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Request for Information – Post-implementation Review IFRS 3 Business Combinations

Grant Thornton International Ltd is pleased to comment on the International Accounting Standards Board's (the Board) Request for Information – Post-implementation Review IFRS 3 *Business Combinations* (the RFI).

In our view IFRS 3 *Business Combinations* and its related requirements provide an appropriate and coherent framework for accounting for this very important class of transaction. We have not identified any fundamental flaws in these requirements and see no need for a major overhaul.

Applying this Standard, and auditing the results of its application, do of course present some challenges and can require significant judgement. However, that is probably inevitable in view of the complexity and diversity of business combination transactions.

Our main comments on the matters raised in the RFI relate to the following topics:

Definition of a business

We have experienced some challenges in applying IFRS 3's definition of a business and supporting guidance (although it should also be acknowledged that most cases are clear). The challenges arise most frequently in relation to assets that are capable of generating a return with relatively few processes or other inputs, with investment property being the most prominent case in point.

Despite the challenges, we believe the existing definition and guidance generally provides a reasonable basis for professional judgment. We would caution against attempting to enhance the guidance by trying to change or expand it in a way that would substantially reduce the need for judgment. That said, we do have some observations about aspects of the guidance and why it is challenging to apply with consistency for some transactions. We discuss these aspects, and suggest some areas in which targeted clarifications could be helpful and improve consistency, in our response to Question 2.

Separate recognition of intangible assets

In our experience identifying and valuing certain (primarily non-contractual) intangible assets can be complex and costly. We also have some doubts as to the practical usefulness of recognising some of these assets separately from goodwill.

Taken together, we think these matters give the Board reason to revisit its cost-benefit assessment in relation to IFRS 3's requirements on separate recognition of intangible assets.

Accounting for contingent payments linked to future employment

We frequently encounter scenarios involving contingent payments to selling shareholders that remain employed post-combination. We have observed differences of view in how IFRS 3's guidance is interpreted and applied, but many constituents believe that IFRS 3 requires such payments to be treated in full as post-combination remuneration.

We have seen several fact patterns in which (in our view) bifurcating such payments into a consideration component and a compensation component would better represent the economic substance of the arrangement. We suggest the Standard should be amended to make it clear that this is possible.

Our responses to the questions in the RFI are set out in the Appendix to this letter. These responses note several other areas that in our experience sometimes give rise to questions of application and interpretation. We report these matters for the consideration of the Board and the review team and do not view them as fundamental flaws or matters requiring urgent revision of the Standard.

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If you have any questions on our response, or wish us to amplify our comments, please contact our Global Head of IFRS, Andrew Watchman (andrew.watchman@gti.gt.com or telephone + 44 207 391 9510).

Yours sincerely,

Kenneth C. Sharp

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Responses to questions in the Request for Information RFI

Question 1

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).

This letter is sent on behalf of Grant Thornton International Ltd - one of the world's leading organisations of independently owned and managed accounting and consulting firms. These firms provide assurance, tax and advisory services to privately held businesses and public interest entities. More than 2,500 partners and 38,000 staff provide clients with distinctive, high quality and personalised service in over 120 countries. We serve both publicly quoted entities and the privately-owned sector across the world. In many markets our publicly quoted clients are predominantly smaller listed entities for which issues of practical application of IFRSs are of particular concern.

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

This letter reflects the experience of Grant Thornton member firms in a number of different jurisdictions.

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

We have been involved with both versions of IFRS 3.

(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.

Not applicable**.**

(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).

Not applicable.

Question 2

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

Yes, we believe there are benefits in having specific accounting requirements for business combinations.

Business combinations are typically more significant, complex and infrequent transactions than asset purchases (or acquisitions of a group of assets). We also believe there is an important difference of substance between obtaining control over a business and over an asset. The fact that challenges can arise in distinguishing between a business and a group of assets does not override the existence of such a difference.

For these reasons we believe that a specific and reasonably comprehensive accounting model for business combinations is necessary.

(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?

Distinguishing a business combination from an asset purchase is unproblematic in many cases but nonetheless presents challenges for clients and audit engagement teams in borderline cases. These borderline cases give rise to frequent application questions. These questions are particularly prevalent in certain sectors such as real estate, shipping, the extractive industries and pharmaceuticals.

The fact that the accounting treatment for business combinations is very different to that for an asset purchase (eg in relation to measurement on initial recognition, goodwill, transaction costs, deferred tax on initial temporary differences and disclosures) also puts pressure on the definition and supporting guidance. Management may have a strong preference and also an expectation that the classification of a transaction should reflect how they views that transaction internally. This can lead to robust discussions between management and auditors.

Despite the challenges, we believe the existing definition generally provides a reasonable basis for professional judgment. Although we have identified some aspects of the existing guidance that could be clarified, we think that judgement is inevitable in borderline cases. The outcome of each judgement will also be highly dependent on the specific facts and circumstances. We therefore caution against attempting to enhance the guidance by changing or expanding it in a way that would substantially reduce the need for judgement.

That said, we do have some observations about IFRS 3's guidance that supports the definition, and why it can lead to debate for some transactions. The following list explains some issues that arise in marginal cases and might therefore help to focus the review:

- IFRS 3's guidance is weighted towards explaining when an acquired set is (or could be) a business. It has little or no guidance on when an acquired set is not a business (perhaps motivated by anti-avoidance concerns). This can make it difficult to make the distinction

- IFRS.B7(b) notes that purely administrative functions such as accounting and billing are not processes used to create outputs. We agree with this statement but note that it leads to questions as to distinction between an administrative function and a process. The need to identify 'processes' is a common theme among several of the transaction types noted. For example, are activities associated with operation and maintenance of an asset considered to be processes, or do processes comprise only higher-level activities such as strategic management, sales and marketing and contract negotiation?
- other questions can sometimes arise as to whether a specific acquired resource is a 'process', an 'input' or something else (especially when no employees are involved). For example, would an acquired property management contract or wind farm operating license be considered a process?
- IFRS 3's guidance makes clear that, to be a business, an acquired 'set' need not contain <u>all</u> the inputs or processes that the seller used in operating the business (if market participants are capable of continuing to operate the business by integrating the business with their own inputs and processes etc - IFRS 3.B8). This can lead to questions about:
  - how many inputs/processes should be 'missing' to conclude an acquired set is not a business
  - how to apply the guidance on integrating the acquired set with existing processes and inputs. To expand on this, an existing industry operator - especially in an asset-based industry such as property or shipping - will almost always be capable of using its own existing processes and inputs to the extent they are not acquired in the transaction. This would be the case even for a bare asset purchase. Accordingly, this aspect of B8's guidance is not always helpful in establishing the boundary, even if it serves a useful anti-avoidance purpose
- assessing whether an acquired set is capable of being conducted and managed as a business by a market participant might depend on the type of market participant (eg a financial buyer versus existing industry participant)
- the guidance refers to various indicators (eg employees, liabilities, the four factors in B10(a)-(d)) but also explains that none are determinative in isolation. There is little guidance on relative weighting. Accordingly, some commentators look for 'rules of thumb' to assist in the assessment. For example, some of my colleagues commented that the transfer of employees is considered a strong indicator in practice
- the reference to goodwill in IFRS 3.B12 is not very helpful. Goodwill is only determined once the acquirer has concluded that the acquired set is a business (and in some cases arises in large part as a result of recognising deferred tax).

Question 3

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

This is primarily a question for financial statement users. From our perspective, initially measuring (most) assets acquired and liabilities assumed in a business combination at fair value, or some other current amount, is necessary given that individual costs are generally not determinable. The use of fair value in business combinations accounting is also well-understood and broadly accepted.

(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?

In our experience determining the necessary fair value measurements is often challenging for entities.

The level of challenge is not only attributable to the inherent complexity or subjectivity of the valuation process for particular assets and liabilities, but also stems from the infrequent or one-off nature of business combinations. Many acquirers make little use of fair value in their routine financial reporting and therefore have limited valuation expertise or resources in-house. In the event of a business combination acquirers are required to fair value most assets acquired and liabilities assumed. Accordingly, acquirers commonly need to engage outside valuation specialists to assist in this process.

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

Intangible assets

In our experience the valuation of some intangible assets can be particularly challenging, for a number of reasons. Intangible assets are by nature less detectable than tangible ones. Many are not recognised in the acquiree's pre-combination financial statements. Determining their fair value usually involves estimation techniques as quoted prices are rarely available.

In addition, such assets:

- are rarely (if ever) bought or sold individually
- generate cash flows only in combination with other assets and liabilities
- are unique and may even be challenging to identify and define (ie subject to existence uncertainty).

We believe that the difficulties in valuing some non-contractual intangible assets are an important factor in evaluating whether IFRS 3's existing requirements for separate recognition of intangibles meet the cost-benefit test. Our response to Question 4 considers the usefulness of the resulting information, along with related implementation and auditing challenges.

Other elements

Another element that is often challenging in valuation terms is contingent consideration. This is largely due to the unique and entity-specific features of many such arrangements, and the corresponding absence of observable market inputs. The underlying valuation methods can be complex (due to the non-linear payoff structure and need to consider multiple outcomes). The selection of inputs also requires significant judgement.

Some other areas that in our experience can present difficulties include:

- *valuation of an intangible asset associated with an 'at market lease'* – we find the requirements of IFRS 3.B30, which suggests that an 'at market' operating lease may still have a positive fair value, confusing and contradictory.
- *measuring assumed liabilities* – we note that the quoted price of an entity's debt instruments can be affected by the expectation of a change of control. This is a form of buyer-specific synergy. However, if a level 1 price exists this must be used as a fair value. For assumed liabilities that are unquoted and for which a valuation technique is used, it is not entirely clear whether the non-performance risk component should include or exclude this synergistic effect risk.
- *share-based consideration* – in a similar vein, it has been widely observed that the expectation of an acquisition can affect an acquirer's quoted share price (including share price of a listed legal acquirer in a reverse acquisition). It is common for the number of shares to be issued to be agreed in advance of the acquisition date, for example based on the share price at the date the purchase agreement is prepared. However, the quoted share price at the date control is obtained is used in accounting for the business combination. The result of this is that if, for example, the share price rises between the date at which the purchase agreement is prepared and the acquisition date, the higher share price on the acquisition date is used in determining consideration transferred. This leads to problems in practice where the financial statements show the consideration transferred to be higher than the acquirer had intended, as the acquirer may believe the accounting treatment results in them appearing to have overpaid for the business acquired.
- *deferred revenue* – fair valuing deferred revenue (or performance obligations) can present challenges. We believe a measurement at the amount that would be recognized in accordance with the applicable revenue recognition standard would be simpler and could yield equally or more useful information.
- *asset retirement obligations and other provisions within the scope of IAS 37* – measuring such liabilities at fair value is not especially problematic in itself, but some 'noise' arises in the statement of comprehensive income as a result of remeasurement in accordance with IAS 37 in the post-combination reporting periods. For example, the IAS 37 remeasurement might not reflect non-performance risk in the discount rate in the same way as the acquisition date fair value measurement. We suggest the Board should evaluate ways to address this anomaly.

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?

This is primarily a question for financial statement users.

From our perspective we believe there are clear theoretical advantages to identifying and recognising identifiable assets acquired rather than subsuming them into goodwill. The main advantages are that it provides:

- more granular information on what the acquirer has acquired (and presumably paid for)
- a non-arbitrary basis for post-combination amortisation.

Our concern is that these theoretical advantages may not translate into information that is more useful in practice for intangible assets that are particularly challenging to identify and value.

(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?

Intangible assets that arise from contractual or other legal rights are relatively straightforward to detect. The key issues relate to identifying the intangible assets that qualify for separate recognition, in particular application of the separability criterion for some intangible assets.

Broadly, an asset is considered separable if it is capable of being sold or otherwise transferred without selling the entity in its entirety. Where separation is possible only as part of a larger transaction, considerable judgement is required to determine whether the items under review constitute the acquired business itself or a part of it. For example, the content of a database used by a provider of business intelligence may not be separable from the business itself – there would be no business remaining if the database content was sold to a third party. By contrast, where the content database is a by-product of the business activity and may be licensed out to a third party on non-exclusive terms, then this may indicate its separability.

This is a hypothetical assessment. It is not affected by whether the acquirer actually intends to transfer the intangible asset in question (although such an intention would of course demonstrate separability). Evidence of exchange transactions for the type of asset under review or a similar type may be used to exemplify the separability of the asset, "even if those transactions are infrequent and regardless of whether the acquirer is involved in them" (IFRS 3.B33). A full analysis of the intangible asset and its commercial environment is therefore necessary to determine whether separation from the acquired business is feasible without underlying contractual or legal rights.

(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?

This is primarily a question for financial statement users.

We have however observed that bargain purchase gains are perhaps more commonplace than might be expected given the Board's view that these are essentially anomalous. We also note that 'day-1 gains and losses' are restricted in some other areas that apply fair value accounting on initial recognition (specifically financial instruments accounting).

In our experience these gains are not restricted to transactions involving forced or distressed sales. Bargain purchase gains also arise for reasons that seem less or unrelated to the economics of the negotiated exchange, for example:

- differences of view on valuation including, but not limited to, the acquisition date fair value of contingent consideration and intangible assets
- exceptions to fair value measurement, particularly tax assets and liabilities not being fair-valued
- short-term fluctuations/market reactions in the quoted price of the acquirer's shares when part of the consideration is transferred
- combinations in which the fair value of NCI is lower than the NCI's share of net identifiable assets and NCI is recorded at fair value. In this context we note IFRS 3.34 requires this gain to be attributed to the acquirer. It is questionable whether this attribution results in the most useful or appropriate outcome.

We acknowledge that IFRS 3's requirements on recognition of a gain on a bargain purchase are consistent with a fair value model. Moreover, the alternative models we can envisage face conceptual and practical challenges of their own. Nonetheless we believe the Board should re-evaluate whether the recognition of a day 1 gain is appropriate and results in useful information, particularly in those circumstances where there is contingent consideration or other factors that contribute to a high level of estimation uncertainty.

At a minimum we believe it is essential that the circumstances underlying a material bargain purchase gain are adequately explained.

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?

This is primarily a question for financial statement users.

From our perspective we believe the goodwill impairment test does provide useful information. We have also heard that many users consider that the disclosures required by IAS 36 about an entity's impairment testing are useful. The recognition or non-recognition of an impairment loss, and the disclosures that accompany that assessment, provide insights into developments in the business environment and management's views of future prospects for different parts of the business.

The conceptual basis for the goodwill impairment test, however, is questionable, due to the fact that the amount tested represents a mixture of purchased and internally-generated goodwill. Moreover the absence of a requirement to amortise goodwill is linked to the requirements to recognise more intangible assets separately from goodwill (see our comments in response to question 4).

Further, the usefulness of the quantified measures of goodwill impairments is considerably affected by the high degree of estimation uncertainty referred to below.

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

See our response to part(c) below.

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

Testing goodwill and indefinite-lived intangibles is undoubtedly challenging. However, although we believe there are some aspects of IAS 36 *Impairment of Assets* that might usefully be clarified in due course, the fundamental challenge is the forward-looking nature of the testing process. Accordingly, the most significant challenge for auditors is the assessment of whether management's assumptions are reasonable and supportable. It is difficult to envisage how this can be avoided.

Question 6

(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?

This is primarily a question for financial statement users.

(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 choice is made on an acquisition-by-acquisition basis.

We have not experienced any particular challenges in accounting for NCIs, or auditing such accounting.

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.

This is primarily a question for financial statement users.

(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.

The usefulness of the information resulting from these requirements is best assessed by users. We do believe that IFRS 3 (2008)'s requirements for step acquisitions are significantly clearer and simpler to apply than IFRS 3 (2004)'s.

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?

We believe the disclosures required by IFRS 3 are sufficient to enable users to understand the effect of an acquisition on a group.

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

We have not identified any particular disclosures we consider to not be useful. As noted below, however, we do have some concerns about paragraph B64(q)(ii) of IFRS 3 which requires disclosure of speculative or pro forma-type information.

(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 disclosure required by paragraph B64(q)(ii) of IFRS 3 (the revenue and profit of the combined entity as though the acquisition(s) had occurred at the start of the annual period) can present difficulties. This information is somewhat speculative and its preparation involves making certain assumptions.

The issue concerns which assumptions, and adjustments to the acquiree's standalone results, are appropriate or acceptable in preparing the information. For example, do the reported amounts reflect the impact of synergies and/or financing costs incurred by the acquirer to effect the business combination?

We suggest the Board considers providing some brief, additional guidance on the basis of preparation of this disclosure.

Question 9

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.

We have identified below a number of areas that, in our experience, give rise to questions of interpretation and application. We believe that the first issue (contingent payments linked to future employment) is a significant matter that merits a revision to the Standard. We believe the other issues are less significant but should be considered for clarification if the PIR process indicates these concerns are widespread.

Contingent payments subject to employment conditions

IFRS 3.B55(a) provides guidance on whether contingent payments linked to future employment are treated as part of the consideration transferred or as post-combination employee benefits (remuneration). We frequently encounter scenarios involving contingent payments to selling shareholders that remain employed post-combination. The payments might or might not be forfeited on cessation of employment, depending on the reasons for cessation ("good leaver, "bad leaver") and which party initiates the termination.

We have observed differences of view in how this guidance is interpreted and applied. Some see this as an incontrovertible rule that a future employment requirement has the effect that the payments are 100% post-combination remuneration. Others view it more as a rebuttable presumption to be considered alongside other facts and circumstances.

We have seen several fact patterns in which (in our view) bifurcating such payments into a consideration component and a compensation component would better represent the economic substance of the arrangement. We suggest the Standard should be amended to make it clear that this is possible.

Accounting for acquired contingencies

IFRS 3.56 states: "after initial recognition and until the liability is settled, cancelled or expires the acquirer shall measure a contingent liability recognised in a business combination at the higher of: (a) the amount that would be recognised in accordance with IAS 37; and (b) the amount initially recognised less, if appropriate, cumulative amortisation recognised in accordance with IAS 18".

It is not entirely clear how this requirement applies when the status of the obligation changes (for example if the liability later becomes probable and ceases to be "contingent" in IAS 37 terms).

A related issue can arise in relation to when it is appropriate to reduce the liability due to "cumulative amortisation recognised in accordance with IAS 18 *Revenue*". We find it difficult to identify examples of situations in which amortisation and recognition of revenue would be appropriate. When the new revenue recognition standard is introduced a consequential amendment will be required in this area which could provide an opportunity to clarify the requirements.

Lack of clarity concerning newcos and when they can be the acquirer

IFRS 3.B18 explains that a new entity (newco) formed to issue equity interests to effect a business combination cannot be the acquirer, while a newco that transfers cash or other assets or incurs liabilities may be the acquirer.

We believe this guidance could usefully be expanded to provide more clarity on the factors to consider in determining whether a newco can be the acquirer. We are aware of various broad views at present. In summary these are that a newco that issues cash:

- is generally the acquirer if it survives the transaction
- would be the acquirer only if it survives and has substantive ongoing activities post-combination
- would be the acquirer (at newco level) if it is a vehicle to effect a transfer of control of two or more existing entities to a new group of owners or controlling party.

Lack of clarity when previously held interest is not an entity

IFRS 3 requires that, on acquiring a controlling interest in a business, any previous equity interest is remeasured to fair value with any gain or loss recognised in the same way as if the previous interest had been disposed of (ie in profit or loss in practice). It is not however clear if and how this guidance applies to a previous interest that is not held in an entity – for example an interest in a joint operation that is not conducted in a legal entity.

Measurement period

We support IFRS 3's general approach to the measurement period on the grounds that it provides an important practical relief for preparers. Applying this guidance does however present some challenges.

In particular, making the distinction between new information about facts and circumstances that existed at the acquisition date and changes in facts and circumstances after that date can be difficult. In principle, only information that could have been available to market participants for the individual asset or liability at the acquisition date is relevant to the acquisition date fair value.

Another, albeit less significant, issue is whether the measurement period ends on a single date (ie the earlier of one year and when all the information has been received) or on multiple dates as information specific to each asset and liability is received.

Question 10

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;

Overall we believe IFRS 3 and the related amendments provide an appropriate and coherent framework for accounting for business combinations. A reasonably comprehensive framework is in our view essential given the significance and prevalence of these transactions.

We believe the following areas of IFRS 3 and related amendments are particularly beneficial:

- the use of the acquisition method for all in-scope business combinations
- the use of fair values for the initial measurement of assets acquired and liabilities assumed
- the replacement of IFRS 3(2004)'s requirements for step acquisitions with the current requirements in IFRS 3(2008).

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

The area we would highlight is the extent to which IFRS 3 (2008) requires acquirers to identify and value intangible assets separately from goodwill. We comment on this in more detail in our response to Question 4.

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

In our experience accounting considerations rarely have a significant impact on the way that business combinations are structured, although it is of course important that management is aware of the accounting consequences.