IFRS

STAFF PAPER

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IASB Meeting

Project	Post-implementation Review
Paper topic	IFRS 3 *Business Combinations*— Input obtained from Phase I of the PiR

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Purpose of this paper

1. This paper aims to inform the IASB about the input obtained from the activities undertaken during Phase I of the Post-implementation Review (PiR) of IFRS 3 *Business Combinations*.

2. This paper is structured as follows:

   (a) results of the consultations; and

   (b) preliminary review of the academic research. Appendix 1 to this paper includes a literature summary table.

3. Appendix 2 to this paper deals with information about the level of acquisition activity during the last decade.

Result of the consultations

4. Since July we have gathered input from:

The IASB is the independent standard-setting body of the IFRS Foundation, a not-for-profit corporation promoting the adoption of IFRSs. For more information visit www.ifrs.org

Constituents	Activities
Users	We have had meetings and/or conference calls with: • individual members of the Corporate Reporting Users' Forum (CRUF) and Capital Markets Advisory Committee (CMAC); • CFA Institute (both International and UK branches); • EFRAG User Panel; • CMAC; • User Advisory Council (UAC) of the Canadian Accounting Standards Board (AcSB); and • European Federation of Financial Analysts Societies (EFFAS).
Preparers[1]	We have had meetings and/or conference calls with: • preparers from the pharmaceutical industry; • a European group of preparers (written input); and • Global Preparers Forum (GPF).[2]
Accounting firms	We have had meetings with the global IFRS groups of the largest accounting firms.
National standard-setters and endorsement advisory bodies	We have had meetings and/or conference calls with: • staff of the European Financial Reporting Advisory Group (EFRAG); • European national standard setters at the Consultative Forum of Standard Setters (CFSS) meeting organised

[1] During Phase I of the PiR, we have conducted outreach with preparers with a lower intensity than to other type of constituents mainly, because we expect that preparers will be commenting extensively on the RfI. In addition, the IFRS IC staff have also conducted outreach with preparers and preparer groups in different industry sectors to gain an understanding about the implementation difficulties surrounding the definition of a business to contribute to this review (see Agenda Papers 6 and 6A presented at the May IFRS IC meeting at: http://www.ifrs.org/Meetings/Pages/InterpretationsMay2013.aspx). During Phase II of the PiR, we will conduct much more extensive outreach with preparers.

[2] This Agenda Paper does not incorporate the input from GPF because the posting of this Agenda Paper was earlier than the GPF meeting. We will, however, inform the IASB if there was any relevant input from the GPF meeting that this Agenda Paper does not capture.

Constituents	Activities
	by EFRAG in September; • staff of the United States Financial Accounting Foundation (FAF) and United States Financial Accounting Standards Board (FASB); and • members of the International Forum of Accounting Standard-Setters (IFASS) and World Standard-Setters (WSS). We will also gather input from the Accounting Standards Advisory Forum (ASAF) in December.
Valuation specialists	We have had meetings and/or conference calls with: • International Valuation Standards Council (IVSC); and • valuation specialists from a number of firms.
Regulators	We have had meetings and/or conference calls with: • European Securities and Markets Authority (ESMA); and • International Organization of Securities Commissions (IOSCO).
Academic and other research	We have had meeting and/or conference calls with: • staff of the United States FAF; • ESMA and CASS Business School. See also preliminary academic research review undertaken during Phase I of the PiR in paragraphs 7–10 of this Agenda Paper.
Other IFRS Foundation bodies	We have had the following meetings: • IFRS Interpretations Committee (IFRS IC) meeting in September;[3] and

[3] The Agenda Paper presented at the September IFRS IC meeting can be found at http://www.ifrs.org/Meetings/MeetingDocs/Interpretations%20Committee/2013/September/AP18%20IFRS%203%20Scope%20of%20PIR.pdf

Constituents	Activities
	• Advisory Council meeting in October.

5. The following table compiles the input gathered. We have classified the input received into two broad categories:

   (a) issues dealing with the usefulness of the information (UoI) provided by the Standard; and

   (b) practical implementation (PI) issues.

6. Additionally, we have assigned a degree of relevance, High (H), Medium (M) or Low (L) to those issues to help us assess whether those matters should be included in the Request of Information (RfI) and have included the rationale for the degree of relevance given.

<table>
<tr><th rowspan="2">Issue</th><th rowspan="2">Description</th><th rowspan="2">UoI
PI</th><th colspan="3">Relevance</th><th rowspan="2">Rationale for relevance</th></tr>
<tr><th>H</th><th>M</th><th>L</th></tr>
<tr><td>Definition of a business</td><td>Assessing the existence of a business
The majority of the constituents contacted have identified the assessment of whether a business exists to be a significant practical implementation issue. The assessment of whether a business exists is particularly challenging for specific industries (real estate, shipping industry, mining, oil and gas, life sciences). The matters that make such assessment difficult are summarised below:
• The definition of a business is often found to be too broad, ie “it is hard to prove that a transaction is not a business”. There is little or no guidance on what is not a business.
• There is a perceived lack of guidance in the Standard for an entity to assess the following matters for it to conclude on whether a business exists:
- the identification of the different elements of a business (inputs, processes, outputs) and how much weight to place on them;
- the impact of the absence of any of the elements of a business (ie “how many inputs/processes can be ‘missing’ to conclude an acquired set is yet still a business?”);</td><td>PI</td><td>H</td><td></td><td></td><td>The assessment to determine whether a transaction involves a business is critical to determining whether a transaction is within the scope of the Standard or whether it corresponds to an acquisition of an asset or group of assets. The relevance of the accounting implications of such assessment adds to the importance of the definition of a business (see row below).

Because the assessment of whether a business exists requires a significant degree of judgement, there are frequently divergent views in practice.</td></tr>
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Issue	Description	UoI PI	Relevance			Rationale for relevance
			H	M	L	
	- the acquisition of staff and equipment (or not taking over all of the employees); - inputs and processes that have been outsourced or that are rendered by external third-party providers; and - how much weight to give to the life cycle stage of the operations acquired. • Determining whether a 'set of assets and activities [...] is capable of being conducted and managed as a business by a market participant'. How to limit the meaning of the term 'capable' in the assessment ("any asset is capable of being conducted and managed to provide a return to investors") and how to embed market participants' assumptions to conclude on the existence of a business ("an acquired set will be capable of being conducted and managed as a business by a market participant depending on the type of market participant") are examples of challenges that entities have faced when implementing this particular area of the Standard.					
Different accounting treatments between IFRS 3 and asset	**Accounting for business combination vs asset acquisition** Some constituents have highlighted the lack of alignment in the accounting for specific items within the context of business combinations when compared to the acquisition of an asset or a group of assets (ie 'an asset acquisition').	UoI	H			The relevant accounting differences for the accounting of business combinations and asset purchases place a significant

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purchases	Some of the key accounting differences relates to the accounting for: • the premium paid in the acquisition of a business or a group of assets (goodwill); • deferred taxes; and • acquisition-related costs. **Guidance only available in IFRS 3** IFRS 3 includes guidance that is specifically tailored to the accounting for business combinations that is not included in other IFRSs for the accounting of asset acquisitions: • the accounting for contingent consideration; and • the disclosure requirements. Some constituents have stated that the relevance of the differences between accounting for a business combination and an asset acquisition is an element that influences the conclusions reached by entities on whether a business exists. This factor together with the question whether the lack of accounting alignment is warranted have made some constituents wonder whether more work should be made on answering this question instead of dedicating more efforts to clarifying the definition of a business.					weight on having a clearer definition of a business. As previously mentioned, the assessment that leads to the conclusion on whether a business exists is challenging. In addition, because of the different accounting treatments, this assessment is influenced by the pressure exerted by the different accounting results of both possible options. The effect of incorrect conclusions in this assessment significantly impair the usefulness of the information provided.

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	Allocation of values to individual assets A few constituents have stated that when accounting for acquisition of a group of assets, the values allocated to individual assets using a relative fair value approach in accordance with paragraph 2(b) of IFRS 3 may not be aligned with the requirements in other Standards (for example, IAS 39 *Financial Instruments: Recognition and Measurement* requires financial instruments to be initially recognised at fair value).					
Fair value measurement	**Consistency of valuation practices** Consistency in the implementation of the requirement of measuring assets and liabilities at fair value relies, to a certain extent, on the consistency of valuation practices across different jurisdictions. Some of the valuation specialists with whom we have conducted outreach have mentioned to us that valuation practices vary across jurisdictions, firstly because of lack of global valuation standards and guidance and secondly because of the influence of auditors in the valuation exercise, which, in their view, affects which valuation techniques are more commonly used for measuring the same	UoI/PI	H			The measurement of assets acquired and liabilities assumed at fair value is a key feature of the purchase acquisition method. Different valuation methodologies applied and the perceived lack of guidance for the measurement of specific assets and liabilities at fair value have a direct impact on the consistency and on the accounting results from business combination transactions (for example, the amount of goodwill

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	type of assets in different jurisdictions. In addition, different methodologies are permitted and used in different jurisdictions. For example, national valuation guidelines may limit the valuation techniques permitted but these limitations may not apply elsewhere. **Fair value depresses profitability for any one or two quarters subsequent to the business acquisition** Some users have stated that fair value measurement at the date of the acquisition causes write-ups in assets such as inventory and property, plant and equipment that depresses (operating) profitability during the immediate subsequent quarters. Many users have stated that, even though acquisitions are always a disruptive event when assessing performance, the fair value measurements used when applying the purchase acquisition method do not provide forward-looking information (ie fair value further disrupts the performance indicators of entities after a business acquisition). A few users have stated that, for example, information relating to the basis on which the fair value amount of inventory has been obtained (ie retail or wholesale price) or information relating to the margins that the acquiree was achieving before the acquisition would be useful.					recognised). The quality of the fair value measurements affects directly the quality of the information available for users.

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	Costly process A few constituents have stated that undertaking valuations has proved to be a costly process, particularly in small and medium-sized companies that lack resources. In general, during Phase I of the PiR we have not obtained much information about unexpected costs arising from the implementation of the Standard (see Agenda Paper 13B). **Mix of measurement bases** A few users have stated that measuring assets and liabilities at fair value at the date of acquisition, and subsequently using other bases as required in combination with the measurement bases used by the acquirer to measure its assets and liabilities, causes a mix of measurement bases. This mixture impairs their ability to conduct a satisfactory calculation of returns over capital employed. A few other constituents questioned whether it is appropriate that subsequent measurement bases that are different from fair value lead to Day 2 gains or losses (for example, the different treatment of own credit risk between fair value and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* would lead to changes in the					

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	measurement of a decommissioning liability that would be recognised in profit or loss). In addition, they questioned whether the benefits of measuring specific assets or liabilities at fair value outweigh the costs of obtaining that information and having to change the measurement basis subsequently. **Consideration transferred** In relation to the fair value amounts of shares issued as part of the purchase price, a few constituents have stated that they are not in favour of measuring the share price in accordance with the closing market price of the acquirer's shares on the acquisition date. This is because that price would include the market's reaction to the acquisition. In their view, it is instead the share price during the negotiations that is the one on which management is committed to make a return. **Challenges when measuring the fair value of specific assets and liabilities** A few constituents have mentioned that it is not always clear how to embed market participants' assumptions in the fair value measurements. In addition, measuring the fair value					

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	of the following assets and liabilities at the acquisition date has proven to be challenging: • Intangible assets. See specific section in this table. • Inventory. As mentioned above, many users have raised concerns about the effects of the measurement step-ups observed in inventory. One constituent has stated that guidance dealing with the measurement of inventory at fair value would be useful. • Previously held interests and non-controlling interests. See specific section in this table. • Quoted liabilities. A few constituents have observed that the observable price of quoted debt changes as the acquisition date approaches and wonder whether the inclusion of such 'noise' in the measurement is appropriate. • Unquoted liabilities. Some constituents wonder whether the fair value amount of the liabilities should include the acquiree' or the acquirer's credit risk. • Contingent consideration. See specific section in this table.					

Issue	Description	UoI PI	Relevance			Rationale for relevance
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	• Contingent liabilities. The use of probabilities and the discount rate used are areas in which entities have faced difficulties when measuring contingent liabilities at fair value. A few constituents have stated that the requirements are not restrictive enough to limit the cases in which entities are allowed to conclude that liabilities cannot be measured reliably. This results in some companies not recognising such liabilities. • Pre-existing contractual relationship. There are different views in how to measure the settlement of pre-existing relationships at the acquisition date. In addition, it has proved to be challenging to determine whether the pre-existing relationship is favourable or unfavourable, in particular when the pre-existing relationship has changed significantly since it was established. In other words, from a commercial point of view, the parties would not have entered into the same arrangement at the time of the business combination. • Reacquired rights. A few constituents that have stated that this concept is not well understood. A few valuation specialists have stated that there is a presumption that value must always be given to a reacquired right. In fact, though, if the contractual terms are at arm's length, there is no additional value in the reacquired rights.					

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	• Defensive assets. Even though constituents have stated that these are not assets that are frequently seen in business combinations, they have mentioned that their measurement is challenging because it is difficult to determine who market participants would be, what they would do with the asset and what its useful life would be. **Disclosures relating to fair value measurements** Please see specific section on disclosures in this table.					
Recognition of intangibles separately from goodwill	**Concerns on whether it translates into useful information** Some constituents acknowledge that recognising intangible assets separately from goodwill may be conceptually warranted. However, some of those who do think that it is conceptually sound believe that it is not an exercise that seems to have resulted in the provision of useful information (ie it is not of 'real value') and suggest to revisiting the cost/benefit argument for the following reasons: • The requirement to measure assets acquired and liabilities assumed individually is perceived by	UoI	H			It has been observed that, generally, the amounts allocated to intangibles and goodwill represent a significant weight of the total consideration paid in business combinations.[4] The separate recognition of intangibles from goodwill has a direct impact on the amount of goodwill recognised and on subsequent amortisation charges

[4] 2012 Purchase Price Allocation Study, September 2013, Houlikan Lokey.

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	management as being an accounting compliance exercise and it differs from how management valued the acquisition (ie management valued the business a whole). Some of the intangible assets recognised (for example, customer relationships) meet the contractual criteria for recognition but they do not trade on their own; they were sold as part of the business. This adds pressure on the reliability of the measurements of those assets. • The exercise of recognising intangible assets separately from goodwill is strongly influenced by the accounting result that management seek. This impairs the usefulness of the information resulting from this accounting exercise. Some users have stated that, in many cases, companies recognise intangibles to keep goodwill down because of different reasons: (a) the amortisation charge arising from intangibles in business acquisitions is disregarded by many users; (b) the likelihood of impairment charges in the future are lower. A lack of impairment charges could signal that the acquisition strategy was successful; (c) to give the impression that generated revenues and operating margin before depreciation and amortisation was achieved with relatively lower additions to the fixed and/or intangible asset base,					as well as on any subsequent impairment losses. The quality of this process has a direct effect on the usefulness of the information provided to users.

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	which may be interpreted as a sign of higher efficiency, thereby reducing expectations for future capital expenditure requirements, which may positively impact the valuation of the entity. • The appropriateness of the recognition of certain intangibles is, in many cases, questioned. For example, when the businesses acquired are small entities, customer relationships are sometimes very closely related with key employees. When this happens, it is difficult to conclude this is an asset of the business acquired, because the value lies in those employees. Some constituents believe that, in many instances, assets may be capitalised while having an uncertain capability of generating future benefits (ie "the customers might not come back again"). For example, in the life science industry, a constituent stated that the general trend is that practice has developed so that in-process research and development (IPR&D) projects are recognised earlier in the development process. This has effects on the goodwill amount allocated and on subsequent impairment charges. These constituents questioned the lower headroom for recognition of intangibles in IFRS 3 when compared to IAS 38 *Intangible Assets*.					

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<tr><td></td><td>• Some users would only favour separate recognition for intangibles that are ‘wasting’ (ie intangibles with finite lives). These users would prefer some other intangibles with indefinite useful lives, such as some brands, to be included within goodwill along with appropriate disclosures that would allow understanding of what has been included in goodwill. This preference is based on the fact that, for these users, it is difficult to justify giving a value to some intangibles. In addition, some of the intangibles that are amortised (for example, customer relationships) are also sustained through expenditure that goes to profit or loss. For these users, this would additionally support having those amounts included in goodwill (ie not amortised).

Goodwill and bargain purchases

In addition to the concerns relating to the identification of intangible assets separately from goodwill, a few constituents wondered:

(a) whether goodwill can be considered an asset; and

(b) what the conceptual reasons were for recognising a profit in the case of bargain purchases, which in the view of these constituents risks creating an artificial profit (ie it might be related to future losses to be recognised in the forthcoming years rather than a</td><td></td><td></td><td></td><td></td><td></td></tr>
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Issue	Description	UoI PI	Relevance			Rationale for relevance
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	bargain purchase). These constituents think that the accounting should instead depend on, and reflect, a sounder economic analysis of these transactions. **Disclosures** Many users have stated that information relating to the underlying criteria and rationale used by management in the exercise of identifying and separating intangibles from goodwill will be useful.					
Non-amortisation of goodwill	**Usefulness of the information provided** Some constituents think that testing goodwill for impairment (ie non-amortisation) is the method that provides more useful information. Some other constituents argue that the observed delay in the recognition of impairment losses during the financial crisis provides evidence that a combined method (amortisation and impairment test) would be more appropriate. Users' views also differ, but on the basis of the group of users who have been contacted so far, the number of those that think that the impairment test gives more useful information is higher than those that support the amortisation of goodwill. These are the most frequently reasons given for supporting the amortisation of goodwill:	UoI	H			This is one of the most significant changes that IFRS 3 introduced to the accounting for business combinations in accordance with IAS 22 *Business Combinations*. This together with the fact that views on this matter are split amongst constituents warrants it to be considered an area with high relevance.

Issue	Description	UoI PI	Relevance			Rationale for relevance
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	• cash flows from internally generated goodwill are intermingled with those associated with acquired goodwill when testing the acquired goodwill for impairment, which contributes to the delay in the recognition of impairment losses; • a combination of amortisation and impairment test would result in a more effective approach: amortisation is simpler, less costly and easier to audit; and • subjectivity of the assumptions used in the impairment test: sometimes unrealistic expectations are embedded (ie expectations of growth)—these constituents believe that "management's assumptions are difficult to challenge". The majority of the users contacted support testing goodwill for impairment. The reasons they provide are as follows: • the impairment test allows assessing management's ability to manage (stewardship) and "pushes management to think about the business"; • allows better tracking of the acquisition and of its performance;					

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	• allows more informed judgement on whether the price is justified; • even if impairment charges are recognised late, this can also result being useful information; and • amortising goodwill would be inconsistent with the fact that internally generated goodwill is not recognised. **Impairment test should be more transparent** The majority of users contacted have stated that, because the impairment test is highly subjective, the information provided in the financial statements should assist in making it more transparent. Some users have also stated that it is difficult to gauge the assumptions used by management in the impairment test and they tell us that the information available in the financial statements relating to impairment tests, is in many cases, not useful. For example, some users have stated that the discount rates are often provided in ranges that are too wide to be useful. In those cases they think that more useful information would be to disclose the weighted average discount rate.					

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<tr><th>H</th><th>M</th><th>L</th></tr>
<tr><td>Intangibles</td><td>Recognition
As mentioned above, some constituents have highlighted the lower threshold for recognition of intangibles in business combinations in IFRS 3 compared to IAS 38.
More information about the nature of the intangibles
Some users have stated that more information about the nature of the intangible assets that are recognised when resulting from a business combination would be useful.
Fair value measurement and subsequent amortisation
Relating to the measurement of intangible assets, some constituents, among them many users, believe the measurement is highly subjective. Some of the reasons are as follows:
• The initial valuation of intangible assets relies on assumptions and inputs that are highly subjective (ie there is no market where the price of those intangibles can be observed). In addition, there is a lack of consistency in valuation practices across jurisdictions.
• There is not enough information disclosed (ie significant inputs and valuation techniques used) relating to the fair value amounts recognised.</td><td>UoI</td><td>H</td><td></td><td></td><td>As mentioned above, the weight of the consideration that is allocated to intangibles recognised in a business combination is significant.
In addition to the existence of issues on which the usefulness of information provided by this area of the accounting for business combinations does not seem to be adequate, the practical implementation issues described seem to further impair the usefulness of the information.</td></tr>
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Issue	Description	UoI PI	Relevance			Rationale for relevance
			H	M	L	
	• The amortisation of intangible assets relies on the estimates of useful lives. These estimates are highly subjective. For example, in some industries (eg consumer products) it is difficult to determine whether an asset (such as a brand) has an indefinite life or a finite life. In addition, there are different practices in determining the useful lives of intangible assets. For example, some entities make useful lives equal to the cash flow projection period, some other entities assess useful lives equal to the period over which the greatest part of the present value of cash flows is obtained. As a result, some users have stated that the amortisation charges arising from intangible assets recognised in business combinations do not provide useful information. • In the particular case of intangible assets that are sustained through expenditure that is recognised in profit or loss, many users also questioned conceptually the appropriateness of the amortisation charges. **Disclosures** • Information about the nature of the intangible assets recognised as a result of a business combination. Many users have stated that financial statements typically include very little information about the nature of the					

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	intangible assets recognised and about the underlying assumptions for their recognition and for the assessment of their useful lives.					
Non-controlling interest	**Choice between fair value or proportionate share for each business combination** Some constituents wonder whether the choice for measuring non-controlling interests (NCIs) that are present ownership interests at either fair value or at the proportionate share in the recognised amounts of the acquiree's identifiable net assets for each business combination should instead be an accounting policy choice for all business combinations. A few other constituents wonder whether there should be a measurement choice at all. In the case of bargain purchases, a few constituents are unsure whether the effects that the measurement choice of NCIs has on the resulting gains is appropriate considering that the transaction is the same. Doubts about the appropriateness of the measurement choice have also arisen as a result of observing the recognition of relatively higher gains, as a consequence of the impact of falling markets during the financial crisis on the fair value measurement of NCIs.	PI		M		The project summary, feedback and effects analysis for IFRS 3 published in January 2008 stated that only "approximately 12 per cent of business combinations that occur in jurisdictions applying IFRSs involve the acquisition of only a portion of the equity". However we have learnt that when NCI arises in a business combination the practical implementation matters that arise are significant and contribute to divergence in practice.

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	Measurement See measurement issues in the section dealing with step acquisitions below. **Impairment of goodwill** Many constituents have stated that the effect of NCI on the impairment test (when NCI is measured on a proportionate share basis) is an area in which clarifications in IAS 36 *Impairment of Assets* are needed. In particular: (a) the grossing up of goodwill (ie reallocation of goodwill between NCI and controlling interests) after a change in a parent's ownership interest in a subsidiary. Some constituents have stated that when there have been acquisition and disposal transactions with NCI it is not clear whether the gross up of goodwill should be done maintaining the historical percentage of goodwill or whether it is appropriate to use the current percentage of ownership interest held. This is because paragraph C4 of IAS 36 states that "an entity shall gross up the carrying amount of goodwill allocated to the unit to include the goodwill attributable to the non-controlling interest"; and					

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	(b) the allocation of impairment losses. Some constituents mentioned that the requirement in paragraph C6 of IAS 36 to allocate the impairment loss "…between the parent and the non-controlling interest on the same basis as that on which profit or loss is allocated" may not be appropriate for those cases in which goodwill attributable to the parent is not proportional to the percentage of ownership held (ie this would be the case when there is a control premium paid in the acquisition that has caused the goodwill attributed to the parent and to the NCI to not be proportional to their relative ownership interests). **Mandatory purchases of NCIs in business combinations and put options written on NCIs** Both matters had been previously submitted to the IFRS Interpretations Committee and are currently being considered by the IASB. Constituents with whom we conducted outreach during this first phase of the PiR have confirmed that these areas do still warrant consideration. In particular, we have learnt that in specific jurisdictions it is common to see puts on NCI within the context of business combinations. As a result, for those jurisdictions, clarification on the measurement of those financial instruments is a relevant matter.					

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Step acquisitions and amendments to IAS 27 *Consolidated and Separate Financial Statements* (2008)	**Step acquisitions—remeasurement of previously held interest (PHI) and recognition of gain and losses in profit or loss** *Usefulness of the information* Some users have stated that they do not think that the remeasurement of the PHI in the acquiree provides useful information. In their view the measurement of the interest should express what management has committed to. When remeasuring the PHI at fair value, the new measurement might be impacted by factors (for example, macroeconomic factors) that have little to do with what management can be measured against. A user mentioned that the remeasurement should not be recognised in profit or loss but in other comprehensive income. Some constituents have stated that the principle of recognising a gain on the achievement of control should be reconsidered since there is no actual transaction with a third party with respect to the PHI. They think that the recognition of gains or losses is conceptually hard to understand because there is a disconnection between cash-flows and performance measurement and can lead to profit management.	UoI/PI		M		The amendments to IAS 27 from IFRS 3 (2008) together with the additional guidance provided for the accounting for business combinations were the major changes brought in by IFRS 3 (2008). Apart from the implementation challenges relating to NCIs, most of the issues raised in this area are conceptual and relate to a discomfort with the model required for the accounting for loss of control and step acquisitions rather than practical implementation issues.

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	Measurement of the PHI at fair value before the acquisition Many constituents have stated that it is not clear for them how the fair value of the PHIs should be measured. In particular, they are uncertain about how control and other premiums should be considered in the fair value measurements. They have also referred, in many cases, to the current discussions of the IASB in relation to the measurement of investments in subsidiaries, joint ventures and associates at fair value and how those discussions might affect the measurement of PHIs in the context of business combinations. A valuation specialist stated that differences in practices exist. For example, in how the amount paid for a controlling interest is allocated to the PHI. Some entities measure the PHI using the same per-share value as the purchase price. Others back out of the implied control premium. The measurement of PHI (or NCI) at fair value is particularly challenging when the acquiree is a listed company. *Measurement of NCI at fair value* Some constituents have stated that similar challenges to the ones described for the measurement of PHI are also present in the measurement of NCI at fair value.					

Issue	Description	UoI PI	Relevance			Rationale for relevance
			H	M	L	
	In addition, there are also different views on whether the fair value of NCI on a on a per-share basis equals the fair value of the PHI on a per-share basis. The question is whether there are any synergies that should be considered when measuring the fair value of NCIs as these may flow to the NCI holders but not to the PHI holders (ie the acquirer before the acquisition took place). **Accounting for changes in ownership interest** *Disconnection between cash flow and performance measurement* A few constituents have stated that IFRS 3 and IAS 27(2008) include requirements relating to changes in a parent's ownership interests that are counterintuitive as they disconnect cash flow from performance measurement. For example, in the case of a disposal of an ownership interest in a subsidiary without loss of control, no gains or losses are recognised by the parent in profit or loss even though cash was received in the transaction. *Usefulness of information* A few users have stated that in cases in which there is no loss of control but the change in ownership is significant, accounting for such transactions as equity transactions does					

Issue	Description	UoI PI	Relevance			Rationale for relevance
			H	M	L	
	not provide useful information (ie the increase or decrease in value of non-controlling interests is not adequately reflected through an equity transaction). *Measurement of NCI outside a business combination* A few constituents have stated that there is no guidance on how NCIs should be measured outside a business combination transaction (for example, for transactions where NCIs are originated as a result of a parent disposing of an ownership interest without losing control of the subsidiary). **Loss of control** Some constituents have stated that there is a continued resistance with the concept of recognising gains or losses with respect to the retained interest upon loss of control. A few other constituents do not think that the accounting treatment of transactions when loss of control occurs is appropriate when compared to the accounting treatment for equity transactions. They think that it would be appropriate to reconsider the accounting model.					
Disclosures	**Currently required disclosures** Some users have stated that the following aspects of the currently required disclosures in IFRS 3 could be improved	UoI	H			The quality of the information provided by the Standard heavily depends on the quality of its disclosure requirements.

Issue	Description	UoI PI	Relevance			Rationale for relevance
			H	M	L	
	further: • Disclosures relating to the assets acquired and the liabilities assumed are not generally provided with enough granularity. Some users have stated that having further granularity in those disclosures could help them to assess the acquiree's enterprise value (for example, financial liabilities are typically not broken down into pension liabilities, debt, finance lease obligations, etc). • Proforma disclosures. The current requirements are only for the current reporting period. Many users have stated that comparative and interim proforma disclosures would be very useful information to differentiate organic growth from acquisition driven growth. **Useful information that is not currently required** IFRS 3 (or other relevant IFRSs such as IAS 12 *Income Taxes*, IAS 36 or IAS 38) currently does not require entities to disclose: • The carrying amounts of the assets acquired and liabilities assumed of the acquiree before the business combination. IFRS 3 (2004) required disclosure of the IFRS carrying amounts of those assets and liabilities; however, IFRS 3 (2008) removed that requirement to avoid undue cost.					

Issue	Description	UoI PI	Relevance			Rationale for relevance
			H	M	L	
	Some users have stated that even if those carrying amounts were disclosed under the acquiree's local GAAP, that disclosure would still be useful. Even though a few users have stated that this disclosure would be more useful for specific industries (for example, for financial and capital intensive industries), some believe that it is a generally useful disclosure because it would provide greater visibility on the fair value adjustments carried out by the acquirer. This would allow users to relate those adjustments to the business or to the management style and to better assess the quality of earnings after the acquisition. Generally, some users have stated that it is useful to have historical information about the acquiree. In the case that the acquiree was a public company there would be available information. However, that would not be same if the acquiree was a private company. This disclosure could contribute to fill this gap. This disclosure is also considered to be useful in the case when the acquired business is seasonal (ie a user would like to see the carrying amounts of the assets and the liabilities of the acquiree at the time that those assets/liabilities were acquired without the effect of the remeasurements).					

Issue	Description	UoI PI	Relevance			Rationale for relevance
			H	M	L	
	• Additional tax disclosures. A few users have stated that additional tax information, such as the tax losses in the acquired entity or the effects of the business combination on the expected tax rate, would be useful information. • Goodwill and goodwill impairment by segment as a line item is not required by IFRS 8 *Operating Segments*. Some users have stated that these disclosures would be useful information to understand poor performance of some segments and the outcome of the acquisitions. Some have also stated that bad acquisitions can easily be reallocated between different segments or mixed with other segments that have internally generated intangibles. A few users have also stated that it is difficult to trace goodwill back when there has been a sale. Overall there is a perceived lack of transparency in this area. • Information about subsequent performance. Many users have stated that it is currently difficult to track whether an acquisition was successful. A few users have stated that tracking subsequent performance could be useful for assessing an entity's governance. • *Management Commentary*. Some users stated that it would be useful to have detailed information about the rationale of the acquisition (ie what will happen with the acquisition, expected impact on value creation, margin					

Issue	Description	UoI PI	Relevance			Rationale for relevance
			H	M	L	
	impact, earnings impact etc) and the underlying components of goodwill. If goodwill includes synergies, useful information would be what those synergies are (ie their contribution to revenues or cost reductions), their timing and the corresponding costs. If those disclosures were included in the financial statements they would need to be audited. Consequently, a few users suggested that management should be provided with an opportunity to explain its objectives and its strategies for achieving those objectives; it was suggested that a better document where such a non-binding framework could be included could be the practice statement *Management Commentary*. • A few users have stated that the information relating to business combinations is spread out throughout the financial statements and that it would be useful to have a higher concentration of the information relating to business combinations in a single note and/or increase the internal cohesiveness of the information relating to business combinations in the financial statements by increasing, for example, cross-references and reconciliations.					

Issue	Description	UoI PI	Relevance			Rationale for relevance
			H	M	L	
	Disclosures relating to fair value measurements • Some constituents have stated that information about the inputs and assumptions used to measure the fair value amounts at the date of acquisition would help users to assess the reasonableness of those amounts. This information would be particularly helpful for assets that have been recognised as a result of the acquisition (ie intangible assets). The disclosure requirements in IFRS 13 *Fair Value Measurement* only apply to fair value measurements subsequent to initial recognition.					
Contingent consideration	**Classification as debt or equity** Some constituents have stated that the classification of contingent consideration (and the subsequent requirement to remeasure) is affected by the tension between the debt/equity definitions. As a result, according to these constituents, the first challenge in the accounting for contingent consideration is its classification either as equity or debt.	PI		M		Contingent consideration is an "increasingly popular used mechanism both for closing deals and for addressing post-transaction performance uncertainties."[5] As a result, the practical implementation issues in this area could further impair the consistent application of the

[5] 2012 Contingent Consideration Study, Earn-out Structuring and Valuation, Duff&Phelps, August 2012 can be found at http://www.duffandphelps.com/SiteCollectionDocuments/Reports/DUF_0008_Contingent%20Consideration%20Study8%2020.pdf

Issue	Description	UoI PI	Relevance			Rationale for relevance
			H	M	L	
	Initial measurement When the contingent consideration is classified as a liability, some constituents have stated that entities have an incentive to maximise the recognition of contingent consideration at the acquisition date so that thereafter it is released. These constituents question how useful it is for users to see the volatility caused by the subsequent changes in contingent consideration being recognised in profit or loss. Some have stated that the measurement of contingent consideration at fair value is challenging, including: • there is an inherent uncertainty about estimating the outcome and the probability of low frequency events. Contingent consideration payoffs are asymmetric (ie if the target is not met the payoff may be zero), this fact magnifies the effect of misestimating the underlying variable over which the target has been defined; and • the decision on the discount rate requires judgement (ie the characteristics of the earn out and the level of correlation between the earn out and the market will impact on the selection of an appropriate discount rate). The measurement of contingent consideration at fair value shares similar challenges to contingent liabilities.					Standard.

Issue	Description	UoI PI	Relevance			Rationale for relevance
			H	M	L	
	Incorporating market participants' assumptions when measuring the fair value of contingent liabilities, such as contingent liabilities relating to litigation, might be challenging as there is no active market for many of these liabilities. *Lack of consistent techniques being used* Different techniques are used depending on the jurisdiction. A valuation specialist mentioned to us that the major accounting firms in some jurisdictions more predominantly use option pricing approaches as the structure of the earn out payoffs is non-linear. However, these approaches are complex and may not always be the most appropriate technique. In other jurisdictions the trend is to use less sophisticated methods. **Subsequent measurement** The remeasurement of contingent consideration in profit or loss it not perceived to be appropriate by some constituents. This is the case when the variation in the consideration to be paid relates to an agreed change in the value of an individual asset. In this case, the constituents believe that such variations should not be taken systematically to the profit or loss account but should rather be allocated to the carrying value of the assets concerned. They think that the					

Issue	Description	UoI PI	Relevance			Rationale for relevance
			H	M	L	
	accounting for contingent consideration in the context of business combinations might need to be reconsidered in the light of the IASB's recent decision to look at the accounting for variable payments for the acquisition of tangible or intangible assets, once the proposals in the Exposure Draft *Leases* have been redeliberated. A few users have stated that it is counterintuitive to recognise, in profit or loss, expenses when an agreed target has been achieved and income when an agreed target has not been achieved. These users think that adjusting against goodwill would provide a more sensible answer. A few constituents have also mentioned that, along with the measurement, another significant challenge relating to contingent consideration is to assess whether adjustments in the measurement period reflect the situation as it existed at the acquisition date (ie whether adjustments in the measurement period relate to facts and circumstances that existed at the acquisition date whose information was not available or to adjustments that are attributable to the inaccuracy of the estimation process or to errors). One constituent has stated that, in some cases, contingent considerations are designed to adjust the purchase price to take into account information about the fair value amounts that existed at the acquisition date, but which is not known					

Issue	Description	UoI PI	Relevance			Rationale for relevance
			H	M	L	
	until a long time after this date. According to this constituent, adjusting the value of contingent consideration through profit or loss distorts the measure of performance and does not allow the adjusted value of the assets/liabilities to be reflected in the statement of financial position.					
Consideration vs compensation	Many constituents have mentioned the need to provide guidance in relation to paragraph B55(a) of IFRS 3, which deals with continuing employment to clarify whether a contingent consideration arrangement in which the payments are automatically forfeited if the employment terminates is, on its own, conclusive or, instead, a strong indicator that the arrangement is not consideration of the business combination.	PI		M		This issue has already been discussed at the IFRS Interpretations Committee and the need for clarification has been confirmed by many constituents during this first phase of the review.
Adjustments to fair value amounts during the measurement period	A few constituents have stated that sometimes it is challenging to assess whether adjustments to the fair value amounts in the measurement period reflect the situation as it existed at the acquisition date (ie whether adjustments in the measurement period relate to facts and circumstances that existed at the acquisition date whose information was not available or to adjustments that are attributable to the inaccuracy of the estimation process or to errors).	PI			L	Even though this matter could potentially impair the comparability of the financial information, its pervasiveness is somehow limited.

Issue	Description	UoI PI	Relevance			Rationale for relevance
			H	M	L	
Tax effects of business combinations	**Adjustments to goodwill** One constituent wondered about the usefulness of adjusting goodwill upwards when it results from the recognition of deferred tax liabilities arising from the separate recognition of intangibles that do not have any tax benefits associated. The constituent considered such an adjustment to goodwill as being artificial. **Tax liabilities** One constituent highlighted whether an entity should apply IAS 12 or IFRS 3 in the case of a potential liability arising from an uncertain tax position. In accordance with IAS 12, a contingent tax liability could be recognised when an economic outflow is probable; however, in accordance with IFRS 3, a contingent liability that meets the definition of a liability should be recognised at its fair value at the acquisition date even if the probability of outflows is low.	UoI/PI		M		**Adjustments to goodwill** The understanding of the factors that make up goodwill can be impaired by goodwill write-ups arising from deferred tax liabilities. **Tax liabilities** The lack of clarity in the interaction between Standards can lead to divergence in practice.
Separate Financial Statements	**Step acquisition** A few constituents have highlighted the lack of guidance in relation to whether, in the context of step acquisitions, PHIs should also be remeasured in an entity's separate financial statements.	PI		M		The pervasiveness of these issues will be higher for those jurisdictions in which IFRSs are required in the preparation of separate financial statements.

Issue	Description	UoI PI	Relevance			Rationale for relevance
			H	M	L	
	Acquisition-related costs A few constituents have highlighted the lack of guidance in relation to the accounting treatment for acquisition related costs on an entity's separate financial statements. They wondered whether they should be treated as a cost of the investment or whether a different guidance should be applied.					
Identifying the acquirer	Some constituents have mentioned that it is difficult to assess who is the acquirer, particularly in reverse acquisitions. For these constituents the problem lies with the interpretation of the existing guidance, as it is not always clear where the boundary between acquisition and reverse acquisition is. Relating to this matter, a constituent wonders whether a business can be the acquirer in a reverse acquisition because IFRS 3 defines an 'acquirer' as being an entity. Another constituent believes that additional guidance should be added in paragraph B16 of IFRS 13 to specify how assets should be measured (if they are being used to identify the acquirer).	PI		M		The identification of the acquirer is relevant to assess whether the transaction is within the scope of the Standard and, when it is, the identification of the acquirer additionally impacts on the type of combination (ie whether it is a reverse acquisition).

Issue	Description	UoI PI	Relevance			Rationale for relevance
			H	M	L	
Pooling of interest	One user highlighted the lack of guidance for accounting for transactions under common control in IFRS 3 and referred to its local GAAP stating that IFRS 3 ought to have similar guidance, which is pooling of interests. One constituent mentioned to us that even though he did not question the acquisition method for accounting for business combinations, the removal of the pooling of interests method during the first phase of the Business Combinations project was a relevant conceptual change and, as a result, it should be considered for inclusion in the Request for Information (RfI).	UoI			L	The input received during Phase I of the PiR in relation to this matter has been minimal (ie we have not gathered evidence that it is a matter on which concerns exist).
Acquisition related costs	The input gathered during this first phase of the review has discounted the relevance of the concerns that existed in relation to this matter when IFRS 3 (2008) was being developed (ie "acquisition costs should be included in goodwill to ensure that the total outlay was reflected in the statement of financial position").	UoI			L	The input received during Phase I have discounted the concerns that it existed when the Standard was being developed.

Preliminary review of the academic research

7. We have begun preparing a review of the literature relevant to IFRS 3 by searching for studies of IFRS 3, IAS 38 and IAS 36 available on electronic databases accessed via the internet. The search has been based on the areas of interest identified during Phase I for consideration in the PiR of IFRS 3 (as included in paragraph 18 of the staff paper presented to the IFRS Interpretations Committee in September).

8. Appendix 1 to this paper includes a table that provides a summary of published papers that we have identified thus far. We have found a large number of papers from a range of authors, many of which were published in peer review journals during the period 2007-2013. The research approach is mainly empirical archival, making using of published financial data from annual reports and databases. Some studies consider groups of European countries and there are a small number of single country studies, including studies using data from Australia, New Zealand and Canada. There are also some theoretical modelling papers and studies based on survey research.

9. The papers cover the following areas and research questions:

   (a) Applying the Standards—what methods are (or should be) used and what choices are made by firms? The studies consider questions related to discount rates and the definition of goodwill and cash generating units.

   (b) Goodwill and impairment—what are firms' disclosure practices and level of compliance with IAS 36? Several studies address the extent and quality of disclosure under IFRS 3 and IAS 36.

   (c) Economic impact—how have IFRS 3, IAS 38 and IAS 36 affected the quality of information provided? Many studies explore the association of information provided under IFRS with share prices and market returns, using the 'value relevance' approach. Other studies consider how managerial incentives (such as remuneration) are associated with application of the Standards. One study explores the views of preparers and auditors regarding goodwill accounting.

10. In subsequent work on the literature review we will further explore the material presented in these studies and we will expand the discussion and analysis of their findings. We will also review working papers (the in-progress research) for relevant material that should be included in the review.

Question for the IASB

Question 1—Input gathered during Phase I of the PiR
Does the IASB have any questions on the input gathered during Phase I of the PiR?

Appendix 1—Literature summary table

Topic	Authors	Standard/ Country/Year	Findings
Applying the Standards			
Measuring recoverable amount	Kvaal 2007	IAS 36	An appropriate pre-tax discount rate varies between assets and changes over time. Value in use should be measured using company specific after-tax cash flows.
Calculating DCF	Husmann & Schmidt 2007	IAS 36	Weighted average cost of capital (WACC) is the only suitable starting point for obtaining the discount rate for the DCF calculation.
Discount rates	Carlin & Finch 2010	AUS NZ 24 listed firms	There is opportunism in choice of discount rates. (Bradbury 2010 disagrees with this finding).
Definition of CGUs	Carlin, Kaiying & Finch 2010 (working paper)	AUS	Managers make use of discretion in defining and using cash generating units (CGUs) that is inconsistent with transparent and representationally faithful financial reporting.
Definition of goodwill	Guiliani & Brannstrom 2011	Sweden, Italy 2005	A single definition is not used. There is some accounting 'inertia' (continuation of past practice).
Goodwill recognition	Ott & Gunther 2011 (Working paper)	149 IFRS and US GAAP firms 2005-2008	Goodwill recognition reflects managerial opportunism and synergies from the business combination. Lack of evidence of effect of debt contracting and political visibility.
Attitudes to IFRS 3	Pajunen & Saastamoinen 2013	Finland (survey of auditors)	Managers are opportunistic in goodwill write-off decisions. Auditors favour goodwill accounting under IFRS.

Topic	Authors	Standard/ Country/Year	Findings
Goodwill and impairment			
Disclosure, compliance	Carlin Finch & Laili 2009	MALAYSIA First year of adoption	The level of compliance with IAS 36 is variable.
	Carlin & Finch 2011; Carlin & Finch 2010	AUS 2006-07 200 listed firms	There is systematic non-compliance with IAS 36.
	Glaum, Schmidt & Street 2013	EU (17 countries)	Substantial non-compliance with IAS 36 and IFRS 3 reflecting company and country variables.
	Guthrie & Pang 2103	AUS 2005-2010 287 listed firms	Compliance with goodwill allocation requirements improved but was not complete. Some firms had a smaller number of CGUs than reported segments.
	Amiraslani, Iatridis & Pope 2013	EU	The level of compliance with disclosure requirements involving high effort is lower than the level of compliance with disclosure requirements that involve low effort by managers. There is a tendency to use boilerplate language. The timeliness of recognition of bad news in earnings varies between countries.
	Johansen & Plenborg 2013	Survey of users (n=288) and preparers (n=89)	Disclosure under IFRS 3 and IAS 36 are highly demanded. They are more costly to prepare and users are less satisfied with them (compared to other IFRS disclosure items).
	Camodeca, Almici & Bernadi 2013	UK 2007-2011 85 listed non-financial firms	There is a lack of disclosure of key assumptions of IAS 36 estimation models, especially in the period 2009-2011.

Topic	Authors	Standard/ Country/Year	Findings
Economic impact			
Value relevance	Chalmers, Clinch & Godfrey 2008	AUS 2005	IFRS provide incremental information about goodwill but not about identifiable intangible assets.
	Sahut, Boulerne & Teulon 2011	EU 2002-2007	Book value of intangible assets is higher under IFRS and has stronger association with share price and market returns.
	Oliveira, Rodrigues & Craig 2010	Portugal 1998-2008	The change to IFRS had a positive effect on the valuation of goodwill but no impact on the value relevance of identifiable intangible assets.
	Sahut, Boulerne & Teulon 2011	EU 2008-2011 1,855 listed firms	Identifiable intangible assets are more relevant under IFRS; goodwill is less relevant. There are differences between countries in value relevance.
	AbuGhazaleh & Al-Hares 2012	UK 2005-2006 528 large firms	Impairment losses are value relevant. Managers use impairment to convey private information.
	Qureshi 2012	UK firms 1998-2003	Goodwill amortisation is not value relevant.
	Georgakopoulos, Van Hulzen, Alfonso & Sotiropoulos 2012	EU	Impairment of goodwill is not more value relevant under IFRS but it is more timely.
	Lopes, Lourenco & Soliman 2013	Germany	Non-controlling interests are price by the market in the same manner, irrespective of whether they are reported as equity or non-equity.

Topic	Authors	Standard/ Country/Year	Findings
	Laghi, Mattei & Marcantonio 2013	EU 2008-2011 (UK, France, Germany, Italy, Portugal, Spain)	Goodwill impairment is value relevant in 2008 and 2009 and in France in all years.
	Ledoux & Cormier 2013	Canada	The value relevance on intangible assets and expenses improves under IFRS.
Quality of information	Busacca & Maccarrone 2007	Italy (case study Telecom Italia)	The use of value based measures leads to an increase in quality of information (based on increased 'correctness and transparency' while 'prudence and timeliness' are unchanged).
	Schultz & Weiler 2009		Information about goodwill provided by IFRS 3 and SFAS No. 142 *Goodwill and Other Intangible Assets* can be used to design a performance management system which provided information about value creation and realisation.
	Gordon & Hsu 2012 (working paper)	IFRS and US GAAP	IFRS are more informative about future performance than US GAAP. Impairment reported under IFRS (but not US GAAP) is associated with future earnings and cash flows.
Investment opportunities	Chalmers, Godfrey & Webster 2011	AUS	IFRS 3 treatment better reflects underlying firm economics.
Managerial choice, governance	Verriest & Gaeremynck 2009	EU	Better performing firms and those with stronger corporate governance are more likely to record impairment.
Managerial choices, governance	AbuGhazaleh, Al-Hares & Roberts 2011	UK	Impairment expense is associated with CEO change, income smoothing, and 'big bath' accounting; also effective governance (i.e. the expense

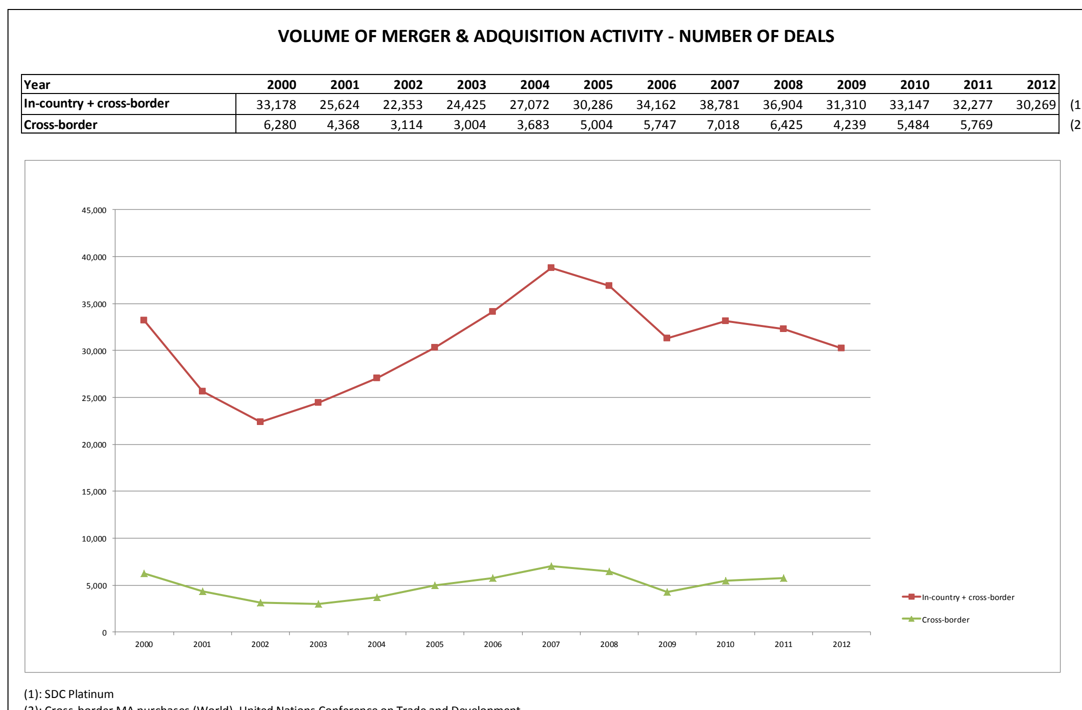
Topic	Authors	Standard/ Country/Year	Findings
			conveys managers' private information).
Change in accounting practice	Bessieux-Ollier, Chavent & Kuentz 2012	France	Three groups of firms were affected differently when they accounted for intangible assets under IFRS. Only one group was significantly affected by change, showing 'inertia' in accounting practice.
Usefulness for analysts	Chalmers, Clinch & Godfrey 2012	AUS	Impairment of goodwill has more information for analysts than straight-line amortisation.
Bonuses and goodwill recognition	Detzen and Zulch (2012)	EU	Managers with larger cash bonuses recognise more goodwill.

Appendix 2—Acquisition activity

1. At the IASB meeting in July, the staff stated as part of the consultations carried out during Phase I of the PiR that they would gather information about whether there has been sufficient acquisition activity throughout the period during which the revised IFRS 3 has been applied to make it worthwhile to proceed to the RfI and Phase II in 2014, or whether the IASB should defer Phase II of the PiR until there has been more acquisition activity.

2. IFRS 3 (2008) was effective for annual reporting periods beginning on or after 1 July 2009. Earlier application was permitted. During the financial crisis period the volume of acquisition activity decreased (please see graph below), however, none of the consulted parties during Phase I of the PiR seemed to think that that decrease would be a good enough justification to not undertake the review of IFRS 3. They have stated that acquisition transactions have occurred and for some companies those have been material.

3. The graph below shows acquisition activity during the last decade. It can be observed that the level of activity in 2010 was similar to the level of activity in 2006 (ie pre-financial crisis).



VOLUME OF MERGER & ADQUISITION ACTIVITY - NUMBER OF DEALS

Year	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	
In-country + cross-border	33,178	25,624	22,353	24,425	27,072	30,286	34,162	38,781	36,904	31,310	33,147	32,277	30,269	(1)
Cross-border	6,280	4,368	3,114	3,004	3,683	5,004	5,747	7,018	6,425	4,239	5,484	5,769		(2)

(1): SDC Platinum
(2): Cross-border MA purchases (World), United Nations Conference on Trade and Development