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Applying IFRS 3 in Accounting for Business Acquisitions

- A Case Study

Bachelor/Master Thesis
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Abstract

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Title: Applying IFRS 3 in Accounting for Business Acquisitions – A Case Study

Background and Problem Discussion: This essay has been commissioned by a Swedish group considering to voluntary adopt the regulations of IAS/IFRS in its accounting. This group has further given us a case; to investigate how the accounting for a specific business acquisition would have been affected by the regulation of IAS/IFRS, or more specifically by IFRS 3 – Business Combinations. When developing IFRS 3, the IASB wanted to create a standard that would provide users of financial statements with the most relevant and reliable information. However, with this ambition IFRS 3 became extensive and implies a number of important changes. The question is how the application of this standard really affects the groups applying it? Is it possible that the IASB, with their ambitions, has made IFRS 3 too demanding or too difficult to apply?

Purpose: The purpose of this essay is to investigate the application of IFRS 3, in order to provide parts of a basis for the decision-making of our assigner in its considerations to voluntary adopt the IAS/IFRSs in its accounting. In order to do this, we aim to identify what issues or practical problems come with the application of IFRS 3. We also aim to examine how IFRS 3 affects consolidated financial statements.

Delimitations: This essay examines the accounting for one specific acquisition in accordance with IFRS 3, and therefore the empirical material is delimited to this acquisition. The accounting for the acquisition was originally established in accordance with Swedish GAAP, which therefore serves as a starting point for our discussions. Further, this essay treats the accounting issues and not the valuation issues that come with the application of IFRS 3.

Method: This essay is a case study limited to the examination of one single acquisition, which limits our ability to come to conclusions applicable to all acquisitions. However, we believe that the results from our case study can be useful and serve as a basis for comparison for other groups facing a first-time adoption of IFRS 3. In carrying through our work with the case, we have examined the accounting regulations of IFRS 3 and Swedish GAAP concerning business acquisitions. We have also carried through interviews with an auditor, and with persons involved in the acquisition.

Results and Conclusions: From the application of IFRS 3 on this acquisition we were able to identify eleven new intangible assets, five of which were considered to meet the criteria for recognition. The value of the recognisable intangible assets would importantly have diminished the value of goodwill recognised in the original accounting for the acquisition. Further, IFRS 3 would have demanded an explanation of this goodwill value as well as much more extensive disclosures. The main effect on the income statements is that goodwill under IFRS 3 would not be amortised, but instead annually tested for impairment. Our conclusion is that IFRS 3 probably demands too much from groups applying it, in relation to the extent it benefits users of financial statements by giving useful information.

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Definitions of Important Terms

Important terms in IFRS 3, and in accounting for business acquisitions, are defined as follows:[1]

Acquisition date	The date on which the acquirer effectively obtains control of the acquiree.
Date of exchange	When a business combination is achieved in a single exchange transaction, the date of exchange is the acquisition date. When a business combination involves more than one exchange transaction, for example when it is achieved in stages by successive share purchases, the date of exchange is the date that each individual investment is recognised in the financial statements of the acquirer.
Agreement date	The date that a substantive agreement between the combining parties is reached and, in the case of publicly listed entities, announced to the public. In the case of a hostile takeover, the earliest date that a substantive agreement between the combining parties is reached is the date that a sufficient number of the acquiree's owners have accepted the acquirer's offer for the acquirer to obtain control of the acquiree.
Business	An integrated set of activities and assets conducted and managed for the purpose of providing: - a return to investors or - lower costs or other economic benefits directly and proportionately to policyholders or participants. A business generally consists of inputs, processes applied to those inputs, and resulting outputs that are, or will be, used to generate revenues. If goodwill is present in a transferred set of activities and assets, the transferred set shall be presumed to be a business.
Business combination	The bringing together of separate entities or businesses into one reporting entity.
Control	The power to govern the financial and operating policies of an entity or business so as to obtain benefits from its activities.
Fair value	The amount for which an asset could be exchanged or a liability settled, between knowledgeable, willing parties in an arm's length transaction.
Minority interests	The portion of the profit or loss and net assets of a subsidiary attributable to equity interests that are not owned, directly or indirectly through subsidiaries, by the parent.

[1]IFRS 3, APPENDIX A

Probable	More likely than not.
Reporting entity	An entity for which there are users who rely on the entity's general purpose financial statements for information that will be useful for them in making decisions about the allocation of resources. A reporting entity can be a single entity or group comprising a parent and all of its subsidiaries.

1. Introduction

In this chapter we introduce the topic of this essay, namely the application of IFRS 3. We describe the background to this topic and discuss the problems leading us to our main questions. Thereafter, the purpose of this essay is explained as well as the delimitations we have chosen to make in our work with the essay.

1.1. Background

Since the year of 2005 all listed groups in Sweden, and in the EU, have to comply with the IAS Regulation 1606/2002[2]. Nonlisted groups may further choose to comply with this IAS Regulation voluntary. The IAS Regulation implies that all of the IAS/IFRSs (International Accounting Standards/International Financial Reporting Standards) issued by the IASB (International Accounting Standards Board) and adopted by the EU shall be applied when establishing consolidated financial statements.

Thus, groups having to comply, or having chosen to comply, with the IAS Regulation have during the last two years been facing a change in their accounting principles. For the Swedish groups, the application of IAS/IFRS involves, to a certain extent, a new way of thinking. While Swedish GAAP (Generally Accepted Accounting Principles) traditionally is being characterised by taking a prudent approach in creating reliable accounting, the regulation of IAS/IFRS focuses on creating an accounting relevant to users of financial statements by for example requiring more fair values and more detailed disclosure. The change to IAS/IFRS accounting consequently implies more difficult assessments as well as a higher degree of transparency.

Issues arising when applying IAS/IFRS and how these issues affect groups and their financial statements are interesting, especially for those groups considering a voluntary adoption of IAS/IFRS. In making this choice, groups want to know what differences to expect in their accounting. They want to know how IAS/IFRS affects their income statements and their balance sheets, and they want to be prepared for the extra amount of work that will be required to establish their financial statements in accordance with IAS/IFRS.

This essay has been written on the commission of a Swedish group now making such considerations, to voluntary adopt the IAS/IFRS. Consequently, this group is investigating how an application of the different IAS/IFRSs would affect them. We have been assigned to look more closely at one of the IAS/IFRSs, namely IFRS 3 – Business Combinations. The group has further given us a case; to investigate how the accounting for a specific business acquisition would have been affected by the regulation of IFRS 3. On the request of the group assigning us to this case, the names of the group as well as the name of the acquired business are left anonymous in this essay. Therefore the group is continuously throughout this essay called *the Acquirer*, and the acquired business is called *the Acquiree*.

IFRS 3 was issued by the IASB on March 31 2004, replacing IAS 22 – Business Combinations[3]. The issuing of IFRS 3 was a part of the first phase of the IASB's Business Combination Project, which had the objective to improve the quality of accounting for business combinations, goodwill and intangible assets[4]. The issuing of IFRS 3 was also made with the objective to reduce the differences between IFRS and US GAAP, in order to seek international convergence in accounting for business combinations.

[2] ÅRL 7 kap. 32 §
[3] IFRS 3, p.78
[4] EFRAG (2004)

"The objective of IFRS 3 is to specify financial reporting by an entity when it undertakes a business combination"[5]. More in detail, IFRS 3 specifies the accounting method that shall be applied in accounting for business combinations and consequently the measurement and accounting treatment of assets and liabilities acquired in a business combination. Further, IFRS 3 specifies the measurement and recognition of goodwill as well as the disclosure required of each business acquisition.

In developing IFRS 3, the IASB wanted to create a standard that would provide users of consolidated financial statements with the most relevant and reliable information. One of the IASB's main objectives, when developing IFRS 3, was therefore to reduce existing options established in the superseded IAS 22[6]. The IASB draw the conclusion that "permitting similar transactions to be accounted for in dissimilar ways impairs the usefulness of the information provided to users of financial information because both comparability and reliability is diminished", and therefore that the standard would be improved if options were reduced[7].

However, with the ambition to develop a standard that would provide users of financial statements with the most useful information, IFRS 3 became extensive and implies a number of very important and significant changes[8]. IFRS 3 makes great demands on groups applying it, both in terms of difficult assessments and in terms of disclosure requirements. The application of IFRS 3 is therefore interesting to study. How does the application of such an extensive and demanding standard really affects the groups applying it? Is it possible that the IASB, with the ambition to provide users with the most useful information, has made IFRS 3 too demanding or difficult to apply?

1.2. Problem Discussion

Applying IFRS 3 in accounting for business acquisitions has several implications, both because of the characteristics of the standard and because of the lacking experiences of applying it. Groups that comply with the regulation of IFRS 3 face numbers of accounting issues, more or less difficult to manage. An accounting for business acquisitions that provides users with the most useful information about those transactions does not come effortlessly.

The complexity of applying IFRS 3 originates, as previously discussed, from the objective of providing the most relevant and reliable information to users of financial statements. The means by which this objective is supposed to be reached are, for example, the clearer requirements of IFRS 3 to separately identify and recognise all assets and liabilities acquired in a business combination. These requirements include both those assets and liabilities appearing, and those assets and liabilities not appearing, on the balance sheet of the acquired business. Consistently, accounting for business acquisitions under IFRS 3 may imply difficult assessments in determining what assets and liabilities that really existed at the acquisition date.

Further, the objective to provide relevant and reliable information about business acquisitions is supposed to be reached by IFRS 3 requiring a high level of disclosure. This high level of disclosure may be both costly and time-demanding, as well as difficult to achieve. The idea is that the disclosure shall put stakeholders in a better position in order to understand what they have really got for their money invested, and that the market will be given greater insight into what really has been acquired. However, the transparency demanded from groups applying IFRS 3 may cause problems. Perhaps such transparency could involve the groups having to leave out

[5] IFRS 3, p.1
[6] EFRAG (2004)
[7] Basis for Conclusions, IFRS 3, BC121
[8] Deloitte Guide (2005)

information that could harm their businesses? Perhaps this transparency required could affect decisions taken by groups in acquiring businesses?

Thus, applying IFRS 3 in accounting for business acquisitions may give rise to several complex issues. The complexity of these issues lies in IFRS 3 demanding companies to make difficult assessments, from the beginning of the acquisition process, and then continuously in accounting for the business combination. Concerning the acquisition process, it has been argued that this needs to become more rigorous, both in planning and executing, under IFRS 3[9]. The reason is that more assets and liabilities have to be identified, and that information about these has to be disclosed.

Further, IFRS 3 may imply important effects on the financial statements. The stricter requirements of identification of especially intangible assets make new assets appear on the balance sheet, assets that have to be valued. Annual impairment tests of goodwill and intangible assets with indefinite useful lives is another example of IFRS 3 requiring difficult assessments, and further creating a risk of unpredicted charges appearing on the income statement. The higher level of disclosure demands more transparency towards the market, as well as more resources on due diligence since IFRS 3 forces managements to understand what they are really buying[10].

The discussion above points out the following problems: How does the application of IFRS 3 really affect groups in their accounting for business acquisitions? Further, how difficult is it to account for business acquisitions under IFRS 3 and how much does this affect the acquisition process? Are the requirements of IFRS 3 reasonable, in terms of difficulties and the amount of work demanded to manage those difficulties? Could accounting for business acquisitions under IFRS 3, because of its complexity, even affects groups in their decision-making?

All of the questions above are interesting and worth being given attention. However, in order to bring about a clear structure of this essay, we have chosen two specific questions at issue. In formulating these two questions at issue, we have considered what would be suitable to investigate and discuss for the group assigning us to this case.

The two questions at issue of this essay are:

1. Which issues arise when applying IFRS 3 in the accounting for business acquisitions?

2. How does the application of IFRS 3 affect the consolidated financial statements?

1.3. Purpose

The purpose of this essay is to investigate the application of IFRS 3, in order to provide parts of a basis for the decision-making of our assigner in its considerations of whether to adopt the IAS Regulation or not.

In order to do this, we aim to identify which issues, or practical problems, that arise when applying IFRS 3 in accounting for business acquisitions. We also aim to examine how the application of IFRS 3 affects the consolidated financial statements.

[9] PricewaterhouseCoopers Guide (2004)
[10] Quilligan L. (2006)

1.4. Delimitations

As mentioned previously, this essay examines the accounting for one specific acquisition made by a Swedish group in the year of 2005. Because of this, the empirical material is limited to the accounting for this specific acquisition of our study. However, we believe that some general conclusions can be made from studying this case, so our analysis and our conclusions are partly general. This is further discussed under 2.1. Choice of Method.

The acquisition of our case was originally accounted for in accordance with Swedish GAAP. Therefore, the differences between Swedish GAAP and IFRS 3 often serve as a starting point in our discussions. As indicated above, parts of IFRS 3 that do not apply to this specific case have been excluded from the scope of this essay. Nonetheless, some parts of IFRS 3 that do not apply to the case are mentioned in order to clarify a difference between IFRS 3 and Swedish GAAP. The reason for this is that these differences can be interesting to our assigner, as well as other Swedish groups facing a first-time application of IFRS 3.

When discussing Swedish GAAP in this essay, we refer to ÅRL, the recommendations from RR (Redovisningsrådet) and common customs concerning accounting for business combinations. The reason for this is that these are the regulations that have been used by *the Acquirer* in the original accounting for the acquisition.

Furthermore, this essay treats the accounting issues and not the valuation issues that come with the application of IFRS 3. Therefore, we have not tried to estimate any values in our application of IFRS 3 on the case of this essay.

1.5. Target group

The readers of this essay are supposed to have fundamental knowledge of accounting and different accounting principles to be able to utilise the information accurately. The fundamental knowledge of accounting is necessary for the reader to be able to critically analyse the material presented.

2. Methodology

In this chapter we describe the choices of method that we have made in our work with this essay. We also justify these choices, and consider how they may have affected the outcome of our study. Finally, we discuss the validity and reliability of our study.

2.1. Choice of Method

As mentioned in the introductory chapter, this essay has been written on the commission of a Swedish group considering a voluntary adoption of IAS/IFRS. Since this group wanted us to study a case; how the accounting for a specific acquisition would have been affected by the regulation of IFRS 3, this essay has become a case study. The case study method involves the examination of a single organisation, event or phenomenon.[11] "The strength of this method is further that it makes it possible for the researcher to concentrate on such a specific event or phenomenon in order to identify the factors that affect the phenomenon in question".

In this essay, we examine the accounting for a single acquisition and the possible effects of applying new accounting principles in the accounting for this acquisition. We believe that concentrating on the accounting for one single acquisition enable us to identify issues and effects that come with the application of IFRS 3, which also is the purpose of this essay. However, every acquisition has its own characteristics, which limits our ability to come to conclusions applicable to all kinds of acquisitions. For example, different acquisitions contain different kinds of assets and liabilities and all of these are, of course, not included in our case study. Nevertheless, by using the acquisition of our case study as an example, we believe that this essay can contribute in clarifying which possible issues and effects that come with the application of IFRS 3. Further, since the acquisition of our case study is rather uncomplicated we believe that the main implications of IFRS 3 become evident, and therefore, also easy to understand.

Those who criticise the case study method argue that it is hard to control the information presented through independent sources, and therefore that there is a risk of subjective results. (IBID) They further point out that it is normally impossible to generalise the results from a case study, and thereby question the value of studying one single event or phenomenon. We believe, on the other hand, that the information coming from a case study can be useful. Further we believe that our case study, by illustrating how IFRS 3 affects the accounting for one specific acquisition, can constitute a basis for comparison for other groups facing a first-time adoption of IFRS 3.

2.2. Collection of Data

In order to find information that could form a basis for our application of IFRS 3 on this case, we began by visiting the homepages of the four biggest audit firms[12]. At these homepages we found a number of guides treating the application of IFRS 3 that helped us in getting an overview of the standard. However, since these application guides may be biased by the audit firms' commercial purposes we have only used them as support and not as a basis for our investigation of IFRS 3.

A great part of the data collection for this study has consisted in the examination of the relevant accounting regulations concerning business acquisitions. We have examined the accounting for business acquisitions both according to Swedish GAAP and according to IFRS. We began with

[11] Bell J. (1995)
[12] Deloitte, Ernst & Young, KPMG and Öhrlings PricewaterhouseCoopers

examining the regulations of IFRS, namely IFRS 3, and the relevant parts of IAS 36 – Impairment of assets and IAS 38 – Intangible assets. Thereafter, we looked more thoroughly into these standards by going through the IASB's Basis for Conclusions. The examination of Swedish GAAP was more comprehensive, and made in order to understand the accounting principles on which the original accounting for the acquisition was based. The examination of Swedish GAAP was also aimed at investigating the differences existing between Swedish GAAP and IFRS.

Further, in order to get more information about the application of IFRS 3 we searched for articles and other studies made on the subject. We used search monitors like Business Source Premier and FAR Komplett, and searched on "IFRS 3", "applying IFRS 3", "accounting for business acquisitions" etc. However, since IFRS 3 is a relatively new standard there are still limited experiences from applying it. Therefore, we also searched for studies on US experiences from applying FAS (Financial Accounting Standard) 141 and 142, accounting standards of US GAAP that are comparable with the regulations of IFRS 3, IAS 36 and IAS 38.

Important data for our application of IFRS 3 on the acquisition of this case study has been provided by the company assigning us to the case. This involves internal data from *the Acquirer* such as the acquisition analysis and due diligence. Further, we have used information from the annual reports of both *the Acquirer* and *the Acquiree*.

2.3. Interviews

As part of our collection of data, we have carried out interviews. First, in order to get a greater understanding of IFRS 3 and what the application of this standard implies, we wanted to interview auditors well-informed on the subject. Therefore, we contacted the four biggest audit firms asking for someone with special knowledge in IFRS 3. Since one of us writers had had a lecture about IFRS 3 with Pernilla Rehnberg at Deloitte, we asked specifically for her when contacting Deloitte. Pernilla Rehnberg agreed to see us for an interview. Our contacts with the three other audit firms did not give any results.

Our purpose with the interview with Pernilla Rehnberg was to get support in interpreting the regulations of IFRS 3. Therefore, we had before the interview thoroughly examined the standard and the Basis for Conclusions to know which areas we needed to discuss. The purpose was further to ask about her view on the standard, how complicated it is to apply and which practical problems that arise when applying it. We also wanted to discuss the differences between IFRS 3 and Swedish GAAP. The interview with Pernilla Rehnberg was carried out at her office. We found a visiting interview most appropriate because it gave us the opportunity to adopt and ask follow-up questions.

The other interviews in our work with this study were those with persons involved in the acquisition at *the Acquirer* and *the Acquiree*. Further, our head contact with the group assigning us to this case has been the CFO (Chief Financial Officer) at *the Acquirer*. In our initial contact with CFO at *the Acquirer*, we presented what kind of information we needed to be able to carry out the case study. Considering our demands, the CFO at *the Acquirer* arranged for us to meet the CFO at *the Acquiree,* and the Investment Director at *the Acquirer* who was the one most involved in the acquisition process. Further, the CFO at *the Acquirer* has supported us throughout the entire process of this essay with necessary information and comments on our work. This has been very helpful, also considering the fact that the CFO at *the Acquirer* has previous experience from IFRS 3 when working as an auditor.

Both of the interviews with *the Acquirer* and *the Acquiree* were visiting interviews, which was necessary for us to be able to get the information that we needed. Since neither of the two

respondents were very familiar with IFRS 3, it was necessary that we had the opportunity to explain the standard before asking our questions. Before the interviews we sent the respondents an overview of the areas we wanted to discuss. By this means, they could be well prepared and gather the information they needed to answer our questions. At the interviews we tried to ask open questions in order to initiate a discussion and to get the respondents to talk freely about for example the strength of *the Acquiree* that could be used in our identification of intangible assets or in our explanation of goodwill. However, because of the fact that two respondents had lacking experiences from IFRS 3 it was sometimes hard to get the information that we needed. Therefore we sometimes had to pose leading questions, presenting our ideas based on the internal data that we had got access to before the interviews, and thereafter asking how these ideas could be considered reflecting reality. We are aware of the fact that this may have resulted in partly biased answers. However, it was the most convenient method to use in order to get the information that we needed.

Concerning the identification of intangible assets, we used the IASB's list of illustrative examples (see table 3.1.) as a checklist in order to ask the respondents which assets that could have been identified at the acquisition date. This may have had negative results on the reliability of our study which is discussed further under 2.7. Validity and Reliability.

2.4. Treatment of Data

In our treatment of data, we used IFRS 3 as a basis in order to clearly structure the data in our frame of references and in our application of IFRS 3. After having examined the accounting for business acquisitions of both IFRS and Swedish GAAP, and having interviewed the auditor Pernilla Rehnberg, we were able to identify different areas where issues or practical problems might appear in our application of IFRS 3. These different areas of issues thereafter constituted a foundation for our work with the case.

The internal data, as well as the interviews at *the Acquirer* and *the Acquiree*, were treated and used in our application of IFRS 3. However, since the acquisition of this case was not accounted for in accordance with IFRS 3, all information needed was not to be found in the internal data. Further, our respondents do not work with the principles of IFRS 3 and could therefore not give us complete information for our application. Therefore, we had to interpret the data that we were provided in order to create our fictitious application of IFRS 3 on this case, constituting our empirical material. Consequently, the empirical results of this essay are not entirely empirical but also contain our own interpretations.

2.5. Analysis of Data

The analysis of this study has been made with the frame of references as a basis. Further, the analysis has been based on our specific application of IFRS 3. From this we have been able to analyse the application of IFRS 3 in more general terms. Throughout our application of IFRS 3 we have identified where issues or practical problems occur. When analysing the empirical results, consisting of our application of IFRS 3 on this case, we have considered these practical problems and discussed them in terms of their complexity.

In our analysis, we have also compared our application of IFRS 3 with the performances of other groups applying IFRS 3. We have looked for similarities, but also for possible differences. However, such a comparison may seem a bit irrelevant since our application is fictitious and possibly not corresponding with the application *the Acquirer* itself would have made. Nevertheless, investigating where other groups have performed poorly, shows where these groups have had problems in their application, or which specific regulations the groups have been reluctant to comply with. This further gives us indications of where *the Acquirer* in our case may get problems

in its future possible application of IFRS 3. Thus, this comparison contributed to our analysis by relating our fictitious application to reality.

In our analysis we have further considered the effects that IFRS 3 may have on financial statements. We have analysed how IFRS 3 affects the items on the balance sheet, the reported result and the level of disclosure, in comparison with Swedish GAAP. This has contributed to our study by indicating how IFRS 3 actually affects accounting for business acquisitions.

2.6. Criticism of the Sources

When using sources in a study, it is important to analyse them critically in order to understand how they may affect the result of the study. For instance, it is important to consider the purpose and originator of the source. Further, when investigating a current subject like the one in this essay, it is important to consider the sources topicality.

Considering our use of the IFRS 3 guides from audit firms, these guides serve their purpose by being very educational and easy to understand. Therefore, they have been useful as a support in interpreting the regulations of IFRS 3. However, it is important to be critical of this kind of source, originating from someone who may have commercial purposes in publishing them. The auditors that create these guides want to sell their services, and may therefore have incentives to make the regulation seem more complicated than it is. In our use of the IFRS 3 guides this have been taken into consideration, so we have focused on the standard itself and only used the guides as a help in our own interpretations.

The same problem exists with many of our sources for prior research. Much of what we have found is articles and studies made by auditors who, as mentioned earlier, tend to complicate things in order to make companies believe they need the auditors' services. Therefore, concerning comments and opinions of auditors found in these articles we have borne in mind that those could be biased from the auditors' own incentives. However, the main part of the information that we have used from these articles is pure facts of how groups applying IFRS 3 actually have accounted for their acquisitions. Such pure facts we find no reason to criticise.

Further, our time limits, as well as those of the group assigning us to this case, have implied that we sometimes have not been able to use the amount of sources that would have given the best result. For instance we have only made two interviews, one with *the Acquirer* and one with *the Acquiree*. A more comprehensive work, interviewing, for example, people in the different divisions of *the Acquiree* would probably have resulted in a more reliable identification of assets acquired. In addition, the two persons interviewed at *the Acquirer* and *the Acquiree* had limited experience of IFRS 3 which also may have affected the results of our study. During the interviews we sometimes had to ask leading questions in order to get the information that we needed, which implies that we may have been given biased answers. The answers might have been different if the experience of our two respondents would have allowed us to ask our questions more openly.

2.7. Validity and Reliability

Validity could be described as the extent to which a measure really measures what it is supposed to.[13] Furthermore, if a measurement is valid, it is free from systematic and random errors. The most important thing is therefore to know what the measurement stands for and use it consistently[14]. We believe that we have achieved a high validity in this study, since our good

[13] Eriksson L. & Wiedersheim F. (2001)
[14] Eivegård R. (2003)

contact with the group assigning us to this case has enabled us to return with questions throughout the whole process. With the exception of the scarcities mentioned above, we have therefore had access to information allowing our study to measure what it was supposed to measure.

Further, we achieved a relatively high validity in our interviews since all of these interviews were visiting interviews. This enabled us to ensure that the respondents understood our questions, and to ask resulting questions which increased our possibility to get the information we asked for. The interviews were not clearly structured but rather became discussions between us and the respondents. Through unstructured interviews, it is possible to ask a lot of questions and get information about conditions the respondents do not deliberately talk about, which can result in answers with high validity[15]. In our interviews, this worked for instance when talking about the strengths of *the Acquiree*, in order to get the respondents to talk about which intangible assets could be identified, or which factors could be considered to have contributed to the value of goodwill.

The reliability of a study measures how reliable an investigation result is. (IBID) When a result repeatedly becomes the same, complete reliability has been achieved. Complete reliability also involves a study not being affected by the ones pursuing it[16]. We cannot ensure that the results of this study would have been the same if someone else would have carried it out, so complete reliability cannot be considered to have been achieved in this study. However, we have carefully considered all of our choices of method in order to achieve the highest reliability possible.

If the group assigning us to this case, i.e. *the Acquirer*, would have made the application of IFRS 3 themselves, the results would probably not have been exactly the same. This is because they, in comparison to us, have further insight into the acquisition process and in *the Acquiree*. Further, the results of this study are to some extent dependant on our own interpretations which could have been biased by our opinions and our way of thinking. Thus, it cannot be ensured that the results of this study would have been the same if someone else would have carried it out, which is something that decreases the reliability of the study. However, in comparison to *the Acquirer*, we can be more objective in our application of IFRS 3 since we have no incentives in trying to affect it one way or another. This increases the reliability of our study.

An important basis for this study is IFRS 3 and other regulatory documents. This material can be considered very reliable, which also increases the reliability of our study. When interpreting these regulatory documents we were supported by the interview with Pernilla Rehnberg. For the purpose of this essay we considered it enough to interview only one auditor. However, this may have decreased the reliability because we were not able to control if the same information would have been given from another auditor.

The answers we got from the CFO at *the Acquiree* and from the Investment Director at *the Acquirer* were very similar; something that we believe increases the reliability of our study. However, to only interview these two respondents may seem insufficient and the reliability would of course have been increased with more respondents. However, for the extent of this study, we believe that the information we got from our two respondents was enough to ensure a reasonable level of reliability.

As mentioned earlier, we had to use some leading questions based on our own ideas during the interviews because of the respondents lacking experience from IFRS 3. Such leading questions

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[15] Andersen H. (1994)

[16] Lundahl P. & Skärvad P-H. (1999)

may have had negative effects on the reliability of our study. Concerning our identification of intangible assets, our use of the IASB's list may have affected which assets that became identified. Some assets may have been left out because they were not on the list, and consequently because we did not ask for them. However, given our limited insight into *the Acquiree* before the interviews, and the respondents lacking experiences of identifying intangible assets in accordance with IFRS 3, we believe that this was the most appropriate method to use.

3. Frame of References

In this chapter we outline the accounting for business acquisitions for Swedish groups applying IFRS. We also point out important differences in accounting for business acquisitions between IFRS and Swedish GAAP. Finally, we describe prior experiences from applying IFRS in accounting for business acquisitions.

As mentioned in the introductory parts of this essay all listed groups in Sweden, and in the EU, have to establish their financial statements in accordance with the IAS Regulation 1606/2002[17]. The IAS Regulation implies that from 1 January 2005, all listed groups in the EU have to comply with the IAS/IFRS adopted by the EU in their accounting. Non listed groups may choose to comply with the IAS regulation and thereby voluntary apply the IAS/IFRS adopted by the EU in their accounting[18]. Further, the Swedish groups applying the IAS/IFRS in establishing their financial statements also have to comply with the RR30 – Complementary accounting regulations for groups.

In accounting for business acquisitions in accordance with the IAS Regulation, the most important standard is IFRS 3 – Business Combinations. The Swedish groups accounting for business acquisitions in accordance with Swedish GAAP, on the other hand, apply the regulations of ÅRL and RR 1:00 – Group accounting. In the following parts of this chapter we describe important parts of accounting for business acquisitions under IFRS 3, and point out where the regulation of this standard differs from the regulation of ÅRL/RR 1:00. The differences between IFRS 3 and Swedish GAAP is further summarised in the part 3.8. Summary of Differences between IFRS 3 and Swedish GAAP of this chapter.

3.1. Introduction to IFRS 3 – Business Combinations

The objective of IFRS 3 is "to specify the financial reporting by an entity when it undertakes a business combination"[19]. IFRS 3 specifies for the business combinations within its scope which method of accounting that shall be applied, comprising the identification of an acquirer as well as the measurement and the allocation of the cost of the business combination. Further, IFRS 3 regulates the identification of the acquired entity's assets, liabilities and contingent liabilities. It regulates how these items shall be measured and when they shall be recognised in the accounting of a business combination. Further, IFRS 3 also specifies the disclosure requirements for business combinations.

IFRS 3 shall be applied in the accounting of business combinations where one entity through the acquisition of another entity has obtained control over that acquired entity. Excluded from the scope of IFRS 3 are business combinations that form a joint venture, that involve entities or businesses under common control, that involve two or more mutual entities and those that form a reporting entity by contract alone without the obtaining of an ownership interest[20].

3.2. Method of Accounting

IFRS 3 allows, without any exceptions, only one method of accounting for business combinations.[21] This method, called the purchase method, shall consequently be used in the accounting of all business combinations within the scope of IFRS 3. The limitation to one single method of accounting for business combinations is one of the main differences between IFRS 3

[17] ÅRL 7 kap. 32 §
[18] ÅRL 7 kap. 33 §
[19] IFRS 3, p.1
[20] IFRS 3, p.3
[21] IFRS 3, p.14

and Swedish GAAP.[22] According to Swedish GAAP two different methods of accounting, the purchase method and the pooling method, are allowed in accounting for business combinations. The pooling method is however only permitted under certain conditions, and implies that only a proportional share of the acquiree's net assets is recognised at fair value in the accounting for the business combination.

In developing IFRS 3, the method of accounting for business combinations was one of the IASB's primary focuses[23]. The decision to allow only one method of accounting for business combinations was considered important by the IASB in order to achieve comparability between the financial statements of different business combinations.[24] Further this decision was considered important in order to prohibit companies from structuring transactions to achieve a desired accounting result.

In accordance with IFRS 3, the purchase method shall be applied from the acquisition date, i.e. the date when the acquirer effectively obtains control of the combining entity.[25] The standard further clarifies that control can be obtained even if a transaction is not closed or finalised in law. The application of the purchase method involves three different steps that are described in the following parts. These three steps of accounting for business combinations, when using the purchase method, are; identifying an acquirer, measuring the cost of the business combination and allocating the cost of the business combination[26].

3.2.1. Identifying an Acquirer

According to the purchase method, a business combination is viewed from the perspective of the combining entity that is identified as the acquirer[27]. An acquirer that is the combining entity obtaining the control of the other combining entities shall always be identified when using the purchase method[28]. Under normal circumstances, the acquirer is the entity acquiring more than one-half of the other entity's voting rights unless it can be demonstrated that such ownership does not constitute control[29]. Control of the other entity can be obtained by other means, for example through an agreement to obtain more than one-half of the voting rights or the power to govern the financial and operating policies[30].

The identification of an acquirer can sometimes be very difficult. In some business combinations difficulties of identifying an acquirer lie in domestic legal, taxation or economic factors[31]. Further, as in the case of reverse acquisitions, the difficulties lie in the fact that the acquirer is actually the entity whose equity interests have been acquired and consequently the acquiree is the entity issuing the acquisition[32].

3.2.2. Measuring the Cost of the Business Combination

The cost of the business combination shall be measured by the acquirer as "the aggregate of the fair values, at the date of the exchange, of assets given, liabilities incurred or assumed, and equity instruments issued by the acquirer, in exchange for control of the acquiree, plus any cost directly

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[22] ÅRL 7 kap. 18-23 §§
[23] Basis for Conclusions, IFRS 3, BC3(a)
[24] Basis for Conclusions, IFRS 3, BC38
[25] IFRS 3, p.39
[26] IFRS 3, p.16
[27] IFRS 3, p.15
[28] IFRS 3, p.17
[29] Deloitte Guide (2004)
[30] IFRS 3, p.19
[31] Basis for Conclusions, IFRS 3, BC54
[32] Basis for Conclusions, IFRS 3, BC59

attributable to the business combination"[33]. Costs directly attributable to the business combination are, for example, professional fees paid to accountants, legal advisers and other consultants to effect the combination.[34] Nonetheless, a portion of general administrative costs and costs of maintaining an acquisition department shall not be included in the cost of a business combination.

When a business combination is effected through more than one exchange transaction, the cost of the combination is the total cost of these transactions[35]. In such cases the assets given and liabilities incurred or assumed by the acquirer shall, as explained earlier, be measured at the fair value at each date of exchange.

In some cases a business combination agreement can provide for adjustments to the cost of the combination. Such an adjustment can be dependent on future events, for example a specified level of profits achieved in future periods.[36] These kinds of adjustments may only be included in the cost of the business combination at the acquisition date, if they are probable and can be measured reliably.

3.2.3. Allocating the Cost of the Business Combination

The purchase method implies that the cost of the business combination shall be allocated at the acquisition date. This allocation shall be done by the acquirer recognising the fair value of the acquiree's identifiable assets, liabilities and contingent liabilities, even those not previously recognised by the acquiree[37]. Any possible minority interests in the acquiree will be stated at the minority's portion of the net fair value of those items in the accounting of the business combination[38].

Since the purchase method implies recognising the total value exchanged in a business combination, it provides users of financial statements with useful information for assessing the investment made by management and the subsequent performance of that investment[39]. The purchase method hereby achieves one of the objectives of financial statements, i.e. to show the accountability of management for the resources entrusted to it[40].

In allocating the cost of the business combination an asset, other than an intangible asset, shall be recognised if it is probable that any associated future economic benefit will flow to the acquirer and if its fair value can be measured reliably.[41] Further, a liability, other than a contingent liability, shall be recognised if it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and if its fair value can be measured reliably.

For an intangible asset or a contingent liability to be recognised it is, however, enough that its fair value can be measured reliably. The remaining difference between the cost of a business combination and the fair value of total net assets acquired is recognised as goodwill[42]. The recognition of the acquiree's assets, liabilities and contingent liabilities as well as the recognition of goodwill are further discussed in the following parts of this chapter.

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[33] IFRS 3, p.24
[34] IFRS 3, p.29
[35] IFRS 3, p.25
[36] IFRS 3, p.33
[37] IFRS 3, p.36
[38] Basis for Conclusions, IFRS 3, BC121
[39] Basis for Conclusions, IFRS 3, BC45
[40] Basis for Conclusions, IFRS 3, BC53
[41] IFRS 3, p.37
[42] IFRS 3, p.51

3.3. The Acquiree's Identifiable Assets and Liabilities

As indicated earlier, the purchase method implies 100 per cent of the acquiree's assets and liabilities to be included in the accounting for a business combination irrespective of the extent of the ownership interest held by the acquirer.[43] This is in order to fulfil the objective of a consolidated financial statement, i.e. to provide users with relevant and reliable financial information about the resources under the control of the parent entity, so as to reflect that the related entities operate as a single economic entity.

However, for an acquirer to be able to recognise the acquiree's assets and liabilities in accounting for a business acquisition, those assets and liabilities must first meet the definitions that are to be found in the IASB's framework. In the framework an asset, and a liability, are defined as follows:[44]

"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."

"A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits."

Further, all identifiable assets and liabilities of an acquiree, which exist at the acquisition date and meet the definitions, shall be recognised by the acquirer at their fair values at the acquisition date if they meet the criteria for recognition.[45] This includes all assets and liabilities the acquirer purchases or assumes, even those not previously recognised in the acquiree's financial statements. This also includes all financial assets or liabilities, irrespective of whether they were not recognised in the acquiree's financial statements.[46] For instance, a tax benefit arising from the acquiree's tax losses, which was not recognised in the acquiree's financial statement, can qualify for recognition as an asset for the business combination. However, there is an exception to the measurement at fair value at the acquisition date according to Swedish GAAP. [47] This exception concerns some financial instruments that are not allowed to be measured at fair value.

The recognition criteria for an asset, other than an intangible asset, are that it shall be probable that any associated future economic benefits will follow to the acquirer, and that the fair value shall be possible to measure reliably[48]. The definition and recognition criteria for an intangible asset are discussed later in this chapter.

The criteria for recognising a liability, other than a contingent liability, are that it shall be probable that an outflow of resources embodying economic benefits will be required to settle the obligation, and that the fair value shall be possible to measure reliably[49]. Contingent liabilities in accounting for business acquisitions are discussed later in this chapter.

Concerning costs for terminating or reducing activities of an acquiree, according to IFRS 3, those may only be recognised as liabilities by the acquirer if "the acquiree has, at the acquisition date, an existing liability for restructuring recognised in accordance with IAS 37 – Provisions, Contingent

[43]Basis for Conclusions, IFRS 3, BC123
[44] IASB Framework (1989)
[45] IFRS 3, p.36
[46] IFRS 3, p.44
[47] ÅRL 4 kap. 14 (b) §
[48] IFRS 3, p.37
[49] IFRS 3, p.37

Liabilities and Contingent assets"[50]. Further, an acquiree's restructuring plan whose execution is conditional on the business acquisition being effected is not a present obligation of the acquiree immediately before the business combination.[51] "Therefore, an acquirer shall not recognise a liability for such restructuring plans as part of allocating the cost of the combination". This is consistent with the regulation of IFRS 3 that only the acquiree's assets or liabilities existing at the acquisition date shall be recognised.

This accounting treatment of costs for restructuring differs from Swedish GAAP. In accordance with Swedish GAAP, future costs for restructuring that are a result from an acquirer's plans at the time of the acquisition shall be recognised as a liability if certain criteria are met.[52] Those criteria are for example that the restructuring plan shall be a direct consequence of the acquisition, that the main features of such a plan has been detailed and that these features have been announced and thereby raised valid expectations of those affected that the plan will be carried out.

This exception for recognising liabilities not existing at the acquisition date has been excluded from IFRS 3, and consequently, costs for restructuring being effected after the acquisition have to be recognised in future financial statements instead.[53] In allowing recognition of future costs for restructuring in the accounting for business acquisitions, Swedish GAAP gives acquirers the opportunity to make an acquisition look better since the costs for restructuring thereby do not have to be recognised in future income statements. Instead costs for restructuring increase the value in goodwill that is being annually amortised. Consequently, this could enable users of financial statements "to evaluate the nature and the financial effect of the business combination"[54], which is one of the reasons for the IASB excluding this kind of accounting treatment.

Concerning other costs or future losses expected to result from a business combination, an acquirer can neither recognise these as liabilities[55]. Such expected future outflows may in fact have affected the price paid by an acquirer as well as the value of existing recognised assets[56], which is one of the reasons such costs or future losses are not allowed to be recognised as liabilities by acquirers. Further, this is also consistent with the regulation of IFRS 3 that recognition only shall be made of those assets or liabilities existing at the acquisition date.

3.4. The Acquiree's Contingent Liabilities

The acquiree's contingent liabilities, recognised by an acquirer in a business combination, must meet the definition of a contingent liability in accordance with IAS 37. This definition of a contingent liability is: [57]

"a possible obligation that arises from the past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity or,

[50] IFRS 3, p.41 (a)
[51] IFRS 3, p.43
[52] RR1:00, p.43
[53] Rehnberg P., Deloitte (2006)
[54] IFRS 3, p. 66
[55] IFRS 3, p.41 (b)
[56] Basis for Conclusions, IFRS 3, BC80
[57] Basis for Conclusions, IFRS 3, BC107

a present obligation that arises from past events but is not recognised either because it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation or because the amount of the obligation cannot be measured with sufficient reliability."

An acquirer shall further separately recognise a contingent liability of the acquiree if its fair value can be measured reliably at the acquisition date.[58] The fair value shall be measured as the amount that a third party would charge to assume those contingent liabilities, which shall reflect expectations about all possible cash flows[59]. If a contingent liability's fair value cannot be measured reliably, the amount of goodwill recognised will be affected instead.

As explained earlier, costs for restructuring conditional on a business acquisition cannot be recognised as liabilities because they do not represent a present obligation at the acquisition date. Those costs can neither be recognised as contingent liabilities, because they do not represent possible obligations arising from a past event[60].

3.5. The Acquiree's Intangible Assets

In allocating the cost of a business combination under IFRS 3, an acquirer separately has to recognise an intangible asset of the acquiree if, and only if, it meets the definition of an intangible asset and its fair value can be measured reliably[61]. This means that an acquirer must examine all of the acquiree's intangible assets, both those previously recognised and those not appearing on the balance sheet of the acquiree, to assess whether they meet the definition of an intangible asset and further if their fair value can be reliably determined. The intangible assets that meet the definition shall be recognised and measured at the acquisition date.

In recognising intangible assets as parts of a business acquisition, IFRS 3 refers to the definition in IAS 38 – Intangible assets. In accordance with this standard an intangible asset is "an identifiable, non-monetary asset without physical substance"[62]. The identifiability criterion is further important, and necessary to be able to separate an intangible asset from goodwill. In accordance with IAS 38, an intangible asset meets the identifiability criterion only if it is separable or arises from contractual or other legal rights[63]. For an intangible asset to be separable it must be possible to separate or divide it from the entity and sell, transfer, license, rent or exchange it, either individually or together with a related contract. However, if an intangible asset arises from contractual or legal rights it is, in accordance with IAS 38, considered identifiable regardless of whether those rights are transferable or separable from other rights and obligations of the entity.

Further, the definition of IAS 38 requires the ability to control the intangible asset and the existence of future economic benefits flowing from that asset to the entity. An entity can be considered to control an intangible asset "if it has the power to obtain the future economic benefits flowing from the underlying resource and restrict the access of others to those benefits"[64]. The control criterion hinder for example intangibles such as skills or resources embodied in an assembled workforce to be recognised.[65] These intangibles usually do not meet the definition of an intangible asset because the entity often has insufficient control over the

[58] IFRS 3, p.37
[59] IFRS 3, Appendix B, B16 (l)
[60] IFRS 3, p.43
[61] IFRS 3, p.45
[62] IAS 38, p.8
[63] IAS 38, p.12
[64] IAS 38, p.13
[65] Deloitte Guide (2004)

actions of persons. Concerning the future economic benefits, IAS 38 states that these "may include revenue from sale of products or services, cost savings or other benefits resulting from the use of the assets"[66].

In issuing IFRS 3, the IASB considered whether the criteria for recognising intangible assets separately from goodwill also should be applied to in-process research and development projects acquired in a business combination, and concluded that they should.[67] The IASB concluded "that adopting different criteria would impair the usefulness of the information provided to users about the assets acquired in a business combination because both comparability and reliability would be diminished". However, the criteria of IAS 38 that an intangible asset can never arise from an in-process research project, but can arise from an in-process development project, shall also be applied in accounting for business combinations. Therefore, intangibles from an in-process research project will be subsumed under goodwill while intangibles from an in-process development project shall be recognised separately from goodwill.

The regulation of IFRS 3, and IAS 38, implies higher demands on identifiable intangible assets being recognised separately from goodwill than the superseded IAS 22[68]. IFRS 3 also implies higher demands on identifying intangible assets separately from goodwill than Swedish GAAP[69]. However, the fact that IFRS 3 implies higher demands on identification of intangible assets than Swedish GAAP is not due to a clear difference in those two set of accounting principles. Swedish GAAP also implies identifiable intangible assets to be recognised in accounting for business acquisitions, but is not as clear about this as IFRS 3. [70] As a result, common customs have developed in Sweden where not that many intangible assets are separately recognised from goodwill which further has implied an acceptance for this accounting treatment. The difference with IFRS 3, from IAS 22 and Swedish GAAP, is that it makes clear how intangible assets shall be identified to avoid excuses of why identification and separation from goodwill cannot be done. The reason for which the IASB wanted to clarify the separate recognition of intangible assets from goodwill was that they considered that this would enhance the usefulness of financial statements[71].

However, with clearer identification requirements concerning intangible assets, the accounting for business acquisitions for groups applying IAS/IFRS has become more complex and demands more difficult assessments. Many intangible assets that previously would have been subsumed within goodwill now must be separately identified and valued[72]. The IASB has, though, created a guidance of illustrative examples of items acquired in a business combination that meet the definition of an identifiable intangible asset and therefore could be recognised separately from goodwill under IFRS 3, given that their fair values can be measured reliably.

The IASB has divided the items that can be recognised as intangible assets into five different categories (see table 3.1. below). Further these items are described as to whether they meet the definition of an identifiable intangible asset because they arise from contractual or legal rights or because they are separable. Most of these items described can be recognised because they arise from contractual or legal rights. However some items, such as customer lists, non-contractual customer relationships and unpatented technology, meet the definition of an intangible asset because they are separable.

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[66] IAS 38, p.17
[67] Basis for conclusions, IFRS 3, BC104-106
[68] Deloitte Guide (2005)
[69] Ernst & Young Guide (2004)
[70] Rehnberg P., Deloitte (2006)
[71] Basis for Conclusions, IFRS 3, BC89
[72] PricewaterhouseCoopers Guide (2004)

Table 3.1.

Category of Intangible Assets	Examples
Marketing-related intangible assets	Trademarks, trade names, internet domain names, trade dress, newspaper mastheads, non-competition agreements
Customer-related intangible assets	Customer lists, order or production backlog, customer contracts and the related customer relationships, non-contractual customer relationships
Artistic-related intangible assets	Plays, operas, books, magazines, newspapers, musical works, pictures, photographs, videos, television programmes
Contract-based intangible assets	Licensing, royalty, advertising, service- or supply contracts, lease agreements, construction permits, franchise agreements, operating rights, use rights (such as drilling, water, air etc.)
Technology-based intangible assets	Patented/unpatented technology, computer software, mask works, databases, trade secrets

Source: IFRS 3, Illustrative Examples

Once being able to identify an intangible asset an acquirer must be able to measure it reliably, which may cause difficult valuation problems. However, it has been stated that it should take a lot for an identifiable intangible asset not being possible to measure reliably.[73] If an intangible asset can be separated, it can most probably also be given a value that is reliable.

In issuing IFRS 3 the IASB was concerned that failing the reliability of measurement might be inappropriately used by entities as a basis for not recognising intangible assets separately from goodwill.[74] They also considered the fact that intangible assets acquired in a business combination often were included in goodwill, despite the requirements in IAS 22 and the previous version of IAS 38 of separate recognition. Therefore, the IASB decided to clarify that the fair value of identifiable intangible assets acquired in a business combination normally can be measured with sufficient reliability to be separately recognised from goodwill. They also clarified "that the only circumstances in which it might not be possible to reliably measure 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 it either is not separable, or is separable but there is no history or evidence of exchange transaction for the same or similar assets".

However, IFRS 3 provides limited guidance on how a reliable fair value of intangible assets actually shall be measured. The valuation hierarchy of IASB indicates that quoted prices on an active market are the most reliable estimate of the fair value of an intangible asset.[75] However, an active market is rare for intangible assets. Therefore, prices of similar recent transactions or, in absence of these, some kind of discounted cash flow model most often have to be used.

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[73] Rehnberg P., Deloitte (2006)
[74] Basis for Conclusions, IFRS 3, BC101-102
[75] IAS 38, p.39

Once an intangible asset has been recognised in the accounting for a business acquisition, the useful life of that intangible asset has to be assessed. In accordance with IAS 38, an acquirer must determine whether the useful life of an intangible asset is to be considered as finite or indefinite[76]. An intangible asset shall be considered having an indefinite useful life if "there is no foreseeable limit to the period over which the asset is expected to generate cash flows"[77]. On the contrary, when "the cash flows are expected to continue for a finite period, the useful life of the asset is limited to that finite period"[78]. Considering intangible assets arising from contractual or legal rights, the useful lives are constrained by the duration of those rights[79]. However, if it is probable that such rights can be renewed without significant cost, this shall also be considered in determining the useful life of an intangible asset.

The determination of useful lives is of crucial importance to the measurement of an intangible asset subsequent to the acquisition date. Intangible assets with finite useful lives shall be amortised over that useful lives.[80] The amortisation method used shall reflect the pattern of which future economic benefits are expected to be consumed.

Intangible assets with indefinite useful lives shall not be amortised but assessed for impairment in accordance with IAS 36 – Impairment of assets at least annually or more frequently if an indicator for impairment is identified[81]. However, an assessment of an intangible asset's useful life to be indefinite does not mean infinite.[82] The useful life of an intangible asset only represent the level of future maintenance expenditure required to maintain the asset at its standard of performance and the entity's ability and intention to reach such a level. Further, the useful life of an intangible asset must be reviewed each period to determine whether it still can be considered to be indefinite.[83] If any events or circumstances indicate that an indefinite useful life no longer can be supported, a finite useful life must be determined and an amortisation over that useful life must begin.

The IAS/IFRS measurement of an intangible asset subsequent to the acquisition date differs from Swedish GAAP. In accordance with Swedish GAAP all intangible assets shall be amortised, and their useful lives be assessed to be no longer than five years.[84] However, a useful life longer than five years can be accepted if that longer useful life with certainty can be determined. RR1:00 states the limit for the useful life of an intangible asset to be 20 years, if circumstances proving otherwise cannot be shown.

3.6. Goodwill

The extensive requirements for identifying intangible assets in IFRS 3 should imply more intangible assets being recognised in the accounting for business acquisitions. However, all items adding value to a business combination cannot be separately recognised as intangible assets. Therefore an acquirer shall recognise goodwill acquired in a business combination representing intangible factors considered in determining the amount to pay for the acquisition. Goodwill acquired in a business combination consequently represents the payment made by an acquirer in

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[76] IAS 38, p.88
[77] Basis for Conclusions, IAS 38, BC60
[78] Basis for Conclusions, IAS 38, BC62
[79] Basis for Conclusions, IAS 38, BC66
[80] IAS 38, p.97
[81] IAS 38, p.108-109
[82] IAS 38, p. 91
[83] IAS 38, p. 109
[84] ÅRL, 4 kap. 4 §

anticipation of future economic benefits from assets that cannot be individually identified and separately recognised[85].

However, in the opposite case an acquirer's interest in the net fair value of identifiable and recognised assets, liabilities and contingent liabilities may exceed the cost of the business combination. That excess, commonly referred to as negative goodwill, may according to the IASB appear for example because of errors in measuring the fair value of either the cost of the combination or the acquiree's identifiable assets, liabilities and contingent liabilities, or because of a bargain purchase[86].

If negative goodwill appears in the accounting for a business acquisition, the acquirer must reassess the identification and measurement of the acquiree's identifiable assets, liabilities and contingent liabilities as well as the cost of the combination.[87] If an excess still remains after that reassessment, the acquirer must immediately recognise a profit or loss for that excess. The treatment of negative goodwill in IFRS 3 differs from Swedish GAAP. In accordance with RR1:00, negative goodwill shall be recognised as a provision as long as it does not refer to expected future losses or costs[88]. This provision shall thereafter be diminished and incomes be recognised as future economic benefits from identifiable and amortisable non-monetary assets gained by the business combination[89].

Concerning the measurement of goodwill in accounting for a business acquisition, an acquirer shall "initially measure 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"[90]. Further, in accordance with IFRS 3, goodwill shall not be amortised[91]. After the initial recognition, goodwill shall instead be measured at cost less any accumulated impairment losses[92]. This measurement of goodwill differs from Swedish GAAP that requires goodwill to be amortised over a useful life of no longer than 20 years if a longer useful life cannot be justified[93].

In accordance with IFRS 3, and IAS 36, an acquirer shall, instead of annual amortisations, test goodwill for impairment annually or more frequently if there are indications that it might be impaired[94]. In effecting these impairment tests, an acquirer must allocate the value of goodwill to cash-generating units, or groups of cash-generating units.[95] The reason for this is that goodwill does not generate cash flows independently from other assets, and consequently, it cannot be impairment tested independently from other assets. Goodwill acquired in a business combination shall be allocated to each of an acquirer's cash-generating units that are expected to benefit from the synergies of the combination. This allocation shall be done irrespective of whether other assets or liabilities of the acquiree are assigned to those units. Each unit to which goodwill is being allocated should represent the lowest level within the entity at which it is monitored for internal management purposes.

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[85] IFRS 3, p.52
[86] Basis for Conclusions, IFRS 3, BC148
[87] IFRS 3, p.56
[88] RR1:00, p.68 & 73
[89] RR1:00, p.72
[90] IFRS 3, p.51
[91] IFRS 3, p.55
[92] IFRS 3, p.54
[93] RR15, p.64
[94] IFRS 3, p.55
[95] IAS 36, p.80

Further, each cash-generating unit or groups of cash-generating units, to which goodwill have been assigned, shall be tested for impairment by comparing the carrying amount of the unit, including goodwill, with the recoverable amount of the unit.[96] If the carrying amount of the unit exceeds the recoverable amount of the unit, the entity shall recognise an impairment loss. This impairment loss shall primarily decrease the value of goodwill but, if this is not enough, an impairment loss shall decrease the value of the cash-generating unit that has been impaired.

The annual impairment tests imply that an acquirer always must be able to justify and explain goodwill recognised in the business combination. The requirement of annual impairment tests does not exist in Swedish GAAP. Under Swedish GAAP, goodwill only has to be tested for impairment when there is an indication that the cash-generating unit has been impaired[97].

3.7. Disclosure

IFRS 3 requires, as indicated earlier, an acquirer to disclose an extensive amount of information concerning a business combination. Some examples of how this information has been disclosed are to be found in Appendix 1. The high level of disclosure was established by the IASB, with three main disclosure objectives discussed below[98]. To fulfil these objectives, IFRS 3 has explicitly specified certain disclosure requirements. However, except for these specific requirements, an entity is also obligated to leave any additional information if it is necessary to fully accomplish the disclosure objectives[99].

The first of the disclosure objectives implies that the disclosure shall enable users of an acquirer's financial statements "to evaluate the nature and financial effect of business combinations that were effected during the reporting period" [100]. Therefore, for each business combinations effected during a reporting period, an entity has to disclose information like the names and descriptions of combining entities, as well as the acquisition dates and the percentage of equity instruments acquired.[101] IFRS 3 also requires disclosures about the cost of the combination and a description of its components, including costs directly attributable to the combination. If equity instruments are issued or is issuable as a part of the cost, the number of equity instruments, information regarding their fair value and how this was determined, must be disclosed. For business combinations effected after the balance sheet date but before the financial statements were authorised for issue, all the previous information shall be disclosed, unless it is impracticable[102].

IFRS 3 also requires the amounts recognised for each class of an acquiree's assets, liabilities and contingent liabilities to be disclosed.[103] The acquirer shall also, unless it would be unpractical, disclose the book values of these classes of intangible assets determined in accordance with IFRS 3 immediately before the acquisition. Concerning the intangible assets the disclosure requirements of IAS 38 must be considered. These requirements imply that an acquirer must leave information for each class of the acquiree's intangible assets about for example their useful lives, amortisation rates and methods, the gross carrying amounts and accumulated amortisation at the beginning and the end of the period[104]. Regarding the contingent liabilities, disclosure requirements in accordance with IAS 37 also have to be accomplished[105].

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[96] IAS 36, p.90
[97] RR1:00 p.65 & RR17 p.77
[98] Basis for Conclusions, IFRS 3, BC170
[99] Deloitte Guide (2004)
[100] IFRS 3, p.66€
[101] IFRS 3, p.67
[102] IFRS 3, p.66
[103] IFRS 3, p.67 (f)
[104] IAS 38, p.118
[105] IFRS 3, p.47

Further, IFRS 3 requires an acquirer to disclose an explanation of the factors that has contributed to a cost that results in the recognition of goodwill.[106] This explanation shall comprise a description of each intangible asset that was not recognised separately from goodwill and an explanation of why the fair value of these intangible assets could not be measured reliably. In the opposite case when negative goodwill appears, an acquirer must disclose the amount of any profit or loss recognised, and furthers, the nature of such a profit or loss.

These examples of disclosure, as well as the rest of the specified disclosure requirements aimed to fulfil the first disclosure objective, could be disclosed in aggregate for acquisitions effected during the reporting period that are individually immaterial[107]. However, IFRS 3 does not specify what criteria determine if an acquisition could be considered immaterial. Therefore, an acquirer has to, from case to case, decide whether an acquisition is immaterial or not.[108] In deciding this, an acquirer could consider different factors such as size or importance of the acquisition. The basis for such consideration must, however, be to evaluate if decisions taken by users of the combining entities' financial statements could differ if all details are being disclosed or not. If an acquirer believe that full disclosure about an acquisition could affect the users' decision-making, such an acquisition shall not be considered immaterial.

The second disclosure objective of IFRS 3 is to enable users of an acquirer's financial statements "to evaluate the financial effects of gains, losses, error corrections and other adjustments recognised in the current period that relate to business combinations that were effected in the current or in previous periods"[109]. If it is relevant for the understanding of a combined entity's financial performance, any gain or loss recognised in the current period related to the identified assets or liabilities or the contingent liabilities assumed shall also be disclosed[110]. Herein is also included information about possible amounts and explanations of adjustments, which has been made as a result of the initial accounting of a business combination being determined only provisionally at the end of that period[111].

The third disclosure objective is "to provide users of an acquirer's financial statements with information that enables them to evaluate changes in the carrying amount of goodwill during the period".[112] This includes information about the impairment tests in accordance with IAS 36.

The disclosure requirements of IFRS 3 are much more extensive that those of Swedish GAAP.[113] IFRS 3 implies that disclosure shall be given of the entire acquisition process, including basic accounting, all over and understatements of values in the acquiree's assets and liabilities as well as the value of goodwill resulting from the acquisition and the composition of that goodwill value. The disclosure requirements of IFRS 3 thus imply more detailed explanations about business acquisitions than Swedish GAAP[114].

[106] IFRS 3, p.67 (h)
[107] IFRS 3, p.68
[108] Rehnberg P., Deloitte, (2006)
[109] IFRS 3, p.72
[110] IFRS 3, p.73
[111] IFRS 3, p.72
[112] IFRS 3, p.74
[113] Rehnberg P., Deloitte, (2006)
[114] RR1:00 p.91-102 & IFRS 3 p.66-77

3.8. Summary of Differences between IFRS 3 and Swedish GAAP

IFRS 3	Swedish GAAP
Method of Accounting	
One single method of accounting is permitted; the purchase method.	Two different kinds of methods of accounting are permitted; the purchase method and the pooling method.
Measurement at Fair Value	
All of the acquiree's assets and liabilities shall be measured at fair value at the acquisition date.	All of the acquiree's assets and liabilities shall be measured at fair value at the date of the acquisition, except for some financial instruments that are not permitted to be measured at fair value.
Costs for Restructuring	
Only those costs for restructuring existing in the acquiree at the date of the acquisition can be recognised in the accounting for the business combination.	Future costs for restructuring that are a result of an acquirer's plans at the time of the acquisition shall be recognised as a liability if certain criteria are met. For example the restructuring plan must be a direct consequence of the acquisition.
Identification of Intangible Assets	
The fact that all identifiable intangible assets shall be recognised separately from goodwill has been further clarified to avoid identifiable intangible assets being subsumed under goodwill.	Identifiable intangible assets shall be recognised, even though this is not as clear as in IFRS 3. As a result, a custom and an acceptance for most intangible assets being subsumed under goodwill has been developed.
Intangible Assets with Indefinite Useful Lives	
Shall not be amortised but tested for impairment annually.	No intangible assets are considered to have indefinite useful lives. Consequently, all intangible assets shall be amortised over no longer than 20 years if other circumstances proving otherwise cannot be shown.
Goodwill	
Shall not be amortised but tested for impairment annually.	Shall be amortised over a useful life of no longer than 20 years if a longer useful life cannot be justified. Consequently, there is no requirement for annual impairment tests of goodwill.

IFRS 3	Swedish GAAP
Negative Goodwill	
If negative goodwill appears, a reassessment of the fair value of the acquiree's assets and liabilities as well as the cost of the combination shall be made. If an excess still remains after that reassessment, the acquirer must immediately recognise a profit or loss for that excess.	Negative goodwill shall be recognised as a provision as long as it does not refer to expected future losses of costs. The provision shall thereafter be diminished and incomes be recognised.
Disclosure	
More extensive and descriptive disclosure requirements of the entire acquisition. Further, IFRS 3 implies great demands on disclosure concerning impairment tests.	Requires less disclosure than IFRS 3.

3.9. Prior Research on the Application of IFRS 3

Swedish groups that have to, or have chosen to, comply with the IAS regulation have only accounted for their business acquisitions in accordance with IFRS 3 since the year of 2005. This means that there are yet limited experiences on the application of the accounting principles of IFRS 3 discussed earlier in this chapter. However, some research has been made on the performances of the Swedish groups applying IFRS 3 that may indicate where these groups have had problems, or possibly a lacking will, to fully comply with the standard. Some of the results of this research are presented below.

However, since there are lacking experiences from applying IFRS 3 in Sweden, and also in the EU, it may be of interest to look at research made on similar accounting for business acquisitions adopted elsewhere. As mentioned in the introductory chapter of this essay, IFRS 3 was developed in order to reduce differences between IFRS and US GAAP. Therefore IFRS 3 became to resemble importantly with the US FAS 141 and 142 issued earlier in 2001. For that reason, we also present some results from research made on the application of FAS 141 and 142.

Concerning the strict identification of the intangible assets required by IFRS 3, a Swedish study shows that less than half of 51 groups examined had identified and recognised intangible assets that were not previously recognised in the acquired entity. [115] The intangible assets that had been recognised were mainly trademarks and customer relationships/contracts but also patents, unpatented technology and beneficial supplier contracts. The disclosures concerning these intangible assets were, however, lacking in terms of the assets' useful lives and the bases for valuation.

Another Swedish study shows that the most commonly occurring intangible assets among those being identified in business combinations were customer contracts and relationships, systems or technology and brands. [116] Further, the chartered accountants Gauffin and Nilsson note that the lacking information provided by most groups makes it difficult to judge the identifications of intangible assets. In many cases, intangible assets are recognised together with other intangible assets, for example "software and customer relationships", "marketing-related intangible assets"

[115] Lagerström B. & Nicander C. (2006)
[116] Gauffin B. & Nilsson S-A. (2006)

or even just "intangible assets", which results in necessary information being withheld from users of financial statements.

In addition, the definitions used on recognised intangible assets are many, which increase the difficulties for users of financial statements to understand and compare the intangible assets that have been identified in the accounting for business acquisitions. (IBID) In total, 40 different definitions on intangible assets have been found, for example trademarks/trade names/trademark rights, customer relationships, customer contracts/agreements, patents, distribution agreement/rights, software/computer software and product rights.

Concerning the classification of intangible assets, a comprehensive field study, made by the IASB on the US experience of FAS 141 and 142, revealed that most groups recognised and reported the intangible assets in accordance with the FAS 142 list of identifiable intangible assets.[117] This list is very similar to the classification system of the IASB's list of intangible assets outlined earlier in this chapter. The study further showed that most of the problems in recognising identifiable intangible assets concerned claims of unreliable measures of fair value. Many groups had not recognised intangible assets separately from goodwill, because they were incapable to obtain a reliable measure of the assets' separate fair values. Furthermore, the recognition of customer contracts, related customer relationships and core deposit intangibles were common problems. A contract-related customer relationship could only be measured reliably with reference to observable market transactions.

Even though the IASB's list with intangible assets categorises five major categories of intangible assets, there is no prescription on groups to present their identified intangible assets accordingly. The purpose of the list is not to prescribe how the intangible assets might be defined or presented, but to exemplify what kinds of intangibles that could be regarded as separately identifiable for accounting purposes. An analysis of the US experience of the application of FAS 141 and 142, made by Mantos Associates, illustrates worrying inconsistencies as an outcome of the freedom in classifying and grouping intangible assets.[118] An example of this inconsistency is the categorisation of rights and licenses. Some groups had used a single right's category and combined a range of completely different rights covering all contract and marketing-related assets, while some companies had distributed them over a wide range of asset classes. Some groups had further aggregated patents with licenses, whereas others had singled them out individually. Furthermore, there was much overlap between different categories of intangible assets, a problem that was also found in research of Swedish groups discussed previously.

The analysis made by Mantos Associates also showed a sharp rise of capitalised intangibles in the figures of 2002-2003 in the United States. (IBID) The value of capitalised intangible assets as a percentage of total market capitalisation almost threefold from the closure of 2002 to 2003. The difference was attributable to intangible assets increased being capitalised during the first year of the new accounting principles. Considering the determination of useful lives of intangible assets, the guidance provided by FAS 141, as well as of IFRS 3, envisages that intangible assets with indefinite useful lives should be rare. Despite this guidance, a larger volume of intangible assets than the US authorities had expected, were defined as having indefinite useful lives.

When it comes to the recognition and justification of goodwill in accordance with IFRS 3, research made on Swedish groups shows that most of the groups had recognised goodwill arising from business acquisitions, and that these recognitions of goodwill in most cases had been

[117] IASB, Project Summary – Field Visits (2004)
[118] Mantos Associates (2004)

explained.[119] However, the explanations of goodwill did most often not provide the kind of information that is required by IFRS 3. According to the study, the most commonly given explanation to recognised goodwill was that it is attributable to expected synergies. The chartered accountants Lagerström and Nicander claim that groups applying IFRS 3 are expected to explain or discuss further what specific synergies they refer to.

Groups performing better in their explanations of the value of goodwill had used other factors such as profitability, market shares as well as competence of acquired personnel. (IBID) However when it came to the explanations why intangible assets are not separated but instead included in goodwill, this was rarely addressed by the groups observed in the study. The groups that had addressed the issue simply mentioned the fact that these intangible assets do not fulfil the recognition criteria. Lagerström and Nicander argue that most groups probably could perform better in this area.

Another study has analysed effected acquisitions by investigating the relations between goodwill and identified intangible assets. This study showed that about 20 per cent of the groups that had recognised goodwill from their business acquisitions did not identify any intangible assets.[120] This seems quite a lot, according to Gauffin and Nilsson, considering the strict requirements of IFRS 3 to identify intangible assets. Concerning information about the factors contributing to goodwill, this study shows as well that the explanations often are too general to fully meet the requirements of IFRS 3. The disclosures are intended to make users of financial statements able to judge the acquisitions and the discussions conducted by management, which, according to Gauffin and Nilsson, means that a certain level of detail is necessary.

When it comes to impairment tests of goodwill and intangible assets with indefinite useful lives, a Swedish study shows that most groups had based these upon discounted cash-flow calculations that, according to the chartered accountant Buisman, require quite a lot of partly subjective assumptions.[121] The disclosure requirements of IFRS 3 are intended to clarify what subjectivity and uncertainty exist in such calculations. However, most of the groups in this study provide insufficient disclosures to attain these objectives. Some groups have, however, performed well and disclosed information about their assumptions on, for example, expected growth and discounted interest rates.

The impairments of certain intangible assets and goodwill may have very significant impacts on a group's income statement, since these assets often represent a majority share of the value of groups today. [122] As an example, the Spanish telecom giant Telefoncia, when having to restate their accounts under US GAAP, and thereby apply FAS 141 and 142, turned its net profit of €2.11 billion under Spanish GAAP into a net loss of €7.18 billion. The main reason for this was that they had to write down goodwill related to acquisitions. Discussions concerning impairment charges further suggest that they create greater volatility in earnings than traditional measures of return.[123] Due to the fact that goodwill is no longer amortised, reported results will be increased in normal years, but negatively affected in years of impairment losses.

Furthermore, after the issuance of FAS 141 and 142 in the United States, managements have in some cases attempted to downplay the significance of goodwill impairments.[124] This by trying to

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[119] Lagerström B. & Nicander C. (2006)
[120] Gauffin B. & Nilsson S-A. (2006)
[121] Buisman J. (2006)
[122] Hadjiloucas T. & Winter R. (2005)
[123] Hütten C. & Lorson P. (2002)
[124] Hadjiloucas T. & Winter R. (2005)

pass them off as irrelevant and non-meaningful, because of the fact that they are one-time occurring and that they do not affect cash-flows. Managements have also blamed the impairments to be resulting from some obscure accounting change. However, the impairments should not be of a great importance for analysts focusing exclusively on cash-flows. Further, by cleaning up the balance sheet, the impairment charges may result in significantly improved returns on equity in following years. Nonetheless, a great charge from impairment is an indication to investors that a company has overpaid for an acquisition.

Concerning the extensive disclosure requirements of IFRS 3, research has shown that most Swedish groups had not, in the year of 2005, succeeded in providing the users of their annual reports with the complete information required.[125] According to Lagerström and Nicander, the result of this is that the users of those annual reports had not been given the conditions to judge the characteristics of the acquisitions and their financial effects, as was intended by the IASB when issuing IFRS 3. However, the annual reports contain more information than before IFRS 3, which serves the interests of all the players of the capital markets. An additional adaptation to the IFRS 3 is though demanded to allow the users of the information to completely benefit from the disclosure requirements of IFRS 3.

Gauffin and Nilsson argue that the Swedish groups to a various extent had succeeded to fulfil the requirements of IFRS 3.[126] In many groups the information provided was very insufficient, especially when it came to value that remains as goodwill after having allocated the cost of the combination on identifiable assets and liabilities. A reoccurring comment in the annual reports of this study is: "Goodwill is attributable to the high profitability in the acquired business and synergies are expected to arise from the acquisition". This comment is difficult to interpret, as to what has not been identified nor valued, but still contributes to create this profitability. Gauffin and Nilsson however concluded, except from the scarcities mentioned previously, that the groups had performed relatively well in their first year of applying IFRS 3. They also concluded that further experiences from the application of IFRS 3 will, most probably, improve the financial reporting of the business acquisitions in the consolidated financial statements of 2006.

Buisman also claimed that Swedish groups, in a number of cases, had not fulfilled all of the disclosure requirements of IFRS 3.[127] For example information about the carrying amounts was missing. However, IFRS 3 states that it is understandable that the carrying amounts could be impractical to disclose, and that entities in that case are allowed to desist from disclosure, if an explanation of why this would be impractical is given. Such explanations were however most often not found.

Buisman is under the impression that many groups have had difficulties in finding the right balance in the new disclosure requirements of IFRS 3. (IBID) The information is supposed to be as transparent as possible which demands detailed information, without revealing business secrets. IFRS 3 requires, as indicated earlier in this chapter, information of a more strategic character for example concerning goodwill, synergies and what assumptions that are behind the impairment tests. This kind of information implies a balance between transparency and the possibility to keep competitive advantages, which demands time and considerations from management to judge the texts that will be disclosed.

Finally, Buisman concluded that more information needed by the stock market is provided after the implementation of IFRS 3, which also reflects the basic idea of the IASB. Even though

[125] Lagerström B. & Nicander C. (2006)
[126] Gauffin B. & Nilsson S-A. (2006)
[127] Buisman J. (2006)

information essential to the stock market in many cases is missing, one shall bear in mind that the transition to IFRS is an exhaustive process that sometimes is underestimated. It is therefore difficult to succeed in attaining all objectives on the first year of the application.

4. Empirical Material and Analysis

In this chapter we present our work with the case study of this essay. We begin this presentation by providing a description of the case. Thereafter, the results from our interviews at the Acquirer and the Acquiree and the results from our work with applying IFRS 3 on the case, constituting our empirical material, are presented. Further, we analyse this empirical material part by part throughout this chapter.

4.1. Description of the Case

The case of this essay treats the accounting for a specific business acquisition. *The Acquirer* is, as mentioned in the introduction, a non-listed Swedish group considering a voluntary adoption of IAS/IFRS. In these considerations the group is investigating how the application of different IAS/IFRSs would affect them. Our assignment is to help the group in their considerations to adopt IAS/IFRS, by investigating how the accounting for a specific business acquisition could have been affected by the application of IFRS 3.

The acquisition of this case study was carried out on 31 May 2005, when *the Acquirer* purchased 100 per cent of the equity in *the Acquiree* and thereby obtained 100 per cent control over the latter. The acquisition was carried out because the management of *the Acquirer* considered the acquisition to be a good deal. An additional intention of with the acquisition was to start the development of a new business activity in the group.

The Acquiree is an engineering company without any production. The business of *the Acquiree* is therefore highly intangible, with great values in knowledge and experience of the employees. The business of *the Acquiree* is further based on projects of great installations. These installations are based on a unique idea of *the Acquiree* that they were first in the world to develop and sell. The unique technology of *the Acquiree* has been developed in different projects all over the world since the beginning forty years ago. *The Acquiree* has itself created a market for its product, and has today a market share of 70 – 100 % on the geographic markets in which it is active. The market for the products of *the Acquiree* is however still relatively small, but has a great potential to grow.

The accounting of this acquisition was established in accordance with Swedish GAAP using the purchase method. The cost of the combination consisted of the purchase price and expenditure on consultants directly attributable to the acquisition. When allocating the cost of the combination, all overstatement of value was recognised as goodwill (see table 4.1. below). The value of goodwill is to be amortised over a useful period of 20 years.

Table 4.1.

Acquisition Analysis 2005-05-31	**MSEK**
Purchase price	570
+ Costs directly attributable to the acquisition	6
= The cost of the combination	**576**
- Equity capital in *the Acquiree*	199
- Overstatement of value	0
+ Understatement of value	0
= Goodwill	**377**

Source: *The Acquirer*

4.2. The Application of IFRS 3

As visible in the acquisition analysis (see table 4.1.), a great value in goodwill arose in the accounting for this acquisition, which makes the application of IFRS 3 on this case very interesting. Under IFRS 3 this great goodwill value would have had to be decomposed and explained, which is what the continuing parts of this chapter mainly are about.

When applying IFRS 3 to the acquisition of this case, we have identified a number of different areas where issues or practical problems may arise. The issues that we discuss mainly represent issues arising from the differences between IFRS 3 and Swedish GAAP. However, in order to provide an overall picture of the accounting for this business acquisition in accordance with IFRS 3 we also discuss areas where no differences exist. For example IFRS 3 requires the use of the purchase method. Since the acquisition of this case was a 100 % acquisition, the purchase method was used also in the original accounting established in accordance with Swedish GAAP. Thus, concerning the method of accounting no differences exist.

The purchase method in accordance with IFRS 3 is, as previously mentioned, divided into three different steps; identifying an acquirer, measuring the cost of the combination and allocating the cost of the combination. First, identifying an acquirer implies no issues or practical problems in this case. The group assigning us to this case can easily be identified as the acquirer, as it was the party that issued the acquisition and thereafter paid a price for the equity in *the Acquiree* to effectively obtain control over the latter. The identification of an acquirer is however not always as easy as in this case. For example, as mentioned in the frame of references, the acquirer is actually the entity whose equity interests have been acquired as in the case of reverse acquisitions.

Second, nor is measuring the cost of the combination a problem in the case of this essay. The acquisition involved only one single transaction, meaning that the exchange date coincided with the acquisition date, which implies that there is only one date on which the cost of the combination shall be measured. Further, the transaction was made in cash meaning that there is no problem determining the fair value of the assets given in exchange for control of *the Acquiree*. This determination could have been more problematic if the control of *the Acquiree* was obtained by transaction of other assets, for example equity instruments or liabilities which fair values would have had to be measured. Measuring the costs of the combination of this case according to IFRS 3 implies no difference from Swedish GAAP. The cost of the combination in accordance with IFRS 3 is therefore, as in the original acquisition analysis (see table 4.1), calculated as the aggregate of the purchase price, 570 MSEK, and the costs directly attributable to the acquisition, 6 MSEK (see the IFRS 3 acquisition analysis in table 4.2.).

Third, allocating the cost of the combination involves more complex areas as well as the most important differences from Swedish GAAP. Consequently, this is where we have identified issues that could have involved practical problems for *the Acquirer* in accounting for the acquisition in accordance with IFRS 3. The issues that we have identified are divided into the following areas; 4.2.1. The Fair Value of *the Acquiree*'s Assets and Liabilities, 4.2.2. *The Acquiree*'s Intangible Assets, 4.2.3. Goodwill, 4.2.4. Annual Impairment Tests and 4.2.3. Disclosure.

4.2.1. The Fair Value of the Acquiree's Assets and Liabilities

When allocating the cost of the combination, the fair values of an acquiree's assets and liabilities have to be determined. First of all, it must be considered whether the carrying amounts of the acquiree's assets and liabilities represent the fair values of these assets and liabilities at the acquisition date. If not, the fair values of those assets or liabilities have to be estimated. Possible over or understatement of values that appear from such estimations shall thereafter be taken into the acquisition analysis when allocating the cost of the combination.

The Case of this Essay

In order to determine the fair values of *the Acquiree*'s assets and liabilities at the acquisition date we have spoken to the CFO at *the Acquiree* as well as the Investment Director at *the Acquirer*. From these conversations, we were informed that the values on *the Acquiree*'s balance sheet, shown in Appendix 2, in large represented the fair values at the acquisition date. Therefore, no fair value adjustments would have had to be made in accounting for the acquisition in accordance with IFRS 3.

Analysis

Determining the fair values of *the Acquiree*'s assets and liabilities do not represent a great problem when applying IFRS 3 to this case. The carrying amounts of *the Acquiree* corresponded to the fair values at the acquisition date, and therefore no difficult fair value assessments would have had to be made. The fair value treatment in IFRS 3 of acquired assets and liabilities implies no difference from Swedish GAAP. Both IFRS 3 and Swedish GAAP require the acquiree's assets and liabilities to be valued at fair value at the acquisition date. Therefore there are no specific effects from applying IFRS 3 in this part of accounting for business acquisitions.

However, to determine the fair values of an acquiree's assets and liabilities when accounting for a business acquisition is not always as easy as in the case of this essay. In acquiring businesses with balance sheets that contain many different items, the determination of fair values could be both costly and time-demanding. Further, if an acquirer is not capable on pursuing the fair value assessments itself it has to engage external specialists, which makes the accounting even more costly. Examples where fair value measurements might cause problems are those of unique assets, which are not traded in an active market. As mentioned in the frame of references, the fair values determined in accounting for business acquisitions must be reliable. In the case of unique assets, a reliable valuation is in practice probably difficult to achieve. The reason for this is that the valuation of such assets often becomes too subjective to be reliable.

4.2.2. The Acquiree's Intangible Assets

When accounting for business combinations in accordance with IFRS 3, it is not only the fair values of assets and liabilities already recognised on the balance sheet of an acquiree that must be determined. The fair values of the acquiree's assets and liabilities that were not recognised by the acquiree before the acquisition must also be determined. Concerning items not previously recognised by an acquiree, these refer mainly to intangible assets that for different reasons do not fulfil the criteria for recognition before being acquired. For instance, intangible assets that have been generated internally can most often not be recognised by the acquiree itself. However, once an acquisition is carried out, an acquirer has paid a price for the total amount of the acquiree's net assets and therefore has to identify and recognise what has been bought.

IFRS 3 makes, as discussed earlier in this essay, strict requirements on the identification of intangible assets in order to enable users of consolidated financial statements to see what is really paid for in an acquisition and to evaluate managements' decisions. In this part of our application of IFRS 3, we have investigated which intangible assets possibly could have been identified at the acquisition date. Further, we have tried to evaluate which of these identified intangible assets that could have been recognised in an IFRS 3 accounting for this business acquisition. At last, we have tried to estimate whether these recognised intangible assets could have been considered to have finite or indefinite useful lives.

4.2.2.1. Identification of the Acquiree's Intangible Assets

When identifying intangible assets in accordance with IFRS 3, the criteria of separability and contractual or legal rights have to be considered. If one of these criteria is considered fulfilled

concerning an intangible asset, this asset has to be identified in accounting for a business acquisition.

The Case of this Essay

In order to identify intangible assets in the case of this essay we have interviewed the CFO at *the Acquiree* and thereafter the Investment Director at *the Acquirer* to get information about which intangible assets they believe exist in *the Acquiree*. Further, we have also consulted the CFO at *the Acquirer*. As a starting point for these discussions we used the IASB's list of identifiable intangible assets (see table 3.1.). Thereafter we considered whether the separability or contractual-legal criteria could be met concerning the possibly identifiable intangible assets of *the Acquiree*. As a result, we have identified the following intangible assets divided into the five different categories of the IASB's list:

Marketing-related Intangible Assets:

Trademark: A trademark is "an asset used in trade to indicate the source of a product and to distinguish it from the products of others"[128]. The trademark of *the Acquiree* in our case mainly comprises a trade name, a logo as well as an image of which values the company represents. The trademark is protected legally, and can therefore be considered to meet the contractual-legal criterion.

Certification mark: *The Acquiree* is ISO certified which functions as a label of quality on its organisation. The CFO at *the Acquiree* informed us that the ISO certification has been very helpful in improving the internal control of the organisation. Further, it is important for *the Acquiree* to be ISO certified because it is dealing with many large, both private and public, organisations in many different countries when contracting new projects. Consequently, having an international certification, which ensures the quality of the organisation, to show potential clients can be of great value to *the Acquiree*. Further, a certification mark from this ISO certification is identifiable as an intangible asset of *the Acquiree* because it meets the contractual-legal criterion.

Internet domain names: "An Internet domain name is a unique alphanumeric name that is used to identify a particular Internet address". (IBID) According to the CFO at *the Acquiree*, the company possesses a number of Internet domain names in various countries. According to the IASB, the registration of a domain name creates an association between that name and a designated computer on the Internet during the period of registration. Therefore, the Internet domain names of *the Acquiree* can be identified as intangible assets meeting the contractual-legal criterion.

Protections of design: *The Acquiree* possesses a number of rights on protected design on some parts of the solutions it delivers. These protections of design arise, of course, from contractual or legal rights and can thereby be identified as intangible assets in *the Acquiree*.

Reference projects: A reference project is a finished project that can be used as a reference when submitting an offer in order to contract a new project. According to both the CFO at *the Acquiree* and the Investment Director at *the Acquirer*, old reference projects are very important in the business of *the Acquiree,* and in some markets even a prerequisite to be able to contract a new project. The reference projects prove that the solutions sold by *the Acquiree* function and that they are durable. *The Acquiree* has reference projects that have been in function for about 40 years, which probably is one of its most important competitive advantages for *the Acquiree* when new actors try to enter the market.

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[128] IFRS 3, Illustrative Examples

Further, since the solutions delivered by *the Acquiree* are unique and still fairly unknown, the existence of its reference projects is even more important. To increase the interest for its solutions in order to expand the market, it is essential to be able to show that the solutions are well-functioning. According to the Investment director, it is further important that *the Acquiree* has these reference projects in many different countries because the clients tend to better trust projects that are working in their own countries.

Based on the importance of these reference projects, we believe that these could be identified as an intangible asset. The identification of the reference projects as an intangible asset is based on the contractual-legal criterion, because they have arisen from contractual agreements.

Customer-related Intangible Assets:
Order backlog: "An order backlog arises from contracts such as purchase or sales orders"[129]. In the case of this essay, the CFO at *the Acquiree* informed us that there exists an important value in *the Acquiree's* order backlog and that the amount of orders is constantly increasing. Further, the Investment Director at *the Acquirer* wanted to point out that not only does *the Acquiree* has an increasing order backlog but more importantly that the orders have great gross margins. This situation existed also at the time of the acquisition so great values probably could have been identified in the order backlog as an intangible asset of *the Acquiree*. The order backlog acquired in a business combination further is identifiable because it meets the contractual-legal criterion which, according to the IASB, is the case even if the purchase or sales orders are cancellable.

Customer relationships related to customer contracts: When discussing whether there is a value in *the Acquiree*'s customer relationships, the CFO at *the Acquiree* explained that most of their customers are one-time customers and therefore that customer relationships are not of crucial importance. However, *the Acquiree* has a few relationships related to customer contracts with recurrent customers that possibly could be identified as an intangible asset. These customer relationships are identifiable because they meet the contractual-legal criterion for an intangible asset.

Furthermore, the Investment Director at *the Acquirer* argued that a customer relationship always is important even though, as in the case of most of *the Acquiree*'s customer relationships, it is a one-time relationship. Further, the Investment Director pointed out that the value of customer relationships depend on whether these relationships have been good or bad. Satisfied customers give the company a good reputation which could attract new customers. However, these customer relationships that the Investment Director mentioned are ended relationships. Therefore, values in those customer relationships cannot be identified since they did not exist at the acquisition date. The values of these old relationships consist rather of the customers creating a positive reputation or image of *the Acquiree*, which is something that partly could be considered taking part in the value of the trademark. The CFO at *the Acquirer* pointed out that the value of these old relationships lies in them being good references, something that is discussed further under 4.2.3. Goodwill.

Artistic-related Intangible Assets:
In this category we have not identified any intangible assets in *the Acquiree*. The business of *the Acquiree* is not of the character that possesses these kinds of assets.

Contract-based Intangible Assets:
Neither in this category have we been able to identify any intangible assets.

[129] IFRS 3, Illustrative Examples

Technology-based Intangible Assets:

Patented technology: *The Acquiree* has patented some functions in its technical solutions. However, the main technology on which its solutions are based cannot be patented. The patented technology can be identified as an intangible asset in *the Acquiree* because it meets the contractual-legal criterion.

Computer software: *The Acquiree* has developed some computer software, for example for calculating the wear on its systems. This computer software is protected legally and therefore meets the contractual-legal criterion for identification as an intangible asset.

Databases: Databases are collections of information of original works, often stored in electronic form[130]. In *the Acquiree* there exist, according to the CFO at *the Acquiree*, databases with basic plans and construction drawings. These basic plans and construction drawings included in the databases of *the Acquiree* are entitled to copyright protection and therefore meet the contractual legal criterion for identification as an intangible asset.

Trade secrets; tools and formulas: The CFO at *the Acquiree* informed us that there exist some trade secrets in specific tools and formulas that are protected and can only be used by authorised persons. These tools and formulas can be considered to meet the contractual-legal criterion for identification as intangible assets in *the Acquiree*.

<u>Analysis</u>

As shown above, we have in this case been able to identify eleven different intangible assets in three of the five categories of the IASB's list of identifiable intangible assets. Thus, the application of IFRS 3 implies a large difference from the original accounting for the acquisition under Swedish GAAP. In the original acquisition analysis (see table 4.1.) no intangible assets were identified; all overstatement of value from the acquisition were instead attributed to goodwill by *the Acquirer*, which also is common customs in accordance with Swedish GAAP.

The identification of intangible assets in this case is consistent with research made on the application of IFRS 3, saying that more intangible assets were identified after the adoption of IFRS 3. However, concerning the inconsistency of the categorisation of intangible assets that have been pointed out in previous research, it is difficult for us to know exactly how *the Acquirer* would have classified its identified intangible assets. Considering the freedom in classifying and grouping intangible assets, it is rather possible that other classifications than those of the IASB would have been used.

In our classification of intangible assets of *the Acquiree*, we found it most appropriate to start from the IASB classifications. In comparison to *the Acquirer*, we have less knowledge and insight into *the Acquiree* which makes it more difficult for us to carry out an identification without having a starting point. Nevertheless, we identified one intangible asset, the reference projects, which was not listed by the IASB.

Studies have shown that many different definitions of intangible assets have appeared on the balance sheets of groups applying IFRS 3, something that decreases the comparability. However, the occurrence of many different definitions of identifiable intangible assets may be unavoidable. Because of the characteristics of intangible assets often being unique to a company, and the fact that we have identified one rather company-specific intangible asset in our case, it is not surprising that such company-specific assets appear even in other acquisitions.

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[130] IFRS 3, Illustrative Examples

Concerning the identification of intangible assets, our experience from this case is that this can be done rather easily. It is not too difficult to imagine what different types of assets that in theory could exist and affect the purchase price. Furthermore, the identification of intangible assets is more or less difficult depending on the kind of intangible asset that shall be identified. For instance, intangible assets arising from contractual or legal rights are less difficult to identify, than those meeting the separability criterion, because of the fact that there are some kind of contractual or legal rights proving the existence of an intangible asset. Further, these contractual or legal rights are considered to give rise to an identifiable intangible asset regardless of whether those rights are separable. This diminishes the complexity of identifying such intangible assets even more. In our identification, and in the IASB's list of intangible assets, these relationships are further clarified, since most identifiable intangible assets are those arising from contractual or legal rights.

Concerning the separability criterion, we found it more difficult to determine whether an intangible asset can be considered identifiable because it is separable. Contrary to the contractual-legal criterion, the criterion of separability requires an assessment to be made. Such an assessment could further be difficult to pursue, since it is not always clear whether an intangible asset is separable, i.e. possible to divide from the entity in order to for example sell or exchange it. In our case, no intangible assets were identified because they meet the separability criteria.

Further, the difficulties in identifying intangible assets in accounting for business acquisitions could be dependent on the size, age and business of the company acquired. In large companies that have been operating for a long time there are probably more intangible assets to assess whether they are identifiable or not. The kind of business, and also number of businesses, in which an acquiree operates could also affect the complexity of identifying intangible assets. In our case, *the Acquiree* is relatively small and only operates in one business which makes the identification less complex. If *the Acquiree* instead would have operated in many different businesses, there would probably have been more possible intangible assets to consider. However, the business of *the Acquiree* in our case is highly dependent on intangible factors which imply that the identification of intangible assets would have taken a great part of the work with accounting for the acquisition in accordance with IFRS 3.

4.2.2.2. Recognition of Identified Intangible Assets

After having identified intangible assets, the next step is to assess whether the fair value of identified intangible assets could be measured reliably and thereby fulfil the criteria for recognition on the consolidated balance sheet. The identified intangible assets that cannot be measured reliably are included in the amount of goodwill.

The Case of this Essay

Earlier, we found eleven different intangible assets of *the Acquiree* that we consider could have been identified at the acquisition date. In order to determine whether the fair value of these intangible assets can be measured reliably, considerations have to be made around the criteria on which they have been identified. As mentioned in the frame of references, the IASB has clarified that the fair value of identified intangible assets, acquired in a business combination, normally can be measured with sufficient reliability to be separately recognised from goodwill. However, the IASB has stated two circumstances in which it might not be possible to reliably measure the fair value of such intangible assets. The first concerns intangible assets that arise from contractual or legal rights that are not separable. The second concerns intangible assets that are separable but there is no history or evidence of exchange transaction for the same or similar assets.

When discussing the fair value measurement of acquired intangible assets with the Investment Director at *the Acquirer*, he mentioned the difficulties in giving such intangible assets appropriate values. The Investment Director further stated that they probably could give the acquired intangible assets values that would be approved by auditors. However, he mentioned, that if someone was asked to criticise those values, it could quite easily be done.

Below, we discuss whether the intangible assets that we have identified could be measured with sufficient reliability to be recognised separately from goodwill. The starting point for such a discussion is the criterion on which the intangible assets have been identified. However, in our case all intangible assets were identified because they meet the contractual-legal criterion.

Trademark: Considering the value of *the Acquiree*'s trademark, the CFO at *the Acquirer* pointed out that it is difficult to estimate the value of a trademark in practice. The reason for this is that it is difficult to assess which economic benefits that are generated specifically from the trademark, since the trademark does not generate economic benefits independently from other assets. However, even though the value of a trademark could be difficult to determine, there is history and evidence of similar transactions. Further, there exist established valuation methods for trademarks, we suppose that the fair value of *the Acquiree*'s trademark could be measured reliably.

Certification mark: The ISO certification, identified as an intangible asset, cannot be separated from *the Acquiree* because it specifically certifies the quality of *the Acquiree*'s organisation. Consequently, the measurement of the certification mark is referable to one of the circumstances, stated by the IASB, where it might not be possible to measure a fair value reliably. We have decided to include the value of the certification mark in goodwill, which is further explained under 4.2.3. Goodwill.

Internet domain names: Concerning the Internet domain names, the CFO at *the Acquirer* informed us that their value is too unimportant to be recognised. Further, he also believed that it in practice would be too difficult to assess a reliable fair value of the rights of Internet domain names. Therefore, the Internet domain names could probably not be separately recognised so they would instead have had to be included in the value of goodwill. This is further mentioned under 4.2.3. Goodwill.

Reference projects: Since the nature of these reference projects implies that they specifically refer to projects finished by *the Acquiree*, it could be difficult to separate them from the latter. Further, since there is no market for these kinds of assets, the valuation would have to be based on the cash flows that they are expected to generate. However, we believe that an estimation of such cash flows would be far too complex to carry out. The reasons for this are that it is very difficult to assess which incomes that are generated specifically from the reference projects. *The Acquiree*'s incomes come from carrying out projects, and are consistently generated from an aggregate of *the Acquiree*'s assets in references, experiences and knowledge etc. Therefore, it is probably impossible to say exactly which part of *the Acquiree*'s incomes that are generated solely from the reference projects so a sufficiently reliable measurement of their fair value probably would be difficult to carry out. We have therefore decided to include the value of the reference projects in the amount of goodwill, which also is explained under 4.2.3. Goodwill.

Order backlog: The fair value of *the Acquiree*'s order backlog could probably quite easily be determined from the gross margins of the orders, which show how much profit each order will generate. Therefore we suppose that the fair value of the order backlog probably could be measured with sufficient reliability to be recognised separately from goodwill.

Customer relationships related to customer contracts: *The Acquiree*'s relationships related to customer contracts with customers of recurrent character were identified as an intangible asset. It is probably possible to predict which incomes these customers will generate so we suppose that they could be given a reliable fair value. However, the CFO at *the Acquirer* has pointed out that their value is probably relatively unimportant since they only refer to relationships with a minority of *the Acquiree*'s customers. Further, the Investment Director at *the Acquirer* pointed out that existing contracts are more important than potential contracts that could arise from customer relationships. Therefore the order backlog, identified previously, must be considered having a greater value than the intangible asset in customer relationships. Thus, the value these customer relationships have could probably be separately recognised, but this value is relatively unimportant.

Protections of design, Patented technology: These identifiable assets of *the Acquiree* arise from legal rights that can be separated. The CFO at *the Acquirer* had some doubts whether the protections of design would have been recognised, given that their value probably is relatively unimportant and also difficult to estimate. However, it should be possible to measure the value of those rights based on the expenses *the Acquiree* have had on the design. Therefore, we consider it probable that the protections of design, as well as the patented technology could be measured with sufficient reliability to be recognised separately from goodwill.

Computer software, Databases, Trade secrets; tools and formulas: Considering the value of these identifiable intangible assets, the CFO at *the Acquirer* mentioned there is next to no value in these specifically. Rather, the value exists in the know-how of *the Acquiree*'s employees that are able to develop and use these intangible assets. Therefore, the value of these intangible assets is not separately recognised but instead included in goodwill, which also is explained under 4.2.3. Goodwill.

Analysis

The discussions above indicate that many of the intangible assets that we identified in *the Acquiree* could not be measured with sufficient reliability to be separately recognised from goodwill. In contrast to the more theoretic identification of intangible assets, the recognition of intangible assets requires fair values to be measurable in practice. In our case, the identified intangible assets where it is uncertain whether they could be measured reliably are the certification mark, the Internet domain names and the reference projects. Because of difficulties in valuating these assets, or because of their relatively unimportant values, they have been included in the amount of goodwill.

Concerning reliable measurements of intangible assets' fair values, as mentioned earlier, the IASB has stated that the fair value of an identified intangible asset normally can be measured with sufficient reliability to be recognised. However, previous research indicates that many groups have had problems in measuring fair values of acquired intangible assets. The research further shows that most of the problems in recognising identifiable intangible assets concerned claims of unreliable measures of fair value. This has also been indicated in our case, since the fair values of many of our identified intangible assets probably are too difficult to valuate to get a reliable fair value. The reasons for difficulties in valuating intangible assets in practice are, as mentioned by the CFO at *the Acquirer* that they often are not traded in a market and therefore the valuation has to be based on expected cash flows. Further it is often difficult, if not impossible, to measure which specific cash flows generated by an intangible asset.

Thus, one difficulty concerning valuation of many intangible assets is that they are so dependent on other assets, and other intangible assets, that they often get mixed with each other. Research

has shown that many groups applying IFRS 3 have grouped their intangible assets together in categories such as “marketing-related intangible assets”, which is something that result in necessary information being withheld from users of financial statements. However, since many intangible assets often generate cash flows in aggregate this may be the only solution.

In developing IFRS 3, the IASB wanted to express themselves so that entities would be forced to recognise the identifiable intangible assets, in accounting for business acquisitions. Further, Pernilla Rehnberg, the auditor who we consulted before beginning our work with the case, stated that intangible assets that are separable should be possible to measure reliably. However, research indicates that this is not always the case in practice. Further, our discussions with the CFO at *the Acquirer* have indicated that many identifiable intangible assets in practice probably not could have been recognised in our case because of difficulties in valuation.

The complexity of measuring the fair value of intangible assets should therefore not be underestimated. Because of the characteristics of intangible assets, often being unique and thereby not being traded in an active market, the valuation process is rarely without problems. Further, IFRS 3 provides limited guidance on how the valuation should be carried out, which leaves the valuation problems to those applying the standard. If a group applying IFRS 3 is unable to carry out a valuation itself, assistance from expensive external experts becomes a necessity.

As mentioned earlier, valuating the intangible assets identified in our case is beyond the scope of this essay. However, we have considered the valuation of our identifiable intangible assets when discussing the reliable measurement criteria. In these considerations we have repeatedly found reasons for valuating problems to occur, for example the difficulties in referring cash flows specifically to one intangible asset. However, there are valuation experts that probably could give most assets a value. We question, though, if groups in their accounting for acquisitions should be forced to employ external experts to valuate every intangible asset identified in an acquisition.

Furthermore, if the valuation of an identified intangible asset is too difficult for an acquirer to carry out itself, how reliable does that valuation become that has to be based on a lot of assumptions to be realised. The Investment Director at *the Acquirer* brought up an interesting point that most values attributed to intangible assets, in allocating the cost of a combination, probably can be criticised quite easily. If this is the case, we question whether measurements that so easily could be criticised, and argued to be incorrect, can be considered reliable.

Concerning the recognition of intangible assets, IFRS 3 implies a difference from Swedish GAAP. In comparison with the original acquisition analysis (see table 4.1.) where no intangible assets were recognised, five different intangible assets are brought up in the IFRS 3 acquisition analysis (see table 4.3.), on which the cost of the combination shall be allocated. Thus, the clearer and stricter demands of identifying intangible assets of IFRS 3 results in more intangible assets being recognised, which is shown both in our case and in previous research. However, this effect of IFRS 3 do not imply a rise in the value of assets, but a reclassification of more intangible assets separated from goodwill. Further, this affects the consolidated income statement which is discussed later under 4.2.2.3. Determining the Useful Lives of Recognised Intangible Assets and under 4.2.3. Goodwill.

The recognition of more intangible assets under IFRS 3, further makes the accounting for business combinations more transparent. An acquirer has to show more specifically what it has acquired, and what factors it considers contribute to the value of the acquiree. This transparency could have negative effects on the competitiveness of a business combination. IFRS 3 may make

business combinations too transparent giving competitors the opportunity to get hold of important information about what creates value in the entity acquired.

4.2.2.3. Determining the Useful Lives of Recognised Intangible Assets

When recognising intangible assets in accounting for business acquisitions, the useful lives of these intangible assets must also be determined. The determination of useful lives is further necessary to determine whether an intangible asset shall be amortised or annually tested for impairment. As mentioned in the frame of references, the determination of an intangible asset's useful life is dependent on the period over which the asset is expected to generate cash flows.

The Case of this Essay

In the case of this essay, we considered that five different intangible assets could have met the criteria for recognition at the acquisition date. For each of those five intangible assets, a useful life has to be determined in accordance with IFRS 3. The first step is to determine whether those assets can be considered to have finite or indefinite useful lives. Crucial to this determination is to assess whether there exists a foreseeable limit to the period over which the intangible asset is expected to generate cash flows. Thereafter, when it comes to the intangible assets with finite useful lives, the length of those finite useful lives must be determined. However, in our application of IFRS 3 on this case we have not tried to estimate the length of finite useful lives. This is because such estimations are too extensive to be included in the scope of this essay. Below, we divide the intangible asset of *the Acquiree* in our case into groups of those having indefinite and finite useful lives.

Intangible Assets with Indefinite Useful Lives:

Trademark: The trademark of *the Acquiree* will most probably exist as an intangible asset as long as *the Acquiree* continues its business. Therefore, we do not see that there is a foreseeable limit to the period over which the trademark is expected to generate cash flows, and consequently we consider the trademark as having an indefinite useful life.

Intangible Assets with Finite Useful Lives:

Protections of design, Patented technology: These two intangible assets arise from legal rights, which imply that their useful lives also are constrained by the duration of those rights. Therefore, we consider these intangible assets to have finite useful lives.

Order backlog: The order backlog has arisen from contracts with *the Acquiree*'s customers, which will generate revenues within a definite future. Therefore, there is a foreseeable limit to the period over which the order backlog is expected to generate cash flows, so we consider it to have a finite useful life.

Customer relationships related to customer contracts: Because of the nature of *the Acquiree*'s project based business, these customer relationships will probably not last forever. Consequently, we believe that there is a foreseeable future in which the customer relationships will generate economic benefits, so we consider their useful lives to be finite.

Analysis

In our discussion regarding useful lives of the intangible assets recognised in our case, we have determined one, the trademark, to have an indefinite useful life. The trademark would not have been amortised under IFRS 3. Instead it would have been tested annually for impairment, which is discussed further under 4.2.4. Annual Impairment Tests. The other intangible assets, with finite useful lives, shall on the other hand be amortised. To pursue these amortisations, the exact useful lives, as well as appropriate amortisation methods, would have had to be determined.

The complexity of determining useful lives of acquired intangible assets, lies firstly in the division of assets having indefinite or finite useful lives. After having discussed whether the recognised intangible assets in our case could be considered as having indefinite or finite useful lives, we conclude that most intangible assets must be assigned finite useful lives. For this main part of assets, the complexity lies not in assigning them to have a finite useful life, but in the determination of the length of that finite useful life. Even though we have not made such assessments in the scope of this essay, we want to highlight the fact that this may be complex and require a lot of time for an acquirer in applying IFRS 3.

Nonetheless, when it comes to intangible assets based on contractual or legal rights with specific duration times, the determination of the finite useful life is easy. In these cases, the useful lives are equal to the time of the rights. However, some of these rights may be renewed, which have to be considered when determining the useful lives. In these cases, considerations have to be made whether the renewableness is probable and whether the cost of renewing is significant.

The fact that only one intangible asset in our case was assigned with an indefinite useful life, is consistent with what the guidance envisages. However, research has shown that in practice, a larger than expected volume of intangible assets has been assigned with indefinite useful lives. A reason for this may be that groups wish to avoid the complexity of determining a finite useful life. On the other hand, the lines between assigning an asset with finite or indefinite useful life can be narrow.

When accounting for the business acquisition of this case in accordance with Swedish GAAP, no intangible assets were identified and consequently no determination of such assets' useful lives had to be done. The only assessment of useful life that had to be made in the original accounting concerned goodwill, which was estimated to have a useful life of 20 years. Thus, IFRS 3 implies more work and considerations around useful lives of separate assets than Swedish GAAP.

Furthermore, the classifications of indefinite or finite useful lives imply different effects on consolidated income statement, which also is a difference from Swedish GAAP. The original accounting for the business combination implies annual amortisations on the total amount of overstatement of value, i.e. goodwill, during its single estimated useful life. Under IFRS 3, only the parts of the overstatement of value consisting of intangible assets with finite lives would be annually amortised, which should imply positive effects on the consolidated income statements. However, the effects on the income statements are dependent on the value and the length of the useful lives of those assets being amortised. What is clear is that the accounting for the business combination becomes more complex because of the recognition of more intangible assets and the determination of those assets useful lives. Instead of amortising goodwill over one estimated useful life, groups applying IFRS 3 every year have to keep track of different intangible assets and their different amortisation plans. Further they will have to reassess those amortisation plans every year, something that will demand extra time and work from the accountants.

4.2.3. Goodwill

After having allocated the cost of the combination on an acquiree's identifiable assets and liabilities that fulfil the criteria for recognition, the overstatement of value that remains is recognised as goodwill. As mentioned earlier, this goodwill value must, under IFRS 3, be justified and explained. Further, the causes for identifiable intangible assets not being possible to recognise separately have to be explained. Thereafter, other factors contributing to the value of goodwill must be explained to justify the overstatement of value paid by the acquirer.

The Case of this Essay

In the original accounting for the business acquisition, the overstatement of value which was equal to the amount of goodwill was not at all described or explained. The information given by *the Acquirer* in the consolidated financial statements was the fact that they had acquired *the Acquiree*, what price was paid and a few phrases about *the Acquiree*'s business. The only information provided by *the Acquirer* concerning goodwill was the amount as well as the useful life and the amortisation method. In order to determine the value of *the Acquiree* as well as a purchase price, the Investment Director at *the Acquirer* informed us that due diligence was carried out partly with help from external consultants. Further, calculations of the value of *the Acquiree* were made based on discounted estimated future cash flows.

Concerning the overstatement of value paid in the acquisition, the explanation given by the Investment Director was merely that the acquisition was a very good investment. Further, he pointed out that *the Acquiree* has a well-managed business and a great potential by being world-leading and having a unique idea. *The Acquiree* has increasing order intakes, and has the last years been able to solve its previous problems with negative margins and profits, which increases *the Acquirer's* reasons to believe that it is a good investment.

Explanations and considerations regarding goodwill in terms of IFRS 3 were however not given by the Investment Director, which is natural considering the fact that the acquisition was not reported in accordance with IFRS 3. Nonetheless, from our discussions with the Investment Director and the CFO at *the Acquirer* we got information about what different factors that could have been used in order to explain the amount of goodwill remaining after our recognition of intangible assets discussed earlier. With the results from these discussions we have been able to identify a number of factors that could have been used to explain the amount of goodwill in accordance with IFRS 3. These different factors, discussed below, are: Unrecognised but Identifiable Intangible Assets, References, Personnel-related Assets and Structure-related Assets.

Unrecognised but Identifiable Intangible Assets:

The identifiable intangible assets that we did not consider to have met the criteria for separate recognition are included in the amount of goodwill. As discussed earlier, these intangible assets could probably not be given reliable fair values which is required to be separately recognised. Explanations why the identifiable intangible assets would not have been recognised in this case are discussed below.

Certification mark: A measurement of the fair value of the certification mark is, according to us, probably too complex to be reliable. The reason for this is that the certification mark is not separable from *the Acquiree*, because the certification specifically refers to the quality of *the Acquiree's* organisation. The value in the certification mark is therefore highly connected with the value of having a functioning organisational structure, so it probably is impossible to reliably measure its value separate from this organisational structure.

Internet domain names: The reason for these not being recognised was mainly that the CFO at *the Acquirer* considered their value to be too unimportant to be recognised. Nonetheless, the Internet domain names is a little part of the value of a functioning organisation so these take part of the structure-related assets discussed below.

Reference projects: The reference projects are, as well as the certification mark, only attributable specifically to *the Acquiree*. Therefore, the reference projects cannot be separated from *the Acquiree* so a reliable measurement of their fair values probably becomes impossible. In

addition, it is probably too difficult to estimate which specific economic benefits are generated by the reference projects to pursue a reliable measurement of their fair values.

Computer software, Databases, Trade secrets; tools and formulas: As in the case with the Internet domain names, these intangible assets were considered having too unimportant values to be recognised. The CFO at *the Acquirer* pointed out that value lies in the know-how of *the Acquiree's* employees and their ability to develop and use such assets. The know-how of *the Acquiree's* employees is further discussed under personnel-related assets below.

References:
Above, in identifying the intangible assets of *the Acquiree*, we discussed the fact that *the Acquiree* has as lot of non-recurring customers and therefore that a value of customer relationships with these customers could not be identified. After all, a relationship is something durable and could therefore not arise from a one-time agreement. However, the Investment Director at *the Acquirer* was of the opinion that there is a value in *the Acquiree's* relationships with its non-recurrent customers. If the relationships have been good, the customers may contribute in creating a good image of *the Acquiree* which may contribute in generating new orders and incomes. However, the customer relationships that the Investment Director referred to are ended relationships and could therefore not be considered as relationships in the context of an intangible asset.

The CFO at *the Acquirer* pointed out that there is not much value in customer relationships of *the Acquiree*, because *the Acquiree* mainly has one-time customers. Nonetheless, he agreed with the Investment Director that there is a value in having had good relationships with old customers. However, this value consists to a greater extent of having good references than customer relationships. We consider that these references could be used in explaining the value of goodwill because both the CFO and Investment Director at *the Acquirer* were of the opinion that these are important.

Personnel-related Assets:
Since *the Acquiree* is an engineering company, the knowledge and experience of its employees is a very important resource of *the Acquiree*. Further, when discussing the overstatement of value paid by *the Acquirer*, the Investment Director pointed out that personnel-related assets were a contributing factor to that overstatement of value. *The Acquiree*'s employees' great knowledge in the technology of the business idea, as well as their great experience from managing projects, is according to the Investment Director of crucial importance to *the Acquiree*'s future success.

The CFO at *the Acquirer* pointed out that he sees a great value in know-how of *the Acquiree's* employees. Further, this know-how is something unique which, according to the CFO, also is a pre-condition for it having a value in the acquisition. This know-how is something that can generate new ideas and technology which is important for *the Acquiree's* future development.

Structure-related Assets:
The Investment Director at *the Acquirer* further informed us that there is important value in the structure capital of *the Acquiree*. *The Acquiree* has a well-functioning organisational structure, as well as principles for managing and leading projects. The organisation also has competent project leaders, and knows how to proceed in order to educate new ones. Further, there exists a great knowledge from making agreements, stemming from the experience of both good and bad agreements. This has given the organisation a feeling of what represents a good agreement, which is very important in the business of *the Acquiree*.

Analysis
When discussing the goodwill value arising from the acquisition with the Investment Director at *the Acquirer* it was clear that he, for natural reasons, does not reason in terms of IFRS 3. When determining the purchase price, *the Acquirer* calculated and assessed future cash flows but did not further divide those cash flows on specific assets. This is something that an application of IFRS 3 would have demanded, but that is not necessary under Swedish GAAP.

The justification of goodwill required by IFRS 3 implies a great difference from Swedish GAAP. However, research shows that many groups in Sweden in their first year of applying IFRS 3 have not provided sufficient justifications of goodwill arising from their acquisitions. The most recurring explanation of recognised goodwill was that it was attributable to expected synergies. In our case there were no synergies, so the goodwill value would have had to be explained differently.

Even though *the Acquirer* did not be reason in terms of IFRS 3 in accounting for this acquisition, we do not believe that a justification of goodwill would have been that difficult. From our discussions with the Investment Director at *the Acquirer*, we were able to identify a number of factors that could have been contributing to the goodwill value. Further, in comparison to the recognition of intangible assets, no specific amounts attributed to each factor have to be estimated. What may be difficult in justifying goodwill is, though, to explain why some identifiable intangible assets cannot be separately recognised. The reasons for this are the lack of experience and guidance on how much explanation is required.

Concerning the effects on the financial statements, IFRS 3 should imply decreasing values in goodwill because of the stricter requirements of recognising intangible assets. However, research shows that this was not always the case in the Swedish groups applying IFRS 3 for the first time. The reason for this could have been a lack of identifiable intangible assets. More probable is, though, that the groups had difficulties in recognising their identifiable intangible assets because of lacking experience. In the case of this essay, we were able to recognise a number of intangible assets, so the original goodwill value would have been decreased if applying IFRS 3. The consolidated financial statements would further have been affected by the abolishment of amortisations of goodwill.

4.2.4. Annual Impairment Tests

As discussed earlier in this essay, intangible assets with indefinite useful lives and goodwill shall not be amortised under IFRS 3. Instead, these assets shall be tested for impairment annually in accordance with IAS 36 – Impairments.

The Case of this Essay
After the initial accounting for the business acquisition in accordance with IFRS 3, *the Acquirer* would annually be faced with problems of impairment testing the trademark and acquired goodwill.

In testing the trademark or the Internet domain names for impairment, *the Acquirer* will have to assess their recoverable amounts, and thereafter compare these with their carrying amounts. This implies that *the Acquirer* every year must reassess the value of these assets, and consequently, estimate expected future cash flows as well as determine suitable discounting factors.

The process of testing goodwill for impairment is a bit more complex. In order to pursue the impairment tests of goodwill, *the Acquirer* first have to determine the cash-generating units on

which the value of goodwill can be allocated. Concerning such cash-generating units, the Investment Director at *the Acquirer* could imagine different possibilities. For example *the Acquiree* could be considered to be one single cash-generating unit, which also would be the less problematic solution for *the Acquirer*. Another possibility could, according to the Investment Director, be to divide *the Acquiree* into three different cash-generating units representing its three geographic markets.

If *the Acquiree* would be divided into three cash-generating units, *the Acquirer* would be faced with the problem of determining how much of the goodwill value that would be appropriate to allocate to each cash-generating unit. Such determination further implies that *the Acquirer* has to assess to what extent each geographic market takes part of *the Acquiree*'s business, and on which assumptions, for example turnover or profitability, the importance of the different markets are based. The allocation of goodwill should further be proportionate to these determinations.

Analysis

The annual impairment testing of goodwill and intangible assets with indefinite useful lives is an issue arising after the initial accounting of a business acquisition. The impairment tests function as an evaluation of management's performances, indicating if acquisitions were beneficial investments.

The complexity of these impairment tests shall however not be underestimated. The valuation of assets being tested for impairment may be very difficult. In our case, the impairment testing concerns goodwill and the trademark. Research shows that most groups have used discounted cash flow calculations in carrying out their impairment tests. Such calculations require a lot of assumptions such as what cash flows that are expected, which discounting factor to use etc. Further, all of those assumptions have to be disclosed. Regarding the trademark, this may be difficult to valuate because of the fact that it does not generate incomes independently from other assets in *the Acquiree*. This is further something that many intangibles have in common. Since the assumptions that have to be made are difficult to regulate, groups may affect the outcomes of their impairment tests after their preferences by making subjective assumptions.

When it comes to goodwill, difficulties arise before the valuation since the goodwill value first has to be allocated on cash-generating units. In our case, it should be possible to avoid this problem by defining *the Acquiree* as one single cash-generating unit. Further, the Investment Director at *the Acquirer* was rather certain that such a solution easily could have been justified. We also consider this desirable solution to be feasible since the business of *the Acquiree* is separate from the one of *the Acquirer*. In addition, the fact that *the Acquiree* is such a small part of *the Acquirer* is also in favour of this solution.

However, IAS 36 implies that cash-generating units shall represent the lowest level possible within the entity. In our case *the Acquirer* could, as previously mentioned, possibly define three different cash-generating units representing *the Acquiree's* three geographic markets. Such a division would, though, imply more problems for *the Acquirer*. *The Acquirer* would be forced to assess on which bases goodwill can be considered to be allocated on the different cash-generating units.

The treatment of goodwill and indefinite-lived intangible assets under IFRS 3 implies a difference from Swedish GAAP. The effect of this difference is that it creates greater volatility on the consolidated income statements. The abolishment of amortisation on these assets generates positive effects on reported results. However, when impairments are necessary a one-time

occurring and less predictable cost appears that negatively affects the reported results. IFRS 3 creates a risk of more surprises as the reported results become more unpredictable.

Research shows that impairment tests of goodwill and intangible assets with indefinite useful lives can have very significant impacts on a company's income statement since they often represent a majority share of the value of groups today. In the case of this essay, similarly the impairment tests can have significant effects since a big part of the purchase price was referable to goodwill and intangible values not being amortised under IFRS 3. However, an impairment of *the Acquiree* would not affect the consolidated income statements significantly because of *the Acquiree's* minor part in the group.

4.2.5. Disclosure

IFRS 3 requires, as mentioned earlier in this essay, an extensive amount of disclosure. The disclosure requirements of IFRS 3 imply that disclosure shall be given of the entire acquisition process in order to enable users of consolidated financial statements to evaluate the nature and financial effects of business combinations.

The Case of this Essay

As previously mentioned, the only information given by *the Acquirer* in the consolidated financial statements established in accordance with Swedish GAAP, was what acquisition had been carried out, what price was paid and a few phrases about *the Acquiree*'s business. The only information provided by *the Acquirer* concerning goodwill, was the amount as well as time and amounts of amortisation.

Concerning the disclosure that has to be provided when applying IFRS 3, the Investment Director at *the Acquirer* was of the opinion that the disclosure requirements of IFRS 3 are too extensive. He further pointed out that *the Acquirer* is a large group, and that *the Acquiree* is a rather unimportant part of the group as a whole. Therefore, he questioned whether someone would be interested in such detailed information. Further, he did not see the disclosure requirements of IFRS 3 as a problem since the information already exists and is needed internally.

However, the CFO at *the Acquiree* informed us that they in general want to disclose as little information as possible. The reason for this is that *the Acquiree* has a lot of new and unknown technology, which implies its business is sensitive to providing too much information as this may benefit competitors.

Analysis

In our discussion with the Investment Director at *the Acquirer,* he mentioned that there are no problems in providing the information that IFRS 3 requires, because this information already exists and is needed for internal use. However, even though the information exists it has not been treated and arranged with as detailed approach as would have been necessary under IFRS 3.

The complexity in providing the information that IFRS 3 requires varies with the different kinds of information that is disclosed. IFRS 3 implies both disclosure of pure quantitative accounting information as well as more explaining and qualitative information. The quantitative information may be easier to provide once you have the figures. However, this information may be sensitive to disclose for competitive reasons. The explaining and qualitative information may, on the other hand, be more difficult to provide accurately since this cannot be exactly regulated. It may consistently be more difficult to know how much explanation is necessary to attain the disclosure level required.

Research has shown that groups have to a various extent succeeded to fulfil the requirements of IFRS 3. In many groups the information provided was very insufficient, especially when it comes to what value remains as goodwill, after having allocated the cost of the combination on identifiable assets and liabilities. This information should however not be too difficult for the groups to disclose, provided that they have effected their accounting for business acquisitions correctly in accordance with IFRS 3.

The information that would have had to be disclosed under IFRS 3 by *the Acquirer* in our case is much more extensive than that provided when accounting in accordance with Swedish GAAP. Instead of just providing a few phrases about the acquisition and information about what goodwill value had been recognised, *the Acquirer* would under IFRS 3 have been required to justify the whole acquisition by explaining all components contributing to the purchase price.

Accounting for business acquisitions in accordance with IFRS 3 implies, as discussed throughout this chapter, a clear division of different components on which the cost of the combination can be allocated. With this division come more requirements of information that have to be disclosed. For example, concerning the five intangible assets recognised in this case, information would have had to be provided about their values and useful lives. Further, since six identified intangible assets probably not could have been reliably measured, this would have had to be explained by *the Acquirer*. Concerning goodwill, as discussed earlier, a description of what has contributed to its value would have had to be provided.

The overall effects concerning the disclosure required by IFRS 3 are first that it requires lots of time and work for *the Acquirer*, and second that it implies much more transparency. In our case the transparency would perhaps not have affected *the Acquirer* as much as *the Acquiree*, because of *the Acquiree's* relatively minor importance in the group as a whole. Some information that would have had to be provided is how *the Acquiree* creates value, something that it for competitive reasons does not want to make public.

Finally, we consider the fact that information about immaterial acquisitions can be disclosed in aggregate. The acquisition in case of this essay could probably be considered immaterial, since it is such a small part of the group as a whole. However, *the Acquirer* did not make any other business acquisitions the same year, so the definition of the acquisition as immaterial would not have affected the disclosure that would have had to be provided.

4.3. The IFRS 3 Accounting for the Business Acquisition

The application of IFRS 3 on this case came to be much about the identification and recognition of intangible assets. To summarise this, we have below outlined an acquisition analysis as it possibly would have looked if the acquisition was accounted for in accordance with IFRS 3.

Table 4.2.

Acquisition Analysis under IFRS 3	**MSEK**
Purchase price	570
+ Costs directly attributable to the acquisition	6
= The cost of the combination	**576**
- Equity capital in *the Acquiree*	199
- Value of the Trademark	X
- Value of the Protections of design	X
- Value of the Order backlog	X
- Value of the Customer relationships related to customer contracts	X
- Value of Patented technology	X
= Goodwill	**G**

As visible above, five new intangible assets have appeared that differs from the original acquisition analysis (see table 4.1.). These different intangible assets could probably have been recognised if the acquisition would have been accounted for in accordance with IFRS 3. A more detailed summary over our application of IFRS 3 on this case is to be found in Appendix 3.

As mentioned earlier, we have not tried to estimate the values of the recognised intangible assets. Thus, we can neither appreciate the value of goodwill remaining after the allocation of the cost of the combination under IFRS 3. However, the CFO at *the Acquirer* believes, after having seen the results from our identification and recognition of intangible assets, that goodwill would have been significantly diminished under IFRS 3. If the order backlog was given a value, which is the gross margin of the order backlog, that value would have been rather important. Further, the CFO believes that also the trademark would have been given a relatively great value. The other items recognised would, however, probably not have been equally important. Much value in *the Acquiree* lies, as mentioned earlier, in know-how and personnel-related assets so goodwill still would have had a relatively high residual value. The difference from the original acquisition analysis would, according to the CFO, however have been significant.

5. Conclusions

In this chapter we present our conclusions from applying IFRS 3 on this case. This we do by answering our two questions at issue presented in the introduction of this essay. Finally, we give our other reflections on the application of IFRS 3.

5.1. Which Issues Arise When Applying IFRS 3 in the Accounting for Business Acquisitions?

From our application of IFRS 3 on the case of this essay, we have come across different areas where issues or practical problems may appear. First of all, the stricter requirements of identifying and recognising intangible assets demand an acquirer to attain greater insight into the acquired business. Because of these strict identification requirements, it is not enough for acquirers to examine their acquisitions by estimating profitability and future cash flows from an acquired business as a whole. The acquirers are demanded to further analyse which specific parts or assets in the acquired businesses that will generate the expected economic benefits. Therefore, IFRS 3 implies more work for acquirers in terms of gathering and evaluating information from different parts of acquired organisations, to be able to identify what contribute to the value of those organisations.

However, we do not find the identification of intangible assets to be very complicated. With the help from the IASB's list of identifiable intangible assets we were, in our case, quite easily able to identify intangible assets that may have existed at the acquisition date. The reason for the identification of intangible assets being relatively uncomplicated is, according to us, that it can remain rather theoretic. The complexity arises first when it comes to the recognition process where practical valuation problems occur.

The recognition of intangible assets implies that it must be possible to carry out a reliable valuation of the different intangible assets identified in an acquisition. Because of this, the valuation process, when accounting for acquisitions in accordance with IFRS 3, may demand a lot of time and work from acquirers. To be able to assess the values of different intangible assets, acquirers have to involve many different parts of the organisation and perhaps also external consultants. Further, the separate valuations of different intangible assets may imply a lot of difficulties. The problem with intangible assets is that they are most often not traded in a market, and consequently the valuation must be based on expected cash flows. This implies further that it must be assessed which specific cash flows that are generated from the different identified intangible assets. The problem is though that many intangible assets do not generate cash flows independently from other assets. Because of this, we believe that many intangible assets, that can be identified, may not be possible to valuate with sufficient reliability to be recognised.

Furthermore, the recognition of more intangible assets implies more time and work with determining useful lives, as well as appropriate amortisation methods for those intangible assets being determined to have finite useful lives. We find this determination to be mainly difficult for intangible assets that do not arise from time-based contractual or legal rights.

Another issue in applying IFRS 3 is the justification of goodwill. This will demand a new way of thinking for those carrying through acquisitions. In our case, when accounting for the acquisition in accordance with Swedish GAAP, *the Acquirer* did not have to reason otherwise than in terms of business opportunities and making a good investment. Under IFRS 3, those responsible for acquisitions have to be able to justify their investments by explaining which different factors

contribute to the value of an acquisition instead of only calculating expected returns from an acquisition as a whole.

The final issue that we have come across concerns the annual impairment tests of goodwill and intangible assets with indefinite useful lives. These impairment tests imply that entire acquisitions every year have to be evaluated to determine if recognised goodwill still can be justified. Further, this also means that acquired businesses annually must be valuated using, for example, assumptions on expected cash flows and discounting factors. The difficulties in testing goodwill for impairment further lie in allocating goodwill to cash-generating units, and thereafter in valuating these different units.

5.2. How Does the Application of IFRS 3 Affect the Consolidated Financial Statements?

The differences from Swedish GAAP coming with IFRS 3 imply several effects on the consolidated financial statements. Below we conclude the effects IFRS 3 may have on the balance sheet, the income statement and on the level of disclosure.

The Balance Sheet:
On the balance sheet, more intangible assets will probably be recognised as a result of the strict requirements of IFRS 3. This was also shown in our case where we were able to identify eleven new intangible assets, of which five probably meet the criteria for being recognised.

As a consequence of more intangible assets being recognised, the amounts of goodwill will be diminished. How much it will be diminished is however difficult to determine, and differs, of course, from case to case depending on the characteristics of the acquired businesses. In our case the goodwill value would probably have been significantly diminished under IFRS 3. However, because of practical valuation problems, the goodwill value would still have been rather important. Further, since goodwill is not amortised but instead tested for impairment its carrying value will probably better reflect its fair value.

The Income Statement:
IFRS 3 will have positive effects on the income statement because of goodwill and some intangible assets no longer being amortised. Amortisation costs will under IFRS 3 only comprise those recognised intangible assets determined to have finite useful lives, which implies that the annual amortisation costs most probably will be diminished. In our case, it was only four of the intangible assets recognised that were considered to have finite useful lives. Consequently, instead of amortising the entire value of goodwill, only the amortisations of those assets would affect the income statement.

However, under IFRS 3 there is a risk of unpredicted costs as a result of impairment tests. Instead of the predictable amortisation costs of goodwill that appear every year under Swedish GAAP, acquirers may randomly face big costs on their income statements. Further, these impairment costs will probably appear when it is least convenient since impairments probably are not necessary in good times. Thus, the impairment tests may increase the volatility on the consolidated income statement and lead to more unpredictable results.

Disclosure:
The disclosure requirements of IFRS 3 are very extensive. IFRS 3 requires transparency into the whole acquisition process to enable users of financial statements to evaluate effected acquisitions. For example all amounts for each class of an acquiree's assets and liabilities recognised at the acquisition date have to be disclosed.

Further, explanations of all the factors that have contributed to the recognition of goodwill have to be disclosed. The value of goodwill must also be justified by disclosing, for example, calculations of expected cash flows and profitability. Concerning the impairment tests, the calculations as well as the assumptions made have to be disclosed, which may be disadvantageous for competitive reasons.

In total, it may be difficult to find a balance of disclosing the information required by IFRS 3 without revealing competitive secrets. Further, difficulties may exist in creating an understanding among those carrying out acquisitions of what information has to be provided. Such an understanding is necessary for a smooth gathering of the information that has to be disclosed.

5.3. Final Reflections

IFRS 3 implies, as discussed throughout this essay, several important differences from Swedish GAAP. Our application of IFRS 3 largely turned out to be a question about identifying and recognising intangible assets in order to decompose the original goodwill value as much as possible. This focus on intangible values, that became the most important in our case, was rather evident since *the Acquiree* is an engineering company whose value is highly intangible. However, we believe that intangibles will have a significant importance in the accounting for most acquisitions under IFRS 3. The reason for this is the increasing importance of intangible assets in the current knowledge-based economy, which implies that acquirers often are willing to pay more in an acquisition than the value of an acquiree's physical assets. Further, this makes the strict requirements of IFRS 3 to identify intangible assets important, in order to show users of financial statements what the value of an acquisition really comprises.

From our identification of intangible assets, we conclude that this can be carried out relatively easily. Further, we found the IASB's list of identifiable intangible assets to be very helpful especially when there is lacking experiences of identifying intangible assets. Further, we reflect whether an increased use of the IASB's list may be a solution for enhancing the comparability, which currently is diminished because of groups using their own definitions. However, intangible assets often have the characteristics of being unique which reduces the possibility to only use general definitions. Therefore, we conclude that many different definitions of intangible assets may not be possible to avoid which makes a good comparability between acquisitions difficult to achieve.

Further, before beginning our investigation of which identified intangible assets that could be considered to meet the criteria for recognition, we believed that most of the intangible assets identified also would be possible to recognise. The reason for this was the fact that the IASB has stated that intangible assets, acquired in a business combination, normally can be measured with sufficient reliability to be separately recognised from goodwill. Further, during our interview with the auditor Pernilla Rehnberg, we were informed that identifiable intangible assets should be possible to measure reliably and thereby possible to recognise. However, reliable measurements of identifiable intangible assets to us often seem to be rather difficult in practice. Our discussions with the CFO at *the Acquirer*, about the intangible assets identified in our case, indicated that several identifiable intangible assets are too complex to valuate to be given a reliable value. Therefore, we conclude that the IASB's conception that most identified intangible assets should be possible to measure reliably may be too ambitious for practitioners to live up to.

The result of previously discussed valuation problems becomes the residual value of goodwill, existing because of inconveniency that all intangible assets cannot be identified and valued. If all intangible assets could be given reliable values, and groups fully complied with the regulation of

IFRS 3 there would not exist any goodwill value. Theoretically, in acquiring a business there is something that acquirers intend to purchase when they pay a price for that business. Further, since there is a purchase price, it should be possible to identify and value what has contributed to that purchase price. However, in the more complex practice, valuation difficulties appear, making the residual value of goodwill necessary. Therefore, we conclude that the idea of IFRS 3, to make goodwill almost non-existing by instead allocating value to intangible assets, may in practice be difficult to achieve.

Furthermore, since IFRS 3 is a relatively new standard there are still limited experiences from applying it. Also, there is very little guidance from the IASB on how reliable measurements of intangible assets shall be carried through. However, in time we will see if groups, with further experiences from the application of IFRS 3, will be better managed to handle the valuation of intangible assets. Otherwise, common customs of applying IFRS 3 may develop in a similar direction to that of Swedish GAAP, and fewer intangible assets than the IASB intended will be recognised in the accounting for business acquisitions. In that case, the IASB may be obligated to provide more guidance on valuating issues in order to enable groups to manage the regulation of IFRS 3.

In the introduction of this essay, it was argued that the acquisition process under IFRS 3 needs to become more rigorous, both in planning and executing, for acquirers to be able to fully meet the IASB's requirements. It was argued that acquirers under IFRS 3 would have to be more prepared to identify exactly what they are buying, which would imply them being obligated to reason in terms of accounting even before the acquisition. However, in practice it is not reasonable that acquirers, before an acquisition, shall reason otherwise than in terms of business opportunities and making good deals. Further, we believe it to be rather improbable that possible acquisitions will be evaluated from the different values of separate parts of those acquisitions. Those issues of the accounting for acquisitions in accordance with IFRS 3 will have to be dealt with after acquisitions have been carried out.

Finally, the objective of IFRS 3 was to provide users of consolidated financial statements with the most relevant and reliable information. With this objective, IFRS 3 became extensive and very demanding for the groups applying it. The regulation of IFRS 3 requires both difficult assessments and much transparency in terms of extensive disclosure. However, after our application of IFRS 3 on the case of this essay, we conclude that many of the assessments that IFRS 3 requires are too difficult which implies that the objective with IFRS 3 may be hard to fully meet. Concerning the extensive disclosure requirements, we question if the advantages for users of financial statements of being provided with that much information are greater than the time and costs groups applying IFRS 3 have to spend to provide it. Further, who is favoured most by the information that shall be provided in accordance with IFRS 3 - the shareholders or the competitors? For instance, if one group discloses its valuation calculations, and its competitor does not, this is probably an advantage for the competitor rather than for the group leaving more disclosures. Thus, our conclusion is that IFRS 3 probably demands too much from groups applying it, in relation to the extent it benefits users of financial statements with useful information.

Propositions on Future Research

- A similar case study of another acquisition could be carried out in order to see if the results would coincide with ours or what would differ. Further, a similar case study would be interesting since the case of this essay does not involve all parts of IFRS 3.

- It would be interesting to carry out a study of the application of IFRS 3 some years from now, when there are further experiences from this application. In such a study it would be interesting to see the development of how groups comply with IFRS 3.

- A study of how common customs of the application of IFRS 3 develop would further be interesting to examine. This could also be interesting to compare with how common customs of the application of RR 1:00 has developed. The regulations of RR 1:00 are fundamentally the same as those of IFRS 3, and the question is therefore if common customs of IFRS 3 will develop in the same direction as common customs of RR 1:00.

Appendix 1: Examples of Disclosure in Accordance With IFRS 3

Below we show some examples of Swedish groups that in the year of 2005 succeeded well in providing the kind of information that IFRS 3 requires[131].

Specification of Goodwill: Stora Enso

On 31 August Stora Enso finalised its acquisition of 100% of the German-based paper merchant group Schneidersöhne, following approval by regulatory and competition authorities. The all-cash acquisition valued the business at EUR 441.6 million, being the equity purchase price of EUR 202.7 million and debt of EUR 238.9 million. Schneidersöhne was consolidated as part of Stora Enso's merchant business, Papyrus, from September.

Schneidersöhne was the second largest paper merchant in Germany by sales volume and the fifth largest in Europe. It had operations in 11 countries, the biggest markets being Germany and Switzerland. At the year end it employed 1 895 staff and had net sales of EUR 1 073.4 million for the year, of which EUR 354.6 million arose after the acquisition.

The operating result for the four months post-acquisition showed a loss of EUR 9.2 million, though this is to be expected immediately after an acquisition, not least as the fair value allocation of EUR 7.2 million for stock had to be expensed. The financial expense for the period was EUR 2.0 million and, after an allowance for tax of EUR 4.4 million, left a net loss for the period of EUR 6.8 million.

The acquisition was accounted for using the purchase method under which Stora Enso allocated the total purchase price to assets and liabilities based on their fair values. **The purchase price of EUR 202.7 million resulted in the allocation of EUR 82.9 million and EUR 35.8 million to intangible and tangible fixed assets respectively, EUR 7.1 million to other assets and liabilities, EUR 40.7 million for tax and goodwill of EUR 114.0 million.**

Fair values of intangibles were calculated according to accepted valuation methodologies and have been based on independent appraisal. The fair value determination of the customer contracts and related customer relationships has been derived from customer turnover rates and cash flow for customers remaining estimated life time. Company and product trade marks were recognised as intangible assets separate from goodwill, their values being derived from discounted cash flow analysis using the relief from royalty method. **Goodwill represents estimated synergies to be achieved, both within Merchants, EUR 39.0 million, as a result of better efficiency in logistical flows, merging of overlapping operations and better purchase conditions from external suppliers, and in existing Stora Enso units expected to benefit through increased sales volumes, EUR 75.0 million.**

Source: Annual report of Stora Enso 2005, part of Note 5 Acquisitions and Disposals

Specification of the Cost of the Combination: TeliaSonera

Acquisition of Chess Holding

Description of and reasons for the acquisition

On November 7, 2005, TeliaSonera for cash consideration acquired 91.2 percent of the shares in Vollvik Gruppen AS (now renamed TeliaSonera Chess Holding AS) in Norway. After making a voluntary offer at the same price per share for the remaining shares, TeliaSonera held all but a small fraction of the shares in Chess Holding at December 31, 2005.

The acquisition has been accounted for using the purchase method of accounting. Under this method, TeliaSonera has allocated the total purchase price to assets acquired and liabilities assumed based on their respective fair values. The determination of fair values has been made using generally accepted procedures. The results of the operations in Chess Holding have been included in the consolidated financial statements as of November 7, 2005.

Chess Holding owns 100 percent of the mobile service provider Chess/Sense in Norway with 396,000 subscribers at the end of October 2005. The acquisition strengthens TeliaSonera's position on the Norwegian mobile market and emphasizes TeliaSonera's ability to progress successfully with its strategy to enhance growth in the home markets. The transaction is expected to be earnings and cash flow accretive to TeliaSonera, before any synergies. The synergies are mostly related to increased utilization of NetCom's network. Chess/Sense continues to operate as a service provider under its own brand on the Norwegian market.

[131] Jan Marton, accounting expert at KPMG and our tutor.

Financial effects

In the period November 7–December 31, 2005, Chess Holding contributed net sales of SEK 208 million and net income of SEK 19 million to the Group. The following table shows the TeliaSonera Group pro forma net sales, net income and earnings per share, including fair value adjustments, had the acquisition taken place at January 1, 2005.

			January–December 2005
SEK in millions, except per share data	**TeliaSonera Group**	**Chess Holding**	**TeliaSonera Group pro forma**
Pro forma net sales	**87,661**	**1,036**	**88,697**
Pro forma net income	**13,694**	**38**	**13,792**
Pro forma basic and diluted earnings per share	**2.56**	**0.01**	**2.57**

Purchase consideration, goodwill and cash-flow effects

Details of purchase consideration and goodwill were as follows:

SEK in millions	
Purchase consideration	
Basic purchase consideration	2,048
Estimated additional purchase consideration	186
Transaction related direct expenses	19
Total purchase consideration	**2,253**
Less fair value of net assets acquired (as specified below)	–164
Goodwill	**2,089**

Transaction related direct expenses capitalized by TeliaSonera in connection with the acquisition represent bankers' fees as well as transaction related legal and accounting fees, and other direct fees and expenses.

Total purchase consideration and the determination of fair values of assets acquired and liabilities assumed is based on preliminary appraisal; thus, such values and goodwill are subject to refinement.

The cash-flow effects were as follows:

SEK in millions	
Total cash purchase consideration	2,054
Less acquired cash and cash equivalents	–199
Net cash outflow from acquisition	**1,855**

Assets acquired and liabilities assumed

Book values and fair values of assets acquired and liabilities assumed were as follows:

SEK in millions	**Book value**	**Fair value adjustments**	**Fair value**
Trade names	4	-	4
Licences	7	-	7
Subscriber contracts	248	136	384
Equipment, tools and installations	4	-	4
Deferred tax assets	86	-9	77
Inventories	3	-	3
Receivables and other current assets	247	-	247
Cash and cash equivalents	199	-	199
Total assets acquired	**798**	**127**	**925**
Deferred tax liabilities	-99	-39	-138
Long-term liabilities	-388	-	-388
Short-term liabilities	-235	-	-235
Total liabilities assumed	**-722**	**-39**	**-761**
Net assets acquired	**76**	**88**	**164**

There were no purchased in-process research and development assets acquired nor any collateral pledged and contingent liabilities arising from the acquisition.

Acquisition of Orange Denmark and Eesti Telekom

General

On October 11, 2004, TeliaSonera acquired Orange's mobile operations in Denmark (Orange Denmark). The previously associated company AS Eesti Telekom became a majority-owned subsidiary of TeliaSonera as of December 28, 2004. The determination of fair values of assets acquired and liabilities assumed as presented in TeliaSonera's 2004 Annual Report was based on preliminary appraisal. After finalizing the valuations and taking into account the additional Eesti Telekom shares acquired in the first quarter of 2005 as a result of the mandatory public offer, the following amendments have been made.

Purchase consideration and additional goodwill

Details of purchase consideration and additional goodwill were as follows:

	Orange Denmark			Eesti Telekom				
	2004			2004			2005	
SEK in millions	**Reported**	**Adjustments**	**Restated**	**Reported**	**Adjustments**	**Restated**	**Additional acquisition**	**Reported**
Purchase consideration								
Cash consideration	**5,522**	**-**	**5,522**	**472**	**-**	**472**	**23**	**495**
Consideration in terms f new share issue (prior to 2004)	**-**	**-**	**-**	**1,843**	**-**	**1,843**	**-**	**1,843**
Transaction related direct expenses	**26**	**-**	**26**	**-**	**-**	**-**	**8**	**8**
Total purchase consideration	**5,548**	**-**	**5,548**	**2,315**	**-**	**2,315**	**31**	**2,346**
Less fair value of net assets acquired (for 2004 as specified below)	-1,685	-243	-1,928	-1,655	-20	-1,675	-12	-1,687
Less amortization of fair values before the company becoming a subsidiary	-	-	-	-142	20	-122	-	-122
Less goodwill (net of amortization until 2003) before the company becoming a subsidiary	-	-	-	-515	-	-515	-	-515
Additional goodwill	**3,863**	**-243**	**3,620**	**3**	**-**	**3**	**19**	**22**

Assets acquired and liabilities assumed

Book values and fair values of assets acquired and liabilities assumed were as follows:

	Orange Denmark				Eesti Telekom			
SEK in millions	**Book value**	**Preliminary fair value adjustments**	**Final fair value adjustments**	**Restated fair value**	**Book value**	**Preliminary fair value adjustments**	**Final fair value adjustments**	**Restated fair value**
Trade names	-	-	-	-	-	101	40	141
Patents, licenses and rights of way	1,133	-629	-	504	52	-	-	52
Interconnect and roaming agreements	-	-	-	-	-	1,004	-352	652
Subscriber contracts	-	536	-	536	-	2,891	-404	2,487
Buildings, land and land improvements	628	-258	-	370	207	180	-64	323
Mobile networks	618	-326	-	292	449	365	-266	548
Fixed networks	-	-	-	-	465	198	-	663
Equipment, tools and installations	422	-241	-	181	42	20	-	62
Investments in associated companies and other equity holdings	1	-	-	1	12	-	-	12
Deferred tax asset	365	-	243	608	-	-	-	-
Other financial fixed assets	-	-	-	-	11	-	-	11
Inventories	23	-	-	23	72	-	-	72
Receivables and other current assets	596	-	-	596	432	-	-	432
Cash and cash equivalents	183	-	-	183	840	-	-	840
Total assets acquired	**3.969**	**-918**	**243**	**3,294**	**2,582**	**4,759**	**-1,046**	**6,295**
Revaluation reserve	-	-	-	-	-	-1,641	542	-1,098
Minority interests	-	-	-	-	-	-3,776	523	-3,253
Other provisions	-	-	-	-	-3	-	-	-3
Long-term liabilities	-553	-	-	-553	-4	-	-	-4
Short-term liabilities	-813	-	-	-813	-262	-	-	-262
Total liabilities assumed	**-1,366**	**-**	**-**	**-1,366**	**-269**	**-5,417**	**1,066**	**-4,620**
Net assets acquired	**2,603**	**-918**	**243**	**1,928**	**2,313**	**-658**	**20**	**1,675**

Source: Annual report of TeliaSonera 2005, Note 34 Business Combinations

Disclosure of Impairment Tests of Goodwill: Atlas Copco

Impairment tests for cash-generating units containing goodwill
The impairment tests have been conducted at divisional level where the divisions are identified as the cash-generating units (CGU). The recoverable amounts of the CGUs have been calculated as value in use, based on management's five-year forecasts for net cash flows. A moderate steady rate of growth of cash flows is used beyond the forecasted period.

Carrying value of goodwill by cash-generating unit for continuing operations

	2005	2004
Compressor Technique		
Oilfree Air	226	126
Industrial Air	193	94
Portable Air	135	94
Business area level	37	31
	591	**345**
Construction and Mining Technique		
Underground Rock Excavation	44	121
Surface Drilling Equipment	106	2
Drilling Solutions	228	327
Secoroc	115	45
Construction Tools	482	418
Craelius	189	98
Business area level	15	12
	1179	**1023**
Industrial Technique		
Chicago Pneumatic	301	204
Business area level	5	5
	306	**209**
Rental Service	**7161**	**5940**
Total	**9237**	**7517**

The only significant carrying amount of goodwill is in Rental Service. For this division the following key assumption have been used:

- Approximately 8% annual revenue growth for the coming five years. In determining assumptions for the projected period, the company focused on various public forecasts for the IS construction industry and particularly the private non-residential construction segment.
- The operating profit margins are expected to continue to improve over 2005 results, albeit at a slower rate than over the last three years.
- The rate of growth of cash flows beyond the forecasted period is 2%,
- A discount rate of 7% (≈12% pre-tax) has been used based on historical debt and equity returns adjusted for the financial risk profile of the US equipment rental industry.

For all remaining impairment tests of goodwill the annual average revenue growth for the coming five years has been estimated for each of the divisions based on their market position and the characteristics and development of their end markets. The assumed revenue growth is within a range of 3-12%, which, on average, is in line with the Group's growth target. The operating profit margins are assumed to be in line with the reported levels of 2005. The long term growth rate in cash flows beyond the forecasted period is 2-3%. The Group's 2005 weighted average cost of capital 8% (≈12% pre-tax) has been used as discount rate to determine the recoverable amounts.

For all divisions the recoverable amounts are in excess of their carrying amounts. Any reasonable adverse change of the assumptions would not reduce the recoverable amount below its carrying amount.

There are no intangible assets with indefinite useful lives other than goodwill.

Source: Annual report of Atlas Copco 2005, part of Note 12 Intangible Assets

Disclosure of Impairment Tests of Goodwill: Telenor

The Group tests goodwill annually for impairment or more frequently if there are indications that goodwill might be impaired. The test is performed at year end. Telenor has not identified any other intangible assets with an indefinite life.

Telenor has identified its mobile and fixed operations in different countries as its cash generating units, in addition to its IT operating company EDB Business Partner, Broadcast DTH operations as well as other units. Goodwill acquired through business combination has been allocated to individual cash-generating units for impairment testing as follows:

Carrying amount of goodwill

NOK in millions	**2005**	**2004**
Pannon, Hungary	4 928	5 228
Sonofon, Denmark	3 054	3 159
DTAC, Thailand	2 288	-
Bredbandsbolaget, Sweden	4 433	-
Cybercity, Denmark	1 066	-
Broadcast, DTH operation, Nordic	1 632	1 707
EDB Business Partner, Norway	1 897	1 981
Other 1)	1 402	1 279
Total carrying amount of goodwill	**20 700**	**13 354**

1) Other includes primarily DiGi.Com – Malaysia and Kyivstar – Ukraine

Telenor has used a combination of value in use and fair value less cost to sell to determine the recoverable amounts of the cash generating units.

Fair value less cost to sell has been derived from quoted market prices where available. DTAC is listed on the Stock Exchange in Singapore, UCOM, which owns shares in DTAC, is listed on the Stock Exchange in Thailand and EDB Business Partner on the Oslo Stock Exchange and the fair value have been derived from the quoted market prices as of 31 December 2005. Currently, we have not included any control premium to determine the fair value less cost to sell, as there is significant headroom between the recoverable and carrying amount.

For the other entities we have used a discounted cash flow analysis based to determine the value in use. Value in use is based on cash flow projections reflecting the financial business plans approved by senior management covering a three-year period. In addition, the calculation includes estimated cash flows for the years 4 to 9 because some of the operations are in a growth phase and will not reach a stable cash flow within three years. Key assumptions are growth rates, markets shares, EBITDA-margins, capital expenditure and discount rates. Cash flows beyond the nine-year period are extrapolated with a long-term growth rate.

The recoverable amounts have been determined for the cash generating units based on the following key assumptions for the years ending 31 December 2004 and 2005:

	Discount (nominal) rate after tax (WACC)		**Long-term growth rate (includes inflation)**	
	2005	**2004**	**2005**	**2004**
Pannon – Hungary	10.8%	12.5%	2%	2%
Sonofon – Denmark 1)	7.3%	8.2%	2%	2%
Bredbandsbolaget – Sweden	7.9%	-	2%	-
Cybercity – Denmark	7.9%	-	2%	-
Broadcast. DTH operation	8.4%	8.8%	2%	2%

1) The valuation in 2004 of Sonofon was performed with assistance from external financial experts based on various valuation methods.

In the calculation we have used estimated cash flows after tax and discount rate after tax. The 2005 pretax discount rates were: Pannon; 11.4%, Sonofon 8.1%, Bredbandsbolaget 8.6%, Cybercity 8.6% and Broadcast DTH 9.3%. The recoverable amounts would not changed if we had used a pre tax rate.

The long term growth rates relates to the periods beyond nine years.

Discount rates – Discount rates are based on Weighted Average Cost of Capital (WACC).The cost of a company's debt and equity capital, weighted accordingly to reflect its capital structure, gives its weighted average cost of capital. The WACC rates used to discount the future cash flows are based on 7 to 15 years risk free interest rates in the relevant markets and take into account the debt premium, market risk premium, gearing, corporate tax rate and asset beta.

Growth rates – Average growth rates in revenues in the period 4 to 9 years, are based on Telenor`s expectation to the market development, but are not higher than expected growth in the relevant line of business based on public available sources. Telenor uses steady growth rates to extrapolate the cash flows beyond nine years. The long-term growth rate beyond nine years is not higher than the expected long-term growth in the economy in which the business operates. For the different business units the expected growth rates converges from its current level experienced over the last few years to the long-term growth level.

Average EBITDA margin – The EBITDA margin represents the operating margin before depreciation and amortization and is estimated based on the margin achieved in the period immediately before the budget period and on estimated future development in the market Committed operational efficiency programs are taken into consideration. Changes in the outcome of these initiatives may affect future estimated EBITDA margin.

Capital expenditure (Capex) – A normalised capex to sales ratio (capital expenditure as a percentage of revenues) is assumed in the long run. In the years 1 to 9 it is taken into consideration capital expenditure necessary to meet the expected growth in revenues. Changes in traffic volumes and the number of subscriptions in the growth phase will also result in a change in future capex to sales ratio. The Broadcast DTH operation leases satellite capacity and capex to sales ratio is not a key assumption for the valuation. To the best of management judgement estimated capital expenditures does not include capital expenditures that enhances the current performance of assets and related cash flows have been treated consistently.

Market shares during the nine-year period are estimated based on average market shares achieved in the periods prior to the start of the period and estimated future development. A change in number of market players may affect future estimated market shares, average price levels and level of usage/number of subscriptions. This may in turn affect future revenue growth.

These values have been compared with external valuation reports and multiples for peers in the telecom business for reasonableness.

Cash generating units were a reasonable possible change in a key assumption could result in an impairment charge;

Bredbandsbolaget
We have estimated the recoverable amount to be in the interval 0–30% above the carrying amount of the cash generating unit as of 31 December 2005. The EBITDA margin is assumed to be the most critical key assumption in the estimation of the recoverable amount. A decrease in the EBITDA margin of 5.4 percentage points, other things being equal, will reduce the recoverable amount to be the same as the carrying amount.

Cybercity
We have estimated the recoverable amount to be in the interval 0–30% above the carrying amount of the cash generating unit as of 31 December 2005. The EBITDA margin is assumed to be the most critical key assumption in the estimation of recoverable amount. A decrease in the EBITDA margin of 3.3 percentage points, other things being equal, will reduce the recoverable amount to be the same as the carrying amount.

Impairment
As of 31 December 2004, Telenor wrote down goodwill in Sonofon Holding A/S by NOK 3,074 million. In 2004 the Danish market was characterized by intense competition and price reductions. Telenor's assessment of the write-down of goodwill in Sonofon was due to Sonofon's slower than expected growth and a review of the expectations of the company's growth potential as of 31 December 2004. The assessment of the fair value was based on various valuation methods, with assistance of external valuations experts. The valuation was based on discounted cash flow analysis, calculation of value based on multiples for peers in the mobile industry and comparison with external valuation reports.

Source: Annual report of Telenor 2005, Note 17 Impairment testing of goodwill

Appendix 2: Balance Sheet of the Acquiree

Balance Sheet of the Acquiree at the Acquisition Date

Noncurrent Assets		**Equity Capital**	
Intangible assets	4	Equity capital	199
Machines and other equipment	10		
Financial assets	1	**Noncurrent Liabilities**	
Other noncurrent assets	4	Long-term debt	2
Total Noncurrent Assets	19	Other noncurrent liabilities	17
		Total Noncurrent Liabilities	19
Current Assets			
Inventories	46	**Current Liabilities**	
Receivables	359	Payables	215
Other current assets	47	Other non-interest liabilities	92
Cash	54	Total Current Liabilities	307
Total Current Assets	506		
Total Assets	**525**	**Equity and Total Liabilities**	**525**

Source: ***The Acquirer***

Appendix 3: Summary of Our Application of IFRS 3

In the table below, our application on IFRS 3 on the acquisition of *the Acquiree* is summarised.

Asset	Treatment under Swedish GAAP	Treatment under IFRS 3	Amortisation under IFRS 3	Effects Income Statement/Balance Sheet
Trademark	Not recognised	Recognised as an intangible asset with indefinite useful life	No, tested annually for impairment	A new item recognised on the balance sheet, positive effect on the Income Statement because of no amortisations
- Protections of design - Order backlog - Customer contracts and the related customer relationships - Patented technology	Not recognised	Recognised as an intangible asset with finite useful life	Yes	New items recognised on the balance sheet, income statement affected by the amortisations of these assets
- Certification mark - Internet domain names - Reference projects - Computer software - Databases - Trade secrets; tools and formulas	Not recognised	Identified but not separately recognised from goodwill	-	-
Goodwill	Recognised and amortised over 20 years	Diminished by over value in receivables and recognised intangible assets	No, tested annually for impairment	Less value in goodwill recognised on the balance sheet, positive effect on the income statement because of no amortisations

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