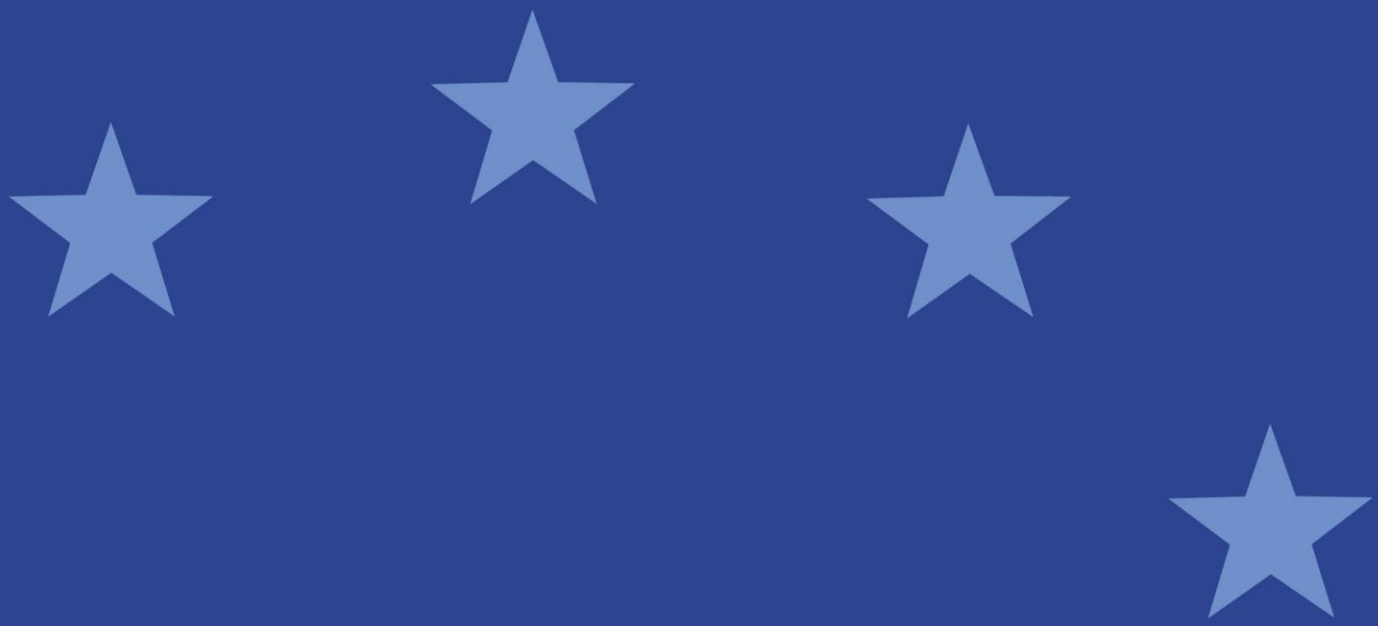
esma European Securities and Markets Authority

ESMA Report

Review on the application of accounting requirements for business combinations in IFRS financial statements



16 June 2014/ESMA/2014/643

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List of abbreviations and acronyms used in this report

BC	Basis for Conclusions
CGU	Cash Generating Unit
FASB	Financial Accounting Standards Board
European Enforcers	European national enforcers that participate in EECS
EECS	European Enforcers Coordination Sessions
EU	European Union
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standards
IFRS IC	IFRS Interpretations Committee
M&A	Merger and Acquisition
MTO	Mandatory tender offer
NCI	Non-controlling Interests
PIR	Post implementation review
RfI	Request for Information

Executive Summary

This report evaluates the consistency of application of key requirements of IFRS 3 - *Business Combinations* and how compliant and entity-specific IFRS 3 disclosures are in the 2012 annual IFRS financial statements of a sample of 56 issuers in the European Union (EU). It also includes other IFRS 3 issues identified as part of the enforcement experience of European national enforcers (European Enforcers) that participate in the European Enforcers Coordination Sessions (EECS).

Transparency of financial information is of paramount importance for investment decisions. Considering the significant impact that business combinations usually have on financial statements, ESMA decided to anticipate the upturn in merger and acquisitions by conducting a limited review of the application of the IFRS 3 requirements and drawing conclusions which should be further considered by issuers in future financial statements. In addition, taking into account that the International Accounting Standards Board (IASB) is performing a Post Implementation Review (PIR) in this area, ESMA believes that this report will assist the IASB in identifying areas where IFRS 3 leads to divergence in practice or lack of comparability and where, therefore, additional clarification or guidance would be helpful in achieving the objectives of the standard.

Overall, the results of the review show that some good business combination disclosures were provided. However, ESMA identified certain areas where improvements are necessary. The items below emerged as being the most significant, but the report also provides ESMA's views on other issues such as: mandatory tender offers (MTOs), the definition of a business and adjustments to fair value amounts during the measurement period.

Recognition and measurement of goodwill and bargain purchase gains

Despite the fact that issuers reviewed recognised goodwill in 86% of the business combinations, representing on average around 54% of the consideration paid, descriptions of the factors making up goodwill were often 'boiler plate', referring only to the possible realisation of synergies without providing details about how those synergies are expected to be achieved. 24% of the business combinations analysed did not recognise any intangibles separately from goodwill. A bargain purchase gain was reported in 11% of the business combinations reviewed but one third of these issuers did not disclose an explanation of why the transaction resulted in a gain. ESMA also notes that bargain purchases appear to happen more frequently than the IASB originally expected.

ESMA urges issuers to provide relevant information about the factors making up goodwill and reasons for bargain purchases. ESMA also believes that, as part of the IASB's disclosure initiative, the IASB should try to improve the disclosures required by IFRS 3 with regards to this information.

Intangible assets and contingent liabilities

Although 92% of issuers presented a summary of the fair values of major assets and liabilities acquired, the level of aggregation of certain assets and liabilities limited the usefulness of the information provided because some were aggregated despite having different nature. ESMA encourages more granular disclosure so that users have better quality information.

The most common intangibles recognised by issuers included in the review were customer-related (58%) and marketing-related intangibles (54%) for which there is usually no observable market. The review results and enforcement experience show that, although valuation techniques used to determine the fair-value of those assets vary considerably, most of them are based on discounted cash flow techniques. Considering the frequency with which customer-related intangibles are recognised in business combinations

and the enforcement issues identified when distinguishing contractual and non-contractual relationships, ESMA encourages the IASB to continue its work analysing whether customer relationships stemming from both contractual and non-contractual arrangements should be subject to the same recognition principles in IFRS 3.

Additionally, European Enforcers' enforcement experience shows that sometimes assumptions used to measure intangible assets at fair value are not applied when measuring those assets subsequently. ESMA expects issuers to consider whether the same assumptions apply.

Only 11% of the issuers reviewed recognised contingent liabilities arising from business combinations. Of these, very few gave the required IFRS 3 disclosures thus, ESMA urges issuers to provide this information. ESMA draws the attention of the IASB to whether the treatment of contingent liabilities in IFRS 3 and IAS 37 - *Provisions, contingent liabilities and contingent assets* could be better aligned.

Disclosure of fair value measurement techniques

ESMA noted that some issuers referred to external valuations of intangible assets without providing details of the techniques and assumptions used to determine their fair value. Only 35% of the issuers reviewed disclosed how fair values were determined. Of these, most disclosed the valuation technique but not the key assumptions. Around 37% of issuers reviewed measured Non-Controlling Interests (NCI) arising from business combinations at fair value but most did not disclose how this was determined.

ESMA encourages issuers to provide information on the assumptions and measurement techniques used in the valuation of material assets, liabilities and of NCI. ESMA also believes that a disclosure merely referring to the use of external valuations without providing additional details does not help users to understand the economics behind those measurements. ESMA also believes that disclosures relating to valuation techniques for acquired assets, liabilities and NCI could be enhanced if IFRS 3 required disclosures such as those included in IFRS 13 – *Fair value Measurement* for recurring measurements.

General observations on disclosures

While IFRS 3 disclosures have generally been provided by issuers, in some cases their understandability was impaired, such as when disclosures were not tailored to the specific circumstances of a transaction or were insubstantial. In other cases, some disclosures were presented outside the financial statements, for example in the management report, or together with other notes to the accounts.

ESMA urges issuers to consider whether disclosures are sufficiently detailed and specific to provide an understanding of the underlying transactions. ESMA believes presenting transaction information in one note assists users in understanding the rationale for the transactions, evaluating assets and liabilities acquired and assessing stewardship.

Next steps

ESMA expects issuers and their auditors to consider the findings of this review when preparing and auditing the IFRS financial statements. Through the recommendations provided in this report, ESMA seeks to improve the compliance with IFRS, enhance comparability of financial statements across Europe and contribute overall to improving the quality of financial reporting.

When this report points to a breach of IFRS requirements and where this breach is considered material, ESMA expects that European Enforcers will take or have already taken appropriate enforcement actions. ESMA will monitor the progress of those actions.

I. Introduction

1. During the financial and economic crisis, Merger and Acquisition (M&A) activity showed a significant slowdown in Europe. Illiquidity of markets, funding issues and concerns related to the uncertainty surrounding the general business environment led European issuers to focus their attention on internal business organisation and restructuring rather than expanding their activities through acquisitions.

2. With the gradual upturn of economic activity in the European markets, business acquisitions are now returning to the agenda of more European issuers. In that context, ESMA and European Enforcers acknowledge the impact that business combinations usually have on issuers' financial statements and the consequences that such transactions have on investment decisions.

3. Against that background, ESMA concluded that it would be helpful to anticipate the upturn in acquisitions by conducting a limited review of the application of the requirements of IFRS 3. Since the last revision of the standard, ESMA has published a number of decisions on various issues as part of the extracts from the EECS database on enforcement[1]. Other issues were submitted directly to the IFRS Interpretations Committee (IFRS IC) to be considered when issuing interpretations or proposing amendments to the standard.

4. In July 2013 the IASB announced that it would undertake a PIR of the effect of IFRS 3 and related reporting requirements. As part of that process, the IASB issued a Request for Information (RfI) in January 2014 and it will analyse the responses received and issue a Feedback Statement including the main findings and any subsequent actions.

5. ESMA remains strongly committed to supporting the IASB's work in developing a single set of high quality, understandable, enforceable and globally accepted standards. This report, therefore, also contains matters for the attention of the IASB and will be submitted as part of the response to the RfI.

6. Taking into account the importance of this topic to analysts and ESMA's policy of liaising with investors' and users' representatives in relation to matters related to transparency of financial information, ESMA discussed the preliminary findings of this report with investors' representatives and has made specific reference to them where relevant.

II. Objectives and scope of the report

7. The main objective of this report is to provide an overview of accounting practices in relation to the application of IFRS 3 requirements in a sample of 2012 financial statements prepared in accordance with the IFRS. ESMA's findings in respect of each of the selected areas are followed by conclusions including matters that ESMA expects issuers to consider when accounting for business combinations. As a contribution to the IASB's RfI for the PIR of IFRS 3, the report identifies conclusions for the attention of the IASB.

8. This report includes the results of a desk-based review of the 2012 financial statements of certain European issuers that disclosed material business combinations and some IFRS 3 issues identified by the European Enforcers during their enforcement activities.

[1] http://www.esma.europa.eu/page/IFRS-Enforcement-0

9. ESMA selected the topics for the review based on ESMA and European Enforcers' enforcement experience by choosing those areas that most frequently resulted in enforcement issues or had more diversity in practice. In addition to general observations on disclosures, the topics selected include:
    a. intangible assets and contingent liabilities
    b. disclosure of fair value measurement techniques
    c. recognition and measurement of goodwill and bargain purchases
    d. mandatory tender offers
    e. contingent consideration
    f. definition of a business, and
    g. adjustments to fair value amounts during the measurement period

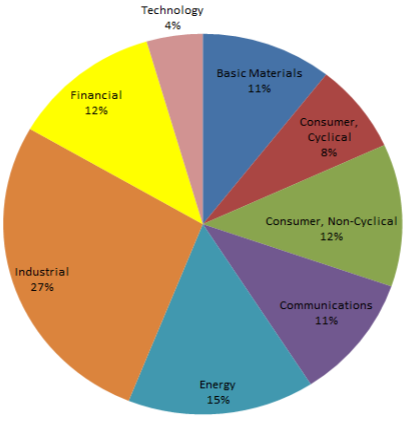
10. The review was performed on a sample of 56 European listed entities from 11 jurisdictions, covering 66 businesses combinations reported in their 2012 annual IFRS financial statements. The sample was selected by first identifying, from publicly available information, 45 European issuers that had the most significant business combinations in that period. European Enforcers then added 11 smaller issuers' financial statements with material business combinations to the review, so that the sample included a wider range of larger and smaller business combinations accounted for in the 2012 financial statements.

11. The total market capitalisation of the selected issuers was € 1055 billion as of the end of 2012, while the consideration paid for the business combinations included in the sample totalled € 76 billion. The amount of goodwill recognised in the financial statements was € 41 billion and the amount of separate intangible assets was € 36 billion.

12. The desk-based review was performed solely on the basis of the information included in the publicly available IFRS financial statements. Consequently, due to the inherent limitations of this type of analysis, the review could not consider the reasons why certain disclosures were omitted by issuers. The review was performed by a dedicated task force composed from representatives of European enforcers and ESMA staff who examined the information provided in the financial statements and analysed the findings in light of their enforcement experience. For the cases included based on the enforcement experience, the European Enforcers had the benefit of access to additional information, when provided by the issuers.

13. The review included issuers from a wide range of industries, as illustrated below.

Chart 1. Business combinations by Industry of the Issuer



III. Overview of IFRS requirements

14. IFRS 3 requires an acquirer to account for the purchase of a business by recognising most of the acquired assets and liabilities at fair value, with goodwill recognised as the difference between the consideration payable and the assets and liabilities recognised. The latest revision of IFRS 3 was finalised in 2008 following a convergence joint project with the Financial Accounting Standards Board (FASB) with the objective of developing a similar standard for business combination accounting by eliminating some of the remaining differences between IFRS 3 and the equivalent US standard. Except for the items mentioned below, the main recognition and measurement requirements for assets and liabilities remained mostly unchanged.

15. In the revised version of IFRS 3 the definition of a business combination was amended to include transactions or other events in which an acquirer obtains control of one or more businesses, such as a business combination through contract alone. A business is defined in IFRS 3 as an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return directly to investors or other owners, members or participants.

16. IFRS 3 (2008) also introduced changes to the measurement principles of NCI in the acquiree, allowing the acquirer to choose between measuring them at fair value at the acquisition date or at the NCI's proportionate share of the acquiree's net identifiable assets.

17. The consideration transferred by the acquirer, including contingent consideration, is now measured at fair value and does not include the costs the acquirer incurs in connection with the business combination, which are now expensed. Changes in the fair value of contingent consideration are no longer recognised as adjustments to goodwill but are recognised in comprehensive income, unless the contingent consideration meets the definition of an equity instrument.

IV. Results of the review

18. This section sets out ESMA's general observations on the quality and consistency of the application of IFRS 3 disclosure requirements and provides detailed findings and conclusions for the topics selected for review.

A. General observations on disclosures

Background

19. IFRS 3 requires issuers to disclose information that enables users to evaluate the nature and financial effect of business combinations. Paragraphs B64 –B66 of IFRS 3 set out the specific disclosures required for each transaction that occurs during or after the reporting period of an issuer.

Findings

20. With some limited exceptions, the review found that the disclosures around business combinations were generally comparable and consistent with the requirements of IFRS 3, which ESMA welcomes. For example, all the issuers provided information regarding the assets and liabilities acquired.

21. 82% of the issuers sampled disclosed how control of a business was obtained. The majority of issuers that disclosed this information stated that control was obtained either by an agreement with the main shareholders (52%) or by tender offers (41%). Very few business combinations occurred through the acquisition of assets and liabilities directly without acquiring an entity.

22. The amounts of revenue and profit or loss of the acquiree since the acquisition date that were included in the consolidated statement of comprehensive income for the period since the business combination were disclosed by 88% of the issuers. 76% disclosed the revenue and profit or loss of the combined entity as if the acquisition date for the business combination that occurred during the year had been at the beginning of the annual reporting period. Non-disclosure of this information in some cases might be related to the fact that the date of the business combination occurred close to the end or in the beginning of the reporting period.

23. ESMA's review also identified examples of disclosures that had not been tailored to the specific circumstances of the company (so-called 'boiler plate disclosures') relating, in particular, to the factors making up the goodwill and the reasons given for bargain purchase gains.

24. In terms of location of the information, ESMA's review identified examples of information, such as the reasons for the business combination or information about acquired assets and liabilities, being presented separately from other information about the business combination, either in the management report or aggregated with information required by other standards according to the nature of the assets recognised (e.g. information on intangibles identified as part of the business combination was presented only in the note on intangible assets).

25. 17% of the financial statements analysed in the review did not include the reasons for acquiring the business or, in some situations, this information was presented in the management report. Non-disclosure of such information in the financial statements may impair the users' understandability on the rationale of the transaction.

Conclusions for issuers

26. Disclosures are most useful when they are tailored to the particular facts and circumstances of an issuer and this is particularly relevant to business combinations. ESMA, therefore, expects issuers to consider whether their IFRS 3 disclosures are sufficiently specific to provide an understanding of the underlying transaction.

27. Although ESMA acknowledges that IFRS 3 does not specify where in the financial statements disclosures should be presented, we believe that having these disclosures together in a single note to the financial statements generally provides the most accessible information for users and improves comparability among issuers. Our discussions with analysts support this view.

Conclusions for the IASB

28. ESMA welcomes the IASB's work on the Disclosure Initiative in exploring how financial reporting disclosures can be improved. As a result of its work, the IASB has proposed an amendment to IAS 1 to explain that, in grouping notes to the accounts in a systemic order, an entity could group notes related to a topic together. ESMA observes that this suggestion is consistent with its own views on grouping business combination disclosures together in a single note.

B. Intangible assets and contingent liabilities

Background

29. IFRS 3 states that, as of the acquisition date, the acquirer shall recognise separately from goodwill: the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree. To qualify for recognition, the identifiable assets acquired and liabilities assumed must meet the definition of an asset or a liability in the Conceptual Framework for Financial Reporting at the acquisition date. According to paragraph 23 of IFRS 3, contingent liabilities of the acquiree are also recognised in a business combination if they meet the definition of a liability and if they can be measured reliably.

30. Paragraph 59 of IFRS 3 requires issuers to disclose information that enables users of the financial statements to evaluate the nature and financial effect of a business combination that occurs in the reporting period. Required disclosures include: the name and a description of the acquiree, the fair value of the consideration transferred, information about contingent consideration arrangements, and additional information about the amounts recognised as of the acquisition date for each major class of assets acquired and liabilities assumed.

Findings

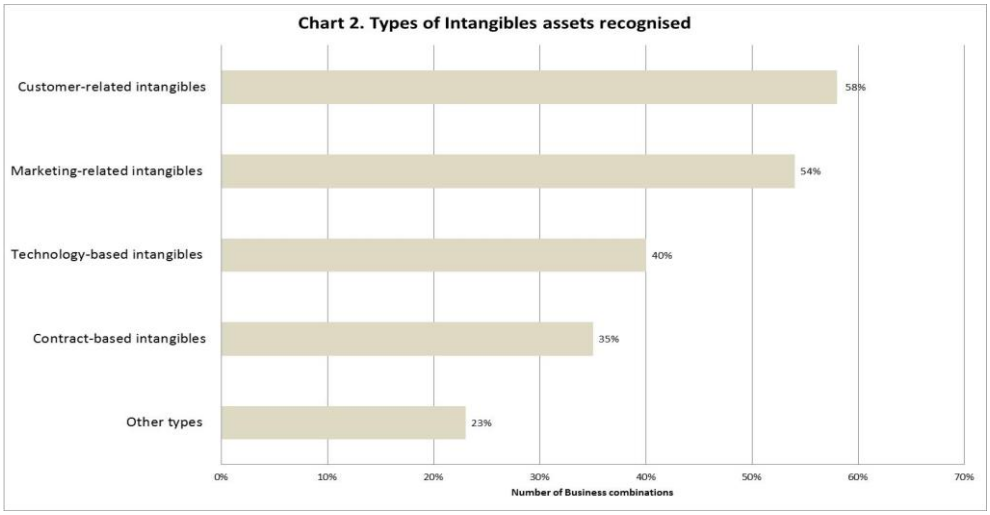
31. Based on the review, 92% of the sampled entities included in the financial statements a summary of the fair values for the major classes of assets and liabilities recognised, as required by IFRS 3. There were cases in which the level of aggregation of major classes of assets and liabilities limited the understandability of some of the information provided because some assets and liabilities were aggregated despite having different natures, e.g. presenting total liabilities only.

32. ESMA has focused its attention in this section on intangible assets and contingent liabilities because more relevant findings arose from the review and European Enforcers' experience on these items than for other topics.

Intangible assets

33. 77% of the issuers included in the sample recognised intangible assets other than goodwill as part of the business combination. 54% of the total amount of intangibles (including goodwill) related to separable intangible assets. Issuers recognised different types of intangibles depending on their industries.

34. The following types of intangibles assets were recognised in the business combinations reviewed:



35. Intangible assets for which usually there is no observable market, such as customer-related and marketing-related intangibles were the most common assets recognised in the review. The customer-related intangibles included: customer relationships, customer lists, customer contracts and order backlogs. Marketing-related intangibles mainly related to brand names and internet domains.

36. Most of the technology-based intangibles were software, whereas contract-based intangibles related to: licences, patents mineral exploration rights, publishing rights, non-competition rights and concession rights. Other types of intangibles were recognised in 23% of the reviewed business combinations, and these included, amongst others, artistic-related intangibles, participation/management fees rights or carbon licence allowances.

37. Enforcement experience shows that the techniques used to measure fair values in a business combination vary significantly and often external experts are engaged. However, depending on the nature of the intangible asset recognised, some methods and techniques are more common. For example, the fair value of customer-related assets is often based on the expected sum of the discounted future earnings from those customers. In calculating this value, a churn-rate is regularly taken into consideration to reflect the decreasing benefits from the acquired customer-base over time. In the case of brands, where no active market is observable, a 'relief from royalty' method is one of the most used methods.

38. ESMA and European enforcers' enforcement experience shows that sometimes the subsequent measurement of intangible assets acquired in a business combination is not consistent with assumptions used to determine their fair value at the acquisition date. For instance, in the case of the customer-based intangibles, the assumed churn-rate used to measure those assets is sometimes ignored and, instead of a declining balance amortisation, a straight-line amortisation method is applied.

39. The useful lives estimated for intangible assets following a business combination tend, in some cases, such as customer relationships, to be significantly longer than the period over which a benefit was estimated when valuing the intangible asset using churn-rates. It is arguable whether applying the straight-line method and useful lives which vary from those used in the business combination reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity according to paragraph 97 of IAS 38 - *Intangible Assets*.

Contingent liabilities

40. 11% of the issuers reviewed recognised contingent liabilities arising from business combinations. However, very few of them disclosed all the information required by IFRS 3 on this topic. Most of the issuers disclosed the nature of the contingent liabilities recognised but not the basis for determining the amounts of the expected payments or estimates of the possible range of outcomes.

Conclusions for issuers

41. ESMA urges issuers to provide more granular disclosure on the acquired assets and liabilities as required by paragraph 29 of IAS 1 – *Presentation of Financial Statements*, which requires information to be presented by material class of separate items, so that users can take decisions based on the most useful information available. ESMA believes that the level of aggregation of the major classes of assets and liabilities should, as a minimum, be aligned with the guidance in paragraph 59 of IAS 1, namely that items of dissimilar nature or function should be presented separately. The use of different measurement bases may suggest that the nature or function differs.

42. ESMA also encourages issuers to consider using consistent assumptions between the initial and subsequent measurement of assets and liabilities arising from business combinations.

43. Although only 11% of the sample recognised contingent liabilities related to the business combination, enforcement experience indicates that contingent liabilities arising in business combinations are not uncommon. Therefore, ESMA urges issuers to recognise contingent liabilities based on IFRS 3's provisions and to disclose all required information, such as the basis for determining the amounts of the payments or estimates of the possible range of outcomes, where material or relevant.

Conclusions for the IASB

Intangible assets

44. ESMA noted that the most prevalent intangible asset recognised separately from goodwill related to customer relationships. Customer relationships stem from both contractual and non-contractual relationships. In its Update from March 2009, the IFRS IC dealt with a question on the circumstances in which a non-contractual customer relationship arises in a business combination and concluded that the way a relationship was established helps to identify whether a customer relationship exists but should not be the primary basis for determining whether the acquirer recognises an intangible asset. Due to the widespread diversity observed by the IFRS IC, it decided to refer this question to the IASB.

45. ESMA agrees with IFRS IC's conclusion as it also believes that the nature of the customer relationship should not determine whether an intangible asset should be recognised. We note that non-contractual cash flows are also considered in the measurement of an existing (contractual) customer relationship. ESMA's experience and the review results confirm that customer relationships play a significant role in business combinations, thus ESMA encourages the IASB to work on this topic as part of the PIR and in particular to deal with the recommendation from the March 2009 IFRIC IC decision.

Contingent liabilities

46. ESMA notes that if a company changes its estimate of the contingent liabilities recognised in a business combination, the subsequent adjustment affects the income statement without the original amount having been recognised as an expense. IFRS 3 requires the recognition of all contingent lia-

bilities which are reliably measurable without requiring an outflow of economic benefits to be probable. Although paragraphs 27 and 28 of IAS 37 prohibit the recognition of contingent liabilities in the statement of financial position or comprehensive income, it requires their disclosure in the notes unless the possibility of an outflow of economic benefits is remote.

47. We would like to recommend that the IASB considers the following:
    - whether the treatment of contingent liabilities in IFRS 3 and IAS 37 could be better aligned and where the impact of a reduction in the amount of a contingent liability should be recognised (consistent with ESMA's letter on the IASB's Discussion Paper - *A review of the Conceptual Framework for Financial Reporting*[2]); and
    - whether a roll-forward of the contingent liabilities balance, similar to the requirement in paragraph 84 of IAS 37, could be required for each business combination so that users are informed about the subsequent development of the recorded contingent liabilities for all reporting periods in which the material contingent liabilities still exist.

C. Disclosure of fair value measurement techniques

Background

48. Although paragraph 18 of IFRS 3 requires that the identifiable assets acquired and the liabilities assumed are recorded at their acquisition date fair values, the standard contains no requirements to disclose the fair value measurement techniques used. IFRS 13 disclosure requirements do not apply to assets and liabilities recognised at fair value in a business combination because paragraph 91 only requires valuation disclosures for those assets and liabilities recognised at fair value on a recurring or non-recurring basis *after* initial recognition. Paragraph 184 of the Basis for Conclusions (BC) of IFRS 13 explains that this is because other fair value disclosures were already considered by existing standards, such as IFRS 3.

49. Paragraph 19 of IFRS 3 requires NCI in the acquiree to be measured at the acquisition date by using either the full or partial goodwill method. Under the full goodwill method, the NCI is measured at fair value, whereas under the partial goodwill method the NCI is measured at the present ownership instruments' proportionate share in the recognised amounts of the acquiree's net assets.

50. Paragraphs 125 – 129 of IAS 1 require disclosure of sources of estimation uncertainty when a significant risk exists within the next financial period of a material adjustment to the carrying amount of assets. This disclosure requirement may apply to certain fair value measurements used in the business combination regardless of whether the measurement period is still open.

Findings

51. ESMA identified diversity in the disclosure of fair value measurement techniques. ESMA noted that some issuers referred to external valuations of intangible assets without providing details of the techniques and assumptions used to determine their fair value. Only 35% of the issuers reviewed disclosed information, where applicable, on how fair values were determined. Of those issuers, most disclosed only the valuation technique used and a few issuers additionally disclosed information on the main assumptions.

[2] [2] http://www.esma.europa.eu/system/files/2013-1951_-_esma_comment_letter_on_the_dp_conceptual_framework_ias.pdf

52. On the other hand, 27% of issuers continue to provide voluntary information on the book values of the assets and liabilities acquired before the business combination occurred. Although this information is not required by IFRS 3, users may find it useful to evaluate the effect of fair value measurements on assets and liabilities.

53. Around 63% of issuers reviewed that recognised NCI arising from business combinations used the proportionate share of net assets of the acquiree to measure them. In the cases where NCI is measured at fair value, disclosures on how those fair values are determined were generally not provided, despite being required by paragraph B64 (o) (ii) of IFRS 3.

Conclusions for issuers

54. Information on the assumptions and/or the measurement techniques used in the valuation of material assets, liabilities and NCI acquired in a business combination it is an important element for the decision making process of users of financial information.

55. ESMA acknowledges that some financial statement users, including some analysts, may not consider some separately recognised intangibles when determining the value of a company. Nevertheless, ESMA believes that information about the valuation of these assets could provide a better understanding of what was received in exchange for the purchase price paid.

56. ESMA also believes that a disclosure merely referring to the use of external valuations without providing additional details does not help users of financial statements to understand the economics behind fair value measurements and evaluate their reliability.

57. In addition, ESMA reminds issuers that paragraphs 125 – 129 of IAS 1 require disclosure of sources of estimation uncertainty when a significant risk exists within the next financial period which may result in a material adjustment to the carrying amount of assets and expects issuers to provide the required disclosures.

Conclusions for the IASB

58. ESMA believes that disclosures required by IFRS 3 relating to valuation techniques used in business combinations for assets, liabilities and NCI could be enhanced if they were harmonised with the disclosures required by paragraphs 91 – 99 of IFRS 13, which include the fair value hierarchy.

59. The review and enforcement activities show that significant intangibles for which no active market exists are regularly recognised in business combinations. Therefore, we believe that such disclosure would increase users' understanding of the net assets acquired as well as enhance the transparency of significant management judgements and the quality of the fair value measurement. ESMA believes that such disclosure may also guard against excessive valuations of intangibles which, in themselves, can lead to immediate bargain purchase gain recognition.

D. Recognition and measurement of goodwill and bargain purchases

Goodwill

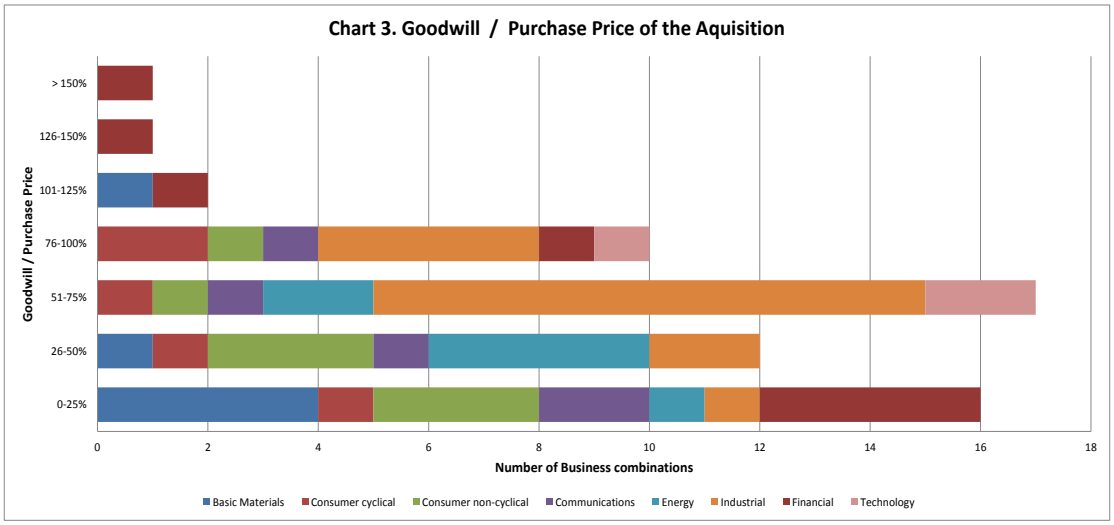
Background

60. IFRS 3 requires recognition of goodwill in the consolidated financial statements of the investing entity when the entity pays a premium over the fair value of the identified assets and liabilities of the target in a business combination. Goodwill represents the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognised.

Findings

61. The issuers reviewed recognised goodwill in 86% of the business combinations, representing on average around 54% of the consideration paid. In 24% of the business combinations analysed entities did not recognise any separate intangibles from goodwill. Three companies, out of which two are in the financial sector, did not recognise any goodwill or bargain purchase.

62. The chart below shows the distribution of goodwill compared to the purchase price for the companies in the review by industry. The entities in the review with the highest goodwill compared to the purchase price are those from the financial service and basic material sectors.



63. Although goodwill represented around 45% of total intangibles, including goodwill, descriptions of the factors making up goodwill were often 'boiler plate' and in approximately 20% of the businesses combinations reviewed, issuers did not disclose any information in that respect.

64. Most issuers explained that goodwill related to the possible realisation of synergies without providing details about how those synergies are expected to be achieved, while some issuers stated that goodwill related to deferred tax liabilities or intangibles that did not fulfil all the conditions to be separately recognised, such as the assembled workforce.

Conclusions for issuers

65. ESMA understands that analysts find detailed information regarding synergies to be particularly useful. ESMA directs issuers who do not recognise any intangible assets separately from goodwill or for which the goodwill to be recognised represents a significant proportion of the consideration paid to the section related to "Identifiable intangible assets" in the illustrative examples of IFRS 3 and urges them to ensure that all qualifying intangible assets are recognised.

66. ESMA found that disclosures around the factors making up goodwill were often missing or insubstantial and reminds issuers that this information is helpful for investors in evaluating the potential benefits of the transaction. Consequently, ESMA encourages issuers to disclose details of the factors such as on how and when synergies are expected to be realised and how they were determined.

Conclusions for the IASB

67. Based on the findings of the review and European Enforcers' experience it was noted that in some situations goodwill is recognised solely in conjunction with deferred tax liabilities; this occurs particularly in the real estate industry. Consequently, ESMA encourages the IASB to consider this issue in the context of the feedback received in the PIR.

Bargain purchases

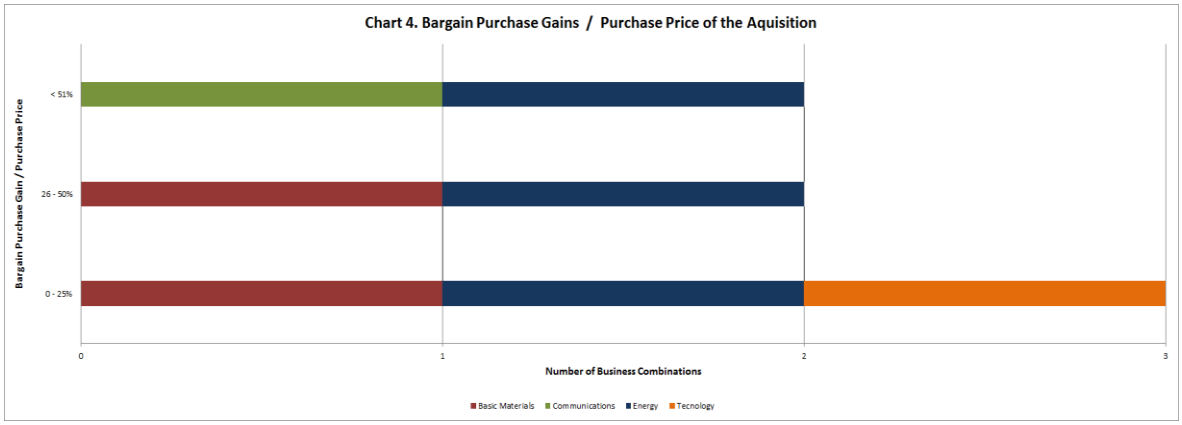
Background

68. Occasionally in a business combination an acquirer will make a bargain purchase in which the amount of the net assets acquired exceeds the consideration paid. If, after reassessing the measurement of the identified assets acquired and liabilities assumed according to paragraph 36 of IFRS 3, the acquirer recognises a gain in the profit and loss account at the acquisition date, then the amount as well as the reasons why the transaction resulted in a gain must be disclosed.

69. The IASB acknowledged in paragraph 374 of the BC of IFRS 3 concerns raised by constituents that a requirement to recognise gains on a bargain purchase might provide an opportunity for inappropriate gain recognition. The IASB believed, however, that standards specifically designed to avoid abuse would inevitably lack neutrality and, therefore, required such gains to be recognised. However, the Board recognises that there is no compelling reason to believe that, in the absence of duress, a seller would willingly and knowingly sell a business for an amount less than its fair value, as indicated in paragraph 381 of the BC of IFRS 3. On that basis, bargain purchases would be rarely expected.

Findings

70. The chart below shows the distribution of the bargain purchase gains compared to the purchase price for the various companies in the review by industry:



71. A bargain purchase gain was reported in 11% of the business combinations reviewed. The gains ranged between 1% and 130% of the consideration paid for the acquisition and between 1% and 32% of the net income before tax of the acquirer. On average, the bargain purchase gains represented around 46% of the consideration paid and around 12% of the net result before taxes.

72. Even when no compelling reason is evident as to why a willing third-party would sell a business for less than its fair value, the review results and enforcement experience show that business combinations accounted for as bargain purchases are not rare. Gains may in part result from a high valuation of intangible assets (i.e. customer-relationships, operator licences, technology), for which there is generally no observable market.

73. Enforcement experience also shows that in some situations bargain gains result because future restructuring costs (that do not fulfil the conditions of contingent liabilities) cannot be recognised, despite the fact they were considered in the negotiations when determining the purchase price of the acquisition or they were deemed necessary.

74. The review also showed that disclosures describing bargain purchase gains are often missing or 'boiler plate', providing insufficient details regarding the factors behind their recognition. 30% of the issuers reviewed in which a bargain purchase gain had been recognised did not disclose any explanation of why the transaction resulted in a gain.

Conclusions for issuers

75. ESMA found that required disclosures about the factors resulting in bargain purchases are often missing or insubstantial. Issuers are expected to provide these disclosures and encouraged to disclose additional information relevant to the specific bargain purchase. The additional information could, for instance, describe how the issuer reassessed the assets and liabilities. If the bargain purchase gain arises due to the exemptions in IFRS 3 for measuring particular items, such as restructuring provisions, this fact and a description of the effect could be provided.

Conclusions for the IASB

76. ESMA encourages the IASB to consider whether the prevalence of bargain purchase gains should result in further debate and potential amendments to IFRS 3. In our view, the following might need to be considered:
    - improving the disclosure requirements on the reasons for a bargain purchase resulting from a business combination;
    - examining the possibility for further exemptions in IAS 37 for the recognition of certain types of liabilities or provisions (such as the case of future restructuring costs). This could be considered as part of the current IASB's project on the revision of the Conceptual Framework.

E. Mandatory tender offers

Background

77. IFRS 3 does not specifically address the accounting in cases where an acquirer gains control through a sequence of transactions, such as, for example, gain of control followed shortly thereafter by the acquisition of additional ownership interest due to regulatory requirements that oblige the acquirer to offer to purchase the ownership interests of NCI, usually referred to as MTOs. MTOs can also be required by legislation in cases in which the acquirer does not gain control but reaches a defined threshold (e.g. 30% of the acquiree).

78. The IFRS IC noted during its March 2013 session that the IASB could address the issue of MTO accounting as part of the IFRS 3 PIR. In its November 2012 update, the IFRS IC tentatively agreed to amend IFRS 3 to provide guidelines to assess whether transactions are linked and concluded that no liability should be recognised, because the contract is executory in nature. In March 2013, however, a small majority of IFRS IC members expressed the view that a liability should be recognised for the MTO, consistent with IAS 32, at the date the acquirer obtains control of the acquiree.

Findings

79. Few business combinations analysed (6%) qualified as step acquisitions. In most of these transactions, following the national legislation, the business combination was followed by a MTO or squeeze out. At the year end, however, all transactions were finalised, so a liability was not disclosed.

80. From their enforcement experience, ESMA and the European enforcers observed cases of MTOs where different accounting treatments were followed. ESMA noted that due to the lack of accounting guidance, there was diversity in practice on two issues: whether the transactions are considered to be linked and whether a liability should be recognised in respect to the obligation to purchase the NCI.

Conclusion for issuers

81. ESMA suggests that issuers use the guidance in paragraph B97 of IFRS 10 *Consolidated Financial Statements* by analogy when determining whether two transactions are linked.

82. ESMA believes that until the IASB clarifies the appropriate accounting treatment for MTOs, issuers should disclose their accounting policies with respect to the recognition or not of a liability. Consequently, ESMA expects issuers to apply the chosen accounting policy consistently over time and de-

scribe it in the notes, in accordance with paragraph 121 – 122 of IAS 1 and paragraphs 10 – 12 of IAS 8 *Accounting Policies, changes in accounting estimates and errors*.

83. Additionally, ESMA believes that, when amounts are significant, the obligation to launch a MTO and the potential cash impacts should be clearly disclosed in the notes to the financial statements, so that users can anticipate them. Any contingent liability must be disclosed in accordance with paragraph 86 of IAS 37.

Conclusion for the IASB

84. When dealing with this subject, ESMA believes that the IASB should also consider cases in which a MTO is legally required even though the acquirer has not taken control of the acquiree, as included in the example above. ESMA observes that the IASB may wish to consider the relevance of the guidance in paragraph B97 of IFRS 10 - *Consolidated Financial Statements* – which considers situations when a company loses control of a subsidiary over two or more transactions and whether this should be accounted for as a single transaction.

F. Contingent consideration

Background

85. Paragraph 39 of IFRS 3 requires consideration for a business combination that is contingent on future events to be initially recognised at fair value. Subsequent changes in the fair value of contingent consideration that is a financial liability are recognised in profit or loss and not as changes to goodwill. Contingent consideration that meets the definition of equity is not re-measured.

86. According to paragraph 45 of IFRS 3, when part of the consideration paid depends on the acquiree meeting an earnings target in the years following the acquisition (an earn-out), any variation of this contingent consideration due to missing or exceeding the target is reflected in the profit and loss account, even if the adjustment occurs during the measurement period of the business combination. Paragraph 58 of IFRS 3 states that achieving a performance target, reaching a specified share price or reaching a milestone on a research and development project are events occurring after the acquisition date, and not measurement period adjustments.

87. Furthermore, where a company acquires an owner-managed business it may elect to employ the former owner for a period, to benefit from his or her knowledge of the business. The company may link payments contingent on the performance of the acquired business to the employment period, such that the vendor forfeits the consideration should he/she leave employment before the consideration vests. In this case, it is arguable whether the nature of the payment is contingent consideration or is an employment expense. If the latter, it would be recognised over the period of employment rather than as an adjustment to goodwill.

88. In January 2013 the IFRS IC issued a decision that confirmed that the accounting in these circumstances is subject to the requirements of paragraph B55 (a) of IFRS 3. Where such arrangements have substance, the contingent payment that is dependent on future employment must be accounted for as an employee expense rather than as a component of goodwill. In the same decision it was proposed revisiting this issue after completion of the PIR.

Findings

89. Although 17% of the business combinations analysed had contingent consideration included as part of the arrangements, only 36% of those transactions disclosed information on how the contingent consideration was determined, as required by paragraph B64 (g) (ii) of IFRS 3. In addition, only 55% of those provided information on the possible ranges of outcomes or explained why a range could not be estimated. Thus, when the information was missing users could not determine whether the maximum amount of contingent consideration had been recognised.

Subsequent re-measurement

90. Based on the European Enforcers' experience, ESMA has noted that in practice issuers did not always apply the requirement to reflect earn-out fluctuations in the profit and loss account; that is, some issuers account for changes due to earn-out fluctuations by modifying the amount of goodwill recognised, when the fluctuations occurred during the measurement period.

91. ESMA is aware that the required accounting treatment results in income when the investee has underperformed (i.e. the contingent consideration is lower than expected) and in expense when the target has been surpassed. Moreover, overestimating the contingent consideration upon initial recognition of the business combination leads to the recognition of higher goodwill, although future events reveal that both the consideration and the resulting goodwill should have been lower. Where goodwill arising from the acquisition has been allocated to a larger Cash Generating Unit (CGU) and is not tested separately, the below-expectation performance of the acquiree cannot be reflected in the level of goodwill recognised at the parent level.

Contingent payments that depend on future employment

92. In ESMA's experience, where a large proportion of the consideration for the business combination is dependent on future employment, the portion that is independent of future employment may be less than the fair value of the net assets acquired. This results in a bargain purchase gain being initially recognised, followed by remuneration for services rendered over the remaining employment period. IFRS 3 anticipates that bargain purchases happen only occasionally and does not give the accounting for contingent payments as employee expense as an example of a circumstance that can result in a bargain purchase.

93. ESMA is aware of a case where an issuer recognised a contingent payment as remuneration for services rendered after restating its accounting policy in order to comply with the IFRS IC's decision from January 2013. The issuer disclosed in its accounting policy that contingent payments to a vendor in a business acquisition were contingent consideration. The payments would, however, be forfeited if the vendor resigned before the date the contingent payment was due to be paid. In order to comply with the IFRS IC's decision, the issuer changed its accounting policy retrospectively and recognised contingent payment as remuneration for services rendered in the previous reporting period.

Conclusions for issuers

94. ESMA believes that the current accounting requirements of IFRS 3 are clear in this regard and urges issuers to comply with them. Since contingent consideration can have a material effect on current and future profits and cash-flows, ESMA reminds issuers to disclose the required information.

Conclusions for the IASB

95. Although the IASB has not asked for further information on this topic as part of its RfI, ESMA is of the view that the IFRS 3 requirements provide clear enforceable guidance on how the subsequent measurement of the contingent consideration and contingent payments that depend on future employment should be accounted for and would be concerned if these requirements were amended in a way that made them harder to enforce.

G. Definition of a business

Background

96. IFRS 3 requirements are applicable for assets acquired and the liabilities assumed if they constitute a business. Otherwise, an issuer shall account for the transaction as an asset acquisition. Paragraphs B7 - B12 of IFRS 3 provide detailed guidance on the definition of a business included in paragraph 3 of IFRS 3.

97. Differences exist in the accounting for a business combination compared to the acquisition of an asset. IFRS 3 contains a number of recognition and measurement principles that deviate from those to be applied on the acquisition of an asset. Examples are the recognition and/or measurement of contingent consideration, goodwill and deferred tax assets/liabilities as well as the accounting for acquisition-related costs.

98. As a result of these differences, the outcome of the assessment of whether the assets acquired and liabilities assumed constitute a business may have a substantial impact on the financial statements.

99. However, the application of the IFRS 3 guidance distinguishing whether an acquisition constitutes a business combination to be accounted for under IFRS 3 requires use of management judgement. For instance, issuers should assess whether the acquired business contains all necessary elements (inputs, processes and outputs) and whether those elements are capable of being conducted and managed by them.

100. In the comment letter sent to the IASB's Exposure Draft on *Sale or Contribution of Assets between an investor and its Associate or Joint Venture*[3], ESMA acknowledges that the assessment to determine whether a subsidiary constitutes a business requires significant judgement. This view was shared by many respondents.

Findings

101. Two issuers in the sample, one in the real estate and the other in the mineral resources industry, indicated that significant judgment was applied in assessing whether the assets acquired constituted a business, but did not provided any further information about how the assessment has been made.

102. From their enforcement experience, European Enforcers are aware of the challenges in distinguishing an asset acquisition from a business combination, in particular, in the real estate, extractive industries and pharmaceutical sectors. Various factors, such as whether the transaction involves a portfolio

[3] ESMA/2013/456 - http://www.esma.europa.eu/system/files/2013-456_sale_or_contribution_iasb_0.pdf

of buildings or a single one, the nature of the activity related to the building and whether personnel is transferred may have different impact on the assessment.

Conclusions for issuers

103. In view of the required amount of management judgment in the assessment of whether an acquisition of assets constitutes a business and the impact on the financial statements, where applicable, ESMA urges issuers to disclose the judgements applied in accordance with paragraph 122 of IAS 1.

Conclusions for the IASB

104. As mentioned, the assessment of whether an acquisition constitutes a business in accordance with IFRS 3 requires significant use of judgement, in particular in specific industries such as real estate, the exploration and extraction of mineral resources or the pharmaceutical sector. Consequently, ESMA encourages the IASB to continue to develop the definition of a business and to improve the guidance regarding the determination of whether the assets acquired constitute a business.

H. Adjustments to fair value amounts during the measurement period

Background

105. For cases where the initial accounting for a business combination is incomplete by the end of the reporting period in which the business combination occurs, paragraph B67 of IFRS 3 requires issuers to disclose that fact and provide the provisional amounts of assets, liabilities, NCI or items of the consideration paid. Additionally, issuers should disclose the reasons why the business combination accounting is incomplete and the nature and amount of any measurement period adjustments recognised during the reporting period.

106. Adjustments to provisional amounts and recognition of newly identified assets and liabilities must be made within the 'measurement period' where they reflect new information obtained about facts and circumstances that existed at the acquisition date. Paragraph 45 of IFRS 3 requires that the measurement period ends at the date on which required information is obtained (or found to be unavailable), or one year from the acquisition date, whichever is the earliest.

107. In the measurement period, issuers should determine the final value of: (i) the identifiable assets acquired, liabilities assumed and any NCI in the acquire; (ii) the consideration transferred for the acquiree or other amount used in measuring goodwill; (iii) the previously-held interests in a step acquisition and (iv) the resulting goodwill or gain on a bargain purchase.

Findings

108. Although issuers generally included an accounting policy for adjustments to the assets and liabilities before the business combination accounting is complete, in only 50% of the financial statements analysed the issuer explicitly mentioned that the measurement period for the business combination was still incomplete at the reporting date. Amongst those entities, only 40% provided reasons why provisional accounting was necessary and only 43% identified which assets may be subject to remeasurement. Moreover, not all the information required by the standard was provided; in some cases only a general description of the adjustments which were booked during the measurement period was disclosed.

109. In other cases, the information provided in the financial statements did not allow users to determine whether the issuers left the measurement period open at the reporting date to finalise the valuations of the identified assets or liabilities or just in case it may become necessary in the future.

Conclusions for issuers

110. ESMA believes that IFRS 3 provides an acquirer with a reasonable period of time after the acquisition date to complete the measurement adjustments. We remind issuers that the measurement period of 12 months should only be used when the initial accounting for a business combination is incomplete for specific assets and/or liabilities, and this should not be a default position for issuers. The issuers should explain in the financial statements why the measurement period is still open; a general statement in the accounting policies is not sufficient.

111. ESMA encourages issuers to clearly disclose all the required information in paragraph B 67 of IFRS 3 in the notes and not provide just a general description of the measurement period adjustments.

Conclusions for the IASB

112. ESMA observes that many companies apply the requirements in IFRS 3 in order to keep the measurement period open for a year without identifying the assets and liabilities that may be re-measured or providing reasons why the accounting has not been finalised. Consequently, the IASB may wish to revisit the disclosure requirements of IFRS 3 in this area.