MALAYSIAN ACCOUNTING STANDARDS BOARD
LEMBAGA PIAWAIAN PERAKAUNAN MALAYSIA

30 May 2014

Mr Hans Hoogervorst
Chairman
International Accounting Standards Board
30 Cannon Street
London, EC4M 6XH
United Kingdom

Dear Mr Hoogervorst

REQUEST FOR INFORMATION *POST-IMPLEMENTATION REVIEW: IFRS 3 BUSINESS COMBINATIONS*

The Malaysian Accounting Standards Board (MASB) welcomes the opportunity to provide comments on the IASB's Request for Information *Post-implementation Review: IFRS 3 Business Combinations.* We support the post-implementation review process and therefore welcome the publication of the Request for Information.

The comments from our constituents on experience with and the effect of, implementing IFRS 3 are attached in the Appendix of this letter.

If you need further clarification, please contact Ms. Tan Bee Leng at +603 2240 9200 or by email at beeleng@masb.org.my.

Thank you.

Yours sincerely,

DATO' MOHAMMAD FAIZ AZMI
Chairman

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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).

<u>Response</u>

Our constituents who commented on the IASB's Request for Information through our due process comprise preparers of financial statements and auditors. Their involvement with business combinations accounting has been mainly with IFRS 3 (2008).

Financial statements are prepared in accordance with the Malaysian Financial Reporting Standards (MFRS) Framework which is an IFRS-compliant Framework. MFRS 101 Presentation of Financial Statements *requires an entity to assert compliance with the MFRS Framework and the IFRS Framework. The MFRS Framework is effective for annual periods beginning on or after 1 January 2012.*

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?

<u>Response</u>

Some respondents believed that there are benefits of having separate accounting treatments for business combinations and assets acquisition. This is because the *different accounting treatments can have a significant impact on a company's earnings, financial ratios and business metrics. Nevertheless:*

- *a few respondents noted that when accounting for acquisition of a group of assets that does not constitute a business, the requirement to allocate the cost of the group to individual identifiable assets and liabilities on the basis of their relative fair values in accordance with paragraph 2(b) of IFRS 3 may not be consistent with the requirements in other Standards (e.g. IFRS 9 Financial Instruments which requires financial instruments to be initially measured at fair value).*

  Accordingly, they recommend the IASB to reconsider the requirements of paragraph 2(b) of IFRS 3.

- *one respondent suggested that guidance should be provided on the accounting treatment for acquisition-related costs on an entity's separate financial statements i.e. whether the acquisition-related costs should be treated as cost of investments or written off to income statements if an entity chooses to account for its investments in subsidiaries, joint ventures and associates at cost in accordance with paragraph 10(a) of IAS 27 Separate Financial Statements.*

  This is because IAS 27 does not define 'cost' except in specific circumstances of certain types of group reorganisation. We believe such guidance is helpful to jurisdictions like Malaysia as MFRSs (=IFRSs) are required to be applied in the preparation of separate financial statements.

However some other respondents were of the view that having separate accounting treatments may encourage a deliberate choice of one or the other in order to have a preferred result/impact on the financial statements. Such different treatments may also result in non-comparability.

Below are some examples to illustrate the point of non-comparability:

(i) In a scenario where one entity has accounted for an acquisition of say a portfolio of investment properties as a business while another has accounted for the acquisition as an acquisition of individual assets (investment properties), the same portfolio of investment properties may be reflected at different carrying values in the two different sets of financial statements.

(ii) In the case of land acquisition, when one acquired a piece of land, the price would be the cost paid for the land. However, if one acquired a company that owns the same piece of land, fair value accounting would apply which may give rise to the recognition of goodwill. In such a scenario, it did not make sense for the same piece of land to be reflected at different values because of the different accounting treatments accorded under business combination and that under an asset acquisition.

In this regard, they opined that there is no perceived benefit in having different accounting treatments for business combinations and asset acquisitions as effectively they could result in assets being booked at different carrying values although in substance both are acquisitions of net assets.

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(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?

Response

Some auditors had encountered scenarios where it is not apparent whether an acquisition meets the definition of a business combination or an asset acquisition. Examples include:

(i) One may argue that the main purpose of acquiring a service concession company is to acquire the valuable concession contract.

Would the acquisition be an acquisition of the concession contract (asset) or the business?

(ii) In a scenario where a business was acquired and in addition to its normal operations, there are landed assets which are idle (and clearly those landed assets on their own would not meet the definition of business).

Would the entity be allowed to segregate the landed assets from the business and to account for them as an asset acquisition?

In this regard, they believed that further guidance should be provided to assist entities to confidently determine whether an acquisition is a business combination instead of an asset acquisition since it would result in different outcomes.

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?

Response

Respondents generally believed the information derived from the fair value measurements is relevant and sufficient.

However, some respondents suggested that disclosures of information pertaining to fair value estimation and the circumstances in which the estimation is done would help users of financial statements better understand the entity's basis of estimation.

(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?

Response

Based on the feedback received from the respondents, the most significant valuation challenges in measuring fair value within the context of business combination accounting include:

- *the lack of active market for certain assets and liabilities.*
- *the assumptions and inputs used are highly subjective.*
- *the choice and sophistication of acceptable valuation techniques and models*

Some auditors noted that the above valuation challenges would have symmetrical effects on auditing, in particular when the degree of estimation uncertainty increases, they may not have sufficient relevant evidence to support them which in turn increases the risks of material misstatement.

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

Response

Based on the feedback received from the respondents, fair value measurement has been more challenging for the following elements:

- *Valuation of intangible assets e.g. intellectual property (refer to further comments in Question 4(b) below)*
- *Valuation of certain financial instruments (e.g. unquoted investments)*
- *Valuation of contingent consideration / earn-out*
- *Valuation of guarantee (requires consideration of the underlying risks, with respect to their probability, magnitude and discount rates)*

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?

Response

Some respondents believed that the separate recognition of intangible assets is useful because it provides useful information about the value of the intangible assets and the reasons for which the acquirer is willing to pay a premium for the acquisition. It also addresses measurement issues since different measures are used for different categories of assets. For these reasons, they believed no change to the separate recognition of intangible assets is needed.

On the other hand, some respondents, while they did not object to the recognition of intangibles, did not support the different accounting treatments for different types of intangibles, specifically goodwill.

(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?

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Response

Most respondents expressed concerns about the reliability of fair value valuations of intangible assets. The reasons given include:

(a) *the initial and subsequent valuations of intangible assets rely on assumptions and inputs that are highly subjective in the absence of markets for those assets.*

(b) *they are not frequently traded on a stand-alone basis and therefore very often there is no active market created for them*

(c) *in the testing for impairment and in the determination of whether an intangible asset (e.g. source code) has an indefinite life or a finite life, it is difficult to identify the future cash flows of recognised intangible asset as they are unique.*

(d) *appropriate valuation methods are not well understood*

(e) *values may be attributed to the wrong asset due to confusion on the source of profit generation*

(f) *failure to understand the entity's core value and the special characteristics of its intangible assets*

(g) *inability to extract intangible assets individually, so that values are counted twice (for example, brands and customer relationships)*

(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?

Response

Some respondents believed the recognition of negative goodwill in profit and loss and the disclosures about the underlying reason are useful because they enhance transparency in financial reporting and the understanding of users as to the justifications of the bargain purchase.

On the other hand, some respondents opined that there is no sound principle to immediately recognise negative goodwill in profit or loss but to assess goodwill for impairment. They found it difficult to reconcile such asymmetrical requirement.

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?

Response

Respondents believed the information obtained from annually assessing goodwill and intangible assets with indefinite useful lives for impairment is useful.

(b) **Do you think that improvements are needed regarding the information provided by the impairment test? If so, what are they?**

<u>Response</u>

Some respondents believed no improvements are needed regarding the information provided by the impairment test while some respondents believed disclosures made by most entities may be boilerplate in nature and are not entity specific. These respondents recommended that the IASB consider establishing appropriate criteria so that it results in entity specific type of disclosures. Having said that, they also acknowledged that the IASB needs to consider the cost against the benefit of more extensive disclosures.

(c) **What are the main implementation, auditing or enforcement challenges in testing goodwill or intangible assets with indefinite useful lives for impairment, and why?**

<u>Response</u>

Based on the feedback received from some respondents, the main implementation and auditing challenges include:

- *the estimates and assumptions underlying impairments require a higher degree of professional skepticism as these judgment areas are susceptible to management bias. It will be challenging for the auditors to verify those estimates and assumptions.*
- *determination of the recoverable amount of the cash-generating unit to which the goodwill or intangible assets with indefinite useful lives relate, and this will exacerbate the level of audit difficulty to the auditors.*
- *insufficient technical skills to handle such high-level tasks on the part of preparers.*

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?**

<u>Response</u>

Generally, respondents found the information on the presentation and measurement requirements for NCIs useful.

However, some respondents believed that having a choice in measuring NCIs, either at fair value or as a proportionate share of the acquiree's net identifiable assets, on an acquisition by acquisition basis is not appropriate. In their view, the selected accounting policy should be consistently applied to all transactions of similar nature and there is no conceptual merit as to why for this type of transactions the accounting policy choice is on an acquisition by acquisition basis.

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Further, inconsistency exists between the accounting requirements of IFRS 10 Consolidated Financial Statements *and IAS 28* Investments in Associates and Joint Ventures.

IFRS 10 requires an entity to attribute total comprehensive income applicable to NCIs to those interests, even if this results in the NCIs having a deficit balance.

However, IAS 28 states that after the entity's interest is reduced to zero, additional losses shall be provided for, and a liability shall be recognised, only to the extent that the entity has incurred legal or constructive obligations or made payments on behalf of the associate or joint venture. These respondents were of the view that a negative NCI balance in the consolidated financial statements has no added value to the financial statements.

(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.

<u>Response</u>

Respondents preferred measurement option is the proportionate share of the acquiree's identifiable net assets. This measurement choice is made on an acquisition-by-acquisition basis.

They commented that they have not encountered any significant or major challenges in the accounting for NCIs (and the auditing aspect) except for measuring NCIs of unquoted acquirees that did not have comparable market information which resulted in the increased use of management judgement.

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.**

<u>Response</u>

Generally, respondents found the information on step acquisition and the accounting for parent's retained investment on loss of control in a former subsidiary to be useful. The information disclosed enable users to:

(a) evaluate the financial effects of any adjustments that are recognised in the current reporting period that relate to business combinations that have occurred either in the current or in previous reporting periods; and

(b) assess the impact from the acquisition and loss control of a subsidiary.

However, some respondents were of the view that the rationale on why a gain/loss arising from remeasurement to be recognised in profit or loss is not well understood, especially when there is no disposal of the retained interest. They believed that it would be conceptually incorrect to assume that there is deemed disposal when in substance there is no disposal.

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?

Response

Generally, respondents were satisfied with the overall disclosure requirements of IFRS 3. In their view, the key function of disclosures is to enable users of financial statements to evaluate the nature and financial effects of any adjustments that are recognised at any point in time. They believed the disclosure requirements of IFRS 3 provide relevant information to the users.

The respondents also shared that they had not encountered any significant or major challenges in preparing and/or auditing the disclosures required under IFRS 3 or its related amendments.

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.

Response

Based on the feedback received from respondents, other matters that the IASB should be aware of include business combinations under common control (BCUCC), put options written on NCI (NCI puts) and contingent consideration (paragraph 58 of IFRS 3).

On the three topics, the respondents noted that the IASB has included BCUCC and NCI puts in its work plan. As regards to contingent consideration classified as an asset or a liability that is within the scope of IFRS 9, the respondents would like the IASB to consider accounting for the resulting gain or loss as part of the purchase consideration instead of recognising either in profit or loss or in other comprehensive income. This is because the contingent consideration is part of the consideration for the acquisition of a business and accordingly, any changes to the fair value of the contingent consideration should be treated as an adjustment to the cost of acquisition of the business. This proposed treatment is also consistent with the principles as contained in IFRIC 1 Changes in Existing Decommissioning, Restoration and Similar Liabilities.

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;**

Response

Based on the feedback received from the respondents, the benefits include enhanced transparency in view of the extensive disclosures.

(b) **have resulted in considerable unexpected costs to users of financial statements, preparers, auditors and/or enforcers of financial information, and why; or**

Response

Based on the feedback received from the respondents, the considerable unexpected costs arise from the increase reliance on expert valuations. This will inevitably put pressure on compliance cost which will in turn give additional audit considerations to auditors.

Some were concerned about the reliability exception. In their view, virtually every IFRS that requires fair value measurement requires such a measurement only if the fair value can be measured reliably. Therefore, if the fair value estimate is so unreliable that it is misleading, an entity may deviate from the requirement of fair value measurement but subject to the auditor's agreement. More often than not, this may give rise to differing views in which one need to be discernible enough as to what constitute "reliability" in different circumstances.

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(c) have had an effect on how acquisitions are carried out (for example, an effect on contractual terms)?

<u>*Response*</u>

Based on the feedback received from the respondents, one of the impacts of IFRS 3 is that the management may need to re-examine their contractual clauses associated with acquisitions particularly with regard to the cash component of earn-out and the determination of fair value adjustments related to those items may need to be recognised in the income statement rather than goodwill. In other words, IFRS 3 could potentially require M&A strategic make-over at the early stage to avoid surprises.