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30 May 2014

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

Re: Request for Information Post-Implementation Review: IFRS 3 Business Combinations

Dear Sir or Madam,

The Accounting Standards Board of Japan (ASBJ) welcomes the opportunity to provide feedback in response to the Request for Information (RfI) on Post Implementation Review (PiR): IFRS 3 *Business Combinations*. This letter was prepared solely to pass on the feedback that the ASBJ Staff received during the outreach with Japanese stakeholders, and does not purport to represent the ASBJ's views on the questions in the RfI.

It has been widely acknowledged that business combinations are one of the most contentious areas in accounting-standards setting, because the size and volume of such transactions continue to increase and their effects on corporate financial reporting are often significant. In addition, there were conflicting views on some important aspects of accounting requirements when IFRS 3 and related standards were developed and such controversy continues to exist.

Against this background, the ASBJ published a request for inputs on its website to solicit feedback on the PiR from Japanese stakeholders. In addition, the ASBJ Staff actively reached out to a number of stakeholders to obtain specific feedback on their experience with business combination standards. Specifically, the ASBJ Staff had one-on-one meetings with three financial statement users (hereinafter referred to as 'users'), ten financial statement preparers (hereinafter referred to as 'preparers') and one audit firm, using a customised questionnaire based on the questions set out in the RfI. Additionally, the ASBJ Staff had two roundtable discussions: one with auditors from major firms, and the other with broader constituents (including users, preparers, auditors, and an academic).

In selecting who to have one-on-one discussions with, the ASBJ Staff decided not to limit the stakeholders to only those who use, prepare and audit consolidated financial statements on the basis of IFRSs ('IFRS-users') but to also include those who use, prepare and audit consolidated financial statements on the basis of US-GAAP ('US-GAAP users') as well. This is because accounting requirements relating to business combinations in both sets of standards are consistent (or almost identical) in many respects. In addition, considering that implementation of IFRSs has started only recently in Japan, the ASBJ Staff thought that it would be able to provide the IASB with more helpful inputs by gathering feedback relating to practical experiences had under US GAAP, as far as the requirements of IFRSs and US GAAP are consistent. As a result, the feedback the ASBJ Staff received through one-on-one meetings is all from large multinational companies, of which the market capitalisation totals approximately 35 trillion JPY (equivalent to 340 billion USD) as of 30 May 2014. Please refer to paragraph 1 of this comment letter for details.

During the meetings, the ASBJ explored stakeholders' views on (a) whether the business combination standards have been implemented effectively, and efficiently, (b) what challenges have been identified in using, preparing, and auditing the financial statements, and (c) what stakeholders recommend for possible improvements of the business combination standards. In responding to each question in the RfI, the ASBJ summarised the feedback received, accompanied by specific comments or suggestions for the IASB's consideration.

With that background, key points of feedback the ASBJ Staff received during the outreach include the following:

(1) Non-amortisation of the acquired goodwill: A significant majority of respondents found that non-amortisation of the goodwill acquired in a business combination (hereinafter referred to as the 'acquired goodwill') did not properly portray the economic substance of the acquired goodwill subsequent to the business combination, primarily because they believe that the acquired goodwill is consumed and replaced with internally generated goodwill over time. Accordingly, they recommended that amortisation of the acquired goodwill be reintroduced so as to ensure matching between costs and incomes subsequent to the business combination, while the concept of impairment testing be maintained (hereinafter referred to as the 'amortisation and impairment approach').

At the same time, some respondents stated that the current 'impairment-only approach' has worked well both in light of providing decision-useful information and fulfilling the stewardship of management. Please refer to paragraphs 36 to 44 of this comment letter for details.

(2) Separate recognition of intangible assets: Many preparers found that the requirements to separately recognise intangible assets from the rest of the acquired goodwill in accordance with the existing accounting requirements would not rectify the information asymmetry between management and users, because such identifications were sometimes inconsistent with whether they factored in values of particular intangible assets when determining the consideration transferred to acquire interests in acquirees. Therefore, they believed that such separate recognitions would not be relevant for users to understand financial conditions of an entity. They also believed that intangible assets were not always estimated with sufficient reliability, and benefits of such separate recognition and measurement did not outweigh the cost of providing this information. Users expressed differing views at to the usefulness of the separate recognition of intangible assets. Please refer to paragraphs 7 to 15 of this comment letter for details.

(3) Other

- **Step acquisitions and loss of control**: Some preparers found that recognising gains or losses on step acquisitions were not consistent with how they see such transactions, because recognising gains or losses on their previously held interests when they purchased additional shares was inconsistent with financial information used for internal management purposes. In addition, some preparers stated that recognising gains or losses on retained interests in investees upon of loss of control did not often reflect how a group's operations will be carried out, for example because they sometimes purported that the relationship with the investees will be unchanged upon the sales of part of investments. Many users stated that they ignored such gains or losses when analysing the financial information. Please refer to paragraphs 50 to 53 of this comment letter for details.
- **Disclosures**: Many preparers found that disclosure of pro forma financial information was excessively costly, compared with the supposed benefit of such disclosure. In addition, auditors found that disclosure of pro forma financial information was very challenging to audit, especially when a business combination occurred close to the end of the reporting period, and/or an acquiree only prepared its consolidated financial statements in accordance with local GAAP rather than IFRSs. Yet, users found pro forma information was helpful to improve the comparability of financial information through the periods. Please refer to paragraphs 57 and 59 of this comment letter for details.

Please also note that although various useful experiences have been provided from auditors during the roundtable discussion, in light of avoiding possible duplication of feedback from others, the ASBJ decided not to include specific comments from auditors to the extent that they may be duplicative with those from the preparers. Therefore, the comments stated as auditor's feedback are limited to those that are provided solely from the auditing (or auditability) perspective.

The ASBJ hopes that our feedback will be helpful for the IASB to assess whether business combination standards have been implemented effectively and efficiently, and what changes could be helpful to improve the quality of financial information prepared in accordance with IFRSs.　If you have any questions, please feel free to contact us.

Yours sincerely

Take Arai

Takehiro Arai
Vice Chairman of the Accounting Standards Board of Japan
Chairman of the Technical Committee for Business Combinations of the ASBJ

Comments on Specific Questions in the RfI

1. Background and Experience

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).[a]

(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) if 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).

(a) Type of user includes: buy-side analyst, sell-side analyst, credit rating analyst, creditor/lender, other (please specify).

1. Please see the following for our response to the above questions.

(a): Accounting standards setter (As stated in the covering letter, it should be noted that this letter is not intended to represent the ASBJ's views on each issue addressed in the questions, but simply to pass on the comments the ASBJ Staff received during the outreach.)

(b): Japan

(c): In Japan, listed companies are required to prepare consolidated financial statements on the basis of one of three sets of accounting standards:

(i) Japanese accounting standards;

(ii) IFRSs (Use of IFRSs has been permitted since the fiscal period beginning 1 April 2009; accordingly, the experiences that the ASBJ provides in this letter relate to IFRS 3 (2008) only.); or

(iii) US GAAP[1].

The following table represents outreach activities conducted by the ASBJ Staff in preparing this comment letter[2].

Type of meetings	Interviewees	IFRSs	US GAAP
One-on-one meetings	FS Users	3[3]	
	FS Preparers	3	7
	Auditors	1	
Round table discussions		2[4]	

It should be noted that nine out of ten companies were ranked Fortune global 500 companies for the year 2013, and the market capitalisation of the ten companies totals approximately 35 trillion JPY (equivalent to 340 billion USD) (which equals approximately 8% of the total market capitalisation of Tokyo Stock Exchanges) as of 30 May 2014.

(d): N/A

(e): N/A

2. Definitions of a Business

Question 2:

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

(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?

(a) Benefits of separate accounting treatments for business combinations and asset acquisitions

[1] Use of US GAAP is permitted for limited number of companies, including those having registered with the US SEC.

[2] In addition to the stakeholders shown in the table, the ASBJ Staff discussed with one company that preparers consolidated financial statements in accordance with Japanese-GAAP on their experience relevant to the questions in the RfI. The feedback that the ASBJ Staff have received from this preparer is shown in the footnote of this letter.

[3] The three users consist of an investment bank (the equity securities sell-side analyst), an asset management firm (the equity securities buy-side analyst) and a credit rating agency (credit rating analyst). All of these users have in-depth knowledge and experience both in IFRSs and US GAAP.

[4] Round table meetings include the one held with members of the Accounting Practice (IFRS) Committee of the Japanese Institute of Certified Public Accountants (JICPA) of which members were represented by each of the major audit firms and the other held with the other broader constituents (including users, preparers, auditors, and an academic).

2. Users did not expressed strong concerns regarding the different accounting treatments between business acquisitions and asset acquisitions under the existing standards.

(b) Practical challenges when assessing if a transaction is a business

3. Many preparers stated that they have not encountered situations that gave rise to significant practical challenges in determining whether a transaction constitutes a business or not. However, some preparers provided the following experiences that they encountered in preparing the consolidated financial statements:

- When a company acquired a factory property (consisting of a land and buildings) from another entity, it also assumed a certain number of employees for a limited period of time as part of the acquisition contract. In that situation, the company found it challenging to determine whether a series of these arrangements should be considered to encompass a "process" (thus, should be accounted for as a business combination), considering that its management perceived the inclusion of the employees for a temporary period in the arrangement merely incidental.

- When a company acquired an entity engaged in mining operations, the acquisition was treated as the 'business combination' when the acquiree started part of the mining operation, while it was treated as an 'asset acquisition' when the mining operation had yet to be initiated. This distinction was very subtle as it depended merely on the timing of the acquisition, thus requiring different accounting treatments was considered to be counterintuitive. Considering that the life of a mining operation is normally limited to a certain period of time, such transactions may well be accounted for as an 'asset acquisition' (such that the premium of the payment should be treated as an intangible asset), regardless of the timing of the acquisition.

3. Fair Value

Question 3:

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

(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?

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

(a) According to the *Conceptual Framework* information is relevant if it has predictive value, confirmatory value or both.

(a) Usefulness of the information derived from fair value measurements

4. Users stated that the information derived from the fair value measurements were relevant for them to assess the prospects for future net cash inflows to an entity.

(b) Challenges in measuring fair value

5. Many preparers stated that there have been challenges in measuring the fair value of intangible assets, goodwill and non controlling interests (NCIs) within the context of business combination accounting. Please refer to paragraphs 11 and 12 (for challenges relating to measurement of intangible assets), paragraphs 33 and 34 (for challenges relating to measuring goodwill in impairment testing) and paragraph 49 (for challenges relating to measurement of NCIs) of this comment letter for details.

(c) Any particular elements which are more challenging to measure fair value

6. As stated in the previous paragraph, many preparers stated that fair value measurement has been more challenging for intangible assets, goodwill and NCIs.

4. Separate Recognition of Intangible Assets from Goodwill and the Accounting for Negative Goodwill

Question 4:

(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?

(b) Do you think changes are needed and, if so, what are they and why? (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?

(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?

<u>Separate Recognition of Intangible Assets</u>

(a) Usefulness of information resulting from separate recognition of intangible assets

7. Users stated that they found separate recognition of intangible assets was generally helpful. Specific experiences that the ASBJ Staff heard during the outreach include the following:

- Separately recognising intangible assets has helped a user to assess the prospect of future cash flow into an entity and improve comparability across entities, because separate recognition helped the user to more appropriately identify resources from which net future cash flows will be generated for the entity.

- Information regarding the nature of intangible assets and periods over which such assets were to be amortised provided a user with helpful information in comparing the financial performance across entities in the same industry.

(b) Implementation, auditing or enforcement challenges

8. Preparers stated that they have encountered significant challenges in separately recognising intangible assets. Key points of these preparers' feedback that the ASBJ Staff received during the outreach include the following:

    (1) Identification of specific intangible assets;

    (2) Measurability of intangible assets; and

    (3) Cost-benefit of separately recognising intangible assets.

Identification of specific intangible assets

9. Some preparers found that separately recognising intangible assets was counterintuitive, when management did not intend to acquire a particular intangible asset in a business combination. A specific experience that the ASBJ Staff heard during the outreach is as follows:

- When a company did not intend to obtain customer-related intangible assets, the company was still required to recognise the assets in accordance with the requirements of standards. A company found that separately recognising such intangible assets would not have been helpful for users, because the financial information failed to reflect managements' views and did not rectify the information asymmetry between management and users.

10. In addition, some preparers stated that, in some situations, they found it challenging to identify intangible assets that should be recognised separately in the statement of financial position. A specific experience that the ASBJ Staff heard during the is as follows:

- When a company acquired an entity whose customers were dispersed, the company faced significant challenges to determine whether, and if so how, it should separately recognise an intangible asset of the 'customer list' (or similar kind), because the resource that provides future cash flows may exist but was challenging to identify.

Measurability of intangible assets

11. Some preparers stated that ensuring the reliability of measurement was sometimes significantly challenging. They argued that measurement of intangible assets was not necessarily reliable in some cases, because companies were required to separately

recognise intangible assets, even when conditions giving rise to intangible assets were too specific and intangible assets with similar terms had never been traded in the normal course of business. Accordingly, some preparers suggested that the notion of "reliable measurement" should be reinstated as the criterion for separate recognition.

- For example, a company entered into an acquisition contract that required a buy-back of securities from the acquirer when a member of the management of the acquiree dies. In such a case, the company found that an estimate of the fair value per se was possible. However, the company was not sure if the reliability of measurement was sufficient, because the term of the transaction was so specific that there was no market transaction to which the company could refer when determining the fair value.

12. In addition, some preparers stated that, although measurement techniques themselves have been established over recent years, a lack of specificity in the guidance of IFRSs (especially, in terms of what should be reasonable inputs to a valuation model) posed difficulties in identifying the appropriate benchmark that an entity should use. They stated that this included, but was not limited to, what factors should be considered in identifying a country-risk, growth rate, and so forth. Accordingly, they suggested that additional guidance should be developed.

Cost-benefit of separately recognising intangible assets

13. Many preparers stated that in practice, auditors required an entity to provide them with the third-party valuation report for intangible assets, whereas the auditors themselves also obtained a third-party valuation report. Although these reports often indicated ranges of value (rather than specific numbers), these ranges were sometimes inconsistent with each other, and hard to reconcile. This resulted in additional charges for third-party experts, and led to delays for the company in finalising the financial accounts due to the needs of further discussion with its auditor, especially when a business combination took place near the period-end.

14. Some preparers also stated that the root-cause of challenges regarding separating intangible assets is similar to those regarding impairment testing of goodwill. Please see paragraph 35 of this letter for the feedback regarding cost-benefit of impairment of goodwill.

15. In addition, many preparers stated that the cost of separately recognising the intangible assets did not outweigh the benefit of doing so, when accounting requirements of intangible in subsequent periods were similar to those of goodwill.

Negative Goodwill

(c) Usefulness of information resulting from recognition as a gain upon the

acquisition of a business

16. Users did not express strong concern over the usefulness of information resulting from recognising negative goodwill as a gain on the date of acquisition. Nevertheless, the ASBJ Staff received the following feedback:

- Users usually excluded such gains when analysing financial information and assessing the prospects of future cash inflows to an entity.
- Some users found that there were some cases in which losses were recognised from an acquired business after recognising gains on negative goodwill at the date of acquisition. Therefore, when gains were recognised for negative goodwill, they paid heightened caution and tracked the subsequent financial performance, so that they could analyse the total return of the business by aggregating gains on negative goodwill and losses incurred after the business combination.
- A user stated that negative goodwill often arose in ordinary transactions rather than only in anomalous transactions.
- Some users found that in some cases disclosure of specific reasons why a gain on negative goodwill was recognised for a business combination was not sufficient, and such disclosure would be useful when analysing the profitability of an acquiree.

17. While some preparers expressly supported the current requirement relating to negative goodwill, many preparers expressed concerns about the usefulness of recognising negative goodwill as a gain on the date of acquisition and disclosures related to bargain purchases. Key points of the preparers' feedback that the ASBJ Staff received during the outreach include the following:
    (1) Frequency of transactions giving rise to negative goodwill;
    (2) Cause of recognising negative goodwill;
    (3) Possibility of resulting in future losses of an acquiree; and
    (4) Challenges in meeting objectives of disclosure requirements.

Frequency of transactions giving rise to negative goodwill

18. Although IFRS 3 and US GAAP may presume that a bargain purchase happens only in anomalous transactions, such as a forced liquidation or distress sale, some preparers found that recognition of negative goodwill was not as rare as assumed. The specific feedback from preparers that the ASBJ Staff heard during the outreach include the following situations:

- Negative goodwill often arose in ordinary transactions rather than only in anomalous transactions. For example, when an acquiree was a listed entity and the price book-value ratio (PBR) (after reflecting the control premium to the stock price) of the acquiree was below 100%, transactions often led to the recognition of negative goodwill, even when the initial measurement of the assets and liabilities was reassessed (ASBJ Staff note that PBR was below 100% for approximately half of entities listed in Japan at the end of April 2014.)

- A company found that when measuring NCIs at fair value, the amount of negative goodwill in part arose from the measurement of the NCIs; however, paragraph 34 of IFRS 3 (or ASC805-30-25-2 in the US GAAP) specifically requires that a gain on negative goodwill be attributed to the acquirer. Accordingly, the company believed that profit or loss for the period attributable to owners of the parent (as required by paragraph 81B of IAS 1) would not be faithfully represented through compliance with the requirement and would not have provided relevant information for users to assess the prospects for future net cash inflows to the company.

Causes of recognising negative goodwill

19. Although an acquirer is required to reassess whether it has correctly identified all of the assets acquired and all of the liabilities assumed and review the procedures used to measure the amounts when the transaction results in negative goodwill, many preparers stated that they found it challenging to identify measurement errors. Specific feedback from preparers that the ASBJ Staff received during the outreach include the following:

- A company found it time consuming to try to identify measurement errors, because it usually outsourced the valuation practice to an external valuation firm and re-performing the valuation would necessitate additional communication with that third party.

- When a company entered into a business combination, where estimation uncertainty of many assets was very high, the company found that it faced significant degree of measurement uncertainties. The company thus considered that negative goodwill should not be recognised immediately as a gain, but should be accounted for as a reduction in the fair value of tangible fixed assets. The company believed that such accounting treatment would be able to prevent abusive accounting outcomes.

20. Besides, one preparer stated that it recognised a large amount of gain when it acquired a software company that recognises few identifiable assets before a business combination as a result of recognising a large amount of intangible assets (such as, in-process R&D and customer-related intangible assets). The company questioned if recognising gain for that large amount of negative goodwill in such situation properly portrayed the economic substance, because the amount of negative goodwill was

subject to significant degree of measurement uncertainties.

Possibility of resulting in future losses of an acquiree

21. Some preparers stated that after they recognised gains on negative goodwill for business combinations, they often ended up recognising losses in subsequent periods. These preparers questioned whether financial information which encompassed gains on negative goodwill provided useful information, because at least in hindsight, gains on the business combinations were compensated by incurrence of losses in the future periods. Specific preparers' feedback that the ASBJ Staff received during the outreach included the following:

- A company found that the cause of negative goodwill was attributable to the expectation that additional expenses (for example, restructuring costs) would be incurred in future periods and such expectations were already reflected in the consideration transferred. The company stated that a mismatch in timing of recognition arose between the gains on negative goodwill and such future costs, because existing business combination standards do not permit an entity to recognise provisions for such future costs.

- A company experienced several instances in which it first recognised a gain on negative goodwill from business combinations and incurred losses in subsequent periods with stagnant performance. Based on the experiences, the company thought that it would be appropriate to account for negative goodwill as a liability or as part of OCI. It was also noted that using OCI would be more appropriate among the two options, considering that negative goodwill would not meet the definition of liabilities.

Challenges in meeting objectives of disclosure requirements

22. Some preparers questioned if disclosures relating to gains on a bargain purchase were really useful. Specific preparers' feedback that the ASBJ Staff received during the outreach include the following:

- Some companies found it significantly challenging to analyse factors that gave rise to negative goodwill, including whether the negative goodwill was due to the state of the acquiree's business at the time of the acquisition or whether it really resulted from the the negotiation process undertaken as part of the acquisition.

5. Non-amortisation of Goodwill and Indefinite-life Intangible Assets

Question 5:
(a) How useful have you found the information obtained from annually assessing goodwill and intangible assets with indefinite useful lives for impairment, and why?
(b) Do you think that improvements are needed regarding the information provided by the impairment test? If so, what are they?
(c) What are the main implementation, auditing or enforcement challenges in testing goodwill or intangible assets with indefinite useful lives for impairment, and why?

23. Considering the flow of our response, the ASBJ first provides its response regarding the goodwill, and then provides its response regarding intangible assets with indefinite useful lives. In addition, the ASBJ provides its response in the order of (a), (c) and (b) as stated in the box above.

<u>Comments on goodwill</u>

(a) Usefulness of the information obtained from impairment-only approaching

24. A significant majority of respondents stated that information resulting from the annual impairment testing of goodwill had some shortcomings, and identified areas for improvements.

Users' feedback

25. One user considered that an impairment loss (or lack of that) based on the impairment-only approach could validate failure (or success) of an acquisition, and provide the user with the confirmatory value. The user pointed out that such confirmatory value would be lost if goodwill were to be amortised.

26. However, some users stated that the impairment-only approach for goodwill often failed to provide useful information. Specific feedback that the ASBJ Staff received during the outreach included the following:

- Users found that impairment charges often came late, and investors usually factored in risk of impairment well before an impairment charge was recognised. A user found that in many cases an impairment loss was often recognised more than one year (or one and a half years) after the user anticipated recognition of an impairment loss.

- Users disregarded the impairment charge when using financial information to assess the enterprise value (EV) because they used figures such as adjusted cash flow/profit information (including, EBITDA), while they referred to accrual-based financial figures when assessing the profit generating power of the company.

27. In addition, some users indicated that in analysing an entities' financial position, they

made adjustments to the amounts presented as net assets in the balance sheet, taking into account the perceived quality of amounts presented as goodwill. Specific feedback that the ASBJ Staff received during the outreach included the following:

- When analysing an entity's financial position, one credit rating analyst deducted the amount of goodwill and made an adjustment using an industry-specific ratio from the amount presented as net assets in the balance sheet, because the analyst considered that the liquidity of goodwill is far lower than other assets.

- Some users made adjustments to the amounts presented as goodwill in the balance sheet, because the amount presented as net assets would have been overstated and key ratios (such as ROA) would have been understated when goodwill was not amortised.

Preparers' feedback

28. Some preparers stated that the impairment-only approach was considered to be useful, because it enabled them to track the operating performance of the acquired business and evaluate whether benefits such as synergies were realised as expected. They also stated that such information also helped users assess the stewardship of the management. In addition, one preparer stated that if goodwill were to be amortised, there would be a cliff-effect in financial performance between before and after amortisation of goodwill ends, which may mislead users' understanding of the entity's performance.

29. However, many preparers questioned if the impairment-only approach provided useful financial information. They stated that it is impossible to distinguish the portion added to internally generated goodwill after a business combination from the rest of value in units in impairment testing, and that the goodwill impairment test at best ensures that the carrying amount of goodwill is recoverable from future cash flows expected to be generated from both acquired goodwill and also internally generated goodwill. Therefore, they stated that the impairment-only approach would not reflect economic substance.

30. In addition, many preparers questioned whether the information resulted from impairment testing was useful especially where the goodwill was reallocated to rearranged units as a result of reorganisations. Specific feedback that the ASBJ Staff received during the outreach included the following:

- Many companies found that a relative fair value approach (which is the approach used for reallocating goodwill to units) led to virtual reallocation of the goodwill and that it was challenging to identify what is meant by the comparision between the goodwill and value of the unit(s). In addition, they often found it challenging to identify the appropriate method that reflects the association between the goodwill and the units, because expected benefits from synergies of the business combination had been often realised before a reorganisation takes place.

Auditors' feedback

31. Auditors stated that current accounting requirements relating to impairment testing is highly judgmental, which seemed to provide latitude for entities as to the extent of which impairment losses are likely to incur. For example, auditors considered that the current requirement for allocation of goodwill to units[5] provided an entity too much latitude in deciding the size of units on which impairment testing are carried out, and that impairment testing would become less effective when larger size were selected for units.

(c) Practical challenges for impairment testing for goodwill or intangible assets with indefinite useful lives

32. Many respondents stated that they encountered various practical challenges in impairment testing. Key points of the feedback the ASBJ Staff received during the outreach are the following:

    (1) Concerns over subjectivity of impairment testing; and

    (2) Unexpected costs resulting from the impairment-only approach.

Concerns over subjectivity of impairment testing

33. Many preparers stated that estimates of values required for impairment testing were often more subjective than the amortisation and impairment approach, because they entailed more judgmental assumptions than the amortisation and impairment approach. Some of them thought that there was a perception that higher degree of latitude exists in determining when an impairment loss is recognised. Specific feedback that the ASBJ Staff received during the outreach included the following:

- Many companies found that the following factors were particularly subjective:
  - Projections of future cash flow based on budgets/forecasts;
  - Discount rate (for example, a growth rate, risks specific to assets);
  - Selection of comparable companies; and
  - Normalisation of market data.

- A company found that when they used a third party valuation specialist, the range of

[5] Paragraph 80 of IAS 36 requires an entity to allocate the goodwill to each unit or group of units that represent the lowest level within the entity at which the goodwill is monitored for internal management purposes as far as it is not larger than an operating segment.

values indicated were different from the valuation specialist report obtained by its auditor. In such situations, the company found it challenging to reconcile these differences.

- A company believed that the assessment of whether the goodwill will be recovered should be assessed from a longer-term perspective, given that a reversal of impairment charges on goodwill is prohibited in subsequent periods. Considering US GAAP permits using a long term average discount rate, the company believed that IFRSs might be modified so that the discount rate reflects a longer-term horizon.

34. Auditors stated that it was always challenging to verify managements' assumptions used in impairment testing because auditors had to rely heavily on assertions of management of the entity including the projection of future cash flows. They found that this type of evidence was inherently subjective, and it was often difficult to challenge managements' assertions.

Unexpected cost resulted from the impairment-only approach

35. Many preparers found that the current impairment-only approach imposed significant costs at a level that was not anticipated before the standard was put in place. Specific feedback that the ASBJ Staff received during the outreach included the following:

- Many companies found that the cost of impairment testing outweighed the benefits, primarily because they were often asked by their external auditors to obtain valuation reports from the third party valuation firms to support management's estimate for annual impairment testing. These companies thought that they paid double the price for the valuation of goodwill; once as their cost and the again as part of their audit fees. In addition, obtaining valuation reports from third party took time, which imposed a hurdle in meeting the tight closing and reporting deadlines for the financial accounts.

(b) Possible improvements for the impairment testing (including further improvements to the overall model of acquired goodwill)

36. Some preparers stated that one of the significant issues was the cost associated with annual impairment testing. Accordingly, as a possible improvement for the impairment testing, some preparers suggested that costs of annual impairment testing for goodwill can be alleviated if the impairment test is only performed when there is an indicator of impairment.

37. In addition, when asking how the requirements of annual impairment testing can be

improved, the ASBJ Staff sought specific comments as to whether the stakeholders support reintroducing amortisation of the acquired goodwill and reasons thereto.

38. During the ASBJ Staff’s outreach, a significant majority of respondents stated that financial information based on the impairment-only approach did not properly portray the acquired goodwill subsequent to the business combination, primarily because they believed that the acquired goodwill was consumed over time and replaced with internally generated goodwill over time, whereas a few respondents stated that the current impairment-only approach worked well. Furthermore, many respondents questioned whether the impairment charge provided useful information primarily because the impairment loss was not necessarily recognised in a timely manner and the impairment test is highly subjective.

39. Accordingly, a significant majority of respondents suggested reintroducing amortisation of goodwill in combination with impairment testing (in other word, the ‘amortisation and impairment approach’) whereas some respondents stated that the current ‘impairment-only approach’ worked well both in light of providing decision-useful information and in assessing the stewardship of management. Key points of feedback the ASBJ Staff received during the outreach are the following:

    (1) Usefulness of information resulting from the amortisation and impairment approach; and

    (2) Estimation of amortisation periods of the acquired goodwill.

Usefulness of information resulting from the amortisation and impairment approach

40. Some users suggested reintroducing the amortisation and impairment approach, because they believed that such an approach would better reflect the economic substance that the value of goodwill diminishes over time and would help them assess the prospect of profitability for entities. They also believed that unless goodwill were amortised over periods subsequent to business combinations, an acquirer would end up in doubling up the income resulted from the business combinations, because the cost of the future income (that is, the investment made for the business combination) would not be recognised. In addition, they pointed out that once an aquiree’s financial performance went under, the acquirer would end up in the negative spiral for sluggish financial performance, because the effect of the poor performance would be further affected by an incurrence of impairment losses for the investment.

41. Furthermore almost all preparers suggested reintroducing the amortisation and impairment approach. Specific feedback that the ASBJ Staff received during the outreach included the following:

- Many companies found that acquired goodwill is an asset that is consumed and replaced with internally generated goodwill over time. Therefore, they believed that acquired goodwill must be amortised to periodically match the additional income generated from the goodwill, which is consistent with the view that an entity's profit is the excess of income earned over the cost invested. Unless the acquired goodwill were amortised over subsequent periods, they believed that it would be impossible to properly portray in the financial statements that the value of the acquired goodwill has decreased over time[6].
- Many companies believed that amortisation of acquired goodwill will help prevent that internally generated goodwill be recognised as an asset on the balance sheets, and believed that it is consistent with the general prohibition in IFRSs and US GAAP regarding the recognition of internally generated goodwill.
- Many companies believed that reintroducing the amortisation and impairment approach would reduce the tension that existed on impairment testing under the current impairment-only approach, and rectify the shortcomings that were inherent in the approach (including, inseparability of internally generated goodwill in impairment testing, subjectivity of assumptions and significant costs and efforts).

Estimation of amortisation period of goodwill

42. Many preparers stated that it is possible to estimate a reasonable period over which the acquired goodwill should be amortised. Specifically, many preparers stated that if goodwill is amortised, the amortisation period should be determined based on the period over which the benefits of the business combination will be realised. The ASBJ Staff received specific suggestions including the following:

- Some companies suggested that acquiree's ability to maintain a standalone business to earn a higher rate of return as well as the period in which synergies and other benefits from combining the acquirer's net assets and businesses will be realised, should be factored in when deciding a period over which goodwill should be amortised.
- Many companies suggested that the expected payback period of the investments (for example, those calculated on the basis of a discounted payback period method) would be a good starting-point, with necessary adjustment made to the period over which the benefit of the business combination would be realised.

43. Many preparers suggested that the amortisation period of goodwill be limited to

[6] One preparer using Japanese GAAP stated that when acquiring a business, management usually evaluated whether the investment (including goodwill) can be recovered from cash inflows from the target business. The company, accordingly, stated that amortisation of acquired goodwill reflects managements' view that goodwill will be recovered in subsequent periods.

20-year, although some stated that a period over which the benefits of the business combination will be realised is, for some industries, often less than 10 years (for example, a technology-intensive industry). These preparers stated that it would be rare that the benefits of a business combination are realised beyond 20 years, and that permitting periods longer than 20-year may result in less comparable financial information. In addition, one preparer stated that 20-year as a maximum period was considered to be appropriate, on the ground that an expected payback period of investments has been appropriately 15 to 16 year for many business combinations, and multiplying 15-16 times earnings is considered as the norm as the starting point to estimate an enterprise value.

44. Some preparers stated that the straight-line method would be the most appropriate method for calculating amortisation when that usage pattern cannot be determined reliably, which is consistent with the treatment of intangible assets with finite useful lives.

<u>Comments on intangible assets with indefinite useful lives</u>

45. Feedback that the ASBJ Staff received on intangible assets with indefinite useful lives was generally consistent with those of goodwill. However, one of the most significant findings was that many preparers classify all separately recognised intangible assets as intangible assets with finite useful lives which are to be amortised over useful life. Specific feedback that the ASBJ Staff received during the outreach included the following:

- A company found that it was challenging to judge whether useful lives of intangible assets with no stated contract period (such as trademarks and customer relationships) are considered to be indefinite.
- A company found that separating intangible assets from the rest of the goodwill may have been arbitrary, and that an incentive for this arbitrary classification would be reduced if both goodwill and intangible assets with indefinite useful life were to be amortised.

6. Non-controlling Interests

Question 6:

(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?

(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.

(a) Usefulness of the information resulting from the presentation and measurement requirement for NCI

46. One of the most significant findings during the ASBJ Staff's outreach was that all preparers using IFRSs who the ASBJ Staff met to discuss this survey elect to measure NCIs in the acquiree at the present ownership instruments' proportionate share in the recognised amounts of the acquiree's identifiable net assets for all business combinations. Accordingly, all experiences regarding the measurement of NCI at fair value explained in the following paragraphs were those of US-GAAP users.

47. Users did not express significant concerns over the information resulting from the presentation and measurement requirements for NCIs. However, users stated that the focus was given to the net asset value attributable to the owners of the parent company; thus, the amount presented as NCIs was generally ignored in analysing financial information. In addition, one user stated that presentation options permitted under IFRS 3 reduced the comparability of financial statements between different companies. Specific feedback that the ASBJ Staff received include the following:

48. Some preparers provided negative feedback on the information resulted from the presentation and measurement requirements for NCIs. Specific feedback that the ASBJ Staff received included the following:

- A company believed that recognition of a gain on negative goodwill as a result of fair value measurement of NCIs would not have provided relevant information for users to assess the prospects for future net cash inflows to the company. Please see paragraph 18 of this letter for details.

- A company found that goodwill attributable to NCI was meaningless from the parent company's shareholders' point of view, because the parent company did not intend to control the portion of goodwill.

(b) Challenges in accounting for NCI

49. Some preparers that measured NCI at fair value stated that they faced challenges in measuring the fair value of NCI. Specific experiences that the ASBJ Staff heard include the following:

- Some companies found it challenging to appropriately identify the control premium from the consideration transferred in measuring the fair value of NCI, because these estimates were hypothetical, and considered to lack objectivity. The company felt that it was highly challenging to appropriately measure the control premium.

7. Step acquisitions and Loss of Control

Question 7:

(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.

(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.

(a) Usefulness of the information resulting from the accounting guidance on step acquisition

50. Users did not express significant concerns regarding the information resulting from the step acquisition guidance, although they stated that gains or losses on step acquisitions were excluded anyway when analysing the financial figures. The ASBJ Staff also received the following feedback:

- A user stated that gains or losses recognised on the company's previously held interests based on a fair value that additional shares were obtained at were found to be misleading because that amount included the control premium.

51. Preparers' views on the usefulness of the information with regard to step acquisitions were mixed. Some preparers expressed support for the requirement, because they believed that moving from and into the group was a significant economic event. However, many preparers found that recognising gains or losses on step acquisitions were not consistent with how they see such transactions, because recognising gains or losses on their previously held interests when they purchased additional shares was inconsistent with financial information used for internal management purposes. Additionally, many preparers stated that the acquired goodwill may have been overstated as a result of gains recognised on its previously held interest, especially when the acquiree's share price was inflated as a result of take-over-bid.

(b) Usefulness of the information resulting from the accounting guidance on loss of control

52. Consistent with the views on step acquisitions, users generally supported the current accounting requirements regarding loss of control, although they stated that gains or losses made on the loss of control were excluded anyway when analysing the financial figures.

53. Preparers' views on the usefulness of the information with regard to loss of control were mixed. Some preparers expressed support for the requirement, because they believed that moving from and into the group was a significant economic event. However, some preparers stated that recognising gains or losses on its retained interests when part of these shares were sold, did not reflect management's views on the business[7].

- A company stated that sales of part of its interests did not necessarily mean that management decided to terminate a close-tie with its subsidiary; rather it only sold part of its shares to buffer the liquidity.
- A company stated that while it recognised a large amount of a gain when it sold part of its shares (which represented a loss of control), it ended up recognising losses when it sold the rest of the interests later.

8. Disclosures

Question 8:

(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?

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

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

(a) Other information needed

54. Users stated that the following additional information would be helpful for them to better understand the effects of acquisitions.

- Detailed explanation regarding the cause of impairment losses that was incurred during a period.

[7] One preparer using Japanese GAAP found that, when a subsidiary became an associate, the retained interests in the associate was still considered to constitute an investment for the group, as far as management has no intention to liquidate the investment. Rather, the preparer still considered the associate was within the 'group', and found that the cliff-effect between a subsidiary and an associate was inconsistent with management's perspective. Therefore, the preparer stated that remeasurement of the retained interests in the associate would not portray economic substance and is likely to be misleading to investors.

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- A comparison between the projected future performances of an acquiree's business estimated at time of acquisition and the actual performance in the subsequent periods.
- Details of acquisition-date fair values for each major class of consideration (see paragraph B64 (f) of IFRS 3).
- Separate financial statements of acquireees, which are required by US GAAP.

(b) Any information that is not useful

55. The ASBJ Staff were not advised of any specific information that users did not find useful and that should not be required to be disclosed.

(c) Main challenges to prepare or audit the disclosures required

56. The ASBJ Staff were advised of the following significant challenges when preparing or auditing the disclosures required by the standards[8].

Comments from preparers

57. Many preparers expressed concerns about the pro-forma financial information relating to the revenue and profit or loss of the combined entity for the current reporting period being presented as though the acquisition date for all business combinations that occurred during the year had occurred as of the beginning of the annual reporting period (as required by paragraph B64 (q) (ii) of IFRS 3), although users found that information was helpful. Specific feedback that the ASBJ Staff received include the following:

- Many companies stated that the pro-forma financial information would not have been useful because that information did not reflect the synergy of the business combination (which they believed would be essential to assess the effect of business combinations).
- Some companies stated that it was not clear what assumptions should be factored in when preparing pro forma financial information. They suggested that if the disclosure of pro forma financial information were still to be required, additional guidance should be provided.

58. Some preparers found that part of the disclosures required by IAS 36 regarding impairment testing related to confidential information. Considering the risk of commercial harm by disclosing such information, they found it challenging to decide the extent to which details should be disclosed.

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[8] One preparer who uses Japanese GAAP stated that the amounts of revenue and profit or loss of the *acquiree* since the acquisition date included in the consolidated statement of comprehensive income for the reporting period (as required by IFRS 3 (q) (i)) required disproportionate time and effort for the company, when it merged with a large listed company.

Comments from auditors

59. Auditors found that disclosure of the pro forma financial information (as required by paragraph B64 (q) (ii) of IFRS 3) was significantly challenging for auditors in light of auditability, especially when the business combination occurred close to the end of the reporting period, and/or the acquiree only prepared its consolidated financial statements in accordance with local GAAP rather than IFRSs.

9. Other Matters

Question 9:

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.

(a) Usefulness of information provided by IFRS 3

60. Other than those stated in our responses above, the ASBJ Staff did not received specific feedback that indicated any other areas for possible improvements.

(b) Practical implementation matters

61. In regards to a business combination achieved in stages, some preparers provided the following experiences:

- A company obtained control of an acquiree through multiple transactions, but it found that IFRS 3 is unclear about whether these transactions should be accounted for as an integral set of transactions or whether they should be accounted for as separate transactions. The company faced similar challenges when it sold shares in its subsidiary through multiple transactions.

- A company found that it was significantly challenging to meet the financial reporting deadline, when it had to remeasure its retained equity interest at its fair value for loss of control that occurred close to the end of the reporting period. Drawing from the experience, the company suggested that the similar concept of ‘measurement period’ in a business combination be introduced to such remeasurement requirement, so as to accommodate potential challenges that an entity may face when a loss of control took place close to the end of the reporting period.

(c) Other matters

62. A preparer expressed a concern over the possibility that business combination standards of IFRSs and US GAAP may be divergent as a result of future standard-setting activities. Having acknowledged that the business combination standards of the two bodies are currently aligned, the preparer suggested that the IASB and FASB should share the implementation experience and that a future project should be undertaken jointly between the two boards so that they can minimise the divergence.

10. Effects

Question 10:

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)?

(a) Benefits of IFRS 3 and related amendments

63. Except for specific areas that were identified as needing possible improvements, users generally appreciated the financial information resulting from the existing business combination standards. However, the ASBJ Staff did not receive feedback that identified specific areas of IFRS 3 and related amendments that represents benefits to users, preparers and auditors of financial statements.

(b) Practical implementation matters

64. Many preparers stated that each of the following requirements or a combination of them resulted in considerable unexpected costs to them. Please see the detailed explanations for our responses to each of the questions in this letter).

    (1) Requirements relating to separate recognition of intangible assets (see paragraphs 13 and 15);

    (2) Impairment-testing of the acquired goodwill (see paragraph 35); and

    (3) Disclosure of pro-forma financial information (see paragraphs 57 and 59).

65. In addition, auditors stated that auditing pro-forma financial information posed significant auditing challenges, especially where such information was required to be audited. They noted that financial reporting regimes of the US and Japan permit auditors to scope out that information from the audit of the financial statements, while

other financial reporting regimes require that such information be scoped in as subject matter of the audit.

(c) Other matters

66. The ASBJ Staff did not receive specific feedback that indicated that IFRS 3 and related standards had effects on how acquisitions are carried out.