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International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

RE: Request for Information – RFI (IFRS3 – Business Combination)

Dear Board Members,

The Comitê de Pronunciamentos Contábeis - CPC (Brazilian Accounting Pronouncements Committee)[1] welcomes the opportunity to respond to the Request for Information – RFI (IFRS3 – Business Combination).

1. Your background and experience

We are a standard-setting body engaged in the study, development and issuance of accounting standards, interpretations and guidance for Brazilian companies.

2. Definition of a business

2.(a) – Are there benefits of having separate accounting treatments for business combinations and asset acquisitions? If so, what are these benefits?

Our response: In general, we do not believe that users of financial statements will have any direct benefits from this difference since in both cases the assets acquired, whether separately or in a business combination, will be measured at fair value.

Having separate accounting treatments implies that the price paid for an acquisition of assets (or of net assets that do not constitute a business) should be allocated to each item acquired, so that no goodwill (or a gain from a bargain purchase) is recognized. We understand that the assumption is that the price paid for an acquisition of a set of net assets substantially refers to the sum of the fair value of each element in this set (assets and liabilities). However, there are no studies in Brazil showing if this is in fact the most frequent case or if otherwise the payment of an amount that exceeds the sum of the fair value of net assets more often occurs, in which case the net assets acquired would be recognized for an amount in excess of their individual fair values, which could result in impairment losses in the future.

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[1] The Brazilian Accounting Pronouncements Committee (CPC) is a standard-setting body engaged in the study, development and issuance of accounting standards, interpretations and guidance for Brazilian companies. Our members are nominated by the following entities: ABRASCA (Brazilian Listed Companies Association), APIMEC (National Association of Capital Market Investment Professionals and Analysts), BMFBOVESPA (Brazilian Stock Exchange and Mercantile & Future Exchange), CFC (Federal Accounting Council), FIPECAFI (Financial and Accounting Research Institute Foundation) and IBRACON (Brazilian Institute of Independent Auditors).

Thus, if a premium is paid for the set of assets acquired (that does not meet the definition of a business), its allocation will be driven by the individual fair value of assets acquired, which is an arbitrary procedure that may not result in the best information being provided (empirical evidence must be collected to this end). The premium paid in such transactions may be subsequently charged, in whole or in part, to the income statement as an impairment loss on the individual asset(s).

It seems more reasonable to recognize the premium paid as an intangible asset, and its accounting treatment will consider the economic bases that support it as well as its nature (either indefinite or finite useful life). This procedure is consistent with the intention expressed by the IASB itself to recognize more intangible assets in the financial statements, and it also enhances the predictive value of disclosed accounting information (prediction of future cash flows); and

Another aspect is that the capitalization of transaction costs makes no economic sense in terms of a business combination; but in the case of an acquisition of assets that does not meet the definition of a business, such costs should be recorded in the balance sheet when they are essential to bring the assets to their working condition, as they will contribute to the net income for more than one period and represent actual costs to controlling and non-controlling interests.

2.(b) – What were the main challenges you faced when assessing a transaction to determine whether it is a business?

Our response: Establishing a difference between a business acquisition and an acquisition of individual assets is still a complex area, depending on the transaction, which may lead to diverse practical implementations in some cases. It has been particularly difficult with the real estate industry (e.g. acquisition of shopping malls, land, farms and offices). Another challenge has been the recognition of identifiable assets and liabilities in a business combination.

3. Fair Value

3.(a) – To what extent is the information derived from the fair value measurements relevant and the information disclosed about fair value measurements sufficient? If there are deficiencies, what are they?

Our response: Conceptually, the adoption of fair value provides users of financial statements with relevant information, allowing the post-acquisition performance of the acquired business to be more adequately assessed, since the acquired assets and liabilities are measured at fair value. We believe that the current level of fair value disclosure is appropriate.

As for the fair value of net assets, to the extent that it represents the theoretical cash amount the acquirer would obtain at the acquisition date for the sale of identifiable assets and transfer of liabilities assumed of the acquired business, the information is relevant not only because it enables users to understand how much of the price attributable to the business can be immediately recovered from the sale of net assets, but also and mainly because it enables users to understand the importance of goodwill in terms of the expected future profits the acquired business will have to generate in order for the capital invested in obtaining control of the business to be recovered.

Regarding disclosure requirements for fair value measurements, it is worth mentioning that IFRS 3 establishes the objectives to be met by disclosures about combinations that occurred during the current period or in prior periods, as well as an indication of which disclosures would meet these objectives. It seems that the disclosure requirements contained in IFRS 3, as well as the disclosure requirements of IFRS 13 Fair Value Measurements are sufficient.

However, please note that the full adoption of IFRS is relatively recent in Brazil (from 2010), as well as the application of IFRS 13, which became effective for fiscal year 2013. We believe there has not been enough time to assess the quality of fair value measurement disclosures. Moreover, in general, IFRS disclosure requirements have been a challenge to be faced by regulators and standard setters.

3.(b) – What have been the most significant valuation challenges in measuring fair value within the context of business combination accounting? What have been the most significant challenges when auditing or enforcing those fair value measurements?

Our response: The first major challenge has been to identify assets and liabilities acquired in the context of business combination accounting. In emerging economies such as our jurisdiction, statistics and economic data are not available in significant volumes when compared to more developed markets. Scarce information, especially in our jurisdiction, makes fair value measurement more complex in general.

Other challenges faced:

(a) determining the date of acquisition;

(b) determining the consideration paid. Especially when the acquired business is a service company and the seller continues providing services/acting as an executive officer of the business acquired. Part of the consideration is often deferred, and the amount may vary depending on the duration of continuing employment with the acquired business, in which case the consideration paid for the business must be segregated from any amounts paid as remuneration for post-combination services. In practice, this segregation is extremely complex. We believe the IASB should include additional guidance on this topic.

(c) reconciliation of WACC, WARA and IRR rates

(d) fair valuing assets and liabilities (choosing the correct technique, considering all the information available and choosing the most appropriate inputs)

(e) use of the Tax Amortization Benefit (especially in relation to hypothetical transactions which have never or rarely occurred such as the potential sale of a concession agreement)

(f) deferred tax impacts (especially in relation to tax deductible goodwill)

It should be mentioned that it is quite difficult to validate the fair value measurement of assets where market value is not available, so the basic focus is evaluating the quality of adopted assumptions, as well as the quality of the model inputs. This, together with the lack of qualified personnel at the acquirer, implies that the acquirer will incur additional costs hiring independent appraisers, especially where buyer and seller have not negotiated and closed the deal on the basis of a multiple of earnings (EBITDA, Revenue and Operating Cash).

3.(c) – Has fair value measurement been more challenging for particular elements: for example, specific assets, liabilities, consideration etc.)?

Our response: The measurement of contingent assets, contingent liabilities and contingent consideration (as per previous answer) has been rather complex due to the very nature of the liabilities and the difficulty in obtaining assurance about the assumptions necessary for measurement. The fair value measurement of certain intangible assets, such as agreements not to compete, has proven to be a very complex area. This derives from the fact that certain identifiable assets and liabilities in a business combination are not usually traded separately, and the measurement process is complex, from defining the pricing technique a market participant would adopt to price such assets or liabilities to obtaining variables (inputs) applicable to their measurement.

However, despite its challenges, fair value is the only possible useful information to assess the financial and economic impacts (current and future) arising from a combination. In other words, the future business performance will be better measured if there is an adequate starting point, and this is offered by a reasonable and properly determined fair value.

4. Separate recognition of intangible assets from goodwill and the accounting for negative goodwill

4.(a) – Do you find the separate recognition of intangible assets useful? If so, why? How does it contribute to your understanding and analysis of the acquired business? Do you think changes are needed? If so, what are they and why?

Our response: Yes, we believe the separate recognition of intangible assets enables measuring business performance and predicting future cash flows and acquired financial and economic impacts, since it allows the account for the use of individual assets when their benefits are recognized by the acquired business.

For illustration purposes, we may consider the following: Entity A acquires 100% of Entity B for $100, paid in one lump sum; the fair value of the identifiable net assets (INA) is then $80, and net worth (NW) is $50. The main difference between NW and INA are the trademarks developed by Entity B. Note that the business was acquired for $100, but the theoretical cash amount to be obtained by Entity A would be $80 if it sold the assets and transferred the liabilities at fair value separately on the date of the combination, which includes the sale of intangible assets (trademarks). Accordingly, goodwill adequately represents the excess amount whose recovery depends only on the business' future cash flows (or future profits), given that $80 could be obtained today at the sole discretion of Entity A, but the return on the total investment ($100, i.e. $80 in INA and $20 allocated to goodwill) will depend on the future cash flows to be generated by the business.

In this context, how the identifiable net assets were measured becomes relevant, given that their attributed fair value should adequately reflect the cash amount to be obtained by the acquirer from the sale thereof on the date of acquisition. This means that if there are identifiable intangible assets not reliably measured at fair value, they could not be recognized separately from goodwill.

4.(b) – What are the main implementation, auditing or enforcement challenges in the separate recognition of intangible assets from goodwill? What do you think are the main causes of those challenges?

Our response: The main challenges involve their identification and, in some cases, measurement, as previously mentioned. We believe the challenge is caused by the complexity of certain business environments, and the nature of identifiable assets and liabilities. The measurement of identifiable assets and liabilities is complex, since many of these assets and liabilities are not generally traded individually (no active market), making it difficult to determine the best fair value measurement technique and to obtain applicable assumptions.

It should be mentioned that the adoption of pricing models implies that we have (i) skilled, qualified, experienced personnel that is familiar with models applicable to each case; and (ii) databases and/or reliable sources of information, from which observable inputs may be obtained and emerging markets like Brazil still have significantly lack these two elements.

4.(c) – How useful do you find the recognition of negative goodwill in profit or loss and the disclosures about the underlying reasons why the transaction resulted in a gain?

Our response: We believe that the recognition of a gain from a bargain purchase (negative goodwill) in profit and loss for the period provides useful information to the users of financial statements. The disclosures should be primarily based on a concise and complete explanation of the basis that generated such a gain.

This assertion is justifiable as there is no reason why the recognition of a gain from a transaction between unrelated parties who negotiate the control of net assets should be deferred. That would oppose the very Conceptual Framework for Financial Reporting.

As for the reasons why the transaction resulted in negative goodwill, it is essential that the user assess the transaction so that the disclosed information enables to identify its cause (whether it resulted from the bargaining power of acquirers, from market conditions, from the condition of the acquired business, from a stop loss motivated by the former owner or controlling shareholder or even from a combination of several aspects).

A gain from a bargain purchase is believed to be rare, and goodwill is what usually occurs in a business transaction. Thus, it is clear to assume, when a business is offered for sale, that the seller) will estimate the price for which the business could be sold, and this involves measuring the value of that business both as a continuing operation (using the present value of future cash to be generated by the business or the market price of shares, among other methods) and as a discontinued operation (fair value of the business' net assets), and certainly the seller will target to sell it for the higher of the two resulting figures. Therefore, in practice, if the fair value of net assets is the higher amount, this will be the price asked by the seller regardless of what the acquirer will do with the business (whether continue or discontinue the operations) and its net assets (use or sell them). Accordingly, apart from a possible gain from a bargain purchase arising from poor measurements, given the existing exceptions in IFRS 3, a transaction may only result in a gain from a bargain purchase to the acquirer when the

parties are not equally knowledgeable of the subject or when their measurement bases are significantly different.

In this context, we should go back to the example in answer to question 4 (a), in which a business was fully acquired for $100 and the fair value of net assets was $80. Assuming the contrary, i.e. that the price paid was $80 and the fair value of net assets was $100, the recognition of a $20 gain from a bargain purchase is appropriate given that the buyer could obtain $100 in “theoretical cash” from the sale of net assets, which were bought for only $80. Therefore, there was an economic gain of $20, which does not depend on the business’ future cash flows, but rather on the acquirer’s “will” obtain to sell the net assets.

5. Non-amortization of goodwill and indefinitive-life intangible assets

5.(a) – How useful have you found the information obtained from annually assessing goodwill and intangible assets with indefinite useful lives for impairment, and why?

Our response: Considering that “indefinite useful life” is not “non-finite useful life”, the impairment test is essential for the frequent assessment of future cash flows of expected economic benefits from the intangible asset. Thus, we believe that such information is critical, with emphasis on the criteria and assumptions used in the impairment test of goodwill and indefinite-life intangible assets.

In this context, there should be a disclosure requirement for the reasons and judgments that caused the non-recognition of losses after these tests in cases where the financial and economic performance of the entity or business segment shows contrary evidence to the non-recognition of losses.

Accordingly, as opposed to the impairment test, the amortization of these assets would not result in useful information, since it would involve the adoption of random useful life and impose costs with no economic basis to the performance of periods to which this life refers. For example, if a business is acquired including goodwill and the economic value of that business subsequently increases on a continuous basis, then the expected realizable value will exceed the amount originally attributable to the business, and there is no present doubt on the realization of goodwill while the business that generated such goodwill is not realized (or the cash-generating units to which it was allocated).

5.(b) – Do you think that improvements are needed regarding the information provided by the impairment test? If so, what are they?

Our response: We would like to see more robust disclosure in this area so that reader can understand the subjectivity and potential alternatives (ex. more detailed information when Market inputs were not used, impacts of alternative valuation techniques, more detailed information when the calculation is close to impairment, explaining why management expectations were used instead of historical values for inputs).

One of the existing requirements for determining the value in use of a cash-generating unit prohibits the use of cash inflow and outflow projections for periods beyond those covered by approved budgets, for which the entity shall extrapolate cash projections using steady or declining growth rates. Considering that the value in use for impairment

purposes is not a fair value measurement, as stated in IFRS 13, this limitation could result in the recognition of losses that would otherwise not exist.

5.(c) – What are the main implementation, auditing or enforcement challenges in testing goodwill or intangible assets with indefinite useful lives for impairment, and why?

Our response: The main challenges in testing goodwill for impairment are:

(i) Conclude on the reasonableness of the assumptions used (considering the world's recent economic environment, as well as the volatility of both local and international financial markets;

(ii) Allocation of goodwill by business segment, not only when goodwill arises but also in subsequent restructuring processe; and

(iii) Subjective definition of the discount rate and conflicting guidelines, e.g. should WACC be used as the discount rate? If so, why should the entity's capital structure not influence the choice of the discount rate? Is the entity's credit risk part of the discount rate? If not, what does the entity's overall credit risk have to do with the volatile results (set of risk factors) of a CGU, for example?

6. Non-controlling interests

6.(a) – How useful is the information resulting from the presentation and measurement requirements for NCIs? Does the information resulting from those requirements reflect the claims on consolidated equity that are not attributable to the parent? If not, what improvements do you think are needed?

Our response: We believe that the current resulting information is useful and enables a broad view of the economic group as a whole regardless of its shareholding structure.

However, there are also questions and discussions in relation to transactions for purchase and sale of NCI being recorded directly in shareholders' equity (especially as goodwill is recorded on the acquisition of NCI for tax purposes).

Regarding the existence of two criteria for measuring non-controlling interests, it is worth mentioning that the fair value measurement results in an adequate determination of the economic value of goodwill from a business combination from a group perspective (full goodwill), which is consistent with how the former controlling shareholder, in case it is an entity, will recognize in its financial statements the remaining interests in the former subsidiary, if any (this is because IFRS 10 requires the remaining interest to be measured at fair value upon loss of control).

Conversely, the other method for measuring non-controlling interests allowed by IFRS 3, i.e. their proportionate share of net assets, is also adequate, particularly where control is obtained by an acquirer that has no equity instruments of the business (a case not yet seen in Brazil) or in cases of equity acquisition. In the event of an equity acquisition, for instance, non-controlling interests include a residual interest not only in the net assets of the business whose control is being gained by another entity, but also in the net assets of the business of the acquirer (or otherwise, in the net assets of the acquirer including the business subject to the equity acquisition). In Brazil, an equity acquisition, which is quite usual, implies that the acquiree will become a wholly-owned

subsidiary of the acquirer, in which case the acquiree's former owners will become owners of the acquirer, but will not hold control. Accordingly, measuring such interests on the basis of their proportionate share of net assets (formed by the sum of the carrying amount of the acquirer's net assets and the fair value of the net assets of the business acquired through equity acquisition) represents useful information.

6.(b) – What are the main challenges in the accounting for NCIs, or auditing or enforcing such accounting? Please specify the measurement option under which those challenges arise. To help us assess your answer better, we would be grateful if you could please specify the measurement option under which you account for NCIs and whether this measurement choice is made on an acquisition-by-acquisition basis or on a general basis for all NCIs and why?

Our response: The main challenges refer to complex corporate structures involving shareholders with different economic rights. We have seen NCIs being measured on the basis of the fair value of identifiable assets and liabilities, often because the preparers deem it to be more objective information, especially when the acquiree is an entity with equity instruments not traded in an active market.

In Brazil, they are often measured by reference to the proportionate share held by non-controlling shareholders on the fair value of the subsidiary's net assets.

7. Step acquisitions and loss of control

7.(a) – How useful do you find the information resulting from the step acquisition guidance in IFRS 3? If any of the information is unhelpful, please explain why.

Our response: Considering that we believe that the financial statements represent an economic overview of the group as a whole, irrespective of its shareholding structure, the consolidated financial statements should not reflect the economic impacts from transactions among its owners. Therefore, we believe the required accounting treatment is consistent with the general principles of a business combination.

We believe the IASB should further clarify how to account for additional investments in an associate or jointly venture. IAS 28 refers to IFRS 3. However, IFRS 3 requires the recognition of identifiable assets and liabilities at fair value only on the date on which control is obtained; all the transactions involving the purchase and sale of interests in subsidiaries whose control is retained will be subsequently recognized in an equity account. In the case of an entity that has, say, a 30% interest in an associated company and later acquires an additional 10%, the question that emerges is how to apply the concept of purchase price allocation here, i.e. should all of the assets be recognized at fair value or should they reflect the partial fair value at the time each interest stake was acquired? We believe that there is inconsistence in practice in this regards. Any accounting treatment that differs from the one defined in IFRS 3 (2008 version) will harm what goodwill should actually represent: the excess amount between the "price attributable to the business" and the "theoretical cash amount obtained from the sale of the acquiree's net assets" on the date of the business combination. Therefore, we believe that all required information is useful and the required procedures must be retained.

7.(b) - How useful do you find the information provided by the accounting for a parent's retained investment upon the loss of control in a former subsidiary? If any of the information is unhelpful, please explain why.

Our response: The fair value measurement seems more appropriate, since the assets and liabilities controlled by the entity are conceptually being exchanged for an equity interest in the capital of a company. This applies because obtaining control is a significant event; given that control changes hands, the very determination of the value created by the new controlling entity from that business needs a zero base to measure how much value was created by the new controlling entity. Thus, if the control of a business valued in accordance with IFRS 3 was $100, and two years later it is worth $150, the value created totaling $50 will only be known if we know that the business was valued at $100 at the time of purchase. Likewise, the loss of control is a significant event (as recognized by the IASB in the Basis for Conclusions on IAS 27, paragraph BC55, which remained unchanged in IFRS 10) because with the loss of control the condition for value creation changes significantly, either because now the materialization of operational strategies or synergies becomes only potential, in case the former parent company retains at least significant influence, or because these synergies are no longer available, in case the retained interest is but a financial asset. Thus, in either case, a zero base is required to subsequently measure the value obtained/created, and, as control has been lost, the fair value of interest retained in the former subsidiary is the best starting point to which future values can be compared and decisions to either retain or realize the asset can be supported.

8. Disclosures

8.(a) – Is other information needed to properly understand the effect of the acquisition on a group? If so, what information is needed and why would it be useful?

Our response: We believe that the required disclosures are sufficient to understand the transaction. However, the same considerations in response to question 3a. apply hereto. IFRS disclosures in general have been a challenge for preparers, auditors and regulators.

8.(b) – Is there information required to be disclosed that is not useful and that should not be required? Please explain why.

Our response: We believe that all required information is useful considering the financial statement stakeholders and not just a specific group of users. However, the same considerations in response to question 3a. apply hereto. IFRS disclosures in general have been a challenge for preparers, auditors and regulators.

8.(c) – What are the main challenges to preparing, auditing or enforcing the disclosures required by IFRS 3 or by the related amendments, and why?

Our response: A complexity arises for business combinations that occur very close to the financial statements closing date, because the time available for the acquirer to obtain all the necessary information is scarce. As we understand it, the current disclosure requirement for a business combination, even after the financial statements closing date and before their approval, makes the challenge even greater. With respect to the specific disclosure of a business acquired after the balance sheet date, we

believe that the current standard should be amended to reduce the amount of required information.

9. Other matters

The IASB is interested in:

9.(a) – Understanding how useful the information that is provided by the Standard and the related amendments is, and whether improvements are needed, and why;

Our response: We believe that the requirements for recognizing deferred income tax should be revised, as previously mentioned; i.e. the same existing recognition criteria for the acquisition of assets should apply.

Business combinations under common control are a critical area in Brazil. As this topic has not been addressed in a standard, a number of accounting procedures and treatments may be used, threatening the quality and reliability of disclosed information. In other words, a specific standard defining the procedures on how to account for business combinations under common control would significantly increase the quality of accounting information by simply eliminating the various accounting treatments. Stating that the standard does not apply to business combinations under common control is not enough, it must be clear that an entity should not recognize goodwill or appreciation in excess of the adjustment in the non-controlling interest for each level of control, and clearly explain how to account for such combinations.

Another improvement is the exclusion, from the current version of IFRS 3, of the text that made it clear that no additional goodwill or remeasurement of net assets at fair value could arise from transactions involving a change in the relative share of the parties thereto, without entailing in loss of control of the current controlling entity. It is important to clarify that, both in the individual statements of the parent company (which adopt the equity method in Brazil) and in the consolidated statements, the difference between the consideration paid (or received) and the adjustment to noncontrolling interests should be accounted for directly in equity attributable to the owners/shareholders of the parent. This procedure also applies if a gain (or loss) arises from a dilution or concentration in the relative interest held by the parties with no loss of control.

9.(b) – Learning about practical implementation matters, whether from the perspective of applying, auditing or enforcing the Standard and the related amendments; and

Our response: Not applicable

9.(c) – Any learning points for its standard-setting process.

Our response: Not applicable

10. Effects

From your point of view, which areas of IFRS 3 and related amendments:

10.(a) – Represent benefits to users of financial statements, preparers, auditors and/or enforcers of financial information, and why;

Our response: Considering that mandatory adoption of IFRS in Brazil was in 2010, we are not able to measure these benefits. Notwithstanding this and the fact that IFRS 3 (2008 version) made the process of recognizing, measuring and disclosing business combinations more complex, this standard requires the professionals who use it to be more stringent when identifying intangible assets acquired in a business combination and, consequently, less arbitrary when measuring residual goodwill, which is very positive.

10.(b) – Have resulted in considerable unexpected costs to users of financial statements, preparers, auditors and/or enforcers of financial information, and why; or

Our response: Not applicable

10.(c) – Have had an effect on how acquisitions are carried out (for example, an effect on contractual terms).

Our response: Not applicable

If you have any questions about our comments, please contact us at operacoes@cpc.org.br.

Yours sincerely,

Idésio da Silva Coelho Júnior
Chair of International Affairs
Comitê de Pronunciamentos Contábeis (CPC)