FRC MAURITIUS
FINANCIAL REPORTING COUNCIL
(Established under the Financial Reporting Act 2004)

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

Dear Sir

Request for information, Post implementation Review, IFRS 3, Business Combinations

The Financial Reporting Council (FRC) in Mauritius has one of its main functions to promote the provision of high quality financial and non-financial reporting and quality audit.

The FRC has initiated procedures to obtain comments with respect to Post-implementation Review: IFRS 3 Business Combinations at a national level. The participants are the members of the Standards Review Panel, auditors, and preparers of financial statements of companies listed on the Stock Exchange of Mauritius.

The comments and responses to specific questions included in the request for information, Post implementation Review, IFRS 3, Business Combinations, are included in the following pages.

For any further clarifications, please contact us at **frc.mauritius@intnet.mu**

Yours faithfully

Financial Reporting Council FRC Mauritius

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<u>Question 1</u>

Please tell us:
(a) about your role in relation to business combinations (i.e. preparer of financial statements, auditor, valuation specialist, user of financial statements and type of user, regulator, standard-setter, academic, accounting professional body etc).

11 responses were received, including 1 auditor, 1 SRP member, 9 preparers of financial statements.

(b) your principal jurisdiction. If you are a user of financial statements, which geographical regions do you follow or invest in?

No comments

(c) whether your involvement with business combinations accounting has been mainly with IFRS 3 (2004) or IFRS 3 (2008).

Both 2004 and 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.

None of the respondents are recent adopters of IFRS

The preparers have been involved in 16 business combinations accounted under IFRS. The industries of the acquirees are : Transport, Hospitality, Insurance, Financial Services, Transport and IT, Property Investment

The auditors have been involved in 15 business combinations in various industries such as Banking, Insurance, Hotel, Manufacturing.

(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).

Not applicable

Question 2

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

Most of the respondents share the same view:

The benefits are :

- ***Business combination accounting gives a clear view on the evaluation of the new business and its impact on the combined entity.***
- ***It conveys a better understanding of the underlying transactions to users of financial statement. Separate treatment ensures the accounting reflects the substance of the transaction. Therefore, this approach provides users with relevant and useful information that is capable of making a difference in decisions made.***
- ***Additionally, if acquired assets were accounted for in the same way as a business combination, this would result in unnecessary complexity, unintended consequences and cost exceeding benefits. Having simplified accounting treatment for asset acquisitions benefit preparers and auditors.***

(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?

Prepares of financial statements and the Standards Review Panel believe:

The first stage in accounting for an acquisition is to determine whether a transaction or other event is a business combination, which requires that the assets acquired and liabilities assumed constitute a business.

- ***A proper assessment of the conditions in the contract for acquisition must be carried out.***
- ***Albeit the fact that a business is defined in IFRS 3 with detailed guideline set out in paragraphs B5-B12 of the Standard, the definition of a business is ambiguous. Additional implementation guidance and illustrative examples are required to tackle this implementation problem. For instance, the parameters of what constitutes a business could be more clearly defined. Moreover, existing guidance and examples should be reviewed as part of this initiative to ensure that it can be clearly assessed when a business exists.***

Some of the auditing challenges were:

- ***In some transactions, significant judgement is required to determine whether a transaction is a business combination or an asset acquisition. The definition of input, output and process can be judgemental and can be subject to diverse interpretation. The main consideration we take into account are the substance of the transaction and the extent to which the "inputs, outputs and processes" are material to the performance of the business being acquired.***

- ***The other difficult area where there is a lack of guidance is when a company makes an acquisition under common control. Many transactions under common control have commercial substance but the standard does not recognize this fact. The scoping out of business combinations under common control should be restricted to transactions where there is no commercial substance.***

<u>Question 3</u>

(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?

The Standards Review panel is of the view that information derived from the fair value measurements enable users of the financial statements to make an assessment of the investment made by the acquirer, in terms of the assets and liabilities it has obtained control over and of the subsequent performance of the investment through the consumption of assets and settlement of liabilities. Recognising all assets and liabilities acquired, and recognising these at fair value, gives better information about market expectations of the future cash flows related to the assets and liabilities and to their future performance.

The auditors believe that the information about fair value measurements are relevant to the extent that they assist the readers to better understand how the consideration paid by the acquirer has been arrived at. Hence they help users to better assess whether a business combination is a good or bad deal for the acquirer. The level of information provided is generally sufficient.

There are mixed views amongst preparers of financial statements about the relevance of the information derived from the fair value measurements and disclosures. The deficiencies identified were:

- ***lack of market indices and;***
- ***changing economic conditions.***

(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?

The challenges identified by the preparers are:

- ***For private companies, absence of comparable transactions for valuation purposes . Subjectivity in assumptions used.***
- ***Access to or lack of information***
- ***Fair valuing internally generated assets such as brand name of the subsidiary are challenging especially in the absence of market data***

This view is also shared by the auditors who believe that determining fair value of intangible assets such as brand name or customer relationships are very challenging especially in the absence of market data. Identifying the cash flows associated by these intangible assets is also very challenging because the cash flows may be attributable to more than one intangible asset. The discount factor used to establish the present value of the cash flows is also another issue especially that it is sometimes difficult to determine a risk premium due to absence of observable market data. Establishing the cash flow itself is also very challenging as it involves a high degree of subjectivity.

The Standards Review Panel think that from an auditing perspective, some of the challenges that arise when measuring fair value in business combinations are as follows:

• the re-measurement of acquired assets and liabilities on day two for provisions, uncertain tax positions and inventory, because of the limited guidance provided

• identifying and measuring intangibles, as many of them are not valued for any other purpose and do not have a market on which they are traded

• Verifying the fair value of contingent liabilities is extremely challenging for auditors given the significant degree of subjectivity involved.

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

No comments

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

All respondents agree that fair value measurement is challenging for the following assets, which are:

- ***Land***
- ***Intangible assets, such as brands and customer relationship***

<u>Question 4</u>

(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?

Most respondents find the separate recognition of intangible assets useful.

Reasons provided are as follows:

- ***it enables the proper understanding and assessment of intangible assets including its economic useful lives.***
- ***It ensure that the statement of financial position recognise relevant information about significant assets that help justify the acquisition.***

Changes to the Standard are required:

- ***there is little incentive for intangible assets to be recognized . To address this deficiency, changes in the standard are required which include a reconsideration of identifiable intangible assets arising on business combinations and better treatment of identifiable intangible assets.***

- ***another area that should be re-looked at by the IASB includes internally generated intangible assets. In the 'new economy' the requirement to recognise internally generated intangible assets that are only acquired is no longer appropriate.***

(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?

Implementation and enforcement challenges

- ***Difficulties in proper identification and user valuation of intangibles (other than goodwill)***
- ***Subjectivity of estimates used in techniques to fair value intangible assets, e.g. cash flow forecasts, determining discount rate***

- ***The standard does not recognize the inter-relationships between different assets. For example, a company may have a customer list but the customers loyalty to the company may be for different reasons. For example, some customers are loyal because of relationships with the company and some because of the brand / reputation of the company. If the company's brand suffers a reputation damage, it will lose customers regardless of the relationships it has with its customers. Therefore assigning a separate fair value to brand name and customers relationships could be arbitrary.***

The Panel believes that due to the above challenges, additional guidance on the latter is welcomed. Some acquirer decide to recognise goodwill rather than identifiable intangible assets and this poses a challenge to auditors. This issue can be addressed through greater incentive to recognise identifiable assets appropriately

(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?

There are mixed views amongst preparers of the financial statements. Some were of the view that it distorts EPS as the gains recorded is only a book entry, whilst others believe it gives a true and fair view of the business combination.

The disclosures required by paragraph 64(n) of IFRS 3 in relation to negative goodwill is not always useful. IFRS 3 does not specify where in the profit or loss the excess should be shown. This impedes comparability and the Standard should require presentation of this gain on the face of the profit or loss.
Disclosure about the underlying reasons why the transaction resulted in a gain allows the company to explain the circumstances in which it has obtained such a good deal.

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?

Respondents found the information useful for the following reasons:

- ***It allows the company to reassess intangible assets with indefinite useful lives.***
- ***Helps to find out about the facts and circumstances leading to the impairment***
- ***understand the method for determining fair value***
- ***find out in which segment the impaired intangible asset is reported***
- ***it allows the users to assess the post-acquisition performance of businesses acquired by the entity.***

The Standards Review Panel is of the view that Impairment test can be used to convey private information; alternatively, others may use it opportunistically to distort the underlying economics of the firm by being selective with respect to the underlying choices they make when testing goodwill for impairment due to the absence of a specific impairment trigger. There is too much of discretion under the annual impairment requirement. Therefore, ex-ante, it is unclear how the impairment-only approach has affected the reporting of goodwill impairment losses, including the related managerial flexibility exercised in determining them. The costs of goodwill impairment tests exceed the benefits of such test.

Assessing impairment requires valuation of future cash flows. Because those future cash flows are unlikely to be verifiable and contractible, and valuation based on them, are likely to be manipulated.

Goodwill arising on acquisition is eventually consumed and replaced with internally generated goodwill. Therefore, it is better to amortise the goodwill over a fixed period so that goodwill is completely written off over a period after which it is no longer relevant to be recognised. Though amortisation could tackle the weaknesses of the impairment model, there are no potential benefits in further diverging from US GAAP, given that that FASB presently requires impairment testing.

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

Respondents who think improvements are needed stated:

The requirement to annually assess goodwill and intangible assets with indefinite useful lives for impairment imposes significant cost and could be replaced with impairment tests only when there is an indication that the goodwill might be impaired. As a result of the weaknesses with the impairment test, the IASB should consider working with the FASB to improve the current impairment model.

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

The impairment testing model is significantly subjective and complex. Determining the cash flows from the cash generating unit to which the goodwill has been allocated, the discount factor to be applied and the terminal value of the cash flows can be very judgmental. For instance, if a goodwill balance still exists after a certain period (e.g. 10+ years) after the business combination, there is a possibility that it has been replenished by internally generated goodwill and should therefore no longer be recognised. However, it is challenging for auditors to properly verify the impairment test and therefore the financial statement could include goodwill that has probably been fully impaired.

Further guidance and illustrative examples will be useful in this area. The current impairment test for goodwill is difficult to apply in practice.

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?

All respondents agree that the information relating to presentation of NCI is useful as it helps in assessing the proportion of profit attributable to NCI and hence its influence. Moreover, information about NCI helps user of financial statements to understand the measurement basis of NCI (i.e. either fair value or proportionate share of the acquiree's net identifiable assets).

(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.

Respondents believe that the main challenges are : Measuring NCI at fair value , when the acquiree is not quoted on a stock exchange . For such unquoted acquiree, the discount factor and other estimates applied to compute the price per share to determine the fair value of the NCI are judgemental and a source of estimation uncertainty. .

The choice of measurement basis for NCI where there are present ownership interests at either fair value or the present ownership interests' proportionate share in the recognised amounts of the acquiree's net identifiable asset is confusing for auditors and it is not clear why the choice is provided for present ownership interests only and not for all business combinations. For instance, the choice of measuring NCI is not available for step acquisitions. Measuring NCI at fair value poses an auditing problem whereby it is difficult for auditors to understand the measurement.

<u>Question 7</u>

(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.

There are mixed views with respect to the usefulness of information resulting from the step acquisition guidance in IFRS 3

The preparers of the financial statements believe that such information are useful since it helps to identify:

- ***Whether there has been a goodwill or a gain on bargain purchase arising on the step acquisition:***
- ***Cash consideration paid to NCI; and***
- ***Carrying amount of the net assets.***

Moreover, the preparers stated that the details on how to account for step acquisition are well explained in the Standard.

On the other hand, the Standards Review Panel believes that the new guidance in IFRS 3 (2008) in particular paragraph 42 of the Standard to account for combination when control is reached through a 'step acquisition' has led to confusion and conflicting views among auditors. The gain arising from step acquisitions do not always provide useful information.

Additionally, there is currently no guidance in the Standard on accounting for step acquisitions and the acquisition-related costs in the separate financial statements. This has led to divergent practice and confusion among auditors. The IASB should consider adding guidance in IFRS 3 on this issue.

The Auditors are of the view that the guidance in IFRS 3 is fairly straight forward. However, they share the view of the Panel, that it is unclear how re-measuring the non-controlling stake in the acquire at fair value and recognizing a gain or loss on the re-measurement provides useful information to the users.

(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.

Some of the preparers of financial statements believe that the information is useful as it helps to determine:

- ***The disposal proceeds;***
- ***Gain on disposal of the subsidiary to both the group and the parent company;***
- ***Carrying amount of the net assets at the date of disposal.***

Another point raised by preparers is the measurement of fair value of investment retained in a step acquisition. On disposal of a controlling interest, any retained interest in the former subsidiary is measured at fair value on the date that control is lost. When the subsidiary is not listed, the fair value is estimated either through models or in relation to the consideration received for the holding disposed. Such fair value measurement is not useful as it is an approximation.
The Standards Review Panel and the Auditors believe that the requirement to recognise gains or losses on the retained investment upon loss of control in a former subsidiary is hard to understand and many auditors disagree with the recognition of such gains and losses. The accounting treatment should be re-looked.

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?

All the respondents are of the view that the information required to be disclosed is sufficient for the understanding of users.

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

No comments

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

The Standards Review Panel believes that the disclosures required by paragraphs B64 to B67 of the Standard should be reconsidered. The disclosure requirements are cumbersome. Users are more interested in the net effect of business combinations effected during the year. Auditors have difficulties verifying all the disclosures. Some of the disclosures do not benefit users and therefore on a cost and benefit basis in line with the conceptual framework should be reviewed. Given that there is an ongoing project on disclosure framework, it is therefore ripe to consider these disclosure as part of this project and disclosures that place undue cost with no clear benefits should be removed. There are confusion regarding comparative disclosures. The Standard should be clear on the principle relating to this matter.

<u>Question 9</u>

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;

No comments

(b) learning about practical implementation matters, whether from the perspective of applying, auditing or enforcing the Standard and the related amendments; and

No comments

(c) any learning points for its standard-setting process.

The preparers of the financial statements believe that the standards should be practical to take into account the various types of business combinations and should not be costly for implementation.

The Panel and the Auditors believes that the lack of guidance on accounting for common control transaction is a real concern particularly in our jurisdiction where such transactions are very common. It has led to confusion and divergent practice. Where such transactions occur, auditors refer to IAS 22 for guidance and the transaction is accounted using the pooling of interest. However, this approach do not yield the best result. Auditors are puzzled by the fact that they have to refer to an accounting standard that do not exist. Moreover, there are no detailed guidance on pooling in IAS 22. The decision to remove all guidance on pooling was probably not the best decision in hindsight and the IASB has paused this project for a too long time. While initial work has been carried out by the UK FRC and EFRAG, this project has not progressed to an advanced stage. The IASB is urged to address common control transaction on a expedited basis.

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;

- ***The calculation of Goodwill.***
- ***Information for users of accounts to understand how goodwill and gain on bargain purchase has been computed.***
- ***Assumptions used in determining fair value***
- ***The requirements to fair value identifiable assets acquired and the liabilities assumed at the acquisition date.***
- ***The requirement relating to acquired identifiable intangible assets, such as brand name, a patent etc to be recognised by the acquirer***
- ***Intangible assets on the Balance Sheet***

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

- ***Fair valuation exercise***
- ***The Fair value of NCI of an unlisted company.***
- ***Fair value of Contingent consideration..***

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

- ***Assessing the value of the business. Undisclosed or future synergies when combining with the existing businesses***
- ***Brand names or customer list not recognized in the accounts***
- ***Reassessment of contingent liability each year***