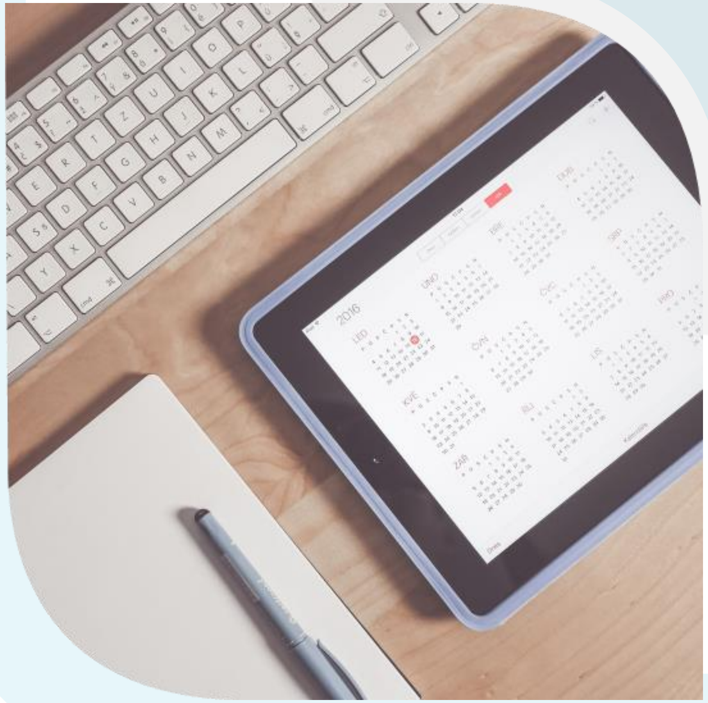
Business Combinations—Disclosures, Goodwill and Impairment

Key messages for EFRAG's Draft Comment letter on BCDGI



DISCLAIMER

This paper has been prepared by the EFRAG Secretariat for discussion at a public meeting of the EFRAG FRB. The paper does not represent the official views of EFRAG or any individual member of the EFRAG FRB or EFRAG FR TEG. The paper is made available to enable the public to follow the discussions in the meeting. Tentative decisions are made in public and reported in the EFRAG Update. EFRAG positions, as approved by the EFRAG FRB, are published as comment letters, discussion or position papers, or in any other form considered appropriate in the circumstances.

OVERVIEW

- **Project objective**
- **Improvements to the disclosure requirements in IFRS 3**
  a) Location of information
  b) Disclosure objectives
  c) Contribution of the acquired business
  d) New information for each business combination
  e) New information for (only) ’strategically important’ business combination
  f) Definition of a 'strategically important' business combination
  g) Who provides the information and for how long
  h) Exemption from disclosing some information
- **Improvements to the impairment test in IAS 36 Impairment of Assets**
  a) Retaining the impairment only model
  b) Reduce shielding and management over-optimism
  c) Value in use
- **Transition requirements**

Project objective

Project objective

IASB tentative decisions

- Leave the **objective** of the project **unchanged** from that described in the DP
- **Consider** possible improvements to the effectiveness of the impairment test of cash generating units containing goodwill

EFRAG key messages

- **Welcomes** the IASB's efforts to explore whether companies can, at a reasonable cost, provide investors with more useful information about the acquisitions those companies make
- **Outcome of the project achieves the right balance** to improve the disclosure requirements and enhance the impairment test, at a reasonable cost to preparers

Improvements to the disclosure requirements in IFRS 3

(a) Location of information – IASB tentative decisions

- Based on the *Conceptual Framework for Financial Reporting (Conceptual Framework)*, information can be required **in financial statements** about:
  - the benefits an entity’s management expects from a business combination
  - the extent to which management’s objectives are being met
    - such as information about the subsequent performance of a business combination, and quantitative information about expected synergies

(a) Location of information – EFRAG key messages

- **Agrees that the financial statements is the best place to provide the proposed disclosure information.**
- **Agrees that the Conceptual Framework does not prohibit** the proposed information from being provided in the financial statements.
- Notes that the proposed information is additional follow up information to what is currently required by IFRS 3, and is already provided to investors (in for example investor presentations) both on acquisition date and post-acquisition. Therefore, the **information should be available.** The IASB has proposed an exemption for providing the information in specific cases.

(b) Disclosure objectives

IASB tentative decisions

- **Add new disclosure objectives** to IFRS 3 that would require an entity to disclose information to help users of financial statements understand:
  - the benefits that an entity expected from a business combination when agreeing the price to acquire a business; and
  - the extent to which an entity's objectives for a business combination are being met

EFRAG key messages

- **General support for the IASB's proposal to add two new disclosure objectives,** to better reflect users' needs

(c) Contribution of the acquired business – IASB tentative decisions

- **Retain** the requirement in **paragraph B64(q) of IFRS 3 (see next slide)**
- **Replace** the term '**profit or loss**' in paragraph B64(q) of IFRS 3 with '**operating profit or loss**', as defined in the IASB's PFS (*Primary Financial Statements*) project
- **Explain the objective** of the **requirement** in **paragraph B64(q)(ii)** of IFRS 3 and **specify that the basis** that an entity applies in preparing this information is an **accounting policy**

(c) Contribution of the acquired business – Paragraph B64(q) of IFRS 3

- Paragraph B64(q) of IFRS 3 requires the acquirer to disclose for each business combination that occurs during the reporting period the amounts of revenue and profit or loss:
  - (i) of the acquiree since the acquisition date included in the consolidated statement of comprehensive income for the reporting period; and
  - (ii) of the combined entity for the current reporting period as though the acquisition date for all business combinations that occurred during the year had been as of the beginning of the annual reporting period
- If disclosure of this information is impracticable the acquirer shall disclose the fact and explain why is impracticable

(c) Contribution of the acquired business – EFRAG key messages

- **Agrees to retain the disclosure information in paragraph B64(q) of IFRS 3**. This information is important for users to perform the year-on-year comparisons of an entity's performance and to understand how the two businesses are combined.
- **Disagrees that the basis for preparing the information required by paragraph B64(q)(ii) of IFRS 3 is an accounting policy.** EFRAG recommends the IASB instead provide application guidance on how to prepare the information.
- **Supports replacing the term 'profit and loss' with 'operating profit and loss'** as defined in *Primary Financial Statements* (PFS). Limits divergence and increases comparability of information.
- Replacing 'profit or loss' with 'operating profit or loss', **users may lose useful information regarding the results of associates and joint ventures of the acquired entity.** EFRAG recommends the IASB to consider this issue. (Under the PFS project, results of **equity accounted** associates and JVs are presented below the operating profit or loss, as part of investing category).

(d) New Information for each business combinations – Strategic rationale

IASB tentative decisions

- **Replace** the requirement for an entity to disclose the ‘primary reasons for the business combination’ in paragraph B64(d) of IFRS 3 with a requirement to disclose the ‘**strategic rationale for undertaking the business combination**’

EFRAG key messages

- **Support for the IASB proposal to require an entity to disclose the ‘strategic rationale’ for undertaking a business combination**, rather than the primary reasons for a business combination, because:
  - it aims to provide clarity on how the business combination fits into the overall business strategy of the business and how it is tied to the nature of synergies
  - is not expected to result in significant changes to current IFRS 3

(d) New Information for each business combinations (expected synergies) IASB tentative decisions

- Require an entity to disclose **additional information about expected synergies** from combining operations of the acquiree and the acquirer, including:
  - **quantitative information about expected synergies disclosed by category**
  - **a description of the expected synergies** from combining operations of the acquiree and the acquirer by specifying each category of expected synergies
  - when the **benefits from the synergies are expected to start and how long** they will last
- Require the information **only in the year of acquisition** (and not in subsequent periods)
- **Not to define** synergies
- **Provide an exemption** for quantitative information about expected synergies in specific circumstances (e.g., legally sensitive information such as restructuring)

(d) New Information for each business combinations – EFRAG key messages

Quantitative information on expected synergies

- **Supports the proposal to disclose quantitative information about expected synergies from combining operations of the acquiree and the acquirer in the year of acquisition.**
- Analysts/users use quantitative information on expected synergies to forecast profits and cash flows over future years, and to assess the future evolution of an entity's risk profile and assess the success of a business combination.
- This information is already available to the entity as part of the M&A process or other internal sources.

(d) New Information for each business combinations – EFRAG key messages

Disaggregation and timing of expected synergies

- **Agrees that requiring entities to specify each category of expected synergies provides useful information for users**
- **Considers the proposed level of disaggregation between different categories of expected synergies** (cost synergies or revenue synergies or both or other synergies) **will help users of financial statements as they use the categories differently**
- EFRAG considers that requiring disclosure to be disaggregated by category of synergy could **help entities identify which categories can be quantified** (considering the high level of uncertainty of information about synergies), and which are considered commercially sensitive in which case an entity could potentially apply the proposed exemption
- EFRAG **agrees with the proposal to require an entity to disclose when the benefits expected from the synergies are expected to start and how long they will last.** This information will help users to assess the timing and duration of the synergies

(d) New Information for each business combinations – EFRAG key messages

Definition of synergies

- **EFRAG agrees with the IASB to not define synergies** as this term is already used in IFRS 3 and entities already apply it in practice
- EFRAG also notes that each business combination is unique and will have its unique set of expected synergies making it difficult to have a defined term that could apply to all business combinations

(e) New information for (only) 'strategically important' business combinations - IASB tentative decisions

- **For 'strategically important' business combinations,** the IASB proposed adding to IFRS 3 requirements to disclose the following **information**:
  a) **in the year of acquisition, the key objectives and related targets** the acquirer will use to determine whether the key objectives are being met. (target information can be disclosed as a range or as a point estimate)
  b) **in the year of acquisition and in subsequent reporting periods, the extent to which the key objectives for the business combination and the related targets are being met**. This includes: (i) actual performance against the key objectives and targets for the business combination; and (ii) a statement of whether actual performance is meeting or has met the key objectives and targets for the business combination
- The information in (b) above is required for as long as the acquirer’s key management personnel reviews the performance of the business combination against its acquisition-date key objectives and targets (KMP is discussed in *Slides 23-25*)
- An entity can apply the exemption from disclosing the information described in a) and b) under certain circumstances (The exemption is discussed in *Slides 26-28*)

(e) New information for (only) 'strategically important' business combinations - EFRAG key messages

Subsequent reporting periods:

- **EFRAG welcomes the IASB's proposal**
- EFRAG highlights the **usefulness of the information on subsequent performance** for users (e.g., in assessing how profitable/successful the BC had been). Furthermore, given the IASB's tentative decision to retain the annual impairment test for goodwill, having better disclosures on subsequent performance is very important for users.
- EFRAG notes that there could be cases **where an entity undertakes a series of smaller (non-strategic) business combinations that if combined could be considered as a strategic acquisition**. EFRAG therefore recommends the IASB to consider **whether specific guidance on is needed** for cases of series of acquisitions that have a strategic acquisition objective

(f) Definition of a 'strategically important' business combination - IASB tentative decisions

- A 'strategically important' business combination would be a business combination for which not meeting the objectives would seriously put at risk the entity achieving its overall business strategy
- A business combination that **meets any one** of the following thresholds would be **'strategically important':**
- **Quantitative**—a business combination in which:
  - the **acquiree's operating profit* exceeds 10% of the acquirer's operating profit**
  - the **acquiree's revenue exceeds 10% of the acquirer's revenue**; or
  - the recognised **assets acquired (including goodwill) exceed 10% of the carrying value of the assets of the acquirer**
- **Qualitative**—a business combination that results in an entity entering:
  - a new geographical area of operations; or
  - a new major line of business

as defined in the Primary Financial Statements project

***as at the acquirer's most recent reporting period date before the business combination.*

(f) Definition of a 'strategically important' business combination – EFRAG key messages

- **Agrees with the IASB proposal to meet one of the proposed thresholds**
- EFRAG considered whether a **combination of both** quantitative and qualitative thresholds would be more appropriate. However, this could further **reduce the population** of business combinations for which the proposed information would be required (the IASB had already made efforts to reduce the information required by focusing on a subset and developing an exemption)
- The concept of materiality would apply in cases when the proposed thresholds would capture business combinations that the entity would consider to be immaterial business combinations. **EFRAG recommends the IASB to elaborate on this point in the Basis of Conclusions**

(f) Definition of a 'strategically important' business combination – EFRAG key messages (2)

Quantitative

- **Supports the proposed quantitative properties** (operating, profit, assets) as:
  - They are already defined in IFRS Accounting Standards
  - They are considered as appropriate measures for reflecting the different reasons for an acquisition.
- Feedback from users suggests that an **enterprise value** threshold should be added in the quantitative properties

Qualitative

- **Supports the proposed qualitative thresholds**
- Most respondents (preparers) to the survey disagreed, mainly because in their view they would result in including non-strategic business combinations. However, EFRAG highlights that the concept of materiality would apply in such cases (see previous slide)

(g) Who provides the information and for how long – IASB tentative decisions

- **Specify a level of management** within an entity to identify the information the entity is required to disclose about the subsequent performance of business combinations; and
- **Describe** that **level of management as the key management personnel**, of the reporting entity, as defined in IAS 24

- For **'strategically important' business combinations**:
  - **Disclose** information about the **subsequent performance** of a business combination **for as long as the entity's management continues to monitor** whether the objectives of the business combination are being met
  - If the entity **doesn't monitor** the achievement of the objectives, the entity should **disclose that fact and the reasons** why it does not do so
  - **To disclose the fact and reasons**, also if it **stops monitoring**, before the end of the second full year after the year of the business combination, whether its objectives for a business combination are being met. In this case, it also has to disclose information about actual performance

(g) Who provides the information and for how long – EFRAG key messages

Who provides the information

- **Agrees to specify the level of management as the entity's key management personnel (KMP), as defined in IAS 24,** instead of using the CODM as defined in IFRS 8.
- Two definitions are quite similar, but using KMP provides a general and principle-based definition and allows to disconnect the level of the review from the reportable segment level.
- Since the information on subsequent performance is requested only for 'strategically important' business combinations, the **KMP represents the appropriate level of monitoring.**
- **Welcomes the clarification that the level of management monitoring** for the purposes of subsequent performance **may not be the same** as the level of management monitoring the business associated with goodwill for the purposes of impairment testing (*please refer to the section improvements to impairment test for more details*).

(g) Who provides the information and for how long – EFRAG key messages

How long the information is provided

- **Agrees to disclose** information about the subsequent performance of a business combination for **as long as the entity's management continues to monitor** it against its acquisition-date key objectives and targets.
- **Agrees to disclose the fact and reasons for not doing so**, if an entity's management:
  - **does not monitor** whether its objectives for a business combination are being met; or/and
  - **stops monitoring**, before the end of the second full year after the year of the business combination
- **Agrees to disclose** the information **as long as management monitors the subsequent performance and considers that two full years after the year of a business combination to be a reasonable minimum period** for the information to be disclosed.

(h) Exemption from disclosing some information – IASB tentative decisions (1)

- Propose **an exemption*** in specific circumstances that would permit an entity not to disclose information about:
  - management’s objectives for a business combination
  - the metrics and targets management will use to monitor whether the objectives for the business combination are being met
  - quantitative information about synergies expected to arise from the business combination
  - qualitative statement of whether actual performance in subsequent periods met the entity’s target for the business combination

** No exemption is proposed from disclosing information about the strategic rational and the subsequent performance*

(h) Exemption from disclosing some information – IASB tentative decisions (2)

- **Propose a principle** for applying an exemption: An entity can use the exemption if disclosing the information can be expected to prejudice seriously any of the entity's objectives for the business combination
- **Propose an application guidance:** In applying the exemption an entity would consider the following:
  - factors in determining whether the exemption is applicable (including the effect of disclosing and the availability of information)
  - whether it is possible to disclose information at a **sufficiently aggregated level** to resolve concerns while still meeting the disclosure objectives
  - to disclose the fact and the reason for applying the exemption, **for each item of information** to which an entity has applied the exemption
  - **to reassess in each reporting period whether the application of the exemption to an item of information is still appropriate**, and if no longer appropriate, the entity would be required to disclose the item of information previously exempted (the reassessment should be performed for as long as the disclosure is required)

(h) Exemption from disclosing some information – EFRAG key messages

- **Welcomes the IASB efforts to address concerns (such as commercial sensitivity) by proposing the exemption** to some items of information under specific circumstances.
- **Welcomes the proposed application guidance** to help entities to identify the circumstances in which application of the exemption would be appropriate.
- Notes that the purpose of the exemption is not to provide entities with an exit route not to provide the information, but rather to use it in those situations in which publicly disclosing the information is expected to seriously prejudice any of the entity's objectives for the business combination.
- In EFRAG's view, the exemption would be used in rare cases (for example in jurisdictions where information on restructuring is subject to legal requirements before being made public).

Questions to EFRAG FRB members

1. Do you agree with the key messages for each of the proposals on the disclosure requirements? If not, please explain and provide your suggestions/alternative views
2. Do you have any other comments on the IASB's disclosure proposals?

Improvements to the Impairment test

(a) Retaining the impairment only model

IASB tentative decisions

- **Retain**:
  - impairment-only model for the subsequent accounting for goodwill
  - requirement to perform a quantitative impairment test annually, and not to pursue any of the alternatives to it that were suggested by respondents
- **not feasible to design a different impairment test** that would, at a reasonable cost, be significantly more effective than the impairment test currently required by IAS 36

EFRAG key messages

Agrees:

- **to retain the annual impairment testing requirement**
- **not to pursue any of the alternatives to an annual quantitative impairment test**
- **that it is not feasible to design a different impairment test** that is significantly more effective than the impairment test in IAS 36 at a reasonable cost

(b) Reduce shielding and management over-optimism – IASB tentative decisions

EFRAG

- **Replace** *'goodwill is monitored for internal management purposes'* in paragraph 80(a) of IAS 36 with *'business associated with the goodwill is monitored for internal management purposes'*
- **Clarify**
  - what 'monitoring' a business means (paragraph 80(a) of IAS 36)
  - that 'operating segment' is the highest level that can be used by an entity in the impairment test (paragraph 80(b) of IAS 36)
  - why an entity should allocate goodwill to a CGUor a group of CGUs
- **Disclose** the reportable segments in which CGUs containing goodwill are included
- **Explain** the difference between management monitoring 'strategically important' business combinations for the purpose of subsequent performance disclosure and management monitoring a business associated with the goodwill for the purpose of impairment testing

(b) Reduce shielding and management over-optimism – EFRAG key messages

EFRAG

- **Welcomes the IASB efforts to address shielding and management over-optimism** but notes that without changing the fundamentals of the impairment test, these improvements remain of a collateral nature.
- **Agrees with the proposed amendments to the paragraphs 80(a) and 80(b)** to emphasise the requirement to allocate goodwill to the lowest reporting level.
- **Agrees to clarify** why goodwill should be allocated to a CGU or a group of CGUs and different levels of management monitoring for disclosure and impairment test purposes.
- **Agrees to disclose** the reportable segments in which CGUs containing goodwill are included.
- Asks for **more guidance**:
  - On **reallocation of goodwill** between the reporting segments
  - How to deal with **right of use assets**

(c) Value in use - IASB tentative decisions

- On **future restructurings**:
  - **remove a constraint to include future asset restructurings and enhancements in estimation of ViU**
- On the **pre-tax cash flows**:
  - **remove the requirement to use pre-tax cash flows and pre-tax discount rates in estimating ViU**
  - require using **internally consistent assumptions** for cash flows and discount rates
  - **disclose** whether a pre-tax or a post-tax discount rate was used

(c) Value in use - EFRAG key messages

Future restructurings and enhancements

- **Agrees with the IASB's proposal to remove the prohibition to include future restructuring and asset enhancements in the estimate value in use** - consistency with management forecasts, cost reduction.
- Including cash flows from a future restructurings or enhancements would reflect **a potential to be restructured already contained within the asset**, which would be in line with the requirements of paragraph 44 of IAS 36 to assess an asset or CGU **in its current condition**.
- **Asks for guidance how to define cash flows used in internally for estimations** to avoid excessive judgement and reduce management over-optimism.

(c) Value in use - EFRAG key messages

Pre-tax cash flows

- **Agrees to remove from IAS 36 the requirement to use pre-tax cash flows and pre-tax discount rates in estimating value in use -** more aligned with market practices, other IFRS Standards and reduce cost.
- **Agrees to disclose whether a pre-tax or a post-tax discount rate was used** in estimating ViU.
- **Asks for guidance and illustrative examples on inclusion of deferred taxes in future cash flows and in the carrying amount of the asset/CGU** in a post-tax calculation.

Questions to EFRAG FRB members

1. Do you agree with the key messages for each of the proposals on the amendments to IAS 36? If not, please explain and provide your suggestions/alternative views
2. Do you have any other comments on the proposed changes to the impairment test?

Transition requirements

Transition requirements

IASB tentative decisions

- To apply the proposed amendments to IFRS 3 and IAS 36 **prospectively with earlier application permitted**
- **Not** to provide first-time adopters with a **specific exemption** from applying the proposed amendments to IFRS 3 and IAS 36

EFRAG key messages

- **Agrees with the prospective application of the amendments to IFRS 3 and IAS 36**
- **Agrees not to propose relief for first-time adopters** from any of the amendments to IFRS 3 or IAS 36 - as it would result in loss of information for users

Questions to EFRAG FRB members

1. Do you agree with the proposed transition requirements? If not, please explain and provide your suggestions/alternative views
2. Do you have any other comments/questions on the project?

Follow us

35 Square de Meeûs, B-1000 Brussels
info@efrag.org - www.efrag.org

EFRAG is co-funded by the European Union through the Single Market Programme in which the EEA-EFTA countries (Norway, Iceland and Liechtenstein), as well as Kosovo participate. Any views and opinions expressed are however those of the presenter only and do not necessarily reflect those of the European Union, the European Commission or of countries that participate in the Single Market Programme. Neither the European Union, the European Commission nor countries participating in the Single market Programme can be held responsible for them.

THANK YOU

EFRAG
Financial reporting