The Institute of Public Accountants

Post Implementation Review: IFRS 3 Business Combinations

20 May 2014

INSTITUTE OF PUBLIC ACCOUNTANTS
Partnership beyond numbers

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The Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

The Chairman
Australian Accounting Standards Board
PO Box 204
Collins Street West Victoria 8007
Australia

Dear Sirs

Re: Post Implementation Review: IFRS 3 Business Combinations

Introduction

The Institute of Public Accountants (IPA) supports the post-implementation review process of accounting standards, such as, IFRS 3 *Business Combinations*. The IPA was pleased to be involved with the recent AASB roundtable on IFRS 3/AASB 3 held in Melbourne, and takes this opportunity to further expand on the issues raised in the context of post-implementation review questions proposed.

The IPA believes that there are no fundamental flaws with IFRS 3 and therefore no significant changes need to be made in either the measurement, recognition or disclosure requirements of the standard. Many of the issues identified in our response relate to compliance failures which should be addressed by auditors and regulators.

The IPA is a professional organisation for accountants recognised for their practical, hands-on skills and a broad understanding of the total business environment. Representing more than 26,000 members nationally and in 57 countries, the IPA represents members and students working in industry, commerce, government, academia and private practice. Over two-thirds of our members work in or with small business and SMEs and are recognised as the trusted advisers to these sectors.

Through representation on special interest groups, the IPA ensures views of its members are voiced with government and key industry sectors and makes representations to Government including the Australian Taxation Office (ATO), Australian Securities and Investments Commission (ASIC), Australian Competition and Consumer Commission (ACCC) and the Australian Prudential Regulation Authority (APRA) on issues affecting.

Executive Summary

Our concerns with respect to IFRS 3 *Business Combinations* arise from the related standards IAS 36 *Impairment of Assets* and IAS 38 *Intangible Assets*. In particular, we believe:

1. The has been a failure to recognise and appropriately measure limited life identifiable intangibles primarily due to accounting arbitrage arising from the non-amortisation of goodwill, and
2. The weaknesses inherent in the Cash Generating Unit basis of assessment of impairment. We would more detailed methodologies should be considered including customer and product probability measures.

We suggest the following enhancements to IFRS 3:

1. A more comprehensive illustrative example of reverse acquisitions
2. Enhanced application guidance relating to the sensitivity analysis under IAS 36 *Impairment of Assets* paragraph 36.133(f)
3. Address the inconsistencies in the application guidance on the definition a Business (IFRS 3.B7-B12)
4. Strictly define goodwill including a justification for indefinite useful life, and
5. Address the conceptual basis for the initial recognition of negative goodwill in the income statement.

Our detailed comments and responses to the questions in the Post Implementation Review of IFRS 3 are set out in Appendix A.

If you would like to discuss our comments, please contact Vicki Stylianou or a member of our technical advisory team at ipasubmissions@publicaccountants.org.au

Yours faithfully

Andrew Conway FIPA
Chief Executive Officer
Institute of Public Accountants

APPENDIX A
Background and Experience

Question 1(a)
Your role in relation to business combinations (i.e. preparer of financial statements, auditor, valuation specialist, user of financial statements and type of user, regulator, standard-setter, academic, accounting professional body etc).

IPA response
The IPA is an accounting professional body. The IPA's technical consultants have experience in providing advice on the business combination transactions; the development and review of goodwill impairment models; and the involvement in litigation in relation to business combination transactions and goodwill impairment.

Question 1(b)
Your principal jurisdiction. If you a user of financial statements, which geographical regions do you invest in?

IPA response
Australia

Question 1(c)
Whether your involvement with business combination accounting has mainly been with IFRS 3 (2004) or IFRS 3 (2008).

IPA response
The IPA's technical consultants have experience with both the 2004 and 2008 version of IFRS 3.

Question 1(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.*

IPA response
Australia adopted IFRS for periods beginning 1 January 2005.
The IPA's technical consultants have been involved in business combinations in the following industries: financial institutions; technology companies; mining exploration companies; biotechnology companies; and business services.

Question 1(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.

IPA response
N/A

Definition of a business

Question 2(a)
Are there any benefits of having separate accounting treatments for business combinations? If so, what are the benefits?

IPA response
The IPA believes it is appropriate for the acquisition of assets to be treated in a different manner from business combinations. However, we are of the view the conceptual basis for the different treatments of transaction costs, contingent consideration and gains on acquisition.

Question 2(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 you take into account in your assessment?

IPA response
While the definition of business at IFRS 3.B7 is clear, the following application guidance at paragraphs IFRS 3.B8-B12 are often contradictory to the definition. The imprecise nature allows preparers to "structure" a transaction to meet the definition of a business or not depending on their objectives. Furthermore, this may allow the recognition of "gains" on the business combination which would not have occurred if the acquisition was accounted for as an asset acquisition.

Fair Value

Question 3(a)
To what extent is the information derived from the fair value measurements relevant and the information disclosed about the fair value measurements sufficient? If there are deficiencies, what are they?

IPA response
While we consider fair value appropriate for business acquisition accounting, the application of disclosure requirements is poor. The disclosure requirements themselves are not at fault rather practice is poor and information in relation to the

nature of intangible assets in, particular, and the sensitivity of fair values is often lacking.

Question 3(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?

IPA response
Many of the valuation challenges related to identifiable intangibles, the measurement of liabilities (in particular, contingent liabilities), contingent consideration and non-controlling interest (for non-listed entities). The audit/enforcement issues surround the wide range of "acceptable" valuations related to these fair values. This is exacerbated by the poor disclosure of the sensitivity of fair values and management bias towards recognition of goodwill over identifiable intangibles (due to the non-amortisation of goodwill).

Question 3(c)
Has fair value measurement been more challenging for particular elements: for example, specific assets, liabilities, consideration etc.?

IPA response
See response to 3(b).

Separate recognition of intangible assets from goodwill and the accounting of negative goodwill

Question 4(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?

IPA response
The separate recognition of intangible should provide useful information. The IPA believes that goodwill recognised should represent the smallest component of intangibles arising from a business combination. Identifiable intangibles such as customer relationships (both contractual and non-contractual), order books, brand names and trademarks should represent the greater majority of the recognised intangibles. The disclosure of such intangibles, together with the pattern of amortisation, when disclosed, should be provide users meaningful information as to the objectives of the acquisition.

Aside from the subjectivity in establishing carrying values of such intangibles the management bias arising from the non-amortisation of goodwill contributes to the non-recognition of identifiable intangibles. Furthermore, the amortisation methodologies based on estimates of useful life can be considered poor estimates of the reduction in value of such intangibles. Guidance on more meaningful amortisation methodologies based for example units of consumption (e.g. for customer relationship intangibles based on customer attrition) should be provided. Alternatively, the consideration of more detailed impairment methodologies should be considered e.g. based on customer or product profitability analysis.

Question 4(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?

IPA response

The wide variety of "acceptable" valuations for certain identifiable intangibles represents a challenge to auditors. However, there are undoubtedly audit failures in relation to disclosure requirements relating to management judgements and sensitivity analysis of such valuations which would to some degree address the issues relating to the wide range of values that can be attributed to such intangible assets. There is also evidence of audit and regulatory failures in relation to initial identification of identifiable intangibles at the time of the business combination and the subsequent preliminary accounting period.

Question 4(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?

IPA response

The IPA has some concern as to the recognition of negative goodwill in the profit and loss. The basis for the concern is twofold:

1. transactions that could be considered as asset acquisitions are structured in such a way as to generate a negative goodwill; and
2. the lack of consistency of recognition of negative goodwill with the treatment of "day 1" gains arising in respect of fair values of financial instruments based on non-market valuations.

Non-amortisation of goodwill and indefinite-life intangible assets

Question 5(a)

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

IPA response

As mentioned above, the IPA believes the non-amortisation of goodwill has created a management bias in determination of identifiable intangibles which has resulted in the overstatement of goodwill at the expense of the recognition of identifiable

intangibles. Furthermore, the current impairment model using, Cash Generating Units, effectively allows the carrying value purchased goodwill to be supported by internally generated goodwill. The IPA is not convinced that purchased goodwill has an indefinite life as and believes the onus should be to estimate the period of the useful life of goodwill. Goodwill must represent something other than a mechanical difference between purchase consideration and the fair value of net assets acquired. While IFRS 3.B64(e) requires a qualitative description of the components of goodwill the level of disclosure is often poor and there is no requirement for justification for the indefinite life ascribed to goodwill.
In relation to other identifiable intangible assets such as brand names and patents an impairment model based on product profitability models may be more appropriate than the current CGU based approach.

Question 5(b)
Do you think that improvements are needed regarding the information provided by the impairment test? If so, what are they?

IPA response
The IPA has concerns in relation to the construction of the impairment test itself rather than the disclosures made in relation to impairment. The current impairment model effectively allows the carrying value purchased goodwill to be supported by internally generated goodwill. Furthermore, we are concerned the current required disclosures have not been effectively met. In particular, we are concerned that the sensitivity analysis required under IAS 36.133(f) is not functioning effectively.
We are concerned goodwill impairments have not been preceded by IAS 36.133(f) disclosures, which either indicate a compliance failure or misunderstanding of the intention of the disclosure requirements.

Question 5(c)
What are the main implementation, auditing or enforcement challenges in testing goodwill or intangible assets with indefinite useful lives for impairment, and why?

IPA response
The IPA has noted the following implementation, audit and enforcement issues relating to impairment testing using value in use:
1. failure to exclude financing inflows and outflows
2. non adjustment of discount rates for specific risk factors
3. use of forecast period in excess of five years without disclosure of explanation
4. failure to normalise terminal values
5. the incorporation of cash flows resulting from the expansion of the capital base of the Cash Generating Unit
6. failure to adjust for working capital requirements, and
7. non-adjustment of growth rates or consideration of market size.

Non-controlling interests

Question 6(a)
How useful is the information 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?

IPA response
The IPA notes that Australian practice is value NCI as proportionate share of net assets acquired (i.e. IFRS 3.19(b) option) and provides sufficient information relating to claims on consolidated equity.

Question 6(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.

IPA response
The IPA notes that the adoption of IFRS 3.19(b) does not generally present implementation, audit or enforceability difficulties. However when NCI is valued at fair value, the measurement issues have been identified relating to the NCI of non-listed entities.

Step acquisitions and loss of control

Question 7(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.

IPA response
While we do not have any conceptual problem with the method of accounting for step-acquisitions, we have noted that there is some confusion in expressed by users and preparers. Consideration should be given to providing more extensive explanatory guidance.

Question 7(b)
How useful do you find the information resulting from accounting for a parent's retained investment upon the loss of control in former subsidiary? If any of the information is unhelpful, please explain why.

IPA response
The IPA finds the information provided on loss of control of a former subsidiary as adequate.

Disclosures

Question 8(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?

IPA response
The IPA believes there should be some form of measure to assess the management's performance in relation to business acquisitions and suggest the IASB undertake or commission a project to establish a performance measurement framework relating to business combinations undertaken.

Question 8(b)
Is there information required to be disclosed that is not useful and that should not be required? Please explain why.

IPA response
The IPA supports the current disclosure regime relating to business combinations.

Question 8(c)
What are the main challenges to preparing, auditing or enforcing the disclosures required by IFRS 3 or by the related amendments, and why?

IPA response
As noted above the IPA has observed a number of issues with compliance with the required disclosures, in particular we are concerned with the poor sensitivity reporting.

Other Matters

Question 9
Are there any 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*

IPA response
The IPA believes IFRS 3 is fundamentally sound, however many of the issues relate to the recognition and measurement of intangibles, including goodwill, and their subsequent impairment testing in accordance IAS 36 and IAS 38.

We have noted prepares and users have expressed some frustration with the current examples provided in relation to reverse acquisition and would suggest that improved illustrative guidance be provided. Such guidance should include a scenario where either the accounting acquirer or the legal acquirers have pre-existing shareholdings.

Effects

Question 10

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

a) *Represent benefits to users of financial statements, prepared, auditors and/or enforcers of the financial information, and why; or*
b) *Have resulted in considerable unexpected cost 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)?*

IPA response

As mentioned above, we are concerned some business acquisitions/asset acquisitions have been structured to reach a desired outcome as either a business acquisitions or asset acquisition as desired by the preparer.

We have also noted instances where transaction costs have incurred by the vendors of the accounting acquiree and rolled into the purchase consideration in attempt to circumvent the write-off of acquisition costs as required by IFRS 3.53.

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