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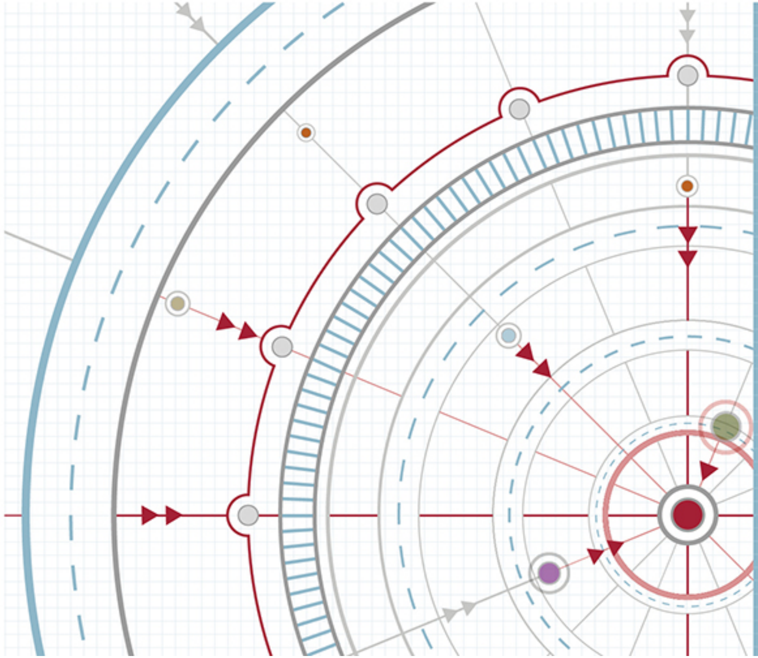

CMAC meeting, 01 November 2018

Agenda Paper 5A

Goodwill and Impairment

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Objective of the meeting

To seek views about:

- the new disclosure objectives being considered for IFRS 3 *Business Combinations* and the disclosure requirements being developed to meet those objectives; and
- whether information generated by those objectives and requirements are likely to meet users' needs.

To understand:

- how investors use the carrying amount of goodwill in making decisions.

Contents of the paper

1. Background and introduction
2. Identifying better disclosures
3. Use of the carrying amount of goodwill in investor analysis
4. Future developments

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Session Agenda (expected timing)

- During the 90 minute session, we expect to structure the discussion as follows:

70 minutes	• Additional disclosures at acquisition date – IASB Staff Tee-Up (topics on slides 5-21) – Q&A discussion covering questions 1-4 (slides 17, 19, 21) • Why is information on the subsequent performance of the acquired business required (key question)? – IASB Staff Tee-Up (topic on slide 22) – Q&A discussion covering question 5 (slide 22) • Additional disclosures for subsequent performance – IASB Staff Tee-Up (topics on slides 23-31) – Q&A discussion covering questions 6-9 (slides 26, 29, 31)
20 minutes	• Use of the carrying amount of goodwill in analysis – IASB Staff Tee-Up (topics on slides 32-34) – Q&A discussion covering questions 10-12 (slide 34)

Background and introduction

Background and Introduction

2009

Entities started implementing revised version of IFRS 3.

2013

The Board sought stakeholder feedback on specified matters as part of the Post-implementation Review (PIR) of IFRS 3.

2015

The Board set as research objectives exploring whether to consider:

- changing the subsequent accounting for goodwill;
- allowing identifiable intangible assets to be included within goodwill;
- providing better information about goodwill and impairment through disclosures; and
- improving the impairment test in IAS 36 *Impairment of Assets.*

July 2018

The Board decided to pursue three objectives for follow-up (see slide 8**) and to issue a *Discussion Paper* as the next step of the project.**

Q4 of 2018

The Board will continue its discussions on how to achieve the objectives the Board is pursuing for the project and work towards starting to draft the *Discussion Paper.*

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Identifying better disclosures

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Objectives for follow-up work for the project

✓ **At the July 2018 Board meeting, the Board tentatively decided to pursue the following three objectives for further exploration of how to address the interrelated problems identified in the research project:**

Objective A	**Identifying disclosures to enable investors to assess:** • **management's rationale for the business combination; and** • **whether the post-acquisition performance of the business combination meets expectations set at the acquisition date.**
Objective B	Simplifying the accounting for goodwill by exploring whether to: • permit an indicator-only approach to determine when an impairment test is required; and/or • reintroduce amortisation of goodwill.
Objective C	Improving the calculation of value in use by exploring whether to: • remove the prohibition on the inclusion in cash flow projections of future enhancements to the asset; and • permit the use of post-tax inputs in the calculation of value in use.

Disclosures for business combinations in IFRS 3

✓ **Summary of the feedback from users about disclosures for business combinations**

Investors are particularly interested in understanding: a) the key drivers justifying the consideration paid for a business combination (and hence the amount of goodwill); and b) whether the acquisition has been successful.
Commonly observed problems with existing disclosure requirements:
The qualitative description of the factors making up the acquired goodwill is often generic, not providing useful information.
It is sometimes difficult to ascertain the total cost of an acquisition (capital investment).
Need for better information on the operating performance of the acquired business (trend analysis).

Existing disclosure objectives of IFRS 3

✓ **Existing disclosure objectives in IFRS 3 require entities to provide information that enables users:**

- to evaluate **the nature and financial effect of a business combination** that occurs during the current reporting period or after the end of the reporting period but before the financial statements are authorised for issue; and
- to evaluate **the financial effects of adjustments recognised** in the current reporting period related to business combinations that occurred in the period or previous reporting periods.

→ Not sufficient to provide users with information about the acquired business and its subsequent performance

Improving disclosure objectives of IFRS 3 (1/2)

✓ **The staff are considering whether to recommend the following as possible improvements to the existing disclosure objectives in IFRS 3:**

1. For business combinations that occur in the current reporting period, an acquirer **shall** disclose information that enables users:

a. to understand the effect of a business combination on the acquirer's financial position, financial performance and cash flows for the current reporting period; and

b. to understand:

New

i. the strategic rationale for and the key objectives of the business combination; and

ii. the factors identified at the date of acquisition that the acquirer will use to assess the extent to which those key objectives have been achieved.

Improving disclosure objectives of IFRS 3 (2/2)

✓ **The staff are considering whether to recommend the following as possible improvements to the existing disclosure objectives in IFRS 3:**

New

2. For business combinations that occurred in previous reporting periods, an acquirer **shall** disclose information that enables users:

a. to assess the extent to which the key objectives of past business combinations have been achieved, as measured by the factors identified at the date of acquisition for assessing the extent of achievement of those objectives; and

b. to understand the effects of adjustments related to those business combinations on the acquirer's financial position, financial performance and cash flows in the current reporting period.

Additional disclosure requirements to meet possible revised objectives of IFRS 3

✓ **To meet first disclosure objective** (see slide 11):

- Existing IFRS 3 disclosure requirements generally meet this objective, but feedback indicates these can be improved.
- Targeted amendments and improvements to the existing disclosure requirements should be considered
  - to prevent limited or boilerplate information; and
  - to provide an insight into the strategic reasons for the business combination and the key drivers supporting the value of the acquired business.

❖ These disclosures are in relation to the information on the acquired business **as at the acquisition date** and help users to initially assess whether the business combination is a **good investment decision**

Additional disclosure requirements for acquired business as at acquisition date (1/4)

✓ Additional disclosure requirements being considered:

1. a **qualitative** description of the **strategic rationale** for the business combination, including the **key objectives** for the business combination

<Brief Analysis>

- Expands the requirement in IFRS 3 to describe the primary reasons for the business combination.
- Provides better information supporting the value of the business combination – the high level strategic rationale and more detailed objectives.
- Key objectives will be used in subsequent reporting periods in assessing the subsequent performance of the acquisition.

Additional disclosure requirements for acquired business as at acquisition date (2/4)

✓ **Additional disclosure requirements being considered (cont'd):**

2. **the amount** or **the range of amounts** of those individual factors that support the amount of goodwill recognised

- eg **a quantitative assessment of the expected synergies** of the business combination together with expected costs to achieve those synergies

<Brief Analysis>

- Responds to feedback that the qualitative description of the factors that make up the goodwill recognised sometimes provides only limited information.
- Provides better information for users to help assess whether the acquisition is a good investment decision.

Additional disclosure requirements for acquired business as at acquisition date (3/4)

✓ **Additional disclosure requirements being considered (cont'd):**

3. separate disclosure of **liabilities for which cash flows were or will be classified as financing activities** assumed at the date of acquisition (ie debt acquired in a transaction)

<Brief Analysis>

- Some entities do not provide separate information on debt obligations assumed in the disclosure of assets acquired and liabilities assumed.
- Debt not defined in current IFRS but could use the IAS 7 amendment definition.
- IAS 7 amendment in 2016 does not provide a split of debt obligations assumed by individual business combination.
- Helps investors to assess the total amount of capital employed in each business combination; some users consider these amounts as part of the total cost of a business combination.
- Could be extended to include pension obligations.
- It should not increase costs to preparers because preparers already have this information.

Questions to CMAC – Disclosures (1/6)

✓ **The overall purpose of this meeting is to get a better understanding of what information users want about acquisitions, how that information is used and CMAC members' views on the staff's initial thoughts on disclosures.**

1. Is the amount of debt obligations assumed on acquisition important information (slide 16)?
   - What is it used for?
   - Should this be extended to pension obligations?

Additional disclosure requirements for acquired business as at acquisition date (4/4)

✓ **Additional disclosure requirements being considered (cont'd):**

4. the amounts of revenue and profit or loss of the acquiree since the acquisition date included in the consolidated statement of comprehensive income for the reporting period

<Brief Analysis>

- Feedback from the PIR that the measure of profit or loss needs to be defined better eg operating profit vs earnings, before acquisition accounting adjustments, etc.
- Requires further discussion and work because 'operating profit' is not defined in IFRS (see Primary Financial Statements project).
- Is disclosure of revenue and profit or loss as though the acquisition had occurred at the start of the year useful? As well as requiring better definition, feedback that cost of preparing this disclosure can be high. Is the disclosure above with comments on seasonality sufficient?

Questions to CMAC – Disclosures (2/6)

✓ **The overall purpose of this meeting is to get a better understanding of what information users want about acquisitions, how that information is used and CMAC members' views on the staff's initial thoughts on disclosures.**

2. For what period should revenue and profit or loss information be provided for the acquired business (slide 18)?
   - How should profit or loss be defined?
   - Should this be for the period prior to acquisition or post acquisition?

Existing disclosure requirements for acquired business as at acquisition date

✓ **Examples of existing IFRS 3 disclosure requirements that could be removed:**

Existing requirement	Comments
For acquired receivables: i. the fair value of the receivables; ii. the gross contractual amounts receivable; and iii. the best estimate at the acquisition date of the contractual cash flows not expected to be collected.	Does this provide useful information? - Additional credit risk disclosures in IFRS 7 should now provide sufficient information on credit risk for all receivables. - This was a user request to understand the credit risk of the receivables acquired – is this information needed any more?
The total amount of goodwill that is expected to be deductible for tax purposes	Why is this information needed about goodwill specifically, rather than any other asset or liability?

Questions to CMAC – Disclosures (3/6)

- ✓ **The overall purpose of this meeting is to get a better understanding of what information users want about acquisitions, how that information is used and CMAC members' views on the staff's initial thoughts on disclosures.**

3. Can these disclosure requirements be removed (slide 20)?
4. Are the improvements proposed on slides 14-18, along with the existing IFRS 3 disclosure requirements, sufficient for users to make an initial assessment of whether an acquisition is a good investment decision?

Additional disclosure requirements to meet possible revised objectives of IFRS 3

✓ **To meet the second disclosure objective (see slide 12)**

– This disclosure objective provides new information for business combinations not previously provided by the existing disclosure requirements of IFRS 3.

❖ These disclosures are in relation to the **subsequent performance of the acquired business** after acquisition

Questions for CMAC – Disclosures

5. Why is information on the acquisition's subsequent performance required?
   – What makes the information about the performance of the acquired business different to the performance of the existing business?

Additional disclosure requirements on subsequent performance (1/6)

✓ **Additional disclosure requirements being considered:**

- **what factors** management **will use to assess** the extent to which the **key objectives** of the business combination have been achieved in future periods
- the **measurement of those factors** that management determined at the acquisition date would be used to assess the extent to which the key objectives of the business combination have been achieved **in subsequent reporting periods**

? Regarding **the factors** used to assess the achievement of key objectives for future periods, we are considering ….. (see following slides)

Additional disclosure requirements on subsequent performance (2/6)

What factors should be disclosed?

Based on how management assess the achievement of the key objectives for internal reporting purposes – staff current proposal
(Pros) • It would be suitable for a diverse population of acquisitions. • It could prevent boilerplate information. • It could help overcome issues with integration and commercial sensitivity.
(Cons) • Some information that users need might be missed. • It could be difficult to audit. • Information may lack comparability. • What if the acquisition is not separately monitored for internal reporting purposes?

- Management would determine the factors that will be used to assess the extent to which the key objectives of the business combination are achieved at the date of acquisition, and would measure the achievement of the key objectives in subsequent reporting periods using these factors.

Additional disclosure requirements on subsequent performance (3/6)

What factors should be disclosed?

Alternative: **Requiring specific measure(s) to be provided**
(Pros) • Key information that users need will be provided. • Information will be comparable.
(Cons) • Feasibility for entities to prepare in all circumstances – may require a more basic measure to be required which may reduce the information content of disclosure. • If management do not actually use the basis to monitor the acquisition, the information may not be produced as rigorously. • Does not give users insight into how management monitor subsequent performance.

Questions to CMAC – Disclosures (4/6)

✓ **The overall purpose of this meeting is to get a better understanding of what information users want about acquisitions, how that information is used and CMAC members' views on the staff's initial thoughts on disclosures.**

6. Which of the methods on slides 24-25 do you prefer?
   - What one specific measure of subsequent performance would you require all entities to provide (if the alternative on slide 25 is followed)?
   - If an entity does not monitor an acquisition should a specific measure be prescribed (if the approach on slide 24 is followed)?

Additional disclosure requirements on subsequent performance (4/6)

Examples of the factors (or specific disclosure requirements) could be as follows:

- estimating the amount of synergies expected to be achieved and monitoring the achievement of those synergies in subsequent periods.
- comparing acquisition date cash flow forecasts for the business combination to actual cash flows in subsequent periods.
- setting acquisition date financial/operating key performance indicator targets and monitoring them in subsequent periods.
- estimating the payback period of the business combination at acquisition date and measuring the business combination's progress in subsequent periods.
- the amount of revenue and/or profit or loss of the acquiree (acquired business) in subsequent reporting periods.
- a measure of segment assets for those segments including acquisitions – to allow a return on asset calculation to be performed.

The information may be about
- the acquired business in isolation; or
- the operating segment or CGU(s) containing the acquired business if integration after acquisition prevents separate information on acquired business

Additional disclosure requirements on subsequent performance (5/6)

Quantitative or qualitative information?

Alternative 1: Quantitative information	Alternative 2: Qualitative information

- Users might consider quantitative information more useful than qualitative information.
- Preparers may not want to provide quantitative information on factors because of:
  - commercial sensitivity; or
  - could represent a profit forecast.

Example: Key objective of acquisition is to generate 500k new customer accounts in geography A by Year X2. In Year X1, 300k new customer accounts achieved (acquisition date forecast 350k). In Year X2, 550k new customer accounts achieved.

Company discloses:	Company discloses:
Year X0 – 500k customer accounts target	Year X0 – key objective of new customer accounts in geography A by Year X2
Year X1 – 300k – variance (50k) to target, commentary that expect to still meet overall target	Year X1 – commentary that Year X1 customer account target missed by 50k or 14% but expect to still meet overall target
Year X2 – 550k – exceeding acquisition target	Year X2 – commentary that customer number target exceeded by 50k or 10%

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Questions to CMAC – Disclosures (5/6)

- ✓ **The overall purpose of this meeting is to get a better understanding of what information users want about acquisitions, how that information is used and CMAC members' views on the staff's initial thoughts on disclosures.**

7. Is the absolute target required to be disclosed or, to prevent a profit forecast or disclosure of commercially sensitive information, could a combination of qualitative information along with variances be sufficient?

Additional disclosure requirements on subsequent performance (6/6)

How long should these disclosures be provided for?

Alternative 1	Alternative 2
Determined by the entity: - the period the entity's management measures and monitors whether the key objectives of the business combination are achieved.	**Specify a period** to provide the information: - minimum period (eg three years) - would this suit all acquisitions?

In both cases an entity would still need to ensure it has provided sufficient information to meet disclosure objective

Questions to CMAC – Disclosures (6/6)

✓ **The overall purpose of this meeting is to get a better understanding of what information users want about acquisitions, how that information is used and CMAC members' views on the staff's initial thoughts on disclosures.**

8. For what period should this information be required and what alternative on slide 30 would you take?
   - In your experience, how quickly do acquisitions go wrong?
9. Do you have any other comments or feedback on the disclosure objectives for business combinations or disclosure requirements proposed?

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Use of the carrying amount of goodwill in investor analysis

Does the carrying amount of goodwill really matter?

- Equity investors generally ignore the carrying amount of goodwill on the balance sheet in making their decisions.
- This may be because the carrying amount of goodwill provides little information on a company's ability to generate future net cash inflows.
- But investors may use ROCE/ROIC metrics as part of their analysis which will include the carrying amount of goodwill.
- Since acquired goodwill can be shielded by unrecognised headroom from existing business in CGU, impairment test may not always result in impairment of acquired goodwill even if acquisition underperforming.
- Acquired goodwill on balance sheet could therefore represent internally generated goodwill rather than original acquired goodwill.

Questions to CMAC – Carrying amount of goodwill

10. Do you use the carrying amount of the goodwill in making investment decisions? If so, how?

11. If, after time, the goodwill represents internally generated goodwill rather than the original acquired goodwill, would this distort your investment decisions? If so, why?

12. Do you think that retail investors or other users of the financial statements could be misled by the carrying amount of goodwill on the balance sheet? If so, why and how?

Future developments

Future developments

- The ideas for new disclosure objectives and requirements are the staff's current thoughts on how to provide better information about the acquired business and have yet to be presented to the Board.
- At the October Board meeting, the Board will discuss the further work required on all the research objectives set.
- Further feedback on the project may be sought at future CMAC meetings.
- Results of the research and ideas developed by the staff expected to be discussed in Board meeting(s) during H1 2019.
- Drafting of the discussion paper would then commence.

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