

## STAFF PAPER

February 2015

## IASB Meeting

Project	Post-implementation Review IFRS 3 <i>Business Combinations</i>		
Paper topic	Next steps		
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**Purpose of the paper**

1. In December 2014 the IASB discussed the feedback received during the Post-implementation Review (PIR) of IFRS 3 *Business Combinations* and identified the most significant topics that it should consider for follow-up to the PIR of IFRS 3<sup>1</sup>.
2. The objective of this paper is to ask the IASB for a decision about what follow-up work we should do on the topics identified in the December 2014 IASB meeting. We also ask the IASB to consider how we should interact with the FASB, who have already started projects addressing some of these topics, and what work we might do to complement their related projects.

**Background information*****Classification of the topics agreed in the December IASB meeting***

3. In its December 2014 meeting, the IASB agreed to classify the topics identified during the PIR of IFRS 3 into four groups on the basis of their significance. The IASB held a preliminary discussion on the possible next steps. In the following table

<sup>1</sup> For further details see AP12B <http://www.ifrs.org/Meetings/MeetingDocs/IASB/2014/December/AP12B-IFRS-IC-Issues-IFRS-3-Findings.pdf>

we report this classification of the topics and the possible next steps proposed by the staff.

Topic	Assessed significance agreed by IASB	Possible next steps proposed by the staff
1. Ineffectiveness and complexity of testing goodwill for impairment.	Higher	Review IAS 36 <i>Impairment of Assets</i> (IAS 36 is not converged with US GAAP). Consider improvements to the impairment model; in particular consider the scope for simplification.
2. Subsequent accounting for goodwill (ie the benefits of an impairment-only approach compared with an amortisation and impairment approach).	Higher	<p>Work with the FASB. FASB is exploring the amortisation and impairment approach with a focus on how to identify the useful life of goodwill.</p> <p>We could additionally investigate whether and how the costs of accounting for goodwill can be reduced without losing the information currently being provided by the impairment-only approach, and which our review of academic studies suggested was value-relevant. This could include considering:</p> <ul style="list-style-type: none"> <li>• whether a variation on an amortisation and impairment model might be developed with an amortisation method that does not undermine the information currently provided by the impairment-only approach; and</li> <li>• what improvements could be made in the short-term to the impairment-only approach in order to address on a timely basis some of the concerns that have been raised, pending developments on the longer-term review of IAS 36.</li> </ul>
3. Challenges in applying the definition of a business.	Medium/high	<p>Work with the FASB. FASB is focusing its analysis on clarifying the definition of a business and the related application guidance.</p> <p>We could additionally consider whether the market-participant approach is preferable to an entity-specific approach when making this assessment.</p>

Topic	Assessed significance agreed by IASB	Possible next steps proposed by the staff
4. Identification and fair value measurement of intangible assets such as customer relationships and brand names.	Medium/high	<p>Work with the FASB. FASB is assessing whether certain intangible assets (eg customer relationships) should be subsumed into goodwill.</p> <p>We could additionally consider what additional guidance could be given to assist in the identification of customer relationship intangibles, and their associated measurement.</p>
5. Information about the subsequent performance of the acquiree.	Medium	Further analysis, eg investigate how practicable it would be to prepare this information, and for how many reporting periods post-acquisition this information should be provided.
6. Usefulness of the subsequent accounting for contingent consideration.	Medium	Further analysis. Some participants suggest investigating whether in some circumstances changes in the fair value of contingent consideration should be recognised against the assets acquired.
7. Fair value measurement of contingent consideration and contingent liabilities.	Medium	Further analysis. Some participants suggest investigating whether contingent consideration and contingent liabilities should be recognised only if they can be measured reliably.
8. Usefulness of the accounting for step acquisitions and loss of control.	Medium	Further analysis. Some participants suggest investigating whether remeasurement gains should be recognised in OCI.
9. Measurement of non-controlling interests.	Lower	Further analysis. Some participants suggest investigating whether the measurement of NCI should be a one-time accounting policy choice for all business combinations (ie it should not be a transaction-by-transaction choice).
10. Pro-forma prior year comparative information.	Lower	Further analysis, eg investigate how practicable it would be to prepare this information.
11. Usefulness of the recognition of negative goodwill in P&L.	Lower	Further analysis. Some participants suggest investigating whether negative goodwill should be recognised in OCI.

Topic	Assessed significance agreed by IASB	Possible next steps proposed by the staff
12. Accounting for contingent payments to selling shareholders who become employees.	Lower	Further analysis. Some participants suggest revisiting the guidance for contingent payments to selling shareholders in circumstances in which those selling shareholders become, or continue as, employees. In their view, this guidance should be one of the indicators to consider in assessing whether such payments should be treated as consideration or as a post-acquisition expense.

### ***FASB activities***

4. IFRS 3 and Statement 141(revised 2007) *Business Combinations* of the US national standard-setter, the Financial Accounting Standards Board (FASB) are converged standards. The FASB added to its technical agenda<sup>2</sup> the following narrow-scope projects:

- (a) *Clarifying the Definition of a Business*: the FASB staff are focusing their analysis on clarifying the definition of a business, while continuing to research potential solutions for differences in the recognition and derecognition accounting for assets and businesses. In its December 2014 meeting the FASB<sup>3</sup> decided:
  - (i) to retain the concept of ‘capable of’ in the definition of a business;
  - (ii) to clarify that to be a business the set of activities and assets must include inputs and one or more substantive processes that together contribute to the ability to create outputs. The Board instructed the staff to develop factors that indicate when a process is substantive;

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<sup>2</sup> For further details, please see [http://www.fasb.org/jsp/FASB/Page/TechnicalAgendaPage&cid=1175805470156#tab\\_1175805471236](http://www.fasb.org/jsp/FASB/Page/TechnicalAgendaPage&cid=1175805470156#tab_1175805471236)

<sup>3</sup> For further details, please see [http://www.fasb.org/jsp/FASB/FASBContent\\_C/ProjectUpdatePage&cid=1176159970856](http://www.fasb.org/jsp/FASB/FASBContent_C/ProjectUpdatePage&cid=1176159970856)

- (iii) that the staff should explore a threshold to be used in the definition of a business, similar to the de minimis threshold in EITF Issue No. 98-3, *Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business*. Issue 98-3 said that if all but a de minimis amount of the fair value of the transferred set of activities and assets was represented by a single tangible or identifiable, intangible asset, that was an indicator that the transferred set was an asset rather than a business.
  - (iv) to revise the definition of outputs to focus on goods and services to customers.
  - (v) not to explore changes to the concept of “a market participant” in the definition of a business.
  - (vi) to explore adding examples to help in the interpretation of what is a business.
- (b) *Accounting for Goodwill for Public Business Entities and Not-for-Profit Entities*: the FASB staff are performing research on the amortisation of goodwill, with a focus on identifying the most appropriate useful life if goodwill were amortised, and on simplifying the impairment test.
- (c) *Accounting for Identifiable Intangible Assets in a Business Combination for Public Business Entities and Not-for-Profit Entities*: this project will evaluate whether certain intangible assets should be subsumed into goodwill, with a focus on customer relationships and non-compete agreements.

We understand that the FASB will probably publish an Exposure Draft, rather than a Discussion Paper, on these topics, although this has not been formally decided yet.

## Staff proposals on the next steps

### *A research project to improve the IAS 36 impairment test (Topic 1)*

5. The most significant finding from the PIR was the need to improve the impairment test. This is needed irrespective of whether amortisation of goodwill is reintroduced.
6. Among the issues that we heard are:
  - (a) difficulties in determining a pre-tax discount rate for the value in use (VIU) calculation.
  - (b) the artificial nature of some of the limitations of the VIU calculation, in particular the prohibition on including expansion capex in cash flow projections and the requirement to perform the test based on the most recent approved budgets, which over time can be substantially different from the business plans at the acquisition date.
  - (c) concerns about the high degree of subjectivity in the assumptions used in the VIU calculation.
  - (d) the apparent ‘lag’ in the time between the impairment occurring and the impairment charge being recognised in the financial statements.
  - (e) difficulties (and subjectivity involved) in allocating goodwill to cash generating units (CGUs) for impairment testing purposes, and reallocating that goodwill when restructuring occurs; and
  - (f) the costs involved in performing the impairment test, including the requirement to perform it annually in the absence of impairment indicators.
7. We think that the improvements needed to IAS 36 require a broad approach, first to ensure all significant issues with impairment testing have been identified, and then to consider the possible alternative approaches. We think that the project should consider the results of relevant academic studies and the interaction with the research project on discount rates. The PIR provided us with significant feedback on the operation of the impairment test, although the focus of the review was not on IAS 36 itself.

8. We think that a research project to improve IAS 36 is needed, irrespective of other decisions that the IASB might take on other follow-up projects arising from the PIR. Given the importance of this topic, we think that our proposed project on improving IAS 36 should begin as soon as possible.
9. Consequently, we propose that a research project should be added to the IASB's agenda, and because of the importance of progressing this, we propose that this should be one of the IASB's higher-priority research projects.
10. IAS 36 is not a converged standard and so we propose that this would be an IASB-only research project, however, we would expect to draw on the relevant work - of other standard setters. The FASB has commented that it is keen to see the results of our work in this area, with the aim of seeing whether US GAAP could be converged with IFRS in this area.
11. The broader scope of this project compared with the FASB's project on accounting for goodwill, will inevitably mean that this will run on a longer time frame, compared with FASB's project, notwithstanding the fact that FASB's project includes consideration of the impairment test. Consequently, we think that the IASB could additionally consider whether short-term improvements to the goodwill impairment test are possible, as part of work that it could do with FASB on its goodwill project.

***Standard-setting projects on the subsequent accounting for goodwill, the definition of a business and the identification and measurement of intangible assets (Topics 2, 3 and 4)***

12. These three topics, which we have assessed as being of higher or medium/high significance, are currently part of the FASB's agenda. These topics relate to the converged Standards.
13. We note that:
  - (a) Accounting Standards Advisory Forum ('ASAF') members generally supported maintaining convergence with US GAAP. Consequently, they

suggested that any amendments to IFRS 3 should be discussed with the FASB<sup>4</sup>; and

- (b) the IFRS Advisory Council ('the Advisory Council') encouraged the IASB to continue to work to maintain convergence, leveraging ASAF to achieve this<sup>5</sup>.

14. Consequently, we think that the IASB should add to its standard-setting agenda projects on the definition of a business, the subsequent accounting for goodwill and the identification and measurement of intangible assets such as customer relationships and brand names.

### Subsequent accounting for goodwill

15. Even though this project would consider whether goodwill should be amortised, we do not think that this project is simply about a choice between retaining the impairment-only approach to goodwill and switching to an amortisation and impairment approach. We think it is important to be clear about what information is most useful to investors, whilst understanding the costs involved in providing that information. We also think that there is a link between the concerns raised in relation to impairment testing and the concerns raised in relation to the non-amortisation of goodwill.
16. We think our objective should be to investigate whether and how the costs of accounting for goodwill can be reduced without losing the information currently being provided, and which our review of academic studies suggested was value relevant. We think that this could include considering:
- (a) whether a variation on an amortisation and impairment model might be developed with an amortisation method that does not undermine the information currently provided by the impairment-only approach (eg an increasing balance amortisation method); and

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<sup>4</sup> See ASAF Summary (October 2014): <http://www.ifrs.org/About-us/IASB/Advisory-bodies/ASAF/Documents/ASAF-summary-Oct-2014.pdf>

<sup>5</sup> See Advisory Council Report (June 2014): <http://www.ifrs.org/The-organisation/IFRS-Advisory-Council/Documents/IFRS-Advisory-Council-Meeting-Report-June-2014.pdf>



- (b) what improvements could be made in the short-term to the impairment-only approach in order to address on a timely basis some of the concerns that have been raised, pending developments on the longer-term review of IAS 36. We note that the Disclosure Initiative has successfully identified some short-term improvements that have been made alongside the longer-term *Principles of Disclosure* research project, and we think it might be possible to do something similar here. For example, we could examine whether an annual impairment test is necessary for goodwill if there are no impairment indicators.
17. We think that approaching this topic in this way would complement the work that FASB is performing.

### *Definition of a business*

18. The focus of the FASB project aims to cover most of the concerns that we heard through our PIR. We think that the additional issue that we heard through the PIR that we think we could explore is whether the market-participant approach is preferable to an entity-specific approach when assessing whether a transaction is a business combination or just an asset purchase.

### *Identification and measurement of intangible assets*

19. One of the concerns that we heard through the PIR is the difficulty in identifying particular intangible assets, and consequently assessing the values of these is difficult and can be costly. In addition to the work that FASB is planning, we think that we could investigate whether additional guidance could be given about the types of intangible assets that are commonly acquired in a business combination and the measurement objective for these assets.

### *Working with FASB*

20. We think that we should work with the FASB on these topics. As we note above, we received very clear messages through the PIR that maintaining convergence is an important priority for many of our stakeholders.
21. Working with the FASB could involve (i) merely monitoring what they are doing, (ii) developing separate staff papers on the same topics at the same time, for separate

Board discussions (parallel co-ordination) but based on regular joint staff discussions, supplemented by periodic joint board discussions, or (iii) joint staff papers with joint board discussions.

22. We do not think that merely monitoring the FASB's work is sufficient; we think the IASB needs to have a significant input to the work to ensure that all aspects of the issues that are relevant to IFRS preparers are considered. Consequently we do not recommend approach (i) above.
23. We think that either parallel co-ordination (alternative (ii)) or full joint projects (alternative (iii)) would provide an effective way of working together with the FASB on these topics.

### ***Other topics***

24. We think that the other topics, Topics 5 to 12, which are all assessed as being of medium or lower significance, should be considered for inclusion in one or more narrow-scope projects. However, we do not see any of these as being urgent issues, and so we think that the question of adding such narrow-scope project(s) should be specifically considered in the agenda consultation later this year.

### ***Staff recommendation***

25. In summary, we are recommending that the IASB should:
  - (a) add to its research agenda a project on improving the impairment test;
  - (b) add to its standard-setting agenda projects on Topics 2, 3 and 4, which are: clarifying the definition of a business, the subsequent accounting for goodwill and the identification and measurement of intangible assets such as customer relationships and brand names;
  - (c) work with the FASB (ie parallel co-ordination or full joint projects) on Topics 2, 3 and 4; and
  - (d) consider in the next IASB agenda consultation whether to add to its agenda one or more narrow-scope projects on topics 5 to 12.

26. If the IASB agrees to add these projects to its agenda (or some combination thereof) we would bring agenda paper(s) to a future IASB meeting with detailed proposals for the scope of each project.

**Questions to IASB members**

- 1 Do you agree with the staff's recommendation to add to the IASB research agenda a project on improving the impairment test?
- 2 Do you agree with the staff's recommendation to add to the IASB standard-setting agenda projects on Topics 2, 3 and 4?
- 3 Do you agree with the staff's recommendation to work with the FASB (ie parallel co-ordination or full joint projects) on Topics 2, 3 and 4?
- 4 Do you agree with the staff's recommendation to consider in the next IASB agenda consultation whether to add to the IASB agenda one or more narrow-scope projects on Topics 5 to 12?