# FEEDBACK STATEMENT

# POST- IMPLEMENTATION REVIEW OF IFRS 3 *BUSINESS COMBINATIONS*

## INTERVIEWS WITH INVESTORS AND ANALYSTS

### BASED ON REAL LIFE CASE STUDIES ON BUSINESS COMBINATIONS

**MARCH - JUNE 2014**

This feedback statement has been prepared for the convenience of European constituents by the EFRAG secretariat and has not been subject to review or discussion by the EFRAG Technical Expert Group.

## Introduction

In January 2014, the International Accounting Standards Board (IASB) published a Request for Information on its Post-implementation Review (PiR) of IFRS 3 *Business Combinations* and requested comments by 30 May 2014.

IFRS 3 outlines the accounting for a transaction in which an acquirer obtains control of a business (e.g. an acquisition or merger). Such business combinations are accounted for using the 'acquisition method', which generally requires assets acquired and liabilities assumed to be measured at their acquisition-date fair values.

IFRS 3 was developed within the IASB's *Business Combinations* project. Consequently, the scope of the PiR includes consequential changes made to IAS 36 *Impairment of Assets* and IAS 27 (2008) *Consolidated and Separate Financial Statements* (replaced by IFRS 10 *Consolidated Financial Statements* in 2011). The package of Standards under review is also collectively referred to in this report as "the Standards".

The objective of the PiR is to understand whether the Standards being reviewed are working as intended and to evaluate their implementation and effects in relation to costs and benefits. It also provides an opportunity for preparers, users and other stakeholders to put forward suggestions on how the Standards can be improved.

## 1. Objective of this Feedback Statement

This Feedback Statement summarises the feedback received during the outreach activities conducted with users and is based on information received as at 2 June 2014.

It has been prepared for the convenience of European constituents, and is intended to be read together with EFRAG's response to the IASB's Request for Information.

## 2. Outreach activities

### What we did

To respond to the IASB's Request for Information, EFRAG together with EFFAS (European Federation of Financial Analysts Societies) consulted a number of European users of financial statements, namely investors and analysts, in the form of telephone meetings and face-to-face interviews, aimed at obtaining evidence from users on the usefulness of the provisions in IFRS 3, and understand what improvements, if any, are needed.

To direct the discussions and the interview process, EFRAG staff together with members of the EFFAS Financial Accounting Committee selected a number of case studies on business combination transactions (of companies that have undertaken a business combination since

2009) taken from published IFRS financial statements and analysed the disclosures reported by the selected companies[1]. The purpose of our work was to identify examples of good disclosures on business combination accounting, irrelevant disclosures and missing information. The case studies were referred to and discussed in the interviews. In this context, we developed a questionnaire designed to facilitate the data collection effort and this was used as a basis for the structured interviews.

The case studies were also discussed at a user outreach event in Brussels on 1 April 2014, held by EFRAG, the European Federation of Financial Analysts Societies (EFFAS) and the Association Belge des Analystes Financiers (ABAF), in cooperation with the IASB. A separate Feedback Statement with a summary of the input received from this event has already been published on 13 June 2014.

EFRAG staff has also consulted with the EFRAG User Panel and the EFFAS Financial Accounting Committee. The feedback received at these meetings is included in this report in a consolidated matter.

### Interviews conducted

We have interviewed **forty users** namely investors (private equity and fund managers) and analysts (equity, financial and credit analysts from the buy-side and the sell-side) from different European countries including Austria (AU), Belgium (BE), Croatia (HR), Denmark (DK), France (FR), Germany (DE), Hungary (HU), Italy (IT), the Netherlands (NL), Norwegian (NO), Portugal (PT), Spain (ES), Sweden (SE) and the United Kingdom (UK). The names of users and their respective organisations have been treated on a confidential basis.

The table below presents the number of respondents by country and respective background.

| | AU | BE | HR | DK | FR | DE | HU | IT | NO | PT | ES | SE | NL | UK | **Total** |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Corporate Finance | | | | | 1 | | | | | | | | | | **1** |
| Credit Analyst | | 2 | | 1 | 2 | 2 | | 1 | | | | | | 2 | **10** |
| Equity Analyst | 1 | 1 | 1 | | 1 | 1 | 1 | 1 | | 1 | 1 | 1 | 2 | 1 | **13** |
| Financial Analyst | | | | | | 5 | | 2 | | | 2 | | | | **9** |
| Fund Managers | | | | | | | | | | | | | | 5 | **5** |
| Investment analyst | | | 1 | | | | | | 1 | | | | | | **2** |
| **Total** | **1** | **3** | **2** | **1** | **4** | **8** | **1** | **4** | **1** | **1** | **3** | **1** | **2** | **8** | **40** |

### Issues covered

We organised our discussions on the main aspects of decision-useful information: the more general aspects which included timeliness of information, transparency, presentation, materiality and overall quality of the information provided in the consolidated financial statements on

[1] AB-Inbev; AMS; Bayer; Fiat; MOL; Nestlé; Netia; Novartis; Porsche-Volkswagen; Roche; SCA; Schneider; SGS; Solvay; and Telefonica.

business combination accounting; and the main accounting and disclosure requirements required by IFRS 3.

In summary, participants discussed the following issues:

- Timeliness and sources of information;
- Presentation
- Understanding the business combination transaction;
- Factors that make up the goodwill recognised, such as synergies
- Subsequent measurement of goodwill (impairment versus amortisation);
- Consideration transferred, including contingent consideration;
- Recognition and measurement of assets acquired and liabilities assumed, particularly intangible assets, inventories and contingent liabilities;
- Bargain purchases accounting;
- Business combinations achieved in stages;
- Other issues: usefulness of information from: pro-forma disclosures, Non-controlling interests accounting, tax deductible goodwill and other assets; and transactions that are recognised separately from the business combination

## 3. Executive summary

### General aspects

The general observations made by users can be summarised as follows:

- *Timeliness of information received*: Many users commented on the timeliness of information received through the consolidated financial statements and noted that the information about a business combination was only made available considerable time after the business combination had been announced. Timeliness of information was fundamental as the markets absorbed the information on the business combination when the deal was announced. In particular, buy/sell-side equity analysts noted that they needed "quick" access to information on business combination transactions for their investment decision making and analysis. Users generally perform their own valuations at the time the deal is announced. These valuations are based on, among others, discounted cash-flow methods (using the so-called "core profit or loss" and future company performance), valuation multiples (e.g. EBITDA multiples) and financial ratios to determine the value of the company, measure the return on investment and assess the success of the underlying business combination.

- *Sources of information*: Many users noted that financial statements are not the only source of information they use to understand the rationale for undertaking a business combination, and considered them to be part of the information that is used by users. Generally speaking, "time is of the essence" once a business combination was announced, and accessibility to information was vital. Relevant information was therefore obtained from different sources (e.g. liaison with management, investor days and press releases), which generally consisted of non-GAAP measures and referred to by users as "core profit and loss". The type and level of information required, varied according to the type of analyst (equity analysts and credit analysts had different information needs).
- *Use of financial statements:* Several users thought that information included in the consolidated financial statements, including the interim financial statements, continued to be useful as an "alert" or verification function (e.g. to confirm their initial assessment; to confirm information previously obtained directly from management as financial statements were the "formal place" to provide information about business combinations).
- *Presentation*: Several users emphasised that information about business combinations was often scattered in the financial statements and it would be useful to integrate all the information on a business combination in a single disclosure note.

### Information about Business Combinations Transactions

The main comments provided by users on the information included in the financial statements about a business combination transaction and its effects can be summarised as follows:

- *Information about the rationale for undertaking the business combination*: Was often too general and lacked "real" insight on the key drivers of the business combination transaction (i.e. what motivated the parties for undertaking it and what is it expected to bring to the acquirer). Many users expressed that information was communicated in a "boiler plate" manner which could apply to any business combination; information needed to be more transaction specific. This was largely perceived as being an audit or enforcement problem rather than a problem of IFRS 3. Several users pointed out that in some cases, information on multiple "less material" acquisitions was aggregated and, consequently, there was lack of information about each individual business combination.
- *Lack of information on the expected synergies from the business combination*: There was a need for more transparency and information that explained the expected synergies to be generated by the business combination and how they translate into revenue or cost reductions in post-acquisition years. For example, analysts working in the pharmaceutical industry would need information on the stage of development of products acquired (for example early-stage of development) to forecast future performance of the company.
- *Subsequent measurement of goodwill and infinite intangible assets*: There were mixed views on the non-amortisation of goodwill and indefinite life intangible assets – some users supported the current impairment model and others preferred an amortisation model (or a combination of both). However, users that supported an impairment model indicated they would like more information about the rationale and basis the company used to determine annual impairment tests.

- *Consideration transferred*: For users, information about the consideration paid for a business combination was very fundamental for their assessments and analyses. However, some users noted that from a stewardship point of view, it was not always easy to understand how a company had paid its acquisition. For example, users noted that they needed to add up the cash outlay, shares and other instruments issues and any debt acquired; however, the presentation and level of details provided by companies varied in practice, it was not always easy to find this information in the financial statements, and often it was included in various places in the annual report.
- *Contingent consideration:* Several users highlighted the importance of having disclosures about subsequent changes to the fair value of the contingent consideration (regardless of the accounting treatment) in order to adjust the figures. Still, most users did not think that gains and losses resulting from future price adjustments to contingent consideration were part of the performance of a company. More specifically, they should be part of the acquisition price and should not be included in profit or loss.
- *Fair value information:* Although many users supported the use of the acquisition-date fair value to measure the assets acquired and liabilities assumed in a business combination, they believed there was a significant lack of information explaining the basis on which the fair values were determined (for example significant inputs and assumptions used in the valuations). Fair values were regarded as highly subjective and generally having only a ‘number’ limiting the usefulness of the information, particularly in terms of forecasting future performance. A number of users indicated that it would be useful to have information on the pre-acquisition book values of assets acquired and liabilities assumed. Information on estimated useful-lives of assets acquired was also mentioned as relevant. This information is *not required* by IFRS 3.
- *Contingent liabilities*: Users considered that information about contingent liabilities was very important as this information would help them in predicting future cash-flows. Still, some users noted that they did not always obtain sufficient information about contingent liabilities; that contingent liabilities could be used as part of earnings management; and that adjustments to contingent liabilities were viewed as non-recurring items of profit or loss.
- *Separate recognition of intangible assets*: The level of granularity on intangible assets arising from a business combination and recognised separately from goodwill, was not particularly relevant. Still, most users called for information on the rationale used by management to determine which intangible assets should be separately recognised from goodwill. This was particularly relevant to allow users to differentiate “core” intangible assets acquired (for example intellectual property and rights in the pharmaceutical industry, brands in the automotive industry) from other intangibles that users would not consider to be relevant. Some users requested a breakdown of ‘wasting’ versus ‘non-wasting’ intangibles.
- *Inventory step-ups to fair value*: Some users expressed concern about measuring acquired inventories at fair value as it could affect future operating margins. Better disclosures to explain the impacts of the step-ups on the gross-margins in future periods until the inventory was sold (disclosure was particularly relevant for inventory that turned over a long period of time) would be useful.

- *Bargain purchases*: Most users interviewed had not seen negative goodwill situations for the companies they followed. Nonetheless, many users questioned whether gains from bargain purchases should be reflected as if they were part the performance of the company, i.e. be accounted for as a “capital gain”. Users would remove the gain from the net profit to assess the performance. While they agreed that the capital gain should not be part of performance (i.e. net profit), they had no strong views on the accounting treatment of the so-called gain. Some argued that the fair values should be adjusted; others felt that putting the gain in Equity/Other Comprehensive Income was a better option.
- *Business combinations achieved in stages:* Many users did not express concerns about the current accounting for step acquisitions. They considered such a gain or loss as a non-recurring item or as not being part of performance of the company and would adjust their valuation models if necessary.

A summary of views expressed on other (less commented on) matters were:

- *Pro-forma information*: Users found pro-forma information (i.e. presentation of financial information as if the business combination had occurred at the beginning of the annual period) very useful; however a number of users considered that the presentation of pro-forma information often varied in practice and its presentation could be improved.
- *Non-controlling interests*: Users provided mixed views on how a company should measure non-controlling interests. Some preferred the proportionate method; others preferred the fair value method; others were just not in favour of having options, particularly on a case-by-case basis. Some of these users noted that they would like to have disclosures about the reasons for the selected measurement bases.
- *Information on tax deductible goodwill and other tax deductible assets:* Users highlighted that it was crucial to have information that would give them a good understanding of the tax structure of the deal and its implications on the price paid and future cash flows.
- *Separate transactions:* Several users explained that they appreciated information that helped them in understanding whether there were “transactions” that were related to the business combination, but had not been accounted for as part of the business combination transaction given the requirements in IFRS 3.

## 4. General Aspects

### Timeliness and sources of information

Many users noted that the annual financial statements of the acquirer were usually published a considerable time after the business combination had been announced. For many users timeliness of information was fundamental as equity markets absorbed the information on the business combination on the date the acquisition was announced.

*Most users noted that the information included in the financial statements was only available a considerable time after the business combination had been announced*

*Users perform their own valuations at the time the deal is announced to determine so-called "core profit or loss"*

Most users, especially buy/sell-side equity analysts, noted that accessibility to information was important and generally they needed "quick" access to information on business combination transactions to keep up with market reactions. These users indicated that they perform their own valuations at the time the deal is announced. These valuations are based on, among others, discounted cash-flow methods (using the so-called "core profit or loss" and future company performance), valuation multiples (e.g. EBITDA multiples) and financial ratios to determine the value of the company, measure the return on investment and assess the success of the underlying business combination. As explained below, information to do these analyses was gathered from other sources.

Some users added that interim financial reports often do not provide comprehensive information about business combination transactions. This reduces their appreciation of how the deal was evolving in cases when the acquisition had been reported in the prior annual reporting period.

*Most users explained that relevant information about M&A activities was obtained from different sources - the information included in the financial statements was only part of the information that is used*

Many users noted that the financial statements were not the primary source of information they use to understand the rationale for undertaking a business combination and to perform their initial analysis. Relevant information on merger and acquisition (M&A) activity was obtained through a range of different sources, such as:

- liaison with management;
- press releases;
- conference calls;
- investor days;
- analyst meetings;
- financial data and news providers (e.g. Bloomberg and

Reuters); and

- one-on-one meetings and direct contacts with management.

Most users explained that the negotiation process generally starts months ahead of a deal being "officially announced", and users follow the negotiation process carefully and gathered information during the process rather than only "on the day of the acquisition".

*Users noted that financial statements are useful nevertheless, to understand the progress the group had made since acquisition date*

However, several users thought that the information included in the consolidated financial statements continued to be useful as an "alert" or verification function to support and confirm the information obtained when the business combination was announced. Users explained that they would usually use consolidated financial statements to:

- confirm their initial assessment;
- use as a reference source ( as a sort of "cook book");
- identify and assess trends;
- obtain detailed information to complete and/or confirm information already obtained directly from management as financial statements were the "formal place" to obtain detailed disclosures about business combinations; and
- evaluate the "progress made" on the business combination.

### Presentation

*Users emphasised that information about business combinations was often scattered in the financial statements*

A number of users noted that information about business combinations were often scattered in the financial statements. For example, the reasons for the acquisition were usually comprehensively explained in the management report, but the remaining information about business combinations would be reflected "everywhere" in different notes of the financial statements.

*It would be useful to integrate all the information on a business combination in a single disclosure note*

Several users noted that it would be useful to integrate all the information on a business combination in a single disclosure note in the financial statements. Some users added that, in cases where a company had undertaken more than one business combination it would be useful to have separate information on each of the transactions tabled out in an understandable manner, even if each business combination was, individually, "not material".

For example, some users noted that information about the structure of the deal and the consideration paid was, in many cases, included in various places in the financial statements making it difficult to find and evaluate in a coherent manner. For analysts, consideration paid for a business combination was very fundamental, as it could impact on various factors including stewardship and the way analysts assessed the success of a business combination in relation to return on investment.

One user noted that financial statements have grown considerably over the years, and consequently, it was more difficult and burdensome to find "integrated" information on business combinations. Other users shared similar views and called for a more uniform approach of presenting related information.

## 5. Detailed findings on the accounting for Business Combinations

### Overall

Users considered business combinations to be significant transactions and needed comprehensive information about the objectives and the expected synergies from the underlying transactions, and how those synergies translated into post-combination (recurring) profit or loss and cash-flows, and therefore, performance.

### Understanding the business combination transaction

Most users noted that the information about the identification of the business combination and the primary reasons for undertaking the transaction is very useful.

*Many users noted that the annual financial statements were not the primary source of information to understand the rationale of a business combination*

However, for many users the consolidated financial statements were not the primary source of information to understand the primary reasons for a business combination. As noted above, timeliness was a key factor for investment decision-making; therefore by the time the financial statements were published, users would already have insight into the reasons for the business combination and the factors that led to the transaction. Users considered the financial statements to be only part of the information that they analysed.

*Many users expressed concerns about the quality of the information disclosed about the primary reasons for business combinations and they often needed to be supported by other sources of*

Many users expressed concerns about the quality of the information disclosed in the financial statements on the rationale for undertaking the business combination transaction (i.e. what motivated the parties for undertaking the transaction and what is it expected to bring to the combined group). In their view, companies often provided very general "boiler plate" data that lacked insight on the rationale for the acquisition and what it would bring to the *information*

buyer.

*When asked about possible improvements, users called for more insightful disclosures about the "real economic reasons" for undertaking the business combination transaction*

When asked about possible improvements, users called for more insightful disclosures about the "real economic reasons" for undertaking the business combination transaction, and how the acquisition would help the acquirer in the market and contribute to future earnings. Users looked for information that was specific to the business combination transaction and related to facts and circumstances that lead to the transaction, rather than general reasons about growth and market share, which were considered to be too "boiler plate" to be useful.

Some users raised the need for improvements to IAS 34 *Interim Financial Reporting* with regards to information on business combinations, which users thought were less comprehensive than that reported in the annual accounts. It was also felt that the interim financial statements did not sufficiently explain the developments in business combinations that were still within the "measurement period" under IFRS 3.

Generally users acknowledged that in a number of situations the "real economic reasons" of an acquisition would probably not be disclosed as it might be considered commercially sensitive information. For example, if an acquirer bought a company with the objective of eliminating a competitor, it was unlikely that such information would be revealed. However, there was a need to strike a balance between the information users needed and the information preparers were willing to provide.

### Factors that make up the goodwill recognised, such as synergies

In general, all users mentioned that they needed information to understand the reasons for the total amount paid. The price paid was a key factor in analysing the business combination, particularly from a stewardship point of view.

*Users generally perform their own valuations to determine "core profits" which they include in their cash flow models - understanding synergies helps them achieve this*

Generally speaking, many users (especially buy and sell-side equity and financial analysts) tend to ignore the goodwill number as they focus on the future cash flows that the business acquired expects to generate. Many users explained that they perform their own valuations to determine "core profits" to include in their own cash flow models, and would not consider the separate "goodwill" number or the information on newly created intangible assets when making their assessments.

Many users considered that the price paid for a business was, to a large extent, driven by expected synergies. Understanding the synergies expected from the business combination helped them model their analyses and cash flow models.

*Many users considered that information about expected synergies and how those expectations materialised post-acquisition was very useful for them*

These users considered that information about "the factors that make up the goodwill", expected synergies from those factors, including quantitative information, and how those expectations materialised and translated into revenues or cost reductions in post-acquisition periods, was very useful for them. This type of information helped users to better understand the level of cost savings achieved by the acquirer after the business combination, and consequently, whether or not it had been a successful acquisition.

A number of other users considered that the information provided by financial statements about goodwill and synergies was very general and very subjective; this was not useful to help users monitor the initial expectations and expected costs savings in post-acquisition reporting periods. Users noted that they would rely on other sources to obtain information on "synergies".

When referring to disclosure improvements, a number of users believe that the information about synergies in the financial statements could be improved and called for:

- follow-up information about synergies in subsequent years, namely whether initial expectations were being materialised in subsequent periods, as this information helped them in assessing the success of a business combination; ;
- information about how the acquirer intends to achieve the synergies;
- information about synergies detailed by segment.

*Focus on market information to determine own valuations on core profitability*

*Some users based their analysis on the price paid and used other information available related to M&A activities, such as valuation multiples, to assess whether the entity had entered into an overpriced or a bargain*

Some equity analysts explained that the price paid was the key factor, regardless the amount of assets and liabilities to be recognised, including goodwill.

These analysts explained that they focused their analysis on market information when assessing whether the entity had entered into an overpriced or a bargain acquisition. These users mentioned that they would perform their own valuations to determine "core profit or loss" numbers which they would use in their analyses of *acquisition*

the business combination. For example, users indicated that they would use, among others, valuation multiples (e.g. EBITDA multiples) and financial ratios that measure a company's return on investment to understand whether it had been an overpriced acquisition and the reasons for the price paid.

Some other users explained that they would look for detailed information about the factors that make up the goodwill only if it was a significant element of the transaction. For example, one user usually compared the goodwill amount against the total price paid and if the goodwill was less than 20% of the price paid, he would not focus his analysis on the factors that make the goodwill. Another user explained that he often compared goodwill that the company had recognised with goodwill recognised in other similar transactions in the market before deciding to look for further information.

### Subsequent measurement of goodwill (impairment versus amortisation)

*Some supported the annual impairment test model while others preferred the amortisation model (or a combination of both)*

Currently companies are required to test goodwill for impairment every year. When discussing the usefulness of the information obtained from annually assessing goodwill for impairment, users provided mixed views. Some supported the annual impairment test model while others preferred the amortisation model (or a combination of both). There were also a number of users who did not have strong views about the subsequent measurement of goodwill since they would anyhow ignore the amount in their analysis.

*Supporters of the impairment model*

*Supporters of an impairment-only model said it was a better way of demonstrating whether management expectations of the business combination, and the synergies it was expected to bring, had been met*

Some users supported the requirement to test goodwill annually for impairment. The impairment model provided evidence that the business combination was running as expected and the acquirer was still expecting future economic benefits, such as synergies, from the business combination. In their view, impairment was a better way of demonstrating whether management expectations and the synergies expected from a business combination transaction, had been met.

Supporters of an “impairment-only” model thought that systematic amortisation of goodwill in profit or loss dismissed “economic reality”. The impairment model was also perceived to be more appropriate from a stewardship perspective, and helped relate the price paid to what was acquired.

Some users noted that they are not concerned about the volatility in profit or loss created by the impairment model. One highlighted that impairment does not have a "cash impact" and, an efficient market would have taken it into account before the impairment was recognised for accounting purposes.

Another user (research analyst) thought that there was no evidence to demonstrate that impairments were recorded "too late".

*However, supporters of an "impairment-only" model would like to have more information disclosed about the annual impairment test*

However, most of these users requested additional information on how the impairment was determined. Users often have to rely on the inputs and valuation techniques used by companies to determine impairment, when making assessments about the value of a business. However, the information provided in the financial statements did not always explain the basis for the impairment calculation, including assumptions and level of inputs, and was generally considered to be insufficient for their analysis. These users stated that they would like to have more information:

- that would help them to compare the information provided by segments and the information related to the amount of goodwill allocated to each cash-generating unit, which was often missing in the financial statements; and
- about how the impairment tests had been done, namely management key assumptions and inputs.

Some others noted that information about management assumptions would generally not be useful. The only instance where analysts did use the information was when impairment was actually recorded in the financial statements; in such cases analysts would use the residual cash flows to compare to their own valuations.

*Supporters of goodwill amortisation*

Some users considered an amortisation model to provide more "forward-looking" information than an impairment model. There was an understanding that goodwill represents the ability for an entity to generate future income, which needs to be considered when deciding how to account for goodwill in the periods, in which, in principle it is generating income.

*Some users indicated that when impairments were not reported by companies, they "expected the worst"*

One of the main concerns noted by these users was that impairments generally took a long time to be reported in the financial statements, and, often they were reported too late. Some users indicated that when impairments were not reported by companies, they “expected the worst”; and when impairment was recorded in the accounts, it created “uncertainty” and could raise questions about the initial expectations and the performance of the business combination.

A number of users noted that goodwill amortisation was part of the over or under-performance of the acquired company. These users considered that such expenses should be taken into account, provided that the amortisation period was reasonable.

There were a number of other reasons why users support the amortisation of goodwill and indefinite intangible assets:

*Other users would prefer to have a goodwill amortisation model as it would provide useful information to users and would be more operational and less costly to be applied in practice*

- it would decrease volatility in profit or loss when compared to an impairment model;
- it would be more operational and less costly to be applied in practice;
- the amortisation would be recognised in profit or loss on a systematic basis over the period in which the entity consumes the economics benefits associated with goodwill – and therefore relate the income it generates with its consumption;
- it would improve comparability between two identical companies – one expanding its business through acquisitions (and therefore accounting for goodwill) and the other expanding through organic growth. The write-off of goodwill on an annual basis would not discriminate both companies. Conversely, if a company does *not* amortise goodwill over the years, margins could be inferior in the company with organic growth. In this case, the impairment model “discriminates” between the two largely identical companies;
- it would ensure that the acquired goodwill is recognised in profit or loss and no internally generated goodwill is recognised as an asset in its place;
- the assumptions used in the impairment test are often subjective and difficult to analyse; and
- it is difficult to know whether the company was performing the annual impairment tests in an appropriate manner.

When asked about what useful life should be allocated to goodwill, some users replied that management would have to use their judgement to determine an estimate. Generally speaking users did not expect goodwill "to last" for more than 10 or 15 years.

Some users preferred a combination of systematic amortisation supplemented by an impairment test.

Finally, a number of other users did not have a strong view over whether goodwill should be amortised or impaired. Some of these users explained that their analysis was focused on future cash-flows; and neither impairments nor amortisations impacted future cash-flows.

Some others looked at impairment only as an indicator of an overpayment. They generally would ignore goodwill and as long as the amortisation or impairment is clearly disclosed, they would be able to adjust for these amounts.

### Consideration transferred, including contingent consideration

*Information about the deal structure and consideration paid*

*Information about the structure of the business combination transaction, including consideration paid was fundamental and considered a key measurement of stewardship*

Many users highlighted that information about the structure of the business combination transaction, including consideration paid, was fundamental to their analysis. They noted that "consideration paid" was a key measurement of stewardship, as it helped users understanding what and how a company had paid for an acquisition. Generally speaking, one would assume that transactions are not undertaken without a thorough analysis of the structure and terms during the negotiation process. In the case studies examined, good examples of information about the structure of the business combinations were found, but users also provided evidence of examples of disclosures that they found unhelpful.

*A number of users called for additional information about the deal structure and types of consideration paid which should be provided in a single disclosure note*

Credit analysts in particular appreciated having information that could assist them in determining the impacts that consideration paid would have on the company´s debt structure and the effects on debt/equity ratios.

The following information was considered useful:

- the deal structure, such as different types of consideration paid or to be paid (e.g. cash, equity instruments, other type of assets), payment dates and whether payments can be anticipated or postponed by the acquirer;
- information about how the transaction had been financed

(equity, in debt, etc.) and impact on leverage ratios;

- having the various elements of consideration paid in a single note (information was often scattered throughout the accounts);
- information about whether the former shareholders would receive any kind of dividend before the transaction was completed;
- information about the exchange rate used to account for the business combination when the acquiree was located in a country with a different currency to that of the parent company; and
- information about how the company was going to restructure its debt (or that of the Group) after the acquisition.

Some users noted that there could be situations where disclosing the total amount of consideration paid might be subject to certain constraints, as the buy-sell agreement might include confidential clauses.

*Contingent consideration*

The accounting treatment for contingent consideration and related disclosures was identified as an important issue for users. Some users considered the information provided on contingent consideration to be sufficient.

*It was important to have information that allowed users to estimate future additional payments relating to consideration and how probable such payments were*

However, other users noted that in some cases, in particular complex transactions that entailed complex consideration structures, the structure of the consideration “package” was not always sufficiently explained.

Contingent consideration was structured in different ways and took many forms. It was often a significant part of total consideration paid, which could “change the picture of the transaction and was considered to be part of the risk profile of the transaction”. It was therefore important to have information that allowed users to estimate future additional payments and how probable such payments were.

*Subsequent measurement of contingent consideration*

Several users highlighted the importance of having disclosures about subsequent changes to the fair value of contingent consideration, particularly information that would help them understand the reasons for adjusting to the price.

Some users noted that the accounting treatment of subsequent changes in the fair value of contingent consideration depended on facts and circumstances. It was important to understand the factors that led to "postponed" payments and have information on the numbers. It was less important where in the accounts the adjustments were recognised, as users did not view such adjustments as performance.

*Most users did not think that gains and losses related to future price adjustments to contingent consideration were part of the performance; contingent consideration was part of acquisition price (investment value)*

Some users supported the requirements to recognise adjustments to contingent consideration in profit or loss as such changes occurred after the acquisition date. Generally, users did not "really care" about where the adjustments made to contingent consideration were recognised, as long as the adjustments were disclosed. These users expressed a preference for the profit or loss since that would be the "easiest" place to find the information instead of going through the notes.

However, most users, including those who supported the requirements, considered that adjustments to contingent consideration were not part of the performance of a company and, were inclined to ignore the profit or loss movements related to subsequent changes to contingent consideration.

Some of those users noted that they would usually consider adjustments to contingent consideration as an adjustment to the original acquisition price (investment value) – and would adjust the fair values of the assets and liabilities or, more likely, an adjustment to the initial goodwill. An example provided by users of the pharmaceutical industry was the acquisition of intangibles assets – such as intellectual property and rights over a product – which were priced based on future developments of the product. In such cases, it made sense to adjust the value of the intangibles for additional payments made.

### Recognition and measurement of assets acquired and liabilities assumed, particularly intangible assets, inventories and contingent liabilities

*Information about amounts recognised at the acquisition date for each major class of assets acquired*

*Most users considered that it was useful to have in the disclosures both the historic book values and the*

Many users considered information about the amounts recognised as of the acquisition date for each class of assets acquired and liabilities to be useful for their analysis. These users explained that such "segregation" helped them understand what had been *acquisition-date fair values of the assets acquired and liabilities assumed*

acquired by the company and how the company had allocated the transaction price. It was also important that information was presented in a standardised way to facilitate its assessment.

However, a number of users considered that the disclosures could be improved and provided a number of suggestions, namely that:

*Many users would like to have further information about how the entity had determined the fair value of the assets and liabilities; the reason for the significant step-ups and more granular information for each class of assets*

- information about the amounts recognised as of the acquisition date, particularly when derived from the fair value measurements, was particularly useful when combined with information on the pre-acquisition book values of the assets acquired and liabilities assumed. This information would assist users in assessing whether there had been significant steps-ups in the business combination;

- further disclosures would be welcomed about how the entity had determined the fair value of the assets and liabilities, namely the methods applied, inputs used and main assumptions taken. Some of these users added that this would be particularly useful to better understand the step-ups to the fair values;

- additional explanations to help users in understanding the reason why there had been a significant step-up;

- it was important to have more “granular information” on each major class of assets. A number of users explained that although companies provide some information about the fair value for each major class of assets, these classes of assets were often not completely described and could include various units of account with different assumptions within each unit of account. One user explained that companies did not distinguish between assumptions made for the retail and corporate business for a particular class of assets. Such information could be relevant and would provide information about particular characteristics of the class of assets (e.g. whether the retail loan and receivables portfolio include an interest rate floor that impacts the fair value);

- it was not useful to have information about accumulated amounts of the assets acquired and liabilities assumed from different business combinations in a single column of a table;

- it was useful to have information about the expected useful life of the assets acquired;

- it would be useful to have more specific requirements about the presentation of disclosures in order to make the information more comparable and easier to understand. One user noted that the information provided by companies varied a lot in practice and sometimes it was difficult to understand the tables provided by the acquirer; and

- one user indicated that he would be interested in having information about future depreciations and deferred taxes.

However, some users noted that they often faced time constraints and were not able to analyse comprehensively the information disclosed about the acquired assets and liabilities assumed (information which was only made available sometime after the acquisition date). As previously mentioned, users often noted that they focus their analysis on market information (e.g. valuation multiples) and develop their own future cash flow assessments to help them understand whether it had been an overpriced acquisition.

*Some users noted that it would be useful to have more comprehensive information about the liabilities acquired in a business combination transaction*

*Information about liabilities assumed*

Some users noted that it would be useful to have more comprehensive information about the liabilities acquired in a business combination transaction, including contingent liabilities and a break-down of the type of liability - whether it is debt, pension liabilities, short-term liability, overdraft, etc.

Credit analysts and fixed-income analysts focused on the impact acquired debt would have on the company's gearing and net debt position. This was fundamental information to their evaluation of the company; pre and post-acquisition date. Generally speaking, these analysts considered that debt disclosures needed to be improved. An example provided, was the lack of information about how a company was going to restructure its debt position after a business combination. It was not always clear what an acquirer would do with the debt assumed in a business combination transaction. From a credit perspective, it was vital to understand how a company structured its capital. There were cases when users would turn to the separate financial statements to understand debt/capital structures of the underlying company.

Disclosures about contingent liabilities, as such liabilities impacted the future cash-flows of the company was also considered important. Still, some users noted that:

- often not much information was provided about contingent liabilities;
- contingent liabilities could be used as part of earnings management; and
- adjustments to contingent liabilities were viewed as non-recurring items in profit or loss.

*Separate recognition of intangible assets from goodwill*

*Many users stated that they had some reservations about certain intangible assets, such as customer relationships and brands, and wanted more information about the basis for recognition of those intangibles and how they had been measured. Detailed "granular" information was not generally relevant to users*

Most users expressed some reservations about the recognition of certain intangible assets, including intangible assets that had not been previously recognised by the acquiree (such as customer-based intangibles – for example customer relationships, brands…) and intangibles for which there was no active market.

Overall, several users noted that detailed "granular" information was not particularly relevant. Their main focus was on the "entire" business acquired, and not on the "separate" assets and liabilities assumed.

<u>Views of those who considered useful to have information about intangible assets can be summarised as follows:</u>

*Some users supported differentiating "wasting" intangibles from "non-wasting" intangibles. Some intangibles waste over time and others do not*

Some users supported differentiating "wasting" intangibles from "non-wasting" intangibles. For example, the approval of a medical product could be considered a non-wasting intangible. Some other intangibles truly deplete over time and lose their value (for example customer relationships and technology-based intangibles). In such cases, the amortisation charges were real costs. There is no clear "differentiation" regarding which intangibles should be depreciated and which ones should not.

Some of these users noted that the amount of intangible assets could be high, particularly in the pharmaceutical industry where the research costs incurred by the acquiree would be recognised in the accounts of the acquirer at the date of acquisition.

Most users called for further disclosures about the rationale for recognising intangible assets separately from goodwill; and how the entity had determined the fair value of the intangible assets, particularly the methods applied, the inputs used, the main assumptions and related cash-flows. Finally, users have also noted that it would be useful to have more information on the tax effects of intangible assets (please see the section on *"usefulness of the* *information on tax deductible goodwill").*

*A number of users explained that they would not usually focus their analysis on new intangible assets and had the view that some of these assets "were vague in nature"*

Views of users who usually did not focus their analysis on new intangible assets

A number of users noted that they did not focus their analysis on the information derived from the recognition and measurement of new intangible assets created through the business combination. In addition, they had some reservations about the recognition of certain intangible assets, such as customer lists, which were "vague in nature".

These users generally noted that the measurement of such intangible assets could be challenging as they depended on significant judgement from management regarding the inputs and assumptions used (too subjective to be useful).

However, users were interested to understand the impact of such intangibles on future earnings, such as future depreciation costs. Some of these users noted that it would be useful to present separately in the balance sheet intangible assets with an indefinite useful life and those intangibles with a definite useful life.

*Measuring inventory at acquisition-date fair value*

*Some users expressed concern about measuring acquired inventories at fair value as it would potentially affect future operating margins*

Some users expressed concerns about measuring acquired inventories at the acquisition-date fair values as such values had a potentially misleading impact on future operating margins.

When referring to possible improvements users suggested:

- requiring disclosures that would help users forecast future gross margins on inventory and assess the effects of such changes on post-combination profit or loss and cash flows. Some users thought that pro-forma information would already help understand the profits being generated by the inventory, but they would welcome information that would help them forecast future gross margins; and

- having the information about impact on future period margins presented together with information about step-ups. Some noted that such information was particularly important for inventory that turns over a long period of time (for example jewellery).

Nevertheless, one user indicated he would not like to have an exception regarding the measurement of inventories at the acquisition-date fair value, as this would open the door for additional exceptions.

### Bargain purchases accounting

Most users were not familiar with negative goodwill in the companies they were following and stated that negative goodwill never occurred in the particular industry they were analysing.

When discussing the accounting treatment and disclosures related to bargain purchases, users provided a number of different views and suggestions.

Some users noted that if a company recognises negative goodwill, then it was fundamental to have information that clearly sets out why the transaction resulted in a bargain purchase.

*Many users questioned whether bargain purchase gains should affect the performance of the company*

Some other users questioned whether negative goodwill actually existed; and whether it was the value of assets acquired and liabilities assumed that needed to be adjusted. These users argued that in an arm's length transaction it did not make sense to have the consideration being lower than the fair value of the assets acquired and liabilities assumed.

One user noted that this would raise significant concerns about stewardship of the acquiree's management. This user said that he would suspect that probably it was more an initial measurement problem of the acquired assets and liabilities.

Many users questioned whether bargain purchase gains should affect the performance of a company (i.e. accounted for in profit or loss as a "capital gain"). Some added that they would usually adjust their recurring earnings analysis if necessary. One user specifically noted that nothing was "realised" and therefore the gain should not be recognised in profit or loss. Some of these users provided different suggestions about how to account for bargain purchases. These include:

- accounting for negative goodwill in other comprehensive income and not in profit or loss;
- not accounting negative goodwill in profit or loss as profit or loss should be restricted to ordinary business transactions; or
- having negative goodwill directly adjusted in equity.

Finally, some users were not significantly concerned about the accounting for bargain purchases, as long as the amount of the gain was clearly disclosed in the financial statements or in the notes.

### Business combinations achieved in stages

Many users did not express significant concerns about the current accounting for step acquisitions.

*Most users emphasised that they tended to consider such a gain or loss as a non-recurring item or as not being part of the performance of the company*

Some users explained that the information resulting from the remeasurement was useful as it provided them with updated information about the value of the previously held interest. One equity analyst noted that if the gain or loss is accounted for in profit or loss, it would probably call users' attention more than if the information was only disclosed in a note.

However, most users considered such a gain or loss as a non-recurring item or as not being part of the performance of the company, and would adjust their valuation models if necessary. Users indicated that it would be useful to have such gains (or losses) clearly identified in the financial statements. Some users noted that remeasurement of previously held interest, in profit or loss did not provide useful information as such gains or losses seemed artificial.

Other comments made were:

- one user suggested recognising the gain or loss in other comprehensive income. In contrast, another user questioned the accounting treatment as the distinction between other comprehensive income and profit or loss was not very clear;
- on loss of control accounting, one user explained that in a number of cases, particularly in transactions that involved the selling of real estate by banks, there were difficulties in understanding the transaction due to the limited information provided, particularly when trying to reconcile the information related to transaction price, the net assets derecognised and the total gain recognised;
- some users questioned the relevance of fair value information in situations where there were practical difficulties related to the application of the acquisition-date fair value measurement principle. These users thought that in such situations, an entity should not be required to remeasure previously held interest; and

- some users highlighted that transactions undertaken close to one another (such as a squeeze-out of the remaining shares) raised questions about whether they should be accounted for as a single transaction or as separate transactions. One user considered that it would be useful to have information that could help follow-up the issue in subsequent periods.

### Other issues

*Usefulness of information from pro-forma disclosures*

In general, users found pro-forma information (i.e. presentation of financial information as if the business combination had occurred at the beginning of the annual period) very useful as it allowed users to evaluate the financial performance with and without the business combination transaction.

Some users noted that this information was often well disclosed by management at the date of acquisition; and they used the financial statements to confirm the initial assessments and understand progress made in post-acquisition periods.

However, a number of users considered that the presentation of pro-forma information varied in practice and was often not very well presented. One user explained that, from his experience, companies would only provide such information if it was an important business combination.

When referring to possible improvements, users noted that:

- they would like to have additional historical information; for example, some users noted that they would welcome pro-forma information as at the previous reporting date and noted that such information was even more important when the acquiree was not a listed company. Some other users would like to have historical information from the last three or five years;

- they would like to have more details and not only the headlines of the information;

- the IASB should define more specifically which information should be disclosed;

- they would like that the pro-forma information make reference to impacts on gross margin per product and per geographical area;

- it would be useful to have information about how the pro-forma information had been prepared (e.g. depreciation rules used, etc.); and
- it would be useful to have pro-forma information about cash-flow statements.

*Usefulness of information derived from NCI accounting*

*Users provided mixed views on how a company should account for non-controlling interest. Some preferred the proportionate method; others preferred the fair value option; others were just not in favour of having options; and some would like to have disclosures about the reasons why a certain method had been used*

In general, users did not express significant concerns about the accounting for non-controlling interests (NCI).

Users that remarked on NCI provided mixed views on how a company should account for it. Some preferred the proportionate method; others preferred fair value and others did not have a preference.

However, users considered that if NCI were measured at fair value, it was fundamental to know the methodology and inputs used to evaluate consistency of the amounts recognised; and it was important to know the reason why a company had chosen one of the options.

Some users considered that only one measurement bases should be permitted as options in accounting created comparability issues. Specifically, some did not consider it useful to have an option to measure NCI at their fair value or proportionate method on a transaction by transaction basis. One of these users argued that it could lead to manipulation of the financial statements. Some of these users supported fair value measurement of NCI. These users argued that for consistency reasons it would be better to have everything at fair value and it made sense to use fair value if the acquirer was going to acquire additional shares in the near future. Others preferred the proportionate method.

*Usefulness of information on tax deductible goodwill and other assets*

*It was crucial to understand the tax structure and its implications on the price paid and future cash flows*

Users in general considered information on tax impacts on goodwill as vital information because it had an impact on future cash flows and the amounts could be significant. Users recognised that, in some cases, tax regimes have an important impact on future cash flows and deals are often structured with an objective of optimising tax-related cash flows. It was therefore crucial to understand the tax structure and its implications on the price paid and future cash flows.

One user specifically noted that information about tax deductible goodwill was useful because it allowed estimation on any impacts on the regulatory capital. However, this user believed that this kind of disclosure was not being currently provided in practice by all companies.

Other users noted that it would be useful have more information on the tax effects of other assets, such as intangible assets, acquired in a business combination. It was mentioned that in some industries, intangible assets that arose in a business combination transaction benefited from tax breaks or in some cases were tax deductible; such “tax purpose” information and the underlying impacts on future cash flows was very useful information for users.

*Transactions that are recognised separately from the business combination*

Several users explained that they valued information that helped them understand whether there were “transactions” that were related to the business combination, but had not been accounted for as part of the business combination transaction given the requirements in IFRS 3.

A “separate transaction” could include, for example, a situation when an acquirer sells a group of assets (or a business) post acquisition. For accounting purposes, the question is whether the sale is part of the business combination or whether it should be treated as a separate transaction.

Users generally welcomed information that would help users to assess what part of the consideration transferred might be recovered by selling assets not considered important but the company had to acquire as part of a deal.

The following additional remarks were made:

- One user believed that there was not enough transparency in the financial statements on transactions that were recognised separately. It was not easy to understand the information being provided by companies and, in some cases, it was not clear why the transaction had been (or not been) accounted for as part of the original business combination;
- Separate transactions were part of the “history” of a business

combination transaction and would be considered by users when assessing the "entire package" underlying the business combination transaction; and

- Another user explained that information about separate transactions helped to assess what part of the consideration transferred might be "recovered" by selling assets that were not considered "core assets" but that the company had to acquire as part of the business combination transaction.