European Securities and Markets Authority

The Chair

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ESMA/2014/645

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

The IASB's Request for information on the Post-Implementation Review: IFRS 3 Business Combinations

Dear Mr Hoogervorst,

The European Securities and Markets Authority (ESMA) thanks you for the opportunity to contribute to the IASB's Post-Implementation Review (PIR) of IFRS 3 - *Business Combinations*. We are pleased to provide you with the following comments with the aim of improving the transparency and decision usefulness of financial statements and the enforceability of IFRSs.

ESMA strongly supports performing post-implementation reviews as an opportunity to assess the effects of standards on financial statements and their evaluation by various stakeholders. In that context, we believe that post-implementation reviews should pay particular attention to the enforceability of the standards and whether further improvements are necessary to reduce the divergence in practice and achieve the objective of developing a single set of high quality, understandable, enforceable and globally accepted standards.

ESMA has considered the request for information from the IASB on the PIR of IFRS 3 and believes that ESMA's *Report on the application of accounting requirements for business combinations in the IFRS financial statements ("ESMA Report on IFRS 3")* provides the IASB with useful information on areas where IFRS 3 requirements allow divergence in practice or lack of comparability and where additional clarification or guidance would be helpful in achieving the objectives of the standard.

ESMA's Report on IFRS 3 provides an analysis of the consistency in the application of key requirements of IFRS 3 and assesses how compliant and entity-specific the disclosures required by IFRS 3 are in the 2012 annual IFRS financial statements of a sample of 56 issuers in the European Union. In addition, the report includes other IFRS 3 issues identified as part of the enforcement experience of European enforcers. This report is included as Appendix I to this letter, together with a table of references linking specific parts or sections of the report to the questions in the request for information (Appendix II).

As indicated in the ESMA Report on IFRS 3, based on the results of the review, ESMA considers that the IASB should revisit the IFRS 3 disclosure requirements in line with the findings of the IASB's Disclosure Initiative project. We believe that the IASB should evaluate these disclosures in order to ensure that they provide useful and relevant information to investors, in particular in relation to the valuation techniques used

ESMA also suggests that the IASB considers whether further requirements to provide pro-forma information could be required by the standard. The experience of securities regulators in the EU indicates that pro-forma financial information provided in accordance with EU legislation[1] is useful for the decision making process of users of the IFRS financial statements.

As question 5 of the request for information specifically addresses the usefulness of information obtained from annually assessing goodwill for impairment and its enforceability, ESMA prepared a separate answer on this matter (please refer to Appendix III to this letter). In this regard, we also draw your attention to ESMA's *Report 'European enforcers review of impairment of goodwill and other intangible assets in the IFRS financial statements'*[2], which includes findings on the application of the requirements of IAS 36 - *Impairment of non-financial assets*.

Please do not hesitate to contact us should you wish to discuss all or any of the matters presented in this letter or the Reports attached to it.

Yours sincerely,

Steven Maijoor
Chair
European Securities and Markets Authority

[1] Annex II of Commission regulation (EC) No 809/2004 (Prospectus Directive implementation Regulation)
[2] http://www.esma.europa.eu/system/files/2013-02.pdf

List of Appendices

Appendix I. ESMA Report on the application of accounting requirements for business combinations in the IFRS financial statements *(please refer to separate document (2014/ESMA/643))*[3]

Appendix II. Table of references between the application of accounting requirements for business combinations in the IFRS financial statements and the questions in the request for information

Appendix III. ESMA answer on the IASB Request for Information: Post-Implementation review of IFRS 3 – Business Combinations – Question 5 - Accounting for Goodwill

3 http://www.esma.europa.eu/system/files/2014-643_esma_report_on_the_ifrs_3.pdf

Appendix II – Table of references between the application of accounting requirements for business combinations in the IFRS financial statements and the questions in the request for information

Question 1. Background and experience

1. The European Securities and Markets Authority (ESMA) is an independent EU Authority that contributes to establishing consistent application of International Financial Reporting Standards (IFRS) in the European Union and to building a common supervisory culture and consistent approaches between national competent authorities in the EU.

2. European listed companies apply IFRS for their consolidated financial statements since 2005.

Table of references:

Questions from the RfI	Sections/Paragraphs of the ESMA report on IFRS 3
Question 2.Definition of a Business	Paragraphs 101-104
Question 3.Fair Value	Paragraphs 51-59
Question 4. Separate recognition of intangible assets from goodwill and the accounting for negative goodwill	Paragraphs 33- 39; Paragraphs 42, 44-45 Paragraphs 70-76
Question 5. Non-amortisation of goodwill and indefinite-life intangible assets	Appendix III to this letter
Question 6. Non-controlling interests	Paragraph 53 and 58
Question 7. Step acquisitions and loss of control	*Partially responded by* Paragraphs 79-84
Question 8. Disclosures	Paragraphs 20-28; Paragraphs 51-59 (question 3) Paragraphs 61-66; Paragraphs 108-112
Question 9. Other matters	Paragraphs 31 and 41 Paragraphs 40, 43, 46-47 Paragraphs 67; Paragraphs 89-95

Appendix III – ESMA answer related to IASB Request for Information: Post-Implementation review of IFRS 3 – Business Combinations – Accounting for Goodwill

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?

1. In recent years ESMA has identified the application of the requirements related to the impairment testing of goodwill from IAS 36 – Impairment of Assets as one of the areas posing great challenges to enforcers. In 2012, ESMA performed a review of the application of these IAS 36 requirements on a sample of IFRS financial statements for the year ended on 31 December 2011, which results were published in a report in January 2013 (ESMA/2013/24) ('Report on Impairment').

2. The Report on Impairment illustrates among others that despite the financial and economic crisis and deteriorated economic outlook, goodwill impairment losses were limited to a handful of issuers, concentrated in a limited number of industries and identified shortcomings in relation to disclosures.

3. Based on the Report on Impairment and other recent publications stemming from enforcement activities (e.g. extracts from the enforcement database), ESMA has identified several issues where enforcement of current requirements related to goodwill impairment test is challenging. These issues are linked to both the recognition and measurement of impairment losses and the disclosures related to the impairment test on goodwill. Therefore, ESMA encourages the IASB to assess possible improvements to the current requirements related to these matters.

Enforceability issues related to the impairment test on goodwill

4. One of the main issues that enforcers face with regard to the recognition and measurement of impairment losses is the assessment of the future cash flows in case the recoverable amount is calculated using the value in use (VIU) approach. The existing requirements in IAS 36 make it very difficult for enforcers to challenge cash flow projections prepared by the management, even when these assumptions seem much more optimistic than based on general economic forecasts or the

[4] http://www.esma.europa.eu/system/files/2013-02.pdf

entity's own past performance. These difficulties might contribute to the perceived time lag between the identification of deterioration of the future cash flow prospects based on market derived indicators (e.g. market capitalisation falling below the book value) and the recognition of the impairment losses in the IFRS financial statements.

5. ESMA identified shortcomings related to the description of the management approach to determining the value(s) assigned to each assumption, whether those values(s) reflect past experience or, if appropriate, are consistent with external sources of information as required by paragraph 134(d)(ii) of IAS 36. The high level of subjectivity in determining many assumptions and estimates combined with disclosures requirements that prove difficult to be enforced creates an incentive for earnings management. This conclusion seems also to be widely confirmed by the academic literature.

6. The Report on Impairment shows the lack of informative disclosures on the sensitivity of the impairment tests' results to the changes in assumptions. ESMA is concerned that the sensitivity analysis disclosures in paragraph 134(f) of IAS 36 are required only in certain circumstances. The resulting lack of transparency implies that users of the financial statements cannot assess whether the disclosures were omitted because the headroom in the impairment test was significant or because of other reasons. Therefore, ESMA suggests that the IASB considers strengthening these disclosure requirements.

7. The Report on Impairment also points to a number of issues related to disclosures about the determination and description of the growth rate and the discount rate as well as the description of the methods used to determine the recoverable amount. In respect to the disclosures about key assumptions it highlights that these disclosures were often not provided, or were not entity specific.

8. In addition to the elements included above which come mainly from the findings of the Report on Impairment, based on the coordination of enforcement activities in Europe, ESMA has identified additional issues which raise concerns about the enforceability of specific provisions in IAS 36:

9. Allocation and reallocation of goodwill to cash generating units (CGU) – ESMA is concerned about the flexibility of principles related to the allocation of goodwill to CGUs. In some cases, CGUs from different business areas that have different levels of profitability are combined into a group of CGUs to which a goodwill or part of a goodwill will be allocated, with the specific aim to avoid recognition of impairment on goodwill. Furthermore, an internal reorganisation may allow issuers to avoid recognising an impairment of goodwill. The lack of more specific criteria for dealing with such cases makes their enforceability particularly difficult.

10. Discounted cash-flows method (DCF) – The DCF method is commonly used for determining the VIU. However, ESMA notes that the DCF method is also widely used to estimate the fair value less cost to sell (FVLCS) when no market value or more broadly no market data is available. ESMA is aware that for many market participants it is difficult to understand the differences between the use and outcome of the DCF model (although with variations) for both the VIU and the FVLCTS calculations. Although ESMA acknowledges that the DCF method could be used for both VIU and FVLCS calculation, clarification of the differences between the uses of the DCF method for the two calculations could enhance enforceability of IAS 36.

Possible improvements to the current goodwill impairment model

11. On the basis of the experience of enforcers with the currently applied impairment model in IAS 36 and of the conclusions from the Report on Impairment, ESMA suggests that the IASB considers targeted improvements to IAS 36. These improvements could include the following:

12. Improvements to disclosure requirements on impairment of goodwill – The IASB could consider enhancing the disclosure requirements e.g. by requiring mandatory disclosure of the sensitivity analysis. ESMA believes that the existence of an indication that an asset may be impaired justifies additional disclosure requirements and would improve transparency to the market. ESMA noted many cases when despite the existence of an impairment indicator (e.g. market capitalisation of the entity or of the CGU being lower than its book value), the disclosures provided did not enable users to understand why no impairment expense had been recognised. Furthermore, IASB could also consider requiring reconciliation between VIU and FVLCS values in these circumstances.

13. Sensitivity analysis disclosure when an impairment expense has been recognised - The IASB could clarify paragraph 134(f) of IAS 36 and explicitly require disclosures of the sensitivity analysis in the case an impairment loss occurred during the reporting period presented. ESMA believes that the objective of the sensitivity analysis is to provide users with information on the impacts possible changes in key assumptions would have on the amount of goodwill recognised at the end of the reporting period. However, based on the current wording used in paragraph 134(f)(iii) of IAS 36 many issuers believe that as the carrying amount is equal to the recoverable amount no disclosure of sensitivity analysis is required.

14. Sensitivity analysis related to key assumptions - Based on its experience, ESMA suggests that the IASB explicitly states in IAS 36 that when a sensitivity analysis needs to be provided, the requirement does not only apply to the growth rate and the discount rate but also to other key assumptions. ESMA understands that this proposal is aligned with the IASB's initial intention

about the disclosure of sensitivity analysis but is worried that this intention might not be clear based on the current wording of paragraph 134 of IAS 36.

15. Pre-tax and post-tax discount rate – In light of the fact that post-tax rate is used when calculating fair value according to IFRS 13 – Fair Value Measurement, ESMA suggests IASB to reconsider its requirement to disclose only the pre-tax rate when measuring the recoverable amount based on the VIU calculation. Use and disclosure of the pre-tax rate for goodwill impairment test can be confusing to users of financial statements as observable market information is available only for post-tax rates.

16. Significance of goodwill - ESMA believes that the IASB should consider introducing an additional test that would trigger additional disclosures in order to capture impairment tests that may have a material impact on the statement of comprehensive income. The disclosure requirements in paragraph 134 of IAS 36 are to be applied 'to the cash generating unit for which the carrying amount of goodwill or intangible assets with indefinite useful life allocated to that unit is significant in comparison with the entity's total carrying amount of goodwill or intangible assets with indefinite useful lives'. Although ESMA understands the purpose of assessing the significance of these amounts, ESMA notes that due to the significance of total goodwill in the accounts of some issuers, the impact of an impairment loss linked to a small part of that total amount of goodwill might nevertheless be material to the entity.

Broader reconsideration of concepts used in the current accounting model for goodwill

17. ESMA is aware that a debate on concepts used in the current accounting model for goodwill is open. ESMA believes that the IASB needs to consider carefully the experience gained with the application of the current model and also assess whether that or any other model is the most appropriate to provide useful information to users of financial statements. The usefulness of information provided to the users should be determinative for any future changes to be proposed to the concepts underpinning the accounting model for goodwill.

18. ESMA has not undertaken a comprehensive assessment of the different models that could be possibly envisaged for subsequent accounting for goodwill, after its initial recognition. However, ESMA believes that any model envisaged should take into account the significant changes in the assumptions and expectations that occur between the date when goodwill was allocated and the date of the new assessment. ESMA believes it might be useful to think about different approaches depending on whether those expectations are still met.

19. ESMA points out that in order to assess whether fundamental changes in the principles underpinning the accounting for goodwill are necessary, the IASB should also evaluate the experience with the current goodwill accounting model in the light of its expectations when IFRS 3 was designed, and the reasons that led to abandon the previous goodwill accounting based on the amortisation model. At the same time, ESMA strongly believes that any model for accounting for goodwill should reflect the impact of economic cycles on businesses but should not be specifically tailored for a particular economic environment.