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IFRS in Focus

IASB publishes Discussion Paper on *Business Combinations—Disclosures, Goodwill and Impairment*

Contents

The International Accounting Standards Board (IASB) has issued Discussion Paper DP/2020/1 *Business Combinations—Disclosures, Goodwill and Impairment*. In this edition of *IFRS in Focus*, we outline the key concepts of the DP.

- The IASB is proposing to develop enhanced disclosure requirements to improve the information companies provide to investors about the businesses those companies buy. This includes proposals to require companies to disclose management's objectives for acquisitions in the year of acquisition and how acquisitions have performed against those objectives in subsequent periods.
- The IASB is also proposing that amortisation of goodwill should not be reintroduced.
- To simplify the impairment test, the IASB's view is that amendments should be proposed to provide relief from the annual impairment test and simplify how value in use is estimated.
- The comment period for the DP ends on 15 September 2020.

Introduction

In 2013 and 2014, the IASB carried out a post-implementation review (PIR) of IFRS 3 *Business Combinations* to assess whether the Standard worked as intended. As a result of the PIR, the IASB started two projects. One was to clarify and narrow the definition of a business, which has now been finalised. The other one is the Goodwill and Impairment project under which the DP is now published.

With this project, the IASB wants to improve the information companies provide to investors, at a reasonable cost, about the businesses those companies buy. The IASB is mainly seeking comments on the usefulness and feasibility of its new disclosure ideas and any new evidence or new arguments on how goodwill should be accounted for.

For more information please see the following websites:

www.iasplus.com

www.deloitte.com

Improving disclosures about business combinations

Subsequent performance of acquisitions

During the PIR, the IASB received comments that companies do not provide sufficient information to help users of their financial statements understand acquisitions and their subsequent performance, i.e. whether management's objectives for the acquisition are being met.

IFRS 3 requires a company to disclose the primary reasons for an acquisition. To provide more useful and entity-specific information, the IASB's preliminary view is that it should propose replacing this with a requirement to disclose:

- The strategic rationale for undertaking the business combination
- Management's objectives for the acquisition at the acquisition date

A company's management is likely to pursue a number of objectives when making an acquisition and use several metrics for measuring progress towards those objectives. These metrics could be financial—for example amounts of synergies, profit measures, returns on capital—or non-financial—for example market share, retention of staff, product launch—or both.

In the IASB's preliminary view, an entity should be required to disclose the following:

- In the year in which an acquisition occurs, the metrics that management (the chief operating decision maker or 'CODM' as described in IFRS 8 *Operating Segments*) will use to monitor whether the objectives of the acquisition are being met.
- The extent to which management's objectives for the acquisition are being met using those metrics, for as long as management monitors the acquisition against its objectives.
- If management does not monitor whether its objectives for the acquisition are being met, that fact and the reasons why it does not do so.
- If management stops monitoring whether its objectives for the acquisition are being met before the end of the second full year after the year of acquisition, that fact and the reasons why it has done so.
- If management changes the metrics it uses to monitor whether its objectives for the acquisition are being met, the new metrics and the reasons for the change.

Observation

In reaching this preliminary view, the IASB observed that disclosing a company's internal information about an acquisition would have the advantage that the information is likely to be more robust than that generated solely for external reporting. Additionally, the approach would minimise the cost to the company of providing this information.

Other targeted improvements

During the PIR of IFRS 3, investors have indicated that they would like more information on synergies and defined benefit pension liabilities in acquisitions. In addition, they stated that the guidance on so called pro forma information should be improved. The pro forma information currently required by IFRS 3 is the revenue and profit or loss of the combined entity for the current reporting period as though the acquisition date had been at the beginning of the annual reporting period.

To address these and other detailed issues, the IASB's preliminary view is that they should develop the following proposals:

- Add disclosure objectives to IFRS 3 that require companies to provide information to help investors to understand:
  - the benefits that a company's management expected from an acquisition when agreeing the price to acquire a business; and
  - the extent to which management's objectives for an acquisition are being met.
- Make targeted improvements to the disclosure requirements of IFRS 3 to:
  - require a company to disclose a description of the synergies expected from combining the operations of the acquired business with the company's business, when the synergies are expected to be realised, the estimated amount or range of amounts of the synergies, and the estimated cost or range of costs to achieve those synergies.

- specify that liabilities arising from financing activities and defined benefit pension liabilities are major classes of liabilities (requiring these liabilities incurred to be disclosed separately)
- replace the term 'profit or loss' in the requirement to provide pro forma information with the term 'operating profit before deducting acquisition-related transaction and integration costs'. Operating profit or loss would be defined as in the Exposure Draft *General Presentation and Disclosures*.
- add a requirement to disclose the cash flows from operating activities of the acquired business after the acquisition date, and of the combined entity on a pro forma basis for the current reporting period.

Goodwill: impairment and amortisation

Can the impairment test be made more effective?

During the PIR of IFRS 3, stakeholders have said that companies generally recognise goodwill impairment losses in their financial statements too late, long after the events that caused those losses. They urged the IASB to make the impairment test more effective at recognising impairment losses on goodwill, so that it can provide a timely signal about whether the performance of an acquisition is meeting expectations.

Goodwill is tested for impairment as part of the cash-generating unit or group of cash-generating units to which it has been allocated. Therefore, headroom in a cash-generating unit can shield goodwill against impairment. The headroom of a cash-generating unit is the difference between its recoverable amount and the carrying amount of its recognised assets—including goodwill—and liabilities.

The IASB has explored designing an impairment test based on this headroom (the 'headroom approach'). This test attempted to allocate at least some of the reduction in the value of cash-generating units containing goodwill to the acquired goodwill, rather than allocating it all first to the unrecognised headroom in the impairment test in IAS 36 *Impairment of Assets*.

However, stakeholders have said this approach would add significant cost to performing the impairment test. In addition, the IASB concluded that the 'headroom approach' would reduce shielding but not eliminate it. The IASB's preliminary view is therefore that it is not feasible to design a different impairment test that is significantly more effective than the impairment test in IAS 36 at recognising impairment losses on goodwill on a timely basis at a reasonable cost. Nevertheless, the IASB would welcome any suggestions stakeholders have for making the impairment test more effective at recognising impairment losses on goodwill on a timely basis and in a cost-effective manner.

Should amortisation of goodwill be reintroduced?

Having concluded that the impairment test cannot be significantly improved at a reasonable cost, the IASB considered whether to reintroduce amortisation of goodwill (in addition to an impairment test).

Amortisation could take some pressure off the impairment test, which may make the impairment test easier and less costly to apply and provide a simple mechanism that targets the acquired goodwill directly. By reducing the carrying amount of acquired goodwill, amortisation might help resolve the concerns of those stakeholders who believe the carrying amount of goodwill can be overstated because of management over-optimism or because goodwill is not tested for impairment directly.

Proponents of goodwill amortisation argue that acquired goodwill is a wasting asset with a finite useful life. In addition, the future costs that maintain a company's reputation and competitiveness would generate new goodwill internally rather than maintain the acquired goodwill. The acquired goodwill is continually consumed and replaced by internally generated goodwill.

Proponents of retaining the impairment-only model consider that the evidence continues to confirm that an amortisation expense provides investors with no useful information because determining the useful life of goodwill is arbitrary. In addition, while estimates of cash flows will always be subject to management judgement, if applied well, the impairment test is expected to meet its objective of ensuring that the combined assets, including goodwill, are carried at no more than their combined recoverable amount.

The IASB's preliminary view is to maintain the impairment-only approach as there is no compelling evidence that amortising goodwill would significantly improve the information provided to investors or significantly reduce the cost of performing the impairment test.

Observation

When the IASB voted on this preliminary view, only a small majority (8 out of 14 IASB members) agreed that the IASB should retain the impairment-only model. The IASB is asking constituents whether they agree with this view or whether amortisation should be reintroduced to address the main reasons that impairment losses on goodwill are not recognised on a timely basis. The IASB is also asking how proponents of amortisation would determine the useful life of goodwill and its amortisation pattern.

Presentation of total equity excluding goodwill

The IASB has already proposed in its Exposure Draft *General Presentation and Disclosures* to require goodwill to be presented as a separate line item on the balance sheet. The IASB's preliminary view is that it should develop a proposal to help investors better understand a company's financial position by requiring the presentation on the balance sheet of the amount of total equity excluding goodwill.

Presenting the amount of total equity excluding goodwill:

- would provide further transparency about the effect of goodwill and so contribute further to investors' understanding of a company's financial position.
- could help to highlight those companies for which goodwill is a significant portion of their total equity.

Although it is simple for investors to calculate this amount, the IASB considers that presenting this amount separately would give it more prominence.

Simplifying the impairment test

Relief from an annual impairment test

Stakeholders have said that one reason why the impairment test is costly and complex is the requirement to perform the test annually even if there is no indication of impairment.

The principal concern about providing a relief from an annual impairment test is whether it would make the impairment test less robust. It could delay the recognition of impairment losses on goodwill, which some stakeholders consider are already recognised too late, and so reduce the value of the information of these impairment losses.

Some stakeholders, including some preparers, regard carrying out an impairment test every year as a good governance mechanism. Performing the test prompts management to assess the cash-generating processes within its business, promoting good stewardship. Some investors have commented that the disclosures relating to the impairment test are useful, particularly information about the test's assumptions and sensitivities.

The IASB's preliminary view is that it should develop a proposal to remove the requirement for a company to perform an annual impairment test for cash-generating units containing goodwill if there is no indication that the cash-generating units may be impaired. IASB members have different views on how much cost such a change would save, and on how much it may reduce the robustness of the impairment test. Because moving to an indicator-based approach would place more reliance on identifying indicators of impairment, the IASB plans to assess whether it needs to update the list of indicators in IAS 36.

The IASB's preliminary view is that the removal of the requirement to perform an annual impairment test should extend to intangible assets with indefinite useful lives and intangible assets not yet available for use.

Observation
Only a narrow majority (8 out of 14 IASB members) favoured removing the requirement for an annual impairment test, even though the IASB's preliminary view is that it should not reintroduce amortisation. They agree that removing the requirement would make the test marginally less robust. However, they also consider that when the company has no indicator of impairment the benefits of testing for impairment are minimal and so do not justify the cost in those cases.

Simplifying value in use estimates

Remove restriction of uncommitted restructuring and asset enhancement cash flows

In determining value in use, companies are required to exclude cash flows expected to arise from a future restructuring or enhancement of an asset's performance. Some stakeholders have explained that this requirement can cause cost and complexity because excluding such cash flows requires management to adjust its financial budgets or forecasts.

The IASB expects that removing the restriction on these cash flows would indeed reduce cost and complexity. Moreover, the impairment test would be less prone to error because estimates of value in use would probably be based on cash flow projections which are prepared, monitored and used internally for decision-making regularly, rather than forecasts produced solely for external financial reporting once or twice a year.

The IASB's preliminary view is that it should develop a proposal to remove from IAS 36 the restriction on including cash flows arising from a future restructuring to which a company is not yet committed or from improving or enhancing an asset's performance.

This proposal would apply not only to cash-generating units containing goodwill but to all assets and cash-generating units within the scope of IAS 36.

The IASB's preliminary view is that setting a probability threshold to determine when these cash flows should be included or requiring additional qualitative disclosures is unnecessary for these cash flows. These cash flows would still be subject to the same requirements that apply to all cash flows included in estimates of value in use—companies would be required to use reasonable and supportable assumptions based on the most recent financial budgets or forecasts approved by management.

Allowing post-tax discount rate and post-tax cash flows

Stakeholders said determining pre-tax discount rates is costly and complex. They explained that a pre-tax discount rate is hard to understand, is not observable and does not provide useful information because it is generally not used for valuation purposes. In practice, valuations of assets are generally performed on a post-tax basis.

The IASB agrees and expects removing the requirement to use pre-tax cash flows and pre-tax discount rates would:

- make the test easier to understand by aligning it with common valuation practice.
- not require companies to calculate pre-tax discount rates solely to satisfy the disclosure requirements of IAS 36.
- provide investors with more useful information, because companies generally use post-tax discount rates as an input in estimating value in use.
- better align value in use in IAS 36 with fair value in IFRS 13 *Fair Value Measurement*.

The IASB's preliminary view is that it should develop a proposal to:

- remove the explicit requirement to use pre-tax cash flows and pre-tax discount rates in estimating value in use.

- require a company to use internally consistent assumptions for cash flows and discount rates regardless of whether value in use is estimated on a pre-tax or post-tax basis.
- retain the requirement for companies to disclose the discount rate used but remove the requirement that the discount rate disclosed should be a pre-tax rate.

This proposal would apply not only to cash-generating units containing goodwill but to all assets and cash-generating units within the scope of IAS 36.

Observation

The IASB considered, but decided not to provide the following simplifications and guidance for the impairment test:

- adding more guidance on the difference between entity-specific inputs used in value in use and market-participant inputs used in fair value less costs of disposal.
- mandating only one method for estimating the recoverable amount of an asset (either value in use or fair value less costs of disposal), or requiring a company to select the method that reflects the way the company expects to recover an asset.
- allowing companies to test goodwill at the entity level or at the level of reportable segments rather than requiring companies to allocate goodwill to groups of cash-generating units that represent the lowest level at which the goodwill is monitored for internal management purposes.
- adding guidance on identifying cash-generating units and on allocating goodwill to cash-generating units.

Intangible assets

Many respondents to the PIR of IFRS 3 identified challenges with the requirement to recognise separately from goodwill all identifiable intangible assets acquired in a business combination. The challenges relate to both costs and benefits. Some investors expressed concerns about the usefulness of the information provided. Other stakeholders said that identifying and measuring some of those identifiable intangible assets could be complex, subjective and costly.

The IASB considered how including in goodwill some intangible assets could resolve these concerns. In addition, the IASB identified the following disadvantages in changing the requirements:

- Goodwill would be commingled with identifiable intangible assets with different characteristics, leading to a loss of information about those assets.
- Reducing the proportion of intangible assets recognised separately would not respond to the frequent calls to improve financial reporting by providing more information about intangible assets that are increasingly important in modern economies.
- If the IASB does not reintroduce amortisation of goodwill, then including intangible assets with finite useful lives within goodwill would lead to a loss of information about the consumption of those intangible assets. If the IASB reintroduces amortisation of goodwill, commingling these intangible assets with goodwill may make it even more difficult to determine an appropriate useful life for goodwill.
- Some additional complexity could arise. For example, if identifiable intangible assets are included within goodwill and subsequently sold, what profit should a company recognise on sale?

Therefore, the IASB's preliminary view is that it should not develop a proposal to change the recognition criteria for identifiable intangible assets acquired in a business combination.

Other standard-setters

The DP contains a section that summarises the contents of an Invitation to Comment published by the US Financial Accounting Standards Board (FASB) in July 2019 and of a Research Report published by the Australian Accounting Standards Board (AASB) on IAS 36 in March 2019.

IFRS 3 is converged in many respects with US generally accepted accounting principles (US GAAP). For example, in accordance with both IFRS 3 and US GAAP for public companies, companies do not amortise goodwill. The IASB asks respondents to the DP whether any of the questions in the DP depend on whether the outcome is consistent with US GAAP as it exists today, or as it may be after the FASB's current work. If so, respondents should indicate which of their answers would change and why.

The IASB is also interested in feedback from stakeholders on whether, as the AASB report recommends, the IASB should review IAS 36 in its entirety and issue a new Standard in its place. Such a review is beyond the scope of this project. Therefore, the IASB encourages stakeholders to respond to the IASB's 2020 Agenda Consultation to help it decide whether it should add to its work plan a broader project to review IAS 36.

Next steps

The IASB invites comments on all matters in the DP and, in particular, on the questions set out at the end of each section under 'Questions for respondents'. In addition, respondents are encouraged to raise other comments on the IASB's preliminary views presented in the DP and whether the IASB should consider any other topics in response to the PIR of IFRS 3.

Comments are to be received by 15 September 2020.

The views expressed in the DP are preliminary and subject to change. The IASB will consider the comments received on the DP before deciding whether to develop an Exposure Draft with proposals to amend or replace parts of IFRS 3 and IAS 36.

Further information

If you have any questions about the Discussion Paper please speak to your usual Deloitte contact or get in touch with a contact identified in this *IFRS* in Focus.

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