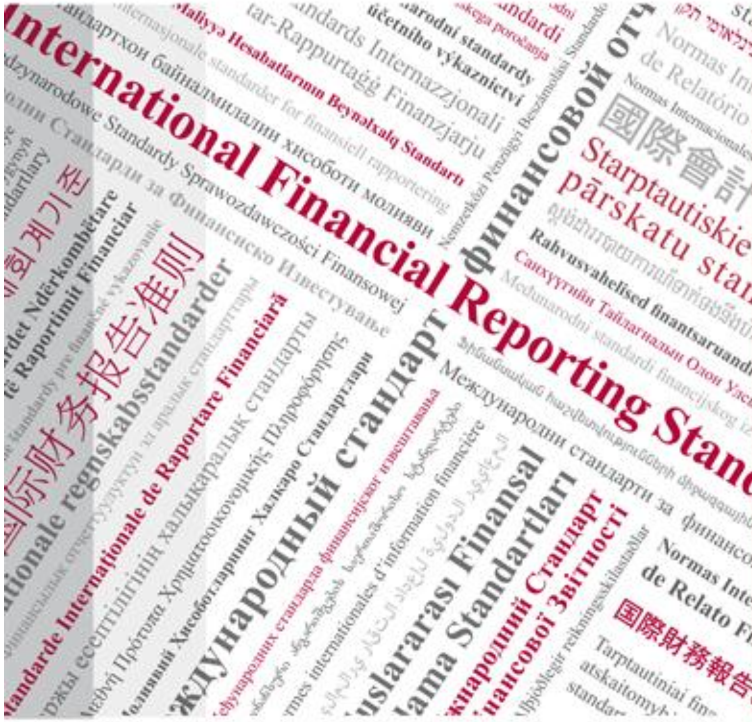
International Financial Reporting Standards



Post-implementation Review of IFRS 3 *Business Combinations*

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The views expressed in this presentation are those of the presenter, not necessarily those of the IASB or IFRS Foundation.

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Agenda

- Current status of the Post-implementation Review (PIR) for IFRS 3 *Business Combinations.*

- Main feedback received so far from outreach activities

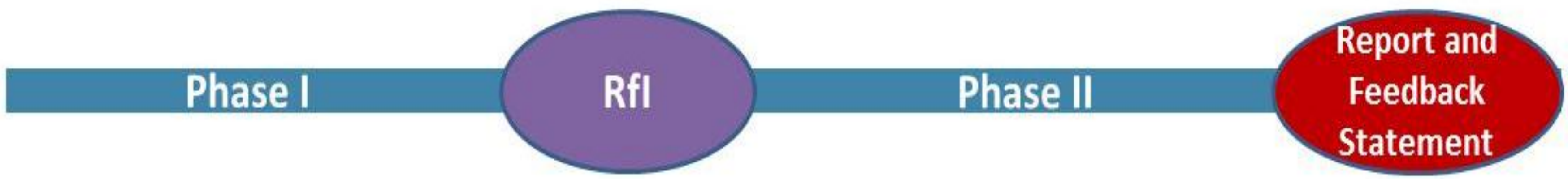
- Next steps

International Financial Reporting Standards

Current status of the Post-implementation Review for IFRS 3

Current status of the PIR for IFRS 3

- Request for Information was published on 30 January 2014. Comment period ended on 30 May 2014*.



- Planning and agree scope
- Identification of the issues

- Submissions analysis
- Investigation of the issues through outreach activities

- Publication of the findings and the IASB's responses to them

* This presentation was prepared on 22 May 2014. Feedback from comment letters is not included in this presentation.

Main feedback received so far from outreach activities

PIR IFRS 3 – Feedback received so far

Definition of a business:

- The definition of a business is broad, especially the term "*capable*".
- There is limited guidance on what is not a business.
- Most of the uncertainty regarding the definition of a business arises from consideration of the processes that need to be in place in a business.
- The assessment is particularly challenging for specific industries (eg real estate, shipping, mining, oil and gas, pharmaceutical).
- Some of the existing accounting differences between asset acquisitions and business combinations should be eliminated, for example the accounting for:
    - deferred tax assets and liabilities,
    - the acquisition-related costs,
    - contingent consideration,
    - contingent liabilities.

PIR IFRS 3 – Feedback received so far

Fair value measurements:

- Relevance of fair values:
  - 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.
  - Tangible assets become a mix of historical cost and fair value, making it hard to analyse trends.
  - Writing up acquired inventory to fair value depresses profitability for 1-2 quarters with no benefit.
  - Fair value does not facilitate the comparison of trends between companies that grow organically and those that grow through acquisitions.
- Challenges:
  - Valuations are costly and subjective
  - Contingent liabilities and contingen consideration are particularly difficult to measure.
  - Determining whether pre-existing contractual relationships are favourable or unfavourable can be complex and time-consuming.

PIR IFRS 3 – Feedback received so far

Separate recognition of intangible assets from goodwill:

- Usefulness:
  - Intangible assets with indefinite life and those that cannot be sold without the underlying business should not be separated from goodwill, because are similar to goodwill.
  - Intangible assets with definite useful life that generate identifiable future revenues (eg patents) should be separated from goodwill.
  - Intangible assets that are tax deductible should be separated, because are useful to estimate future tax expenses.
  - Management value the business as a whole, rather than individually value the assets acquired and the liabilities assumed.
  - The recognition of these intangible assets may result in negative goodwill.
- Challenges:
  - The measurement of some intangible assets requires much use of judgement and is costly.
  - The subsequent amortisation of intangible assets relies on estimates of useful lives, which are also subjective.

PIR IFRS 3 – Feedback received so far

Non-amortisation of goodwill and indefinite-lived intangible assets:

- Usefulness
  - Non-amortisation of goodwill:
    - is useful to calculate performance measures (such as Return of Invested Capital), which can be used to assess stewardship;
    - permits understanding of whether the management has overpaid or whether the acquisition was successful.
  - Impairment test is not effective. Impairment losses are not recognised early enough. The market ignores the impairment test results.
- Challenges:
  - Impairment test is costly and complex.
  - The assumptions used in the impairment test are subjective/too optimistic.
  - Purchased goodwill may be supported by internally generated goodwill (ie it is difficult to separate the cash flows between these two).
  - Goodwill sometimes is generated by deferred tax liabilities.

PIR IFRS 3 – Feedback received so far

Non-controlling interests (NCI):

- The current measurement option:
  - results in different outcomes when subsequent acquisitions of NCI are contemplated;
  - results in different goodwill or gains (in bargain purchases);
  - should be a one-time accounting policy choice for all business combinations (ie it should not be a transaction-by-transaction choice);
  - only one measurement method should be permitted.
- Challenges in the accounting for NCI:
  - When ownership interest decreases without loss of control (eg from 80% to 60%), it is not clear how NCI should be measured (ie % of net asset + goodwill, % of net asset without goodwill, or fair value?).
  - Is the mandatory purchase of any NCI a liability?

PIR IFRS 3 – Feedback received so far

Step acquisitions:

- The previously held equity interest:
    - should not be remeasured at the acquisition-date fair value, because
        - the cost paid for each stake is useful to assess management stewardship;
        - the more the acquirer pays, the bigger is the gain on the remeasurement.
    - should be remeasured, but the gain should be recognised in OCI.
- The valuation at fair value is particularly challenging when, for example, the acquirer held a 49% interest and acquires an additional 2% to get control

Loss of control:

- The valuation at fair value of the retained interest is challenging particularly if the former subsidiary is not listed.
- The retained interest should not be remeasured at fair value.

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PIR IFRS 3 – Feedback received so far

Additional disclosures:

- Information about subsequent performance of the acquiree.
- Pro forma income statements and cash flow information about acquisitions to analyse the effects that these transactions have on the entity's accounts.
- Prior year pro forma information that allows to recompose the latest 12 months information
- Carrying amounts of the assets acquired and liabilities assumed.
- Additional tax disclosures (eg tax losses in the acquired entity, effects of the business combination on the expected tax rate etc).

Better disclosures:

- The primary reasons for the business combination are not sufficiently clear.
- The total consideration paid including the debt acquired, pension liabilities assumed, etc
- Information about inputs and assumptions used to measure the fair value amounts at the date of acquisition.
- Underlying criteria and rationale used by management when identifying and separating intangibles from goodwill.
- More information about the nature of the intangible assets that are recognised as a result of a business combination.

Next Steps

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Next steps

- Present to the IASB:
  - an analysis of the comments received.
  - a review of the academic literature on IFRS 3
  - a comparison between our findings and FAF findings.
- Publication of the findings and the IASB's responses to them
- Discuss our findings with FASB/FAF Staff.
- Think about how we can cooperate with FASB to maintain convergence.

Question to the Advisory Council Members:

Do you have any comments or suggestions about the next steps that we plan to take, including in relation to how we can cooperate with FASB?

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

- Contacts:
  - Michael Stewart: Director of Implementation Activities (mstewart@ifrs.org)
  - Leonardo Piombino: Visiting Fellow (lpiombino@ifrs.org)

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Thank you


individual comments
questions
comment
expressions of individual views
comments
feedback
questions
feedback
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