Federation of European Accountants
Fédération des Experts comptables Européens

Mr Hans Hoogervorst
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19 May 2014

Ref.: ACC/AKI/HBL/PGI/SRO

Dear Chairman,

Re: FEE Response to Request for Information - Post Implementation Review: IFRS 3 Business Combinations

FEE (the Federation of European Accountants, www.fee.be) is pleased to provide you below with its responses to the Request for Information (RfI) in relation to the Post-implementation Review of IFRS 3 Business Combinations, issued by the IASB in January 2014.

FEE strongly supports the IASB's process of post-implementation reviews two years, or so, after a new IFRS has become mandatory and been implemented. We believe that it is important that the IASB solicits and considers the practical experience of all stakeholders as part of its process of improving IFRSs.

FEE agrees that one of the key issue to be addressed as part of this PiR is whether the differentiated treatment for acquisitions of assets as opposed to acquisitions of business is justified. Indeed, while FEE believes that this differentiated treatment is conceptually justified with respect to goodwill, we have serious doubts when it comes to the other differences in accounting treatment. Also, we consider that there are significant practical difficulties in distinguishing the two in certain circumstances and, particularly, in certain industry sectors. Consequently, we believe that it would be beneficial for the IASB to provide further clarification as to the crucial defining characteristics of a "business".

FEE supports the application of fair value to business combinations. We do, however, have some concerns that the current requirement to separate out identifiable intangible assets from goodwill does not always produce meaningful and relevant information for the users of the financial statements.

FEE favours the concept of separating other intangible assets from the residual goodwill but we have identified practical problems that arise from this requirement, particularly with regards to recognising intangible assets arising from non-contractual customer relationships.

FEE supported the requirement for an annual impairment review of goodwill and indefinite-life intangible assets, as opposed to amortisation, when it was introduced into IFRS 3. In the years since implementation, it has become apparent that there are significant issues arising from the practical application of annual impairment reviews. The impairment approach has also been criticised because the significance of judgements involved in the performance or impairment test and of the perception that impairment losses are sometimes recognised too late. This consequently leads to problems for auditors in obtaining the same level of assurance as would be the case for many other items in the financial statements.

Having said that, there are also problems with the amortisation approach, particularly related to the relevance of what could be seen as arbitrary annual charges to the financial statements.

Our Member Bodies have different experiences relating to the practical application of annual impairment reviews as opposed to amortisation. Some FEE members support the requirement for annual impairment-only reviews contained in the Standard, albeit as the "least-worst" option. Others favour amortisation of goodwill over its limited useful life combined with regular impairment testing. Both views are examined in further detail in the Appendix.

Consequently, FEE believes that there is a need for the IASB to further research the comparative merits of both the impairment only and amortisation approaches and also review the appropriateness of immediate write-off through profit and loss of negative goodwill as part of the PiR process.

FEE also suggests that the IASB considers whether modifications to IAS 36 could improve the effectiveness and robustness of the impairment tests.

FEE's views on the specific questions on which the IASB would particularly value comments are set out in the Appendix.

For further information on this letter, please contact Paul Gisby, Project Manager, at the FEE Team on +32 2 285 40 70 or via e-mail at paul.gisby@fee.be.

Yours sincerely,

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Chief Executive

Encl.

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Association Internationale reconnue par Arrêté Royal en date du 30 décembre 1986

Question 1 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)]

(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).

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

(1) FEE (Fédération des Experts-comptables Européens – Federation of European Accountants) is an international non-profit organisation that represents 47 institutes of professional accountants and auditors from 36 European countries, including all of the 28 EU member states.

(2) FEE has a combined membership of more than 800 000 professional accountants, working in different capacities in public practice, small and large accountancy firms, businesses of all sizes, government and education. Our membership includes the preparers of financial statements as well as auditors and has experience with the practical application of both IFRS 3 (2004) and IFRS 3 (2008).

Question 2 – 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?

(3) FEE agrees that one of the key issues to be addressed as part of this PiR is whether the differentiated treatment for acquisitions of assets as opposed to acquisitions of business is justified. Indeed, while FEE believes that this differentiated treatment is conceptually justified with respect to goodwill, we have serious doubts when it comes to the other differences in accounting treatment. For items such as deferred tax, contingent consideration and transaction costs, the difference in treatment appears justified by practical considerations rather than conceptually. For transactions costs, the difference in treatment highlights the fact that current IFRS require that acquisition of a business is recognised at fair value while acquisition of most non-financial assets is recognised at cost. The justification of this fundamental difference is not self-explanatory and would need to be further investigated.

(4) Furthermore, we believe that in some circumstances, determining whether a group of assets constitutes a business is difficult and subjective.

(5) Consequently, we would recommend that the IASB revisit whether the separate treatment of deferred tax, contingent consideration and acquisition costs is really justified. Considering the difficulties that arise from having to determine whether a transaction represents an acquisition of assets or a business combination.

(6) In our experience, the main challenges in applying the guidance in IFRS 3 on this topic relate to the assessment of the relevance of processes acquired as part of the acquired set of assets and significance of the processes missing from the set. This is particularly the case where only some of the processes are being acquired and it is necessary to determine whether the processes that are acquired (and those missing) are necessary to the production of outputs or are merely administrative processes.

(7) This assessment is particularly challenging in certain industries, including the real estate, financial services, extractive and pharmaceutical industries.

(8) For example, in the real estate industry, there are considerable practical difficulties in determining whether the processes acquired, which are often of an administrative nature, represent processes necessary to the production of outputs or merely serve to safeguard and manage the real estate properties. At the extremes, the qualification of transactions is generally clear: the acquisition of a standalone unoccupied property is undeniably acquisition of an asset and the

acquisition of a building already fully tenanted along with the employees and management systems necessary to leasing and administrative functions is undeniably acquisition of a business. However the dividing line between the two extremes is not clear. What are the processes necessary to transform a standalone property into a business: the processes of finding tenants, negotiating rents, drawing up letting agreements and then managing the property on an ongoing basis? Does it matter whether the building is already fully occupied?

(9) In respect of the pharmaceutical and extractive industries, entities tend to define the output giving rise to a business based on their business model. This definition of the "output" is then determinative of the required processes. For example, the acquisition of a pharmaceutical product for which regulatory approval had already be gained could be treated as a business combination by one entity that has an established production capability but as an asset acquisition by another entity that must either establish its own production capacity or commence the process for third party production of the product. Indeed, in these industries, the key issue is often establishing at what point a research or an exploration project becomes a business. However, it would be useful to clarify whether such an approach was the approach intended in IFRS 3. We believe that there is diversity in practice.

(10) Consequently FEE believes that it would be useful for the IASB to provide further clarification as to the essential characteristics of a business as opposed to a collection of assets.

Question 3 – 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?

(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?

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

(11) In general, we believe that the information derived from fair value measurements is relevant when accounting for business combinations. However, there are specific situations where such a measurement may not result in the most relevant information. Most notably, we suggest that the IASB considers whether fair value is the most relevant measurement basis for intangible assets, such as a brand, that the acquirer does not intend to use subsequently because it prefers to promote its own pre-existing brands. Some question the relevance of measuring the acquired brand at fair value at the acquisition date if it is followed by a write-down shortly thereafter to reflect its non-use by the acquirer. In such circumstances, some argue that expected value in use would be a more relevant basis for valuing such assets.

(12) Additionally, determining the fair value of inventory often requires measuring the work remaining to be performed on work-in-process and the margin thereon. These estimates can be difficult to determine. Guidance on measurement of inventory at fair value may help ensuring more consistent practices.

(13) We have also encountered some conceptual problems relating to the valuation of acquired financial liabilities, namely whether the financial liabilities should reflect the credit risk of the acquiree as a standalone entity or be adjusted for the credit risk of the acquirer. The impact of guarantees required or expected to be provided by the acquirer is further unclear. Guidance on this issue would be welcomed.

(14) Further, measurement at fair value of assets and liabilities at the time of the business combination creates difficulties when such measurement is inconsistent with the standard applicable subsequently to the item. This is the case in particular with respect to contingent liabilities that are required to be recognised at fair value according to IFRS 13 as part of a business combination but would not meet the recognition criteria of IAS 37 in the normal course of operations (because it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation). Another difficulty with respect to items that are within the scope of IAS 37 relates to the discount rate used at the date of acquisition (in establishing fair value) that is not necessarily consistent with the subsequent measurement of provisions under IAS 37.

(15) A consequence of measuring assets at fair value is that this generally results in recognition of deferred tax liabilities, which then results in an increase in goodwill. In fact, in some circumstances goodwill recognised derives solely from the recognition of deferred tax liabilities. In such circumstances, practical difficulties may arise performing the impairment test on goodwill. While it is not directly linked to IFRS 3, it may be useful as part of this PiR to assess how to address this issue.

(16) In our experience, a significant valuation challenge in measuring fair value relates to those classes of assets and liabilities where there is no readily identifiable external market.

(17) Determining the fair value of contingent consideration is often highly judgemental, particularly considering that parties tend to include such clauses in the purchase agreement when the fair value of the business is subject to uncertainties.

(18) Similarly, establishing the fair value of the pre-existing interest on step acquisitions and of non-controlling interests upon acquisition of control is often difficult and judgemental. We elaborate further on this issue in our response to Questions 6 and 7.

(19) In respect of disclosures of fair value measurement, we believe that the current disclosure requirements do provide sufficient disclosure to properly inform the users of the financial statements in respect to fair value measurements.

Question 4 - 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?

(20) We believe that it is difficult to separate the matters raised in this question from those relating to the debate about impairment versus amortisation of goodwill and, consequently have presented our thoughts on this matter combined with the answer to Question 5.

Question 5 - 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?

(21) FEE believes that the requirement to recognise separately all identifiable intangible assets from residual goodwill does not always produce relevant information, especially where the asset so identified is not separable from the business or from other rights and obligations. In these circumstances, the calculation of fair value is extremely subjective. Separate recognition and measurement at fair value of non-contractual customer relationships, including, but not limited to, those in the banking industry, are particularly problematic in this respect.

(22) We note that the separate recognition of intangible assets often triggers the need to recognise a deferred tax asset, with the consequence of increasing goodwill. The IASB should investigate how to best address the practical difficulties in performing impairment test on goodwill when a significant portion of the goodwill arises from the recognition of deferred tax liabilities.

(23) We also have concerns regarding the requirement to recognise a gain in profit or loss for negative goodwill that arises in a purchase price allocation that includes intangible assets for which the measurement is highly subjective. We question the relevance of recognising separately the negative goodwill and the "subjective" intangible assets in such circumstances.

(24) Even where negative goodwill does represent a genuine bargain, we believe that it will often have arisen due to the target business having structural problems resulting in future restructuring costs in the hands of the acquiring company. In such circumstances, the requirement that the negative goodwill be immediately recognised in profit and loss may be seen as inappropriate since the gain is "reversed" by subsequent charges.

(25) The annual impairment review approach has been criticised because of practical concerns related to the performance of the impairment test, of the significance of judgements involved and of the perception that impairment losses are sometimes recognised too late. This issue might also arise with the amortisation with impairment approach, albeit with a less significant potential impact on financial information.

(26) Further, the non-amortisation of goodwill and of certain intangible assets puts pressure on the impairment test. We question whether impairment tests required by IAS 36 always provide an appropriate surrogate to amortisation. For example, we question whether it is reasonable for assets to be carried on the balance sheet for very long period of time with no or marginal impairment during that period. We believe that the reason these assets do not require impairment is that externally acquired goodwill becomes internally generated goodwill over the course of time, such that the asset that "passes" the impairment test is no longer the one initially recognised. This is inconsistent with the prohibition from recognising internally generated goodwill.

(27) Difficulties in performing the impairment tests also arise from the allocation of goodwill to CGUs (or groups of CGUs) outside the acquired set that may be subjective, and from allocation of goodwill to a group of CGUs that operate in different functional currencies. We suggest that this is another area that the IASB should investigate to determine whether there are some inconsistencies that can be resolved, whether the tests can be simplified or whether additional guidance is warranted.

(28) Further, we have noted diversity in application of IAS 36, even after several years of experience with the revised standard.

(29) However, there are also problems with the amortisation approach. There are issues in determining the appropriate amortisation period for the asset, and concerns that amortisation results in arbitrary accounting and leads to annual charges that are of little relevance to users of the financial statements when evaluating the performance of the entity. Additionally, the amortisation method does not remove the requirement for management to consider whether an impairment of goodwill is necessary.

(30) At present, some FEE members still support the requirement for annual impairment-only reviews contained in the Standard. They believe that this still remains the best method as it is the purest from a conceptual viewpoint. However, others favour amortising acquired goodwill over its limited useful life, combined with regular impairment testing. In their view, acquired goodwill is an asset with a limited useful life and should thus be amortised on a systematic basis over this life. They do not view the problem of determining the useful life as being a compelling conceptual argument against the amortisation of goodwill, as this problem also applies to other intangible assets with a definite life.

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(31) Supporters of the amortisation method accept the need for regular impairment reviews but believe that amortisation reduces the pressure on the impairment review process and thereby facilitates reliable measurement. Simultaneously, the issue of acquired goodwill being replaced with internally generated goodwill ceases to be an issue when the useful life of goodwill is sufficiently short.

(32) Due to this divergence of views, FEE believes that this is an important matter that warrants further consideration by the IASB. We consider that it is a good opportunity to examine again the underlying conceptual basis for accounting for goodwill and other intangibles. This review should address matters such as the whole question of impairment as opposed to amortisation, the different alternatives for Day 1 and Day 2 accounting for goodwill and the immediate write-off of negative goodwill through profit and loss. We also consider that IAS 36 should be reviewed to identify any ways in which the impairment review process could be made more robust and effective.

Question 6 - 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.

(c) 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.

(33) We admit that measuring NCI at fair value and recognising a “full” goodwill is conceptually in line with the entity perspective retained in IFRS 3. Indeed, if goodwill is to be regarded as an asset (even a residual asset), it is logical to recognise that asset in full in common with other assets. Additionally, as NCIs will receive their share of the benefits that goodwill generates in the future, it is appropriate that the valuation of their share of goodwill is on the same basis as that of the parent.

(34) However, measuring NCI at fair value presents significant practical difficulties. This estimation is highly subjective when shares of the acquiree are not traded in an active market. In practice, there is no objective way to determine the control premium paid by the acquirer in order to determine a minority fair value. Hence, whether an entity attempts such an estimate or applies a simple rule of three, the result is highly tentative. Consequently, it is also very difficult to audit.

(35) Whilst we acknowledge the conceptual basis for permitting the measurement of NCI at fair value, we believe that there are considerable difficulties in the practical application of this basis for both the preparers and auditors of the financial statements.

(36) This is why on balance FEE believes that the current option in IFRS 3 should be retained.

(37) Regardless of the treatment applied to NCI, we believe that there are still problems arising in practice in dealing with put options over NCIs and request that the IASB restarts its work in this area, which appears to have largely stalled since the draft interpretation in May 2012. We also believe that the issue of accounting for mandatory tender offers also on hold should be addressed.

Question 7 - 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.

(38) Even if we consider that the current accounting treatment has conceptual merits and is consistent with the entity approach, FEE has doubts as to the relevance of the information resulting from the requirements on step acquisitions and losses of control. In the absence of an exchange transaction on the shares previously held (or those retained), we question the reasonableness of the principles underlying the required accounting. Further the concerns we expressed in response to Question 6 on the difficulties of measuring NCI at fair value are equally applicable to the measurement of the shares previously held (or those retained).

(39) With respect to decreases in ownership, we are also concerned about the consequences of recognising gains/losses on such transactions in equity when the transaction does not result in a loss of control. We note that as a consequence, when an entity disposes of an interest in a subsidiary through successive transactions, the performance reported in comprehensive income does not reflect the full impact of the gains (or losses) realised on the investment. Only gains and losses arising from the loss of control, and subsequently, are recognised in comprehensive income.

(40) Further, while we understand the conceptual basis of the current treatment, we do question the relevance of recognising in profit or loss gains/losses that could be considered by many users as mere accounting adjustments with no link to actual transactions. Consequently, we would recommend that the IASB researches in more detail whether the users of financial statements find the current accounting treatment useful and how they treat the resulting profit and loss impacts when determining their estimate of the future profitability of the entity.

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Question 8 – 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?

(41) FEE believes that users are better placed to assess the usefulness of the information disclosed. Among others, their views on the following two aspects of the disclosure requirements may be particularly useful. First, whether they find the information on goodwill (in particular the reasons why the transaction resulted in goodwill) informative since we find that it tends to be boilerplate. Second, the usefulness of the information on pro-forma revenue and net income as if the transaction had taken place at the beginning of the period. If users find this information useful, it may be appropriate for the IASB to provide further guidance on the preparation of this pro-forma information since currently IFRS 3 does not explain what adjustments, if any, should be made in combining the results of the acquirer and the acquiree for the period before the acquisition.

Question 9 - 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) The continued lack of guidance with respect to common control transactions (including, but not limited to, business combination) is a source of difficulty and diversity in practice that should be addressed as a matter of priority.

(43) We believe that the concept (and measurement requirements) of reacquired rights is not well understood and merits clarification. Similarly, we believe that there is diversity in practice in terms of application of the requirements relating to pre-existing relationships. Therefore, we consider that the IASB should provide further clarification on these issues.

(44) Distinguishing whether the amounts paid to former owners that continue to provide employee services represent purchase price or compensation is another matter that requires further consideration. We believe that the IASB should reconsider the current rule in IFRS 3 (as interpreted by the IFRIC IC) that the existence of service condition necessarily means that a contingent payment is a compensation arrangement. It may be appropriate to consider that instead a service condition creates a rebuttable presumption of a compensation arrangement. On a practical level, we have also found that it can be challenging to assign a fair value to the consideration being paid, especially in circumstances where the former owner or owners are an integral part of the "goodwill" being acquired. In such circumstances, it can often prove problematic to separate out that element of agreed future remuneration that relates to the disposal of their interest from that which represents genuine remuneration for future services. In such circumstances, there may not be any other categories of shareholder to use as a basis for ascertaining the fair value paid for the shares.

Question 10 – 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)?

(45) In FEE's opinion the IFRS has certainly increased the effort required from and the costs incurred by the preparers of the financial statements. As an illustration, the difficulty in establishing whether a group of assets constitutes a business (as discussed in our response to Question 3) combined with the significant differences in accounting between the acquisition of assets as opposed to the acquisition of a business have put pressure on preparers and may have led to deals being structured in a different manner.

(46) We have not conducted any research to identify whether the Standard benefits either preparers or enforcers and we have not identified any benefits to auditors arising from the application of the Standard of which we can make you aware. We believe that the question of benefit is best addressed to the users of the financial statements.