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CHANGES IN IFRS 3 ACCOUNTING FOR BUSINESS COMBINATIONS: A FEEDBACK AND EFFECTS ANALYSIS

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ABSTRACT

This research reviews the effect of IFRS (International Financial Reporting Standards) 3 with a focus on the changes in accounting procedures under business combinations. A content analysis research methodology was used to code and categories feedback data on the effects of IFRS as positive and negative. Results indicated that IFRS is considered successful by 71% of its users and unsuccessful by 29% of its users. IFRS success is credited to the enhancement of comparability of accounting information and streamlining of acquisition methods and goodwill under business combinations. Contrarily, IFRS is considered unsuccessful, because it is riddled with negative consequences, such as rising costs of compliance and preparation, especially in developing and less industrialized nations. We conclude that comparability of accounting information on an international scale is the most positive effect of IFRS 3, while increasing cost of compliance is the greatest negative effect of IFRS 3. We suggest that the International Accounting Standards Board (IASB), Financial Accounting Standards Board (FASB), and other bodies involved in setting global accounting standards should focus on finding ways to incentivize developing countries and companies to comply with the standards. We recommend further studies on ways to assist companies to reduce preparation costs resulting from IFRS changes.

JEL: M16

KEYWORDS: Business Combinations, Acquisition, Goodwill

INTRODUCTION

IFRS aims to improve three key things, relevance, reliability and comparability of information. Without these characteristics, the evidence provided by a reporting entity in its financial statements regarding a business combination might have undesirable effects. To that goal, IFRS establishes a fair playing ground for disclosures on the recognition and measurement of assets and liabilities. In addition, the IFRS establishes guidelines for determining goodwill and what is relevant to disclose to enable users of financial statements to evaluate the nature and financial effects of a business combination (IFRS 3, 2011). Several issues, such as high cost of compliance preparation and documentation faced by developing countries have continued to deface the beauty of IFRS3 intentions. Examining the IFRS Timeline between 2001 and 2013 (Appendix A and B), these issues have not been addressed. In the wake of mounting compliance issues, and global increases in cost of acquisition litigation in the past five years, as well as the 70% to 90% failure rate in mergers and acquisitions, the importance of IFRS functions can hardly be overemphasized. In the United States for example, the percentage of deals subject to litigation increased from 53% in 2007 to 96% in 2012 (Daines & Koumrian, 2013; McMorris, 2016). The need for revisions in accounting procedures addressing many issues have become stronger, particularly as "accounting for business combinations has been identified previously as an area of significant divergence" (IFRS, 2015).

Despite the importance of improved comparability of accounting information (Deloitte, 2016), few studies have assessed the effect of IFRS 3, in terms of the changes in the acquisition method and goodwill, from the perspectives of the users of accounting information in multiple geographical regions. This study examined content in over 300 studies on the effects of IFRS in multiple regions. The result showed a popular acceptance of IFRS as successful mainly in some developed nations. The next section of this paper discusses relevant literature, followed by another section on data and methodology. After the data and methodology section is the presentation of results followed by the concluding statements.

LITERATURE REVIEW

In this section, the effects of IFRS in previous studies are reviewed. Under IFRS 3, a business combination occurs when cash is transferred and liabilities are incurred (Deloitte, 2016; IFRS 3, 2011). It also includes issuing equity instruments or contracts or any combination thereof as stated in IFRS 3, section B5 and B6. There are two steps in ascertaining whether a business combination has taken place. The first step is proof of acquisition. A business combination must involve the acquisition of a business entity by another, without which a combination is ruled out. The second is the test of acquisition to make sure three elements, input-process-output are involved. Inputs are economic resources, such as non-current assets and intellectual property that create outputs when one or more processes are applied to them. Process refers to an existing system, standard, protocol, convention or rule that when applied to an input or inputs, creates outputs. Process included strategic management, operational processes, resource management or field support procedures. Output refers to the result of inputs and processes applied to a system (Deloitte, 2016; IFRS 3, 2011). It is noteworthy that IFRS 3 would not apply in conditions, where the formation of a joint venture is taking place as in IFRS 3 section 2(a), non-business transactions as in IFRS 3section 2 (b), and in common control transactions as stipulated in IFRS 3, section 2(c). Also, included are acquisitions by an investment entity of a subsidiary that is required to be measured at fair value through profit or loss under IFRS 10 Consolidated Financial Statements (Deloitte, 2016; IFRS 3, 2011).

The "acquisition method" is fundamental to accounting for business combinations in IFRS 3 under acquisitions and mergers. In the acquisition method, it is a required practice that assets obtained, and liabilities undertaken are defined and recorded at their fair values at the acquisition date. This was part of the revision in January 2008, which applied to business combinations occurring in an entity's first annual period beginning on or after 1 July 2009. IFRS 3.53, identifies acquisition costs as including finder's fees; advisory, legal, accounting, valuation and other professional or consulting fees; and general administrative costs. It also includes costs of maintaining an acquisitions department (IFRS 3, 2011). The cost of acquisition is determined either in cost or with reference to IAS 39 Financial Instruments: Recognition and Measurement under IFRS 3. The cost of acquisition under the US standards is determined using the equity method. Goodwill in SFAS 142 is allocated to reporting units as functional segments of a going concern or enterprise, while under IFRS 3 goodwill is allocated to cash-generating units. A cash-generating unit is defined in IAS 36 Impairment of Assets as the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets (Deloitte, 2016; IFRS 3, 2011). The cash-generating units may be like or smaller than reporting units mentioned in SFAS 142.

In 1997 the Financial Accounting Standards Board (FASB) enacted the Concepts Statement No.6, in which it decided that goodwill is an asset (Al-Khadash & Salah, 2009; Johnson & Petrone, 1999). Many options were in existence before the accounting standards on goodwill was ushered in. Fundamentally they included the asset-based methods capitalization and the elimination methods for the immediate write-off against reserves (Lewis and Pendrill, 2004). However, this paper focuses on two treatments for goodwill; amortization and impairment.

In amortization, the cost of intangible assets is amortized over a period perceived as beneficial to the acquisition. Under International Accounting Standard No. 22 (IAS 22), accounting for business combinations applied amortization throughout the goodwill's useful life for a given number of years, usually subject to a maximum of twenty years. This approach was replaced by IFRS 3, because the amortization method is plagued by so many issues. First, determining the useful life of goodwill is subjectively arbitrary and difficult, even when using specific years as indicated in IFRS 3. Thus, the impairment approach became favored.

The current treatment of goodwill allowed by IFRS 3 is the impairment approach (IFRS 3, 2011). In this method, goodwill is written-down to a recoverable amount through the income statement. When the book value or carrying amount is greater than the expected cash flow from goodwill, and deemed non-recoverable, a condition of impairment is said to exist. Post-acquisition performance and value of goodwill or its degree of impairment and deterioration can examining indicators, such as return on assets (ROA). As ROA becomes less significant, write-off methods become more applicable and indicate that goodwill be deleted or expensed based on expected zero future goodwill value or benefits (Johnson & Petrone, 1999). That IFRS 3 upheld the same amendments of goodwill and business combination accounting adopted by FASB in 2001 represents no change. It is interesting to note the similarity between IFRS 3 and US standards, which lies in the wording of the treatment of the acquisition cost. According to IFRS 3, acquisition cost is measured and applied from the date of the acquisition or the date the acquirer takes control of the acquiree net assets (Appendix B). On the other hand, under US standards the cost is applicable from the date of the announcement.

Positive findings abound from many studies on the post implementation of IFRS 3. Hamberg, Paananen, & Novak (2011) observed that after the adoption of IFRS 3 in January 2005 the amount of capitalized goodwill increased substantially in Sweden. They noted that goodwill impairments under IFRS was significantly lower than goodwill amortizations and impairments made under Swedish GAAP. Most importantly they stated that the adoption of IFRS 3 increased reported earnings. Analyzing the economic incentives that influenced impairment decision at the onset of the adoption of IFRS 3, Hamberg, Paananen, & Novak (2011) found that tenured management was negatively associated with the impairment decision, and most firms did not reclassify goodwill or make additional impairments. Firms with substantial amounts of goodwill continued to make very high returns on investment even with low earnings. "The revised IFRS 3 and amended International Accounting Standards (IAS) 27 meet the qualitative criteria for endorsement as defined by the IAS Regulation 1606/2002 and will have positive cost-benefits effects" (European Commission, 2008, p. 16). That was the conclusion of the commission after a long and detailed feedback and effects analysis of IFRS 3.

In another scenario, Glaum, Schmidt, Street, & Vogel (2013) analyzed the compliance to International Financial Reporting Standards, with a focus on disclosures required by IFRS 3. On Business Combinations and International Accounting Standard 36: Impairment of Assets, they found a great deal of non-compliance. Earlier in a study, O'Connell & Sullivan (2009) reported a statistically significant increase in Net Income, in 2004 in about 75% of firms studied. On earnings management, Jeanjean & Stolowy (2008) argued that sharing rules is not a sufficient condition to create a common business language, rather management incentives and national institutional factors, which play important roles in determining financial reporting characteristics should be the basis.

Jangwon (2013) found that Initial Public Offering (IPO) underpricing is lower for IPO firms using IFRS than those using domestic GAAP. He concluded that the impact of IFRS on IPO underpricing is greater in IPO firms listed jurisdictions with strong enforcement, and the use of IFRS reduces IPO underpricing compared with domestic Generally Accepted Accounting Principles (GAAP) since IFRS facilitates comparability. The down side is that the advantages of enhanced comparability in the use of IFRS are manifest only only when there is evidence of high-quality enforcement. A documention of the the accounting consequences of the adoption of IFRS 3 and the stock market's reaction in Swdeen indicated that in the post adoption period after January 2005, the amount of capitalized goodwill increased substantially (Mattias, Mari, & Jiri, 2011). This increase was attributed to the fair value measures that allowed managers to use their discretion in determining fair value. Mattias, Mari, & Jiri (2011) found that goodwill impairments under IFRS to be considerably lower than goodwill amortizations and impairments under Swedish GAAP. They concluded that the adoption of IFRS 3 increased reported earnings. Other findings by Mattias, Mari, & Jiri (2011) was that firms did not reclassify goodwill or make additional impairments, and firms with substantial amounts of goodwill yielded abnormally high returns despite abnormally low earnings. They also reported a positive reation from investors who perceived the accrual-based increase in earnings as a result of IFRS 3 to be an indication of higher future cash flows.

The impact of IFRS 3 has not yielded positive effects in all accounting areas or across nations. IFRS 3 affected the accounting for acquisitions of companies but not the Group's acquisition strategy, as noted by PR Newswire (2005). An effects analysis of three countries UK, Ireland and Italy showed that profits under IFRS was greater than reported under GAAP, and net worth was higher (Fifield, Finningham, Fox, Power, & Veneziani, 2011). However, further details from Fifield, Finningham, Fox, Power, & Veneziani (2011) revealed that while UK and Italian companies experienced an increase in equity from IFRS, the Irish firms in the sample recorded a decrease. This study concluded that the the impact of IFRS on profit and net worth cannot be attributed to on single factors or event, but to all the core standards including IFRS 2, IFRS 3, IFRS 5, IAS 10, IAS 12, IAS 16, IAS 17, IAS 19, IAS 38 and IAS 39. Based on the above observation, Fifield, Finningham, Fox, Power, & Veneziani (2011) recommended a multi-country perspective for future IFRS research. Since the effects and efficacy individual IFRS varies from one country to another.

Summarising the effect of IFRS in Europe, Sacho (2006) grouped the effects of IFRS into five categories, as the earnings volatility effect, the gearing effect, the disclosure effect, the decision-making effect on fund managers, and the effect on management. Sacho noted that the most significant effect was the shift from the traditional basis of preparing financial statements under the historical cost method to the more complex model of fair value accounting, which to a great extent influenced the changes we have seen in IFRS 3 on business combinations and fair value.

Not sounding quite pumped up about the effects of IFRS, Sacho (2006) furthermore, addressed the negative effects of IFRS. He observed that IFRS in the fair value approach, characteristic of IFRS3, is akin to high volatility in earnings and uncertainty in the future, which complicates the understanding of what a company classifies as debt. For instance, under IFRS, European companies have to report all derivatives at fair value on the balance sheet, and all subsidiaries and off-balance sheet financing vehicles are required to be consolidated (Sacho, 2006). In a concluding statement, Sacho stated that IFRS requires greater disclosure than the European GAAPs, and in the process improved transparency, which though more cumbersome, seems to be promoting greater understanding of corporate performance among investors. In other word, investor perceptions of value is improved as well as investor investment decisions. On the strengh of the findings and arguments reviewed, which interestingly suggested that the IASB, the SEC and the European Commission should devote more effort to harmonizing incentives and institutional factors rather than harmonizing accounting standards.

DATA AND METHODOLOGY

In this study, a content analysis methodology was used to assess the feedback and effects of IFRS 3, based on the critical framework of the changes it brought about in four key areas, cost, clarity of principles and guidance, transparency, and comparability. Data was collected from more than 300 articles in journals, periodicals, books, the internet, and dissertations were reviewed. Articles that met the inclusion criteria by addressing four key areas on feedback and effects, as well as addressed in detail the critical shades of changes in IFRS 3 on business combinations, were selected. Information from the articles were extracted and tabulated according to regions as shown in Table 1.

This section presents four content analyses frameworks and their coding (Boolaky, 2006). The three tables reporting analysis results are, Table 1 feedback and effects, Table 2 positive effects, and Table 3 negative effects. The analysis framwork is based on four important and sensitive areas of IFRS 3 effects, that could be perceived as positive or negative depending on their benefits (Deloitte, 2016; European Commission, 2008; IFRS, 2015). These include cost-benefits effect (positive or negative), additional costs of compliance to disclosure requirements and cost of preparation and change of concept in certain critical areas like partial acquisitions. Of interest are clearer principles and additional guidance integrated in the standards, transparency through additional disclosure and comparability on an international level.

Cost benefits effects are coded CBE. When positive the code is CBEP and when negative CBEN. Cost of compliance is coded CC, when reported as increased it is coded CCI, and when reported ad decreased it is coded CCD. Cost of preparation and change of concept is codded CPC, when reported as increased it is Codded CPCI, and CPCD when reported as decreased. Clearer principles and additional guidance integrated in the standards is coded CPAG. When increased, it is codded CPAGI, and CPAGD when decreased**.** Transparency through additional disclosure is coded TRAD. When increased, it is coded TRADI, and when decreased it is coded TRADD. Comparability on international level is coded COIL. COILI when increased, and COILD, when decreased.

RESULTS

Table 1 reports the summary data on coded information by region (Europe, Africa, and Asia) from articles based on the analysis framework. It also shows the total for each classification in the framework.

Table 1: IFRS3 Feedback and Effects Summary Data

	CBE				CPAG		TRAD		COIL	
Region	**CCI**	**CCD**	**CPCI**	**CPCD**	**CPAGI**	**CPAGD**	**TRADI**	**TRADD**	**COILI**	**COILD**
Europe	14	26	10	30	35	5	24	16	35	5
Africa	30	10	5	35	33	7	30	10	37	3
Asia	15	25	30	10	30	10	35	5	34	6
Total	59	61	45	75	98	22	89	31	106	14

Table 1 shows IFRS 3 Feedback and Effects Summary Data. Because the effects of IFRS 3 varies within and between countries (Sacho, 2006; O'Connell & Sullivan, 2009), data from Table 1 was reorganized into two groups, positive effects and negative effects, and that gave rise to 2 and Table 3.

Tables 2 and 3 categorize the data from Table 1 into two groups. Table 2 shows three key areas of positive impact. The first is comparability on international level increase (COILI). The second is clearer principles and guidelines increase (CPAGI), and the third is transparency and disclosures increase (TRADI).

Table 2: IFRS3 Positive Effects Data

Positive Effects	Score
Cost of compliance decreased (CCD)	61
Cost of preparation decreased (CPCD)	75
Clearer principles and guidelines increased (CPAGI)	98
Transparency and disclosures increased (TRADI)	89
Comparability on international level increased (COILI)	106
Total	429

Table 2 shows three key areas of positive impact. The first is comparability on international level increase (COILI). The second is clearer principles and guidelines increase (CPAGI), and the third is transparency and disclosures increase (TRADI).

Table 3 shows three key areas of negative impact. The first is cost of compliance increase (CCI). The second is cost of preparation increase (CPCI), and the third is transparency and disclosures decrease (TRADD).

Table 3: IFRS3 Negative Effects Data

Negative Effects	Score
Cost of compliance Increased (CCI)	59
Cost of preparation increased (CPCI)	45
Clearer principles and guidelines decreased (CPAGD)	22
Transparency and disclosures decreased TRADD	31
Comparability on international level decreased (COILD)	14
Total	171

Table 3 shows three key areas of negative impact. The first is cost of compliance increase (CCI). The second is cost of preparation increase (CPCI), and the third is transparency and disclosures decrease (TRADD).

Table 4 presents the grand total on positive and negative effects. The 429 units out of 600 units means that 71 percent of the studies reviewed indicated that IFRS3 is having a positive effect on relevance, reliability and comparability of accounting information. It portends that the changes in international financial reporting standards, say in IFRS3 are viewed favorably by companies and investors using the guidelines. On the contrary, 171 units out of 600 or 29 percent of contents reviewed on IFRS 3 are negative about its effects.

Table 4: Grand Total Positive and Negative Effects

Positive Effect	Negative Effect	Total
429	171	600
71%	29%	100%

This table shows positive and negative contents in the articles reviewed, on the effects IFRS 3 in percentages. The table shows 429 units of positive content on IFRS3, and 171 negative content on IFRS3, totaling 600 units of positive and negative contents.

CONCLUDING COMMENTS

This study concludes that the greatest or the most significant effect of IFRS 3 is the increased comparability on international level, evidenced by the changes in accounting principles for business combinations and goodwill. These elements are widely accepted by many studies as favorable to many companies and investors. However, increasing cost of compliance and preparation, are areas where IFRS is indicated as having the greatest negative effect. Thus, the overall benefit of IFRS 3 is unclear.

Relevance, reliability and comparability (RRC) are the key words that qualify and describe the type of information businesses are expected to provide, under IFRS 3 for business combinations, such as in acquisitions and mergers (Holmlund & Thunvall, 2014). IFRS has done a good job framing the principles for the recognition and measurement of acquired assets and liabilities, especially the determination of goodwill and the necessary disclosures. However, there remains the need to address areas of greatest negative impact, such as the increasing cost compliance and cost of preparation. Credit goes to the US Financial Accounting Standards Board (FASB) and the IFRS 3 (2004) for the hard work that resulted in IFRS 3 (2008). Their revisions led to birth of IFRS3 and the high degree of convergence between IFRSs and US GAAP in the accounting for business combinations we see today. However, significant differences still exist. Most importantly, this study recommends, finding ways to reduce cost of compliance and preparation, for example through incentives, such as compliance incentives.

APPENDICES

Appendix A: IFRS Timeline

Date	Event	Accomplishment
July 2001	Project from the old IASC added to IASB agenda	History of the project
5 December 2002	Exposure Draft ED 3 *Business Combinations*. Proposed amendments to IAS 36 and IAS 38 published	Comment deadline 4 April 2003
31 March 2004	IFRS 3 *Business Combinations* (2004) and related amended of IAS 36 and IAS 38 released IFRS 3 supersedes IAS 22.	Effective for business combinations for which the agreement date is on or after 31 March 2004
29 April 2004		deadline 31 July 2004
	Exposure Draft *Combinations by Contract Alone or Involving Mutual Entities* published	
30 June 2005	Exposure Draft *Proposed Amendments to IFRS 3* published	Comment deadline 28 October 2005
10 January 2008	IFRS 3 *Business Combinations* (2008) issued or released	Applies to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after 1 July 2009
6 May 2010	Amended by *Annual Improvements to IFRSs 2010* (measurement of non-controlling interests, replaced share-based payment awards, transitional arrangements for contingent consideration)	Effective for annual periods beginning on or after 1 July 2010
12 December 2013	Amended by *Annual Improvements to IFRSs 2010–2012 Cycle* (contingent consideration)	Applicable for business combinations for which the acquisition date is on or after 1 July 2014
12 December 2013	Amended by *Annual Improvements to IFRSs 2011–2013 Cycle* (scope exception for joint ventures)	Effective for annual periods beginning on or after 1 July 2014

Source: Deloitte (2016) http://www.iasplus.com/en/standards/ifrs/ifrs3. *Accounting For Business Combinations: IFRS 3 (2008) And IFRS 3 (2004).*

Appendix B: Areas of IFR3 Change /Impact

Area	Description
Transaction costs	acquisition costs such as adviser's fees, stamp duty and similar costs cannot be included in the measurement of goodwill
Calculation of goodwill	pre-existing ownership interests are measured fair valued at acquisition date option to measure non-controlling interests on the basis of fair value or net assets (transaction by transaction)
Contingent consideration (e.g. earn-outs)	fair value accounting at the acquisition date subsequent changes do not impact goodwill but are accounted for separately
Transactions arising in conjunction with business combinations	new detailed guidance on the split between compensation and consideration for replacement share-based payment awards
	settlement of pre-existing relationships (contracts, legal cases, etc.) can result in a gain/loss
	unrecognized deferred taxes no longer impact goodwill on subsequent measurement
Recognition and measurement	'reliable measurement' exclusion for intangible assets removed new guidance on indemnification assets and assets not expected to be used
Changes in ownership interests	buying or selling minority interests in a subsidiary only impacts equity loss of control requires fair valuing of retained holding and recycling of reserves

Source: Deloitte (2016) Retrieved from http://www.iasplus.com/en/standards/ifrs/ifrs3

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