Financial Reporting Committee

IFRS Foundation
30 Cannon Street
London EC4M 6XH
United Kingdom

E-mail submission: commentletters@ifrs.org

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Dear Sir/ Madam

Post-implementation review of IFRS 3 Business Combinations

We welcome the opportunity to comment on the above Request for information.

Who we are

The 100 Group of Finance Directors represents the views of the finance directors of FTSE 100 and several large UK private companies. Our member companies represent almost 90% of the market capitalisation of the UK FTSE 100 Index. Our aim is to contribute positively to the development of UK and international policy and practice on matters that affect our businesses, including taxation, financial reporting, corporate governance and capital market regulation. Whilst this letter expresses the views of The 100 Group of Finance Directors as a whole, those views are not necessarily those of our individual members or their respective employers.

Our views

We set out in the Appendix our responses to the specific questions that are included in the Consultation Paper. We summarise our views below.

Fair value measurements of intangible fixed assets are highly judgemental and complex

Fair value measurements of intangible fixed assets are highly judgemental, subject to a large number of assumptions and only provide a benchmark at a historic point in time. As such they are unlikely to be consistent between companies and give an impression of accuracy that does not reflect the nature of the calculations. We believe that, beyond the period of the acquisition when the measurements provide relevant information on the values of assets acquired, users of accounts often disregard this information.

Fair value information is often disregarded by users of accounts and yet preparing and auditing this information is costly and time consuming

We believe that users of accounts often disregard fair value information in respect of business combinations partly because investors have used other sources of information by the time the financial statements are published. However, the calculations are often difficult to prepare, taking a significant amount of time and often require the employment of specialist

valuers which makes the exercise costly. In our view the cost benefit test is not met and we urge you to explore whether there are more practical ways of achieving the objectives of IFRS 3.

Separating recognisable intangible assets from goodwill is of little value to users and the requirement to distinguish between the two should be removed

In our opinion, separating recognisable intangible assets from goodwill is of little value to users of accounts. While there may be some benefit to preparers in establishing and demonstrating the value of what has been acquired in a business combination, the impact of amortisation charges in subsequent years (in the case of intangible assets with finite useful lives) is not helpful to preparers and, as noted above, this information is often disregarded by users of accounts.

In our opinion, all intangible assets including goodwill should be recognised as a single category of asset and amortised over an appropriate period. The comprehensive disclosure of different components of assets should be voluntary if this is helpful to provide an account of the business combination to support the principle of 'stewardship'.

Annual impairment tests provide little value in many cases - an amortisation model would yield practical benefits to preparers and users

The outcome of the annual impairment test for goodwill and other indefinite life assets can be highly sensitive to a number of assumptions that are judgemental. Preparing and auditing annual impairment assessments is therefore often complex, time consuming and costly.

Where there is significant headroom, an annual impairment test provides little value to preparers or users.

Where there is marginal headroom an impairment review is clearly necessary and appropriate to support the balance sheet valuation. However we note that where an impairment charge is booked it has usually been anticipated by the market and already factored into the share price, suggesting that there is no new information produced by the impairment review exercise.

As noted above, we believe that recognising one class of intangible assets arising from a business combination and amortising the balance over an appropriate period would yield practical benefits to both preparers and users of accounts.

Please feel free to contact me on russhoulden100groupfd@kpmg.co.uk should you wish to discuss our comments.

Yours sincerely

Russ Houlden
Chairman
Financial Reporting Committee
The 100 Group of Finance Directors

APPENDIX

RESPONSES TO SPECIFIC QUESTIONS

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).

(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).

Please refer to the "Who we are" paragraph of the main body of this letter.

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 of having separate accounting treatments for business combinations and asset acquisitions. In our view, some of the non-intuitive accounting requirements driven by the fair value focus of IFRS 3 (e.g. in respect of changes in contingent consideration, settlement of pre-existing collaborations, revaluation of existing holdings in step acquisitions) create complexity with little added value for users.

The primary benefit, therefore, of having separate accounting treatments for business combinations and asset acquisitions is that this unnecessary complexity driven by the requirements of IFRS 3 can be avoided where a transaction qualifies for treatment as an asset acquisition. Whilst we do not comment on industry-specific matters, we note that in certain industries, including the real estate sector, asset acquisition accounting is far more reflective of the underlying transaction than IFRS 3. In our view, the scope for asset-based corporate acquisition is too narrow – we further comment on this point under Question 2(b).

(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?

In our view, the definition of a business as it is currently interpreted is too wide. The majority of our member companies are large multi-national companies. It is nearly always the case that any acquisition of a group of assets can be construed as a business acquisition,

because market participants (i.e. other large multi-national companies) will almost always have the additional resource and processes in existence to assimilate the assets into their businesses and make them "capable of being conducted and managed as a business". Certainly as soon as any other processes or resources are included, even if they are only incidental to the asset acquisition, it becomes very difficult to view the acquisition as anything other than of a business under the current scope of IFRS 3.

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?

In our view, the fair value measurements in the context of business combinations are often considered by users of financial statements to be irrelevant and the information is of little value other than as a basis for allocating the purchase price. Fair value measurements are highly judgemental, subject to a large number of assumptions and only provide a benchmark at a point in time in the past. We understand that users of accounts often disregard this fair value information.

Furthermore the existence of calculations, particularly related to the valuation of recognisable intangible assets implies a level of accuracy that simply is not the case given the multiple and highly judgemental assumptions required in these calculations. This undermines any relevance of the fair value information and the associated disclosures.

(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?

By definition, fair value measurements are judgemental and for any given fair value measurement, the key assumptions can be selected from a relatively wide range, resulting in a high degree of sensitivity.

Different industries will experience different areas of challenge. Generally, intangible assets, pre-existing relationships, contingent consideration liabilities and contingent liabilities are areas with significant valuation challenges in the context of business combination accounting. We note that many of our members experience much difficulty in determining fair values where there is little or lack of market evidence or third-party negotiations.

We also note that due to the highly judgemental nature of fair value judgements, preparers and auditors spend significant time and resource in auditing these areas. In our experience, a specific audit difference is rarely proposed in this area, despite the level of focus exercised during audits.

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

As noted in our answer to question 3(b), the challenging areas in the context of fair value measurement include intangible assets, pre-existing relationships, contingent consideration liabilities and contingent liabilities.

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?

In our view, where a separate valuation of intangible assets is included in pre-acquisition business proposal and due diligence, the information can be useful in helping management demonstrate how they are exercising stewardship responsibilities in their allocation of resource in the purchase of the intangible assets. However, this usefulness is limited to providing the users of accounts with an understanding of what has been purchased at the point of acquisition only. In subsequent years the carrying value of these intangible assets is not useful to most users of accounts.

In our view, it would therefore be more helpful to users of accounts if directors provide appropriate disclosures to support the business case of business combination transactions and to demonstrate the exercise of stewardship. The level of disclosure required to achieve this will vary between different transactions and therefore should be determined on a case by case basis. Also, given that subsequent amortisation charges are typically excluded from underlying earnings, we believe that all intangible assets including goodwill (except those normally capitalised individually in accordance with other accounting standards – e.g. software, exploration and evaluation assets) should be recognised as a single class of asset and amortised over an appropriate period.

(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?

The calculations involved in the separation of intangible assets from goodwill can be complex and highly judgemental. We therefore struggle to see how meaningful comparability can be achieved. We refer you to our answer under Question 4(a) for alternative suggestions on how such challenges may be overcome and comparability may be improved.

(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?

If negative goodwill arises genuinely from a bargain transaction and the reasons for it being a bargain transaction can be ascertained, we think it appropriate to recognise negative goodwill in profit or loss. We therefore find the recognition of negative goodwill useful in this context. However if amortisation of all intangibles is adopted (per our suggestion above) we consider it appropriate for the principle to be applied consistently to negative goodwill, such that the amount is spread over the relevant period, similar to the concept of accounting for lease incentives.

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?

We note that the non-amortisation of goodwill was expected to assist the user to assess return on capital employed. In our view, the current requirement for annual assessment of goodwill and indefinite-lived intangibles is inconsistent with this primary aim, given that recognised intangible assets are amortised where they have finite useful economic lives.

We also note that there are challenges in finding the right level at which cash generating units (CGUs) are recognised. Many of our members experience rapidly changing business environments, resulting in reallocation of CGUs and potential volatility of results. The change in CGUs can be significant and reflecting this change year-on-year in annual impairment tests is challenging.

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

In the context of current requirements, we consider that the current disclosure requirements in respect of impairment tests and their outcomes, if properly applied, are sufficient.

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

Where there is significant headroom, the information gathered from annual impairment testing is not particularly useful to preparers, certainly in comparison with the effort required to carry out the impairment tests.

Where there is marginal level of headroom, auditing or enforcing the results of impairment assessments can be challenging due to the highly judgemental nature of the work and the fact that the valuation is sensitive to a number of assumptions.

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?

(b) What are the main challenges in the accounting for NCIs, or auditing or enforcing such accounting? Please specify the measurement option under which those challenges arise.

To help us assess your answer better, we would be grateful if you could please specify the measurement option under which you account for NCIs that are present ownership interests and whether this measurement choice is made on an acquisition-by-acquisition basis.

There is a choice of options in how NCIs are measured and presented and therefore this limits comparability.

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.

In our view, the current guidance does not provide useful information on how management have exercised their stewardship responsibilities in the use of company resources in their business acquisition activity. The current accounting results in an arbitrary gain or loss that is non-intuitive to many users and often adjusted for by users of accounts. Similarly, many companies remove the impact of step acquisitions from underlying earnings, indicating a consensus that this is not considered beneficial to users of accounts.

(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.

We consider the current accounting for divestment to be useful with the impact recognised in the profit and loss. We do not propose any changes in this area.

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?

In our view, the disclosure of information in respect of business combinations should focus on management demonstrating their exercise of stewardship. To that end, we consider that it is necessary for management to disclose sufficient information to justify a transaction using both qualitative and quantitative information as appropriate. We believe the extent of disclosures should be considered on a case by case basis and the application of principles rather than the dictate of specific disclosures would be appropriate in most cases and therefore the standard should be principle-based to encourage best practice reporting.

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

The impact of the acquired business on the acquirer's results as if the acquisition had occurred at the start of the year is of little value in our view and creates practical difficulties for preparers. This is explained in more detail in our answers to other questions.

(c) What are the main challenges to preparing, auditing or enforcing the disclosures required by IFRS 3 or by the related amendments, and why?

An acquired business can be quickly assimilated into existing operations. Identifying the post-acquisition impact on the acquirer's group results is often not possible, nor meaningful in this situation. For a business with significant order book or inventory levels, this will result in these assets being fair valued on the date of acquisition which effectively recognises profit within the assets recognised on acquisition, in advance of revenue recognition. This can significantly deflate post acquisition profits until these assets are fully amortised such that the disclosure of this information is misleading if used to predict future results.

We also note that the effort required in preparing and auditing these disclosures can sometimes be a distraction to the acquired business; we have not seen evidence that users of the financial statements use this information.

In addition, there is significant cost of preparing and auditing information relating to future cash flows.

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 refer you to our suggestions for improvement contained within this letter.

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;

In our view, the allocation of the purchase price is useful information, although the dividing line between intangible assets and goodwill is somewhat arbitrary and we have suggested an alternative approach in this respect.

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

The identification and valuation of pre-existing relationships requires a considerable degree of effort and judgement for a result that is generally not well understood by users and often ignored.

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

While it is difficult to identify direct impacts of IFRS 3 on the contractual negotiations related to business combinations there is anecdotal evidence that the accounting impacts are considered during negotiations; examples include share options granted, and retention bonuses agreed, on acquisition of a business.

Accounting for contingent consideration is not popular with preparers but we have not seen evidence of earn out agreements being avoided solely because of the accounting impact.