Project **_Annual Improvements_**

Topic **IFRS 3 _Business Combinations_ – Settlement of a pre-existing relationship between the acquirer and the acquiree**

Introduction

1. The Interpretations Committee received a request asking for a clarification of the guidance that applies to the settlement of pre-existing relationship between the acquirer and the acquiree in a business combination.

2. The request suggested that clarification be made through the 2009-2011 cycle on *Annual Improvements*.

Objective

3. The objective of this paper is to:

   (a) provide background information on the issue;

   (b) provide an analysis on the issue;

   (c) present the staff's conclusion on the analysis;

   (d) present an assessment of the issue against the proposed criteria for inclusion of an issue within *Annual Improvements*; and

   (e) make a recommendation to the Interpretations Committee.

Issue raised

4. The request (reproduced in Appendix C) describes situations where an acquiree T has a customer/supplier relationship (a relationship) with its acquirer A prior to the business combination. In the analysis below, the staff assume for ease of reference that T is A's supplier.

5. The staff note that in instances where a third party were to acquire T, the relationship is an identifiable asset of T in accordance with IFRS 3 *Business Combinations*.

6. However, in situations where A is the acquirer, the request highlights a concern that arises over existing divergent interpretations of the guidance set out in paragraph B52 of IFRS 3. This paragraph provides for the accounting for the settlement of a pre-existing relationship between A and T.

7. In certain jurisdictions, some believe that the business combination does not "settle" the pre-existing relationship. In their opinion, what has been settled is any "off-market" element of the relationship. Therefore entities in those jurisdictions are inclined to recognise in the consolidated statement of financial position the relationship as an identifiable intangible asset of the business combination.

8. Others believe that the expression "settlement of a pre-existing relationship" is clear that it requires the pre-existing relationship to not be recognised as an identifiable asset of the business combination.

9. These divergent interpretations have consequences on the amount of goodwill recognised; goodwill is of a higher amount in situations where the relationship is not recognised.

10. Further implications are that constituents who believe that the guidance on settlement relates only to the off-market value of the relationship often describe the intangible asset as having an indefinite useful life. Therefore, the intangible asset is not subject to depreciation but to impairment each reporting period. However, the accounting for impairment of intangibles differs from the accounting

for impairment of goodwill in that goodwill is allocated to those parts of the acquirer's business benefiting from the acquisition whereas the indefinite life intangible asset isn't. Also, impairment of indefinite life intangible assets can be reversed in appropriate circumstances whereas impairment of goodwill cannot be.

11. Appendix B of the paper reproduces the relevant literature in IFRS 3.

Staff analysis

12. The staff believe that to address the concern described above, the underlying question is what assets and liabilities should be presented from the group's perspective to reflect the business combination.

13. To this question, the staff identify two views for the recognition of the relationship:

    (a) View A1: the relationship should be recognised separately from goodwill even though it is an intragroup relationship.

    (b) View A2: the relationship should be recognised separately from goodwill only to the extent that it is an intangible asset of the group post-combination.

Analysis of view A1

14. Let's introduce another party to the bid, entity B, that has no customer/supplier relationship with T.

15. Proponents of view A1 believe that since B would characterise the relationship between A and T as an identifiable intangible asset of the business combination, the relationship is an intangible asset of the group and should be separately recognised from goodwill irrespective of the acquirer's involvement in the relationship.

16. The rationale for this accounting treatment is that while performing a purchase accounting, B identifies and measures the relationship using the "market

participant" approach described in IFRS 3. Those in favour of view A1 argue that from the market's perspective the relationship is an intangible asset that still exists post-combination.

17. Therefore, those who support this view are of the opinion that economically, the business combination does not extinguish the relationship between A and T. What it settles though is the potential "off-market" part of the relationship.

18. In support of this analysis, they read paragraph B52 as only addressing the accounting for the amount by which the contract is favourable or unfavourable, ie the "off-market" amount.

19. The staff also note that a further argument in favour of view A1 is the accounting treatment for internally generated intangible assets that may be recognised under certain circumstances. One could argue that immediately after the combination the pre-existing relationship has become an internally generated intangible asset of the group that ought to be recognised if the criteria in paragraph 57 of IAS 38 are met.

20. The staff believe that this conclusion could reasonably be reached even though paragraph 63 of IAS 38 prohibits the recognition of certain items - and the staff acknowledge that a relationship such as described in the situation submitted is one of the items cited. The staff note that the reason why these internally generated intangible assets shall not be recognised is that the cost of these items cannot be distinguished from the cost of developing the business as a whole. The staff is of the opinion that in the context of a business combination, when the relationship can be measured and identified on a market, it is clearly distinguishable.

21. In addition, when presenting the accounting for the acquisition of intangible assets as part of a business combination, paragraph 33 of IAS 38 refers to the recognition of intangible assets criteria in paragraph 21 of IAS 38 but remains silent over the potential impact of the consolidation process on the recognition of the intangible asset.

22. The staff have some sympathy for view A1 because from the market's perspective the relationship has a value of its own and might be recognised.

Analysis of view A2

23. Those who support view A2 are of the opinion that, because the purpose of financial information is to present the effect of the business combination from the group's perspective, any intragroup relationship should be eliminated as a result of the consolidation process.

24. Proponents of view A2 argue that the business combination has the effect of extinguishing the relationship from the perspective of the group seen as a single entity. Therefore to them, it is clear that paragraph B52 of IFRS 3 addresses situations where the business combination settles the pre-existing relationship between A and T and that the relationship no longer exists for a user that would look at the group as a single entity.

25. The staff acknowledge that with respect to a reference to intragroup elimination as a result of the consolidation process, a counterargument is that the pre-existing relationship might be an intangible asset of T prior to the combination, but the acquirer A may not have a corresponding liability that would eliminate as a result of combining entities A and T.

26. However, the staff favour view A2 because they rely on the definition of consolidated financial statements that aim to present the group as a single economic entity. From outside the group post-combination, the pre-existing relationship should add up to the goodwill where it represents synergies for the group.

27. In support of this view, the staff note that the illustrative example IE56 for IFRS 3 reproduced in Appendix B to the paper concludes that the 'at-market' component of the contract is part of goodwill.

Review of US GAAP guidance

28. Because IFRS 3 is a joint standard with the FASB, the staff reviewed the guidance in Topic 805 *Business Combinations*. The staff noted that the wording for the application guidance in section 805-10-55-20 mirrors the wording in paragraph B52 of IFRS 3.

Overall conclusion

29. The staff note that applying the measurement principle in IFRS 3 leads to identify the relationship as a separate asset while applying recognition and consolidation process principles lead to the conclusion that the relationship no longer exists from the group's perspective. Therefore the staff believe that there is a conflict within IFRS 3 as to which of the measurement principle or the recognition principle should take precedence to determine the appropriate accounting.

30. At this stage of the analysis, the staff present to the Interpretations Committee the following findings:

    (a) IFRS 3 lacks guidance on the accounting for transactions that become intragroup transactions as a result of the business combination; and

    (b) A perceived inconsistency exists between the measurement and the recognition principles within IFRS 3;

    (c) Illustrative examples IE54 to IE57 to IFRS 3 indicate that the relationship should not be recognised separately from goodwill.

Annual Improvements criteria assessment

31. Because it was initially presented for clarification through *Annual Improvements*, the staff propose an assessment of the inclusion of the issue against the proposed enhanced criteria reproduced in full below:

    (a) The proposed amendment has one or both of the following characteristics:

(i) clarifying—the proposed amendment would improve IFRSs by:

- clarifying unclear wording in existing IFRSs, or
- providing guidance where an absence of guidance is causing concern.

A clarifying amendment maintains consistency with the existing principles within the applicable IFRSs. It does not propose a new principle, or a change to an existing principle.

(ii) correcting—the proposed amendment would improve IFRSs by:

- resolving a conflict between existing requirements of IFRSs and providing a straightforward rationale for which existing requirement should be applied, or
- addressing an oversight or relatively minor unintended consequence of the existing requirements of IFRSs.

A correcting amendment does not propose a new principle or a change to an existing principle, but may create an exception from an existing principle.

(b) The proposed amendment has a narrow and well-defined purpose, ie the consequences of the proposed change have been considered sufficiently and identified.

(c) It is probable that the IASB will reach conclusion on the issue on a timely basis. Inability to reach agreement on a timely basis may indicate that the cause of the issue is more fundamental than can be resolved within annual improvements.

(d) If the proposed amendment would amend IFRSs that are the subject of a current or planned IASB project, there must be a pressing need to make the amendment sooner than the project would.

32. In the staff's opinion, the issue satisfies the above proposed *Annual Improvements* criteria:

(a) In the staff's opinion, the change that could be proposed is a clarification that a pre-existing relationship settled in a business combination should not be recognised separately from goodwill. The staff acknowledge though that the clarification would not address the more general conflict in IFRS 3 over which of the market-participant measurement or recognition principle takes precedence, but it would address the more narrow issue that was the subject of the submission.

(b) In the staff's opinion, the change proposed is limited to pre-existing relationship settled in a business combination therefore it has a narrow and well-defined purpose.

(c) The staff think that the Board could reach a conclusion on a timely basis on this issue.

(d) There is no current or planned Board project to review the accounting of contingent consideration arising from business combinations.

Possible paths forward and staff's recommendation

33. Although the staff believe that no intangible asset should be separately recognised for what the staff think becomes an intragroup relationship on the date of acquisition, the staff acknowledge that the current wording for paragraph B52 of IFRS 3 is currently subject to divergent interpretations.

34. In addition, the staff believe that the conflict in IFRS 3 over which of the market-participant measurement or recognition principles takes precedence should be solved to enhance consistency within IFRS 3.

35. The staff has identified several paths forward:

(a) View B1: Propose an amendment to paragraph B52 of IFRS 3 through *Annual Improvements* to clarify that an intangible asset previously recognised to reflect that a relationship between the acquirer and the acquiree should not be recognised as a result of the business combination. The staff note that the issue meets the proposed criteria for inclusion in *Annual Improvements* (see paragraph 32 of the paper);

(b) View B2: Recommend that the Interpretations Committee should take this issue to its agenda with a view to propose an interpretation to address the more general question of the perceived conflict in IFRS 3 over which of the market-participant measurement or recognition principles takes precedence on the grounds that such guidance would go beyond an annual improvement of IFRS 3;

(c) View B3: Recommend that the Interpretations Committee should not take this issue to its agenda and that the Board should address this issue as part of its implementation review for IFRS 3.

36. The staff believe that the Interpretations Committee should recommend that the Board include the issue within *Annual Improvements*. Therefore, the staff recommend view B1 should be the appropriate path forward.

37. If the Interpretations Committee agrees with the staff recommendation, the staff have suggested wording for the proposed amendment in Appendix D.

38. Should the Interpretations Committee recommend that view B3 should be followed, the staff proposes a wording for a tentative agenda decision in Appendix A to the paper.

Questions for the Interpretations Committee

Question 1 – Staff recommendation
Does the Interpretations Committee agree with the staff recommendation to address the issue through *Annual Improvements*? If not, what path forward does the Interpretations Committee recommend should be followed?

Appendix A – Staff draft of proposed Tentative Agenda Decision

Below is a staff prepared draft of the Tentative Agenda Decision consistent with view B3 presented in the paper.

IFRS 3 *Business Combinations* – Settlement of a pre-existing relationship between the acquirer and the acquiree

The IFRS Interpretations Committee received a request asking for clarification on the accounting for a pre-existing relationship between the acquirer and the acquiree in a business combination. The concern arises from current divergent practices.

The Interpretations Committee noted that arguments are well balanced as to whether settlement of the pre-existing relationship means that the relationship no longer exists or refers only to the settlement of the off-market element of the relationship. In the first situation no intangible asset would be separately recognised in the acquiree's consolidated statement of financial position whereas in the second situation the relationship would be recognised separately from goodwill.

In view of the existing guidance in IFRSs, the Interpretations Committee concluded that significant diversity is likely to exist in practice on this issue. The Interpretations Committee decided that the issue could be best resolved by referring it to the Board as part of the implementation review for IFRS 3. Therefore, the Interpretations Committee [decided] not to add the issue to its agenda.

Appendix B – Current IFRS 3 (revised 2008) relevant literature

Below are reproduced paragraphs B51 to B52 of IFRS 3.

Effective settlement of a pre-existing relationship between the acquirer and acquiree in a business combination (application of paragraph 52(a))

B51 The acquirer and acquiree may have a relationship that existed before they contemplated the business combination, referred to here as a 'pre-existing relationship'. A pre-existing relationship between the acquirer and acquiree may be contractual (for example, vendor and customer or licensor and licensee) or non-contractual (for example, plaintiff and defendant).

B52 If the business combination in effect settles a pre-existing relationship, the acquirer recognises a gain or loss, measured as follows:

(a) for a pre-existing non-contractual relationship (such as a lawsuit), fair value.

(b) for a pre-existing contractual relationship, the lesser of (i) and (ii):

(i) the amount by which the contract is favourable or unfavourable from the perspective of the acquirer when compared with terms for current market transactions for the same or similar items. (An unfavourable contract is a contract that is unfavourable in terms of current market terms. It is not necessarily an onerous contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.)

(ii) the amount of any stated settlement provisions in the contract available to the counterparty to whom the contract is unfavourable.

If (ii) is less than (i), the difference is included as part of the business combination accounting.

The amount of gain or loss recognised may depend in part on whether the acquirer had previously recognised a related asset or liability, and the reported gain or loss therefore may differ from the amount calculated by applying the above requirements.

Below are reproduced paragraphs IE54 to IE57 of Illustrative Examples to IFRS 3.

Settlement of a pre-existing relationship

Illustrating the consequences of applying paragraphs 51, 52 and B50–B53 of IFRS 3.

IE54 AC purchases electronic components from TC under a five-year supply contract at fixed rates. Currently, the fixed rates are higher than the rates at which AC could purchase similar electronic components from another supplier. The supply contract allows AC to terminate the contract before the end of the initial five-year term but only by paying a CU6 million penalty. With three years remaining under the supply contract, AC pays CU50 million to acquire TC, which is the fair value of TC based on what other market participants would be willing to pay.

IE55 Included in the total fair value of TC is CU8 million related to the fair value of the supply contract with AC. The CU8 million represents a CU3 million component that is 'at market' because the pricing is comparable to pricing for current market transactions for the same or similar items (selling effort, customer relationships and so on) and a CU5 million component for pricing that is unfavourable to AC because it exceeds the price of current market transactions for similar items. TC has no other identifiable assets or liabilities related to the supply contract, and AC has not recognised any assets or liabilities related to the supply contract before the business combination.

IE56 In this example, AC calculates a loss of CU5 million (the lesser of the CU6 million stated settlement amount and the amount by which the contract is unfavourable to the acquirer) separately from the business combination. The CU3 million ‘at-market’ component of the contract is part of goodwill.

IE57 Whether AC had recognised previously an amount in its financial statements related to a pre-existing relationship will affect the amount recognised as a gain or loss for the effective settlement of the relationship. Suppose that IFRSs had required AC to recognise a CU6 million liability for the supply contract before the business combination. In that situation, AC recognises a CU1 million settlement gain on the contract in profit or loss at the acquisition date (the CU5 million measured loss on the contract less the CU6 million loss previously recognised). In other words, AC has in effect settled a recognised liability of CU6 million for CU5 million, resulting in a gain of CU1 million.

Appendix C – Request for inclusion in the *Annual Improvements* project

IFRS 3 p.B52 - Effective settlement of a pre-existing relationship

Issue:

We don't believe that a customer relationship arises when a pre-existing relationship is effectively settled in a business combination. We believe that any such on-going relationship becomes an 'intercompany' relationship and is eliminated upon the acquisition. We are aware that others take a different view and strictly apply a market participant approach, thereby recognising a customer relationship intangible asset.

Proposed solution:

Consider clarifying that a customer relationship intangible asset would not be recognised upon the effective settlement of a pre-existing relationship.

Appendix D – Draft amendment to IFRS 3 *Business Combinations*

D1 This appendix includes drafting of the proposed amendment. It is based on the text included in the most recently issued standards (including the *Improvements to IFRSs* issued in May 2010). New text is underlined and deleted text is struck through.

Proposed amendment to IFRS 3 *Business Combinations*

Paragraph B52 is amended (new text is underlined).

Effective settlement of a pre-existing relationship between the acquirer and acquiree in a business combination (application of paragraph 52(a))

B51 The acquirer and acquiree may have a relationship that existed before they contemplated the business combination, referred to here as a 'pre-existing relationship'. A pre-existing relationship between the acquirer and acquiree may be contractual (for example, vendor and customer or licensor and licensee) or non-contractual (for example, plaintiff and defendant).

B52 If the business combination in effect settles a pre-existing relationship, the acquirer recognises a gain or loss, measured as follows:

(a) for a pre-existing non-contractual relationship (such as a lawsuit), fair value.

(b) for a pre-existing contractual relationship, the lesser of (i) and (ii):

(i) the amount by which the contract is favourable or unfavourable from the perspective of the acquirer when compared with terms for current market transactions for the same or similar items. (An unfavourable contract is a contract that is unfavourable in terms of current market terms. It is not necessarily an onerous contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.)

(ii) the amount of any stated settlement provisions in the contract available to the counterparty to whom the contract is unfavourable.

If (ii) is less than (i), the difference is included as part of the business combination accounting.

The amount of gain or loss recognised may depend in part on whether the acquirer had previously recognised a related asset or liability, and the reported gain or loss therefore may differ from the amount calculated by applying the above requirements. <u>If a pre-existing relationship is settled in a business combination, the acquirer does not recognise an asset or liability in respect of that relationship in its consolidated statement of financial position.</u>

Effective date and transition

Effective date

64B *Improvements to IFRSs* issued in [date] amended paragraph B52. An entity shall apply this amendment for annual periods beginning on or after 1 January 2013. Earlier application is permitted.

Basis for Conclusions on proposed amendment to IFRS 3 *Business Combinations*

This Basis for Conclusions accompanies, but is not part of, the proposed amendment.

Changes as a result of *Improvements to IFRSs* (2012)

BC1 The Board noted that paragraph B52 needed to be clarified to reflect that a pre-existing relationship between the acquirer and acquiree should not be recognised in the consolidated statement of financial position when such a relationship is settled by the business combination.

Therefore, as part of *Improvements to IFRSs* issued in [month] 2012, the Board decided to amend paragraph B52.