ISCA INSTITUTE OF SINGAPORE CHARTERED ACCOUNTANTS

60 Cecil Street ISCA House
Singapore 049709
TEL +65 6749 8060
FAX +65 6749 8061

Global Mindset, Asian Insights

17 June 2014

International Accounting Standards Board
1st Floor 30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sirs,

Request for Information – Post-implementation Review: IFRS 3 Business Combinations

The Institute of Singapore Chartered Accountants (ISCA), formerly the Institute of Certified Public Accountants of Singapore, is pleased to respond to the Request for Information (RfI) in relation to the Post-implementation Review of IFRS 3 Business Combination (IFRS 3), issued by the IASB in January 2014.

To solicit meaningful feedback for this RfI, ISCA sought views from its members through a two-month public consultation and the ISCA Financial Reporting Committee which comprises experienced technical accounting professionals from large accounting firms, listed companies, and regulatory bodies, as well academics from established local universities. Two focus group sessions comprising preparers of financial statements and valuation specialists were conducted and the useful inputs received by ISCA during these sessions were also incorporated where relevant.

We note that over the years, the business combination project has undergone a number of changes to make the standard more useful for users of financial statements in their assessment of stewardship or accountability of management. Notwithstanding this, we are of the view that there are still some areas in IFRS 3, such as definition of a business, where further clarification is required to promote effective application of the related requirement.

We note that some differentiated accounting treatment between business combinations and asset acquisitions gives rise to structuring opportunities whereby companies structure their deals such that they achieve their preferred accounting treatment. We recommend that IASB re-assess whether differentiated treatment, other than goodwill recognition, is justified and warranted.

We also wish to highlight some issues and challenges in relation to fair value measurement and annual goodwill impairment review for IASB's consideration.

Our comments on the specific questions in the RfI are as follows.

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 the 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) A business is defined under IFRS 3 as an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members of participants.

Based on the above definition of business, the value of a business should be worth more than the sum of all its individual net assets, justifying the recognition of the resulting goodwill.

For asset acquisitions, the cost is allocated to the individual identifiable assets and liabilities on the basis of their relative fair values at the date of purchase. Such a transaction or event does not give rise to goodwill.

We agree that differentiated treatment is justified for goodwill. We do not however see convincing reasons or perceived benefits for other differences in accounting treatment such as those stated below. These differences could instead result in structuring opportunities whereby companies structure their deals such that they achieve their preferred accounting treatment.

(i) The recognition of deferred taxes arising from initial recognition of assets and liabilities in the case of business combinations, but not in the case of asset acquisitions.

(ii) The expensing of acquisition-related costs in the case of business combinations, but for asset acquisitions, these costs are capitalised.

(iii) The different measurement basis used for assets acquired under a business combination (fair value at acquisition date) and assets acquired under the case of asset acquisitions (cost basis for most non-financial assets). For example, the carrying value of a hotel would be different, depending on whether the acquisition is treated as a business combination or an asset acquisition.

(iv) Contingent liabilities assumed in a business combination are recognised if it represents present obligation that arises from past events and its fair value can be measured reliably with subsequent changes to profit or loss. Under asset acquisition, this is not recognised and is subject to IAS 37.

We recommend that IASB re-assess whether differentiated treatment, other than goodwill, is justified and warranted.

(b) We note that practical implementation challenges exist in industries such as real estate, pharmaceutical and biotechnology. Purchasers may have an incentive to treat the transaction as a business combination in order to allocate a portion of the purchase consideration paid for the acquisition to goodwill. Value allocated to goodwill could be "protected" from impairment within a profitable cash generating unit. However, value allocated to buildings and intellectual property assets would be subject to amortisation.

Paragraph B8 of the application guidance states that "a business need not include all the inputs or processes that the seller used in operating that business if market participants are capable of acquiring the business and continuing to produce outputs, for example, by integrating the business with their own inputs and processes". Significant judgment is therefore required to assess whether the newly acquired "business" can be integrated into the acquirer's own inputs and processes.

In the real estate industry, processes are often administrative in nature, and market participants will almost always have the additional resources and processes in existence to assimilate the assets into their businesses to make them "capable of being conducted and managed for the purpose of providing a return". It is therefore very easy for these requirements to be met such that most acquisitions can be assessed as a business, so long as market participants have all the necessary systems and processes in place.

In conclusion, the definition of a business in IFRS 3 is very wide, not sufficiently precise and allows a high degree of judgment. We recommend that IASB provide further

clarification as to the essential characteristics of a business as opposed to a bundle of assets.

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?

Fair value measurements at acquisition date provide useful information about management's stewardship and accountability with regards to investment decisions. It provides for users a means for measuring the transaction and its implications for the entity in which they are investing.

Deficiencies in fair value measurement include "Day 2" issues, subjectivity of valuation models used to estimate fair value with different experts having a range of values and the objectivity and quality of data inputs into valuation models.

More specific challenges that we wish to highlight are:

(i) The relevance of measuring non-financial liabilities (contingent liabilities) acquired in a business combination at fair value in accordance with IFRS 13. Non-performance risk adjustments recognised in fair value measurement would be reversed on day 2 through profit or loss when the non-financial liability is measured in accordance with IAS 37. We would suggest that IASB considers granting an exemption to allow measurement of non-financial liabilities to be in accordance with IAS 37 instead of IFRS 13 (similar to exemption given to pension liabilities and income taxes).

(ii) The measurement of assets at fair value generally results in the recognition of deferred tax liabilities, which then results in an increase in goodwill. In some circumstances, goodwill recognised is derived solely from the recognition of deferred tax liabilities, resulting in practical difficulties in the performance of goodwill impairment test.

(iii) Determining the fair value of contingent consideration (where determining the probability of occurrence of non-financial contingent events can be very subjective and arbitrary).

(iv) "Day 2" immediate write-off of goodwill in respect of Reverse-Take-Over (RTO) acquisitions

IFRS 3 requires the acquirer to measure the identifiable assets acquired and liabilities assumed at their acquisition-date fair values, which is the date the acquirer obtains control of the acquiree.

In the scenario of a typical Reverse-Take-Over (RTO), the accounting acquiree (legal parent) is a listed shell company whilst the accounting acquirer (legal subsidiary) is an operating private company looking to obtain a listing status.

The purchase consideration is satisfied through a share for share exchange and determining the cost of the business combination requires an estimation of the fair value of the shares issued.

In the case of RTO acquisitions, where a published price does not exist for the shares of the legal subsidiary, the cost of the business combination is determined by reference to the fair value of the legal parent (the accounting acquiree) i.e. the share price of the legal parent at the date on which the acquirer effectively obtains control of the acquiree (date of exchange). This date typically occurs many months after the date of announcement of the intended RTO. The prolonged time period between the date of announcement and the date of exchange introduces many variables that affect the price of the shares (upwards), resulting in a significant goodwill being recognised upon completion of the business combination. The use of the share price at the date of exchange, whilst reflecting marking price, typically does not provide a true reflection of the fair value of the shell company. The derived goodwill would be written-off immediately as the shell company has minimal business operations and no goodwill can be attributable to it.

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?

We note that there are diverse views with regards to requirement for goodwill to be tested annually for impairment. The main challenges relating to the annual impairment review are as follows:

(i) The impairment exercise entails a high level of judgment, subjectivity and complexity. Disclosures made by many entities also appear to be boilerplate in nature and not entity specific. Accordingly, there are mixed views about the usefulness of the information obtained from an annual impairment test.

(ii) Impairment testing, due to the high level of subjectivity and complexity, is subject to manipulation to achieve the desired result.

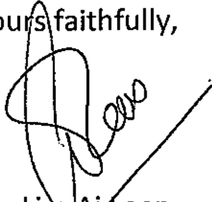
(iii) The notion that goodwill has indefinite useful life seems questionable. Acquired goodwill at date of business combination is typically dissimilar from the goodwill that is assessed for impairment in subsequent years. This could be attributed to rapidly changing business environment, changes in management's business strategy, operations or through additional capital invested into the business. Goodwill is eventually consumed and replaced with internally generated goodwill, which under existing IAS 38, is prohibited from recognition.

Due to the many issues and difficulties encountered with the annual impairment review exercise, there are views to return to the pre IFRS 3 (2004) requirements whereby goodwill is to be amortised over a fixed period of time. Although regular amortisation of goodwill may not produce reliable and relevant information, it is simple to apply and provides a practical answer to the fact that without amortisation, acquired goodwill is gradually replaced by internally generated goodwill. Returning to amortisation also appears to solve many of the issues encountered with impairment testing.

Due to the divergence in views and the significance of the subject matter, we would recommend that IASB work on improving the current impairment model.

Should you require any further clarification, please feel free to contact Ms Lim Ju May, Deputy Director, Technical Standards Development and Advisory, or Mr Ang Soon Lii, Manager, Technical Standards Development and Advisory, at ISCA via email at jumay.lim@isca.org.sg or soonlii.ang@isca.org.sg respectively.

Yours faithfully,



Ms Lim Ai Leen
Executive Director
Technical Knowledge Centre and Quality Assurance