Deutsches Rechnungslegungs Standards Committee e.V.
Accounting Standards Committee of Germany

® IFRS-Fachausschuss

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Mr Hans Hoogervorst
Chairman of the
International Accounting Standards Board
30 Cannon Street
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Berlin, 6 June 2014

Dear Hans,

Post-implementation Review - IFRS 3 Business Combinations

On behalf of the Accounting Standards Committee of Germany (ASCG) I am writing to provide our views regarding the Post-implementation Review – IFRS 3 *Business Combinations*. The views expressed hereafter are based on our experience with the application of IFRS 3 in Germany and also reflect our consultation of German constituents on the IASB's Request for Information (RfI) as part of the Post-implementation Review.

The feedback received would lead us to the conclusion that the accounting requirements and guidance introduced with IFRS 3 have not achieved improvements from a cost-benefit perspective in all aspects. Some requirements of IFRS 3 have increased the cost significantly; most entities consult external valuation experts to compile the financial reporting information. We think changes are necessary to address these cost-benefit concerns. We do not consider the alternatives expressed in the RfI (i) to retain IFRS 3 as issued or (ii) to continue to monitor the implementation of IFRS 3 to be viable options.

As the result of the first phase of the Post-implementation Review the RfI lists the areas in which possible unexpected costs or implementation problems were encountered. We generally agree with the identified areas and we focus our comments on the following topics:

- Definition of a business
- Identification of intangible assets
- Measurement of assets and liabilities
- Amortisation of goodwill
- Step acquisitions and loss of control
- Contingent considerations
- Pre-existing relationships

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Additionally, the opportunity to re-evaluate some IFRS 3 guidance in light of the IASB's views and conceptual thinking developed in the – albeit – ongoing *Conceptual Framework* project, particularly the measurement concepts should not be discarded too easily. The timing of the RfI and the Conceptual Framework project does not seem to foster such consideration, nor does the view that differences between Standards and the Framework should be explained when setting new or revising Standards. However, we believe that different concepts in IFRS 3 and a revised *Conceptual Framework* (or other IFRSs) are undesirable and ultimately impair the quality of IFRS.

Definition of a business

We believe the definition of a business as defined in IFRS 3 should be narrowed to address concerns that some transactions are not perceived as a form of business combination by preparers and users. For example, the acquisition of a business without any intention of the acquirer to keep integrated activities should not be accounted for as a business combination, if the main purpose was to acquire a predominant strategic asset. All expected synergy effects would only arise from obtaining the control over that predominant strategic asset.

Furthermore, we believe there is a general need for more guidance and clarification as to what constitutes a business. The clarification should also extend to cross-cutting issues with other IFRSs; for example, the relation between the defined term "business" and the term "operation" (as used in IAS 36 *Impairment of Assets* to address the accounting of a disposal of parts of a cash generating unit to which goodwill is allocated) have led to questions in practice. It is not clear whether an "operation" (IAS 36.86) is considered to be smaller or larger than a "business" as defined in IFRS 3.

Identification of intangible assets

Preparers experienced the identification of intangible assets in accordance with IFRS 3 as extremely challenging and complex. The degree of judgement when identifying and measuring intangible assets, such as brands and customer lists, raises further concerns in practice. There are severe doubts whether the current requirements result in useful information to users of financial statements that justify the related cost, especially if the information is not considered useful by management.

In light of those cost-benefit concerns some preparers recommend changes to the existing guidance in IFRS 3. For example, there are suggestions to address the balance between complexity, objectivity and relevance of information through the implementation of a cluster-based approach identifying classes of intangibles with similar characteristics based on internal management or based on measurement interdependence of intangible assets. Another suggestion

for improving the identification process is the general distinction between wasting and non-wasting assets.

We recommend to the IASB exploring together with users and preparers whether the guidance in IFRS 3 could be improved to address the cost-benefit concerns regarding the degree necessary for identifying intangible assets acquired.

Measurement of assets and liabilities

In our view, the measurement of assets acquired and liabilities assumed in a business combination is the most costly and challenging part regarding the application of IFRS 3, especially the measurement of intangible assets. Preparers indicated the need to hire external valuation expertise to compile the fair value information of highest and best use of the acquired assets by other market participants if the market price is not readily available. In most cases the fair value information is not used further by management and is often considered by preparers being an "artificial" valuation exercise.

Amortisation of goodwill

We learned from constituents that the requirements for impairment testing introduced with IFRS 3 and IAS 36 proved to be very complex in practice and have raised the cost significantly for preparers. The fact that the IASB has chosen an amortisation approach for the IFRS for SMEs for subsequent measurement of goodwill underpins the assumption of larger cost for an impairment-only approach.

Regarding the benefits of an impairment-only approach, we observed general scepticism from German users of financial statements about the quality and usefulness of information relating to the subsequent measurement of acquired goodwill due to the large degree of management judgement. Feedback from preparers confirmed this observation, and in this context they also pointed to the additional, often costly, communication efforts necessary to justify the entity's accounting for goodwill to users.

Furthermore, we believe that most of the synergies included in the recognised amount of goodwill are consumed over time, which would justify an amortisation approach. We even consider that without sufficient reinvestments, synergies and other not individually identifiable economic resources only exist for a relatively short period if the business environment of the entity is very competitive or dynamic. Within this context many constituents in Germany express concerns that most of the recognised amount of acquired goodwill is in practice replaced over time with not recognisable internally generated goodwill. This leads to a de facto discrimination of entities with organic growth compared to entities that grow through acquisitions as the amount and timing of goodwill impairments might differ significantly.

In summary, we received strong feedback that due to the above illustrated issues there is little acceptance of the impairment-only approach in light of cost-benefit considerations. Our predominant impression is that the benefits - justifying the increased cost arising from an impairment-only approach - are not observable in practice. An amortisation of goodwill would not remove the general requirement for goodwill impairment testing. However, especially if the amortisation period for goodwill is relatively short, there is less need for very rigid annual impairment testing; that would ultimately result in cost relief for preparers.

Step acquisition and loss of control

The change introduced to IFRS 3 in 2008 relating to step acquisitions and accounting for loss of control has achieved its simplification purpose for preparers. However, there are widespread doubts on the preparer side about the financial effects arising from the remeasurement of previously held investment/retained investment in case of step acquisition/loss of control, i.e. the presentation of these remeasurements in profit or loss.

Preparers consider the effect to be hard to convey to the users of financial statements as the gain or loss does not reflect performance of the period but should be treated as a special item. It is also considered to be counter-intuitive to justify the presentation in profit or loss on the basis of a derecognition notion, i.e. achieving control of an entity causes the acquirer to derecognise the previously held investment.

We encourage the IASB to review how to best portray the financial effect arising from business combinations in the statement of profit or loss and other comprehensive income.

Contingent considerations

Preparers consistently addressed in our consultation the complexity and difficulties regarding the measurement of contingent consideration in accordance with IFRS 3. Because of the accounting burden, there is a trend to avoid contingent consideration wherever possible. Additionally, there is general disbelief whether the information is particularly useful for users of the financial statements because of the vast degree of uncertainty and necessary management judgement.

Furthermore it was mentioned that even the vast majority of investors does not expect the current accounting consequence, ie recognising subsequent measurement changes through profit or loss, if the contingent liability is directly linked with the development of a single asset as part of the business combination. In other words, if no general earn out clauses are negotiated, it is a usual negotiation outcome to agree on a contingent consideration in relation to a specific asset, as it may be of overall importance for future value generation. Thus users expect subse-

quent payments for such an asset to be recognised as subsequent cost under a historical cost accounting model.

Based on the feedback received, we believe the IASB should review its basis for conclusions and the accounting guidance in IFRS 3 in this area.

Pre-existing relationships

For some business combinations in Germany application of IFRS 3 revealed substantial amounts relating to the settlement of pre-existing relationships. Preparers expressed concerns regarding the application of measurement requirements in IFRS 3 to determine whether pre-existing relationships are favourable or unfavourable. The determination can be very burdensome and involves, in most cases, a significant degree of management judgement.

Furthermore, there are concerns regarding the accounting implications for the settlement of pre-existing relationships through business combinations. Beside the concerns about recognising gains in profit or loss where no effective realisation of such gain has occurred, concerns relate to the fact that the judgement to determine of whether pre-existing relationships are favourable or unfavourable impacts the determination of acquired goodwill.

Conceptual Framework project

We foresee potential conflicts between the current measurement principle and corresponding guidance underlying IFRS 3 and the IASB's preliminary view developed in the Discussion Paper for measurement guidance in a revised *Conceptual Framework*.

The Discussion Paper highlighted that the selection of a measurement:

a) for a particular asset should depend on how that asset contributes to future cash flows; and
b) for a particular liability should depend on how the entity will settle or fulfil that liability.

Furthermore the IASB emphasised in the Discussion Paper that "[…] the subsequent measurement should be the same as, or at least consistent with, the initial measurement."

As noted in our comment letter on the Discussion Paper, we are supportive of these high-level measurement proposals for a revised *Conceptual Framework*. In our view, the proposals in the *Conceptual Framework* would result in a closer linkage of measurement with the way the assets are used within the entity and how they will contribute to future cash flows. Therefore, we think that current guidance in IFRS 3 requiring the highest and best use perspective of other market participants (e.g. the guidance in IFRS 3.B43 regarding assets that the acquirer intends not to use or to use in a way that is different from the way other market participants would use them)

could be considered as inconsistent with the thinking for a revised *Conceptual Framework* regarding the selection of measurement.

We perceive that the measurement principles developed in the Discussion Paper would provide a better basis for forecasting future performance, as they allow users to rely on what the acquirer seeks to do with the assets obtained and liabilities assumed. Furthermore, these principles could address the doubts about relevance of fair value information at acquisition date if the fair value amount is fully impaired shortly thereafter to reflect its non-use by the acquirer.

Similarly, the measurement for liabilities would be linked with the way the entity will settle or fulfil the obligation to transfer economic resources. Therefore, the initial measurement of acquired liabilities would be the settlement value and not the market value of these obligations at acquisition date if those liabilities will be settled according to their terms.

We encourage the IASB to analyse and compare the IFRS 3 requirements with the directions tentatively taken in the *Conceptual Framework* project as part of the Post-implementation Review. The preliminary views developed in the *Conceptual Framework* project might assist in evaluating constituents' comments for a revision of IFRS 3 guidance.

If you would like to discuss our comments and views further, please do not hesitate to contact me.

Yours sincerely,

Liesel Knorr
President