

THE CHALLENGES OF GOODWILL ACCOUNTING

THE FINANCIAL REPORTING
OF LISTED REAL ESTATE COMPANIES
AT 31 DECEMBER 2015



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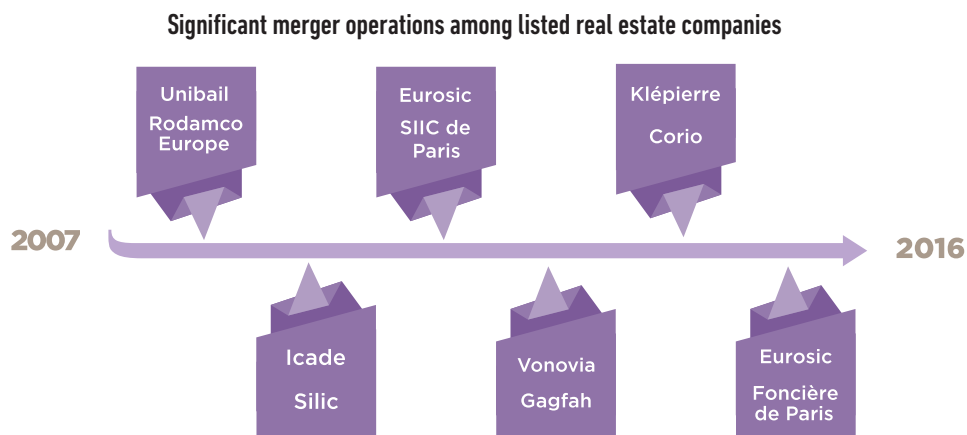
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INTRODUCTION

According to an article in Les Echos of 15 June 2016, “in 2015, the amount of goodwill impairments more than doubled in CAC 40 companies, rising to €5.84 billion compared with €2.61 billion a year earlier”. In our sample, Klépierre contributed €595 million to this total.

We therefore decided to accompany our survey of the financial reporting of listed real estate companies with a study of a salient topic. This year we turn our attention to the issues raised by the merger operations of listed real estate companies and the resulting accounting treatment of goodwill.



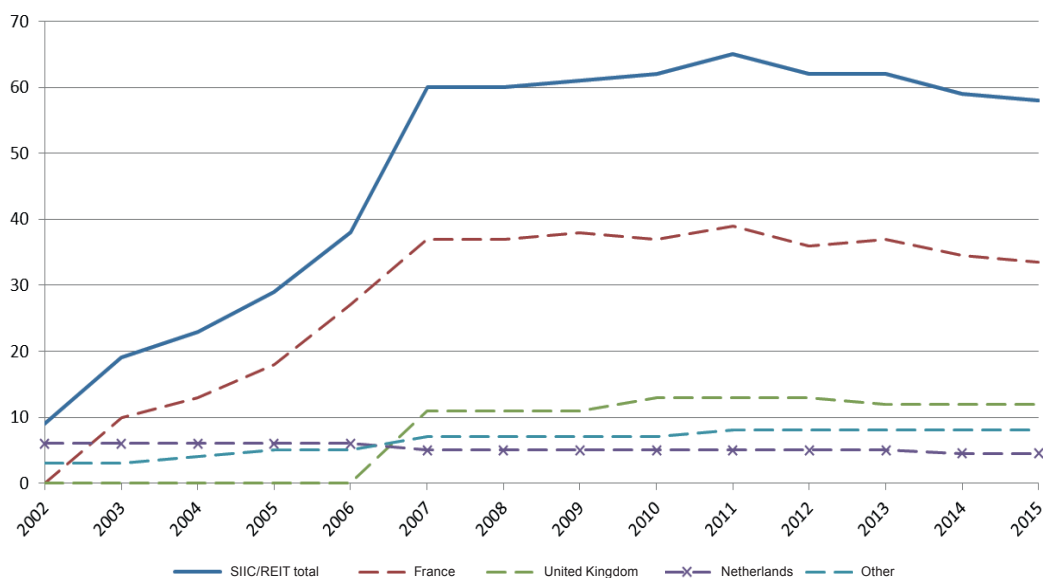
An original subject reflecting the current trend in the SIIC market towards a reduction in the number of players as real estate companies go in search of critical mass, value creation and synergies.

Will this trend towards concentration continue?

In an interview with *Capital Finance* (n° 1238 of 9 May 2016) Benoît Faure-Jarrosion, an analyst responsible for the real estate segment at Invest Securities, suggested that “*the days of huge transactions, like the one between Unibail and Rodamco in 2007, or between Klépierre and Corio two years ago, seem to be behind us. To finance their expansion, majors in the sector are instead opening up the capital of structures bringing together certain of their assets – for example, as Altarea Cogedim did with Allianz in 2013.*”

The question of the accounting treatment of these operations, which has never really been decided for SIICs, deserves consideration.

Movements in the number of REITs in Europe since 2002



Comments from Laurent Ternisien, Senior Advisor, EPRA

“ If we look back to the United States and Europe twenty years ago, the listed real estate companies market, and more particularly the market capitalisation of these real estate companies, was twice the size in Europe that it was in the US. However, today the US market is three times the size of the European market, with a Europe that represents around 15% of our global index.

This reduction in Europe’s share – accompanied by increasing market capitalisation – must be seen in the light of a number of factors, one of which is size.

The average size of an REIT in the US is €5bn while the average size of an SIIC in Europe is €1bn. Investors are demanding large structures that allow for a certain degree of liquidity, one of the main advantages of real estate. So this race for size seems likely to continue. ”

Real Estate Breakfast Briefing – Mazars – Financial reporting of real estate companies in Europe
2 June 2016

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THE REGULATORY FRAMEWORK

IFRS 3 R AND IAS 40: A COMPARISON

How an acquisition is accounted for depends whether the acquiring entity records the operation as a business combination or an acquisition of individual immovable assets. This requires judgement, and the circumstances of the operation must be taken into account. **In the case of a business combination, the operation will be accounted for in accordance with IFRS 3 R. The costs of the operation are recognised as an expense, and goodwill (or badwill) will arise from the acquisition. In the case of individual assets IAS 40 will be applied, costs will be capitalised and there will be no recognition of goodwill.**

Let's take the example of the acquisition of a real estate asset via a vehicle. The company has no staff and has no management contract. There are two methods of recognition under IFRSs, with significant impacts on presentation on the statement of financial position and on the income statement:

- **Application of IAS 40:** no recognition of goodwill and capitalisation of the acquisition costs in the building:



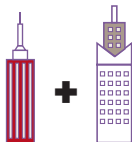
Acquiring company A	
Building: 1,000	Equity: 500
Cash: 10	Financial liabilities: 490
	Accounts due to suppliers: 20

Price: 220 via borrowing + **5** in acquisition costs



Acquiree company B	
Building net carrying value: 100 (fair value: 200)	Equity: 50
Receivables: 10	Accounts due to suppliers: 60

NAV = 150 = 50 + (200-100)



A + B (under IAS 40)	
Fixed assets: 1 275	Equity: 500
Receivables: 10	Financial liabilities: 710
Cash: 5	Accounts due to suppliers: 80

NB: for the purposes of impairment testing, the value of the immovable asset formerly held by B will be compared with the valuation excluding duties by an independent real estate appraiser.

- **Application of IFRS 3 R:** recognition of goodwill if price paid (excluding acquisition costs) is higher than the NAV. Costs are recognised in expenses and an impairment test is conducted on the goodwill.



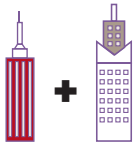
Acquiring company A	
Building: 1,000	Equity: 500
Cash: 10	Financial liabilities: 490
Accounts due to suppliers: 20	

Price: 220 via borrowing + **5** in acquisition costs



Acquiree company B	
Building net carrying value: 100 (fair value: 200)	Equity: 50
Receivables: 10	Accounts due to suppliers: 60

NAV = 150



A + B (IFRS 3R)	
Goodwill: 70	Equity: 495
Fixed assets: 1,200 Building A: 1,000; Building B: 200	Financial liabilities: 710
Receivables: 10	Accounts due to suppliers: 80
Cash: 5	

We recommend that the reasons leading company A to apply IAS 40 or IFRS 3R should be explained, with details of the goodwill calculation carried out when acquiring another real estate company.

On 28 June 2016 the IASB published a **draft amendment** to IFRS 3, aiming to clarify the concept of business. This exposure draft sets out a new two-stage approach for determining when a business exists:

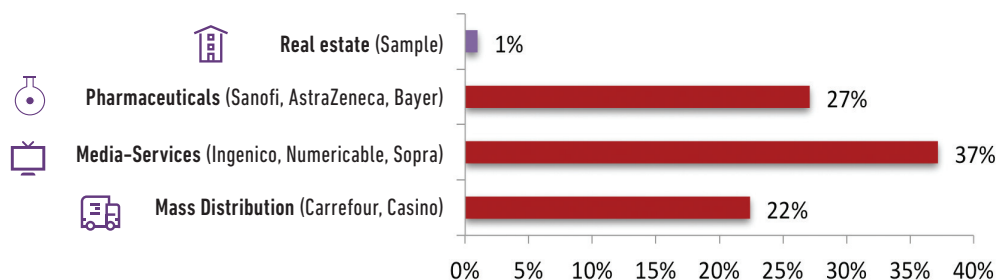
1. The concentration of fair value test: this step consists of determining whether substantially all of the fair value of the gross assets acquired is concentrated in a single asset or group of similar assets, in which case the operation is not a business combination.
2. Evaluating whether an acquired process is substantive. This second stage sets out criteria for determining whether the transferred activities or assets generate outputs at the acquisition date.

SECTORAL
COMPARISON AND
DISCLOSURES ON THE
TYPES OF GOODWILL
ACCOUNTED FOR ON
THE BALANCE SHEET

SECTORAL COMPARISON: PROPORTION OF GOODWILL IN TOTAL ASSETS

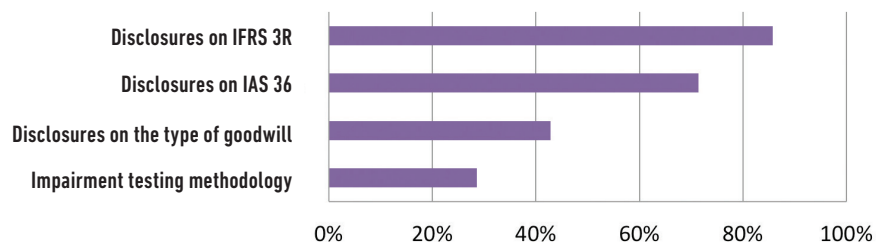
In operations of this type, the accounting choices made by the acquiring entity are often the subject of discussions between regulators, auditors and finance departments.

Given the balance sheet structure of real estate companies, however, the significance of goodwill remains marginal in comparison with other business sectors.



DISCLOSURES ON GOODWILL IMPAIRMENT AND DETAILS OF CASH-GENERATING UNITS (CGUS)

IAS 36 requires entities to test goodwill and long-term non-financial assets, such as investment property, and to establish whether there is evidence of impairment.



	Altarea-Cogedim	British Land	Eurosic	Foncière de Paris	Foncière des Régions	Gecina	Hammerson	Icade	INTU	Mercialys	Klépierre	Land Securities	Société Foncière Lyonnaise	Unibail-Rodamco
IFRS 3R	•	•	•	•	•	•	•	•	•	•	•	•	•	•
IAS 40	•		•		•	•	•	•		•			•	•
Goodwill impairment	•	N/A	N/A	•		N/A		•		N/A	•	•	N/A	•
Disclosures on the details of CGUs	•	N/A	N/A	•		N/A				N/A	•		N/A	

Several types of goodwill are accounted for on the balance sheet of listed real estate companies:

- 37%** | **TAX OPTIMISATION OF ASSETS**
Goodwill relating to tax optimisation resulting from the method of disposal chosen for the asset. A real estate company can dispose of an asset in the form of an asset deal or a share deal. This has an impact on the rate of levies payable, and in some countries in particular there are clear advantages to the disposal of shares in a vehicle holding the real estate asset in question.
- 34%** | **VALUE OF MANAGEMENT ACTIVITIES**
Goodwill arising from management activities in the acquiree.
- 15%** | **INCREASE IN VALUE OF ASSETS SINCE THEIR ACQUISITION DATE (KLÉPIERRE)**
Goodwill resulting from an increase in the fair value of the immovable asset during the appraisal period, which may not exceed one year from the acquisition date.
- 5%** | **GOODWILL ON FIRST CONSOLIDATION**
Goodwill techniques accompanying the recognition of a deferred tax liability due to the reappraisal of the building. This concerns SIICs with establishments abroad.

Disclosures not made represent 9%.

3

OVERVIEW OF RECENT MERGERS IN THE REAL ESTATE SECTOR

We have identified five significant operations:



These operations have been given diverse accounting treatments. We have identified and summarised the accounting impacts in the table below.

Two operations have resulted in the recognition of badwill.

Goodwill, which was recognised in the other three business combinations, has experienced different fates:

- **UNIBAIL** fully impaired the goodwill of €1.3bn, explaining that no surplus value could be identified once the acquisition price had been allocated;
- **KLÉPIERRE** retained residual goodwill and documented its nature, ascribing it to tax optimisation, service activities and the increased fair value of the assets since acquisition;
- **VONOVIA** recorded no goodwill impairment, explaining that the operation would create synergies.

	Operations	Operation type	Goodwill / Badwill	Amount	Impairment tests	Impairment	Net goodwill	Allocation
Offices	Icade SILIC December 2013	Shares	Badwill	-€2m			-€2m	Income statement
	Eurosic SIIC de Paris July 2014	Cash	Badwill	-€1m			-€1m	Income statement
Retail	Unibail-Rodamco May 2007	Shares	Goodwill Premium to NAV: 23%	€1,300m	Yes	-€1 300m	-	- No allocation (goodwill impaired)
	Deutsche Annington Gagfah March 2015	Shares Cash	Goodwill Premium to NAV: 15%	€2,265m	Yes	-	€2,265m	- 100% allocated to synergies in the integration of Gagfah
	Klepierre Corio March 2015	Shares	Goodwill Premium to NAV: 37%	€1,363m	Yes	-€595m	€768m	- €110m allocated to the 9 retail centres sold in the Netherlands (derecognised) - €265m for optimisation of deferred taxes - €175m for additional value of management activities (including cost synergies) - €218m for increase in the value of assets since their acquisition date

The goodwill represents synergies from the integration of GAGFAH's real estate business. Further information on goodwill can be found in note [19] Intangible Assets.

The allocation/reallocation of goodwill to the business areas and to the Extension CGU was performed based on the two indicators that reflect the synergy effects expected to be generated as a result of the business combination: "direct planned synergies" and "fair values."

Source: Vonovia annual report

Accounting for Business Combinations

€1.3 Bn of the goodwill recorded as part of the business combination between Unibail and Rodamco has been impaired.

This goodwill impairment is a technical adjustment which does not impact the 2007 recurring profits nor the triple net asset value of the company, nor does it imply any change in the value of and outlook for the Rodamco assets acquired. A total of €1.6 Bn of goodwill arose because of the accounting treatment (IFRS 3) of the Rodamco acquisition when Unibail used Unibail shares at a premium to NAV to buy Rodamco shares at a premium to NAV.

This accounting goodwill has now either been written off or allocated to appropriate accounting items.

Source: Unibail-Rodamco 2007 annual report

A part of the goodwill related to the Corio acquisition was allocated to the 9 Dutch shopping centers disposed, for an amount of 110 million euros that was consequently written off. In addition, as a result of the implementation of IAS 36, an impairment test was performed on this goodwill as of December 31, 2015 and resulted in a 595 million euro impairment. As a consequence, a total of 704.5 million euro impairment was recorded for the year.

The residual goodwill in the financial statements amounts to 658 million euros and can be split as follows:

- 265 million euros relating to optimization of deferred taxes;
- 175 million euros relating to the additional value of management activities (including cost synergies);
- 218 million euros relating to an increase in the valuation of Corio assets recorded since the acquisition date.

Source: Klépierre annual report

In millions of euros		
Fair value of Corio investments properties		6,515
Value of Management activities		175
Optimized value of deferred taxes		265
Total Recoverable amount	A	6,955
Carrying net amount of Corio assets		6,297
Goodwill as of January 8, 2015		1,363
Goodwill write-off following Netherlands assets disposal		-110
Total Net accounting value	B	7,550
Goodwill Impairment	-A-B	-595
Residual goodwill		658

CONCLUSION

After setting out the main principles of the regulatory framework, we identified the different types of goodwill that are recognised by listed real estate companies in Europe.

An analyse of the most recent large-scale operations demonstrates that the approach adopted by the acquiring entity has a significant accounting impact.

We are now wondering whether EPRA should issue a recommendation.

Comments from Laurent Ternisien, Senior Advisor, EPRA

“ *The treatment of goodwill is a topical question: it was on the agenda of the most recent meeting of our Reporting & Accounting committee, where it was decided to set up a sub-committee to examine this very issue.*

EPRA has a role in standardisation and transparency in our industry, and next year we will be able to give you more clarifications in this area. ”

Real Estate Breakfast Briefing – Mazars – Financial Reporting of Real Estate Companies in Europe
2 June 2016



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