

JOINT OUTREACH EVENT

POST- IMPLEMENTATION REVIEW OF IFRS 3 *BUSINESS COMBINATIONS*

BRUSSELS

1 APRIL 2014

This feedback statement has been prepared for the convenience of European constituents by the EFRAG secretariat and has not been subject to review or discussion by the EFRAG Technical Expert Group. It has been reviewed by the EFFAS and ABAF Secretariats and by IASB staff and has been jointly approved for publication by representatives of EFRAG, EFFAS, ABAF and the IASB who attended the joint outreach event.

Introduction

In 2013, the International Accounting Standards Board (IASB) started work on the Post-implementation Review of IFRS 3 *Business Combinations*. A Request for Information was published in January 2014 seeking views on the experience with, and the effect of, implementing IFRS 3.

This feedback statement has been prepared for the convenience of European constituents and summarises the input received in a joint outreach event ('the event') on the Post-implementation Review of IFRS 3 held on 1 April 2014 in Brussels. The event was held by EFRAG, the European Federation of Financial Analysts Societies (EFFAS) and the Association Belge des Analystes Financiers (ABAF), in cooperation with the IASB. The event attracted, in addition to users, a range of other stakeholders such as preparers and European organisations. The views expressed in this feedback statement are intended to reflect the individual views expressed by participants.

The event was part of a series of discussions with European users (investors and analysts) in the form of meetings and interviews, and offered an opportunity to obtain input from users and other participants on the usefulness of the provisions in IFRS 3, and understand what improvements, if any, are needed.

The event was chaired by Hans Buysse, Member of the EFFAS Executive Management Committee, and Françoise Flores, EFRAG Chairman. Other speakers at the event included Serge Pattyn (member of the EFRAG User Panel and EFRAG Technical Expert Group), Javier de Frutos, Chairman of EFFAS Financial Accounting Committee, Philippe Danjou and Stephen Cooper from the IASB Board.

Serge Pattyn and Javier de Frutos presented a selected number of case studies on business combination transactions taken from published IFRS financial statements. They also summarised the feedback obtained from discussions held with users up to that date. Philippe Danjou and Stephen Cooper provided a brief outline of the development of IFRS 3 and the road map for the Post-implementation Review. They also outlined the possible next steps, and responded to participants' questions.

Issues covered

Participants discussed the following issues:

- Understanding the Business Combination
- Goodwill accounting and related disclosures
- Consideration transferred, including contingent consideration
- Recognition and measurement of assets acquired and liabilities assumed, particularly intangible assets, inventories and contingent liabilities
- Bargain purchases

- Business combinations achieved in stages
- Other issues

Main comments

The key points can be summarised as follows:

- The information provided in the financial statements regarding the primary reasons for undertaking a business combination was considered too general and quantitative information was often very subjective.
- It would be relevant to have information on the reasons for entering into the business combination from the seller's perspective. This would help users gain a better understanding of the primary drivers of the transaction and what factors "motivated" the buyer and the seller to undertake it.
- There was a concern regarding the timeliness of information received through the annual accounts given that markets typically react on the day the acquisition is announced.
- There is a need for more transparency regarding expected synergies which should be quantified and the basis for such expectations disclosed. Post-acquisition reporting periods should demonstrate whether synergies expected at the acquisition date have been met to enable users to assess whether it had been a successful business combination.
- Adjustments to contingent consideration were not considered to be part of performance and should not be reflected in profit or loss. Some participants commented that it was counter-intuitive to account for an increase in the fair value of a contingent consideration liability as an expense in profit or loss.
- Determining the fair value of consideration in a "share-for-share" business combination was noted as an area of practical difficulty.
- There was a need for improved transparency on the recognition and measurement at fair value of acquired intangible assets, particularly intangibles that had not been previously recognised by the acquiree and intangibles with no active market (for example customer-related intangibles). Some users questioned the relevance of fair value information of such intangibles.
- It would be useful to have information on the pre-acquisition book values of assets acquired and liabilities assumed to enable users to gain a better understanding of the step-ups in value to fair value and the factors that made up goodwill.
- The different accounting treatment for acquisition of assets and businesses placed considerable stress on the definition of a business. It was not always obvious when an acquisition met the definition of a business.
- Bargain purchase accounting and the recognition of a gain in profit or loss was considered to be counter-intuitive particularly when the acquirer plans to undertake a restructure the business or part-of the business acquired.

Detailed comments received

Understanding the Business Combination

Serge Pattyn introduced the disclosure requirements in paragraph B64(d) of IFRS 3 on the primary reasons for the business combination. He explained that users had, in general, supported the disclosure requirements and noted that understanding the reasons for the undertaking the business combination was fundamental.

Some users had highlighted that in practice companies often provided very general information on the reasons for undertaking an acquisition; for example gaining market share, having access to new emerging markets, strengthening technology and achieving cost savings. The problem was that the information sometimes lacked insight on what the acquisition would bring to the buyer. Also, the quantitative information provided was often very subjective and therefore difficult for analysts to fully understand.

There was also a concern regarding the timeliness of the information, and preliminary findings had indicated that users received the information provided in the annual report too late. Equity markets absorbed the information on the business combination on the date the acquisition was announced.

One participant added that it would be relevant to understand the business acquisition from the seller's perspective. This would help users gain a better understanding of what "motivated" the business combination.

Goodwill accounting and related disclosures

Paragraph B64(e) of IFRS 3 requires an acquirer to provide a qualitative description of the factors that make up the goodwill. Preliminary findings indicate that users often focus on the price paid as the primary driver for the business combination, and not on goodwill, when assessing whether the entity had entered into an overpriced or a bargain acquisition.

Hans Buysse noted that the price paid for a business was, to a large extent, driven by expected synergies. Therefore, he considered that information about expected synergies and how those expectations materialised post-acquisition was very useful. This type of information helped users to better understand the level

Reasons for the business combinations were too general and quantitative information was often very subjective

There was a concern regarding the timeliness of the information provided by the annual report

It would be relevant to have such information from the sellers' perspective

Participants considered that information about expected synergies and how those expectations materialised over time helped them understand the effects of the business combination

of cost savings achieved by the acquirer after the business combination and, consequently, whether or not it had been a successful acquisition. Javier de Frutos added that it was difficult to measure what “synergies” represent and this made any requirement around synergies more complicated.

Stephen Cooper agreed that information about the price paid in an acquisition was fundamental and therefore understood that users are focused on the price paid; nonetheless, information about goodwill was equally important for users as it helped them to understand what had been acquired.

Philippe Danjou added that IFRS 3 only required a “qualitative” description of the factors that supported the goodwill recognised. Companies could provide “quantitative” information about synergies; such information was not required by IFRS 3 but perhaps it was a point that the IASB could consider. It was noted that business combination accounting required a lot of work that could not be provided on the date of the acquisition, and time was needed to identify the assets acquired and liabilities assumed.

Consideration transferred, including contingent consideration

Serge Pattyn explained that paragraph B64(g) of IFRS 3 required disclosure about the amount recognised for contingent consideration at the acquisition date, as well as a description of the basis for determining that amount. Adjustments to contingent consideration are accounted for in profit or loss under IFRS 3. Users sometimes questioned the information usefulness of accounting for adjustments to contingent consideration (e.g. earn-outs that are contingent on future events) in profit or loss (i.e. as part of performance).

Philippe Danjou acknowledged that there were users who believed that adjustments to contingent consideration should be considered to be part of the original acquisition price (as adjustments to consideration transferred), particularly in cases when the consideration could be related to a specific asset. He referred to the pharmaceutical industry. However, there were also users who believed that adjustments to consideration that occurred, for example, one year after the acquisition date should be accounted for in profit or loss.

One participant observed that the accounting treatment for contingent consideration in IFRS depended on whether an entity

Participants debated whether adjustments to contingent consideration should be reflected in the financial statements as part of performance (i.e. in profit or loss)

It was counter-intuitive to account for an increase in the fair value of contingent consideration as an expense in profit or loss

was acquiring an asset (i.e. asset acquisition) or a business (i.e. business combination). However, it was not always obvious whether an acquisition involved an “asset” or a “business”. Inevitably, the difference in accounting significantly affected the debate about how to account for contingent consideration. In addition, this participant noted it was counter-intuitive to account for an increase in the fair value of contingent consideration as a loss, when in fact the increase resulted from improved performance of the business acquired.

Javier de Frutos considered “earn-out” adjustments in profit or loss as a “one-off” event and would therefore not consider them as part of performance. This view was supported by other participants.

Stephen Cooper thought that some of the difficulties with the accounting for contingent consideration arose because of the existence of many different types of contingent consideration. If the adjustments to contingent consideration resulted from additional information (obtained after the acquisition date) that related to facts and circumstances which existed at the acquisition date, the acquirer had to adjust the amounts recognised at the acquisition date (if the change occurred within the measurement period). The question was how to distinguish post-acquisition expense from actual consideration paid.

Participants referred to some of the practical difficulties related to the application of the acquisition-date fair value measurement principle in “share for share exchanges”

One participant referred to practical difficulties arising from the application of the acquisition-date fair value measurement principle, particularly when applying the definition in IFRS 13 *Fair Value Measurement*. This participant provided the example of a “share-for-share exchange” business combination where the acquirer would use acquisition-date market prices of the acquirer’s shares to measure consideration transferred. Typically the quoted price of the shares at the date of acquisition would include markets’ expectations and expected synergies from the business combination. The amount of the goodwill recognised at date of acquisition would be significantly impacted by the changes in value between the date the announcement was made and the acquisition date. This would have an effect on the impairment of goodwill in future periods.

Recognition and measurement at fair value of assets acquired and liabilities assumed, particularly intangible assets and inventories

Serge Pattyn explained that IFRS 3 required an acquirer to recognise identifiable assets acquired, liabilities assumed and non-

controlling interest, separately from goodwill. Paragraph B64(i) of IFRS 3 required disclosure of the corresponding amounts for each major class of assets acquired and liabilities assumed that were recognised at the acquisition date. Preliminary findings indicate that users are sometimes sceptical about the recognition of assets that had not been previously recognised by the acquiree (e.g. customer relationships, new technologies, know-how). Some users would disregard such intangibles; others considered them to be part of goodwill. Some users had mentioned that business combinations included a significant amount of assets (and liabilities) that are difficult to measure at fair value.

Participants call for information which allowed them to compare the historic book values and the acquisition-date fair values of the assets acquired and liabilities assumed

One participant thought it was useful to have detailed segregation of the assets acquired and liabilities assumed in a business combination, including intangible assets. However, this participant had some reservations about certain intangible assets - such as customer relationships; particularly when no active market existed for those intangibles. It would be useful to have information that allowed users to compare the “historic book values” with “acquisition-date fair values” of the assets acquired and liabilities assumed. This would assist users to gain a better understanding of the step-ups in value at acquisition date to fair value, and the factors that made up the goodwill.

Stephen Cooper explained that the IASB had decided to develop a criterion for the separate recognition of acquired intangibles after concluding that financial statements would be more transparent and useful to users. Users would have a break-down of what had been acquired, which he thought was useful, despite subjectivity in determining fair value.

Serge Pattyn noted that preliminary findings indicated some users had concerns about measuring acquired inventories at acquisition-date fair values, as such values had a potentially misleading impact on future operating margins. Some argued that inventories do not have a “fair value” and suggested using a “replacement” value to measure inventories at acquisition date.

Philippe Danjou acknowledged the need to understand how inventory acquired should be reflected in the profit or loss during the course of the reporting period(s) the inventory is sold. However, he did not think the solution was in the accounting, but rather in the disclosures. Stephen Cooper added that the question on fair value measurement of inventory acquired in a business

combination was a difficult issue, and he recognised the distortion to margins this issue can create. It would be helpful to have research conducted in this area to better understand what companies were doing in practice.

Serge Pattyn asked whether there were significant step-ups in value occur for property, plant and equipment. He mentioned that he had seen significant step-ups relating to new intangible assets not previously recognised.

Participants referred to the discussion about having different IFRS accounting requirements for “asset acquisitions” and “business combinations”. This distinction placed considerable stress on the definition of a business

One participant referred to the discussion on the different IFRS accounting requirements for acquisition of assets and acquisition of businesses. Such a distinction placed considerable stress on the definition of a business, and risked leading to continual discussions on what should be applied in each individual transaction.

Philippe Danjou explained that the IASB had established the fair value measurement principle in IFRS 3 to enable users to make a better assessment of the price paid. However, there was a question about when to stop. The IASB could consider disclosures to explain the effect of using acquisition-date fair values on future operating margins.

Contingent liabilities

Serge Pattyn explained that IFRS 3 requires an acquirer to recognise as at the acquisition date a contingent liability assumed in a business combination and provides guidance on subsequent measurement. Adjustments that result from events that occur after the “measurement period” are recognised in profit or loss. He noted that accounting for contingent liabilities was another difficult area in IFRS 3, and some users had raised the question about whether adjustments in profit or loss made sense.

Philippe Danjou explained that the measurement period in IFRS 3 provided a cut-off date for a company to adjust contingencies assumed at the acquisition date. Thereafter, a company enters into current period adjustments.

Françoise Flores added that if the IASB reconsiders the reliability criterion in recognition more generally, some items would not be recognised by an acquirer.

Bargain purchases

Serge Pattyn noted that users had not raised significant concerns about the accounting for bargain purchases. However, some questioned whether bargain purchases should affect the performance of a company (i.e. accounted for in profit or loss). A second point was whether negative goodwill actually existed, or whether it was the value of assets acquired that needed adjustment.

Some questioned whether bargain purchase gains should be recognised in profit or loss.

One participant noted that in the banking industry it was very rare to have so-called “badwill”; however when it did happen a company tended to adjust assets and liabilities; rarely would a bank recognise a gain from a bargain purchase. Thus, they would tend to be, to some extent, conservative on the values attributed to the assets acquired and liabilities assumed in a business combination. For example, banks had a lot of portfolios of assets that included various derivatives, so there was a tendency to re-visit the value of the portfolios at the acquisition date, rather than recognise a gain.

Participants thought it was counter-intuitive to recognise a gain related to a bargain purchase when the acquirer anticipated a significant restructure in the near future and could not include it as part of the initial business combination accounting

One other participant questioned the usefulness of recognising a gain related to a bargain purchase at acquisition date, particularly in situations where the acquirer envisages a significant restructuring plan soon after the business combination. The recognition of such a gain was counter-intuitive.

Philippe Danjou noted that the topic of restructuring costs was a topical issue. IFRS 3 did not allow the recognition of provisions that did not meet the recognition criteria of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. Therefore, it was possible to have situations where the acquirer anticipated a future restructuring but could not include it as part of the initial business combination accounting. The IASB would therefore consider the issue regarding the counter-intuitiveness.

Business combinations achieved in stages

Preliminary findings indicated that some users have reservations about the gain which resulted from the remeasurement of previously held equity interest. Users had emphasised that they tended to consider such a gain as a non-recurring item or simply as not being part of the performance of the company.

Participants referred to the application difficulties related to the remeasurement to

One participant referred to the difficulties in applying the remeasurement principle when there were no quoted prices for the

acquisition-date fair value principle when there were no quoted prices of the previously held equity interest

previously held equity interest (investment).

Stephen Cooper explained that the remeasurement issue was probably more related to presentation and specifically about how performance was presented in the financial statements, rather than whether it should be recognised. The increase in price was part of the exchange transaction. Notably, such gains (or losses) should be presented more prominently and in a clearer way in the financial statements so that users could better assess the different components of performance of an entity.

Philippe Danjou commented that some people were concerned that such gains and losses were not realised; however this was not a conceptual reason not to recognise the gain (or loss) in profit or loss.

Participants discussed whether acquisition transactions undertaken close to one-another (such as a squeeze-out of the remaining shares) should be accounted for a single transaction or as separate transaction. It was noted that it would depend on facts and circumstances. For example, in the case of a mandatory squeeze-out it could be that the two transactions should be considered as a single transaction and accounted for as such.

Timeliness of information

Regarding timeliness of information, Serge Pattyn explained that users had emphasised that financial statements were often published a few months after a business combination had been announced. For a number of users, the information in the annual reports was comprehensive but it came too late.

Philippe Danjou noted that the application of the acquisition method, including the purchase price allocation, required a lot of work and the whole process would only be complete sometime after the acquisition. Therefore, the IASB conveyed that it would be difficult for companies to provide all the relevant information related to a business combination at a date close to the acquisition date.

Javier de Frutos noted that markets react very quickly and thus timeliness of information was fundamental. He provided a real life example of a business combination that had been recently announced, where the market had reacted very quickly to new information about the business combination. This could have a positive (or negative effect) on the share price. Therefore, he

Participants referred to the issue of timeliness of the information provided by the company's financial statements. Participants considered that detailed information about business combinations should be made available to users as soon as possible, to complement their initial assessment

considered that detailed information about business combinations should be made available to users as soon as possible (e.g. within interim financial reports), to complement their initial assessment.

Other issues

Serge Pattyn explained that users in general found pro-forma information very useful. Javier de Frutos and others present agreed.

On the topic of materiality, Serge Pattyn asked whether participants had any comments on materiality in the context of a business combination. One participant made reference to the Framework to assess whether information was material or not. Philippe Danjou mentioned that “materiality” was an important topic for the IASB and they had a separate project on materiality.

Overall, Javier de Frutos thought that IFRS 3 provides a lot of useful information. However, there was a need to be more focused on what disclosures were needed to understand the business combination. This would be to complement what is already required by IFRS 3.

Concluding remarks

Françoise Flores and Hans Buysse thanked the speakers and participants for an insightful discussion.