Tuesday 30 September 2014
The Grange City Hotel (London)

Meeting documentation

World Standard-setters Meeting

Education session: Post-implementation review (PIR) of IFRS 3 *Business Combinations*

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The Grange City Hotel (London)

Education session:
Post implementation review (PIR) of
IFRS 3 *Business Combinations*

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WSS Meeting 29-30 September 2014

International Financial Reporting Standards

Post-implementation Review of IFRS 3 *Business Combinations*

Michael Stewart – Director of Implementation Activities

Agenda

- Current status of the Post-implementation Review (PIR) for IFRS 3 *Business Combinations.*
- Main feedback received from comment letters and outreach activities
- Next steps

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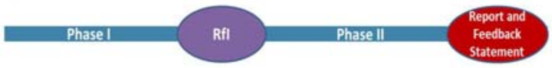
Current status of the Post-implementation Review for IFRS 3

Current status of the PIR for IFRS 3

- Request for Information published on 30 January 2014.
- Comment period ended on 30 May 2014.
- Summary of the comment letters received will be presented at the September IASB meeting*



- 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 in August 2014.

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Main feedback received from comment letters and outreach activities

PIR IFRS 3 – Main feedback received

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 – Main feedback received

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Fair value measurements

The most significant valuation challenges are:

- identification and measurement of intangible assets, in particular:
  - non-contractual intangible assets;
  - intangible assets for which there is no active market;
  - intangible assets in the "early stage" of development.
- Contingent liabilities - due to the uncertainties regarding outcomes. A number of different valuation approaches are used in practice
- Contingent consideration - due to the complexities and uncertainties in the arrangements. This is particularly relevant in the pharmaceutical industry.

PIR IFRS 3 – Main feedback received

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Separate recognition of intangible assets from goodwill:

- Usefulness - Users have mixed views.
- It is useful because:
  - it provides an insight on why a company purchased another company;
  - it provides information on the future cash flows arising from the acquiree;
  - it helps in understanding the components of the acquired business, including its primary assets (i.e. the value-drivers).
- It is not useful because:
  - The valuation of intangible assets such as brands and customer relations, is highly subjective. These intangible assets should be recognised only if there is a market for them.
  - Amortisation of these intangible assets appears to be double counting; post-combination results include amortisation and ongoing maintenance expense.
  - Management value the business as a whole, rather than individually value the assets acquired and the liabilities assumed.

PIR IFRS 3 – Main feedback received

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

- Usefulness - Users have mixed views.
  - 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 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).

PIR IFRS 3 – Main feedback received

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Academic literature review

- We reviewed 28 published academic studies on business combination accounting.
- This review provides evidence generally in support of the current requirements relating to goodwill and other intangible assets.
- In particular, several studies show that:
  - the amount of goodwill and other intangible assets recognised in accordance with IFRS 3 is positively associated with share prices (ie the information is useful for investors)
  - there is a significant negative association between goodwill impairment expense and share price (ie impairment expense provides relevant information)
  - managers are exercising their discretion in the recognition of goodwill and impairment expense. Some studies point to earnings management and income smoothing and a lack of timeliness in recognising impairment.
  - impairment-related disclosures are important to users but there are some areas for improvement.

PIR IFRS 3 – Main feedback received

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Non-controlling interests (NCI):

- The current measurement option:
  - results in different goodwill or gains (in bargain purchases);
  - results in different outcomes when subsequent acquisitions of NCI are contemplated;
  - 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 a NCI a liability?

PIR IFRS 3 – Main feedback received

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Step acquisitions and loss of control

Usefulness

- the previously held equity interest should not be remeasured at the acquisition-date fair value, because
  - remeasurement gains or losses of previously held/retained interest are non-recurring items that are not part of the performance of the entity.
  - 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.
  - the unit price for a large block of shares is different from the unit price for the last few shares needed to acquire control. A previously held large minority interest should not be remeasured at the price paid to acquiring the last few shares that were publicly traded.
- remeasurement gains or losses should be recognised in OCI.

PIR IFRS 3 – Main feedback received

Additional disclosures requested:

- 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
- Pre-acquisition 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).

Existing disclosures - possible improvements:

- 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.

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Next Steps

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 and compare our findings with FASB/FAF Staff.

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Questions to WSS members

Questions to WSS members

Main feedback received:

1. In your view, which are the most critical/urgent issues from the PIR that the IASB should consider as part of its agenda-setting process?

Next Steps:

2. Many think that maintaining convergence with US GAAP is important, especially for business combination accounting. What is your view on that?
3. Do you have any comments or suggestions about the next steps that we plan to take?

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)

Thank you

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