SwissHoldings

Verband der Industrie- und Dienstleistungskonzerne in der Schweiz
Fédération des groupes industriels et de services en Suisse
Federation of Industrial and Service Groups in Switzerland

30 May 2014

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

Comment Letter on Post-Implementation Review (PIR) – IFRS 3 Business Combinations

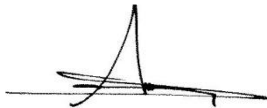
Dear Sir/Madam,

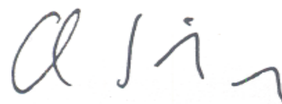
SwissHoldings, the Swiss Federation of Industrial and Service Groups in Switzerland, represents 58 Swiss groups, including most of the country's major industrial and commercial enterprises. We very much welcome the opportunity to provide comments to the PIR on IFRS 3 Business Combinations. Our response (in the appendix) has been prepared in conjunction with our member companies.

We thank you for the opportunity to submit our comments on your proposal.

Yours sincerely

SwissHoldings
Federation of Industrial and Service Groups in Switzerland





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APPENDIX

ANSWERS TO SPECIFIC QUESTIONS IN INVITATION TO COMMENT

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) *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).*

Companies represented by SH have been working in an IFRS environment for many years and so have experience of using both the 2004 and 2008 versions of IFRS 3. The comments below have been prepared in conjunction with senior finance staff of member organizations who are involved in the preparation of our member companies' consolidated financial statements which are usually prepared under IFRS.

Question 2 – Definition of a business

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

There are some benefits for having separate accounting treatments for intellectual property (IP) acquired via business combinations and single asset acquisitions as clearly, business combinations are more complex and permit the recognition of goodwill in addition to separately recognizing intangible assets acquired. However, we do not agree that there should be different accounting treatments for intangible assets e.g. IP acquired via a business combination and assets acquired separately as this is difficult to explain to non-specialists, the Board of Directors of our member companies and the users of the consolidated financial statements of our member companies. Given the substantial differences between the two accounting models as outlined in the table below, there will always be situations in which the accounting differences will have to be explained. The current two approaches give scope to designing specific structures to exploit the extensive accounting arbitrage between the two models which brings the IFRS standard setting into question. Furthermore, the current accounting model for business combinations is overly complex so we would support a simplification in the direction of the current model for asset acquisitions (IAS 38) as outlined in the table below.

A main concern is the accounting for contingent consideration. This is not specifically addressed in the PIR. Our views on this are outlined in our response to Question 3.

In any case, in those circumstances where the subsequent measurement of contingent consideration liabilities is directly linked with the evolution of an increase in value of a related asset e.g. an in-progress R&D project, any payment resulting from the contingent consideration (the liability) should be recognized as an increase in value of the underlying asset. Current IFRS 3 (2008) has created an "accounting mismatch" as the liability and the related asset are not subsequently measured on the same bases.

Difference	**Asset Acquisition**	**Business Combination**
Contingent consideration	Generally, record when condition is fulfilled. Recognize subsequent payment as a component of the cost of the asset if it represents an amount that can be capitalized.	*Current IFRS 3* Record at acquisition-date fair value and record subsequent changes in fair value through earnings if classified as a liability. *Proposal* Use asset acquisition model. If this approach is not accepted, allow changes in fair value to be recognized as an adjustment to the related asset in the "accounting mismatch" situations.
Intangible assets, including goodwill	Recognize intangible assets but do not recognize goodwill.	*Current IFRS 3* Recognize intangible assets at fair value if they meet the identifiable criteria. Recognize goodwill as a separate asset. *Proposal* Retain current IFRS 3 as goodwill not usual in asset acquisitions.
Deferred taxes	Initial book and tax values generally are the same therefore typically no initial deferred tax required to be recognized. Even if there is a difference, no deferred tax is recognized as an exemption under IAS 12 applies.	*Current IFRS 3* Record most temporary book/tax differences for assets acquired and liabilities assumed with an offsetting entry to goodwill. *Proposal* Reconsider inclusion of the tax amortization benefit (TAB) by allowing it to be also included in value in use calculations. If the TAB is retained in determining fair value, allow deferred tax on book/tax difference of related asset to be discounted to reflect mechanism used to produce the TAB.
Acquired contingencies	Record when probable and reasonably estimable.	*Current IFRS 3* If fair value is determinable, recognize and measure at fair value at acquisition date or during the measurement period. Otherwise, record when probable and reason-

Difference	Asset Acquisition	Business Combination
		ably estimable. *Proposal* Use asset acquisition model.
Transaction costs	Record as a component of the consideration transferred to acquire the group of assets.	*Current IFRS 3* Expense as incurred. *Proposal* Use asset acquisition model.

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?*

i) *Definition of a business*

IFRS 3 (2008) as compared to IFRS 3 (2004) has broadened the definition of transactions that should be considered as a business by adding the notion of “capable of being conducted” as a business. As a consequence we see a tendency to consider certain agreements, such as those concerning licensing activities, as potentially being treated as a business. We consider that it was not the aim of the standard setters to broaden the definition of a business to such an extent that almost any acquisition of a group of assets be considered as a business.

According to IFRS 3 (2008), a business is an integrated set of activities that is capable of being conducted and managed for the purpose of providing a return. Operationally, a business consists of inputs, outputs and processes. Not all these three components need to be present but any missing component must be available to a market participant either due to the market participant owning the missing component or being able to acquire them in the market.

Given this, the definition of a business with the notion of “capable of being conducted as a business”, when applied to a “process” which, when applied to inputs have the ability to create outputs, is therefore problematic. For example, in an acquisition of a limited portfolio of assets such as intellectual property (IP) (e.g. rights to develop a specific molecule in the pharmaceuticals industry, or the acquisition of technology under development in other industries), usually, an acquirer in the same industry would have the ability to commercialize these assets. The transfer of technology would normally represent the input and processes that another market participant in the industry could turn into marketable products. This is especially true if some key personnel who are employed by the acquiree and who work on the molecule prior to the acquisition are transferred. Given this scenario, does the combined transaction (employment of key personnel and acquisition of IP rights) fall within the scope of IFRS 3? We would think, yes. And therefore IFRS 3 accounting would apply.

Would this be the case if no employees were transferred? We would think, no and therefore IAS 38 would apply.

Such transactions usually include the agreement to pay significant milestone payments (contingent considerations) in the case of successful development of the molecule. So whether or not such transactions are classified as business combinations increases the importance of the definition of a business in such situations.

We suggest that more guidance be given on the relevance of the factors listed below to determine whether a business combination exists or not.

	Factor	Relevant for a business combination?	Comment
1	Assets or share acquisition	?	The acquisition of shares that transfer the control of an entity is a primary factor for considering that a business combination exists, but this may be rebutted. In our view, more guidance is required. *(see comment below)*
2	Employees	Yes	The transfer of employees is a relevant indicator to consider that processes are included in the assets transferred.
3	Manufacturing facilities	Yes	Usually the transfer of a manufacturing facility implies the transfer of employees. In this case, we consider that the definition of a business is reached.
4	Goodwill/ negative goodwill	?	BC 12 implies that this is an important factor. This needs further assessment.
5	Portfolio of assets, especially intangible assets (eg early stage development IP, customer lists, patents etc)	?	Further guidance is required to assess at what point enough components have been transferred to enable a market participant to commercialize the assets as required for a business combination.
6	Inventories	No	It should be specified that the inclusion of inventories in a group of assets acquired does not automatically imply that the group of assets is a business.
7	Contractual arrangements and outsourcing of key processes	No	This factor is linked to the development stage: guidance is required that acquiring a marketed product may imply that some contractual arrangements may be included in the group of assets transferred. This does not imply automatically that the group of asset is a business.
8	Use of developed technology	No	Guidance is required concerning using a technology owned by a third party and whether or not exclusivity and the period over which that technology can be used is an important factor to consider. We consider that a developed technology can be transferred without the transaction being a business.
9	Existence of assumed liabilities or contingencies	No	Guidance is required that the transfer of an asset with its associated risk (for instance remediation risk related to a piece of land) does not automatically qualify as a business combination.

If the factors listed above were all taken into consideration in determining whether a group of assets are a business, this would mean, without much exaggeration, that the only transaction that could qualify for an asset acquisition would be the acquisition of goods for trading activities.

For example using Appendix B B8, raw material could be considered as a business, because raw material could be “integrated in the acquirer’s own input and processes” by a market participant to produce outputs. This description clearly needs clarification.

Furthermore, we recommend elimination of paragraph B9 related to the stage of development of new businesses as this implies for example in the pharmaceuticals industry that the acquisition of a one product biotechnology with a product in development is already a “business” whereas the larger pharmaceutical company may consider the substance of the transaction to be a single product in development.

Similarly, we also recommend that paragraph B11 related to the capabilities of producing output for any market participants is eliminated or at least clarified. As indicated above, this potentially results in the acquisition of any IP by a larger player in the industry being classified as a business combination.

These paragraphs extend the definition of a business beyond what is reasonable.

ii) Are acquisitions via share deals by default “business combinations”?

Further guidance is required as to whether or not acquisitions via share deals are by default business combinations. Acquiring a company brings with it certain attributes which acquiring the same assets via a direct purchase do not. These are, principally but not exclusively, related to the potential tax consequences for both the seller and acquirer. Another factor that is important in a share deal is the different legal situation concerning prior activities related to the assets included in the legal entity. Furthermore, even if the acquired entity only includes limited assets, such as intellectual property (IP) (e.g. in the pharmaceuticals industry rights to a specific molecule or in the software, publication and other industries patents or copyrights) valuation of the acquired assets at the required fair value taking into account the related deferred tax consequences will often generate goodwill. Appendix B of IFRS 3 para B12 states that “in the absence of evidence to the contrary, a particular set of assets and activities in which goodwill is present shall be presumed to be a business combination.”

This would seem to imply, coupled with the points raised above that an acquirer of intellectual property typically has the means to turn the acquired assets into saleable products, that there is a (rarely) rebuttable presumption to be overcome that all share deals *per se* are classified as business combinations. This point therefore requires further clarification.

Question 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?

There are several aspects related to the required fair value measurement under IFRS 3 where improvement is required of which the principal items are:

- Do the fair value requirements produce relevant information?

Many preparers find that the required fair value measurements produce information that is of little value to their users, especially when it comes to the impact on their reported performance. This has resulted in many preparers needing to prepare non-IFRS “core” income statement data that eliminates the income statement impact of the additional depreciation and amortization that arise from the fair value approach required under IFRS 3 for Business Combinations.

It is accepted that management of entities that enter into significant acquisitions need to be held accountable to their stakeholders for their acquisitions, however, this should not enter into the

performance measurement of the entity in such a prominent way. We suggest that the Board therefore needs to address this point as part of its assessment of the adequacy of current financial statement presentation approaches.

Especially for those industries which do not capitalize significant amounts of development costs due to regulatory and other commercial challenges which make the resulting outcome of future economic benefits uncertain, IFRS should allow a performance measurement approach that eliminates the distortion that acquisitions bring to the income statement. This would better enable a comparison of entities within the same industry that have performed few acquisitions with those that have performed many.

- Does it make sense to use different measurement requirements for contingent consideration and contingent liabilities compared to measurement requirements outside of a business combination?

The valuation approaches required under IFRS 3 for both accounting for contingent consideration and contingent liabilities are different in a business combination scenario compared to situations outside of a business combination.

Contingent consideration

In the case of contingent consideration, as outlined above, an approach is required that not only results in a different initial measurement basis but also in a different accounting approach to amounts finally paid. As indicated below, there is often a difference in treatment from an income statement and asset recognition perspective.

The accounting treatment of contingent consideration is defined in the paragraph 58 of IFRS 3 as follows:

Some changes in the fair value of contingent consideration that the acquirer recognises after the acquisition date may be the result of additional information that the acquirer obtained after that date about facts and circumstances that existed at the acquisition date. Such changes are measurement period adjustments in accordance with paragraphs 45-49. However, changes resulting from events after the acquisition date, such as meeting an earnings target, reaching a specified share price or reaching a milestone on a research and development project, are not measurement period adjustments. The acquirer shall account for changes in the fair value of contingent consideration that are not measurement period adjustments as follows:

(a) Contingent consideration classified as equity shall not be remeasured and its subsequent settlement shall be accounted for within equity.

(b) Other contingent consideration that:
   (i) is within the scope of IFRS 9 shall be measured at fair value at each reporting date and changes in fair value shall be recognised in profit or loss in accordance with IFRS 9.
   (ii) is not within the scope of IFRS 9 shall be measured at fair value at each reporting date and changes in fair value shall be recognised in profit and loss.

We note that paragraph 58 has been reviewed recently to take out the mention to IAS 37 that was initially included in IFRS 3 (2008). It is interesting to underline that the criteria to understand in which circumstances contingent consideration fall into IFRS 9 (b i above) and in which circumstance they do not fall in IFRS 9 (b ii above) have still not been defined. However, paragraph 58 states clearly that all changes in fair value should be recognized in profit and loss whether the liability is a financial liability or not.

In our opinion this paragraph should be modified in order to solve the issue that many preparers are facing and that is that under circumstances outside of a business combination, payments to

the previous owners of the same underlying assets that have been acquired in the business combination would be capitalized as assets and would not be expensed.

This issue concerning the subsequent measurement of contingent consideration recognized as a liability was addressed during the development of the standard as IFRS 3R.BC 357 states that:

"Except for adjustments during the measurement period to provisional estimates of fair values at the acquisition date, the boards concluded that subsequent changes in the fair value of a liability for contingent consideration do not affect the acquisition-date fair value of the consideration transferred. Rather, those subsequent changes in value are generally directly related to post-combination events and changes in circumstances related to the combined entity. Thus, subsequent changes in value for post-combination events and circumstances should not affect the measurement of the consideration transferred or goodwill on the acquisition date. (The boards acknowledge that some changes in fair value might result from events and circumstances related in part to a pre-combination period. But that part of the change is usually indistinguishable from the part related to the post-combination period and the boards concluded that the benefits in those limited circumstances that might result from making such fine distinctions would not justify the costs that such a requirement would impose.)"

- The paragraph above in parenthesis shows that the Board has looked at the issue, but did not understand how pervasive the issue is.
- Experience has shown that the circumstances in which the issue arises are not "limited" as stated above but are indeed systematic in business combinations, especially those involving acquisitions related to intellectual property that is under development.
- The "fine distinctions" needed to distinguish post acquisition changes related to specific pre-existing assets versus other post acquisition changes is in our view not that complex to perform and is increasingly acknowledged as resulting in an "accounting mismatch".
- The cost/benefit argument should not be used as a factor for ignoring this issue. It is now the appropriate time as part of this post implementation review to perform the analysis and correct this matter.

The definition of accounting mismatches is included in the current IFRS literature. "Accounting mismatches" are measurement or recognition inconsistencies that arise from recognizing or measuring assets and liabilities or recognizing the related gains and losses on different bases. "Accounting mismatches" should be distinguished from "economic mismatches". We find the definition of those two types of mismatches in IFRS 4 BC172 and BC173:

"(a) Accounting mismatch arises if changes in economic conditions affect assets and liabilities to the same extent, but the carrying amounts of those assets and liabilities do not respond equally to those economic changes. Specifically, accounting mismatch occurs if an entity uses different measurement bases for assets and liabilities."

(b) Economic mismatch arises if the values of, or cash flows from, assets and liabilities respond differently to changes in economic conditions. It is worth noting that economic mismatch is not necessarily eliminated by an asset-liability management program that involves investing in assets to provide the optimal risk-return trade-off for the package of assets and liabilities.

Several cases of "accounting mismatch" can be found in the current IFRS standards or projects (whether this wording of "accounting mismatch" has been used or not) such as in IFRS 9, IAS 40, IFRIC 1, the current projects on Insurance and Leases. In all cases the accounting treatment to solve the accounting mismatch is identical: the recognition or measurement of an asset and its linked liability is done on the same basis.

We request that this is introduced as the solution for the contingent consideration mismatch.

Contingent liabilities

The initial measurement of contingent liabilities in a business combination uses a different approach compared to the IAS 32/39 requirements outside of a business combination. We do not see why there should be a different measurement basis for contingent liabilities which are acquired as part of a business combination compared to situations outside of a business combination.

This adds to confusion both with senior management of our member organizations, as well as with users of the consolidated financial statements of our members.

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?

As preparers we focus on the first part of this question.

We wish to highlight the following challenges:

- Allocation of purchase price to acquired inventory and acquired intangible assets are interconnected

Acquired inventory is required to be valued at fair value which is the selling price to be received by the acquiree less a normal distributor's margin. Acquired intangible assets such as acquired marketing rights are typically valued using an excess earnings approach which recognizes both the acquiree's manufacturing, marketing and distribution margins. This results in the acquiree's manufacturing and marketing margins being included in both the fair value of acquired inventory and the value of the acquired marketing rights. In order to avoid this double count an adjustment is usually made to the value of the intangible assets. However, this double count is not considered in the amortization of the intangible asset and inventory. This is because IAS 38 currently requires that acquired intangible assets, which are available for use should be amortized from the date of acquisition using the basis that will be used for the useful life of the intangible asset. Charging the income statement with both the fair value of the acquired inventory through costs of goods sold and an amortization charge for the acquired marketing rights results in the income statement being charged twice for the same valuation components related to the manufacturing and marketing margins and therefore distorts and lowers the income statement results until all the acquired inventory has been sold.

The Board should clarify that it is not its intention to distort the income statement of the acquirer by, in effect, charging part of the amortization twice until all the acquired inventory has been sold and should therefore propose a solution to avoid this double counting. This could be achieved, for example, by allowing the amortization of those intangible assets which need to be included in the fair value of acquired inventory to commence only after the acquired inventory has been sold, in order to eliminate the double counting of the intangible asset component included in the acquired inventory valuation and the amortization charge.

- Obtaining consistency between valuation approach for initial valuation of intangible assets and subsequent impairment testing

Another significant challenge is the valuation model used for the purchase price allocation used in the opening balance sheet of the acquiree compared with the valuation model used for impairment tests. Independent professional valuation appraisers often use the excess earnings model for the initial purchase price allocation whereas many of our member companies often use the discounted cash flow model for impairment testing purposes. In particular the adjustments made to the post tax earnings to get to cash flows or excess earnings differ between the models. These differences are usually not value neutral, which we consider to be an issue. Therefore the Board should explore whether additional guidance could help to harmonize the valuation models.

We suggest that the Board works together with the organization of independent appraisers to produce implementation guidance so as to harmonize the appropriate valuation approaches on initial recognition of the assets at fair value and in subsequent period's impairment tests.

Question 4 – Separate recognition of intangible assets from goodwill and the accounting for negative goodwill

a) *Do you find the separate recognition of intangible assets useful? If so, why? How does it contribute to your understanding and analysis of the acquired business? Do you think changes are needed and, if so, what are they and why?*

As indicated above, many internal and external users of the consolidated financial statements find that the result of amortizing and depreciating the separately identified assets measured at fair value is of limited value and even distorts the subsequent reporting of the performance of the enterprise. As long as this approach is maintained, the distortion of the enterprise's performance needs to be addressed with urgency in a separate IFRS Presentation project.

Although we can accept that there is some value in determining the identified net asset components of the purchase price, we remain unconvinced of the cost/benefit of the required valuations which usually need to be performed with the assistance of external professional appraisers.

Furthermore, assuming that the current approach of separately valuing identified intangible assets is retained, we do not understand why certain intangible assets, such as the value of the assembled work-force that is acquired, cannot be separately valued whereas a value is required to be placed on customer relationships. We consider that similar assumptions could be used to value both these types of intangible assets. Clarification should be provided why there is a difference in approaches between these two types of intangible assets.

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*?

As indicated above there is substantial cost involved in identifying the separately identified assets especially in the area of intangible assets. In many industries, for example where a remaining patent or copyright-period determines the useful life and amortization period of the identified intangible assets, IAS 38 allows use of a simplified composite approach and value just one composite intangible asset combining the value of the patent or copyright, marketing and customer relationship intangible assets.

In order to minimize the costs of separately valuing acquired assets, especially intangible assets arising from intellectual property rights it would be useful to have more implementation guidance on what are acceptable simplification methods.

c) *How useful do you find the recognition of negative goodwill in profit or loss and the disclosures about the underlying reasons why the transaction resulted in a gain?*

We consider that there might be a few bargain purchase transactions with negative goodwill, but do not consider the recognition of a gain on day one is justified. We consider that where negative goodwill is calculated that there should be a rebuttable presumption that the gain arises from an inappropriate calculation of the individual fair values of the identified net assets. The negative goodwill amount should therefore be used to proportionately reduce the net asset base (as in the separate acquisition of an asset) and not be treated as a day one gain. We accept that for indefinite life intangible assets, the "lower" value will only be reflected in the income statement, if the asset is impaired.

Question 5 – Non-amortisation of goodwill and indefinite-life intangible assets

a) *How useful have you found the information obtained from annually assessing goodwill and intangible assets with indefinite useful lives for impairment, and why?*

There is a substantial cost involved in producing impairment tests. These are especially burdensome for complex organizations with many business units, and even more so for smaller organizations.

Similarly the impact of charging the income statement with any related impairment expense distorts the performance of the period.

Non-amortization of goodwill is considered questionable, in particular for acquisitive enterprises, as there is a tendency for the balance sheet to show increasing amounts of goodwill. There must come some point in the future when a limit is reached as to how much is appropriate for a given enterprise and, conceptually, how much of the original goodwill still exists decades after an acquisition. Considering also that the income statement is seen as the primary indicator of performance and custodianship, in our view a systematic charge in the income statement for amortization of goodwill more accurately reflects the consumption of benefits obtained through acquisitions, rather than an impairment-only approach which is perceived as the cost of failures of the business plan.

Consequentially it is preferable to have a systematic amortization approach.

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

We believe that sufficient information on the assumptions and approach are required by the current standard. Disclosure of additional details could result in disclosing additional forward looking information which we consider not appropriate.

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

A major cause of complexity in testing for impairment is the requirement to assess not only the fair value less cost to sell of an asset but also its value in use. We consider that the value in use model of IAS 36 is poorly understood and requires more implementation guidance.

Areas of particular challenge are:

- the requirement to use a pre-tax discount rate in a value in use calculation is poorly understood. The rate itself is also extremely difficult to calculate and needs more implementation guidance.
- the requirement to exclude enhancements to the current status of the asset requires that special cash flow calculations need to be produced just for impairment testing purposes. This significantly increases the cost of conducting the impairment test and also produces values which are not consistent with management's best expectations or with the actions that a market participant would likely take. Considering that the definition of a business considers hypothetical actions that a market participant could take to integrate it into their own outputs and processes, it seems incoherent that highly likely planned actions (often to integrate the business into the acquirer) are excluded from a value in use calculation.

Question 6 – Non-controlling interests

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

We consider that the information resulting from the current IFRS 3 presentation and measurement requirements for NCI's to be acceptable, particularly if this is determined based on the proportionate share of the recognised amount of the acquiree's identifiable net assets. For the reasons mentioned in the following answers to this sub-section we do not consider that an approach trying to reflect the "fair value" of the NCI to be an improvement.

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.*

If the fair value measurement option was chosen, challenges may arise in the determination of the fair value of quoted NCI. This is because IFRS 13 seems to require the fair value to be based on the share price without considering any kind of premium or discount. In particular on the acquisition date of the majority stake as a result the quoted per share price of any outstanding NCI might be distorted.

Question 7 – Step acquisitions and loss of control

a) *How useful do you find the information resulting from the step acquisition guidance in IFRS 3? If any of the information is unhelpful, please explain why.*

The recognition of a gain on a previously held equity interest (PHEI) is controversial, in particular its measurement.

In a step acquisition with a remaining non-controlling interest, the fair value of the PHEI is not necessarily the price per share paid for the controlling interest (as acknowledged by IFRS 3.B45) but also not necessarily the price of the outstanding shares which might be impacted by market speculation. This is especially the case where the acquirer wishes to "squeeze-out" the remaining non-controlling interest and needs to pay a premium to do this. For example if an entity acquires a 30% stake in a first step and then another 60% stake in a second step. Should market expectation of a premium for the outstanding 10% remaining NCI or the actual premium agreed to be paid be used to value the gain on the initial 30% PHEI as currently required under IFRS 13? We consider that the valuation of the initial minority interest PHEI and gain to be recorded as part of the total consideration for obtaining control, is unrelated to the value of the final NCI. This is because the per share price an acquirer would have been prepared to pay, if it had to acquire 100% of an entity in one step, will not be equal to the per share price it paid to acquire 60% plus the price paid in a potential squeeze out of the outstanding 10% NCI. In a step acquisition the acquisition of the controlling interest usually comprises the entire control premium, whereas the acquisition of the initial non-controlling interest typically does not include a premium. In a 100% acquisition the entire premium should therefore be allocated to 100% of the shares not just 60% plus 10% as in the example above. If the price paid per share for the 60% plus 10% interests is applied to the PHEI it results in a per share value and therefore gain on the PHEI which is totally inappropriate.

We consider that the PHEI should be considered as a unit of account which takes into account that it is a block of shares with limited rights and a value typically based on its future dividend streams and should not be valued based on the final price paid or expected to be paid for the last few shares as part of the "squeeze-out" as this often will have the highest premium and per share value.

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?*

We believe it is appropriate to measure a retained interest at its fair value at the time of loss of control. However, the IASB needs to address subsequent measurement approaches for the retained interest. At present there is an inconsistency as a retained interest that is not an associated company or joint venture is measured at fair value whereas this is not the case for an associated company or a joint venture where equity accounting is applied.

Question 8 – Disclosures

a) Is other information needed to properly understand the effect of the acquisition on a group? If so, what information is needed and why would it be useful?

The existing disclosure requirements are extremely exhaustive and do not require further expansion.

b) Is there information required to be disclosed that is not useful and that should not be required?

We consider that especially the requirement of paragraph B64 (q) (ii) to basically disclose pro forma data as if the business combination transaction had been consummated at the beginning of the reporting period to be particularly onerous and should be eliminated.

In our view, the usefulness of the IFRS 3.B64(e) qualitative disclosure of the reasons for goodwill is limited because disclosures will tend to be general rather than specific. The commercial strategy that supports an acquisition including the value of any goodwill is often complex and difficult to summarize concisely.

We would challenge the IFRS 3.B64(k) requirement to disclose how much goodwill will be tax deductible. This often cannot be quantified until negotiations with affected tax authorities, which may be protracted, have been completed. Goodwill is only one of the elements recognized in acquisition accounting and we would question the relevance of singling its tax deductibility out for disclosure. As the scope of the required disclosure does not include the expected timing of tax deductions, its value to financial statement users is in any case limited.

There are other minor details for which it is debatable whether separate disclosure is needed such as details on acquired accounts receivables.

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

There are no particular challenges in preparing this information.

Question 9 – Other matters

Are there other matters that you think the IASB should be aware of as it considers the PiR of IFRS 3?

The IASB is interested in:

a) understanding how useful the information that is provided by the Standard and the related amendments is, and whether improvements are needed, and why;

As explained above, we have considerable reservations about the relevance of much of the accounting and disclosures required by IFRS 3.

b) *learning about practical implementation matters, whether from the perspective of applying, auditing or enforcing the Standard and the related amendments;*

If a business combination settles a pre-existing relationship, the settlement should be considered a separate transaction and any gain or loss should be recognized in the profit and loss statement under IFRS 3.52. Any situation where an enterprise acquires its in-licensing partner is a situation in which an in-licensing contract is settled.

In several industries, eg pharmaceuticals, such a transaction would typically be due to a favorable development of the in-licensed compound such that the settlement of the in-licensing agreement results normally in a gain.

Guidance is needed as to how to determine the gain. Typically the change in value is reflected in a higher royalty rate, which would have to be paid, if a compound is in-licensed at a later stage of the development process. Therefore the valuation approach used in these circumstances would use the "relief from royalty method" – as a result there are two possible interpretations:

- Option 1 would be to use market rates at the date of the business combination for royalties for in-licensing a similar compound at the same stage of the development the acquired compound was in when it was in-licensed should be considered as a benchmark.
- Option 2 would value using the rate which would be paid for in-licensing a similar compound at the same stage of the development as the acquired compound was in when it was in-licensed, but knowing that the development will progress successfully to the stage which this compound is in at the date of the business combination, should be considered as a benchmark. Such a rate is not observable on the market as there are no development projects for which successful progression of development is certain.

Which approach should be used is the subject of much debate in the impacted industries.

We consider that option 1 is the preferred solution as option 2 in effect results in recording an additional gain which to some extent is a recovery of previously expensed development costs and therefore is not appropriate.

Additional guidance is required as to how to interpret and implement the guidance in this section of IFRS 3 so as to avoid unintended consequences.

c) *any learning points for its standard-setting process.*

The significant differences between the accounting for a single asset acquisition and a business should have been considered more thoroughly during the standard setting process and we encourage the Board to address this as a matter of urgency.

Question 10 – Effects

From your point of view, which areas of IFRS 3 and related amendments:

a) *represent benefits to users of financial statements, preparers, auditors and/or enforcers of financial information, and why;*

As mentioned above, many aspects related to the allocation of the purchase price add complexity and cost to accounting for business combinations and have only limited benefits to the users of the resulting consolidated financial statements.

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

The assessment of the initial fair value both of contingent consideration and identified net assets can be complex and costly.

Some of our members, particularly those subject to SEC review, have had extensive questions from regulators concerning the assumptions and approaches that have been used. This despite the fact that reputable appraisers and auditors have been involved and many of the topics have been extensively discussed internally with their respective senior management and audit committees. These challenges have all resulted in substantial internal and external costs even if the approaches used by our members have finally been accepted.

Areas that have been challenged include:

- use of pre or post tax discount rates
- approach to valuing previously held equity interest and resulting gain recognition
- approach to minimize the impact of double counting of expenses in the income statement during the period when acquired inventory is consumed

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

As highlighted above there is a very substantial unfavorable impact of business combination accounting compared to asset acquisition accounting especially where contingent consideration is involved. This often leads to attempts to restructure the contractual terms of a transaction to avoid business combination accounting as much as possible. This is not considered good for the image of IFRS.