EFRAG

European Financial Reporting Advisory Group

24 June 2014

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

Dear Sir/Madam,

Re: IFRS 3 *Business combinations* Post-implementation Review

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing in response to the Request for Information on the Post-implementation Review (PiR) of IFRS 3 *Business Combinations* issued by the IASB in January 2014. The scope of the PiR includes the consequential changes made to IAS 36 *Impairment of Assets* and IAS 27 (2008) *Consolidated and Separate Financial Statements* (replaced by IFRS 10 *Consolidated Financial Statements* in 2010) which were published at the same time as the revised IFRS 3 in 2008. These are referred to in this letter as 'the Standards'.

EFRAG representatives, in partnership with some European National Standard Setters and European user organisations, notably the European Federation of Financial Analysts Societies (EFFAS), have held or participated in several outreach activities with preparers and users of financial statements in order to identify implementation difficulties and understand the overall effects and benefits of the Standards. The feedback received from the various outreach activities and events has been summarised in two separate feedback statements which are included as **Appendix 1** – feedback from preparer outreach activities and **Appendix 2** – feedback from user outreach activities. This letter, together with the accompanying Appendices, reflects the evidence gathered from European constituents on their experiences with the Standards.

In summary, the evidence received indicates that many preparers believe that, from a cost-benefit perspective, the Standards have not worked as intended in respect to all the issues that they set out to address. Although many preparers acknowledge the conceptual merits of the overall acquisition accounting model in IFRS, most expressed significant concerns regarding the level of effort required and costs incurred to meet its requirements. Many preparers question whether the increase in costs has exceeded the benefits to users. We have learned that users take a holistic perspective when analysing a business combination, and tend to focus primarily on the "entirety" of what had been acquired for the consideration paid, rather than on the individual assets acquired and liabilities assumed.

This leads to the conclusion that, in several cases, users request rather different information than that required by the Standards. A more general comment made by users, was that that information about business combinations was often scattered in the financial statements. Users also commented that information reported in the financial statements in relation to the rationale underlying the business combination was often of a "boiler plate" nature and did not provide sufficient insight on the key drivers of the transaction and its effects.

Many analysts, especially buy/sell-side equity analysts, need information on the day the deal is announced to keep abreast with market reactions. Relevant information is therefore sourced from channels such as capital market days and direct contacts with the company's management. For these users, the financial statements, including the interim financial statements, if used at all, had an "alert" or verification of knowledge function. Some of these users raised the need for improvements to IAS 34 *Interim Financial Reporting* with regards to information on business combinations.

The paragraphs that follow outline the more significant matters raised on the specific issues addressed in the Request for Information.

Definition of a business

Many preparers noted that the assessment of whether a business exists or not, is a significant practical difficulty. A primary concern expressed is that the definition in IFRS 3 is too broad and lacks guidance on what should not be considered a business. This has resulted in a number of acquisitions being treated as business combinations, when, in the view of preparers, they should have been treated as "asset acquisitions". Specific examples include the acquisition of a strategic asset, a service contract or a licensing agreement, which are often acquired within a legal entity. Many preparers encourage the IASB to reconsider the scope of the definition of a business and provide more guidance and clarification as to what constitutes a business.

We found that users generally did not have strong views about whether an acquisition met the definition of a business or not since the distinction between assets and businesses had never been of concern to them.

Fair value measurement

Many preparers expressed significant difficulty with determining the fair values of certain assets and liabilities. In additional, they stated that the valuations were often performed by external experts and were considered to be very costly.

Preparers also reported specific concerns with fair valuing those intangible assets that were not recognised in the financial statements of the acquiree, such as non-contractual intangibles, intangibles for which there is no active market and intangible assets in the "early stage" of development such as in-process R&D. Given the significant degree of judgement required, preparers considered that the fair values of such intangibles resulted in unreliable measurements and in some cases inconsistent measurements (given the lack of guidance on standardised 'fair value' models). Reliability concerns were also expressed with regard to the measurement of loans and receivables (in the banking industry), pre-existing relationships, and previously held/retained interests in step acquisition/loss of control transactions. Fair value of consideration in an equity-share transaction was also noted as an area of difficulty.

Several preparers also questioned the relevance of measuring certain assets, for example a brand that was acquired as part of the business combination transaction, at fair value at the acquisition date if the acquirer did *not intend* to use the asset in the way same as "a market participant". These preparers viewed recognition and measurement at fair value of such assets as a "hypothetical" accounting exercise which did not reflect the nature of the business combination transaction from the perspective of the acquiring entity. A measurement based on expected value in use for the entity (others said "entity-specific value") was thought to be a more relevant measurement bases for such assets.

Similar to preparers, most users regard fair values as highly subjective. Users generally noted that having only a 'number' with no or limited supporting information on how fair value of individual assets and liabilities was determined, limited the usefulness of the information, particularly in terms of forecasting future performance.

Overall, users called for more information that explained the basis on which the fair values were determined (for example significant inputs and assumptions used in the valuations). In relation to the "step-ups" on inventory acquired through a business combination, users called for disclosures that would help them forecast the impact "step-ups" would have on gross margins reported in profit or loss in future periods (this was particularly important for inventory thatturned over a long period of time). Other suggestions put forward by users include the provision of information on the acquiree's book values of assets acquired and liabilities assumed, and information on estimated useful-lives of assets acquired was also mentioned as relevant.

Separate recognition of intangible assets from goodwill

Preparers generally agreed that recognising intangible assets separately from goodwill provides useful information for users, especially when it provides a better understanding of what had been paid for through the acquisition price. However, the process of separately recognising intangible assets was considered by many preparers to be highly complex, subjective and costly given the requirement to measure the intangible assets at fair value. Some preparers viewed the purchase price allocation to identifiable intangible assets as a "pure accounting exercise" while the parties involved in the transaction might not have considered these assets when assessing the transaction (and agreeing the price).

Some preparers suggested a less granular "cluster-based" approach for classes of intangibles with similar characteristics, and others suggested a simplified allocation of the excess of the consideration paid over the fair value of tangible balance sheet items which could be amortised over a specific period.

The feedback received indicates that users generally on focus on the "entirety" of what had been acquired for the price paid, and do not consider the level of detail on individual intangible assets particularly relevant. However, users found that financial statements lacked information on the synergies expected from a business combination and how management expected these to translate into revenue or cost reductions in future years. Users tended to develop their own forecasts on estimates of future performance, and considered having better insight into expected synergies would be extremely helpful. Many users called for information on the rationale used by management to determine which intangible assets should be separately recognised from goodwill. Generally speaking users appreciate information that would allow them to differentiate "core" intangible assets acquired from other intangibles considered less relevant for their analysis.

Subsequent accounting for goodwill

Most preparers stated that the impairment test is an area of great difficulty involving significant judgement, which has resulted in significant costs.

Overall, preparers had mixed views on the most appropriate accounting treatment for subsequent accounting for goodwill. Whilst many preparers did not dispute the conceptual basis and potential relevance of an "impairment-only" model, many argued that there are a number of significant practical issues that outweigh the conceptual merits and intended benefits. Many preparers (including some of those that supported the conceptual merits of the impairment-only model), indicated that requiring/allowing amortisation of goodwill would reduce the emphasis on the impairment test and significantly ease the practical burden and the level of costs incurred by preparers in this regard. .

Users also expressed mixed views on the non-amortisation of goodwill – some users supported the current impairment model and others preferred an amortisation model (or a combination of both). However, users that supported an impairment model asked for additional information about the basis for determining the annual impairment tests.

The reasons given by preparers and users in support of a preferred model were generally consistent. Those that supported a mandatory impairment model argued that it helped review the performance of a business combination and assess changes in the initial assumptions made. Those against, noted various reasons why the information derived from the impairment model was not useful. For example, the model created irregular volatility in the profit or loss, resulted in "double dips" in profit or loss, goodwill consisted mainly of synergies which were often difficult to demonstrate in subsequent periods and were likely to be consumed over time and replaced with internally generated goodwill. Both preparers and users noted there was also a high degree of subjectively involved which cast doubt on whether the information was reliable. Some users questioned whether impairment charges were being recognised on a timely basis.

Measurement of contingent consideration

Several preparers expressed concern about the measurement of contingent consideration particularly when it was based on technical accomplishments or future business achievements (especially for early stage or transactions with multiple targets). It was challenging to fair value these future contingent payments at the acquisition date based on the probability of success of each milestone.

Some preparers noted that when contingent consideration liabilities are directly linked to a particular (new) intangible asset acquired (for example an in-process research project), the values of the liability and related intangible asset respond equally to the related changes in the development of the project. These preparers suggest that changes in fair value of the liability could be recognised as an adjustment to the related intangible asset, instead of in profit or loss, to avoid potential "accounting mismatches".

Most users thought that contingent consideration should be part of acquisition price for the business combination and therefore added to the investment value. . These users did not think that gains and losses resulting from future price adjustments were part of the performance of a company. Users generally indicated that it was important to understand the factors that led to "postponed" consideration payments, and less concerned "where in the accounts" the adjustments were recognised as they would exclude them from the performance statement. The structure of consideration package, including contingent consideration, and its effects on the company's debt structure, was considered by some users as vital information.

Step acquisitions and loss of control

Several of the preparers with experiences in step acquisitions and loss of control transactions disagreed with the remeasurement of previously held/retained interest and reflecting that remeasurement in profit or loss. Such gains and losses were considered to be "hypothetical" as there was no cash flow and they the transactions did not affect the previously held/retained interest.

Users generally did not have strong views on this matter, although most users considered ”remeasurement” gains or losses of previously held/retained interest as non-recurring items that were not part of the performance of the company.

If you would like to discuss our comments further, please do not hesitate to contact Isabel Batista or me.

Yours sincerely,

Françoise Flores

EFRAG Chairman

EFRAG
European Financial Reporting Advisory Group

APPENDIX 1

FEEDBACK STATEMENT

Preparer Outreach Activities

POST-IMPLEMENTATION REVIEW

IFRS 3 – *BUSINESS COMBINATIONS*

This feedback statement has been prepared for the convenience of European constituents by the EFRAG secretariat and has not been subject to review or discussion by the EFRAG Technical Expert Group.

Table of contents

Introduction

In January 2014, the International Accounting Standards Board (IASB) published the Request for Information on its Post-implementation Review (PiR) of IFRS 3 *Business Combinations* and requested comments by 30 May 2014.

IFRS 3 was developed within the IASB's Business Combinations project. Consequently the scope of the PiR includes consequential changes made to IAS 36 *Impairment of Assets* and IAS 27 (2008) *Consolidated and Separate Financial Statements* (replaced by IFRS 10 *Consolidated Financial Statements* in 2010) which were published at the same time as IFRS 3 in 2008. The package of Standards under review is also collectively referred to in this document as "the Standards".

The objective of the PiR is to understand whether the Standards being reviewed are working as intended and to evaluate their implementation and effects in relation to costs and benefits. It also provides an opportunity for preparers, users and other stakeholders to put forward suggestions on how the Standards under review can be improved.

In May 2013, The Financial Accounting Foundation (FAF) published its post implementation review of the US Standard on business combinations. The Business Combination project was, in principle, undertaken together with the Financial Accounting Standards Board (FASB) when the FASB developed Statement 141R. IFRS 3 and Statement 141R contain similar principles; however some significant differences still remain that largely arise because of the interaction of the two Standards with other Standards in both sets of GAAP that have not yet been converged.

Other information on this project is available on the EFRAG website.

Objective of this Feedback Statement

This document summarises the feedback received from European preparers and other constituents through questionnaires received and discussions held with preparers. It also includes feedback gathered at outreach events organised by European National Standard Setters (NSS) on the PiR of IFRS 3 in which EFRAG staff participated.

Feedback reported is based on information received as at 30 May 2014. This report accompanies EFRAG's response to the IASB's Request for Information.

Outreach activities

Objective and methodology

The outreach work focused on preparers of financial statements and was carried out by EFRAG jointly with NSS from France (ANC), Germany (ASCG), Italy (OIC) and the United Kingdom (FRC) in coordination with the IASB staff. NSS from other European countries also assisted in the work by calling on companies in their jurisdictions to participate in the outreach work.

Consistent with the objective of the PiR, the outreach work aimed at obtaining evidence about whether the Standards were implemented on a consistent basis and to understand the challenges and any unintended consequences arising from their introduction and implementation. The feedback received from the outreach activities assisted EFRAG, and its partners, to develop a response to the IASB's Request for Information on the PiR of IFRS 3.

Feedback was gathered through a questionnaire that was largely based on the questions included in the IASB's Request for Information. Many preparers responded to the questions on the benefits of the Standards. This report includes this feedback. EFRAG staff also held telephone meetings with some respondents to gather additional insights on the issues reported. The questionnaire covered the following issues:

- Definition of a business
- Fair value measurement
- Separate recognition of intangible assets from goodwill and the accounting for negative goodwill
- Non-amortisation of goodwill and indefinite-life Intangible assets
- Non-controlling interests
- Step acquisitions and loss of control
- Disclosures
- Other matters
- Effects

EFRAG staff also participated in four outreach events on the PiR of IFRS 3 organised by the FRC jointly with the ICAEW in London, the ANC in Paris, and the OIC in Milan and Rome during March, April and May 2014. The feedback received at these events has been included in this report in a consolidated matter.

Level of participation in the questionnaires

EFRAG staff received 31 responses from preparers (respondents) which included three European preparer/accountant associations. Almost all preparer respondents are listed companies (or part of) European listed groups. The table below presents the number of respondents by country and by industry[1]:

[1] This table excludes preparers and other constituents that participated in the outreach events conducted by European NSS in London, Paris, Milan and Rome.

Respondents by country:

Austria	2
European	2
Finland	1
France	1
Germany	4
Italy	8
Luxembourg	1
Poland	5
Spain	4
Sweden	1
Switzerland	2
	31

Respondents by industry:

Auditors	1
Automobile	1
Banking and insurance	5
Chemicals	1
Construction & Materials	1
Electric Utilities	3
Food & beverage	1
Industrial goods & services	2
Mining	1
Oil & gas	3
Pharmaceutical	3
Preparer organisations	3
Technology	2
Telecommunication	3
Transport	1
	31

Executive Summary

While many preparers indicated support for the overall acquisition accounting model in IFRS, most expressed significant concerns relating to the level of effort required and costs incurred to meet its requirements, and questioned whether IFRS 3 and related Standards have worked as intended in respect to all the issues that they set out to address. An important conclusion from the outreach work is that various preparers question whether the increase in costs, considered by some to be very significant, has been compensated by benefits to users, particularly given the level of complexity and high level of judgement required to meet some of the requirements.

The main comments made by respondents can be summarised as follows:

(a) **The definition of a business**

Respondents generally agree there are benefits of having a separate accounting treatment for business combinations and asset acquisitions because such transactions are conceptually and economically different.

Many respondents expressed concerns with the definition of a business, and noted that the assessment of whether a business exists or not is a significant practical difficulty. Respondents generally noted that the definition in IFRS 3 is too broad and lacks guidance on what should not be considered a business. This has resulted in a number of acquisitions being treated as business combinations, when, in the view of the preparers, they should have been treated as “asset acquisitions”. The broadening of the definition of a business resulted when IFRS 3 (revised 2008) added the notion of “capable of being conducted” as a business. In practice many acquisitions are “capable” of being a business, and this raises a question about whether such a “wide application” was the intention of IFRS 3. Specific challenges were noted in respect to acquisitions of “single asset” entities and acquisitions/disposals of “service and outsourcing agreements”. In addition, some respondents noted that the lack of guidance in IFRS 3 on the “inputs, processes and outputs” has resulted in diversity in the way some companies interpret the definition.

Overall, the tension between an asset and a business stems from the different accounting requirements in IFRS for acquisition of assets and acquisitions of businesses.

(b) **Fair value measurement**

More than half of respondents agree that the fair value measurement in a business combination provides useful information.

However, many respondents (including those that support fair value measurement) noted significant challenges in determining the fair value of certain assets and liabilities. With respect to assets acquired, the main concerns relate to fair value measurement of intangible assets, in particular, intangibles not recognised in the financial statements of the acquiree, non-contractual intangibles, intangibles for which there is no active market and intangible assets in the “early stage” of development such R&D intangibles. Determining the fair value of such intangibles requires the use of complex valuation models using assumptions and estimates that require a significant level of judgement. This may result in the models providing inconsistent and in some cases unreliable measurements.

Some respondents questioned the relevance of measuring certain intangible assets (such as brands) at fair value at the acquisition date if the acquirer does not intend to use it in the way same as “a market participant”, and believe that expected value in use (others said “entity value”) to be a more relevant basis for measuring such assets.

Reliability concerns were also expressed with regard to the measurement of loans and receivables in the banking industry, pre-existing relationships, and measurement of previously held and retained interest in step acquisition and loss of control transactions. Some respondents noted that future restructuring costs to be undertaken by an acquirer should be part of the fair value measurement on the date of the acquisition. Fair value of consideration in an equity-share transaction was also an area of difficulty.

Respondents noted that the valuations on fair value measurement are often performed by external valuators which can be a very costly process.

(c) **Separate recognition of intangible assets from goodwill**

A majority of respondents agree that recognising intangible assets at fair value separately from goodwill provides useful information, especially when it provides users with a better understanding of what has been paid for through the acquisition price.

However, many of these respondents expressed significant concerns with separately identifying specific intangible assets from goodwill.

Overall, respondents considered the process of separately recognising intangible assets to be highly complex, subjective and costly. Some viewed the purchase price allocation to identifiable intangible assets as a pure accounting exercise while the parties involved in the transaction might not have considered these assets when assessing the transaction (and agreeing the price). Similar to fair value measurement, the main concerns relate to intangibles not recognised in the financial statements of the acquiree, non-contractual intangibles, intangibles for which there is no active market and intangible assets in the “early stage” of development such R&D intangibles.

Suggestions made by respondents broadly fell in two categories:

- Some respondents suggested a less “granular” approach to separation of intangibles (for example a cluster-based approach based on classes of intangibles with similar amortisation periods).

- Others suggested a simplified allocation of the excess of the consideration paid over the fair value of tangible balance sheet items which could be amortised over a specific period.

(d) **Subsequent accounting for goodwill (impairment model)**

Some respondents supported an impairment-only model, others supported amortisation and a third category supported a combination of both (mandatory amortisation combined with impairment).

Most respondents noted the impairment test to be an area of great difficulty involving significant judgement, which has resulted in significant costs to preparers. Whilst many of these respondents do not dispute the conceptual basis of the impairment model in IAS 36 and the potential relevance of an "impairment-only" model, they argue that there are a number of practical issues that outweigh the conceptual merits and intended benefits. Requiring/allowing amortisation of goodwill would reduce the emphasis on the impairment test and ease the burden for preparers.

(e) **Contingent consideration**

Several respondents believe that adjustments to contingent consideration should be included either in goodwill or in the value of specific assets acquired.

Other areas of concern expressed can be summarised as follows:

(f) **Non-controlling interest (NCI)** – Respondents generally found the information on NCI useful. However, there were mixed views on having two different measurement options for NCI; some supported having an option and others would prefer a single measurement option. Most respondents (that responded to this question) measure NCI using "proportionate interest" mainly because of the difficulty in determining the fair value of NCI.

(g) **Negative goodwill (bargain purchases)** – Respondents (that responded to this question - more than half) had split views on the required accounting treatment. While some agree that bargain purchases should be accounted for in profit or loss, others believe that it should not always be the case. When negative goodwill results mainly from anticipated future losses (such as restructuring costs the acquirer expects to incur), the immediate recognition of negative goodwill as a gain in profit or loss is counter-intuitive and leads to a periodic mismatch when the future losses are recognised.

(h) **Step acquisitions and loss of control** – Some respondents did not believe that the remeasurement of the previously held/retained interest in the acquiree provides useful information. Specific concerns and practical difficulties noted by respondents include the following:

(i) absence of a market price for previously held/retained interest;

(ii) it was counter-intuitive to realise gains or losses before the investment is sold or impaired; and

(iii) structuring opportunities because of the different accounting between gain/loss of control (accounted for in profit or loss) and acquisition/disposal of interest whilst retaining control (accounted for in equity).

(i) **Disclosures** – Respondents stated that the currently required disclosures in IFRS 3 should not be increased, with some noting that they are already excessive and do not always provide useful information. Information should be condensed to focus on more relevant items.

Detailed findings

[Question 1 related to background information of respondents]

Question 2 - Definition of a business

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

Respondents agree there are benefits of different accounting treatment for business combinations and asset acquisitions

Many respondents agree there are benefits of having a separate accounting treatment for business combinations and asset acquisitions.

A few other respondents questioned whether the different treatment for acquisition of assets and businesses is justified. Some said that the different treatment is conceptually justified with respect to goodwill, but question the other differences in accounting treatment such as deferred tax, contingent consideration and transaction costs.

The following were the main reasons why the accounting for an asset and a business should be different:

There are conceptual and economic differences between the two types of transactions, and also because of the more simplified accounting for asset acquisitions compared to business combinations

- There is a conceptual difference between business combinations and asset acquisitions. Business combinations require the separation of goodwill and other intangible assets acquired in order to assist users gain a better understanding of the transaction and what was acquired for the price paid. Also, business combinations are subject to a number of specific disclosures to help users understand the nature and financial effect of such transactions.

- The objectives of undertaking a business combination and an asset acquisition are different. For “asset deals”, the focus is on the “assets” acquired, so what mattered was the fair value of the underlying asset or group of assets. For example, in some cases a “business” is acquired through a legal entity primary for its assets or a strategic asset – for example intangible assets (R&D, licences, patents and service contracts) or assets (investment property).

- A number of respondents noted that the accounting for business combinations is far more complex compared to acquisition of assets, given the significant differences in accounting treatments which often involved application of "level 2" and "level 3" measurement bases under IFRS 13 *Fair Value Measurement*. [Also see response to (b) below].

(b) What are the main practical implementation, challenges you face when assessing a transaction to determine whether it is a business? For the practical implementation challenges that you have indicated, what are the main considerations that you take into account in your assessment?

Many respondents expressed practical difficulty when assessing whether a transaction is a business combination or an asset acquisition. The level of difficulty, and sometimes the reasons varied; although the main areas of difficulty were the following:

The definition of a business was noted as a significant area of practical difficulty for respondents from various industries

- definition of a business is too broad;
- lack of guidance on the elements of a business; and
- significant differences in the accounting treatment for acquisition of assets and businesses.

Respondents from various industries (real estate, financial services, extractive, pharmaceutical industries and, telecommunications) identified the assessment of whether a business exists to be a significant practical challenge.

Some other respondents did not encounter particular challenges in the assessment. These respondents generally said that most of their acquisitions represented businesses. For example, one respondent (airline industry) noted that the investments made were clearly separable into acquisitions of single assets (capital expenditures in the course of operating activities, i.e. expansion investments) and investments into identifiable businesses (e.g. acquisition of market share, new businesses, etc.).

The definition of a business is too broad

Definition of a business is too broad. Adding the notion of "capable of being conducted" as a business has broadened the definition of transactions that are considered a business under IFRS 3

Some respondents believe that the root cause of the problem is that the definition of a business is too broad. IFRS 3 (2008) compared to IFRS 3 (2004) has broadened the definition of transactions that are considered a business by adding the notion of "capable of being conducted" as a business. Some of these respondents noted that most acquisitions are "capable" of being a business; however there was a question about whether that was the objective of IFRS 3, particularly when what was being acquired was an "asset or a collection of assets". Respondents provided the following examples of practical implementation difficulty:

- Respondents from the pharmaceutical industry provided examples of "single asset" entity acquisitions, in which a single asset is placed into a legal entity (often for tax reasons of the vendor) and sold/acquired in that way. Following the definition of IFRS 3, these 'asset acquisitions' are sometimes treated as business combinations" instead of an acquisition of an asset. Similar "single-asset" structures were reported by other respondents (real-estate industry) where investment properties are often (in some countries almost always) sold in separate companies as "corporate wrappers".

Clarity is needed in cases when an asset deal is not an acquisition of a business but rather a service contract or a licensing agreement

- A respondent from the telecommunications industry indicated that there were cases when an asset deal is not considered to be a "real" acquisition of a business (from the perspective of the buyer) but rather a service contract to provide outsourcing services to clients. This respondent said it was necessary to differentiate between "asset deals" and "share deals" in order to make it clear that there are instances when an asset deal is not an acquisition of a business but rather a service contract or a licensing agreement.

- One respondent provided an example of an outsourcing agreement through the sale of labour contracts to a newly formed entity, which is controlled by a third party. The question was whether there was a sale of a business rather a servicing contract.

Lack of guidance on 'inputs', 'process' and 'outputs'

More than half of respondents believe that IFRS 3 lacks application guidance and practical examples on the application of the definition.

These respondents recommend the IASB to provide further clarification on the essential characteristics within the definition of a business. Some respondents highlighted that the main challenges in applying the guidance in IFRS 3 is the distinction between input and process and the assessment of the relevance of processes acquired:

- Respondents from the real estate industry mentioned practical difficulties in determining whether the processes acquired, which are often of an administrative nature, represent processes necessary to the production of outputs or merely serve to safeguard and manage the real estate properties.

Clarify that the acquirer must have the control over the process for the integrated set of activity to qualify as a process

- Respondents from the pharmaceutical and extractive industries noted that it was not clear what makes up a “process” and what an “output” could represent. In the pharmaceutical industry, an early stage of development R&D asset may not have a commercial output for many years (if at all). Entities tend to define the output giving rise to a business based on their business model, which is then determinative of the required processes. Some respondents noted that an acquirer should have *control over the process* for the integrated set of activity to qualify as a process. The definition of a “process” should indicate that any system, standard, protocol, etc., should be controlled by the acquirer as a result of the acquisition and therefore have ability to create outputs.

A key issue is often establishing at what point a research or an exploration project becomes a business

- One respondent provided an example of an acquisition of a pharmaceutical product for which regulatory approval had already been granted. In some cases this could be treated as a business combination by one entity that has an established production capability, but as an asset acquisition by another entity (that must either establish its own production capacity or commence the process for third party production of the product). A key issue is often establishing at what point a research or an exploration project becomes a business.

Significant differences in accounting treatments

The significant differences in the accounting for business combinations and asset acquisitions is a key issue

The significant differences in the accounting for business combinations and asset acquisitions were noted by various respondents to be a key issue. This caused distorting differences in accounting for deferred taxation, contingent consideration and transaction costs, and left scope for extensive debate and potential accounting arbitrage when structuring a transaction.

Question 3 - Fair value measurement

(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?

More than half of respondents agreed that information about the fair value measurements is relevant and sufficient

More than half of respondents agreed that the information produced by IFRS 3 is relevant.

- However, some respondents noted a concern about assumptions used in fair value models as such information was considered "sensitive". Although users might find such information useful, preparers were reluctant to disclose strategic matters and commercially sensitive information. Other respondents supported providing information about the assumptions and/or the measurement techniques used to determine fair values.

- Various respondents noted that information of the carrying amount of the assets and liabilities acquired in the business combination would increase the usefulness of the information. This disclosure is currently not required by IFRS 3.

The other half of respondents considered that information derived from fair value measurement was too subjective to lead to useful information. Some respondents stated that the fair value measurement required by IFRS 13 was seen as a "hypothetical" accounting exercise and did not reflect the nature of the acquired business for the acquiring entity.

The significant valuation challenges are discussed in the response to (b) below.

(b) What have been the most significant valuation challenges in measuring fair value within the context of business combination accounting?

Fair value measurement represents a challenging exercise for some intangibles assets

A majority of respondents expressed significant challenges in determining the fair value of certain assets and liabilities.

[For more detail on the types of assets and liabilities see response to (c) below].

The most significant valuation challenges reported were:

Valuation methods

The application of different valuation techniques and the high level of judgement and assumptions made by management increase the subjectivity of the fair value measurements

The application of complex (and different) valuation methods and the determination of the respective inputs require a high level of judgement that reduced the objectivity of the valuations. One respondent said that in theory, only one fair value exists for each identified asset. However, in practice, judgement regarding valuation parameters and complex valuation models will lead to different fair values. Consistency in the application of valuation models (and standardised models) could also affect comparability of information.

Given the level of complexity and judgement involved in the measurement of some of the assets and liabilities acquired, these respondents did not think the fair values always represented reliable measurements.

In relation to specific assets, some respondents noted that the lack of good benchmarks and data added complexity and subjectivity to the process. Practical examples and guidance on the type of valuation model to be used would be helpful to value certain assets and liabilities (customer-related intangibles, i.e. customer lists), as there was insufficient guidance in IFRS 13.

Many respondents noted that the required valuations are often performed by external valuators which can be a very costly process.

Fair value is a hypothetical number

Some respondents had concerns with the "hypothetical" market participant approach of fair value as define in IFRS 13

Some respondents considered the fair value exercise of acquired asset and assumed liabilities to be a hypothetical exercise unrelated to the economic rationale of the negotiation.

Some other respondents questioned the relevance of measuring certain intangible assets (such as brands) at fair value at the acquisition date if the acquirer does not intend to use it in the same way as "a market participant". These respondents suggested a measurement based on expected value in use to be a more relevant basis in such cases. Overall, these respondents support a more entity-based perspective to measure acquired assets and assumed in a business combination, rather than a "hypothetical" market participant approach under IFRS 13 i.e. what other companies would be willing to pay for each item leading to recognised values that sometimes are quite different from the value for the acquirer.

Level of resources and costs incurred

Undertaking valuations to meet the requirements in IFRS 3 has proved to be a costly process

A majority of respondents noted that fair value measurement requires considerable resources. Often companies do not have sufficient in-house expertise to perform some of the purchase price allocation. The use of external resources can be extremely costly and respondents raised the question of a cost-benefit balance when complying with IFRS 3.

Other matters

Non-recognition of future restructuring provisions was a concern

Some respondents noted that future restructuring costs planned to be undertaken by an acquirer should be part of the fair value measurement on the date of the acquisition. Those liabilities were usually considered when negotiating the consideration transferred and therefore should not be treated as a post-acquisition cost.

The mixed recognition and measurement model in IFRS was highlighted as a concern

Some respondents stated that the fair value measurement of assets and liabilities creates difficulties when such measurement is inconsistent with other Standards. In particular, some respondents mentioned that, in a business combination, contingent liabilities were required to be recognised and measured at fair value according to IFRS 13 but would not meet the recognition criteria of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* in the normal course of operation.

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

A majority of respondents expressed significant challenges in determining the fair value of certain assets and liabilities.

Measurement of intangible assets without active markets (i.e. customer relationships, patents, brand names, research and development and oil and gas assets), subsequent measurement of contingent consideration and accounting for restructuring costs have been identified as the main challenges

Examples of the most significant valuation challenges included the following:

- intangible assets;
- contingent consideration (refer to response to Question 9);
- measurement of loans and receivable portfolios (banking industry);
- pre-existing contractual relationships; and
- measurement of own shares when part of the consideration paid (equity shares).

Other comments included the following:

- avoidance of double counts on initial recognition was identified as a main challenge by some respondents;
- some respondents questioned the recognition of inventory at fair value because a major part of the gross profit was added to the inventory values and led to lower future margins.

Intangible assets

Many respondents expressed significant valuation challenges in measuring fair value of certain intangible assets particularly:

- non-contractual intangibles (such as customer lists, customer relationships);
- intangible assets for which no active market (or observable market) exists (customer-related intangibles, marketing-related intangibles such as brands, trademarks and internet domains, technology-based intangibles software- and contract-based intangibles relating to licenses and concession rights); and
- intangible assets in their "early-stage" of development (such as R&D and assets in the mining industry).

Determining the fair value of such intangibles requires the use of complex valuation models based on assumptions and estimates that require a significant level of judgement.

For example, one respondent from the pharmaceutical industry noted that fair value of R&D intangible assets is highly judgemental and based mainly on level 3 inputs under IFRS 13. Due to the early stage of development of most R&D intangibles, and the highly specialised nature of these, it is challenging to obtain market participant inputs.

Given the level of complexity and judgement involved in the measurement of these intangibles, these respondents did not think that the fair values always produced reliable measurements.

Measurement of expected losses on loans and receivables

Some respondents from the banking industry reported a concern regarding the measurement at fair value of loan (and receivables') portfolios. The issue arises given the lack of an active market for these types of assets. Some of specific issues mentioned were:

- determining the credit risk of the borrower;
- determining the appropriate interest rate to use in the fair value calculation; and

- impairment Standard not yet available (with respect to expected credit losses to be recognised).

One respondent suggested a more aggregated level of separation (at portfolio level of assets) to resolve this concern.

Pre-existing contractual relationships

Some respondents noted that the fair value of pre-existing relationships is a challenging area. These respondents questioned the outcome of the accounting treatment when a gain on a pre-existing relationship is recognised when an acquirer had a pre-existing license agreement with the acquiree. This gives rise to the recognition of unrealised gains where the value of the asset previously held is derecognised and the asset re-recognised at fair value at the acquisition date). These respondents acknowledged the treatment to be an "anti-abuse" provision.

Measurement of own shares

Some respondents expressed concern with the accounting for consideration transferred paid in shares (often referred to as share-for-share transactions).

The issue relates to potential changes in fair value (of the underlying shares) between the date when the business combination is agreed and announced and the acquisition date under IFRS 3 (date control passes to the acquirer). Using the acquisition date instead of the date the "deal is negotiated" affects significantly the consideration amount and consequently the accounting for goodwill.

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

(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 and, if so, what are they and why?

A majority of respondents considered separate recognition of intangible assets (or some intangible assets) to be useful information. Some of the benefits noted were the following:

Majority of respondents considered the separate recognition of intangible assets to be useful

- increases transparency and the understanding for the acquired business and the reasons for undertaking the acquisition; and

- assists users in understanding the key value drivers of the business combination and establishes specific reference points for assessing the performance of the acquired business.

Other respondents specifically noted that they did not think the information provided by separate recognition of intangible assets was useful. The following comments were made:

- The information was difficult for users to understand, especially when the assets identified were not separable from the business or from other rights and obligations; or when the assets acquired had not been previously recognised by the acquiree in its accounts. In these circumstances, the calculation of fair value was extremely subjective.

- One respondent noted that, on the one hand, separation of intangible assets was used (for the reasons noted above) but, on the other hand, the separation and valuation of acquired intangible assets has to reflect the market view, which does not necessarily represent the motivation of the acquirer regarding the acquired business. If the acquirer is willing to pay for certain synergies, but not for certain intangible assets, this should be reflected in the accounting. Other respondents shared similar views.

One respondent did not have a view as this respondent had not encountered significant intangible assets.

(b) What are the main implementation challenges in the separate recognition of intangible assets from goodwill? What do you think are the main causes of those challenges?

A majority of respondents expressed significant practical implementation challenges regarding the "granular" level of identification and separation of intangible assets.

The high level of subjectivity, the difficulty in obtaining accruable and timely data as well as the complexity of the valuation methods were pointed out as the main implementation challenges

The practical implementation difficulty related to the same intangible assets discussed in the response to Questions 3 (b) and 3 (c). These respondents generally noted that separate recognition was highly complex and required a high of judgement.

As explained in the response to Question 3 (b), the valuation process was also a very costly process due to the requirement of using external consultants in the process.

Highly complex and requires high level of judgement

Many respondents stated that the process relied highly on judgement along with a lack of reliable benchmarks and accurate data. Judgement based on various versions of the income approach (relief from royalty, avoided cost approach, cost profits method, etc.). As mentioned in the response to Question 3, the lack of active markets for some intangibles and lack of similar transactions to benchmark against was also raised by many respondents when determining fair value for these intangibles.

Others pointed out the difficulty in receiving accruable and timely data to be used in the discounted cash flow models for determining the fair values of acquired assets and liabilities. In addition, they mentioned the complexity of valuation models and uncertainty about which models to use for which intangible assets.

In the banking industry, it is difficult to identify which are the intangible assets to be recognised (for example whether they relate to customers or to products).

Regulatory requirements

Some respondents (banking industry) noted an inconsistency between the accounting treatment for goodwill under IFRS 3 and for regulatory purposes (Basel III), given that intangible assets were subtracted directly from regulatory capital.

Respondents from the banking industry noted an inconsistency between the accounting treatment for goodwill under IFRS 3 and for regulatory purposes (Basel III)

In addition, some noted that there might be another inconsistency in terms of tax effects. If companies impaired the full amount of goodwill they would only impact 70% their regulatory capital due to the fact that a deferred tax asset would be recognised for deductible goodwill (in some jurisdictions).

Suggestions put forward

The following two broad suggestions were made by respondents:

- some respondents propose less "granular" separation of intangibles and proposed a cluster-based approach based on classes of intangibles with similar amortisation periods based on the company's business strategy; and

Some respondents propose less "granular" separation of intangibles

- a few respondents suggested a simplified allocation of the excess of the consideration paid over the fair value of tangible balance sheet items which could be amortised over a specific period.

(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?*

Respondents had split views on whether bargain purchase gains should be recognised in profit or loss

Respondents that responded to this question (more than half) had split views on the required accounting treatment. While some agree that gains arising from bargain purchases should be accounted for in profit or loss, others believe that it should not always be the case.

Some respondents believe that the recognition of negative goodwill could indicate the presence of structural problems in the acquiree that could result in a future liability for restructuring costs. This liability should be recognised at the acquisition date. In cases where negative goodwill results mainly from anticipated future losses, the immediate recognition of negative goodwill as a gain in profit or loss leads to a periodic mismatch when the future loses are recognised, which is often difficult to explain to users.

Another respondent noted that a “gain” generated by the fair valuation of items such as intangible assets (which are inherently judgemental) should not be recognised on the date of the acquisition. There is a risk that the company could recognise a “bargain purchase” at the acquisition-date based on judgemental values and in future years recognise an impairment loss if the “fair value” estimated was not correct.

Some respondents considered that as negative goodwill only happens in rare occasions the recognition through other comprehensive income (OCI) could be justified.

A few respondents considered that negative goodwill should be recognised as a decrease in the value of assets and not as a gain in profit or loss and that the treatment granted to bargain purchases was difficult for users to understand.

One respondent thought that disclosures about the underlying reasons that give rise to negative goodwill would be useful as they increase transparency and the understanding for the acquired business.

Question 5 - Non-amortisation of goodwill and indefinite-life intangible assets

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

Some respondents supported an impairment-only model, for goodwill and indefinite–life intangibles; others supported

Some respondents supported an impairment-only model, for goodwill and indefinite–life intangibles, others supported amortisation and a third category supported a combination of both (mandatory amortisation combined with impairment)

amortisation and a third category supported a combination of both (mandatory amortisation combined with impairment).

Just under half of respondents supported the existing impairment model. The main reasons included:

- it was useful to understand the dynamics of value of a business combination and helped review the performance of the value drivers in the business and assessing changes in business assumptions considered when the business combination took place;

Supporters of the actual model argued that impairment test allows a proper review of the performance of the value drivers in the business and of the changes in business assumption considered in an initial stage of the business combination

- it provided a better understanding of the economic results over time, compared to an amortisation model; and

- given the special nature of goodwill, information reported through an impairment test is more relevant than the one provided through systematic amortisation of goodwill. Amortising the goodwill on a regular basis did not permit a fair representation of the business trend.

Just over half of respondents believe that the IASB should reconsider the amortisation model for goodwill (also see response to (c) below).

- the impairment model was pro-cyclical and conceptually flawed; and

- the information derived from an impairment test was not useful;

Some respondents did not comment on this question or did not indicate a preferred view.

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

Some respondents did not identify any relevant improvement.

Others did not answer this question.

Suggestions for improvement are discussed in (c) below.

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

A majority of respondents indicated practical implementation challenges in impairment testing goodwill or intangible assets with indefinite useful lives.

Impairment test has been identified as a complex, subjective and costly process

Some respondents noted that the impairment test is one of the most complex processes within an organisation requiring a lot of resources, time and a stringent set of internal controls.

The main concerns noted were:

- Challenging and judgemental exercise - these respondents cited various challenges in performing an impairment test. It created irregular volatility in the profit or loss, and resulted in "double dips" in profit or loss. Some of the practical complexities included:

  (i) determining the WACC;

  (ii) assessing the appropriate growth rate to include in the discounted cash flow model; and

  (iii) allocation of corporate assets in cash-generating units (CGU).

Some respondents argued that due to the complexity, irregular volatility in profit and loss, "double-dip" effects and the inherent assumption of "never-ending" synergies amortisation model should be revisited

- Goodwill is difficult to track - some respondents noted that goodwill consisted mainly of synergies which were often difficult to demonstrate in subsequent periods. In many cases, synergies moved to different parts of the group, through reorganisations, and it was hard to "track" the goodwill.

- Internally generated goodwill - some respondents questioned whether IAS 36 always provided an appropriate surrogate for amortisation. For example, whether it was reasonable for assets to be carried on the balance sheet for a very long period of time with no or marginal impairment charges during that period. These respondents thought that the main reason these assets do not require impairment is that externally acquired goodwill become internally generated over time, so that the asset that then "passes" the impairment test is no longer the one initially recognised.

- An accounting exercise - some noted that the testing of goodwill and intangible assets with indefinite useful lives for impairment (annually or triggered) is a mere accounting exercise, but is not used by management or other users of financial statements for assessing the performance of a CGU/ business. The impairment-only approach has various weaknesses of which one is the room for judgement when determining the fair value or value in use of a CGU. Overall, this respondent believes that the impairment-only approach does not properly reflect the consumption of goodwill over its useful life. Other respondents had similar views.

- Internal processes: some respondents expressed concerns regarding the requirements included in IAS 36 when entities carry out the impairment test because IFRS 3 does not fit the internal planning and control processes of entities involved in business combinations. The concerns raised were the requirement to use pre-tax discount rates (when for management purposes post-tax rates are used) and disregarding planned restructuring.

These respondents noted that given the above significant concerns, the IASB should reconsider the annual impairment test requirement. Some of the main suggestions include:

- allow/require amortisation of goodwill to reduce the emphasis on goodwill impairment and the pro-cyclically it causes;
- reconsider which intangible assets could be recognised within goodwill;
- post-tax discounts rates should be used as this was in line with the way management assessed impairment; and
- some respondents mentioned that disclosure of real impairment test drivers and key information should be required by IAS 36. In addition, they mentioned that information on cash flows should be more analytical. However, the same number of respondents mentioned that disclosure requirements should be reduced as the information reported was not useful for users.

Question 6 – Non-controlling interests (NCI)

(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?

NCI information was useful and reflects claims on consolidated equity not attributable to the parent

A majority of respondents noted that the information resulting from the presentation and measurement for NCI was useful and reflects claims on consolidated equity not attributable to the parent.

Most of the respondents considered "proportionate interest" of NCI as the option that better reflects "reality of the business"

Most of the respondents that provided a view on the measurement option in IFRS 3 for NCI measure NCI using the "proportionate interest" method. Two main reasons were:

- the entity has not acquired the goodwill attributable to the NCI, and therefore it should not be recognised; and
- difficulty in measuring NCI at fair value.

Only a few respondents supported measurement of NCI at fair value. These respondents noted that the acquirer is a unique economic entity and therefore the goodwill should be accounted for in relation to the whole entity.

(b) What are the main challenges in the accounting for NCIs? Please specify the measurement option under which those challenges arise.

Around half of respondents responded to this question.

Some of these respondents supported having an option and others indicate a preference for a single measurement option

Some of these respondents supported having an option and others indicate a preference for a single measurement option.

The main challenges noted in the accounting for NCI relate to measurement of NCI. The acquisition of a majority shareholding includes a "control premium" that should not be considered in the value of the NCI.

Respondents identified lack of guidance on the impairment test on goodwill when NCI are measure at fair value

Some respondents also noted a concern with valuation and impairment in relation to NCI given the lack of guidance on how to develop the impairment test on goodwill if the "full goodwill" method is applied. There was also a lack of guidance on how to treat the control premium and whether adjustments to the measurement of NCI were needed.

Question 7 - Step acquisitions and loss of control

(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.

(b) How useful do you find the information resulting from 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.

Views over the usefulness information resulting from the step acquisition guidance were split. Some found it useful because it sets guidance for all

Around half of respondents replied to this question.

Some respondents considered the information resulting from the step acquisition guidance in IFRS 3 to be useful because it *entities and removed unnecessary complexity*

provides guidance for all entities and removed the unnecessary complexity included in IFRS 3 (2004).

A majority of these respondents disagreed with the accounting treatment for step acquisitions and loss of control under IFRS 3/IFRS10.

The main concerns expressed were as follows:

- Results in the recognition of hypothetical gains and losses that do not reflect the effects of the transactions, as there is no payment made or received (no effect on cash flows).

Others respondents considered that step up process creates artificial values that increases the value of the intangibles and was not part of the performance of the business

- There is no economic reason for having a different goodwill number in a step-acquisition and an acquisition realised in a single transaction.
- Absence of a market price for previously held/retained interest. Some respondents stated that adjusting previously held interests in the acquiree generates artificial values as acquiring control implies a premium which was reflected in the price paid.
- Others noted that it was counter-intuitive to realise gains or losses before the investment is sold or impaired, and such accounting was difficult to explain to users.
- A few respondents mentioned that step-up of previously held interest increases goodwill or intangibles, without adding significant information to the reader.

(c) Have you encountered any operational (practical) difficulty in remeasuring any previously held equity interest at acquisition-date fair value?

(d) Have you encountered any operational (practical) difficulty in remeasuring any retained equity interest at fair value upon loss of control in a former subsidiary?

Measurement of the "control premium" incorporated in the business combination and complexity of valuation techniques were identified as major challenges

About one third of respondents responded to these two questions. About half of these respondents did not report operational difficulties.

The other half noted that the main operational challenge was to determine the control premium incorporated in the transaction price in order to determine the NCI value. It was also difficult to determine the fair value of NCI when the shares were not quoted.

Some respondents from the banking sector observed possible unintended consequences of IFRS 3 when accounting for steps acquisitions and loss of control (e.g. in a first step from 100% to 70% and in a second step from 70% to 30%) as they can be made with the only objective of raising regulatory capital. Such "structuring" could arise when multiple steps are used to achieve a desired accounting outcome. The question is whether the multiple steps represent a linked transaction or separate transactions, which lead to different accounting outcomes.

Question 8 – Disclosures

(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?

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

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

The majority of respondents considered current disclosures to be sufficient

A majority of respondents considered the current disclosure requirements to be sufficient and offered useful information.

Some respondents indicating that there was a need to reduce disclosures, rather than increase them.

The main challenges expressed by respondents were the following:

- difficulties when confidentiality clauses are included in business combination agreements. General terms disclosures should not penalise or put companies at a disadvantage; and
- difficulty in providing pro-forma information. Guidance on how to determine pro-forma information was required.

Respondents acknowledge the disclosure of confidential clauses and pro-forma information as the main challenges

Some of the main suggestions by respondents were:

- few respondents noted that there should be a specific requirement to disclose additional information relevant to the bargain purchase;
- if users find information on pro-forma revenue and net income useful, it may be appropriate for the IASB to provide further guidance on the preparation of pro-forma information since current IFRS 3 does not explain, what adjustments, if any, should be made in combining the results of the acquirer and the acquire for the period before the acquisition.

Question 9 – Other matters

Are there other matters that you think the IASB should be aware of as it considers the Post-implementation Review of IFRS 3? The IASB is interested in:

> (a) *understanding how useful the information that is provided by the Standard and the related amendments is, and whether improvements are needed, and why;*
>
> (b) *learning about practical implementation matters, whether from the perspective of applying the Standard and the related amendments; and*
>
> (c) *any learning points for its standard-setting process.*

The other main matters mentioned by respondents, and not included in the other questions, were the following:

Contingent consideration

Various respondents expressed concerns regarding the measurement of contingent consideration paid in a business combination. Difficulties arose particularly when it was based on technical accomplishments or future business achievements (especially for early stage or transactions with multiple targets).

Several respondents expressed concerns regarding the measurement of contingent consideration. It was challenging to fair value these contingent payments at the acquisition date based on the probability of success of each milestone

Respondents from the pharmaceutical industry pointed out that the fair value of contingent consideration (especially those linked to R&D compounds) was highly judgemental and difficult to determine. Some of these respondents noted that acquisition deals have multiple success-based contingent consideration payments based on the research and development period of a drug, being on average 12-20 years to get a preclinical compound. Therefore it was challenging to fair value these contingent payments at the acquisition-date based on the probability of success of each milestone.

In addition, some respondents noted that when contingent consideration liabilities are directly linked to a particular intangible asset acquired (for example a progress research), the values of the liability and related intangible asset respond equally to the related changes in the development of the project. However, the subsequent measurement of the liability is at fair value whereas the intangible asset is subsequently measured at amortised cost, which resulted in an “accounting mismatch”. These respondents noted that this issue could be solved if changes in fair value of the liability could be recognised as an adjustment to the related intangible asset.

Separate transactions

Other respondents found difficulties in determining whether a particular transaction or arrangement was part of what the acquirer and acquiree exchanged in the business combination or was a separate transaction (i.e. when an acquirer obtains control over an indirect subsidiary of the acquiree because the latter has an agreement with a third party that is enforceable due to a change in the subsidiary's ownership). Those respondents argued that guidance in IFRS 3 could be improved to clarify similar issues.

Capitalisation of transaction costs and lack of guidance regarding valuation techniques were other matters raised by respondents

Transaction costs

Some respondents argued that transaction costs involved in a business combination should be included in the cost of the business combination (capitalised).

Lack of guidance

Some respondents stated that IFRS should provide more guidance regarding several topics:

- business combinations under common control;
- the treatment of a customer relationship of the acquiree with the acquirer; and
- provisions for onerous contracts of the acquiree related to the acquirer or trade receivables.

Question 10 - Effects

From your point of view, which areas of IFRS 3 and any consequential amendments to other Standards:

(a) *represent benefits to users of financial statements, preparers, auditors and/or enforcers of financial information, and why;*

The main benefits identified by respondents were:

Price purchase allocation process and separation of intangibles represented the main benefits for respondents

- price purchase allocation represents a major benefit to readers of financial statements and provides a comprehensive understanding of the real substance of acquired assets and liabilities and the meaning of the purchase price;
- the separation of goodwill and some intangible assets provides valuable information on the value drivers and a benchmark;
- some respondents indicated that any benefits would be best addressed by users of financial statements; and

- one respondent noted that a positive effect was the recognition of transaction costs in profit or loss.

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

More than half of respondents stated that fair value measurement, separation of intangible assets and the impairment test process resulted in considerable unexpected cost

More than half of respondents pointed out that the most considerable unexpected costs arose from the fair value measurement, separation of intangible assets and the impairment test.

Costs arose due to the need to use external valuation experts or, if conducted internally, the significant effort required, the management's judgement, uncertainty in inputs and assumptions.

(c) have had an effect on how acquisitions are carried out (for example, an effect on contractual terms)?

Differences in accounting for assets and business combinations and rewording of financial covenants were identified as the main effects

Some of the main effects noted were:

- definition of a business (refer to response to Question 2);
- differences between accounting for the acquisition of a business and a single asset, in particular regarding the accounting for contingent consideration and deferred taxes. In this regard, the difficulty in establishing whether a group of assets constitutes a business combined with the significant differences in accounting between the acquisition of assets as opposed to the acquisition of a business led to deals being structured in a different manner;
- as a result of the changes introduced in IFRS3 (2008), financial covenants calculation had to be reworded to avoid confusion and unexpected doubts on accounting; and
- the absence of amortisation has created a significant incentive to inflate acquisition price in the past years.

APPENDIX A – List of participants

Participant	***Country***	***Industry***
ArcelorMittal S.A.	Luxemburg	Industrial goods & services
A.S.A.	Austria	Electric utility
Auditor	Austria	Auditor
Novartis International AG	Switzerland	Pharmaceutical
SEAG	Sweden	Preparer organisations
KGHM Polska Miedź	Poland	Mining
Repsol, S.A.	Spain	Oil and gas
Kemira Oyj	Finland	Chemicals
Asseco Poland, S.A.	Poland	Technology
Ferrovial, S.A.	Spain	Construction
PZU Group	Poland	Insurance
Polska Grupa Energetyczna	Poland	Electric utility
AmRest	Poland	Food & beverage
Sanofi, S.A.	France	Pharmaceutical
Business Europe	European	Preparer organisations
Telefonica, S.A.	Spain	Telecommunication
Deutsche Telekom AG	Germany	Telecommunication
Anonymous Italian	Italy	Banking
Ferrovie dello Stato Italiane Group	Italy	Transport
Anonymous Italian III	Italy	Oil and gas
Anonymous Italian IV	Italy	Banking
Anonymous Italian V	Italy	Telecommunication
Hoffmann-La Roche AG	Switzerland	Pharmaceutical
Deutsche Lufthansa AG	Germany	Industrial goods & services
Linde Group	Germany	Gases and engineering
Anonymous Italian VI	Italy	Banking
Anonymous Italian VII	Italy	Technology
Enel S.p.A.	Italy	Electric utility
Daimler AG	Germany	Automobile
FEE	European	Preparer organisations
Banc Sabadell, S.A.	Spain	Banking

EFRAG
European Financial Reporting Advisory Group

EFFAS THE EUROPEAN FEDERATION OF FINANCIAL ANALYSTS SOCIETIES

APPENDIX 2

FEEDBACK STATEMENT

POST- IMPLEMENTATION REVIEW OF IFRS 3 *BUSINESS COMBINATIONS*

INTERVIEWS WITH INVESTORS AND ANALYSTS

BASED ON REAL LIFE CASE STUDIES ON BUSINESS COMBINATIONS

MARCH - JUNE 2014

This feedback statement has been prepared for the convenience of European constituents by the EFRAG secretariat and has not been subject to review or discussion by the EFRAG Technical Expert Group.

Introduction

In January 2014, the International Accounting Standards Board (IASB) published a Request for Information on its Post-implementation Review (PiR) of IFRS 3 *Business Combinations* and requested comments by 30 May 2014.

IFRS 3 outlines the accounting for a transaction in which an acquirer obtains control of a business (e.g. an acquisition or merger). Such business combinations are accounted for using the 'acquisition method', which generally requires assets acquired and liabilities assumed to be measured at their acquisition-date fair values.

IFRS 3 was developed within the IASB's *Business Combinations* project. Consequently, the scope of the PiR includes consequential changes made to IAS 36 *Impairment of Assets* and IAS 27 (2008) *Consolidated and Separate Financial Statements* (replaced by IFRS 10 *Consolidated Financial Statements* in 2011). The package of Standards under review is also collectively referred to in this report as “the Standards”.

The objective of the PiR is to understand whether the Standards being reviewed are working as intended and to evaluate their implementation and effects in relation to costs and benefits. It also provides an opportunity for preparers, users and other stakeholders to put forward suggestions on how the Standards can be improved.

1. Objective of this Feedback Statement

This Feedback Statement summarises the feedback received during the outreach activities conducted with users and is based on information received as at 2 June 2014.

It has been prepared for the convenience of European constituents, and is intended to be read together with EFRAG's response to the IASB's Request for Information.

2. Outreach activities

What we did

To respond to the IASB's Request for Information, EFRAG together with EFFAS (European Federation of Financial Analysts Societies) consulted a number of European users of financial statements, namely investors and analysts, in the form of telephone meetings and face-to-face interviews, aimed at obtaining evidence from users on the usefulness of the provisions in IFRS 3, and understand what improvements, if any, are needed.

To direct the discussions and the interview process, EFRAG staff together with members of the EFFAS Financial Accounting Committee selected a number of case studies on business combination transactions (of companies that have undertaken a business combination since 2009) taken from published IFRS financial statements and analysed the disclosures reported by the selected companies[1]. The purpose of our work was to identify examples of good disclosures on business combination accounting, irrelevant disclosures and missing information. The case studies were referred to and discussed in the interviews. In this context, we developed a questionnaire designed to facilitate the data collection effort and this was used as a basis for the structured interviews.

The case studies were also discussed at a user outreach event in Brussels on 1 April 2014, held by EFRAG, the European Federation of Financial Analysts Societies (EFFAS) and the Association Belge des Analystes Financiers (ABAF), in cooperation with the IASB. A separate Feedback Statement with a summary of the input received from this event has already been published on 13 June 2014.

EFRAG staff has also consulted with the EFRAG User Panel and the EFFAS Financial Accounting Committee. The feedback received at these meetings is included in this report in a consolidated matter.

Interviews conducted

We have interviewed **forty users** namely investors (private equity and fund managers) and analysts (equity, financial and credit analysts from the buy-side and the sell-side) from different European countries including Austria (AU), Belgium (BE), Croatia (HR), Denmark (DK), France (FR), Germany (DE), Hungary (HU), Italy (IT), the Netherlands (NL), Norwegian (NO), Portugal (PT), Spain (ES), Sweden (SE) and the United Kingdom (UK). The names of users and their respective organisations have been treated on a confidential basis.

The table below presents the number of respondents by country and respective background.

	AU	BE	HR	DK	FR	DE	HU	IT	NO	PT	ES	SE	NL	UK	**Total**
Corporate Finance					1										**1**
Credit Analyst		2		1	2	2		1						2	**10**
Equity Analyst	1	1	1		1	1	1	1		1	1	1	2	1	**13**
Financial Analyst						5		2			2				**9**
Fund Managers														5	**5**
Investment analyst			1						1						**2**
Total	**1**	**3**	**2**	**1**	**4**	**8**	**1**	**4**	**1**	**1**	**3**	**1**	**2**	**8**	**40**

[1] AB-Inbev; AMS; Bayer; Fiat; MOL; Nestlé; Netia; Novartis; Porsche-Volkswagen; Roche; SCA; Schneider; SGS; Solvay; and Telefonica.

Issues covered

We organised our discussions on the main aspects of decision-useful information: the more general aspects which included timeliness of information, transparency, presentation, materiality and overall quality of the information provided in the consolidated financial statements on business combination accounting; and the main accounting and disclosure requirements required by IFRS 3.

In summary, participants discussed the following issues:

- Timeliness and sources of information;
- Presentation
- Understanding the business combination transaction;
- Factors that make up the goodwill recognised, such as synergies
- Subsequent measurement of goodwill (impairment versus amortisation);
- Consideration transferred, including contingent consideration;
- Recognition and measurement of assets acquired and liabilities assumed, particularly intangible assets, inventories and contingent liabilities;
- Bargain purchases accounting;
- Business combinations achieved in stages;
- Other issues: usefulness of information from: pro-forma disclosures, Non-controlling interests accounting, tax deductible goodwill and other assets; and transactions that are recognised separately from the business combination

3. Executive summary

General aspects

The general observations made by users can be summarised as follows:

- *Timeliness of information received*: Many users commented on the timeliness of information received through the consolidated financial statements and noted that the information about a business combination was only made available considerable time after the business combination had been announced. Timeliness of information was fundamental as the markets absorbed the information on the business combination when the deal was announced. In particular, buy/sell-side equity analysts noted that they needed “quick” access to information on business combination transactions for their investment decision making and analysis. Users generally perform their own valuations at the time the deal is announced. These valuations are based on, among others, discounted cash-flow methods (using the so-called “core profit or loss” and future company performance), valuation multiples (e.g. EBITDA multiples) and financial ratios to determine the value of the company, measure the return on investment and assess the success of the underlying business combination.

- *Sources of information*: Many users noted that financial statements are not the only source of information they use to understand the rationale for undertaking a business combination, and considered them to be part of the information that is used by users. Generally speaking, "time is of the essence" once a business combination was announced, and accessibility to information was vital. Relevant information was therefore obtained from different sources (e.g. liaison with management, investor days and press releases), which generally consisted of non-GAAP measures and referred to by users as "core profit and loss". The type and level of information required, varied according to the type of analyst (equity analysts and credit analysts had different information needs).
- *Use of financial statements:* Several users thought that information included in the consolidated financial statements, including the interim financial statements, continued to be useful as an "alert" or verification function (e.g. to confirm their initial assessment; to confirm information previously obtained directly from management as financial statements were the "formal place" to provide information about business combinations).
- *Presentation*: Several users emphasised that information about business combinations was often scattered in the financial statements and it would be useful to integrate all the information on a business combination in a single disclosure note.

Information about Business Combinations Transactions

The main comments provided by users on the information included in the financial statements about a business combination transaction and its effects can be summarised as follows:

- *Information about the rationale for undertaking the business combination*: Was often too general and lacked "real" insight on the key drivers of the business combination transaction (i.e. what motivated the parties for undertaking it and what is it expected to bring to the acquirer). Many users expressed that information was communicated in a "boiler plate" manner which could apply to any business combination; information needed to be more transaction specific. This was largely perceived as being an audit or enforcement problem rather than a problem of IFRS 3. Several users pointed out that in some cases, information on multiple "less material" acquisitions was aggregated and, consequently, there was lack of information about each individual business combination.
- *Lack of information on the expected synergies from the business combination*: There was a need for more transparency and information that explained the expected synergies to be generated by the business combination and how they translate into revenue or cost reductions in post-acquisition years. For example, analysts working in the pharmaceutical industry would need information on the stage of development of products acquired (for example early-stage of development) to forecast future performance of the company.
- *Subsequent measurement of goodwill and infinite intangible assets*: There were mixed views on the non-amortisation of goodwill and indefinite life intangible assets – some users supported the current impairment model and others preferred an amortisation model (or a combination of

both). However, users that supported an impairment model indicated they would like more information about the rationale and basis the company used to determine annual impairment tests.

- *Consideration transferred*: For users, information about the consideration paid for a business combination was very fundamental for their assessments and analyses. However, some users noted that from a stewardship point of view, it was not always easy to understand how a company had paid its acquisition. For example, users noted that they needed to add up the cash outlay, shares and other instruments issues and any debt acquired; however, the presentation and level of details provided by companies varied in practice, it was not always easy to find this information in the financial statements, and often it was included in various places in the annual report.
- *Contingent consideration:* Several users highlighted the importance of having disclosures about subsequent changes to the fair value of the contingent consideration (regardless of the accounting treatment) in order to adjust the figures. Still, most users did not think that gains and losses resulting from future price adjustments to contingent consideration were part of the performance of a company. More specifically, they should be part of the acquisition price and should not be included in profit or loss.
- *Fair value information:* Although many users supported the use of the acquisition-date fair value to measure the assets acquired and liabilities assumed in a business combination, they believed there was a significant lack of information explaining the basis on which the fair values were determined (for example significant inputs and assumptions used in the valuations). Fair values were regarded as highly subjective and generally having only a ‘number’ limiting the usefulness of the information, particularly in terms of forecasting future performance. A number of users indicated that it would be useful to have information on the pre-acquisition book values of assets acquired and liabilities assumed. Information on estimated useful-lives of assets acquired was also mentioned as relevant. This information is *not required* by IFRS 3.
- *Contingent liabilities*: Users considered that information about contingent liabilities was very important as this information would help them in predicting future cash-flows. Still, some users noted that they did not always obtain sufficient information about contingent liabilities; that contingent liabilities could be used as part of earnings management; and that adjustments to contingent liabilities were viewed as non-recurring items of profit or loss.
- *Separate recognition of intangible assets*: The level of granularity on intangible assets arising from a business combination and recognised separately from goodwill, was not particularly relevant. Still, most users called for information on the rationale used by management to determine which intangible assets should be separately recognised from goodwill. This was particularly relevant to allow users to differentiate “core” intangible assets acquired (for example intellectual property and rights in the pharmaceutical industry, brands in the automotive industry) from other intangibles that users would not consider to be relevant. Some users requested a breakdown of ‘wasting’ versus ‘non-wasting’ intangibles.

- *Inventory step-ups to fair value*: Some users expressed concern about measuring acquired inventories at fair value as it could affect future operating margins. Better disclosures to explain the impacts of the step-ups on the gross-margins in future periods until the inventory was sold (disclosure was particularly relevant for inventory that turned over a long period of time) would be useful.
- *Bargain purchases*: Most users interviewed had not seen negative goodwill situations for the companies they followed. Nonetheless, many users questioned whether gains from bargain purchases should be reflected as if they were part the performance of the company, i.e. be accounted for as a “capital gain”. Users would remove the gain from the net profit to assess the performance. While they agreed that the capital gain should not be part of performance (i.e. net profit), they had no strong views on the accounting treatment of the so-called gain. Some argued that the fair values should be adjusted; others felt that putting the gain in Equity/Other Comprehensive Income was a better option.
- *Business combinations achieved in stages:* Many users did not express concerns about the current accounting for step acquisitions. They considered such a gain or loss as a non-recurring item or as not being part of performance of the company and would adjust their valuation models if necessary.

A summary of views expressed on other (less commented on) matters were:

- *Pro-forma information*: Users found pro-forma information (i.e. presentation of financial information as if the business combination had occurred at the beginning of the annual period) very useful; however a number of users considered that the presentation of pro-forma information often varied in practice and its presentation could be improved.
- *Non-controlling interests*: Users provided mixed views on how a company should measure non-controlling interests. Some preferred the proportionate method; others preferred the fair value method; others were just not in favour of having options, particularly on a case-by-case basis. Some of these users noted that they would like to have disclosures about the reasons for the selected measurement bases.
- *Information on tax deductible goodwill and other tax deductible assets:* Users highlighted that it was crucial to have information that would give them a good understanding of the tax structure of the deal and its implications on the price paid and future cash flows.
- *Separate transactions:* Several users explained that they appreciated information that helped them in understanding whether there were “transactions” that were related to the business combination, but had not been accounted for as part of the business combination transaction given the requirements in IFRS 3.

4. General Aspects

Timeliness and sources of information

Most users noted that the information included in the financial statements was only available a considerable time after the business combination had been announced

Users perform their own valuations at the time the deal is announced to determine so-called "core profit or loss"

Many users noted that the annual financial statements of the acquirer were usually published a considerable time after the business combination had been announced. For many users timeliness of information was fundamental as equity markets absorbed the information on the business combination on the date the acquisition was announced.

Most users, especially buy/sell-side equity analysts, noted that accessibility to information was important and generally they needed "quick" access to information on business combination transactions to keep up with market reactions. These users indicated that they perform their own valuations at the time the deal is announced. These valuations are based on, among others, discounted cash-flow methods (using the so-called "core profit or loss" and future company performance), valuation multiples (e.g. EBITDA multiples) and financial ratios to determine the value of the company, measure the return on investment and assess the success of the underlying business combination. As explained below, information to do these analyses was gathered from other sources.

Some users added that interim financial reports often do not provide comprehensive information about business combination transactions. This reduces their appreciation of how the deal was evolving in cases when the acquisition had been reported in the prior annual reporting period.

Most users explained that relevant information about M&A activities was obtained from different sources - the information included in the financial statements was only part of the information that is used

Many users noted that the financial statements were not the primary source of information they use to understand the rationale for undertaking a business combination and to perform their initial analysis. Relevant information on merger and acquisition (M&A) activity was obtained through a range of different sources, such as:

- liaison with management;
- press releases;
- conference calls;
- investor days;
- analyst meetings;

- financial data and news providers (e.g. Bloomberg and Reuters); and
- one-on-one meetings and direct contacts with management.

Most users explained that the negotiation process generally starts months ahead of a deal being "officially announced", and users follow the negotiation process carefully and gathered information during the process rather than only "on the day of the acquisition".

Users noted that financial statements are useful nevertheless, to understand the progress the group had made since acquisition date

However, several users thought that the information included in the consolidated financial statements continued to be useful as an "alert" or verification function to support and confirm the information obtained when the business combination was announced. Users explained that they would usually use consolidated financial statements to:

- confirm their initial assessment;
- use as a reference source (as a sort of "cook book");
- identify and assess trends;
- obtain detailed information to complete and/or confirm information already obtained directly from management as financial statements were the "formal place" to obtain detailed disclosures about business combinations; and
- evaluate the "progress made" on the business combination.

Presentation

Users emphasised that information about business combinations was often scattered in the financial statements

A number of users noted that information about business combinations were often scattered in the financial statements. For example, the reasons for the acquisition were usually comprehensively explained in the management report, but the remaining information about business combinations would be reflected "everywhere" in different notes of the financial statements.

It would be useful to integrate all the information on a business combination in a single disclosure note

Several users noted that it would be useful to integrate all the information on a business combination in a single disclosure note in the financial statements. Some users added that, in cases where a company had undertaken more than one business combination it would be useful to have separate information on each of the transactions tabled out in an understandable manner, even if each business combination was, individually, "not material".

For example, some users noted that information about the structure of the deal and the consideration paid was, in many cases, included in various places in the financial statements making it difficult to find and evaluate in a coherent manner. For analysts, consideration paid for a business combination was very fundamental, as it could impact on various factors including stewardship and the way analysts assessed the success of a business combination in relation to return on investment.

One user noted that financial statements have grown considerably over the years, and consequently, it was more difficult and burdensome to find "integrated" information on business combinations. Other users shared similar views and called for a more uniform approach of presenting related information.

5. Detailed findings on the accounting for Business Combinations

Overall

Users considered business combinations to be significant transactions and needed comprehensive information about the objectives and the expected synergies from the underlying transactions, and how those synergies translated into post-combination (recurring) profit or loss and cash-flows, and therefore, performance.

Understanding the business combination transaction

Most users noted that the information about the identification of the business combination and the primary reasons for undertaking the transaction is very useful.

Many users noted that the annual financial statements were not the primary source of information to understand the rationale of a business combination

However, for many users the consolidated financial statements were not the primary source of information to understand the primary reasons for a business combination. As noted above, timeliness was a key factor for investment decision-making; therefore by the time the financial statements were published, users would already have insight into the reasons for the business combination and the factors that led to the transaction. Users considered the financial statements to be only part of the information that they analysed.

Many users expressed concerns about the quality of the information disclosed about the primary reasons for business combinations and they often needed to be *supported by other sources of information*

Many users expressed concerns about the quality of the information disclosed in the financial statements on the rationale for undertaking the business combination transaction (i.e. what motivated the parties for undertaking the transaction and what is it expected to bring to the combined group). In their view, companies often provided very general “boiler plate” data that lacked insight on the rationale for the acquisition and what it would bring to the buyer.

When asked about possible improvements, users called for more insightful disclosures about the “real economic reasons” for undertaking the business combination transaction

When asked about possible improvements, users called for more insightful disclosures about the “real economic reasons” for undertaking the business combination transaction, and how the acquisition would help the acquirer in the market and contribute to future earnings. Users looked for information that was specific to the business combination transaction and related to facts and circumstances that lead to the transaction, rather than general reasons about growth and market share, which were considered to be too “boiler plate” to be useful.

Some users raised the need for improvements to IAS 34 *Interim Financial Reporting* with regards to information on business combinations, which users thought were less comprehensive than that reported in the annual accounts. It was also felt that the interim financial statements did not sufficiently explain the developments in business combinations that were still within the “measurement period” under IFRS 3.

Generally users acknowledged that in a number of situations the “real economic reasons” of an acquisition would probably not be disclosed as it might be considered commercially sensitive information. For example, if an acquirer bought a company with the objective of eliminating a competitor, it was unlikely that such information would be revealed. However, there was a need to strike a balance between the information users needed and the information preparers were willing to provide.

Factors that make up the goodwill recognised, such as synergies

In general, all users mentioned that they needed information to understand the reasons for the total amount paid. The price paid was a key factor in analysing the business combination, particularly from a stewardship point of view.

Users generally perform their own valuations to determine “core profits” which they include in their cash flow models - understanding *synergies helps them achieve this*

Generally speaking, many users (especially buy and sell-side equity and financial analysts) tend to ignore the goodwill number as they focus on the future cash flows that the business acquired expects to generate. Many users explained that they perform their own valuations to determine "core profits" to include in their own cash flow models, and would not consider the separate "goodwill" number or the information on newly created intangible assets when making their assessments.

Many users considered that information about expected synergies and how those expectations materialised post-acquisition was very useful for them

Many users considered that the price paid for a business was, to a large extent, driven by expected synergies. Understanding the synergies expected from the business combination helped them model their analyses and cash flow models.

These users considered that information about "the factors that make up the goodwill", expected synergies from those factors, including quantitative information, and how those expectations materialised and translated into revenues or cost reductions in post-acquisition periods, was very useful for them. This type of information helped users to better understand the level of cost savings achieved by the acquirer after the business combination, and consequently, whether or not it had been a successful acquisition.

A number of other users considered that the information provided by financial statements about goodwill and synergies was very general and very subjective; this was not useful to help users monitor the initial expectations and expected costs savings in post-acquisition reporting periods. Users noted that they would rely on other sources to obtain information on "synergies".

When referring to disclosure improvements, a number of users believe that the information about synergies in the financial statements could be improved and called for:

- follow-up information about synergies in subsequent years, namely whether initial expectations were being materialised in subsequent periods, as this information helped them in assessing the success of a business combination; ;

- information about how the acquirer intends to achieve the synergies;

- information about synergies detailed by segment.

Some users based their analysis on the price paid and used other information available related to M&A activities, such as valuation *multiples, to assess whether the entity had entered into an overpriced or a bargain acquisition*

Focus on market information to determine own valuations on core profitability

Some equity analysts explained that the price paid was the key factor, regardless the amount of assets and liabilities to be recognised, including goodwill.

These analysts explained that they focused their analysis on market information when assessing whether the entity had entered into an overpriced or a bargain acquisition. These users mentioned that they would perform their own valuations to determine “core profit or loss” numbers which they would use in their analyses of the business combination. For example, users indicated that they would use, among others, valuation multiples (e.g. EBITDA multiples) and financial ratios that measure a company's return on investment to understand whether it had been an overpriced acquisition and the reasons for the price paid.

Some other users explained that they would look for detailed information about the factors that make up the goodwill only if it was a significant element of the transaction. For example, one user usually compared the goodwill amount against the total price paid and if the goodwill was less than 20% of the price paid, he would not focus his analysis on the factors that make the goodwill. Another user explained that he often compared goodwill that the company had recognised with goodwill recognised in other similar transactions in the market before deciding to look for further information.

Subsequent measurement of goodwill (impairment versus amortisation)

Some supported the annual impairment test model while others preferred the amortisation model (or a combination of both)

Currently companies are required to test goodwill for impairment every year. When discussing the usefulness of the information obtained from annually assessing goodwill for impairment, users provided mixed views. Some supported the annual impairment test model while others preferred the amortisation model (or a combination of both). There were also a number of users who did not have strong views about the subsequent measurement of goodwill since they would anyhow ignore the amount in their analysis.

Supporters of the impairment model

Supporters of an impairment-only model said it was a better way of demonstrating whether management expectations of the business combination, and the synergies it was expected to bring, had been met

Some users supported the requirement to test goodwill annually for impairment. The impairment model provided evidence that the business combination was running as expected and the acquirer was still expecting future economic benefits, such as synergies, from the business combination. In their view, impairment was a better way of demonstrating whether management expectations and the synergies expected from a business combination transaction, had been met.

Supporters of an “impairment-only” model thought that systematic amortisation of goodwill in profit or loss dismissed “economic reality”. The impairment model was also perceived to be more appropriate from a stewardship perspective, and helped relate the price paid to what was acquired.

Some users noted that they are not concerned about the volatility in profit or loss created by the impairment model. One highlighted that impairment does not have a “cash impact” and, an efficient market would have taken it into account before the impairment was recognised for accounting purposes.

Another user (research analyst) thought that there was no evidence to demonstrate that impairments were recorded “too late”.

However, supporters of an “impairment-only” model would like to have more information disclosed about the annual impairment test

However, most of these users requested additional information on how the impairment was determined. Users often have to rely on the inputs and valuation techniques used by companies to determine impairment, when making assessments about the value of a business. However, the information provided in the financial statements did not always explain the basis for the impairment calculation, including assumptions and level of inputs, and was generally considered to be insufficient for their analysis. These users stated that they would like to have more information:

- that would help them to compare the information provided by segments and the information related to the amount of goodwill allocated to each cash-generating unit, which was often missing in the financial statements; and
- about how the impairment tests had been done, namely management key assumptions and inputs.

Some others noted that information about management assumptions would generally not be useful. The only instance where analysts did use the information was when impairment was actually recorded in the financial statements; in such cases analysts would use the residual cash flows to compare to their own valuations.

Supporters of goodwill amortisation

Some users indicated that when impairments were not reported by companies, they "expected the worst"

Some users considered an amortisation model to provide more "forward-looking" information than an impairment model. There was an understanding that goodwill represents the ability for an entity to generate future income, which needs to be considered when deciding how to account for goodwill in the periods, in which, in principle it is generating income.

One of the main concerns noted by these users was that impairments generally took a long time to be reported in the financial statements, and, often they were reported too late. Some users indicated that when impairments were not reported by companies, they "expected the worst"; and when impairment was recorded in the accounts, it created "uncertainty" and could raise questions about the initial expectations and the performance of the business combination.

A number of users noted that goodwill amortisation was part of the over or under-performance of the acquired company. These users considered that such expenses should be taken into account, provided that the amortisation period was reasonable.

Other users would prefer to have a goodwill amortisation model as it would provide useful information to users and would be more operational and less costly to be applied in practice

There were a number of other reasons why users support the amortisation of goodwill and indefinite intangible assets:

- it would decrease volatility in profit or loss when compared to an impairment model;
- it would be more operational and less costly to be applied in practice;
- the amortisation would be recognised in profit or loss on a systematic basis over the period in which the entity consumes the economics benefits associated with goodwill – and therefore relate the income it generates with its consumption;

- it would improve comparability between two identical companies – one expanding its business through acquisitions (and therefore accounting for goodwill) and the other expanding through organic growth. The write-off of goodwill on an annual basis would not discriminate both companies. Conversely, if a company does *not* amortise goodwill over the years, margins could be inferior in the company with organic growth. In this case, the impairment model "discriminates" between the two largely identical companies;

- it would ensure that the acquired goodwill is recognised in profit or loss and no internally generated goodwill is recognised as an asset in its place;

- the assumptions used in the impairment test are often subjective and difficult to analyse; and

- it is difficult to know whether the company was performing the annual impairment tests in an appropriate manner.

When asked about what useful life should be allocated to goodwill, some users replied that management would have to use their judgement to determine an estimate. Generally speaking users did not expect goodwill "to last" for more than 10 or 15 years.

Some users preferred a combination of systematic amortisation supplemented by an impairment test.

Finally, a number of other users did not have a strong view over whether goodwill should be amortised or impaired. Some of these users explained that their analysis was focused on future cash-flows; and neither impairments nor amortisations impacted future cash-flows.

Some others looked at impairment only as an indicator of an overpayment. They generally would ignore goodwill and as long as the amortisation or impairment is clearly disclosed, they would be able to adjust for these amounts.

Consideration transferred, including contingent consideration

Information about the deal structure and consideration paid

Information about the structure of the business combination transaction, including consideration paid was fundamental and considered a key measurement of stewardship

Many users highlighted that information about the structure of the business combination transaction, including consideration paid, was fundamental to their analysis. They noted that "consideration paid" was a key measurement of stewardship, as it helped users understanding what and how a company had paid for an acquisition. Generally speaking, one would assume that transactions are not undertaken without a thorough analysis of the structure and terms during the negotiation process. In the case studies examined, good examples of information about the structure of the business combinations were found, but users also provided evidence of examples of disclosures that they found unhelpful.

A number of users called for additional information about the deal structure and types of consideration paid which should be provided in a single disclosure note

Credit analysts in particular appreciated having information that could assist them in determining the impacts that consideration paid would have on the company´s debt structure and the effects on debt/equity ratios.

The following information was considered useful:

- the deal structure, such as different types of consideration paid or to be paid (e.g. cash, equity instruments, other type of assets), payment dates and whether payments can be anticipated or postponed by the acquirer;
- information about how the transaction had been financed (equity, in debt, etc.) and impact on leverage ratios;
- having the various elements of consideration paid in a single note (information was often scattered throughout the accounts);
- information about whether the former shareholders would receive any kind of dividend before the transaction was completed;
- information about the exchange rate used to account for the business combination when the acquiree was located in a country with a different currency to that of the parent company; and
- information about how the company was going to restructure its debt (or that of the Group) after the acquisition.

Some users noted that there could be situations where disclosing the total amount of consideration paid might be subject to certain constraints, as the buy-sell agreement might include confidential clauses.

Contingent consideration

The accounting treatment for contingent consideration and related disclosures was identified as an important issue for users. Some users considered the information provided on contingent consideration to be sufficient.

It was important to have information that allowed users to estimate future additional payments relating to consideration and how probable such payments were

However, other users noted that in some cases, in particular complex transactions that entailed complex consideration structures, the structure of the consideration "package" was not always sufficiently explained.

Contingent consideration was structured in different ways and took many forms. It was often a significant part of total consideration paid, which could "change the picture of the transaction and was considered to be part of the risk profile of the transaction". It was therefore important to have information that allowed users to estimate future additional payments and how probable such payments were.

Subsequent measurement of contingent consideration

Several users highlighted the importance of having disclosures about subsequent changes to the fair value of contingent consideration, particularly information that would help them understand the reasons for adjusting to the price.

Some users noted that the accounting treatment of subsequent changes in the fair value of contingent consideration depended on facts and circumstances. It was important to understand the factors that led to "postponed" payments and have information on the numbers. It was less important where in the accounts the adjustments were recognised, as users did not view such adjustments as performance.

Most users did not think that gains and losses related to future price adjustments to contingent consideration were part of the performance; contingent consideration was part of acquisition price (investment value)

Some users supported the requirements to recognise adjustments to contingent consideration in profit or loss as such changes occurred after the acquisition date. Generally, users did not "really care" about where the adjustments made to contingent consideration were recognised, as long as the adjustments were disclosed. These users expressed a preference for the profit or loss since that would be the "easiest" place to find the information instead of going through the notes.

However, most users, including those who supported the requirements, considered that adjustments to contingent consideration were not part of the performance of a company and, were inclined to ignore the profit or loss movements related to subsequent changes to contingent consideration.

Some of those users noted that they would usually consider adjustments to contingent consideration as an adjustment to the original acquisition price (investment value) – and would adjust the fair values of the assets and liabilities or, more likely, an adjustment to the initial goodwill. An example provided by users of the pharmaceutical industry was the acquisition of intangibles assets – such as intellectual property and rights over a product – which were priced based on future developments of the product. In such cases, it made sense to adjust the value of the intangibles for additional payments made.

Recognition and measurement of assets acquired and liabilities assumed, particularly intangible assets, inventories and contingent liabilities

Information about amounts recognised at the acquisition date for each major class of assets acquired

Most users considered that it was useful to have in the disclosures both the historic book values and the acquisition-date fair values of the assets acquired and liabilities assumed

Many users considered information about the amounts recognised as of the acquisition date for each class of assets acquired and liabilities to be useful for their analysis. These users explained that such “segregation” helped them understand what had been acquired by the company and how the company had allocated the transaction price. It was also important that information was presented in a standardised way to facilitate its assessment.

However, a number of users considered that the disclosures could be improved and provided a number of suggestions, namely that:

Many users would like to have further information about how the entity had determined the fair value of the assets and liabilities; the reason for the significant step-ups and more granular information for each class of assets

- information about the amounts recognised as of the acquisition date, particularly when derived from the fair value measurements, was particularly useful when combined with information on the pre-acquisition book values of the assets acquired and liabilities assumed. This information would assist users in assessing whether there had been significant steps-ups in the business combination;

- further disclosures would be welcomed about how the entity had determined the fair value of the assets and liabilities, namely the methods applied, inputs used and main assumptions taken. Some of these users added that this would be particularly useful to better understand the step-ups to the fair values;

- additional explanations to help users in understanding the reason why there had been a significant step-up;

- it was important to have more "granular information" on each major class of assets. A number of users explained that although companies provide some information about the fair value for each major class of assets, these classes of assets were often not completely described and could include various units of account with different assumptions within each unit of account. One user explained that companies did not distinguish between assumptions made for the retail and corporate business for a particular class of assets. Such information could be relevant and would provide information about particular characteristics of the class of assets (e.g. whether the retail loan and receivables portfolio include an interest rate floor that impacts the fair value);

- it was not useful to have information about accumulated amounts of the assets acquired and liabilities assumed from different business combinations in a single column of a table;

- it was useful to have information about the expected useful life of the assets acquired;

- it would be useful to have more specific requirements about the presentation of disclosures in order to make the information more comparable and easier to understand. One user noted that the information provided by companies varied a lot in practice and sometimes it was difficult to understand the tables provided by the acquirer; and

- one user indicated that he would be interested in having information about future depreciations and deferred taxes.

Some users noted that it would be useful to have more comprehensive information about the liabilities acquired in a business combination transaction

However, some users noted that they often faced time constraints and were not able to analyse comprehensively the information disclosed about the acquired assets and liabilities assumed (information which was only made available sometime after the acquisition date). As previously mentioned, users often noted that they focus their analysis on market information (e.g. valuation multiples) and develop their own future cash flow assessments to help them understand whether it had been an overpriced acquisition.

Information about liabilities assumed

Some users noted that it would be useful to have more comprehensive information about the liabilities acquired in a business combination transaction, including contingent liabilities and a break-down of the type of liability - whether it is debt, pension liabilities, short-term liability, overdraft, etc.

Credit analysts and fixed-income analysts focused on the impact acquired debt would have on the company's gearing and net debt position. This was fundamental information to their evaluation of the company; pre and post-acquisition date. Generally speaking, these analysts considered that debt disclosures needed to be improved. An example provided, was the lack of information about how a company was going to restructure its debt position after a business combination. It was not always clear what an acquirer would do with the debt assumed in a business combination transaction. From a credit perspective, it was vital to understand how a company structured its capital. There were cases when users would turn to the separate financial statements to understand debt/capital structures of the underlying company.

Disclosures about contingent liabilities, as such liabilities impacted the future cash-flows of the company was also considered important. Still, some users noted that:

- often not much information was provided about contingent liabilities;
- contingent liabilities could be used as part of earnings management; and
- adjustments to contingent liabilities were viewed as non-recurring items in profit or loss.

Separate recognition of intangible assets from goodwill

Many users stated that they had some reservations about certain intangible assets, such as customer relationships and brands, and wanted more information about the basis for recognition of those intangibles and how they had been measured. Detailed "granular" information was not generally relevant to users

Most users expressed some reservations about the recognition of certain intangible assets, including intangible assets that had not been previously recognised by the acquiree (such as customer-based intangibles – for example customer relationships, brands…) and intangibles for which there was no active market.

Overall, several users noted that detailed "granular" information was not particularly relevant. Their main focus was on the "entire" business acquired, and not on the "separate" assets and liabilities assumed.

<u>Views of those who considered useful to have information about intangible assets can be summarised as follows:</u>

Some users supported differentiating "wasting" intangibles from "non-wasting" intangibles. Some intangibles waste over time and others do not

Some users supported differentiating "wasting" intangibles from "non-wasting" intangibles. For example, the approval of a medical product could be considered a non-wasting intangible. Some other intangibles truly deplete over time and lose their value (for example customer relationships and technology-based intangibles). In such cases, the amortisation charges were real costs. There is no clear "differentiation" regarding which intangibles should be depreciated and which ones should not.

Some of these users noted that the amount of intangible assets could be high, particularly in the pharmaceutical industry where the research costs incurred by the acquiree would be recognised in the accounts of the acquirer at the date of acquisition.

Most users called for further disclosures about the rationale for recognising intangible assets separately from goodwill; and how the entity had determined the fair value of the intangible assets, particularly the methods applied, the inputs used, the main assumptions and related cash-flows. Finally, users have also noted that it would be useful to have more information on the tax effects of intangible assets (please see the section on *"usefulness of the information on tax deductible goodwill").*

<u>Views of users who usually did not focus their analysis on new intangible assets</u>

A number of users explained that they would not usually focus their analysis on new intangible assets and had the view that some of these assets "were vague in nature"

A number of users noted that they did not focus their analysis on the information derived from the recognition and measurement of new intangible assets created through the business combination. In addition, they had some reservations about the recognition of certain intangible assets, such as customer lists, which were "vague in nature".

These users generally noted that the measurement of such intangible assets could be challenging as they depended on significant judgement from management regarding the inputs and assumptions used (too subjective to be useful).

However, users were interested to understand the impact of such intangibles on future earnings, such as future depreciation costs. Some of these users noted that it would be useful to present separately in the balance sheet intangible assets with an indefinite useful life and those intangibles with a definite useful life.

Measuring inventory at acquisition-date fair value

Some users expressed concern about measuring acquired inventories at fair value as it would potentially affect future operating margins

Some users expressed concerns about measuring acquired inventories at the acquisition-date fair values as such values had a potentially misleading impact on future operating margins.

When referring to possible improvements users suggested:

- requiring disclosures that would help users forecast future gross margins on inventory and assess the effects of such changes on post-combination profit or loss and cash flows. Some users thought that pro-forma information would already help understand the profits being generated by the inventory, but they would welcome information that would help them forecast future gross margins; and

- having the information about impact on future period margins presented together with information about step-ups. Some noted that such information was particularly important for inventory that turns over a long period of time (for example jewellery).

Nevertheless, one user indicated he would not like to have an exception regarding the measurement of inventories at the acquisition-date fair value, as this would open the door for additional exceptions.

Bargain purchases accounting

Most users were not familiar with negative goodwill in the companies they were following and stated that negative goodwill never occurred in the particular industry they were analysing.

When discussing the accounting treatment and disclosures related to bargain purchases, users provided a number of different views and suggestions.

Some users noted that if a company recognises negative goodwill, then it was fundamental to have information that clearly sets out why the transaction resulted in a bargain purchase.

Many users questioned whether bargain purchase gains should affect the performance of the company

Some other users questioned whether negative goodwill actually existed; and whether it was the value of assets acquired and liabilities assumed that needed to be adjusted. These users argued that in an arm's length transaction it did not make sense to have the consideration being lower than the fair value of the assets acquired and liabilities assumed.

One user noted that this would raise significant concerns about stewardship of the acquiree's management. This user said that he would suspect that probably it was more an initial measurement problem of the acquired assets and liabilities.

Many users questioned whether bargain purchase gains should affect the performance of a company (i.e. accounted for in profit or loss as a "capital gain"). Some added that they would usually adjust their recurring earnings analysis if necessary. One user specifically noted that nothing was "realised" and therefore the gain should not be recognised in profit or loss. Some of these users provided different suggestions about how to account for bargain purchases. These include:

- accounting for negative goodwill in other comprehensive income and not in profit or loss;
- not accounting negative goodwill in profit or loss as profit or loss should be restricted to ordinary business transactions; or
- having negative goodwill directly adjusted in equity.

Finally, some users were not significantly concerned about the accounting for bargain purchases, as long as the amount of the gain was clearly disclosed in the financial statements or in the notes.

Business combinations achieved in stages

Many users did not express significant concerns about the current accounting for step acquisitions.

Most users emphasised that they tended to consider such a gain or loss as a non-recurring *item or as not being part of the performance of the company*

Some users explained that the information resulting from the remeasurement was useful as it provided them with updated information about the value of the previously held interest. One equity analyst noted that if the gain or loss is accounted for in profit or loss, it would probably call users' attention more than if the information was only disclosed in a note.

However, most users considered such a gain or loss as a non-recurring item or as not being part of the performance of the company, and would adjust their valuation models if necessary. Users indicated that it would be useful to have such gains (or losses) clearly identified in the financial statements. Some users noted that remeasurement of previously held interest, in profit or loss did not provide useful information as such gains or losses seemed artificial.

Other comments made were:

- one user suggested recognising the gain or loss in other comprehensive income. In contrast, another user questioned the accounting treatment as the distinction between other comprehensive income and profit or loss was not very clear;
- on loss of control accounting, one user explained that in a number of cases, particularly in transactions that involved the selling of real estate by banks, there were difficulties in understanding the transaction due to the limited information provided, particularly when trying to reconcile the information related to transaction price, the net assets derecognised and the total gain recognised;
- some users questioned the relevance of fair value information in situations where there were practical difficulties related to the application of the acquisition-date fair value measurement principle. These users thought that in such situations, an entity should not be required to remeasure previously held interest; and
- some users highlighted that transactions undertaken close to one another (such as a squeeze-out of the remaining shares) raised questions about whether they should be accounted for as a single transaction or as separate transactions. One user considered that it would be useful to have information that could help follow-up the issue in subsequent periods.

Other issues

Usefulness of information from pro-forma disclosures

In general, users found pro-forma information (i.e. presentation of financial information as if the business combination had occurred at the beginning of the annual period) very useful as it allowed users to evaluate the financial performance with and without the business combination transaction.

Some users noted that this information was often well disclosed by management at the date of acquisition; and they used the financial statements to confirm the initial assessments and understand progress made in post-acquisition periods.

However, a number of users considered that the presentation of pro-forma information varied in practice and was often not very well presented. One user explained that, from his experience, companies would only provide such information if it was an important business combination.

When referring to possible improvements, users noted that:

- they would like to have additional historical information; for example, some users noted that they would welcome pro-forma information as at the previous reporting date and noted that such information was even more important when the acquiree was not a listed company. Some other users would like to have historical information from the last three or five years;
- they would like to have more details and not only the headlines of the information;
- the IASB should define more specifically which information should be disclosed;
- they would like that the pro-forma information make reference to impacts on gross margin per product and per geographical area;
- it would be useful to have information about how the pro-forma information had been prepared (e.g. depreciation rules used, etc.); and
- it would be useful to have pro-forma information about cash-flow statements.

Usefulness of information derived from NCI accounting

Users provided mixed views on how a company should

In general, users did not express significant concerns about the accounting for non-controlling interests (NCI).

account for non-controlling interest. Some preferred the proportionate method; others preferred the fair value option; others were just not in favour of having options; and some would like to have disclosures about the reasons why a certain method had been used

Users that remarked on NCI provided mixed views on how a company should account for it. Some preferred the proportionate method; others preferred fair value and others did not have a preference.

However, users considered that if NCI were measured at fair value, it was fundamental to know the methodology and inputs used to evaluate consistency of the amounts recognised; and it was important to know the reason why a company had chosen one of the options.

Some users considered that only one measurement bases should be permitted as options in accounting created comparability issues. Specifically, some did not consider it useful to have an option to measure NCI at their fair value or proportionate method on a transaction by transaction basis. One of these users argued that it could lead to manipulation of the financial statements. Some of these users supported fair value measurement of NCI. These users argued that for consistency reasons it would be better to have everything at fair value and it made sense to use fair value if the acquirer was going to acquire additional shares in the near future. Others preferred the proportionate method.

Usefulness of information on tax deductible goodwill and other assets

It was crucial to understand the tax structure and its implications on the price paid and future cash flows

Users in general considered information on tax impacts on goodwill as vital information because it had an impact on future cash flows and the amounts could be significant. Users recognised that, in some cases, tax regimes have an important impact on future cash flows and deals are often structured with an objective of optimising tax-related cash flows. It was therefore crucial to understand the tax structure and its implications on the price paid and future cash flows.

One user specifically noted that information about tax deductible goodwill was useful because it allowed estimation on any impacts on the regulatory capital. However, this user believed that this kind of disclosure was not being currently provided in practice by all companies.

Other users noted that it would be useful have more information on the tax effects of other assets, such as intangible assets, acquired in a business combination. It was mentioned that in some industries, intangible assets that arose in a business combination transaction benefited from tax breaks or in some cases were tax deductible; such "tax purpose" information and the underlying impacts on future cash flows was very useful information for users.

Transactions that are recognised separately from the business combination

Several users explained that they valued information that helped them understand whether there were "transactions" that were related to the business combination, but had not been accounted for as part of the business combination transaction given the requirements in IFRS 3.

A "separate transaction" could include, for example, a situation when an acquirer sells a group of assets (or a business) post acquisition. For accounting purposes, the question is whether the sale is part of the business combination or whether it should be treated as a separate transaction.

Users generally welcomed information that would help users to assess what part of the consideration transferred might be recovered by selling assets not considered important but the company had to acquire as part of a deal.

The following additional remarks were made:

- One user believed that there was not enough transparency in the financial statements on transactions that were recognised separately. It was not easy to understand the information being provided by companies and, in some cases, it was not clear why the transaction had been (or not been) accounted for as part of the original business combination;

- Separate transactions were part of the "history" of a business combination transaction and would be considered by users when assessing the "entire package" underlying the business combination transaction; and

- Another user explained that information about separate transactions helped to assess what part of the consideration transferred might be “recovered” by selling assets that were not considered “core assets” but that the company had to acquire as part of the business combination transaction.