October 2013

International Financial Reporting Standards

Post-implementation Review of IFRS 3 *Business Combinations*

CMAC Meeting

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Agenda

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- Discussion:

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  (b) Other areas for discussion—Slides 13–20

  (c) Does IFRS 3 provide useful information?—Slide 21

- Appendix 1—Main changes: IAS 22, IFRS 3 (2004), IFRS 3 (2008)—Slides 22–26
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Post-implementation Reviews (PiRs)

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Post-implementation Reviews (PiRs)

- The IASB reviews each new IFRS or major amendment.
- PiRs are contemplated in our *Due Process Handbook* (the *Handbook*).
- An opportunity to assess the effect of new requirements considering:

  (a) issues that were important or contentious during the development of the Standard and subsequently;

  (b) unexpected costs or implementation problems encountered
- Timing of the review — after the new requirements have been applied internationally for 2 years, which is generally about 30 to 36 months after the effective date.
- Each review has two phases (excerpt from the *Handbook*):

  6.54 […] The first involves an **initial identification** and **assessment** of the matters to be examined, which are then the subject of a public consultation by the IASB in the form of a **Request for Information**. In the second phase, the IASB considers the comments it has received from the Request for Information along with the information it has gathered through other consultative activities. On the basis of that information, the IASB presents its findings and sets out the steps it plans to take, if any, as a result of the review.

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PiR of IFRS 3 *Business Combinations*

- The PiR of IFRS 3 *Business Combinations* is the IASB's second review.
- The *Report and Feedback Statement* of the first Standard to be subject to a PiR, IFRS 8 *Operating Segments*, was published in July 2013.[1]
- The IASB discussed the PiR of IFRS 3 at its July 2013 meeting. At that meeting, the IASB tentatively agreed that the scope of the PiR of IFRS 3 will include:
  - the whole Business Combinations project (ie the first and second phases of the project) which resulted in the issuance of IFRS 3 (2004) and IFRS 3 (2008); and
  - any consequential amendments resulting from the Business Combinations project (ie amendments to IAS 12 *Income Taxes*, IAS 27 *Consolidated and Separate Financial Statements*, IAS 36 *Impairment of Assets* and IAS 38 *Intangible Assets*)

(1): The Report and Feedback Statement of the PiR of IFRS 8 can be found at the following link: http://www.ifrs.org/Current-Projects/IASB-Projects/PIR/IFRS-8/Documents/PIR-IFRS-8-Operatihg-Segments-July-2013.pdf

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The Business Combinations Project

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The Business Combinations (BC) project

2001 **2004** **2008**

IAS 22 — BC project starts — **IFRS 3 (2004)** — **IFRS 3 (2008)**

- Business Combinations was an **area of significant divergence** within and across jurisdictions

- Work on the topic had been undertaken by national standard-setters

FIRST PHASE BC PROJECT

- Replaces IAS 22 *Business Combinations*
- Addresses pooling of interests (ie **only** the use of **the acquisition method** is required)
- **Goodwill impairment replaced amortisation of goodwill**

* FASB concluded the first phase of its project on BC in June 2001 by issuing SFAS 141 *Business Combinations* and SFAS 142 *Goodwill and Other Intangibles*

* Pooling of interests method was removed

* Goodwill impairment replaced amortisation of goodwill

SECOND PHASE BC PROJECT

- **Work undertaken jointly with FASB**
- Broader look at BC accounting (**addressing aspects for which there was no guidance**)
- Examination of requirements carried forward from IAS 22 into IFRS 3 (2004) without reconsideration

- Second phase concluded with the issuance of:

  * IFRS 3 *Business Combinations (as revised in 2008)*
  * SFAS no. 141 (revised 2007) *Business Combinations*

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The acquisition method: purchase price allocation (PPA) process

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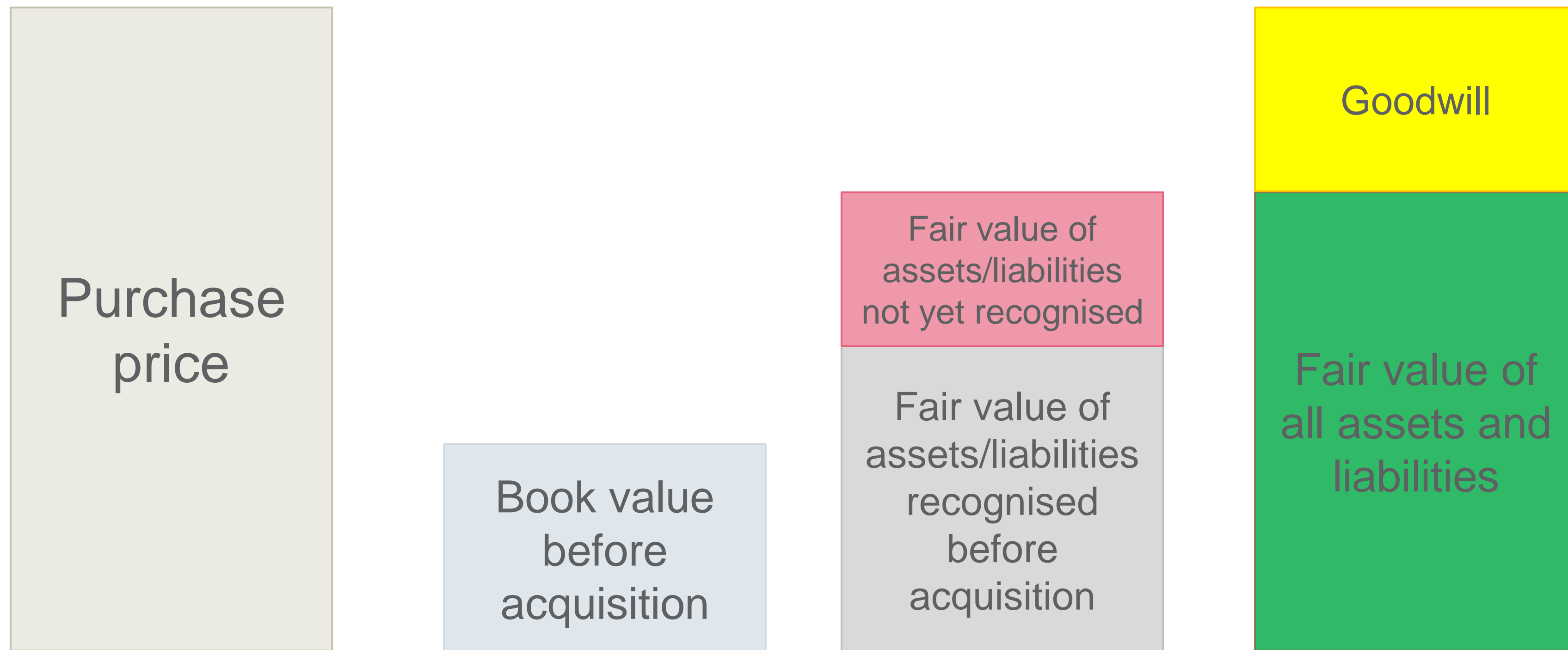
Purchase price allocation (PPA)



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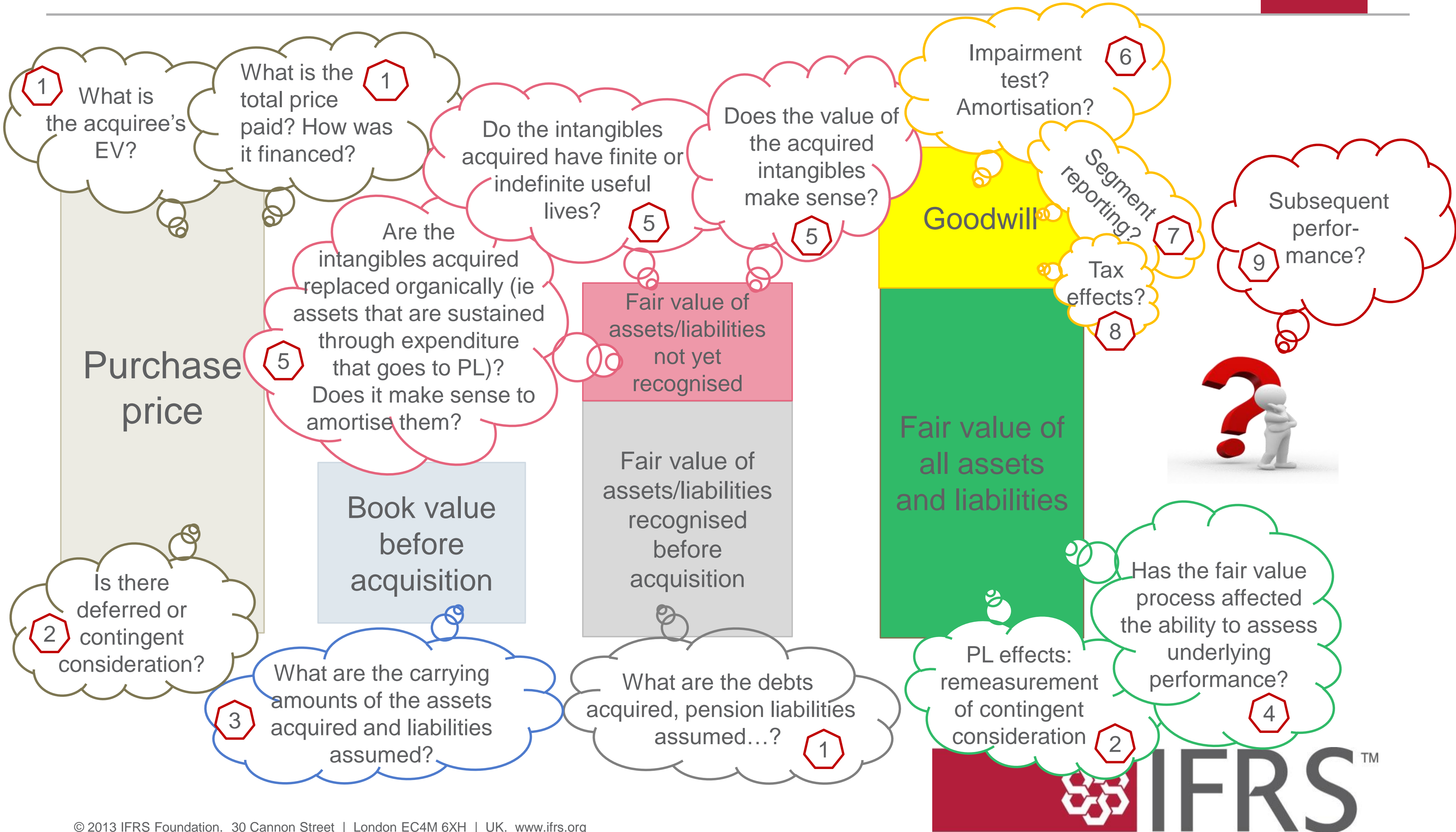
PPA — Investors needs or concerns that we have heard about so far…



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Discussion

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Let’s discuss!

- Please consider the *Illustrative Example* on Disclosures that accompanies IFRS 3 (2008) in Appendix 3. From that example, we would like to discuss:
  - (a) whether those disclosures would help investors in answering:
    - 0 What are the primary reasons for the acquisition? What are the main expected outcomes from the acquisition?
    - 1 What is the total price paid? How was it financed? What is the acquiree’s EV? What are the debts acquired, pension liabilities assumed…?
    - 2 Is there deferred or contingent consideration? PL effects of remeasuring contingent consideration.
    - 8 Tax effects of the acquisition
  - (b) any other areas for improvements observed in the *Illustrative Example*.
- Please consider the following slides to discuss:
  - 3 What are the carrying amounts of the assets acquired and liabilities assumed?—Slide 13
  - 4 Has the fair value process affected the ability to assess the underlying performance?—Slide 14
  - 5 6 Intangibles and goodwill impairment—Slides 15–17
  - 7 Segment reporting—Slides 18–19
  - 9 Subsequent performance—Slide 20
- Appendix 4 includes the relevant disclosure requirements referring to the areas above.

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③ What are the carrying amounts of the assets acquired and liabilities assumed?

- The following disclosure requirement was removed from the current Standard (IFRS 3 2008):

  Paragraph 67 of IFRS 3 (2004):

  […] the acquirer shall disclose the following information for each business combination that was effected during the period:

  (f) the amounts recognised at the acquisition date for each class of the acquiree's assets, liabilities and contingent liabilities, and, unless disclosure would be impracticable, the carrying amounts of each of those classes, determined in accordance with IFRSs, immediately before the combination. If such disclosure would be impracticable, that fact shall be disclosed, together with an explanation of why this is the case.

- Discussion
  - How useful would it be to add it back?

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4 Has the fair value process affected the ability to assess the underlying performance?

- Some concerns raised:
  - "The fair value process impairs investors' ability to assess underlying performance. For example, valuing inventory at fair value depresses profitability with no benefit."
  - Others, however, think that by measuring all assets acquired and liabilities assumed at fair value, and the residual as goodwill, "it is clearer to see what the acquirer spent money on, and whether they overpaid."
- Discussion
  - Why is the ability to assess the underlying performance impaired by the fair value measurements? Is this ability materially distorted?
  - Do you have any other examples (apart from inventory) for which you think that the fair value process impairs the ability to assess the underlying performance?
  - Is there enough information about the main inputs and assumptions used to obtain those fair value measurements?

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5 Intangible assets

- Some concerns frequently raised are listed below:
  - "Entities are not allowed to capitalise internally generated intangibles but they are when those are acquired in business combinations."
  - "There is not enough information to understand whether the acquired intangibles are wasting, permanent or replaced organically in PL."
  - "It does not make sense to amortise intangibles that are sustained through expenditure that goes to PL (ie replaced organically in PL)"
  - "The valuation of intangibles is highly subjective."
- Discussion:
  - What are the implications of those concerns in your analysis? What are the most common adjustments investors make to strip out the purchase price allocation effects?
  - How could those concerns be fixed?

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5 Intangible assets—*continued*

This footnote illustrates the reconciliation of the carrying amounts of an entity's intangible assets. How could this footnote be further improved with regards to business combinations?

	Internally generated intangible assets		Acquired intangible assets					
201X	**Production process**	**Systems development**	**Production process**	**Trademark**	**Marketing and customer-related**	**Systems development**	**Goodwill**	**Total**
Cost								
Opening balance, Jan. 1	4,255	673	76	2,826	2,255	1,840	12,474	24,399
Investments	795	276	-	-	-	79	-	1,150
Business acquisitions	-	-	4	104	278	134	619	1,138
Disposals	(90)	(85)	(1)	(5)	(1)	(36)	-	(219)
Reclassifications	(10)	19	-	-	-	(9)	-	-
Translation differences	(100)	(18)	1	(59)	(105)	(84)	(335)	(699)
Closing balance, Dec. 31	**4,850**	**865**	**80**	**2,866**	**2,426**	**1,924**	**12,758**	**25,769**
Amortisation and impairment losses								
Opening balance, Jan. 1	2,614	428	71	350	951	761	34	5,209
Amortisation for the period	375	111	3	110	229	180	-	1,008
Impairment charge for the period	20	-	3	33	9	4	-	68
Business acquisitions	-	-	-	-	-	1	-	1
Disposals	(81)	(85)	-	(5)	(1)	(36)	-	(209)
Reclassifications	8	(5)	(6)	-	-	15	-	11
Translation differences	(60)	(9)	1	(19)	(43)	(38)	(1)	(168)
Closing balance, Dec. 31	**2,875**	**440**	**71**	**469**	**1,145**	**888**	**33**	**5,920**
Carrying amounts								
at Jan. 1	***1,641***	***245***	***5***	***2,476***	***1,304***	***1,079***	***12,440***	***19,190***
at Dec. 31	***1,975***	***425***	***9***	***2,398***	***1,281***	***1,036***	***12,725***	***19,849***

Required by IAS 38

Not explicitly required by IAS 38

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6 Goodwill impairment

- Discussion:
  - We have heard divided views from investors. Some prefer the impairment test, some would prefer to go back to goodwill amortisation… what are your views?
  - Some pros and cons we have heard so far… would some of the arguments against amortisation or against impairment test be more prevalent depending on the industry?

Pro Impairment Test (against amortisation)	Pro Amortisation (against impairment test)
Allows assessing management's ability to manage (stewardship)	Impairment test delays the recognition of losses
Facilitates communication between users and management	Impairment test is highly subjective; its auditability is challenging
Difficulties in assessing goodwill's useful life (if amortisation was in place)	Costs for preparers will be lower
Amortisation is redundant because goodwill is sustained through expenditure that goes to PL	Goodwill might not be impaired because of internally generated goodwill

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7 How does the acquisition affect segment reporting?

- A major acquisition is likely to have an effect on segment reporting because integrating the new business with the existing business could be the reason for a reorganisation of the business segments.

- IFRS 8 *Operating Segments* requires that the segments are reported from the management perspective based on how the business is managed and that structure is likely to change if new businesses are acquired.

  - If changes in the structure of an entity's internal organisation change the composition of its reportable segments, the corresponding **information for earlier periods**, including interim periods, **must be restated** unless the information is not available and the cost to develop it would be excessive.

  - If the segment information for earlier periods, including interim periods, is not restated to reflect changes in reportable segments, the entity must disclose in the year in which the change occurs **segment information for the current period** on both the **old basis** and the **new basis of segmentation**, unless the necessary information is not available and the cost to develop it would be excessive.

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How does the acquisition affect segment reporting?—*continued*

- Discussion:

  - A few respondents to the PiR of IFRS 8 have suggested that **goodwill impairment** by segment as a line item would be useful information in order to understand poor performance by some sectors and the outcome of acquisitions. What are your views?
  - Which other relevant information arising from an acquisition is normally missing in segment reporting?

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9 Subsequent performance

- *'Once the acquisition has finalised, it is difficult to assess whether the stated strategic ambitions have been met'* (1)
- Some concerns frequently raised:
  - Have targeted synergies been achieved?
  - Can ROI be tracked?
  - Was the acquisition a successful deal?
- Discussion:
  - Do the pro-forma disclosure requirements in IFRS 3 such as the ones below provide useful information? How could they be improved?
    - (a) the amounts of revenue and PL of the acquiree since the acquisition date included in the consolidated PL for the reporting period; and
    - (b) the revenue and PL of the combined entity for the current period as if the acquisition date for all BCs that occurred during the period had been as of the beginning of the period
  - A commonly heard limitation in the ability to provide disclosures related to subsequent performance is that "integration of the acquired entity limits the ability to track the data". Which type of disclosures could still be useful to be provided, considering this constraint?

(1): Five Quick Wins 2011, The Corporate Reporting Users' Forum

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Does IFRS 3 provide useful information?

- The Conceptual Framework states:

  *'If financial information is to be useful, it must be **relevant** and **faithfully represent** what it purports to represent. The usefulness of financial information is enhanced if it is **comparable, verifiable, timely** and **understandable**.'*

- Discussion:
  - What is your initial assessment of the information provided by IFRS 3 in terms of its **relevance** and ability to **faithfully represent** the economic phenomena that it purports to represent?

Qualitative characteristics of useful financial information	
Relevance Predictive value Confirmatory value	**Faithful representation** Completeness Neutrality Free from error
Enhancing Qualitative Characteristics Comparability Verifiability Timeliness Understandability	
Pervasive Constraint Cost	

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Appendix 1—
Main changes: IAS 22, IFRS 3 (2004), IFRS 3 (2008)

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Main changes: IAS 22, IFRS 3 (2004), IFRS 3 (2008)

Issues	IAS 22	IFRS 3 (2004)	IFRS 3 (2008)
Method of accounting for Business Combinations (BC)	Permitted pooling of interests or the purchase method	All BC accounted for by applying the purchase method.	
Cost of a BC	Cash or cash equivalents paid, the fair value (FV) of other purchase consideration given by the acquirer, plus any costs directly attributable to the acquisition.	The FV of assets given, liabilities incurred or assumed, and equity instruments issued by the acquirer, plus any costs directly attributable to the combination.	The FV of the assets transferred, the liabilities incurred by the acquirer to former owners of the acquiree and equity interests issued by the acquirer. Acquisition-related costs must be expensed.
Initial measurement of identifiable assets acquired and liabilities and contingent liabilities assumed in a BC	Permitted an option: *(A) Benchmark treatment*: assets acquired and liabilities assumed initially measured at FV (acquirer's ownership interest) and pre-acquisition carrying amounts (minority interest); *(B) Alternative treatment*: assets acquired and liabilities assumed initially measured at FV.	Acquiree's identifiable assets, liabilities and contingent liabilities are measured by the acquirer at their FVs at the acquisition date.	The acquirer must measure the identifiable assets acquired and liabilities assumed at their acquisition-date fair values.

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Main changes: IAS 22, IFRS 3 (2004), IFRS 3 (2008)—*continued*

Issues	IAS 22	IFRS 3 (2004)	IFRS 3 (2008)
Recognition of liabilities for terminating or reducing the activities of an acquiree	Entities were required to recognise a provision for terminating /reducing activities of the acquiree that was not a liability of the acquiree at the acquisition date.	Recognise liabilities for terminating/reducing activities when the acquiree has a liability in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* .	
Contingent liabilities	Contingent liabilities were subsumed within the amount recognised as goodwill or negative goodwill.	Requires an acquirer to recognise separately the acquiree's contingent liabilities, provided their FVs can be measured reliably.	Retains the guidance in IFRS 3 (2004) but it clarifies that contingent liabilities should not be recognised if they are not liabilities.
Contingent consideration	Contingent consideration was recognised only if it was probable and could be measured reliably. If it was probable and could be measured reliably after the acquisition date, the additional consideration was treated as an adjustment to the cost of the business combination and thus affected the amount of goodwill recognised. There were no specific disclosure requirements, in relation to either the initial agreement or subsequent payments.		A contingent consideration liability must be recognised as part of the BC at FV. After the acquisition date, changes in the FV of the liability would be accounted in accordance with other applicable Standards (normally changes in the FV will be recognised in PL). Disclose the maximum potential amount of future payments under a contingent consideration agreement.

Main changes: IAS 22, IFRS 3 (2004), IFRS 3 (2008)—*continued*

Issues	IAS 22	IFRS 3 (2004)	IFRS 3 (2008)
Intangible assets acquired in a BC	Intangible assets were recognised if, and only if: (a) It was probable that the future economic benefits attributable to the asset would flow to the entity (*probability recognition criterion*); and (b) Its costs could be measured reliably	*(Amendments to IAS 38)* Intangible assets acquired in BC always fulfil the probability recognition criterion. Intangible assets are recognised if their FV can be measured reliably. The FV of intangible assets acquired in a BC can normally be measured with sufficient reliability to be recognised separately from goodwill. If intangibles have a finite useful life, there is a rebuttable presumption that their FV can be measured reliably.	*(Amendments to IAS 38)* Intangible assets acquired in BC always fulfil the probability recognition criterion. The fair value of an intangible asset acquired in a BC can be measured with sufficient reliability to be recognised separately from goodwill.
Goodwill	Goodwill is systematically amortised over its useful life, which could not exceed 20 years.	Initially measured as: Goodwill = (A) Cost of BC – (B) Net FV of acquiree's identifiable assets, liabilities and contingent liabilities Amortisation of goodwill is prohibited, goodwill is required to be tested for impairment annually.	Initially measured as: Goodwill = (A) Cost of BC + NCI + previously held equity interests in the acquiree at FV – (B) Net FV of acquiree's identifiable assets, liabilities and contingent liabilities Goodwill is required to be tested for impairment annually.

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Main changes: IAS 22, IFRS 3 (2004), IFRS 3 (2008)—*continued*

Issues	IAS 22	IFRS 3 (2004)	IFRS 3 (2008)
Non-controlling interests (NCI)	Allowed two options: (a) *Benchmark approach:* minority interest measured at the pre-acquisition carrying amounts (b) *Alternative approach* (see IFRS 3 (2004))	Measured at the minority's proportion of the net FVs of the assets acquired and liabilities assumed (Alternative approach in IAS 22).	For each BC, NCI must be measured: (a) at fair value; or (b) as a proportionate share of the acquiree's net identifiable assets.
Bargain purchases	In most cases, negative goodwill was deferred and amortised to PL, sometimes immediate recognition in PL was required.	• Reassess the identification and measurement of (B) • If (B) > (A), recognise the difference in PL	

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Appendix 2—
FAF’s review of SFAS 141R

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FAF's review of SFAS 141R

- Even though the IFRS and US Standards are the result of a joint effort, our corresponding PiRs are conducted separately. In the case of the US Standard (SFAS 141R), its review has already been undertaken by the independent private-sector organisation responsible for the oversight of the FASB, the Financial Accounting Foundation (FAF), which led to the publication of the *Post-Implementation Review Report on FASB Statement No.141 (revised 2007),* Business Combinations (Statement 141R) in May 2013.(2)

- From the FAF's review:
  - Majority of investor participants indicated that they perceive overall improvements in the relevance, representational faithfulness and comparability of BC information except for NCI.
  - Investors generally view the information provided by Statement 141R as decision useful. The *most useful* information is:
    - description of the transaction;
    - combined earnings as if the acquisition occurred at the beginning of the year; and
    - the post-acquisition earnings of the acquiree.

(2): The FAF's report on Statement 141R can be found at:
http://www.accountingfoundation.org/cs/ContentServer?c=Document_C&pagename=Foundation%2FDocument_C%2FFAFDocumentPage&cid=1176162641881

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FAF’s review of SFAS 141R—*continued*

From the FAF’s review:

- Investors indicated that the information provided by Statement 141R is *less useful* for:
  - forecasting earnings,
  - forecasting cash flows,
  - trend analysis.

- BC disclosure requirements are *too generic* to provide the information investors need to understand the reported fair values (eg the required disclosures do not provide adequate information for them to assess the nature of the uncertainties or the degree of distribution associated with the fair value measurements for acquired loans and for contingent consideration).

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FAF's review of SFAS 141R—*continued*

From the FAF's review:

- The information provided by Statement 141R may not always be representationally faithful:
  - definition of a business (too broad, inconsistent interpretations);
  - bargain purchases (are they conceptually possible? Is the immediate recognition of a bargain purchase gain conceptually sound?);
  - the nature of the BCs between two or more mutual or co-operative entities may not be accurately portrayed.

- FAF review team believe that the application of Statement 141R may not result in decision-useful information consistently and reliably for the following transactions:
  - BCs for which assets/liabilities are difficult to measure at fair value
  - BCs that may be asset purchases
  - BCs that result in bargain purchases
  - BCs that involve mutual entities or more than two entities.

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Where to go for more information

- Project page on the IFRS website:
  - http://www.ifrs.org/Current-Projects/IASB-Projects/PIR/PIR-IFRS-3/Pages/PIR-IFRS-3.aspx

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