Think Ahead ACCA

Business combinations – disclosures, goodwill and impairment

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Comments from ACCA
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GENERAL COMMENTS

ACCA welcomes the opportunity to provide views in response to the IASB's discussion paper on business combinations. This has been done with the assistance of members of ACCA's Global Forum for Corporate Reporting. If further information is needed, please get back to us.

ACCA considers that the proposed disclosures of the objectives and rationale for acquisitions and the monitoring of the performance against those objectives will provide very useful information for investors. They will go a long way to meet the stewardship issues that are raised by acquisitions. We agree that these should be required for material acquisitions only. The disclosure of expected synergies will likewise provide useful information but they raise more issues of commercial sensitivity. There is a case for exempting unlisted companies from both sets of these disclosures.

We support a return to amortisation of goodwill. The factors that are most important for us are the consistent treatment of goodwill with other assets, a recognition that acquired goodwill will be consumed over a period and the large values of goodwill that have developed under the current model. Amortisation may also allow for the current level of harmonisation on this matter between US GAAP and IFRS to continue. We recognise, however, that this change would lead to a number of other issues, including estimating the useful life of the goodwill, the right pattern of amortisation and dealing with the goodwill on transition.

Goodwill that would be amortised must also of course be subject to impairment. The rigour of the current impairment model should not be diminished under either goodwill model. If the impairment-only model is maintained, the annual quantitative test should be retained. Under an amortisation model, impairment assessment would be required where there were indications that impairment may have taken place. The disclosures about objectives and the post-acquisition monitoring of the performance against them will be helpful in highlighting potential impairments sooner than at present.

RESPONSES TO THE SPECIFIC QUESTIONS ASKED

Question 1

Paragraph 1.7 summarises the objective of the Board's research project. Paragraph IN9 summarises the Board's preliminary views. Paragraphs IN50–IN53 explain that these preliminary views are a package and those paragraphs identify some of the links between the individual preliminary views.

The Board has concluded that this package of preliminary views would, if implemented, meet the objective of the project. Companies would be required to provide investors *with more useful information about the businesses those companies acquire. The aim is to help investors to assess performance and more effectively hold management to account for its decisions to acquire those businesses. The Board is of the view that the benefits of providing that information would exceed the costs of providing it.*

(a) Do you agree with the Board's conclusion? Why or why not? If not, what package of decisions would you propose and how would that package meet the project's objective?

(b) Do any of your answers depend on answers to other questions? For example, does your answer on relief from a mandatory quantitative impairment test for goodwill depend on whether the Board reintroduces amortisation of goodwill? Which of your answers depend on other answers and why?

Investors and other users of financial statements do need better information about acquisitions, especially where these are very significant individually or where this is an important part of the company's business model. In many cases acquisitions of other businesses are the single largest investments that company's management make and there should be transparency about the impact of those decisions have on the business and accountability for their performance,

We support the majority of the package of proposals, though we support a reintroduction of amortisation of goodwill. Our answer to the annual impairment test does depend on whether the impairment-only model is retained. Otherwise our reservations about the proposals are set out in the answers to the questions that follow.

Disclosure improvements

Question 2

Paragraphs 2.4–2.44 discuss the Board's preliminary view that it should add new disclosure requirements about the subsequent performance of an acquisition.

1) *Do you think those disclosure requirements would resolve the issue identified in paragraph 2.4—investors' need for better information on the subsequent performance of an acquisition? Why or why not?*

Better information about the performance of major acquisitions is a legitimate and reasonable expectation from investors and other users. Information about the objectives and rationale for an acquisition and the monitoring of its performance are logical elements to achieve that better information and will go a long way to meeting those expectations.

This information is of particular importance to shareholders and other investors fulfilling a stewardship objective. It would often, therefore, be provided to them in a prospectus or similar document if such would be required. The IASB should consider exemptions from these requirements for unlisted companies that may choose or be required to prepare financial statements in compliance with full IFRS.

(b) Do you agree with the disclosure proposals set out in (i)–(vi) below? Why or why not?

(i) A company should be required to disclose information about the strategic rationale and management's (the chief operating decision maker's (CODM's)) objectives for an acquisition as at the acquisition date (see paragraphs 2.8–2.12). Paragraph 7 of IFRS 8 Operating Segments discusses the term 'chief operating decision maker'.

As noted above, we agree that strategic rationale and objectives for acquisition would be helpful disclosure requirements. We very much support the idea that these disclosures should be restricted to material acquisitions. Requiring the disclosures for all acquisitions would in some cases provide a lot of information that might obscure the information about key ones and add to the bulk of the financial statements. Using those where the CODM is actively involved is a way to identify such material acquisitions.

In many cases this may work well, however we note that

- the application of the CODM concept in IFRS8 has produced some inconsistencies in practice
- in many cases the board of directors will decide on making material acquisitions and so determine the rationale and objectives for them, even if the monitoring may be left to the executive management.
- Smaller acquisitions may be monitored by levels of management below CODM, especially in large groups and where there are several of them they may be material in aggregate.

In our view, the standard should simply refer to material acquisitions with guidance that those monitored by the CODM should be considered as material. This would leave to the preparing company the decision for which acquisitions these disclosures would be supplied.

(*ii) A company should be required to disclose information about whether it is meeting those objectives. That information should be based on how management (CODM) monitors and measures whether the acquisition is meeting its objectives (see paragraphs 2.13–2.40), rather than on metrics prescribed by the Board.*

Yes. This is an important way of assessing management's stewardship of the business and material investments made. We strongly support that this should be done using the metrics (financial and non-financial) that management uses in monitoring the performance against objectives.

Many criticisms have been made of the impairment tests of goodwill and other assets, including the speed at which any underperformance is reported. These disclosures are an important way of identifying issues in a timely way.

(iii) If management (CODM) does not monitor an acquisition, the company should be required to disclose that fact and explain why it does not do so. The Board should not require a company to disclose any metrics in such cases (see paragraphs 2.19–2.20).

Agreed. The expectation for material business combinations is that they will be monitored.

(*iv) A company should be required to disclose the information in (ii) for as long as its management (CODM) continues to monitor the acquisition to see whether it is meeting its objectives (see paragraphs 2.41–2.44)*.

Agreed.

(v) If management (CODM) stops monitoring whether those objectives are being met before the end of the second full year after the year of acquisition, the company should be required to disclose that fact and the reasons why it has done so (see paragraphs 2.41–2.44).

Though the expectation would often be that material acquisitions would be monitored for a two-year period, the speed at which integration into the company's existing business will vary. Once integrated it might not be realistic to monitor the acquired business separately and the assessment method would change. Instead of the two-year period a disclosure of when such monitoring ceases would be better, to reinforce the absence of the information in (iv) above.

(*vi) If management (CODM) changes the metrics it uses to monitor whether the objectives of the acquisition are being met, the company should be required to disclose the new metrics and the reasons for the change (see paragraph 2.21).*

Agreed.

(c) Do you agree that the information provided should be based on the information and the acquisitions a company's CODM reviews (see paragraphs 2.33–2.40)? Why or why not? Are you concerned that companies may not provide material information about acquisitions to investors if their disclosures are based on what the CODM reviews? Are you concerned that the volume of disclosures would be onerous if companies' disclosures are not based on the acquisitions the CODM reviews?

See our comments under (b) (i) above on the CODM approach.

(d) Could concerns about commercial sensitivity (see paragraphs 2.27–2.28) inhibit companies from disclosing information about management's (CODM's) objectives for an acquisition and about the metrics used to monitor whether those objectives are being met? Why or why not? Could commercial sensitivity be a valid reason for companies not to disclose some of that information when investors need it? Why or why not?

We consider that the strategic rationale, objectives and metrics to judge performance against those objectives are valid expectations from investors for material acquisitions. In our view these should be capable of being disclosed without infringing on commercially sensitive matters.

(*e) Paragraphs 2.29–2.32 explain the Board's view that the information setting out management's (CODM's) objectives for the acquisition and the metrics used to monitor progress in meeting those objectives is not forward-looking information. Instead, the Board considers the information would reflect management's (CODM's) targets at the time of the acquisition. Are there any constraints in your jurisdiction that could affect a company's ability to disclose this information? What are those constraints and what effect could they have?*

Agreed.

Question 3

Paragraphs 2.53–2.60 explain the Board's preliminary view that it should develop, in addition to proposed new disclosure requirements, proposals to add disclosure objectives 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 an acquisition is meeting management's (CODM's) objectives for the acquisition.*

Do you agree with the Board's preliminary view? Why or why not?

We agree that the benefits that management expects from an acquisition should be explained in order that the reasonableness of the price paid can be assessed and note that this may often include the synergies covered by Q4 below.

We have supported disclosure of the extent to which a material acquisition is meeting the management's objectives – see our response to Q2(b)(ii) above. However, these disclosure objectives seem to be applicable to all acquisitions, but by its definition this aspect can only be applied to those monitored by management. The scope of application should be clarified.

Question 4

Paragraphs 2.62–2.68 and paragraphs 2.69–2.71 explain the Board's preliminary view that it should develop proposals:

- *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 expected cost or range of costs to achieve those synergies; and*
- *to specify that liabilities arising from financing activities and defined benefit pension liabilities are major classes of liabilities.*

Do you agree with the Board's preliminary view? Why or why not?

The disclosures proposed for synergies would be demanding requirements especially when they need to be shown for all acquisitions and not just those significant enough to be monitored by management. We suggest that these should be restricted to the material acquisitions covered by Q2.

As with the disclosures covered by Question 2 above, IASB should consider an exemption for unlisted companies.

The description of synergies can be sensitive, for example when they may involve future restructurings which have not yet been disclosed to the employees or others affected. IASB needs to have some recognition of the issues here. It may be appropriate that entities may not disclose some synergies on the grounds of commercial sensitivity, but are required to explain why.

It is also important for the IASB to define the synergies, for example in terms of whether these are the expectations at the time of the purchase and so most appropriate for the assessment of the purchase price, or the synergies assessed after the acquisition which may be more relevant to subsequent performance. Clarity is needed on whether synergies are forward-looking information or not.

The estimations of future costs and benefits are likely to be very judgmental.

As these specific disclosures of synergies are new, guidance by way of examples and definitions of what is and is not a synergy, is likely to be needed to ensure consistent application.

We agree with the full disclosure of financing liabilities and pension obligations taken on as a result of the acquisition.

Question 5

IFRS 3 Business Combinations requires companies to provide, in the year of acquisition, pro forma information that shows the revenue and profit or loss of the combined business for the current reporting period as though the acquisition date had been at the beginning of the annual reporting period.

Paragraphs 2.82–2.87 explain the Board's preliminary view that it should retain the requirement for companies to prepare this pro forma information.

(a) Do you agree with the Board's preliminary view? Why or why not?

(b) Should the Board develop guidance for companies on how to prepare the pro forma information? Why or why not? If not, should the Board require companies to disclose how they prepared the pro forma information? Why or why not?

IFRS 3 also requires companies to disclose the revenue and profit or loss of the acquired business after the acquisition date, for each acquisition that occurred during the reporting period. Paragraphs 2.78–2.81 explain the Board's preliminary view that it should develop proposals:

- *to replace the term 'profit or loss' with the term 'operating profit before acquisition-related transaction and integration costs' for both the pro forma information and information about the acquired business after the acquisition date. Operating profit or loss would be defined as in the Exposure Draft General Presentation and Disclosures.*
- *to add a requirement that companies should disclose the cash flows from operating activities of the acquired business after the acquisition date, and of the combined business on a pro forma basis for the current reporting period.*

(c) Do you agree with the Board's preliminary view? Why or why not?

We agree with the retention of the requirements for pro-forma information about performance in the year of acquisition.

Guidance for the preparation of the information is likely to be useful.

We agree with the refinement of the profit/loss to be used in the pro-forma. Acquisition related transaction costs and integration costs are new terms and will need definitions and examples to help ensure consistent application.

We agree with the pro-forma cash flow disclosures.

Question 6

As discussed in paragraphs 3.2–3.52, the Board investigated whether it is feasible to make the impairment test for cash-generating units containing goodwill significantly more effective at recognising impairment losses on goodwill on a timely basis than the *impairment test set out in IAS 36 Impairment of Assets. The Board's preliminary view is that this is not feasible.*

> *(a) Do you agree that it is not feasible to design an impairment test that is significantly more effective at the timely recognition of impairment losses on goodwill at a reasonable cost? Why or why not?*
>
> *(b) If you do not agree, how should the Board change the impairment test? How would those changes make the test significantly more effective? What cost would be required to implement those changes?*
>
> *(c) Paragraph 3.20 discusses two reasons for the concerns that impairment losses on goodwill are not recognised on a timely basis: estimates that are too optimistic; and shielding. In your view, are these the main reasons for those concerns? Are there other main reasons for those concerns?*
>
> *(d) Should the Board consider any other aspects of IAS 36 in this project as a result of concerns raised in the Post-implementation Review (PIR) of IFRS 3?*

We agree that the impairment test cannot be made more effective at a reasonable cost. We note and agree with the board's assessment of the 'headroom approach'.

In the absence of an improvement in the impairment test, we also note that the disclosures on the performance against objectives and metrics will be a significant help in identifying, on a more timely basis, any underperformance in a material acquisition. Any such underperformance revealed by these disclosures should be included among the indicators that would trigger a full impairment assessment.

We agree that over-optimism in the cash flow forecasts for the value in use estimation and shielding the acquired goodwill are the main reasons for the issue of impairment not being recognised on a timely basis.

Question 7

Paragraphs 3.86–3.94 summarise the reasons for the Board's preliminary view that it should not reintroduce amortisation of goodwill and instead should retain the impairment-only model for the subsequent accounting for goodwill.

> *(a) Do you agree that the Board should not reintroduce amortisation of goodwill? Why or why not? (If the Board were to reintroduce amortisation, companies would still need to test whether goodwill is impaired.)*
>
> *(b) Has your view on amortisation of goodwill changed since 2004? What new evidence or arguments have emerged since 2004 to make you change your view, or to confirm the view you already had?*

(c) Would reintroducing amortisation resolve the main reasons for the concerns that companies do not recognise impairment losses on goodwill on a timely basis (see Question 6(c))? Why or why not?

(d) Do you view acquired goodwill as distinct from goodwill subsequently generated internally in the same cash-generating units? Why or why not?

(e) If amortisation were to be reintroduced, do you think companies would adjust or create new management performance measures to add back the amortisation expense? (Management performance measures are defined in the Exposure Draft General Presentation and Disclosures.) Why or why not? Under the impairment-only model, are companies adding back impairment losses in their management performance measures? Why or why not?

(f) If you favour reintroducing amortisation of goodwill, how should the useful life of goodwill and its amortisation pattern be determined? In your view how would this contribute to making the information more useful to investors?

We support the reintroduction of amortisation of goodwill. The main reasons for doing so are the consistent treatment for goodwill with other assets and the expectation that the acquired goodwill will be consumed over time and will be realised in the future cash flows of the business. We note that business models are increasingly digitalised and so likely to have a shorter lifespan than before and so the associated goodwill will tend to be consumed more quickly. An important factor is also the great extent of the build-up of goodwill in some listed companies during the time that the current impairment-only model has been in place.

We do not expect that amortisation will resolve all the concerns over the timely recognition of impairment losses. The amortisation period is likely to be longer than the period before overpayment for an acquisition becomes evident. If there were to be amortisation required in future, the importance and rigour of impairment testing must be maintained. For material acquisitions the disclosure of the objectives and rationale and of the metrics monitoring the performance against them will be very useful in assessing whether an impairment may have taken place.

We do regard goodwill on an acquisition in principle as separate from the goodwill that may be generated internally following the integration of the acquired business.

In supporting amortisation of goodwill, we expect that many companies will continue to emphasise management performance measures such as EBITDA that will add back the amortisation. Equally, we expect many investors will also ignore the amortisation. The Board needs to consider the investor views that it receives particularly carefully in this regard.

We accept that the reintroduction of amortisation will raise a number of difficult issues including the estimation of useful life for an asset that is difficult to identify let alone measure. Despite this, the lives and amortisation methods should not be fixed in the standard, but be entity-specific. Users of the accounts should have management's estimation of the period that is expected to benefit from the acquisition. The general pattern of acquisition and then integration of these businesses such that the acquired goodwill cannot be separately identified after a few years, together with the digital business models noted above, would point to shorter rather than longer lives.

Transition from one accounting treatment to another would raise significant issues especially given the growth in the extent of current goodwill balances.

Question 8

Paragraphs 3.107–3.114 explain the Board's preliminary view that it should develop a proposal to require companies to present on their balance sheets the amount of total equity excluding goodwill. The Board would be likely to require companies to present this amount as a free-standing item, not as a subtotal within the structure of the balance sheet (see the Appendix to this Discussion Paper).

> *(a) Should the Board develop such a proposal? Why or why not?*
>
> *(b) Do you have any comments on how a company should present such an amount?*

We do not support this proposal.

Such a disclosure will not require any significant cost to preparers, but equally will give no new information to users given that the values of equity and goodwill are evident on the statement of financial position. The value of goodwill is already proposed to be separately shown from other assets in the General Disclosure exposure draft. Goodwill as an asset reflects the growing proportion of the value of many businesses that are represented by intangibles. A separate deduction from equity might imply that the value of those intangibles does not exist.

Question 9

Paragraphs 4.32–4.34 summarise the Board's preliminary view that it should develop proposals to remove the requirement to perform a quantitative impairment test every year. A quantitative impairment test would not be required unless there is an indication of impairment. The same proposal would also be developed for intangible assets with indefinite useful lives and intangible assets not yet available for use.

> *(a) Should the Board develop such proposals? Why or why not?*
>
> *(b) Would such proposals reduce costs significantly (see paragraphs 4.14–4.21)? If so, please provide examples of the nature and extent of any cost reduction. If the proposals would not reduce costs significantly, please explain why not.*
>
> *(c) In your view, would the proposals make the impairment test significantly less robust (see paragraphs 4.22–4.23)? Why or why not?*

If the current impairment-only model is maintained then we would not agree with this proposal.

The qualitative indicators that would trigger a quantitative impairment test would add more judgement from management into the impairment process than is already inevitable in the quantitative elements of forecasting cash flows, discount rates and terminal values. In response to concerns that impairments are not recognised on a timely basis, this would seem to add potential further delay.

Most companies have developed methodologies to perform the annual quantitative impairment test and so cost savings may not be very significant.

As noted above, the trigger approach is less robust than the annual quantitative test.

Question 10

The Board's preliminary view is that it should develop proposals:

- *to remove the restriction in IAS 36 that prohibits companies from including some cash flows in estimating value in use—cash flows arising from a future uncommitted restructuring, or from improving or enhancing the asset's performance (see paragraphs 4.35–4.42); and*
- *to allow companies to use post-tax cash flows and post-tax discount rates in estimating value in use (see paragraphs 4.46–4.52).*

The Board expects that these changes would reduce the cost and complexity of impairment tests and provide more useful and understandable information.

(a) Should the Board develop such proposals? Why or why not?

(b) Should the Board propose requiring discipline, in addition to the discipline already required by IAS 36, in estimating the cash flows that are the subject of this question? Why or why not? If so, please describe how this should be done and state whether this should apply to all cash flows included in estimates of value in use, and why.

On balance, we support this change.

Removing the restriction on the inclusion of certain cash flows in estimating the value in use is likely to enhance the opportunities for over-optimism on behalf of management and so making impairments less timely in some cases, as the IASB have acknowledged in paragraph 4.42.

However, we note the other reasons the Board has proposed this as a simplification, for example to give greater alignment with how the matters are considered internally. We also noted the general requirement that reasonable and supportable assumptions are used in the value in use calculation. A threshold that the cash flows are more likely than not seems to include a reasonable element of discipline.

There will be the need for guidance and examples here to illustrate which sort of future cash flows may now be included.

We agree with allowing post-tax cash flows and discount rates.

Question 11

Paragraph 4.56 summarises the Board's preliminary view that it should not further simplify the impairment test.

> *(a) Should the Board develop any of the simplifications summarised in paragraph 4.55? If so, which simplifications and why? If not, why not?*
>
> *(b) Can you suggest other ways of reducing the cost and complexity of performing the impairment test for goodwill, without making the information provided less useful to investors?*

We have no further simplifications to put forward.

Question 12

Paragraphs 5.4–5.27 explain the Board's preliminary view that it should not develop a proposal to allow some intangible assets to be included in goodwill.

> *(a) Do you agree that the Board should not develop such a proposal? Why or why not?*
>
> *(b) If you do not agree, which of the approaches discussed in paragraph 5.18 should the Board pursue, and why? Would such a change mean that investors would no longer receive useful information? Why or why not? How would this reduce complexity and reduce costs? Which costs would be reduced?*
>
> *(c) Would your view change if amortisation of goodwill were to be reintroduced? Why or why not?*

We agree with the Board's approach.

We note that some investors say that wasting customer-related intangibles that are recognised separately from goodwill together with any amortisation of them, are not relevant to them and are regarded as no different from goodwill. However, we note that in general intangibles are of increasing significance in company values and to remove information concerning them would be a retrograde step. This is a question on which further user outreach by the Board would be important before finalising the standard.

Our view would not change whether amortisation were reintroduced or not.

Question 13

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. Paragraphs 6.2–6.13 summarise an Invitation to Comment issued by the US Financial Accounting Standards Board (FASB).

Do your answers to any of the questions in this Discussion Paper 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, which answers would change and why?

Maintaining similar treatments between IFRS and US GAAP is desirable for comparability between reporting entities. This is especially true for major items such as goodwill. Our preference is that IASB and FASB should collaborate and try to reach a converged solution or at least not allow further divergence. A reversion to amortisation of goodwill in IFRS may help in this.

Question 14

Do you have any other comments on the Board's preliminary views presented in this Discussion Paper? Should the Board consider any other topics in response to the PIR of IFRS 3?

1) Some of the proposals and tentative decisions in this discussion paper make assumptions about the cost/benefits of certain requirements and common practice among preparer companies. For example:

    - The extent of monitoring of acquisitions by the CODM as opposed to other levels in management (Q2)
    - Whether two years is commonly a point up to which CODM monitoring of major acquisitions would occur (Q2)
    - Synergies are likely to be quantified within reasonable bounds and could be disclosed without prejudice to commercial sensitivities (Q4)
    - Removing the need for an annual quantitative impairment test would save significant costs (Q9)

    These and other assumptions would be best confirmed via field-testing of these proposals.

2) Major additions to the disclosure requirements of IFRS3 and IAS36 are being proposed. Before adding them, the Board should review the disclosure requirements of these two standards as a whole to ensure that there are not others that would then have little relevance or that are duplicated.