

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

30 May 2014

Dear Mr Hoogervorst

## **Request for Information Post-implementation Review IFRS 3 *Business Combinations***

Deloitte Touche Tohmatsu Limited is pleased to comment on the International Accounting Standards Board's ('the Board's') Request for Information in respect of its post-implementation review of IFRS 3 *Business Combinations* ('the post-implementation review').

We continue to support the post-implementation review programme as a valuable addition to the Board's due process and to the aim of ensuring consistent, high quality financial reporting that provides valuable information to investors. We believe that the review of IFRS 3 merits particularly careful consideration as this is a standard that frequently presents conceptual and practical issues in preparing and auditing financial statements and addresses highly significant transactions that might frequently be an area of focus for users. We encourage the Board to, as far as possible, address these issues as part of the post-implementation review.

One question with both conceptual and practical implications to which we believe the Board should give serious consideration as part of the post-implementation review is the appropriate subsequent measurement of goodwill and indefinite life intangible assets acquired in a business combination. We recognise the conceptual merits of the current model of non-amortisation coupled with a full annual impairment test but note that this remains, despite ongoing investment in training and education, a source of constant challenge from both securities and audit regulators. We encourage the Board to consult with stakeholders to determine whether the informational value provided by this approach justifies the costs of its application and whether any simplification or clarification of the impairment testing model is possible.

We recognise that a full consideration of this issue may be outside the scope of a post-implementation review of IFRS 3, given it would involve a reappraisal of a conceptual decision reached in the development of the standard and any modification of impairment testing requirements would necessitate amendments to IAS 36 *Impairment of Assets*. Nevertheless, we believe the issue is significant and that the post-implementation review provides an appropriate opportunity to begin its consideration.

We also note that the IFRS for SMEs already requires the amortisation of goodwill. Further, as evidenced by the Financial Accounting Standards Board's ('FASB's') current project 'Accounting for Goodwill for Public Business Entities and Not-for-Profits' and recent decision to permit private companies to amortise goodwill, the subsequent treatment of goodwill acquired in a business combination is currently under consideration in the U.S. We would encourage the Board to engage with FASB on this topic as part of the post-implementation review to ensure continued convergence of IFRSs and US GAAP in this respect.

Our detailed responses to the questions in the request for information are included in the Appendix to this letter.

If you have any questions concerning our comments, please contact Veronica Poole in London at +44 (0) 20 7007 0884.

Yours sincerely

A handwritten signature in black ink, appearing to read 'V. Poole', is positioned above the typed name.

Veronica Poole  
Global IFRS Leader

## Appendix

### Question 1 – 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).*
- (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).*

This response is submitted on behalf of member firms of the Deloitte Touche Tohmatsu network. This network includes member firms operating in jurisdictions that have required public companies to report under IFRSs for a number of years, jurisdictions that have recently implemented such a requirement and jurisdictions that do not require the use of IFRSs.

For the purposes of responding to the post-implementation review questions, we are commenting in our capacity as auditors of financial statements. In this capacity, we have been involved in accounting for business combinations using 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?*

There is a difference between a simple asset purchase and the acquisition of a complex business, but we believe that the distinction between different types of transactions and the relevance of the resulting differences in accounting should be reconsidered. The distinction between the two can be problematic in particular industries (for example, real estate, mining, agricultural activities and outsourcing) due to issues such as identifying whether a 'market participant' would be able to integrate the acquired entity with its own inputs and processes and whether a 'start up' company in the early stages of development is capable of producing outputs. Recent and proposed changes to IFRSs (for example, on acquisition of an

interest in a joint operation and sale or contribution of assets between an investor and associate or joint venture) also introduce this distinction to transactions involving joint arrangements and associates. This might result in additional circumstances in which it is unclear whether the definition of a business is met.

In addition, we do not believe the accounting differences arising as a result of this distinction are well understood. It is generally accepted that goodwill should not arise outside of a business combination, but other distinctions are unclear either in respect of why they arise (for example, the differing treatment of temporary differences at the date of the transaction required by IAS 12 *Income Taxes* and of transaction costs) or whether they arise (for example, the treatment of a 'stepped acquisition' of an asset is not clearly defined by IFRSs).

Further, the accounting for the acquisition of an entity that does not constitute a business is unclear in respect of the treatment of NCI and the treatment of stepped acquisitions.

### Question 3 – Fair value

- *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?*
- *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?*
- *Has fair value measurement been more challenging for particular elements: for example, specific assets, liabilities, consideration etc?*

We generally believe that fair value provides the most relevant measurement basis for assets and liabilities acquired in a business combination. However, as auditors, we face particular difficulties in auditing the fair value measurements either due to issues inherent in the item being measured or due to a lack of guidance on how to establish fair value.

#### Issues inherent to an item

- Estimating the fair value of contingent purchase price arrangements. The significance of the judgements and estimates required in estimating the fair value of these arrangements is challenging from an audit perspective, both at the acquisition date and in subsequent periods until the contingency is resolved. Similarly, the valuation of intangible assets can involve a high degree of judgement.
- Establishing the fair value of the pre-existing interest on step acquisitions and of non-controlling interests in partially controlled subsidiaries is often difficult and judgemental. 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 non-controlling fair value.
- Determining the fair value of non-financial assets when the unit of account for accounting purposes differs from the unit of account for valuation purposes e.g. machine that is part of an assembly line – how to value that asset on a stand-alone basis when its value is dependent on the value of other assets on the line e.g. taking into account contributory asset charges, etc.

#### Lack of guidance

- Unit of account for non-controlling position (in order to value either the pre-existing interest on step acquisitions or non-controlling interests in partially held subsidiaries): should it be the

individual shares or the block of shares? Is the answer the same whether the shares are traded in an active market or not?

- Fair value of acquired debt: should it reflect the credit risk of the acquiree or of the acquirer? Similarly, if the acquirer assumes a vendor's guarantee of the acquiree's third party debt, is this a separate obligation or a factor in the valuation of the debt?
- Is the concept of a 'control premium' relevant to the fair value of a non-controlling interest?
- The revisions to IFRS 3 in 2008 removed useful guidance on the determination of fair value for certain items. For example, the guidance on measuring inventory clearly established that fair value excluded the margin on the remaining work to be performed by the acquirer (including the selling efforts). The measurement of deferred revenue presents similar challenges.
- At what time should equity instruments issued be measured (midnight, opening of market, close of market?)

Further, we note that in certain circumstances, inconsistency arises between the requirement to recognise and measure items acquired at fair value and the requirements of the Standard that apply to item subsequently.

- The key area where this raises concerns is with respect to provisions, unfavourable contract obligations that are not onerous and contingent liabilities. This is the case in particular with respect to contingent liabilities that are required to be recognised at fair value 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. We highlight that decommissioning liabilities / asset retirement obligations and long-term supply contracts are particularly significant issues in certain industries.
- Apart from provisions, there are other circumstances when assets or liabilities might not subsequently be measured at fair value (e.g. current tax balances, particularly relating to uncertain tax positions).

Currently, IFRS 3 provides specific relief from a 'day 2' switch from fair value to measurement in accordance with other applicable IFRSs for a few specific items. The IASB may want to consider whether a general approach can be developed to address this issue.

We also note that, while we believe that establishing the fair value of amounts at the date of acquisition has conceptual merit, in some circumstance, the information obtained from measuring equity instruments transferred as consideration on the date control is obtained (rather than on the date of announcement or date that the number of shares to be transferred in consideration) may be affected by movements in the share price resulting from factors unrelated to the business combination. This is particularly true when a period between the agreement date and the acquisition date is prolonged (due to regulatory approval, for example).

## 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?*

We generally believe that the separate recognition of intangible assets provides relevant information on the business acquired. Nevertheless it is a difficult exercise and the evaluation of the fair value of intangible assets can be highly subjective.

The circumstances in which difficulties are encountered include

- The measurement of customer relationships – especially non-contractual customer relationships.
- Separate recognition at fair value of intangible assets that the acquirer already owns (e.g., customer relationships when there is overlap in the customer base of the acquirer and the acquiree) or that the acquirer does not intend to use (e.g., a brand acquired and held for defensive reasons).
- The concepts of reacquired rights and of pre-existing relationships are not well understood and would benefit from further clarification. Further, while not directly linked to IFRS 3, we note that the identification of a reacquired right as an intangible asset in the context of a business combination has raised questions about payment of an amount to terminate a contract (such as franchise or distribution agreements) outside a business combination can, in some circumstances represent the reacquisition of a right requiring recognition of an intangible asset, and if so in which circumstances?
- The identification of whether an intangible asset has a finite or indefinite life can also be subjective

Whether or not the recognition of negative goodwill in profit or loss provides relevant information depends on circumstances. In some cases, acquirers do indeed make a good deal (for example when the seller is under duress) and in those cases recognition of a gain at the date of acquisition provides relevant information.

However, in other circumstances, the upfront gain arises because the buyer is accepting future costs that cannot be recognised as part of the purchase price allocation (restructurings, loss making operations, etc). In such circumstances, the recognition of a gain in profit or loss may be seen as inconsistent with the commonly accepted concepts that revenue should not be recognised if it is subject to a later reversal and that a gain is not normally recognised upon acquisition of an asset. As stated above, since the valuation of certain items involved in a business combination (such as intangibles) is inherently subjective and often fall within the level 3 hierarchy of fair value measurement, the amount of resulting upfront gain is also subjective.

## 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?*

Whilst noting that users of financial statements would be best placed to assess the usefulness of information on annual impairment assessments, we believe (as stated in our cover letter and response to Question 3 above) that there are practical and cost/benefit issues to be considered in respect of fair value measurement and subsequent impairment testing. In addition, we believe that there are conceptual issues to include in any reconsideration of the non-amortisation of goodwill and indefinite-life intangible assets.

For each of these, the extent to which the value of the asset recognised at the date of acquisition endures indefinitely rather than diminishing and being replaced by a similar internally generated asset derived from the entity's subsequent behaviour (for example, in dealing with customers) and expenditure (for example, on marketing and advertising) is arguable.

Conversely, we recognise that any 'useful economic life' assigned to goodwill and indefinite life intangible assets would, by necessity, be to some extent arbitrary and that as a result one could challenge the conceptual basis of a resultant systematic amortisation expense as well as its usefulness in assessing the entity's performance. Such an approach would also have its own practical challenges, notably by increasing the focus on identification of indicators of impairment, and the practical difficulties of performing an impairment test (for example identification of cash-generating units, determination of the appropriate level at which to test goodwill, the issues noted in our response to Question 6 on impairment testing when NCI exists and the judgement inherent in forecasting future performance) would remain if such an indicator were identified.

Accordingly, in revisiting the issue, we encourage the Board to look at the issue from wide perspectives (both conceptually and practically) and to look at available research papers related to this matter.

## 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.*

While the measurement of NCI at fair value may be more consistent conceptually with the entity perspective in IFRS 3 and IFRS 10, the subjectivity involved in this measurement (see comments in response to Question 3) is such that the information produced is not necessarily more relevant than a measurement based on net identifiable assets.

Some of the issues that should be considered for improvement include

- Measurement of NCI in transactions other than business combinations (such as partial disposals without a loss of control): does the choice between measurement of NCI at fair value and share

of net assets apply in such circumstances? If NCI can be measured based on share of net assets, does this include a pro rata share of goodwill?

- Impact of other instruments when NCI are measured on the basis of proportionate share of net assets: In such a case, would the proportionate share of NCI be determined by (i) deducting other forms of NCI at fair value, (ii) deducting other forms of NCI based on participation in liquidation, or (iii) not deducting other forms of NCI
- The measurement of NCI in a combination achieved by contract alone
- Impact of acquisition of NCI when NCI was initially measured at proportionate share of net assets: does it make sense to remain with a partial goodwill?

It may also be appropriate for the IASB to consider whether the choice in the measurement basis of NCI should be made on an acquisition-by-acquisition basis or whether it should be an accounting policy choice to be applied consistently for all similar transactions.

The basis of measurement of NCI has consequences on the subsequent impairment test on goodwill. The following issues should be considered for improvement:

- NCI at fair value: IAS 36.C6 indicates that if a subsidiary, or part of a subsidiary, with a non-controlling interest is itself a cash-generating unit, the impairment loss is allocated between the parent and the non-controlling interest on the same basis as that on which profit or loss is allocated. Accordingly, despite the fact that the goodwill attributable to the parent and to the NCI may not be proportional to the percentage of ownership held by each, any impairment loss arising on the goodwill shall be allocated to the parent and to the NCI on the same basis as that on which profit or loss is allocated (i.e. in proportion to their respective present ownership interests). It may be appropriate to address this apparent inconsistency.
- NCI at proportionate share of net asset: it may be useful to clarify whether the gross up of goodwill required by IAS 36 can be made on a basis other than proportionally, and if so in what circumstances can an alternative basis be used.

## 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.*

While we understand the conceptual basis for the accounting requirement for step acquisitions and loss of control transactions within the context of the entity perspective of IFRS 3 and IFRS 10, the relevance of the information in terms of profit or loss is questionable since these transactions do not involve actual exchange transactions. Conversely recognition of partial disposals without a loss of control in equity could be seen as excluding a realised gain or loss from profit or loss. As a result of this requirement, when subsidiaries are disposed of through step transactions, only the gain/loss on the transaction that results in a loss of control is recognised in profit or loss. Hence, comprehensive income does not portray the full realised gain/loss on these transactions.

The relevance of the information produced is also affected by the subjectivity involved in estimating the fair value of the pre-existing interest on step acquisitions and of non-controlling interests in partially controlled subsidiaries, as mentioned in our response to Question 3.



On a separate issue, it may be useful to clarify the treatment of these transactions in the separate financial statements of the parent as we believe that this is an area of divergence in practice.

## 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?*

While users are better placed to answer the question of the usefulness of the disclosure provided, we have the following observations:

- Some of the disclosures provided tend to be boilerplate (in particular, the explanation of the source of goodwill or negative goodwill and the reasons the purchase price allocation is not finalised). The IASB may want to investigate the reason for the lack of information provided and, if justified, consider whether the requirement to provide these specific disclosures should be maintained.
- Considering the difficulties raised in response to earlier questions with respect to valuation on assets and liabilities (in particular intangible assets), some may question whether the information provided with respect to the determination of fair value is sufficient. For example, should more specific disclosures be required with respect to assumptions and sensitivity analysis?
- The predictive value of the pro forma information on revenue and net profit and loss as if the transaction had taken place at the beginning of the year is questionable, especially due to the lack of guidance on how this information should be prepared. If users indicate that this information is useful, the IASB should consider whether further guidance is required. For example, what adjustments, if any, should be made in combining the results of the acquirer and the acquiree for the period before the acquisition?
- The disclosure requirements of IFRS 3 take no account of the significance of a business combination. The possibility of disclosing varying levels of detail depending on how significant the business combination is to the entity may be something to consider as part of the Board's Disclosure Initiative.

It would also be useful for the IASB to clarify whether it is necessary to provide disclosures about prior period business combinations.

## 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.*

### **Scope exception: common control transactions**

- The lack of standard applicable to business combinations under common control is a continuing source of difficulties. However, as we noted in our response to the IASB Agenda Setting Consultation, we do not consider the business combinations aspect of common control transactions to be of sufficient urgency to be addressed by an immediate and narrow scope project. Rather, we think that the accounting concepts to be applied to transactions under common control generally should be explored first (either as a first step in the Board's proposed research project on business combinations under common control or as a separate exercise), in order to allow any subsequent consideration of, for example, group reconstructions to result in robust and principle-based guidance.

### **Put over NCI and mandatory purchases of non-controlling interests in business combinations**

- We note that the accounting for put options over NCIs continues to raise concerns and that it would be useful for the IASB to address this issue ahead of any wider project on the distinction between debt and equity.
- Similarly, the issue of the accounting for mandatory tender offers is also a source of difficulties that would benefit from clarification.

### **Contingent consideration: compensation for post-combination services vs purchase price consideration**

- We continue to disagree with the decision reached by the IFRS IC with respect to whether paragraph B55(a) of IFRS 3 is conclusive in determining that payments to an employee that are forfeited upon termination of employment are remuneration for post-combination services). As previously stated, we believe that the fact that the issue requires a deeper consideration is illustrated by circumstances in which under the terms of a business combination all selling shareholders become employees and all consideration for their shares is forfeited upon termination of employment. These arrangements can arise in business combinations where there is no other means of securing intangible assets (for example, customer (for example, customer relationships and business know-how) that would be lost were the shareholder/employee to leave the business, thereby causing a significant deterioration in the fair value of the business acquired. Such payments may, in economic terms, include an element of remuneration but treating them entirely as such (potentially resulting in a significant bargain purchase gain at the date of acquisition, due in part to recognition of those intangible assets, followed by remuneration expense which could be multiple times the acquiree's profits) does not provide a faithful representation of the transaction.

## Contingent consideration: other issues

- The requirement on accounting for contingent consideration as part of business combination has raised questions on the accounting for similar arrangements in other transactions (e.g., acquisition of associates or joint ventures or purchase of intangible assets and property, plant and equipment).

## Business combinations by contract alone

- As noted in our response to the tentative agenda decision included in the January 2014 *IFRIC Update*, the current conflict in IFRS 3.43 (and potentially between IFRS 3 and IFRS 10) in respect of stapling transactions should be addressed. In addition, we note that many stapling transactions involve entities that do not meet the definition of a business and that there is a lack of guidance for such transactions and, more generally, that the references to control in IFRS 3 should be examined to ensure that there is no discrepancy with IFRS 10 (for example, the discussion of common control in IFRS 3.B2 is based on the definition of control prior to the implementation of IFRS 10).

## Basis adjustment of goodwill as a result of hedge accounting

- Foreign currency exchange risk of commitment to purchase a business is eligible for hedge accounting under both IAS 39 and IFRS 9 and goodwill may be basis adjusted for this type of hedging. However, since the amount hedged is not simply the goodwill, there could be a case where the gain on hedging exceeds goodwill (or loss on hedging exceeds negative goodwill). The accounting for the excess is not clear. Further, the impact, if any, of hedging accounting on the requirement in IAS 21.47 to consider goodwill as an asset of the foreign operation is not clear. Is the impact, if any, the same whether or not goodwill is basis adjusted?

## Other issues

- Increase in ownership from a passive investment to associates or joint ventures and purchase of an additional stake in existing associates: the extent to which the requirements in IFRS 3 and IFRS 10 can or should be used by analogy for these transactions is unclear.
- Recognition of an indemnification asset arising from acquisition of a subsidiary in separate financial statements (specifically, whether any movement in the value of that asset should be recognised in profit or loss or as an adjustment to the cost of the investment in the subsidiary).
- Reclassification of the foreign currency translation reserve upon partial disposals: the application of the consequential amendments made to IAS 21 as part of the revisions of IAS 27 (2008) continues to cause difficulty in practice.
- Recognition of a parent's contractual obligation towards the net liabilities of a subsidiary: in part as a result of the comment in IAS 27(2008).BC35 (or IFRS 10.BCZ162) that the entity should "account for that arrangement separately and the arrangement should not affect how the entity attributes comprehensive income to the controlling and non-controlling interests", it is not clear how the obligation should be recognised (charge to comprehensive income vs equity).

## 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)?*

As noted above, we believe that the requirements for fair value measurement on a business combination and the ongoing requirement for a full annual impairment review are sources of significant cost for auditors of financial statements.