AP 2

Post-implementation Review of IFRS 3 *Business Combinations*

CMAC Meeting

27 February 2014

The views expressed in this presentation are those of the presenter, not necessarily those of the IASB or IFRS Foundation.

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Agenda

- Current status of the Post-implementation Review (PiR) for IFRS 3 *Business Combinations*
- Request for Information (RfI)
  - Topics and questions relevant to investors/analysts
  - Related feedback to date on such topics

International Financial Reporting Standards

Current status of the Post-implementation Review for IFRS 3

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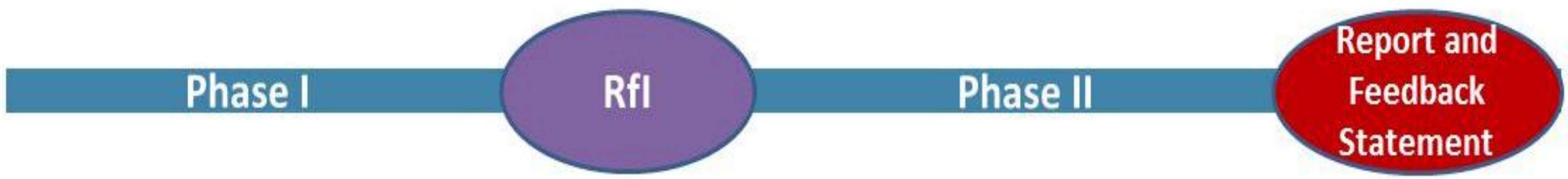
Current status of the Post-implementation Review (PiR) for IFRS 3

- Request for Information (RfI) was published on 30 January 2014. This public consultation initiates Phase II of the PiR.



- Planning and agree scope
- Identification of the issues

- Submissions analysis
- Investigation of the issues through outreach activities

- Publication of the findings and the IASB's responses to them

International Financial Reporting Standards

Request for Information (RfI)

Definition of a business

Question: Are there benefits of having separate accounting treatments for business combinations and asset acquisitions? If so, what are they?

Issue: IFRS 3 defines a **business** as: *"an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants."*

The assessment of this requires judgement, and the accounting will differ depending on the result.

ACCOUNTING FOR AN ASSET ACQUISITION

- Assign carrying amount to the identifiable **assets** acquired and **liabilities** assumed based on their **relative fair values**;
- **No goodwill** is recognised;
- **Acquisition-related costs are capitalised** to the assets;
- **Deferred tax assets** and **deferred tax liabilities are not recognised**; and
- **No specific disclosure requirements**

ACCOUNTING FOR A BUSINESS COMBINATION

- Identifiable **assets** acquired and **liabilities** assumed are **measured** at their acquisition date **fair values**;
- **Goodwill** or a gain from a **bargain purchase** is recognised;
- **Acquisition-related costs are expensed**;
- **Deferred tax assets** and **deferred tax liabilities** arising from the initial recognition of assets and liabilities **are recognised** on the acquisition date; and
- **Specific disclosure requirements**

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Fair value—Measurement

Question:
To what extent is the information derived from the fair value measurements *relevant*?

Information is *relevant* if it has predictive value, confirmatory value or both.

We have heard so far that:

- By measuring all assets acquired and liabilities assumed at fair value, and the residual as goodwill, "it is clearer to see what the acquirer spent money on, and whether they overpaid."
- Tangible assets become a mix of historical and fair value, making it hard to analyse trends.
- Writing up acquired inventory to fair value depresses profitability for 1-2 quarters with no benefit.
- Fair value does not facilitate the comparison of trends between companies (within the same industry or across industries) that grow organically and those that grow through acquisitions.

Fair value—Disclosures

Questions:
To what extent is the information disclosed about fair value measurements sufficient?

If there are deficiencies, what are they?

CU millions	CARRYING AMOUNT	FAIR VALUE ADJUSTMENT	ADJUSTED BALANCE
Assets			
Customer relationships		592	592
PPE	6		6
Trade receivables	194		194
Prepaid expenses	558		558
Cash and cash equivalents	700		700
TOTAL ASSETS	**1,458**	**592**	**2,050**
Liabilities			
Deferred tax liabilities		75	75
Trade and other payables	538		538
Current tax liabilities	14		14
Other short-term liabilities	89		89
TOTAL LIABILITIES	**641**	**75**	**716**
TOTAL IDENTIFIABLE NET ASSETS			**1,334**
GOODWILL ARISING ON ACQUISITION			**813**
PURCHASE CONSIDERATION			**2,147**

Voluntarily disclosed

Required to be disclosed by IFRS 3

Based on financial statements of a chemical company

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Separate recognition of intangible assets from goodwill

Questions:
Do you find the separate recognition of intangible assets *useful? If so, why? How does it contribute to your understanding and analysis of the acquired business?**

Do you think changes are needed to the accounting requirements? If so, what are they and why?

We have heard so far that:

- Identifying and separating the value of intangible assets from the value of the goodwill is unnecessary, may be difficult to audit, and may require to much use of judgement.
- There is not enough information disclosed relating to the fair value amounts recognised.
- The subsequent amortisation of intangibles relies on estimates of useful lives, which are also highly subjective.

*For financial information to be *useful*, it must be *relevant* and *faithfully represent* what it purports to represent.

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Separate recognition of intangible assets from goodwill—*continued*

This illustrates disclosure of the separate recognition of intangible assets from goodwill.
Should this be further improved with regards to business combinations?

	Internally generated intangible assets		Acquired intangible assets					
201X	**Production process**	**Systems development**	**Production process**	**Trademark**	**Marketing and customer-related**	**Systems development**	**Goodwill**	**Total**
Cost								
Opening balance, Jan. 1	4,255	673	76	2,826	2,255	1,840	12,474	24,399
Investments	795	276	-	-	-	79	-	1,150
Business acquisitions	-	-	4	104	278	134	619	1,139
Disposals	(90)	(85)	(1)	(5)	(1)	(36)	-	(218)
Reclassifications	(10)	19	-	-	-	(9)	-	-
Translation differences	(100)	(18)	1	(59)	(105)	(84)	(335)	(700)
Closing balance, Dec. 31	**4,850**	**865**	**80**	**2,866**	**2,427**	**1,924**	**12,758**	**25,770**
Amortisation and impairment losses								
Opening balance, Jan. 1	2,614	428	71	350	951	761	34	5,209
Amortisation for the period	375	111	3	110	229	180	-	1,008
Impairment charge for the period	20	-	3	33	9	4	-	69
Business acquisitions	-	-	-	-	-	1	-	1
Disposals	(81)	(85)	-	(5)	(1)	(36)	-	(208)
Reclassifications	8	(5)	(6)	-	-	15	-	12
Translation differences	(60)	(9)	1	(19)	(43)	(38)	(1)	(169)
Closing balance, Dec. 31	**2,876**	**440**	**72**	**469**	**1,145**	**887**	**33**	**5,922**
Carrying amounts								
at Jan. 1	***1,641***	***245***	***5***	***2,476***	***1,304***	***1,079***	***12,440***	***19,190***
at Dec. 31	***1,974***	***425***	***8***	***2,397***	***1,282***	***1,037***	***12,725***	***19,848***

Accounting for negative goodwill

Questions:
Do you find recognising negative goodwill in profit or loss *useful*?

How *useful* do you find the disclosures about the underlying reasons why the transaction resulted in a gain?

Old treatment (pre-amended IFRS 3)	Current treatment (final IFRS 3)
In most cases, negative goodwill was **deferred** and **amortised to profit or loss**. Sometimes immediate recognition in profit or loss was required.	If **goodwill is negative** then it is **recognised** immediately **in profit or loss**.
	Disclosure of **the amount** and **the line item** in the income statement in which the negative goodwill is recognised is required.
	An entity is required to provide a **description of the reasons** why the transaction resulted in a gain.

Impairing goodwill and indefinite-lived intangible assets

Questions:

(a) How *useful* have you found the disclosures about the assessment of goodwill and intangible assets (with indefinite useful lives) for impairment, and why?

(b) Do you think that improvements are needed regarding the information provided by the related impairment tests? If so, what are they?

We have heard so far that:

Impairment is often delayed, and the market anticipates impairment.

Amortisation of goodwill is not the right answer, because it may often hide bad investment decisions.

Amortisation of goodwill is the right answer because management is too optimistic and impairment may come too late.

Disclosures about impairment should be enhanced.

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Impairment disclosures—Example

The following is an adapted excerpt of the impairment note of a public company. **Should this be further improved?**

Impairment

Impairment losses

The net impairment losses recognised in the consolidated income statement, as a separate line item within operating profit, in respect of goodwill, licences and property, plant and equipment are as follows:

Cash generating unit	Reportable Segment	20X2 CUm	20X1 CUm	20X0 CUm
Country A	Country A	3,000	1,500	—
Country B	Country B	750	2,400	—
Country C	Country C	500	1,500	—
Country D	Country D	—	—	2,700
		4,250	**5,400**	**2,700**

Pre-tax adjusted discount rates

The impairment losses were based on value in use calculations. The pre-tax adjusted discount rates used in the value in use calculations are as follows:

Pre-tax adjusted discount rates	20X2	20X1	20X0
Country A	14.20%	13.10%	—
Country B	12.50%	13.50%	—
Country C	18.50%	15.25%	—
Country D			14.75%

Information also provided by the company for the years ended 20X1 and 20X0.

Of the total impairment charge for the year (CU4,250m), CU4,000m relates to goodwill and CU250 m relates to licences and property, plant and equipment.

The impairment charges were principally driven by:

* increased discount rates due to ….; and

* lower cash flows within business plans because of ….

Impairment disclosures—Example continued

Key assumptions used in the value in use calculations

Assumption	How determined
Budgeted EBITDA	...
Budgeted capital expenditure	...
Long-term growth rate	...
Pre-tax risk adjusted discount rate	...

Sensitivity to changes in assumptions

Other than as disclosed below, management believes that no reasonably possible change in any of the above key assumptions would cause the carrying value of any cash generating unit to exceed its recoverable amount.

31 December 20X2

The estimated recoverable amounts of the Group's operations in Country A, Country B and Country C equalled their respective carrying values and, consequently, any adverse change in key assumption would, in isolation, cause a further impairment loss to be recognised.
The follwing table shows the key assumptions used in value in use calculations:

Assumptions used in value in use calculations	Country A	Country B	Country C
Pre-tax adjusted discount rate	14.20%	12.50%	18.50%
Long-term growth rate	1.0%	1.4%	0.8%
Budgeted EBITDA	(2.2)	2.5	(5.5)
Budgeted capital expenditure	7.3-9.5	7.2-9.2	6.2-8.5

(*)

(*): information also provided by the company for the year ended 20X1.

The changes to assumptions used in the impairment test would, in isolation, lead to an (increase)/decrease to the aggregate impairment losses recognised in the year ended 31 December 20X2.

	Country A		Country B		Country C	
Changes to the assumptions used	Increase by 2pps	Decrease by 2pps	Increase by 2pps	Decrease by 2pps	Increase by 2pps	Decrease by 2pps
Pre-tax adjusted discount rate	(1.1)	1.5	(1.3)	0.8	(0.1)	0.1
Long-term growth rate	1.5	(1.8)	1.3	(1.6)	0.02	(0.03)
Budgeted EBITDA	1.9	(1.3)	(0.5)	0.6	0.02	(0.03)
Budgeted capital expenditure	(1.4)	0.8	1.2	0.8	(0.1)	0.1

(*)

Non-controlling interests (NCIs)

Question:
How *useful* is the information resulting from the measurement of NCIs?

Currently NCIs can be measured at fair value or proportionately to the fair value of the acquiree's net identifiable asset. This measurement option has an effect on the amount of goodwill recognised.

Entity A acquires 60% of Entity B

Case 1—NCIs are measured at fair value		***Case 2—NCIs are measured proportionately***	
(In CU)			
Cash consideration	150	Cash consideration	150
Fair value of NCI	100	NCI (proportionate share: 40% x CU50)	20
Fair value of net identifiable assets	50	Fair value of net identifiable assets	50
Goodwill	**200**	**Goodwill**	**120**

Entities are required to disclose:

(a) the *amount of the NCI* in the acquiree recognised at the acquisition date and the *measurement basis* for that amount; and

(b) for each NCI in an acquiree measured at fair value, the *valuation technique(s)* and *significant inputs* used to measure that value.

Step acquisitions

Question:
How *useful* do you find the information resulting from step acquisition accounting today? If any of the information is unhelpful, please explain why.

Main changes introduced by IFRS 3 (2008):

(a) Goodwill is measured at the acquisition date. Previously, a portion of goodwill was calculated at each step.

(a) The acquirer remeasures its previously held equity interest at its acquisition-date fair value and recognises the related gain or loss in profit or loss. Previously, the equity interest was not remeasured.

Step acquisitions—Example

Entity A acquires 25% of Entity B on 1 January 20X0 for CU225. Entity A acquires a further 75% of Entity B on 1 January 20X5 for CU900.

Some data:

Entity B (target company)	1/01/20X0	1/01/20X5
Purchase consideration	225	900
Fair value of net assets	800	1,000
% acquired	25	75
Fair value of % acquired	200	750
25% interest held (equity method)		258
Fair value of 25% interest held		300

- On 01/01/20X0, 25% of Entity B's FV = CU200
- On 01/01/20X5, 25% of Entity B's FV = CU250*

Increase in value = CU50

Investment in Entity B:

Investment in Entity B	
Investment in B on 1/01/20X0	**225**
Share in profit since acquisition	20
Share in OCI since acquisition	13
Investment in B on 1/01/20X5	**258**

Due to performance

Δ = CU33

Other FV increase

CU17

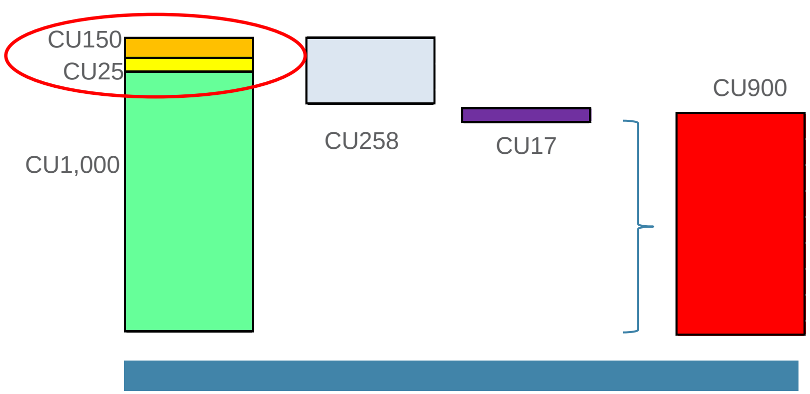
(*): Calculated based on 25% of fair value of net assets (CU1,000).

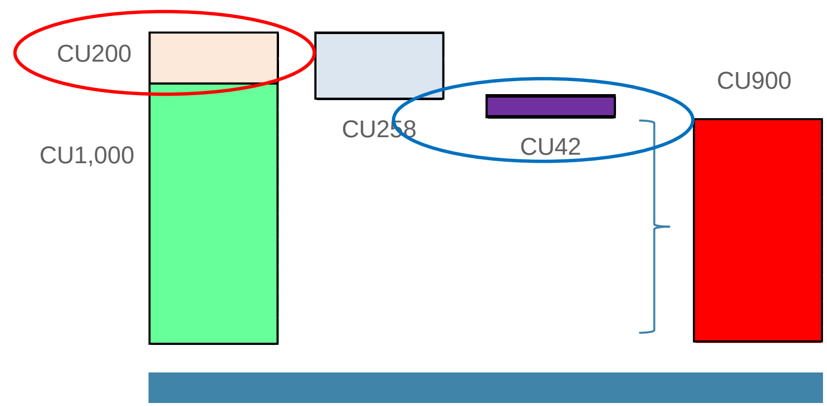
Step acquisitions—Example—*continued*

Comparison of accounting treatments (Old vs New)

Pre-IFRS 3 (2008) accounting treatment	
Fair value of net assets	1,000
Goodwill for first tranche (25%)	25 (CU225 - CU200)
Goodwill for second tranche (75%)	150 (CU900 - CU750)
Asset revaluation reserve	17 (CU250 - CU200 - CU33)
Purchase consideration	900
Investment in Entity B	258

IFRS 3 (2008) accounting treatment	
Fair value of net assets	1,000
Goodwill	200 (CU900 + CU300 - CU1,000)
Profit (remeasurement of investment in B)	42 (CU300 - CU258)
OCI (*)	13
Purchase consideration	900
Investment in Entity B	258





(*): OCI has not been represented in the figure for IFRS 3 (2008) above (it would have been debited against a credit either in PL or OCI).

Loss of control

Question:
How *useful* do you find the information resulting from the accounting for an entity's *retained investment* upon the loss of control in a former subsidiary? If any of the information is not useful, please explain why.

IFRS 3 (2008) amended IAS 27 (2003) to require that:

- any investment that an entity retained in a former subsidiary after control is lost is measured at fair value at the date that control is lost (previously the retained investment was initially measured at its carrying amount)

- any resulting gain or loss should be recognised in profit or loss (previously there was no remeasurement)

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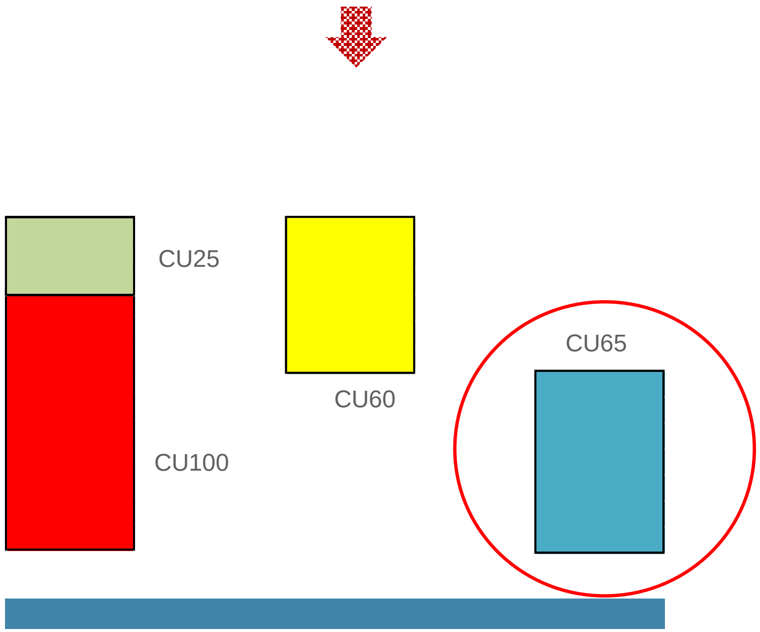
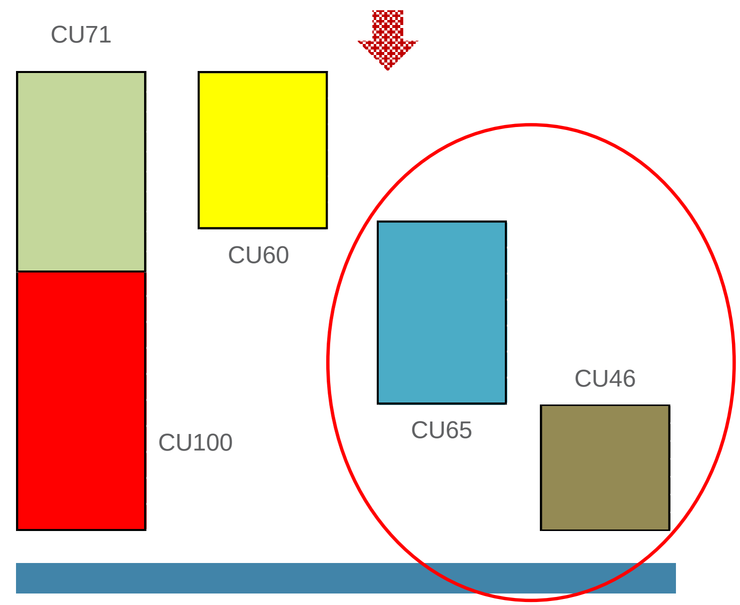
Loss of control—Example

Entity Gamma has a 60% investment in Entity Beta with carrying amount of CU60. Gamma sells 35% of Beta (carrying amount of CU35) for CU100, reducing its holding to 25% (carrying amount of 25CU).

Old accounting treatment	
Cash proceeds	100
Carrying amount of subsidiary	60
Investment in associate (25% carrying amount)	25
Profit of sale of 35%	65 (CU100 - CU35)

New accounting treatment	
Cash proceeds	100
Carrying amount of subsidiary	60
Investment in associate (25% remeasured)	71
Profit of sale of 35%	65 (CU100 - CU35)
Profit on remeasurement of the 25% retained	46 (CU71 - CU25)





Disclosures

Questions:

Do you need additional information to enable you to properly understand the effect of the acquisition on an entity?

If so, what information is missing from disclosures today and why would it be useful?

Disclosures—*continued*

We have heard that the following disclosures are missing and would be useful:

- The primary reasons for the business combination.
- Pro forma income statements and cash flow information about acquisitions to analyse the effects that these transactions have on the entity's accounts.
- Prior year pro forma information that allows to recompose the latest 12 months information
- Carrying amounts of the assets acquired and liabilities assumed. Disclosures to be provided with enough granularity to include pension liabilities, debt, finance lease obligations etc.
- Information about inputs and assumptions used to measure the fair value amounts at the date of acquisition.
- Underlying criteria and rationale used by management when identifying and separating intangibles from goodwill.
- More information about the nature of the intangible assets that are recognised as a result of a business combination.
- Goodwill and goodwill impairment by segment as a line item.
- Impairment test should be more transparent.
- Additional tax disclosures (eg tax losses in the acquired entity, effects of the business combination on the expected tax rate etc).
- Information about subsequent performance.

What else would be useful?

Where to go for more information

- Project page on the IFRS website:
  - http://www.ifrs.org/Current-Projects/IASB-Projects/PIR/PIR-IFRS-3/Pages/PIR-IFRS-3.aspx

- Contacts:
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Thank you


individual comments
questions
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expressions of individual views
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