ICAEW REPRESENTATION 77/14

REQUEST FOR INFORMATION: IFRS 3 BUSINESS COMBINATIONS

ICAEW welcomes the opportunity to comment on the *Request for Information: IFRS 3 Business Combinations* published by the IASB on 30 January 2014.

This response of 23 May has been prepared on behalf of ICAEW by the Financial Reporting Faculty. Recognised internationally as a leading authority on financial reporting, the faculty, through its Financial Reporting Committee, is responsible for formulating ICAEW policy on financial reporting issues and makes submissions to standard setters and other external bodies on behalf of ICAEW. The faculty provides an extensive range of services to its members including providing practical assistance with common financial reporting problems.

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MAJOR POINTS

Overall the standard works well

1. The objective of IFRS 3 is to improve the relevance, reliability and comparability of the information an entity provides in its financial statements about a business combination and its effects. We believe that, on the whole, this has been achieved and that the standard helps to focus the minds of both preparers and users of the financial statements on what has been acquired and why the acquirer paid what they did for the acquiree. We therefore believe that the overall effect of the standard has been positive. However, as set out below, we are concerned that some areas of the standard lead to additional costs for preparers with little benefit for users of the financial statements

The definition of a business needs clarifying

2. We acknowledge that in most straightforward cases the existing definition of a business works and we are generally supportive of the approach adopted by the standard. However, in some cases the distinction between what is and isn't a business is unclear. The board may therefore wish to consider providing expanded guidance in this area. See our answer to question 2 below for more details.

The costs of separately recognising some intangibles outweigh the benefits

3. The standard casts the net widely when defining identifiable intangibles. This means that certain intangibles that are acquired in a typical business combination – such as customer relationships, customer lists and brands – need to be separately recognised and measured at fair value at the date of acquisition even though it is not possible to recognise equivalent internally generated intangibles. Businesses will often incur significant costs in order to obtain these fair values but given that both users and preparers see little, if any, advantage in separately recognising such intangibles, it is difficult to argue that the benefits outweigh the costs. The UK's Financial Reporting Council recently undertook some research into this area and we urge the board to consider their findings. See our answer to question 4 below for more details.

There are some problems with the approach to step acquisitions

4. The current approach to accounting for step acquisitions and loss of control has some benefits. It is relatively uncomplicated and as the same approach must be applied to all such transactions there is a consistency that many welcome. However, we believe that there are some problems that need to be addressed as the resultant gains and losses are widely regarded by both users and preparers as being meaningless and of little decision-usefulness. See our answer to question 7 below for more details.

Consideration which is paid only on condition of continuing employment may not always be correctly accounted for

5. It is fairly common for purchase agreements to include arrangements in which the former owners of the business receive consideration that they will forfeit if they leave employment. Paragraph B55(a) states that payments under such arrangements should be treated as compensation for post-acquisition services unless the service condition is not substantive. In other words, the contingent payment should not be included in the cost of the acquisition. In our view, there needs to be more room for judgement in determining whether a payment should be treated as part of the cost of the acquisition or as a post-acquisition expense. See our answer to question 9 below for more details.

RESPONSES TO SPECIFIC QUESTIONS

Q1: Your background and experience

Please tell us:

a) **about your role in relation to business combinations (ie preparer of financial statements, auditor, valuation specialist, user of financial statements and type of user, regulator, standard-setter, academic, accounting professional body etc).**

b) **your principal jurisdiction. If you are a user of financial statements, which geographical regions do you follow or invest in?**

c) **whether your involvement with business combinations accounting has been mainly with IFRS 3 (2004) or IFRS 3 (2008).**

d) **if you are a preparer of financial statements:**

   (i) **whether your jurisdiction or company is a recent adopter of IFRS and, if so, the year of adoption; and**

   (ii) **with how many business combinations accounted for under IFRS has your organisation been involved since 2004 and what were the industries of the acquirees in those combinations.**

e) **if you are a user of financial statements, please briefly describe the main business combinations accounted for under IFRS that you have analysed since 2004 (for example, geographical regions in which those transactions took place, what were the industries of the acquirees in those business combinations etc).**

6. ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter, working in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 142,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.

7. ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.

Q2: Definition of a business

a) **Are there benefits of having separate accounting treatments for business combinations and asset acquisitions? If so, what are these benefits?**

b) **What are the main practical implementation, auditing or enforcement challenges you face when assessing a transaction to determine whether it is a business? For the practical implementation challenges that you have indicated, what are the main considerations that you take into account in your assessment?**

8. We agree that business combinations and asset acquisitions are two very different types of transaction and are generally supportive of having separate accounting treatments for them. The distinction between the two is important as the accounting for business combinations differs significantly from accounting for asset purchases in several key aspects eg, different values are assigned to acquired assets and liabilities, goodwill or a gain on a bargain purchase is or isn't recognised, deferred tax is or isn't recognised and transaction costs are expensed or capitalised. We believe that having different accounting outcomes is appropriate because of the different nature of the transactions.

9. It is therefore essential that there is a clear dividing line between what does and doesn't meet the definition of a business. We acknowledge that in most straightforward cases the existing definition works and we are generally supportive of the approach adopted by the standard.

However, in some cases the distinction between what is and isn't a business is unclear. The board may therefore wish to consider providing expanded guidance in this area.

10. Perhaps the classic example of an acquisition where applying the standard can be a challenge is that of the purchase of a single investment property along with an obligation to provide services such as basic maintenance and security services that are purely ancillary to the property. While some argue that this meets the definition of a business as it is a group of assets and liabilities that is capable of being conducted and managed as such by a market participant, others argue that such acquisitions should be accounted for as asset purchases. There are therefore inconsistencies in how the standard is applied to such transactions in practice.

11. Similar debates can arise when, for example, the company acquired is in the development stage and is not yet producing saleable outputs or where the integrated set of activities transferred does not include all the activities or assets that the seller used in operating the business.

12. In its May 2013 update, the IFRS Interpretations Committee acknowledged that difficulties can arise when determining whether the acquisition of a single investment property meets the definition of a business in accordance with IFRS 3. It also acknowledged that there were broader issues around the definition of a business that should be addressed as part of this post implementation review.

13. The boundary between what is and isn't a business needs to be more clearly demarcated. While we would not advocate a strict rules-based approach, we nonetheless feel that more guidance is needed to help draw a clearer dividing line between the two types of transaction. This could be achieved by making it clear that, unless there is evidence to the contrary, certain transactions will not be considered to be business combinations. More guidance could also be added to help preparers apply their judgement when determining whether the acquired operation is or isn't a business, perhaps by emphasising which features are most critical in making that assessment.

Q3: Fair value

a) To what extent is the information derived from the fair value measurements relevant and the information disclosed about fair value measurements sufficient? If there are deficiencies, what are they?

b) What have been the most significant valuation challenges in measuring fair value within the context of business combination accounting? What have been the most significant challenges when auditing or enforcing those fair value measurements?

c) Has fair value measurement been more challenging for particular elements: for example, specific assets, liabilities, consideration etc?

14. The principle of recognising and measuring identifiable assets acquired and liabilities assumed at their acquisition date fair value is well established and well understood. This approach generally provides users of the financial statements with information that is not only relevant but more comparable and more understandable than measurement at cost. The exceptions which the standard requires to these recognition and measurement principles also appear appropriate.

15. However, as discussed further in our answer to question 4 below, we have concerns about applying this approach to certain intangible assets that many find difficult to see as separate from goodwill. Calculating fair values for such intangibles can be not only challenging but also costly. The intangibles and related amortisation are frequently reversed out in computing the adjusted measures discussed with analysts. In many cases, such valuations therefore seem to be of little benefit and are often ignored by users of the financial statements.

16. We would welcome additional disclosures explaining how fair values have been derived. These could, perhaps, be akin to some of the existing disclosures required by IFRS 13.

Q4: Separate recognition of intangible assets from goodwill and the accounting for negative goodwill

a) Do you find the separate recognition of intangible assets useful? If so, why? How does it contribute to your understanding and analysis of the acquired business? Do you think changes are needed and, if so, what are they and why?

b) What are the main implementation, auditing or enforcement challenges in the separate recognition of intangible assets from goodwill? What do you think are the main causes of those challenges?

c) How useful do you find the recognition of negative goodwill in profit or loss and the disclosures about the underlying reasons why the transaction resulted in a gain?

17. In many cases it is useful to recognise intangible assets separately from goodwill. Doing so can provide useful information about the assets acquired and the price paid. Few would argue with the separate recognition of intangibles such as patents, trademarks, licences and computer software.

18. However, the standard casts the net much wider than this when defining identifiable intangibles. This means that many of the other intangibles that are acquired in a typical business combination – such as customer relationships, customer lists and brands – also need to be separately recognised and measured at fair value at the date of acquisition even though it is not possible to recognise equivalent internally generated intangibles.

19. Many people are uncomfortable with this. They struggle to see how many of these ill-defined items can ever meet the definition of an asset. Even those who accept that they are assets struggle to understand the values put on them or the useful lives over which they are amortised.

20. Moreover, businesses will often incur significant costs in order to obtain these fair values. Few businesses will have internal resources with the specialist knowledge needed to undertake these valuations and employing external experts can be expensive. Given that both users and preparers see little, if any, advantage in separately recognising such intangibles, it is difficult to argue that the benefits of separately recognising and amortising such intangible assets outweigh the costs of doing so.

21. The UK's Financial Reporting Council recently undertook some research into investor views on intangible assets and their amortisation. Many of the people who took part in this study put forward the view that intangible assets can be differentiated into two different types which they refer to as 'wasting' and 'organically replaced' intangibles.

22. Their view was that only 'wasting' intangibles – which they defined as having finite useful lives and identifiable future revenue streams – should be recognised separately from goodwill. In contrast, they argued that 'organically replaced' intangibles – which are replenished on an on-going basis through marketing and promotion – should not be separately recognised and that they should instead be subsumed within goodwill. We agree with their analysis.

23. While we agree with the principle of recognising negative goodwill in profit or loss, we acknowledge that many feel that recognising a one-off gain provides little in the way of decision-useful information and that it is often ignored by analysts.

24. In many ways, the issue of negative goodwill is tied into the issue of separately recognising lots of 'organically replaced' intangibles. If fewer of these intangibles were recognised, negative goodwill would arise less often. Regardless of what decisions are made about whether such assets should or shouldn't be subsumed within goodwill, we believe that a case can be made for restricting their recognition where doing so would create or augment negative goodwill. Doing so would limit the recognition of negative goodwill to instances where there is clearly a bargain purchase ie, those instances where there is a clearer rationale for recording a one-off gain in profit or loss.

Q5: Non-amortisation of goodwill and indefinite-life intangible assets

a) How useful have you found the information obtained from annually assessing goodwill and intangible assets with indefinite useful lives for impairment, and why?

b) Do you think that improvements are needed regarding the information provided by the impairment test? If so, what are they?

c) What are the main implementation, auditing or enforcement challenges in testing goodwill or intangible assets with indefinite useful lives for impairment, and why?

25. We agree that it is appropriate for some intangible assets to have indefinite lives as in some instances there is no foreseeable limit on the period during which an entity expects to consume the future economic benefit that those assets embody. However, the value of such indefinite-life assets is only sustained through internally-generated value created by expenditure on, for example, marketing and promotion.

26. We are therefore supportive of the current model of testing goodwill annually for impairment as we believe that it provides the most relevant information for assessing not only the carrying amount of indefinite-life assets but also the performance of management. That information is, however, a lagging rather than a leading indicator and in many cases the recognition of an impairment therefore has confirmatory rather than predictive value.

27. However, we acknowledge that the impairment model does have some limitations. The effectiveness of the model is inevitably reduced by the degree of estimation required in determining value in use which, in some instances, can result in a degree of discretion in determining not only when the impairment charge is recognised but also its amount. Moreover, it can be a complex and time-consuming exercise and there can sometimes be a disconnection between the unit of account prescribed by the standard and the way in which management runs its business in practice.

28. There are, of course, some who argue that goodwill should be amortised on a straight-line basis over a finite useful life. Many of those who advocate a return to this approach argue that doing so makes management more accountable for their decisions because a charge would be recognised in profit or loss, thus enabling users to determine whether the extra income generated by the acquiree justifies the price paid for it. While we have some sympathy for these views, overall we do not support them as we feel that the information provided by the amortisation model is fairly meaningless and would almost certainly be ignored by analysts. As noted above, we believe that the existing model provides more decision-useful information.

29. The question of the appropriate treatment of other indefinite-life intangible assets is, perhaps, a more vexing one. At present there are a number of inconsistencies in practice. For example, one entity may recognise a brand as an indefinite-life intangible while a second may amortise a similar brand over a finite useful life and a third may simply leave it – correctly or otherwise – as part of an amorphous goodwill figure. As discussed in our response to question 4, we believe that all ‘organically replaced’ intangibles should be subsumed within goodwill.

30. There is some debate about whether the disclosures relating to the impairment testing process are useful or not. Some feel that they are too detailed and another example of disclosure overload whereas others would like to see even more disclosure. In our view, the present disclosure requirements provide useful information, most notably on key management assumptions and discount rates. However, we are aware that there are some inconsistencies in the application of these requirements and that the quality of the disclosures provided is lacking in some instances. This, however, is a matter for regulators rather than for the standard-setter. We would therefore urge the board to resist the temptation to supplement the current requirements as we believe that – if applied as intended – the current disclosures should provide adequate information. Adding more disclosure would risk incurring additional costs that would accrue little, if any, substantive benefits.

Q6: Non-controlling interests

a) How useful is the information resulting from the presentation and measurement requirements for NCIs? Does the information resulting from those requirements reflect the claims on consolidated equity that are not attributable to the parent? If not, what improvements do you think are needed?

b) What are the main challenges in the accounting for NCIs, or auditing or enforcing such accounting? Please specify the measurement option under which those challenges arise.

To help us assess your answer better, we would be grateful if you could please specify the measurement option under which you account for NCIs that are present ownership interests and whether this measurement choice is made on an acquisition-by-acquisition basis.

31. We are generally happy with the requirements relating to non-controlling interests and have no suggested improvements.

32. Although IFRS 3 allows a choice between measuring non-controlling interests at either fair value or the present ownership interests' proportionate share in the recognised amounts of the acquiree's net identifiable assets, we note that a significant majority elect to take the latter option as in most cases it is the simplest option.

33. The existence of such a choice inevitably leads to inconsistencies in practice, especially as it is an acquisition-by-acquisition choice. While some may argue for the uniformity that would come with requiring one option or the other, in truth there appears to be little appetite for change. We therefore do not suggest any amendment to the standard's current requirements.

Q7: Step acquisitions and loss of control

a) How useful do you find the information resulting from the step acquisition guidance in IFRS 3? If any of the information is unhelpful, please explain why.

b) How useful do you find the information resulting from the accounting for a parent's retained investment upon the loss of control in a former subsidiary? If any of the information is unhelpful, please explain why.

34. The current approach to accounting for step acquisitions and loss of control has some benefits. It is relatively uncomplicated and as the same approach must be applied to all such transactions there is a consistency that many welcome. However, we believe that there are some problems that need to be addressed.

35. The standard requires previously held equity interests to be remeasured to fair value when control is gained. Similarly, it requires interests retained when control is lost to be remeasured to fair value. In both cases, the resulting gain or loss is recognised in profit or loss. However, our understanding is that the resultant gains and losses are widely regarded by both users and preparers as being meaningless and of little decision-usefulness. The required approach also creates potential structuring opportunities.

36. The erstwhile approach of measuring the acquiree's assets and liabilities at fair value at each step in the acquisition process for the purposes of calculating a portion of goodwill was not without its faults, not least because it could be not only complicated but also costly to apply in practice. Moreover, the goodwill figure that it produced was arguably meaningless. While we accept that reverting to this approach would be one option, we instead encourage the board to undertake a project to consider other alternative solutions to this conundrum.

Q8: Disclosures

a) Is other information needed to properly understand the effect of the acquisition on a group? If so, what information is needed and why would it be useful?

b) Is there information required to be disclosed that is not useful and that should not be required? Please explain why.

c) What are the main challenges to preparing, auditing or enforcing the disclosures required by IFRS 3 or by the related amendments, and why?

37. Paragraphs 59-63 of the standard are useful as they set out high level disclosure principles. However, they refer in turn to paragraphs B64-67 which augment these principles with a long list of what are often very detailed and very specific disclosures that must be made if these overall objectives are to be met. Unfortunately this means that disclosures all too often become driven by what in effect is a detailed checklist approach and potentially useful information becomes lost amid a deluge of detail and boilerplate text.

38. We urge the board to step back and critically assess each of the disclosures that are required by paragraphs B64-67 with the aim of cutting some of the clutter and refocusing the disclosures on those issues that really matter to the users of the financial statements eg, why the acquirer paid what they did and why they believe sufficient benefits will accrue to justify the outlay. We do not need more disclosures, we need better disclosures.

39. Disclosures that we believe are candidates for deletion include – but are not limited to – paragraph B64(h)'s requirements relating to acquired receivables and the B64(q)(ii)'s requirement to disclose the revenue and profit or loss of the combined entity for the current period as though the acquisition date for all business combinations that occurred during the year had been as of the beginning of the financial reporting period. In our experience, these disclosures are little valued and – in the case of the latter – inconsistently prepared due to the assumptions that inevitably need to be made when preparing such pro forma numbers. In our view, IFRSs should not mandate the inclusion of such pro forma information.

40. If the long list of disclosures must be retained, we recommend that the board clearly states that the full list of disclosures should not be regarded as mandatory in all situations eg, while many of the disclosures may be necessary when there is a significant acquisition that is of importance to the group as a whole, they may not all be needed for smaller, less significant acquisitions. In fact, this should be made clear even if some of the existing detailed disclosures are culled.

41. Having said that there are currently too many disclosures, there are nonetheless some areas where we think further information would be of benefit. For example, we have already mentioned in our reply to question 3 above that we feel that some disclosures about an entity's fair value methodologies would be helpful. We are also aware that many users find it difficult to find the information about debt acquired that they are looking for.

Q9: Other matters

Are there other matters that you think the IASB should be aware of as it considers the PiR of IFRS 3?

The IASB is interested in:

a) understanding how useful the information that is provided by the Standard and the related amendments is, and whether improvements are needed, and why;

b) learning about practical implementation matters, whether from the perspective of applying, auditing or enforcing the Standard and the related amendments; and

c) any learning points for its standard-setting process.

42. It is fairly common for purchase agreements to include arrangements under which the former owners of the business receive consideration that they will forfeit if they leave employment. When the standard was first issued there was some debate about whether such contingent consideration should be treated as part of the consideration transferred in the acquisition or as an expense in the post-acquisition profit or loss.

43. Paragraph B55(a) states that such compensation should be treated as compensation for post-acquisition services unless the service condition is not substantive. In other words, the contingent payment should not be included in the cost of the acquisition. We note that the IFRS Interpretation Committee recently received a request for guidance on this issue but confirmed that the language in paragraph B55(a) was conclusive and declined to add this matter to their agenda.

44. In our view, there needs to be more room for judgement in determining whether a payment should be treated as part of the cost of the acquisition or as a post-acquisition expense. A list of indicators and some illustrative examples may prove more helpful in allowing such judgement to be applied appropriately. If the existing rule is to be retained, it should not be included in a paragraph purporting to set out indicators.

45. The standard scopes out business combinations under common control. The treatment of such combinations varies in practice and clear guidance would be welcomed. We appreciate that the board currently has a research project on this matter. We would, nonetheless, urge them to ensure that this project is treated as high priority.

46. The interaction between IFRS 3 and IFRS 5 during a disposal can in some instances result in the impact of the disposal being recorded in two different accounting periods. Moreover, the timing of recognition as held for sale can make a significant difference to the profit or loss recorded on the transaction. This can be very confusing for users and we therefore urge the board to give this matter due consideration.

Q10: Effects

From your point of view, which areas of IFRS 3 and related amendments:

a) represent benefits to users of financial statements, preparers, auditors and/or enforcers of financial information, and why;

b) have resulted in considerable unexpected costs to users of financial statements, preparers, auditors and/or enforcers of financial information, and why; or

c) have had an effect on how acquisitions are carried out (for example, an effect on contractual terms)?

47. The objective of IFRS 3 is to improve the relevance, reliability and comparability of the information an entity provides in its financial statements about a business combination and its effects. We believe that, on the whole, this has been achieved and that the standard helps to focus the minds of both preparers and users of the financial statements on what has been acquired and why the acquirer paid what they did for the acquiree. We therefore believe that the overall effect of the standard has been positive.

48. Overall, we believe that IFRS 3 is cohesive and comprehensive standard that is an improvement on its predecessors. The approach of clearly setting out the standard’s principles and then unabashedly highlighting exceptions to them generally makes it easy to follow and understand. It is an approach that could – and perhaps should – be adopted in other standards.

49. The standard does, however, come with its costs. Most notably, significant time and effort are often incurred identifying and valuing separable intangible assets. We have already raised a number of concerns relating to this area in our answers to earlier questions.

50. The standard also creates a number of potential structuring opportunities, most notably in relation to step acquisitions. We have raised this concern in our answer to question 7 above.