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Mr Hans Hoogervorst
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
UNITED KINGDOM

Dear Hans,

IASB Request for Information
Post-implementation Review: IFRS 3 Business Combinations

The Australian Accounting Standards Board is pleased to submit its comments on the Request for Information to the International Accounting Standards Board. In formulating its views, the AASB sought and considered the views of its Australian constituents, through both holding a Discussion Forum and publishing the Request for Information. The comment letters received are published on the AASB's website.

The AASB supports the work of the IASB in carrying out post-implementation reviews of IFRSs after they have been applied in financial statements for a number of years. The AASB's most significant comments on the more substantive specific questions raised in the Request for Information are noted in this letter for your consideration, and expanded on further in the attached pages, together with responses to the other specific questions.

The AASB supports the general approach in IFRS 3 to accounting for business combinations, including the fair value measurement basis, as providing useful information to users of general purpose financial statements. The AASB considers that although various improvements could be made to IFRS 3, major revisions are not required and thus a major project is not warranted. For example, the AASB supports the recognition of impairment of goodwill and indefinite-life intangible assets, rather than amortisation, and the fair value remeasurement of previously held equity interests for business combinations achieved in stages.

As there is a difference of substance between business combinations and asset acquisitions, different accounting treatments are warranted. It is therefore critical that the distinction between business combinations and asset acquisitions is clear. However, the AASB considers that the IFRS 3 definition of a business and the accompanying Application Guidance can be difficult to apply, resulting in uncertainty and additional costs in analysing transactions, and requiring significant judgements in classifying transactions, potentially with divergent outcomes across entities. Clarifying the distinction should be a major focus of any standard-setting project arising out of the post-implementation review.

The AASB notes that many of the main issues in practice relate to the application of other IFRSs to acquired intangible assets and goodwill, particularly the impairment requirements under IAS 36 *Impairment of Assets*.

Any decision by the IASB to establish a standard-setting project arising out of the post-implementation review should be made in the context of its periodic agenda consultation, so that competing priorities can be properly considered.

If you have queries regarding any matters in this submission, please contact Clark Anstis (canstis@aasb.gov.au).

Yours sincerely,

Angus Thomson
Acting Chair

Specific AASB comments on IASB Request for Information
Post-implementation Review: IFRS 3 Business Combinations

Specific Questions for Comment

The AASB provides the following comments on the IASB's specific questions set out in the Request for Information.

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).[a]

(a) Type of user includes: buy-side analyst, sell-side analyst, credit rating analyst, creditor/lender, other (please specify).

(b) your principal jurisdiction. …

(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 …

(e) if you are a user of financial statements …

The AASB establishes accounting standards in Australia for both private sector entities and public sector entities through a due process that includes consultation with preparers, auditors and users of financial statements. Australian Accounting Standards incorporate IFRSs. For-profit entities with public accountability that are required to comply with Tier 1 requirements under Australian Accounting Standards, and other entities electing to apply those Tier 1 requirements, would simultaneously comply with IFRSs.

IFRS 3 *Business Combinations* (2004) was incorporated into AASB 3 *Business Combinations* (2004) and IFRS 3 (2008) was incorporated into AASB 3 (2008).

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?

There is a difference of substance between business combinations and asset acquisitions, so that different accounting treatments are warranted. For example, combinations result in the acquisition of identifiable and unidentifiable assets and liabilities, which gives rise to the need to address the accounting for goodwill. However, it is therefore critical that the distinction between business combinations and asset acquisitions is clear.[1] The AASB considers that this distinction should be a major focus of any standard-setting project arising out of the post-implementation review. As the exclusion of asset acquisitions from the existing scope of IFRS 3 is appropriate, the accounting for asset acquisitions should not be included in any business combinations project. This would limit the scope of the project to a manageable size.

The IFRS 3 definition of a business and the accompanying Application Guidance can be difficult to apply, resulting in uncertainty and additional costs in analysing transactions to distinguish business combinations and asset acquisitions, and requiring significant judgements, potentially with divergent outcomes across entities. The AASB considers that improvements are required to the definition and to the Application Guidance, since in some circumstances they may be interpreted as being inconsistent. Constituents have identified particular difficulties in applying the Guidance in relation to the acquisition of investment property, extractive industry assets, agricultural assets and financial assets such as loans.

For example, paragraph B8 of IFRS 3 seems to indicate that an acquired set of assets and activities can be regarded as a business even when it relies on integration with the acquirer's own inputs and processes to produce outputs … or when integration with a market participant's inputs and processes could produce outputs. Therefore, it is unclear whether an integrated set of acquired assets and activities must include significant processes in order for the definition of a business to be met, or whether the definition can be satisfied when only nominal processes are acquired or even when no processes are acquired.

Furthermore, the guidance on activities and assets in the development stage (paragraph B10) also makes it difficult to distinguish acquired assets and businesses, as a plan to produce outputs appears to be all that is required for a set of activities and assets to qualify as a business.

The AASB noted the insertion of paragraph 14A into IAS 40 *Investment Property* by the IFRS *Annual Improvements to IFRSs 2011–2013 Cycle* (December 2013), but, as advised previously in its submission on the preceding Exposure Draft ED/2012/2, disagrees that the judgement as to whether the acquisition of an investment property is the acquisition of an asset or a business combination depends only upon IFRS 3. The characteristics of an investment property considered in IAS 40 can be relevant in applying the definition of a business.

1 The distinction would also affect other areas of accounting that depend on identifying a business by reference to the definition in IFRS 3. This was noted by the AASB in its submission on IASB Exposure Draft ED/2012/6, as the proposed requirements for the sale or contribution of assets between an investor and its associate or joint venture differed according to whether the subject of the sale or contribution was a business or other assets.

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?[a] If there are deficiencies, what are they?

(a) According to the *Conceptual Framework* information is relevant if it has predictive value, confirmatory value or both.

(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?

The AASB supports the use of fair value as the measurement basis for assets and liabilities acquired through business combinations. The AASB does acknowledge that there can be difficulties in its application, such as the potential range for fair value measured under various models and the difficulty of measuring contingent consideration, contingent liabilities and untraded intangible assets. The range of measurement models and values potentially allows entities to produce fair values that suit their preferred accounting outcomes, subject to audit views when applicable. However, the AASB notes that the application of IFRS 13 *Fair Value Measurement* (applicable from 2013) should assist in developing greater consistency in applying fair value measurement models.

The interaction with other Standards also deserves consideration, particularly where fair value as per IFRS 3 differs from measurement bases under other Standards. This can mean that measurements under IFRS 3 require restatement at future reporting dates. Some particular exceptions to the application of other Standards are provided in paragraphs 54-58 of IFRS 3, but these are not exhaustive. For example, provisions measured at fair value under IFRS 3 are subject to the differing subsequent measurement requirements of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, i.e. the best estimate of the expenditure required to settle the obligation.

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?

The AASB supports the separate recognition of goodwill and intangible assets, on the grounds that this best reflects the various assets acquired through a business combination.

The AASB notes that academic studies in Australia have generally supported the value relevance of goodwill and intangible asset information. However, there are opposing views also, such as the recognition of identifiable intangible assets being associated with higher acquisition premiums and overpayment. If the latter were the case, then the separate recognition and disclosure of intangible assets would be better than inclusion in goodwill balances, providing a better basis for the application and analysis of amortisation and impairment policies.

The AASB noted that the accounting for negative goodwill (gain on bargain purchase) had been discussed for a very long time and saw no reason to reopen the debates.

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?

The AASB believes that recognising impairment of goodwill and indefinite-life intangible assets is a better accounting policy than amortisation, since impairment testing is intended to reflect factors specific to an entity whereas amortisation methods are arbitrary. Properly applied, impairment testing should provide more useful information to financial statement users than amortisation.

The AASB notes concerns of some constituents regarding the effectiveness of impairment testing and suggests that the IASB consider a review of the requirements of IAS 36 *Impairment of Assets*. However, such a review should be separate from any project on the accounting for business combinations, so that the scope of such a project would not be too broad.

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.

Based on anecdotal evidence, the accounting policy usually adopted in Australia is to measure non-controlling interests based on the present ownership instruments' proportionate share in the recognised amounts of the acquiree's identifiable net assets, rather than fair value. Apart from the additional cost that might be incurred to measure NCI at fair value, constituents noted that adopting the fair value measurement basis would have the general effect of increasing an amount of goodwill, with increased impairment expense in the future.

The AASB considers that measuring NCI at fair value is consistent with the fair value measurement basis for assets and liabilities acquired and thus supports retention of the fair value option. This would also be consistent with the requirement for the fair value measurement of NCI under US GAAP.

The AASB is concerned that the option for the measurement of NCI is available for each business combination without any restriction. Consideration should be given to requiring entities to choose one measurement basis to apply to all of their business combinations.

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.

In the AASB's view, both the obtaining of control of an entity and the loss of control of the entity are significant economic events for which fair value measurement is appropriate. This applies in step acquisition cases as well. The AASB therefore supports the remeasurement of the previously held equity interest in an acquiree at the acquisition-date fair value and the recognition of any resulting gain or loss in profit or loss. Similarly, the AASB supports the remeasurement through profit or loss of any investment retained in a former subsidiary when control is lost.

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?

The AASB generally supports the disclosure requirements set out in IFRS 3. However, the AASB notes significant concern amongst constituents in respect of the requirement in paragraph B64(q)(ii) to disclose pro forma revenue and profit or loss amounts for the combined entity determined as if all business combinations during the period had occurred at the start of the period. This disclosure can be costly to develop and subjective, given estimation difficulties, which limits its utility to financial statement users. The IASB should consider whether to delete the requirement.

Some constituents refer to non-compliance with various disclosure requirements, which is supported by some academic research. However, most of these comments relate to impairment disclosures required by IAS 36, rather than the disclosure requirements set out in IFRS 3. For example, Carlin and Finch (2010) found significant non-disclosure of discount rates used in estimating the recoverable amount of cash-generating units.[2]

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.

The AASB considers that the application guidance in paragraphs B54 and B55 of IFRS 3 should be improved. This guidance addresses determining whether arrangements for contingent payments to employees or selling shareholders are contingent consideration in the business combination or separate remuneration transactions (i.e. payments for services rendered in the post-acquisition period). Numerous constituents have indicated that there are significant implementation issues, requiring detailed analysis and judgement in applying the requirements. These issues may permit the structuring of payment arrangements to achieve desired accounting outcomes.

The AASB concluded that although various improvements could be made to IFRS 3, major revisions are not required and thus a major project is not warranted. The AASB noted that many of the main issues in practice relate to the application of other IFRSs to acquired intangible assets and goodwill. Any decision by the IASB to establish a standard-setting project arising out of the post-implementation review should be made in the context of its periodic agenda consultation, so that competing priorities can be properly considered.

2 T M Carlin and N Finch, ‘Resisting Compliance with IFRS Goodwill Accounting and Reporting Disclosures: Evidence from Australia’, *Journal of Accounting & Organizational Change*, 6/2, pp. 260-280.

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)?

The AASB supports the general approach in IFRS 3 to accounting for business combinations, including the fair value measurement basis, as providing useful information to users of general purpose financial statements. The AASB notes that some of the uncertainties in applying detailed requirements may give entities the opportunity to modify the terms of a business combination in order to achieve a particular accounting outcome. Therefore, the AASB sees merit in addressing inconsistencies and interpretative issues raised in this submission, without fundamental changes to the business combinations accounting model.