STAFF PAPER

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Accounting Standards Advisory Forum

Project	Post-implementation Review IFRS 3 *Business Combinations*
Paper topic	Findings and next steps

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Purpose of the paper

1. The objective of this paper is to:
   (a) communicate to ASAF members the findings of the Post-implementation Review (PIR) of IFRS 3 *Business Combinations;*
   (b) communicate the IASB decision about what follow-up work it should do on these findings; and
   (c) ask for ASAF members advice on the follow-up work that the IASB is planning to do.

IASB findings about IFRS 3

Summary of the feedback received

2. Investors have mixed views on the following topics.
   (a) Subsequent accounting for goodwill: some investors supported the current requirements, because they think that the non-amortisation of goodwill helps them to understand whether an acquisition is working as expected. Other users support the amortisation of goodwill, because goodwill acquired in a business combination is supported and replaced by internally generated goodwill over time.

(b) Separate recognition of intangible assets: some investors support the current practice, because it provides an insight on why a company purchased another company. Other investors do not support the current practice of identifying additional intangible assets (eg brands, customer relations, etc) beyond goodwill, because it is highly subjective. They think that these intangible assets should be recognised only if there is a market for them.

(c) Measurement of non-controlling interests (NCIs): some investors think that NCIs should be measured using the proportionate method, while other investors prefer the fair value method, and others did not have a preference.

(d) Subsequent accounting for contingent consideration: some investors think that the current requirements are counterintuitive, because the acquirer recognises a loss if the acquiree is performing better than expected. Other investors support the current requirements, because they help the investors to know how the acquirer is performing.

3. Some investors do not support the current requirements on step acquisitions and loss of control and are asking for additional information about the subsequent performance of the acquired business.

4. Many preparers think that there are some areas in which implementation challenges have arisen and where further clarification would be useful. These areas are the following.

(a) The definition of a business: many preparers think the definition of a business is too broad and that more guidance is needed to determine whether a transaction is a business combination or an asset acquisition, especially when the processes acquired are not significant and when the entity acquired does not generate revenues.

(b) Fair value measurement: many preparers think that contingent consideration, contingent liabilities and intangible assets, such as brand names and customer relations, are difficult to measure at fair value.

(c) Impairment test for goodwill: many preparers think that the impairment test is complex, time-consuming and expensive and involves significant judgements, especially in determining the assumptions used in the value in use calculation and in allocating goodwill to the cash-generating units.

(d) Contingent payments to selling shareholders who become employees: Many preparers ask the IASB to revisit the accounting for these payments. In their view, the fact that contingent payments are forfeited if employment terminates should not be a conclusive rule, but should instead be one of the indicators that should be considered in assessing whether such contingent consideration should be treated as part of the consideration transferred or as a post-acquisition expense.

5. Some participants in the PIR expressed concerns regarding the level of effort required and costs incurred to meet the requirements of IFRS 3. They think that these costs may, in at least some cases, have exceeded the benefits to users.

Many participants in the PIR think that the IASB should try to work together with the Financial Accounting Standards Board (FASB) if future changes are considered, in order to mitigate the risk of divergence on business combination accounting. Many noted that the FASB has recently decided to reconsider the post-acquisition accounting for goodwill and they would support a similar effort by the IASB.

Review of academic research and related literature

6. An important part of the PIR has been the review of academic research and other available literature[1]. This review considered evidence from relevant studies on the value relevance of goodwill, other intangible assets and impairment. It also reports findings of studies investigating application issues and compliance with IFRS 3 and IAS 36. The evidence in this review was drawn from publicly available published papers, located via Google Scholar and other databases of academic studies. Evidence from working papers that are not yet published was generally not included, because the results of these studies may change prior to publication.

7. We think that this review provides evidence that generally supports the current requirements, particularly in relation to the usefulness for firms using IFRS 3 and IAS

[1] For further details see Agenda Paper 12G (September 2014 IASB meeting) http://www.ifrs.org/Meetings/MeetingDocs/IASB/2014/September/AP12G-PIR%20IFRS%203.pdf

36 of reported goodwill, other intangible assets and goodwill impairment. As expected, some studies showed the impact of managerial incentives on impairment recognition. Nevertheless some authors pointed to an association between impairment and economic factors, market indicators and firm earnings and concluded that impairment recognition was conveying relevant information. Other studies identified areas for improvement, particularly in relation to disclosure practices.

Classification of the topics agreed in the December 2014 IASB meeting

8. 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[2]. The IASB assessed the significance of the topics using the following criteria:

   (a) Have investors[3] expressed concerns about the usefulness of the information provided by the current requirements?

   (b) Have preparers[4], auditors or regulators expressed concerns about the application of the current requirements?

   (c) Is the topic included in the issues recommended by the ASAF for further work?

   (d) Is the topic included in the Financial Accounting Foundation's Report on PIR of Statement 141 (revised 2007) *Business Combinations* or on the FASB agenda?

9. In that meeting, the IASB agreed to classify the topics identified during the PIR of IFRS 3 into four groups on the basis of their significance. In the following table we report this classification of the topics and the possible next steps proposed by the staff.

[2] For further details see AP12B http://www.ifrs.org/Meetings/MeetingDocs/IASB/2014/December/AP12B-IFRS-IC-Issues-IFRS-3-Findings.pdf

[3] Including the Capital Markets Advisory Committee (CMAC).

[4] Including the Global Preparers Forum (GPF).

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 *Impairment of Assets* (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	The IASB could 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: • how improvements to the impairment-only approach (in particular to the impairment test) could address some of the concerns that have been raised; and • 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.
3. Challenges in applying the definition of a business.	Medium/high	Clarifying the definition of a business and the related application guidance.
4. Identification and fair value measurement of intangible assets such as customer relationships and brand names.	Medium/high	Assessing whether certain intangible assets (eg customer relationships) should be subsumed into goodwill. Considering what additional guidance could be given to assist in the identification of customer relationship intangibles, and their associated measurement.
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.

Topic	Assessed significance agreed by IASB	Possible next steps proposed by the staff
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.
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.

Follow-up work agreed in the February 2015 IASB meeting

10. In its February 2015 meeting, the IASB decided to add the following issues to its research agenda. The first three are interrelated:

    (a) how to improve the impairment test in IAS 36 *Impairment of Assets* (Topic 1);

(b) the subsequent accounting for goodwill, including the relative merits of an impairment-only approach and an amortisation and impairment approach (Topic 2);

(c) the identification and measurement of intangible assets such as customer relationships and brand names (Topic 3); and

(d) how to clarify the definition of a business (Topic 4).

Staff proposals on the issues added to the IASB research agenda

11. We will bring agenda papers to future IASB meetings with detailed proposals for the scope of each research project. We are still thinking about to what extent, and how, we might combine our work on the first three topics. In the following paragraphs we provide a preliminary overview of the issues that we would like to address in these research projects.

How to improve the IAS 36 impairment test (Topic 1)

12. 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.

13. 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.

14. 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, even though the focus of the review was not on IAS 36 itself.

Question to ASAF members
What advice do you have on our preliminary proposals on Topic 1?

Subsequent accounting for goodwill (Topic 2)

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 that the objective of this research 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) how improvements to the impairment-only approach (in particular to the impairment test) could address some of the concerns that have been raised; and

(b) 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).

17. We think that we need to:

(a) understand why there are differences between participants feedback and academic evidence;

(b) analyse the causes of the concerns about the impairment-only approach;

(c) understand the cost-benefit trade off of the impairment-only approach and the consequences of any change.

18. We also think that we should:

(a) consider the results of the work recently undertaken by ASBJ, EFRAG and OIC on this topic; and

(b) continue to liaise with FASB staff that are already working on this issue to share the benefits from each other's work on this topic.

Question to ASAF members
What advice do you have on our preliminary proposals on Topic 2?

Identification and measurement of intangible assets (Topic 3)

19. The main causes of the challenges in recognising and measuring intangible assets described by participants to the PIR are:

(a) many intangible assets are not frequently traded on a stand-alone basis and therefore there is very often no active market for them;

(b) many intangible assets are unique and it is therefore not easy to identify and assess their value;

(c) valuation methods are complex and subjective;

(d) the measurement is more complex when the intangible assets are not based on legally enforceable rights; and

(e) the useful life of some intangible assets is subjective.

20. We think that the research should consider whether certain intangible assets (eg customer relationships, intangible assets with indefinite useful lives) should be subsumed into goodwill; and 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.

21. We also think that we should continue to liaise with FASB staff that are already working on this issue to share the benefits from each other's work on this topic.

Question to ASAF members
What advice do you have on our preliminary proposals on Topic 3?

How to clarify the definition of a business (Topic 4)

22. We think that applying the definition of a business is particularly challenging in some industries, such as real estate, extractive activities, pharmaceutical, technology and shipping. The main challenges that participants to the PIR have faced when determining whether an acquisition includes a business are the following:

(a) the assessment of the relevance of processes acquired as part of the acquired set of assets and significance of the processes missing from the set;

(b) the definition of a business is too broad and IFRS 3 has little or no guidance on when an acquired set of assets is not a business;

(c) the wording 'capable of being conducted as a business' does not help in determining whether a transaction includes a business;

(d) clarity is required on the definition of a business when the entity acquired does not generate revenues.

(e) the term 'market participant' is not defined in IFRS 3. Some sets of assets may be considered a business for a specific group of market participants if they could integrate the set of assets in their processes. However, the same set of assets might not be considered as a business from the perspective of other market participants. Further guidance on what constitutes a market participant would help in this determination.

(f) the assessment is primarily fact-driven, instead of taking the business rationale, the strategic considerations and objectives of the acquirer into account.

23. We think that the IASB should consider how it could clarify the definition of a business and the related application guidance in order to address the issues identified by the participants to the review.

24. We also think that we should continue to liaise with FASB staff that are already working on this issue to share the benefits from each other's work on this topic.

25. We also heard from PIR participants about concerns over the different accounting treatment for business combinations compared with asset acquisitions. We think that the IASB could additionally consider whether and how those accounting differences could be reduced, thereby relieving some of the pressure on the definition of a business.

Question to ASAF members
What advice do you have on our preliminary proposals on Topic 4?