Staff paper

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IASB® meeting

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Project	**Goodwill and Impairment**
Topic	**Identifying a subset of business combinations**
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Purpose and structure

1. As noted in Agenda Paper 18A, we think the International Accounting Standards Board (IASB) should explore how to identify a subset of business combinations to which its preliminary views on disclosure requirements would apply. The preliminary views on disclosure requirements were included in the Discussion Paper *Business Combinations—Disclosures, Goodwill and Impairment* and are summarised in Agenda Paper 18A.

2. Agenda Paper 18B analyses whether the IASB should require an entity to disclose information that would be required applying its preliminary views for only a subset of business combinations and if so, what items of information should be required only for that subset.

3. This paper analyses how to:

   (a) describe the subset of business combinations (paragraphs 6–11); and

   (b) identify that subset of business combinations (paragraphs 12–44).

Key messages

4. If the IASB decides to require entities to disclose some of the information that would be disclosed applying the preliminary views for only a subset of 'material' business combinations, we think the subset should be 'strategically important' business combinations, that is a business combination, for which not meeting the objectives would seriously put at risk the entity achieving its overall business strategy.

5. We think the IASB should identify 'strategically important' business combinations using a closed list of thresholds, for which meeting any one of those thresholds would require an entity to disclose information for that business combination. We think the thresholds should be both:

   (a) Quantitative—that is, business combinations in which:

      (i) the acquiree's operating profit (as defined by the Primary Financial Statements project) exceeds 10% of the acquirer's operating profit, for the most recent annual reporting period of the acquirer ending before the business combination; and

      (ii) the amounts recognised as of the acquisition date for all assets acquired (including goodwill) exceeds 10% of the carrying value of the assets recognised on the acquirer's balance sheet as at the most recent reporting period date of the acquirer before the business combination.

   (b) Qualitative—that is business combinations that result in the entity entering a new geographical area of operations or a new major line of business.

Describing the subset of business combinations

6. IFRS 3 *Business Combinations* includes requirements for 'material' and 'immaterial' business combinations. As we noted in paragraph 33 of Agenda Paper 18B, this alternative would require entities to disclose additional information for a subset of 'material' business combinations and is not intended to describe a 'material' business combination.

7. In developing this alternative, we think it is important to first describe, at a high level, the types of business combinations such a subset would capture. Even though it is possible the IASB might not include that description or 'label' within the requirements, depending on the particular approach it uses in designing those requirements (see paragraphs 12–44), we think such a description or label would help:

   (a) guide the design of the specific requirements to identify business combinations that would be captured by this subset;

   (b) distinguish this subset from 'material' business combinations;

   (c) explain the IASB's intentions; and

   (d) entities understand and apply the requirements.

8. The IASB's preliminary view would require entities to disclose information for only those business combinations that an entity's Chief Operating Decision Maker (CODM) monitors. As noted in paragraph 2.38(b) of the Discussion Paper, this approach would focus on the 'most important' business combinations. Some stakeholders, including some users of financial statements (users), said the information that would be provided applying the preliminary views should be required for only 'major' or 'fundamental' business combinations (paragraphs 2.34 and 2.36 of the Discussion Paper).

9. We think the subset should capture business combinations that are 'strategically important' to an entity. A 'strategically important' business combination could be described along the lines of 'a business combination, for which not meeting the objectives would seriously put at risk the entity achieving its overall business strategy.'

10. We think such a description would capture both large business combinations and smaller business combinations with significant strategic value because an entity's overall business strategy could be seriously put at risk by, for example:

    (a) committing a large amount of capital to a failed business combination; or

    (b) failing to enter new markets or geographies that are essential to the entity's overall business strategy.

11. Labelling the subset as 'strategically important' business combinations:

    (a) avoids use of terms such as 'significant' that are used in other IFRS Accounting Standards. In [Agenda Paper 18B] to the April 2022 IASB meeting, we suggested the IASB could amend its preliminary views to require entities to disclose information only for 'significant' business combinations. However, there were concerns that such a label might create confusion. Labelling the business combinations as 'strategically important' could help avoid such confusion.

    (b) builds on the preliminary view that would require an entity disclose the strategic rationale for the business combination.

Identifying the subset

12. In Agenda Paper 18A to the July 2022 IASB meeting we discussed three ways the IASB could identify a subset of business combinations—a quantitative threshold, qualitative threshold or a factor-based approach.

13. Feedback from IASB members in July 2022 and from members of the Accounting Standards Advisory Forum (ASAF) at the ASAF meeting in July 2022 did not indicate a preference for a particular way. However, that feedback suggested that identifying a subset should take into consideration both quantitative and qualitative aspects of a business combination. Reflecting on that feedback and considering the types of business combinations we think the subset should capture (paragraph 9), we agree that quantitative or qualitative considerations on their own might be insufficient to identify 'strategically important' business combinations.

14. We think there are two ways the IASB could develop requirements for entities to identify 'strategically important' business combinations, both of which include qualitative and quantitative considerations:

    (a) open list of factors (paragraphs 15–23); and

    (b) closed list of thresholds (paragraphs 24–43).

Open list of factors

Description of the approach

15. This approach would require the IASB to describe in IFRS 3 the type of business combinations the subset is intended to capture—that is, 'strategically important' business combinations (see paragraphs 6–11)—and to supplement that description with an open list of factors an entity would consider when assessing whether a business combination meets that description.

16. The factors on that list would be neither individually determinative nor exhaustive. An entity would be required to consider the factors in assessing whether the business combination meets the description but meeting one of the factors would not necessarily result in the entity being required to disclose information about that business combination. An entity would also not be limited to consider only the listed factors—the entity might determine that a business combination is 'strategically important' (and that the entity is therefore, required to disclose information about that business combination) even if that business combination does not meet any of the listed factors.

17. This approach would be similar to the requirements in IAS 21 *The Effects of Changes in Foreign Exchange Rates*, that define what functional currency is and provide a list of factors an entity needs to consider when assessing its functional currency.

Factors

18. Paragraph 35 of Agenda Paper 18A to the IASB's July 2022 meeting discussed factors that the IASB could include. Those factors include:

    (a) the business combination will result in the entity operating in a new geographic location or a separate major line of business;

    (b) the business combination would require approval from those charged with governance, or from shareholders in an annual general meeting;

    (c) local regulations would require the entity to:

        (i) obtain approval by the local regulator for the business combination; or

(ii) provide information about the business combination to its shareholders (for example, class 1 transactions in the United Kingdom);

(d) the performance of the acquired business will be disclosed as a separate reportable segment applying IFRS 8 *Operating Segments*;

(e) the subsequent performance of the business combination will be reviewed by the entity's CODM; and

(f) the entity has provided information similar to that which would be required by the IASB's preliminary views for that business combination outside its financial statements.

19. The list does not include any explicit consideration of the size of a business combination. While the IASB could include some explicit quantitative factors, doing so might be unnecessary because the list implicitly includes quantitative considerations. For example, large business combinations could be captured by the acquired business being a separate reportable segment or local regulations requiring the entity to provide information about the business combination to its shareholders.

20. As noted in paragraph 126 of Agenda Paper 18C to the IASB's April 2021 meeting, and paragraph 8 of Agenda Paper 18A to the IASB's April 2022 meeting, one common area of feedback from users is that they would like to have more information about a series of business combinations undertaken to achieve a single strategic objective. In July 2022 one ASAF member suggested requiring an entity consider possible future developments when determining whether a business combination should be included in the subset applying a factor-based approach. We think requiring an entity to consider the factors both in the current state and expected future developments when assessing whether a business combination is 'strategically important' could help capture the first in a series of business combinations undertaken to achieve a single strategic objective. This is because the entity would be required to consider expected future developments linked to that business combination.

Advantages and disadvantages

21. Using an open list of factors for identifying business combinations is closer to the principle-based approach the IASB typically uses in setting IFRS Accounting Standards. If applied properly, this approach can provide users with useful information by being adaptive to business combinations undertaken to satisfy different strategic needs of an entity.

22. However, it may be difficult to devise an open list of factors that are distinguishable from factors that an entity would consider when applying materiality. The open list of factors (paragraph 18) may be viewed as guidance for entities to identify 'material' business combinations rather than 'strategically important' business combinations.

23. An open list of factors may also be difficult to enforce. The application of this approach would, by nature, be judgemental and there may not always be sufficient objective evidence to determine whether a business combination is 'strategically important'. This could create tension among auditors, preparers and regulators and may not be as effective as a closed list approach in capturing applicable business combinations, leading to greater cost for preparers.

Closed list of thresholds

Approach

24. This approach would require the IASB to specify what constitutes a 'strategically important' business combination and an entity would be required to disclose the information described in the preliminary views if the business combination meets at least one of the prescribed thresholds.

25. There is precedence in IFRS Accounting Standards for using such an approach. For example, paragraph 13 of IFRS 8 requires an entity to report separately information about an operating segment if specified quantitative thresholds are met.

Thresholds

26. We think the thresholds should be both:

    (a) quantitative (paragraphs 27–38); and

    (b) qualitative (paragraphs 39–42).

Quantitative thresholds

27. Regulations in some jurisdictions require an entity to provide additional information about a business combination if that business combination meet specific quantitative thresholds. For example, we understand that:

    (a) Canadian regulations have different thresholds for listed and non-listed entities to provide additional information for business combinations. The regulations require a listed entity to disclose additional information in the form of a Business Acquisition Report if any 2 of the following 3 thresholds are met (for a non-listed entity, additional information is required if either of the first two criteria are met):

        (i) asset—if an entity's proportionate share of the consolidated assets of an acquiree exceeds a percentage of the consolidated assets of the entity and the acquiree prior to the acquisition date. The percentages are 30% and 100% for listed and non-listed entities respectively.

        (ii) investment— if an entity's investment in and advances to an acquiree exceed a percentage of the consolidated assets of the entity and the acquiree prior to the acquisition date. The percentages are 30% and 100% for listed and non-listed entities respectively.

        (iii) profit or loss—if the proportionate profit or loss from continuing operations (excluding income tax) of an acquiree that is attributable to the parent of a listed entity exceeds 30% of the consolidated profit or loss from continuing operations (excluding income tax) of the listed entity and the acquiree prior to the acquisition date.

    (b) UK regulations require an entity to provide additional information for business combinations in which any one of four of the below criteria exceeds 5% (class 2 transactions) and to require shareholders of the acquiring entity to vote on business combinations when any one of these criteria exceeds 25% (class 1 transactions). The criteria are:

        (i) gross assets—calculated by dividing the gross assets of the acquired business by the gross assets of the acquirer.

        (ii) profit—calculated by dividing the profits attributable to the assets that are the subject of the transaction by the profits of the acquirer.

        (iii) consideration—calculated by taking the consideration for the transaction (which could include any liabilities of the acquired business the acquirer agrees to discharge) as a percentage of the aggregate market value of all the ordinary shares (excluding treasury shares) of the acquirer.

(iv) gross capital—calculated by dividing the gross capital[1] of the acquired business by the gross capital of the acquirer.

(c) South African regulations require an entity to provide additional information for business combinations in which any one of three of the below criteria exceeds 5% (category 2 transactions) and to require shareholders of the acquiring entity to vote on business combinations where any one of these criteria exceeds 30% (category 1 transactions). The criteria are:

(i) consideration to market capitalisation—the consideration divided by the aggregate market value of all the acquirer's listed equity securities, excluding treasury shares of the acquirer.

(ii) dilution—the number of listed equity securities issued by the acquirer as consideration for an acquisition compared to those in issue, excluding treasury shares prior to the transaction.

(iii) transactions to be settled partly in cash and partly in shares—the category size for such transaction is to be calculated by first assessing the cash to market capitalisation percentage and then adding this percentage to the dilution percentage.

28. We think the IASB can build on the thresholds used by regulators. These thresholds have been designed by regulators to target, what are in their view, the most important business combinations and we are not aware of concerns relating to how these thresholds work in practice. Building on the thresholds used by regulators the IASB would need to consider:

(a) criteria (paragraphs 29–32);

(b) percentages (paragraphs 33–36) and

(c) aggregation (paragraphs 37–38)

Criteria

29. As noted in paragraph 27 regulators use various criteria. These include criteria based on primary financial statement measures (eg gross assets and profit) and criteria based on other measures (eg consideration and market capitalisation).

30. We think the IASB should use criteria based on IFRS accounting measures—this will allow the IASB to leverage existing definitions in IFRS Accounting Standards and avoid the difficulty of defining new criteria. For example, defining consideration in the same way as the regulations in paragraph 27 might need to refer to concepts such as 'enterprise value' and 'net-debt'. As noted in paragraph BC11 of IAS 7 *Statement of Cash Flows*, it might be difficult to define 'debt' (and therefore to define 'net-debt).

31. In addition, criteria based on market capitalisation would not be applicable to non-listed entities that report using IFRS Accounting Standards.

32. Within criteria based on primary financial statement measures, the Canadian and UK regulations referred to in paragraph 27 use criteria based on both profit and loss and balance sheet measures. We think the IASB should do the same and use:

[1] Gross capital of the acquired business is calculated as the sum of consideration, any shares or debt not being acquired, all other liabilities including minority interest and the excess of current liabilities over current assets.
Gross capital of the acquirer is calculated as the sum of the market value of listed shares and debt, all other liabilities including minority interest, and the excess of current liabilities over current assets.

(a) operating profit (as defined by the IASB's Primary Financial Statements project) for the most recent annual reporting period of the acquirer ending before the business combination—we think this has three benefits:

(i) doing so would exclude financing and investment income and expenses, which, if included, could result in different conclusions based on how the acquirer and acquiree are financed.

(ii) defining the level of profit or loss rather than just requiring entities to use 'profit or loss' would prevent entities using different measures and therefore disclosing information inconsistently.

(iii) doing so would be consistent with the IASB's tentative decision in November 2021 to replace the term 'profit or loss' in paragraph B64(q) of IFRS 3 with 'operating profit or loss'.

(b) a comparison of the amounts recognised as of the acquisition date for all assets acquired (including goodwill) to the carrying value of the assets recognised on the acquirer's balance sheet as at the most recent reporting period date of the acquirer before the business combination. This would build on the requirement in paragraph B64(i) for an entity to disclose the amounts recognised as at the most recent reporting period date of the acquirer before the business combination.

Percentages

33. The regulations in paragraph 27 use percentages ranging from 5% to 30%. We think this sets the range for the IASB to consider. We acknowledge that deciding what percentage to apply to the criteria in paragraph 32 is driven by practical rather than conceptual considerations.

34. The following items of information help assess the percentage to use:

(a) In July 2022, we presented the IASB with research on the number of business combinations that might be captured by different quantitative thresholds (paragraphs 28–31 of Agenda Paper 18A to the IASB's July 2022 meeting). We found that the proportion of acquisitions that represent at least 5% of the revenue, profit, total assets or net assets of that of the reporting entity was approximately the same proportion of disposals reported as discontinued operations in financial statements when compared to the total number of disposals (with the exception of disposals in Asia-Oceania).

(b) At the July 2022 ASAF meeting, one ASAF member said using 5% would capture too many business combinations. Another ASAF member suggested using 10% for an asset criteria and 5% for a revenue criteria.

(c) We tried to obtain information about the frequency in which the thresholds described in paragraph 27 are met. We assessed only Canadian business combinations because we were unable to obtain complete information about transactions in the UK and South Africa. In 2021 we identified 56 business combinations for which a Business Acquisition Report was published. For context, Capital IQ has information about 3,668 listed entities and 1,322 transactions undertaken by Canadian entities that completed in 2021 (although that figure includes transactions that are not business combinations as defined in IFRS 3 and so is not directly comparable). We also reviewed the financial statements for the period that covered the Business Acquisition Report for all entities publishing a Business Acquisition Report in 2021. Those financial statements disclosed information about 125 'material' business combinations.

35. The information in paragraph 34 is mixed and does not strongly support a particular percentage within the range. As noted in paragraph 35 of Agenda Paper 18B, the purpose of the IASB requiring information for a subset of 'material' business combinations is to reduce the cost of applying the additional disclosure requirements. Accordingly, we think the IASB should use a percentage that would

capture fewer business combinations than are currently considered 'material' while not resulting in entities disclosing information for too few business combinations.

36. In our view, an appropriate percentage sits between the 5% and 30% range used in national regulations. We think 10% seems like a reasonable compromise, based on the information available.

Aggregation

37. Some of the regulations listed in paragraph 27 require an entity to aggregate some business combinations together when assessing the thresholds in specific circumstances. We considered whether the IASB should require an entity to assess quantitative thresholds in aggregate to help identified linked business combinations and respond to the user feedback described in paragraph 20. For example, an entity could be required to (a) apply the thresholds in aggregate to all businesses acquired in the 12 months prior to the business combination being assessed; and (b) disclose, in aggregate, information about those business combinations.

38. We think the IASB should not propose such a requirement because:

    (a) As noted in paragraph 35 of Agenda Paper 18B, the objective of requiring information for only a subset of 'material' business combinations is to reduce the monetary cost of applying the additional disclosure requirements. Aggregating business combinations together may increase the complexity of the requirements and therefore the cost of applying the requirements. For example, if an entity is acquiring several businesses as part of the same strategic rationale and those business are acquired in different reporting periods, the entity may need to continually restate its objectives for the aggregate group of business combinations.

    (b) An entity's management might not monitor the performance of the aggregate group of business combinations in the way the IASB define that group. If that were the case the entity would disclose only that it is not monitoring that group because it is aggregated in a different way to how the IASB required business combinations to be aggregated. We think this might not provide users with useful information.

Qualitative thresholds

39. For qualitative thresholds, we think the focus should be to capture business combinations that are quantitatively small but are nonetheless strategically important because they signal a strategic shift (eg the entity implementing a new strategy). At its July 2022 meeting, one ASAF member suggested an entity's entry into a new industry as a possible qualitative threshold. In our view, entry into a new geographical area of operations or a new major line of business signal a strategic shift.

40. Assessing whether a business combination constitutes an entity's entry into a new geographical area of operations or a new major line of business could require judgment. However, IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* already requires an entity to make a similar assessment when assessing a discontinued operation. Paragraph 32 of IFRS 5 defines a discontinued operation as 'a component of an entity that… (a) represents a separate major line of business or geographical area of operations…'.

41. In addition, we think requiring an entity to identify business combinations that involve entering a new geographical area of operations or a new major line of business could help identify the first business combination in a series of linked business combinations. Therefore, we think the qualitative criteria could also help partially respond to the user feedback described in paragraph 20.

42. We considered whether to also use some of the other thresholds discussed in paragraph 18. We think keeping the list of thresholds short helps reduce the cost of applying the requirements. In addition, as noted in paragraph 19, we think some of those factors are designed to implicitly capture 'large' business combinations. If the IASB already sets a quantitative threshold as discussed in paragraphs 27–38, we think including those thresholds would be unnecessary. Accordingly, we suggest not considering those other thresholds.

Advantages and disadvantages of the approach

43. A closed list of thresholds would be less aligned with a principles-based approach than the open list of factors approach discussed above (see paragraphs 15–23). However, we think a closed list of thresholds would:

    (a) require less judgements and thereby be less costly than the open list of factors approach. This would reduce preparers' cost in applying the additional disclosure requirements.

    (b) be easier for auditors and regulators to audit and enforce thereby preventing tension among preparers, auditors and regulators.

Staff recommendation

44. As noted in paragraph 35 of Agenda Paper 18B, the objective of requiring information for only a subset of 'material' business combinations is to reduce the monetary cost of applying the additional disclosure requirements. As explained in paragraph 43, using a closed list of thresholds more closely aligns with that objective. Accordingly, we recommend the IASB should identify 'strategically important' business combinations using a closed list of thresholds, for which meeting any one of those thresholds would require an entity to disclose information for that business combination. Paragraph 5 summarises our recommendation.