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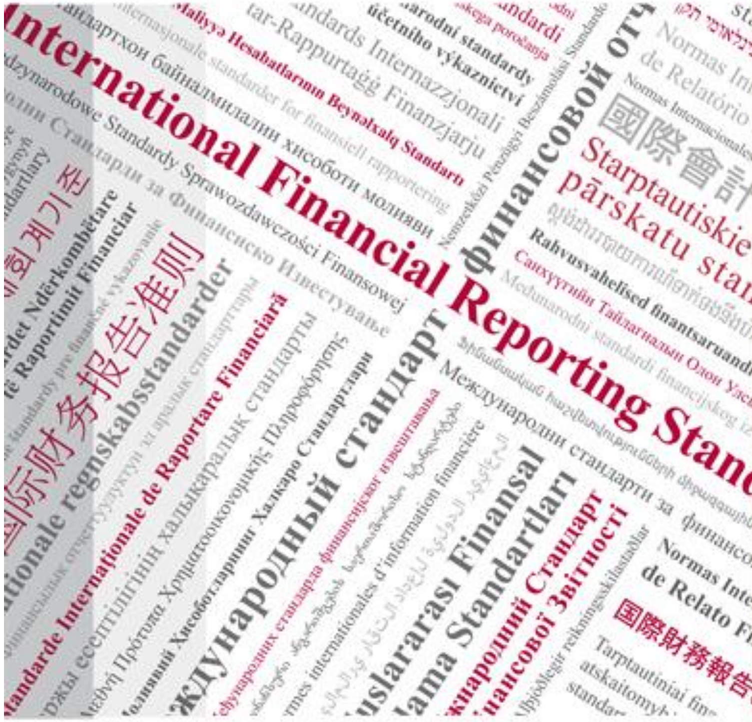

Post-implementation Review of IFRS 3 *Business Combinations*

CMAC/GPF Meeting 30 June 2014

Agenda Paper 5

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

For this session, you will have

- Background presentation (see this set of slides)
- Breakout sessions to discuss two topics:
  - Two groups will discuss Agenda Paper 5A:
    - Separate recognition of intangible assets from goodwill
    - Non-amortisation of goodwill and indefinite-lived intangible assets
  - Two groups will discuss Agenda Paper 5B:
    - Step-acquisitions, loss of control, disclosures, transaction costs and contingent considerations
- Then, report back and entire group discussion

Agenda

- Current status of the Post-implementation Review (PIR) for IFRS 3 *Business Combinations.*
- Main feedback received so far from outreach activities
- Appendix: Key requirements of IFRS 3

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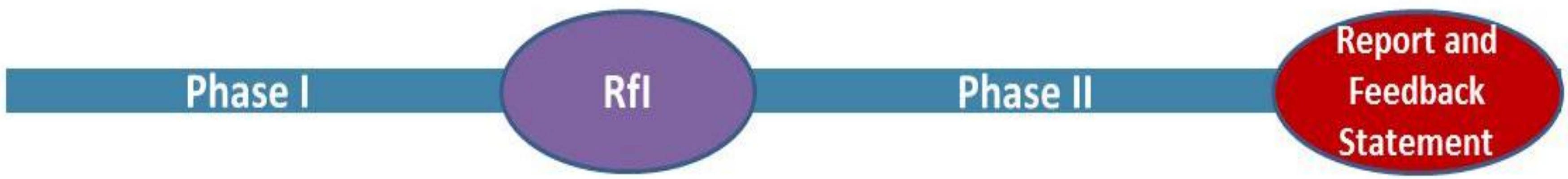
Current status of the Post-implementation Review for IFRS 3

Current status of the PIR for IFRS 3

- Request for Information was published on 30 January 2014. Comment period ended on 30 May 2014*.



- 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

* This presentation was prepared on 12 June 2014. Feedback from comment letters is not included in this presentation.

Main feedback received so far from outreach activities

PIR IFRS 3 – Feedback received so far

Separate recognition of intangible assets from goodwill:

- Usefulness:
  - Intangible assets with indefinite life and those that cannot be sold without the underlying business should not be separated from goodwill, because are similar to goodwill.
  - Intangible assets with definite useful life that generate identifiable future revenues (eg patents) should be separated from goodwill.
  - Intangible assets that are tax deductible should be separated, because are useful to estimate future tax expenses.
  - Management value the business as a whole, rather than individually value the assets acquired and the liabilities assumed.
  - The recognition of these intangible assets may result in negative goodwill.
- Challenges:
  - The measurement of some intangible assets requires much use of judgement and is costly.
  - The subsequent amortisation of intangible assets relies on estimates of useful lives, which are also subjective.

PIR IFRS 3 – Feedback received so far

Non-amortisation of goodwill and indefinite-lived intangible assets:

- Usefulness
  - Non-amortisation of goodwill:
    - is useful to calculate performance measures (such as Return of Invested Capital), which can be used to assess stewardship;
    - permits understanding of whether the management has overpaid or whether the acquisition was successful.
  - Impairment test is not effective. Impairment losses are not recognised early enough. The market ignores the impairment test results.
- Challenges:
  - Impairment test is costly and complex.
  - The assumptions used in the impairment test are subjective/too optimistic.
  - Purchased goodwill may be supported by internally generated goodwill (ie it is difficult to separate the cash flows between these two).
  - Goodwill sometimes is generated by deferred tax liabilities.

PIR IFRS 3 – Feedback received so far

Step acquisitions:

- The previously held equity interest:
  - should not be remeasured at the acquisition-date fair value, because
    - the cost paid for each stake is useful to assess management stewardship;
    - the more the acquirer pays, the bigger is the gain on the remeasurement.
  - should be remeasured, but the gain should be recognised in OCI.
- The valuation at fair value is particularly challenging when, for example, the acquirer held a 49% interest and acquires an additional 2% to get control

Loss of control:

- The valuation at fair value of the retained interest is challenging particularly if the former subsidiary is not listed.
- The retained interest should not be remeasured at fair value.

PIR IFRS 3 – Feedback received so far

Additional disclosures:

- Information about subsequent performance of the acquiree.
- 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.
- Additional tax disclosures (eg tax losses in the acquired entity, effects of the business combination on the expected tax rate etc).

Better disclosures:

- The primary reasons for the business combination are not sufficiently clear.
- The total consideration paid including the debt acquired, pension liabilities assumed, etc
- More information about assumptions used to determine the recoverable amount of goodwill.
- 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.

PIR IFRS 3 – Feedback received so far

Other matters:

- the measurement of contingent consideration at fair value is challenging, because is difficult to estimate the probability of the future event that should occur.
- the subsequent measurement of contingent consideration in P&L is not appropriate, because the contingent consideration is part of the total consideration paid (ie variations should be recognised against the asset acquired or goodwill)
- transaction costs should be included in goodwill, because they are part of the total consideration paid (transaction costs are now recognised in P&L)

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Appendix:
Key requirements of IFRS 3

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Key requirements of IFRS 3

- A **business combination** is a transaction in which an acquirer obtains control of a business
- A business combination must be accounted for by applying the **acquisition method**, which requires:
  - recognising and measuring the identifiable assets acquired, the liabilities assumed and any NCI in the acquiree; and
  - recognising and measuring goodwill or a gain from a bargain purchase.
- The acquirer **measures** the assets acquired and liabilities assumed at their acquisition-date **fair values.**
- The acquirer may **recognise** some assets and liabilities that the acquiree had not previously recognised as assets and liabilities in its financial statements. For example:
  - **Intangible assets** that the acquiree developed internally;
  - contingent liability even if it is not probable that an outflow of resources will be required to settle the obligation.

Key requirements of IFRS 3 and IAS 36

- **Goodwill** and intangible assets with an indefinite useful life are not amortised. They are tested for impairment at least annually.
- **IAS 36** requires to **disclose**:
  - for each cash generating unit and reportable segment, the amount of **impairment loss** recognised;
  - the carrying amount of goodwill allocated to the cash generating unit
  - the **discount rates** used;
  - the **events that caused the impairment** loss;
  - the **assumption used** in calculating the recoverable amount;
  - the **sensitivity analysis**;
- The **consideration** transferred in a business combination (including any contingent consideration) is measured at **fair value**.
- Changes in the fair value of **contingent consideration** resulting from future events (eg meeting an earning target) are generally recognised in profit or loss.

Key requirements of IFRS 3 and IFRS 10

- In a **step acquisition** (ie a business combination achieved in stages), the acquirer:
  - – remeasures its previously held equity interest in the acquiree at its acquisition-date fair value and recognise the resulting gain or loss in P&L; and
  - – measures goodwill only at acquisition date.
- If a parent **loses control** of a subsidiary, the parent recognises:
  - any investment retained in the former subsidiary at its fair value when control is lost
  - any resulting gain or loss in P&L.
- **Transaction costs** are recognised in profit or loss.

Key requirements of IFRS 3

- IFRS 3 requires the acquirer to **disclose** information that enables users of its financial statements to evaluate the **nature and financial effect** of a business combination.
- IFRS 3 requires to **disclose**:
  - the primary **reasons** for the business combination;
  - a description of the factors that make up the goodwill recognised (eg expected **synergies**);
  - a description of the **contingent consideration** arrangement and the amount recognised;
  - **amounts recognised** for each class of assets acquired and liabilities assumed;
  - the amount of any gain recognised in a **bargain purchase** and the reasons why the transaction resulted in a gain;
  - the amount of the **NCI** in the acquiree recognised at the acquisition date and the measurement basis for that amount;
  - …

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:
  - Michael Stewart: Director of Implementation Activities (mstewart@ifrs.org)
  - Leonardo Piombino: Visiting Fellow (lpiombino@ifrs.org)

Thank you


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