CFA Society
United Kingdom

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IASB
30 Cannon Street
London EC4M 6XH

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

The Financial Reporting and Analysis Committee (FRAC) of the CFA Society of the UK (CFA UK) welcomes the opportunity to respond to the International Accounting Standards Board's (IASB) Request for Information on IFRS 3 Business Combinations.

Executive Summary

Acquisitions are an important subject for investors as they can often involve the creation or destruction of significant value. Investors are particularly interested in assessing whether an acquisition has been successful and holding management accountable. In practice, once an acquisition has been completed it can often be hard to track its performance. It is important that investors can do this for three reasons: a) to calculate the return on the (often large) investment, which means tracking how much the acquired company has contributed to profits/cash flow; b) to be able to distinguish the acquirer's organic growth from acquired growth; and c) to hold management to account for achieving synergies and other execution targets.

A key concern many investors have with IFRS 3 accounting is the amortisation charge arising from certain intangibles such as brands and customer lists. These costs appear to be double counting as the maintenance of these assets is already expensed through the income statement as another cost, such as sales and marketing. As such, most analysts add back these amortisation charges in their measures of underlying earnings. The majority view on the committee was that we would prefer that difficult-to-define (or difficult-to-separate from the overall business) and 'indefinite-lived' intangibles, such as brands and customer relationships, are subsumed into goodwill and subject to impairment testing rather than periodic amortisation. However, there was a minority view that all intangibles wear out and that amortisation reflects the need for future investment to replace them, in addition to the expensed "maintenance" costs of marketing, research etc.

To make impairment tests more useful to investors, companies should carry them out whenever there is a significant change in market conditions that would drive a change in profit forecasts. Although we recognise that IAS 36 Impairment of Assets already requires this, in practice this does not often happen. The outcome of the impairment test should be disclosed as soon as possible. At a minimum, results of the annual impairment test should be published with the preliminary full-year results.

Main response

1. Your background and experience

CFA UK represents more than 10,000 investment professionals working across the financial sector including asset managers, buy-side analysts, sell-side analysts and credit rating analysts, among others. For advocacy purposes in the field of financial reporting, these members are represented by the Financial Reporting and Analysis Committee.

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?

Asset acquisition accounting is presumably less onerous than business combination accounting and hence for small transactions (relative to the size of the acquirer) they are perhaps a pragmatic approach.

The advantage of having business combination accounting (as opposed to using asset acquisition accounting) for large transactions is that, hopefully, it forces management teams and their boards to more closely consider the acquisition price, as they have to identify the assets/liabilities and goodwill being acquired, and the synergies that justify paying the premium that forms part of goodwill.

The treatment of acquisition fees is inconsistent. We would favour the expensing of such fees for both asset acquisitions and business combinations on the grounds that the fees themselves do not create an asset.

(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?

Not applicable to us.

3. Fair Value

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

We believe fair value measurement has been applied to too many intangible assets by extending the concept of separability too far and by assuming that if an asset is identifiable it can be reliably measured.
While it is interesting to see a breakdown of intangible assets into categories such as technology, licences, trademarks, customer relationships and goodwill, we are concerned that the valuations of those items are spuriously accurate estimates. Moreover, we find it strange that those assets may be ascribed a relatively small proportion of the purchase price when compared with goodwill. We think companies should be obligated to provide more information to justify the amount ascribed to goodwill, notably through disclosure of synergy assumptions. This would help us to hold management to account for the performance of the acquisition.

Finally, many analysts do not agree with writing up acquired inventory to fair value and usually ignore these adjustments from their measure of underlying earnings. The reduced profitability in the first period following the acquisition is not viewed as sustainable or recurring. Although we understand the rationale for writing inventory up to current market value, in practice no one would pay full value for stock they were going to trade out post acquisition because there would be no profit and no point.

(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?

Not applicable to us.

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

Not applicable to us.

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?

We think there are two main categories of intangible assets: (1) those that are contractual, have a finite life and are separate from the overall business (even if they may be needed to operate according to the company's business model); and (2) those that are inextricably linked to the overall business and have an indefinite life (even if they exist through contract). We think the second category should not be recognised and measured separately, but instead be subsumed within goodwill.

We think it is appropriate to have separate recognition of those intangible assets that fit the first category, such as licences (e.g. for wireless spectrum) that have a finite life. Separate recognition for such assets is useful, as they are not organically replaced but instead require large capital expenditure after long intervals (i.e. will be renewed once the current licence expires). As such, the recognition and amortisation of these assets is appropriate, as it is a proxy for the replacement cost of the asset.

However, the separate recognition of intangibles in the second category, such as trademarks, customer relationships and some technology, is less useful to analysts. We do not find the amortisation of them to be helpful and we think that conceptually they are more akin to goodwill because of the inability to separate them from the overall business. For such assets, where the lifespan is not defined and may in fact be indefinite, we believe a corresponding ongoing cost for maintaining those assets already appears in sales and marketing. Amortisation of such "assets" while also expensing the related "maintenance cost" would appear to be double counting. Assets with an indefinite economic life that are difficult conceptually to separate from the value of the business overall should be subsumed within goodwill, left on the balance sheet and impairment tested at regular intervals and/or when there is evidence of potential impairment. This, in effect, means reversing the move towards greater amortisation of intangible asset values.

The alternative would be to allow for capitalisation of marketing costs, which could offset the amortisation charge and preserve the value of the customer relationship and brand assets on the balance sheet. Similarly with "technology" assets that are subject to amortisation there is scope for potential double counting as R&D costs associated with an acquired technology are expensed through the income statement.

We think the Board should give further consideration to this issue of double-counting so that users of accounts can make better decisions about the inclusion/inclusion of amortisation charges in their financial analysis.

(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?

Not applicable to us.

(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?

Investors and analysts usually strip out such a gain from their assessment of underlying earnings. They tend to assume that the transaction price is the fair value on that date. If it is genuinely a bargain, the benefits will come through in subsequent profits and revaluations.

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?

Although we have not conducted a comprehensive survey of company disclosures, a limited survey suggests the information contained in annual reports regarding impairments can be quite useful. Insightful disclosures include discount rates used, long-term growth rates as well as profit and capital expenditure assumptions. Sensitivities of goodwill to changes in these assumptions is useful as well as information about changes in assumptions that led to an impairment. Given that our survey of company disclosures has been quite narrow, we do not know if these disclosures are consistent across all companies or if we have just found a few examples of best practice.

What would also be useful would be a description of progress on reaching synergy targets and how that relates to the passing, or not, of an impairment test.

However, a big problem with this information is its timeliness. The annual report usually appears long after a company has reported its full-year results (which themselves have little detail on the impairments). Moreover, impairment charges taken at full (or half) year results usually reflect market conditions that have been clear for several quarters. As such, analysts have already taken account of the reduced value – the fall in market price reflects reduced cash flow forecasts. It may be the case that even though IAS 36 requires an impairment to be taken whenever there is a "triggering event" (such as unfavourable market conditions) companies are waiting until the end of the financial year to perform the impairment test. Writedowns as a result of impairment testing are, however, useful for stewardship purposes because management is admitting it overpaid and can be formally held to account.

In addition, we are concerned about the application of the impairment test to the extent that companies seem to be allowed a free choice in determining recoverable amount because of the entity-specific nature of value in use. We think a fair value based impairment model would be more objective and would reduce the scope for management to "pass" the impairment test by making assertions about how much better they are at managing assets than the market thinks they are. We think the Board should fundamentally review IAS 36.

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

The usefulness of impairment tests is related to the evidence they provide about management of acquisitions; the more granularity, the better. The big question is over timeliness since impairments tend to lag well behind market signals of a loss in value. Rather than increase the frequency of impairment tests from the current annual requirement, the need to conduct a test in response to value-threatening events should be reinforced. More information about the assumptions fed into valuation models would be useful. Such granular disclosure should come out with the preliminary full-year results, rather than just appearing in the notes of the annual report.

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

Not applicable to us.

<u>6. Non-controlling interests</u>

(a) How useful is the information resulting from the presentation and measurement requirements for NCIs? Does the information resulting from those requirements reflect the claims on consolidated equity that are not attributable to the parent?
If not, what improvements do you think are needed?

This is not an area of general concern to analysts; though we appreciate there may be specific companies where the choice between accounting for NCIs at fair value or proportionate share of net identifiable assets can produce materially different outcomes. Analysts tend to concentrate on profit and cash flow forecasts for the group (including NCIs) and include an estimate for the buyout costs of minorities. We think that the Board should remove the option in IFRS 3 as it makes it difficult to compare companies that account for partial acquisitions differently. Our preference would be to require companies to measure NCIs at fair value because when valuing a company analysts will seek to determine a market price for the minority interests.

(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.

Not applicable to us.

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.

This is not an area of general concern to analysts though we appreciate there may be specific companies where gains or losses recognised in a step acquisition can be quite large (e.g. if there has been significant price appreciation of a minority investment at the time the investor obtains control). Such items are, however, usually small relative to the main group accounts. These non-recurring, non-cash gains and losses would tend to be excluded from cash flow forecasts so it is important that they be clearly identified.

(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.

This is not a frequent occurrence and usually not material to group accounts. As such, it is not an area of significant concern for analysts. The value of investments should be as transparent as possible. Fair value is the most useful measure for sum-of-the-parts valuations and to assess any potential gains/losses on disposal.

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?

Once an acquisition has been completed it can often be hard to track its performance so we think better disclosure is needed to allow analysts to do so. For example, it is important to know how much of the business has grown organically versus how much it has grown through acquisitions. Up to the end of the first full year after the acquisition, it would be helpful to know the contribution of the acquiree to revenue, gross profit and/or operating profit, as well as the comparable measures for the acquiree in the year before the acquisition. It would also be useful to see what the prior-year revenue and profit would have been for the combined group on a proforma basis. This would enable investors to more easily assess organic growth.

We would like a record to be kept of the full cost of the acquisition: equity, net debt assumed, pensions liabilities assumed, fees and restructuring costs. Analysts need this to carry out return on investment calculations.

Regarding the constituents of expanded goodwill, there is some concern about the potential loss of information on intangible assets such as brands and customer relationships. This could be covered by a better explanation of expected synergies – for instance, the acquirer's aim of expanding the sales of the acquiree's products through its larger distribution network. For brands, the company might use external valuers and cite a range of outcomes. Alternatively, management could be asked to provide a commentary in the note on goodwill on its constituent parts and their relative importance. This would follow any breakdown employed in the impairment tests.

Where there are anticipated restructuring costs in order to realise the synergies that justify an acquisition, we would like the company to disclose subsequent progress (amounts and timing) on achieving the cost savings and on the related spending on restructuring.

Since tax arbitrage is increasingly being cited as a potential "benefit" of an acquisition, the acquirer should set out its targets for tax rate reduction and the potential gains to net income. Post-acquisition, progress on achieving these gains should be reported on along with the gains from restructuring etc.

We think it would be useful also to have more information about the inputs and methodologies used to measure the fair value of the acquired assets and liabilities, such as the disclosures in IFRS 13 Fair Value Measurement.

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

As discussed above we do not feel that the separate disclosure of certain intangibles such as customer lists and brands is useful. We are more concerned, however, with the amortisation of these intangibles and the potential double counting in the income statement that this entails.

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

Not applicable to us.

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.

No specific comments.

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)?

No specific comments.

We look forward to discussing the issues raised in this response.

Yours sincerely,

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CFA Society of the UK

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CFA Society of the UK

About CFA UK and CFA Institute

The CFA Society of the UK (CFA UK) represents the interests of more than 10,000 leading members of the UK investment profession. The society, which was founded in 1955, is one of the largest member societies of CFA Institute and is committed to leading the development of the investment profession through the promotion of the highest ethical standards and through the provision of continuing education, advocacy, information and career support on behalf of its members. Most CFA UK members have earned the Chartered Financial Analyst® (CFA®) designation, or are candidates registered in CFA Institute's CFA Program. Both members and candidates attest to adhere to CFA Institute's Code of Ethics and Standards of Professional Conduct.

CFA Institute is the global association for investment professionals. It administers the CFA and CIPM curriculum and exam programs worldwide; publishes research; conducts professional development programs; and sets voluntary, ethics-based professional and performance-reporting standards for the investment industry. CFA Institute has more than 100,000 members in 140 countries, of which more than 90,000 hold the Chartered Financial Analyst (CFA) designation.