



EFFAS THE EUROPEAN FEDERATION OF FINANCIAL ANALYSTS SOCIETIES

IASB – International Accounting Standards Board
IFRS – International Financial Reporting Standard

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Exposure Draft: *Post-implementation Review: IFRS-3 Business Combinations*

Comments by the European Federation of Financial Analysts Societies (EFFAS) Commission on Financial Accounting (FAC)

Dear Madam, dear Sir,

EFFAS Commission on Financial Accounting is pleased to share with you the views of European users regarding the *Post-implementation Review of IFRS-3 Business Combinations*. To draw these comments FAC has held discussions between its members and other analysts in their respective constitutions. Based on this, FAC has decided to focus on what considers being the main issues that need to be addressed and for which users would contemplate improvements.

As we did previously we would like to encourage the IASB to continue developing the Standards avoiding complexity. We believe that given the technical nature of the Standards this approach would most certainly lead to a more homogenous understanding. Clear and comparable examples are always useful for users.

Questions

Question-3: Fair-Value measurement

As analysts we support the fair value approach that is being applied in IFRS-3. Nonetheless, in many cases the allocation of the purchase price to the individual assets acquired and liabilities assumed is subjective. This causes that users repeatedly question fair value attributed to assets acquired and liabilities assumed as recognized by the acquirer.

Despite our support of the fair value, we still would like to express a couple of concerns.

One concern relates to the fair value of inventory. In certain companies the fair value of an acquired inventory could include a margin exceeding normal selling costs. If the size of the inventory is material the effect can be that the margin for quite some time after the acquisition date will be lower than normal, hence not faithfully reflecting the operational performance of the group. As operating margin is one of the most important variables, in particular with regard to profitability and hence valuation, we would like to see this effect on the profit margin, if material, explicitly disclosed. We also think that from this perspective and to limit a negative impact on the operating margins it would be advisable that the Standard provides guidance as to the fair value of inventory in a Business Combinations.

An additional concern relates to intangible assets. IFRS-3 allows the acquirer to recognize intangible assets that had not been previously recognized by the *acquiree*. For instance some of the newly created intangibles like customer relationships may have a limited lifespan. We understand that in the absence of a requirement to amortize goodwill it makes sense not to subsume certain intangibles with a limited lifespan into goodwill.

Estimating fair values for intangible assets acquired in a Business Combinations is a costly exercise for preparers and its advantage can be questioned. It is our experience as analysts that we rarely look at the values accounted for. An exception would be for those intangible assets for which a reliable measure of fair value can be attained.

A third aspect on the fair value requirement relates to gains from bargain purchases. We are aware that there can be cases where the “net” fair value of the assets acquired and liabilities assumed can exceed the purchase price. However, we believe such cases are rare and not that many have been encountered in practice. As an example, we do not understand when a shipping line acquires another shipping line and the acquirer is often able to get an independent valuation to certify that the fair value of the ships exceeds the purchase price. It is difficult for us to understand that this should be possible in competitive markets with several competitors. Thus, what we would like to see a limit to the recognition of a bargain purchase to those cases where the fair values can be ascertained by prices set in active markets.

As a final comment we would suggest that when determining the fair value of the acquired entity contingent considerations are not included

Question-5: Amortization of goodwill and impairment test

As mentioned in point (b) regarding the information provided by the impairment approach, our starting point is to argue on how the impairment test has been implemented since the standard was adopted ten years ago. Our experience is that the information provided by this test is insufficient for users of financial statements to assess whether or not the main inputs considered are reasonable.

In many cases the disclosed assumptions are boilerplate information and when companies disclose assumptions like discount and infinite growth rates this level of disclosure is limited to assess whether or not the goodwill should be written down.

Our experience is that when companies base their value on DCF analyses, the impairment test is based on management assumptions that can be rather optimistic in order not to recognize impairments. However, a sensitivity analysis would be helpful and not only when the fair value is close to the book value.

A practical point is that when information related to a goodwill impairment is recognized and the acquirer accepts that the investment was overpaid it comes very often years after the market became aware of the underperforming investment and therefore it fails to provide new information.

At the same time, we feel that asking for disclosure of sensitive business plans for each cash-generating unit to which goodwill has been allocated is an unrealistic demand.

Firstly, this kind of disclosure would increase significantly the size of notes which is not a priority from a users' perspective. This is particularly true for large groups where the number of cash-generating units can be higher than the number of operating segments identified in the financial statements. Secondly, we believe that it would end disclosing sensitive information for each business concern and this could clearly become a dangerous approach for companies not to mention potential regulatory and compliance issues. Thirdly, we think that even if such a level of disclosure was to be required, users will simply end with a much larger amount of boilerplate information.

We would also like to stress a key conceptual point regarding the impairment test. Once acquired goodwill is allocated to a cash-generating unit, it is then reviewed periodically for possible impairment. But the test in fact compares the acquired goodwill with the goodwill recreated by the group since the new subsidiary has been acquired and the goodwill previously created by the group in the same cash-generating unit and never recognized in the books of the group. This situation makes the impairment test unable to guarantee that the goodwill acquired is not overvalued.

We would like to add that the test fundamentally causes confusion between goodwill acquired with a business and the goodwill recreated for this business since it was acquired, a point that is inconsistent with the current framework preventing groups to recognize their own goodwill.

Finally, a crucial argument for not amortizing goodwill is that the useful lifespan is indefinite and might be difficult to be assessed. As users, we have difficulty in accepting such an argument. We believe that many assets have useful lifespan that can be determined. For instance when a new generation of machines and equipment is acquired, management can make a reasonable and educated guess on the useful lifetime of the assets.

In concluding we believe that in many cases the impairment test has become a subjective exercise providing insufficient relevant information to users. We should however recognize its merits when valuing assets acquired and goodwill created that is supposed to generate cash. Thus, the current impairment test should be improved and probably co-exist with an amortization mechanism for intangible assets.

We thus recommend (1) reviewing the basis for applying the impairment test particularly reducing subjective assumptions and (2) consider re-introducing an amortization mechanism for well-defined intangibles. It should be considered and preferred by users that for assets such as trade-marks and selling and manufacturing licenses, among others, an amortization period with a limit of between 15 and 20 years is recognized.

Additionally, it is suggested that a proper disclosure separating goodwill amortization from the rest of the depreciation and amortization items is reported in the income statement. This separate disclosure would also be necessary in the segment reporting information.

Question-7: Step-acquisition

Regarding point (a) the standard requires information which we believe causes some counterintuitive effects. Requirements such as (a) recording a capital gain when taking control of a company in which the group already holds a minority stake, (b) reducing ownership from 100% to 51% in a subsidiary at a lower price than acquired and recording no losses and (c) destroying equity, partially, in the parent company when buying-out a non-controlling interest at a price significantly higher than its book value provides no useful information for analysts.

We however, as most analysts, do not consider capital gains resulting from lowering ownership in a controlled subsidiary as performance. This type of capital gain is considered as a *one-off* result and will be excluded for valuation purposes. In fact we would prefer to account for such a capital gain or capital loss, as it might be more appropriate, than for the current counterintuitive effects generated by the standard. Most analysts would exclude this accounting effect from performance valuation.

Question-8: Disclosures

Although IFRS-3 requires an entity to disclose quite a lot of information related to Business Combinations, we have witnessed that the information presented is often disseminated in the financial statements. In fact it is sometimes difficult to have a good understanding of the total consideration paid. How the information on the Business Combinations is presented is a key element for analysts as it adds to the understandability of the transaction. The *added value* of the Business Combinations to the group's performance going forward, the assets recognized, the liabilities assumed and all the other relevant information with regard to the transaction should be reported in a more cohesive basis to facilitate a clear understanding of the Business Combinations. This information integrated in a specific section should be an approach to be considered. Additionally timing of disclosures is crucial given stock prices sensitiveness to companies' Business Combinations announcements.

Finally, we would like to stress that FAC views expressed in this letter largely coincide with other analysts' opinion based on the research undertaken in the second quarter with EFRAG and your technical team. In fact, we consider that IFRS-3 disclosures are sufficient in terms of information although as noted the Standard should be strengthened as to the way the information is presented. Moreover, information provided should be material in contrast with compliant and requirements should be more enforceable. A check-list approach should not be contemplated.

If you would like to further discuss the views expressed here-in please do not hesitate to contact us.

Best regards,

Javier de Frutos, Chairman
EFFAS Commission on
Financial Accounting

EFFAS Commission on Financial Accounting

EFFAS was established in 1962 as an association for nationally-based investment professionals in Europe. Headquartered in Frankfurt am Main, EFFAS comprises 27 member organisations representing more than 16,000 investment professionals. The Commission on Financial Accounting is a standing commission of EFFAS aiming at proposing and commenting on financial issues from an analyst standpoint. FAC members are Javier de Frutos (Chairman, IEAF-Spain), Jacques de Greling (Vice-Chairman- SFAF, France), Rolf Rundfelt (SFF, Sweden), Friedrich Spandl (ÖVFA, Austria), Henning Strom (NFF, Norway), Serge Pattyn (BVFA/ABAF, Belgium), Jérôme Vial (SFAA, Switzerland), Ivano Mattei (AIAF, Italy) and Taras Koval (USFA, Ukraine).