be assessed for impairment in accordance with IAS 36. [IAS 38.111]

Subsequent Expenditure

Subsequent expenditure on an intangible asset after its purchase or completion should be recognised as an expense when it is incurred, unless it is probable that this expenditure will enable the asset to generate future economic benefits in excess of its originally assessed standard of performance and the expenditure can be measured and attributed to the asset reliably. [IAS 38.60]

Disclosure

For each class of intangible asset, disclose: [IAS 38.118 and 38.122]

- useful life or amortisation rate
- amortisation method
- gross carrying amount
- accumulated amortisation and impairment losses
- line items in the income statement in which amortisation is included
- reconciliation of the carrying amount at the beginning and the end of the period showing:
 - additions (business combinations separately)
 - assets held for sale
 - retirements and other disposals
 - revaluations
 - impairments
 - reversals of impairments
 - amortisation
 - foreign exchange differences
- basis for determining that an intangible has an indefinite life
- description and carrying amount of individually material intangible assets
- certain special disclosures about intangible assets acquired by way of government grants
- information about intangible assets whose title is restricted
- commitments to acquire intangible assets

Additional disclosures are required about:

- intangible assets carried at revalued amounts [IAS 38.124]

the amount of research and development expenditure recognised as an expense in the current period [IAS 38.126]

APPENDIX 2

IFRS 3 Standard on accounting treatment for Goodwill

BUSINESS COMBINATIONS

Scope

Definition of business combination. A business combination is the bringing together of separate entities or businesses into one reporting entity. [IFRS 3.4]

Scope exclusions. IFRS 3 applies to all business combinations except combinations of entities under common control, combinations of mutual entities, combinations by contract without exchange of ownership interest, and formations of joint ventures. [IFRS 3.3]

Method of Accounting for Business Combinations

Purchase method. All business combinations within the scope of IFRS 3 must be accounted for using the purchase method. [IFRS 3.14] The pooling of interests method is prohibited.

Acquirer must be identified. The old IAS 22 had required the pooling method if an acquirer could not be identified. Under IFRS 3, an acquirer must be identified for all business combinations. [IFRS 3.17]

Identification of an Acquirer

Control. The acquirer is the combining entity that obtains control of the other combining entities or businesses. [IFRS 3.17] IFRS 3 provides considerable guidance for identifying the acquirer. [IFRS 3.19-23]

Cost of a Business Combination

Fair value of consideration given plus costs. The acquirer measures the cost of a business combination at the sum of 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 any costs directly attributable to the combination. [IFRS 3.24] If equity instruments are issued as consideration for the acquisition, the market price of those equity instruments at the date of exchange is considered to provide the best evidence of fair value. If a market price does not exist, or is not considered reliable, other valuation techniques are used to measure fair value. [IFRS 3.27]

Cost adjustments contingent on future events. If the cost is subject to adjustment contingent on future events, the acquirer includes the amount of that adjustment in the cost of the combination at the acquisition date if the adjustment is probable and can be measured reliably. [IFRS 3.32] However, if the contingent payment either is not probable or cannot be measured reliably, it is not measured as part of the initial cost of the business combination. If that adjustment subsequently becomes probable and can be measured reliably, the additional consideration is treated as an adjustment to the cost of the combination. [IAS 3.34]

Recognition and Measurement of Identifiable Acquired Assets and Liabilities

Recognition of acquired assets and liabilities. The acquirer recognises separately, at the acquisition date, the acquiree's identifiable assets, liabilities and contingent liabilities that satisfy the following recognition criteria at that date, regardless of whether they had been previously recognised in the acquiree's financial statements: [IAS 3.37]

- an asset other than an intangible asset is recognised if it is probable that any associated future economic benefits will flow to the acquirer, and its fair value can be measured reliably;
- a liability other than a contingent liability is recognised if it is probable that an outflow of resources will be required to settle the obligation, and its fair value can be measured reliably; and
- an intangible asset or a contingent liability is recognised if its fair value can be measured reliably.

Measurement of acquired assets and liabilities. The acquired identifiable assets, liabilities, and contingent liabilities are measured initially by the acquirer at their fair values at the acquisition date, irrespective of the extent of any minority interest. In other words, the identifiable assets acquired, and liabilities and contingent liabilities incurred or assumed, must be initially measured at full fair value, including any minority interest's share of the acquired item.

No restructuring provisions. In applying the purchase method, an acquirer must not recognise provisions for future losses or restructuring costs expected to be incurred as a result of the business combination. These must be treated as post-combination expenses. [IFRS 3.41]

Recognition of intangibles. In applying the purchase method, an intangible item acquired in a business combination, including an in-process research and development project, must be recognised as an asset separately from goodwill if it meets the definition of an asset (it is controlled and provides economic benefits), is either separable or arises from contractual or other legal rights, and its fair value can be measured reliably. [IFRS 3.45]

Recognition of contingent liabilities. In applying the purchase method, an acquirer must recognise contingent liabilities assumed in the business combination, if their fair value is reliably measurable. [IFRS 3.47] After their initial recognition, such contingent liabilities must be remeasured at the higher of: [IFRS 3.48]

- (a) the amount that would be recognised in accordance with IAS 37, and
- (b) the amount initially recognised less, when appropriate, cumulative amortisation recognised in accordance with IAS 18 Revenue.

A contingent liability recognised under IFRS 3 continues to be recognised in subsequent periods even though it does not qualify for recognition under IAS 37.

Step acquisitions. If a business combination involves more than one exchange transaction, each exchange transaction shall be treated separately by the acquirer, using the cost of the transaction and fair value information at the date of each exchange transaction, to determine the amount of any goodwill associated with that transaction. [IFRS 3.58]

Goodwill

Recognition and measurement of goodwill. Goodwill is recognised by the acquirer as an asset from the acquisition date and is initially measured as the excess of the cost of the business combination over the acquirer's share of the net fair values of the acquiree's identifiable assets, liabilities and contingent liabilities. [IFRS 3.51]

No amortisation of goodwill. IFRS 3 prohibits the amortisation of goodwill. Instead goodwill must be tested for impairment at least annually in accordance with IAS 36 Impairment of Assets. [IFRS 3.54]

Negative goodwill. 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) must be recognised immediately in the income statement as a gain. Before concluding that "negative goodwill" has arisen, however, IFRS 3 requires that the acquirer reassess the identification and measurement of the acquiree's identifiable assets, liabilities, and contingent liabilities and the measurement of the cost of the combination. [IFRS 3.56]

Disclosure

For each business combination (or in the aggregate for immaterial combinations), required disclosures by the acquirer include: [IFRS 3.67]

- Names and descriptions of the combining entities or businesses.
- Acquisition date.
- Percentage of voting equity instruments acquired.
- Cost of the combination (with separate disclosure of the number and fair values of equity instruments issued and how fair values were determined)
- Amounts recognised at the acquisition date for each class of the acquiree's assets, liabilities, and contingent liabilities, and, unless impracticable, the carrying amounts of each of those classes, determined in accordance with IFRSs, immediately before the combination.
- Amount of any negative goodwill recognised in profit or loss
- Details about the factors that contributed to recognition of goodwill
- Amount of the acquiree's profit or loss since the acquisition date included in the acquirer's profit or loss for the period, unless impracticable.

The following must also be disclosed unless impracticable: [IFRS 3.70]

- Revenue of the combined entity for the period as though the acquisition date for all business combinations effected during the period had been the beginning of that period.
- Profit or loss of the combined entity for the period as though the acquisition date for all business combinations effected during the period had been the beginning of the period.