Hong Kong Institute of
Certified Public Accountants
香港會計師公會

Our Ref.: C/FRSC

Sent electronically through the IASB Website (www.ifrs.org)

30 May 2014

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

Dear Sirs,

IASB Request for Information of *Post-Implementation Review: IFRS 3 Business Combinations*

The Hong Kong Institute of Certified Public Accountants is the only body authorised by law to promulgate financial reporting, auditing and ethical standards for professional accountants in Hong Kong. We welcome the opportunity to provide you with our comments on this Request for Information. Our responses to the questions raised in your Request for Information are set out in the Appendix for your consideration.

We continue to support the post-implementation review (PIR) initiative with the aim of ensuring consistent, high quality financial reporting that provides useful information to investors.

In our comment letter, we recommend the IASB should consider drawing a clearer dividing line between asset purchases and business acquisitions by clarifying the guidance. The IASB should also reconsider the conceptual basis of some of the different accounting treatments in the two models.

We also recommend the IASB to revisit the accounting treatment of non- amortisation of goodwill (with annual impairment testing) and consider whether the alternative of amortisation-based accounting model (with indicator-based impairment testing) would be more appropriate. Conceptually, we consider that the current approach fails to address the fact that over time purchased goodwill in most cases is inevitably replaced by goodwill that is generated internally. In addition, amortisation of goodwill would increase comparability between entities that grow their business organically and those that grow primarily through acquisition. From a cost-benefit perspective, we believe an amortisation-based model could help to reduce the tension and implementation challenges in identifying and measuring intangibles, which require significant understanding, interaction and cooperation among the accounting and valuation professions.

We also have concerns on the recognition of certain intangible assets that are acquired in a typical business combination such as: customer relationship, customer list and brands. The nature of those intangible assets is similar to a sub-classification of goodwill and it may be questionable to recognize such assets separately.

37th Floor, Wu Chung House,
213 Queen's Road East, Wanchai, Hong Kong
香港灣仔皇后大道東213號胡忠大廈37樓
Tel電話: (852) 2287 7228
Fax傳真: (852) 2865 6776
(852) 2865 6603
Website網址: www.hkicpa.org.hk
Email電郵: hkicpa@hkicpa.org.hk

If you have any questions regarding the matters raised in our submission, please contact Ambrose Wong, our Associate Director of Standard Setting at ambrose@hkicpa.org.hk.

Yours faithfully,

Simon Riley
Acting Director, Standard Setting

SR/AW

Encl.

Hong Kong Institute of CPAs

Comment on IASB Request for Information of Post-Implementation Review: IFRS 3 *Business Combinations*

Question 1 – Your background and experience

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) 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).

The Hong Kong Institute of Certified Public Accountants (HKICPA) is the only body authorised by law to promulgate financial reporting standards for professional accountants in Hong Kong. Hong Kong has fully adopted IFRS since 2005 (word for word) including HKFRS 3 (equivalent to IFRS 3).

This comment letter is prepared by the HKICPA's Financial Reporting Standards Committee (FRSC), which has been mandated by the HKICPA Council to develop financial reporting standards to achieve convergence with IFRS. The FRSC comprises members with backgrounds as preparers, users and auditors of financial statements as well as representatives from regulatory bodies.

In addition to providing our input through this comment letter, we held a roundtable meeting on 12 May 2014 to enable our local stakeholders to directly communicate with IASB member and staffs on the IASB Request for Information. The roundtable meeting was attended by Chungwoo Suh (IASB Board Member), Michael Stewart (IASB Director of Implementation Activities, IASB) and Leonardo Piombino (IASB Project Manager) via video-conference.

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?

(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?

While an asset purchase, in principle, is different in nature from a business acquisition, our stakeholders (including preparers, auditors and regulators) generally consider that determining whether a group of assets constitutes a business could be challenging and involve significant judgement in certain circumstances. This is particularly the case where only some of the processes are being acquired or the processes are embedded in the inputs and it is necessary to determine whether the missing processes are critical from the market participants' perspective. This poses implementation challenges for certain industries in particular, such as in real estate, shipping and the early stage of extractive industry.

As the current accounting requirements for business and asset acquisition are significantly different, it is important for reporting entities to make the appropriate determination on a consistent basis so as to provide users of financial statements with high quality and useful information for decision making purposes. Our stakeholders generally consider the current guidance is not sufficiently clear to enable this financial reporting to be achieved in practice and therefore we consider the IASB should clarify the guidance to help distinguishing between the two types of transactions if it concludes that these two types of transactions should continue to be accounted for in the current different manner.

On the other hand, although we agree that an asset acquisition and a business combination are different in nature, it is not always clear why some of the applicable accounting treatments should be different. Such aspects include accounting for directly attributable acquisition-related costs, deferred taxes, consideration in the form of shares, contingent consideration and step acquisitions. For industries like real estate and those that rely on major assets of finite life, e.g. extractive industries, the distinction between the two could be a rather fine dividing line and yet the differences in accounting treatments could produce very different results, which may not be justifiable. We observe in many such cases the majority of goodwill results from the initial recognition of deferred tax liability. In addition, when the major asset is with finite life or the subsidiary being acquired has a finite operating period, goodwill is consumed through impairment at a later stage of the finite life, rather than consistent with the consumption of the underlying assets. We recommend the IASB to consider if certain differences in accounting treatment could be eliminated or reduced, e.g. by extending the initial recognition exemption of deferred tax relating to assets and liabilities acquired in a business combination.

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?

(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?

We generally believe fair value provides a relevant measurement basis for assets and liabilities acquired in a business combination. Having said that, stakeholders in our jurisdiction generally view such fair value measurement in business combination accounting to be challenging, especially for those classes of assets and liabilities where there is no readily identifiable external market. The determination of fair value of certain non-controlling interests (if the fair value policy is adopted), contingent consideration and pre-existing interests (in step acquisitions) are complex and judgmental. The valuation of certain intangible assets, for example customer relationships, is also complicated as their nature is similar to a sub-classification of goodwill. Please refer to our response to Question 4 for further details.

We note that provisions measured at fair value in an acquisition are initially measured at fair value as part of a business combination but are subsequently measured in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, which is a best-estimate model. We recommend the IASB to consider introducing a further measurement exception for IAS 37 provisions so as to avoid "day 2" losses, which would not faithfully represent the activities of the acquirer.

The standard requires extensive use of fair value estimates where valuation for financial reporting purpose requires not only valuation knowledge but also understanding on accounting concepts and IFRS. We note that the IASB has recently entered into an agreement with the International Valuation Standards Council to ensure both organisations are able to co-operate effectively in the area of fair value measurement for financial reporting. We welcome this initiative by the two bodies and recommend the IASB to expedite the co-operation to ensure that IFRS and the International Valuation Standards are consistent with each other.

On disclosure, we note that IFRS 13 *Fair Value Measurement* only requires disclosure on assumptions for recurring fair value measurement, but not for initial measurement. We believe initial fair value measurement could be highly judgmental and therefore IASB should consider requiring disclosure of such measurement assumptions to enhance understanding by financial statements users.

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?

(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?

We generally believe the separate recognition of intangible assets acquired in a business combination provides useful information. Having said that, there are also concerns on the recognition of certain intangible assets that are acquired in a typical business combination such as: customer relationships, customer lists and brands. The nature of such intangible assets is similar to a sub-classification of goodwill and some stakeholders question whether such intangible assets should be recognised separately. Moreover, while these assets need to be separately recognised and measured at fair value at the date of acquisition entities are not permitted to recognise equivalent internally-generated intangibles. Some stakeholders in our jurisdiction consider such different practices in accounting for seemingly similar items may impair comparability of financial statements.

Significant time and resources are required to separately identify intangible assets from goodwill and their valuation is typically very judgmental. Even though the separate recognition of intangible assets acquired in a business combination may provide useful information, the IASB may need to consider the underlying cost and benefit when evaluating the appropriateness of such a requirement.

The Standard requires negative goodwill to be recognised in profit or loss, but in many instances it may not be a faithful representation of the underlying cause of such an item. BC371 of IFRS 3 states that the Boards consider bargain purchases anomalous transactions – business entities and their owners generally do not knowingly and/or willingly sell assets or business at prices below their values. Having said that, we observe that it is not uncommon for business combination transactions to result in negative goodwill.

While negative goodwill is described as a "bargain purchase" under para 34 of IFRS 3, we are concerned as to whether the transaction is a "genuine bargain" especially as the standard does not define "bargain purchases". There are also other situations which will lead to similar excess of fair value over cost, for example when the acquiree's share price is significantly lower than the book value, the acquirer's share price declines subsequent to the signing of the acquisition agreement (when the consideration is a fixed number of shares), or the acquired business has structural problems resulting in the need to incur future restructuring costs by the acquirer. In such circumstances, it may not be appropriate to immediately recognise negative goodwill in profit and loss since the gain would be negated to some extent by subsequent expenses. In addition, because of the significant judgment involved, in some cases, in valuing assets and liabilities, some of our stakeholders are concerned about recognizing negative goodwill in profit and loss under such circumstances. We recommend the IASB to clarify what is negative goodwill and consider limiting the recognition of negative goodwill by prohibiting recognition unless there is observable input to support such recognition.

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?

(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?

Our stakeholders (including preparers, auditors, investors and regulators) generally consider the current approach (i.e. annually assessing goodwill and intangible assets with indefinite useful lives for impairment) to be challenging and costly, outweighing the benefits. There are concerns that only limited work is performed on identifying the composition of goodwill upon initial recognition and its subsequent allocation. There are also concerns that entities are generally reluctant to disclose the assumption for goodwill impairment assessment when the information is commercially sensitive.

Moreover, from an investor perspective represented to us goodwill impairment is not commonly viewed to carry significant predictive value.

We believe that the current approach conceptually fails to address the fact that over time purchased goodwill in most cases is inevitably replaced by goodwill that is generated internally (if its value is maintained at all). We recommend the IASB to revisit the prohibition on amortisation of goodwill and consider whether an amortisation-based accounting model with indicator-based impairment testing would more faithfully represent that purchased goodwill that will diminish over time due to the rapid change in the economic environment and to be replaced by other business development factors. We consider amortisation of goodwill would also increase comparability between entities that grow their business organically and those that grow through primarily acquisition. Such an amortisation-based model of goodwill accounting will also help reduce pressure on the identification and valuation of intangible assets, the determination of business combination versus asset acquisition, and the (subsequent) identification of cash-generating units to which goodwill is allocated.

In case amortisation of goodwill is to be reinstated in the standard, we consider the IASB may also consider introducing a rebuttable presumption that the amortisation life is no more than a relatively small number of years, for example 5 years to assist implementation.

Moreover, a constituent from a regulatory background commented that under the current requirements there are occasions when sizeable goodwill is recognised as a result of recording a payable for contingent consideration, which has continued to be recognised even if the payable is subsequently released when the acquired entity does not meet the agreed target, on the basis that the goodwill is tested separately under IAS 36 principles. Allowing the goodwill to continue to be recognised in such cases causes this constituent concern that the acquirer's assets may be over-stated – even if in compliance with IAS 36 this might be because the "goodwill" recognised on day one is effectively being supported by existing businesses and not because of an increase in cash inflows from the acquired business, depending on how this "goodwill" was allocated on day one. This concern did not arise under the previous requirement of writing off such movements in contingent consideration against the acquired goodwill.

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?

(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.

Although IFRS 3 provides accounting policy choices to measure non-controlling interests at either fair value or the present ownership interests' proportionate share in the recognised amounts of the acquiree's net identifiable assets, we understand that the majority of companies in our jurisdiction elect to take the latter option. We consider both accounting policy options can be retained, but the standard can be enhanced by requiring entities to select the treatment as a consistent accounting policy choice, rather than a choice that is made each time an entity accounts for an acquisition.

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.

(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.

We consider recognising re-measurement gain on pre-existing investment in step acquisitions before control is attained results in disconnection between cash flow and financial performance. For example: it is difficult for stakeholder to understand the absence of gain or loss for partial disposal with no subsequent recycling upon ultimate loss of control.

The IASB should consider, as part of the review of the Conceptual Framework, the gain or loss relating to the retained interests portion should be recognised in other comprehensive income instead of in profit or loss because it results only from a deemed exchange transaction rather than actual disposal and acquisition transaction. If the IASB considers it should be recognised in other comprehensive income, then whether and how the gain should be recycled at a future date should also be addressed.

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?

(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?

We note that some disclosures presented in financial statements tend to be boilerplate, in particular the explanation of the source of goodwill or negative goodwill and the reasons why purchase price allocation is not finalised. We appreciate the usefulness of such disclosures in principle and consider the IASB should investigate the reason for the lack of case specific information provided in such disclosure and consider whether expanded guidance is required.

We also noted that paragraph B64(q)(ii) of IFRS 3 requires disclosure of the revenue and profit or loss of the combined entity for the current period as though the acquisition had occurred at the beginning or the reporting period. We note that the information relating to that period prior to the acquisition may not always be readily available and there is also a lack of guidance on how this pro forma information should be prepared. The IASB should consider provide further guidance on such disclosure requirement.

We note that the IASB is undergoing the disclosure framework project. We consider that any additional disclosures and guidance on avoiding boilerplate disclosure should be considered in conjunction with that overall project.

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;

(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.

We support the IASB undertaking a specific project on common control transactions.

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;

(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)?

As highlighted in the earlier part of our response, IFRS 3 (2008) has certainly increased the effort required and costs incurred by preparers of financial statements. For example: the difficulty in establishing whether a group of assets constitutes a business combined with the significant differences in accounting between the acquisition of assets, as distinct from the acquisition of a business, have increased preparers' compliance costs.

The IAS 36 concept of cash generating unit and the need to monitor goodwill over an extended period of time, possibly indefinitely, have resulted in considerable unexpected costs to financial statements, preparers and auditors.

We also observed circumstances where companies structure their merger and acquisition deals around the standard, for example: factors in determining consideration versus employee expenses for contingent consideration paying to founding shareholders who continue to work for the combined business.

~ End ~