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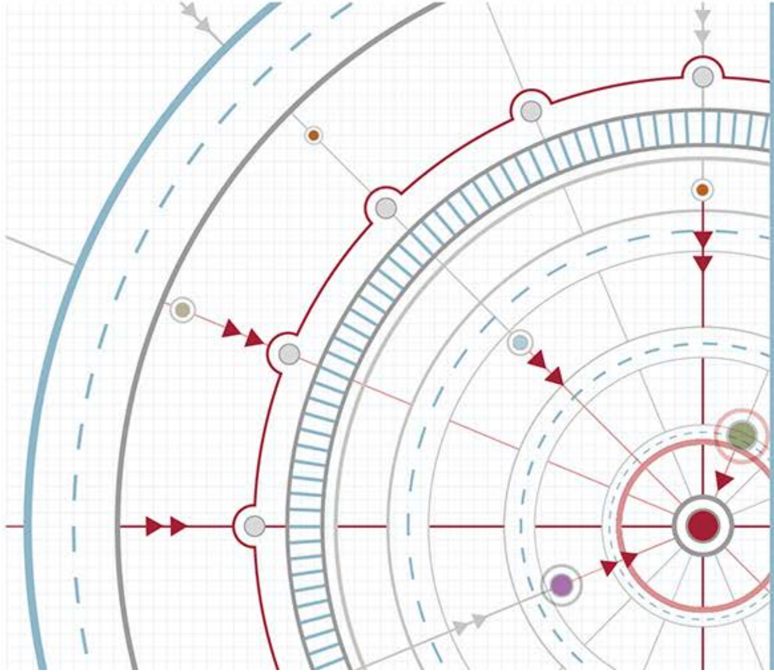
Agenda paper 3



# Goodwill and Impairment

## Joint CMAC-GPF meeting

## June 2019

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# Objective of the meeting



**To discuss:**

- How to overcome barriers (sensitive information and integration) to providing disclosures:
  - of subsequent performance of acquired business, or combined business
  - of expected synergies arising from a business combination
- Possible deletions of existing disclosure requirements of IFRS 3 *Business Combinations*

**Questions to CMAC-GPF members:**

- Case study 1 – barriers due to commercial sensitivity: Slide 28
- Case study 2 – barriers due to integration: Slide 35
- Possible deletions of existing disclosures of IFRS 3: Slide 41

# Contents





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# Background and introduction

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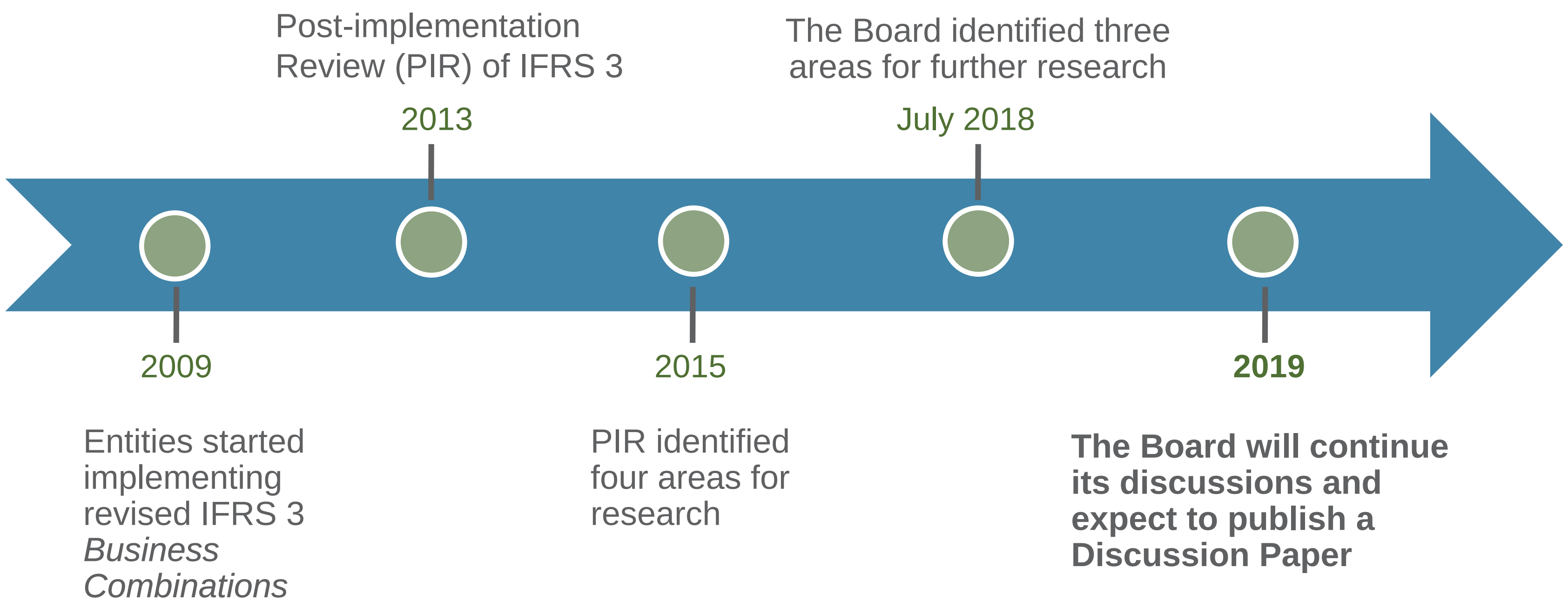
# Goodwill and Impairment—Project timeline





# Project objectives



✓ To address issues identified in the post-implementation review the Board has 3 objectives for further research:

| | |
|---|---|
| **Objective A (Focus for this meeting)** | Identifying **disclosures** to enable investors to assess:<br>• management's rationale for the business combination; and<br>• whether the subsequent performance of the acquired business, or combined business, meets expectations set at the acquisition date |
| Objective B | Exploring whether to simplify the accounting for goodwill by:<br>• permitting an indicator-only approach to determine when an impairment test is required; and/or<br>• reintroducing amortisation of goodwill |
| Objective C | Exploring whether to improve the calculation of value in use by permitting:<br>• cash flow projections to include future restructurings and future enhancements to an asset; and<br>• the use of post-tax inputs in the calculation of value in use |

# Objective A:

# Better disclosures for business combinations

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# Better disclosures for business combinations



- The Board has discussed the staff's proposals to improve disclosures for business combinations:

**Improving disclosure objectives of IFRS 3**

| Additional disclosures on key objectives of a business combination (subsequent performance) | Targeted improvements to the existing disclosure requirements of IFRS 3 | Limited review of IFRS 3 disclosures in the light of the new disclosure objectives |
|---|---|---|

- The Board will determine its preliminary views on the ideas, if any, to express in the Discussion Paper at its June 2019 Board meeting.

# Improving disclosure objectives of IFRS 3



**Adding the following disclosure objectives to provide users with information to help:**

- evaluate the **strategic rationale** for the business combination;
- evaluate the rationale for the **total consideration** to obtain control of the acquiree; and
- **assess performance**; whether the **key objectives** of the business combination are being met.

# Adding new disclosures on subsequent performance



**Add disclosure requirements that will help users assess whether the key objectives of business combinations are being achieved:**

When the business combination occurs:

- the **strategic rationale for the business combination**, eg how the acquisition links to the acquirer's business strategy;
- the **key objectives** of the business combination, eg targets expected arising from the acquisition; and
- the internal measures the chief operating decision maker uses to **assess performance**; whether the key objectives are being met.

In the period the business combination occurs and for at least the **next two years**:

- quantification of those measures to assess whether the key objectives of the business combination are being met.

# Making targeted improvements



**Targeted improvements to IFRS 3 disclosure requirements:**

For each business combination that occurs in the current reporting period:

- a description, if any, of expected **synergies** and the expected timing of achieving those synergies;
- the amount (or the range of amounts) of the synergies and the **expected costs** (or range of expected costs) to achieve the synergies;
- the amount recognised at acquisition for **liabilities arising from financing activities** and **defined benefit pension obligations** assumed; and
- the amounts of the **acquiree's revenue**, **operating profit or loss**, and **cash flow from operating activities** since the acquisition date.

# Limited review of IFRS 3 disclosures



- The staff have identified additional possible amendments to the existing disclosure requirements of IFRS 3.
- Possible amendments will be considered in the next phase of the project, following feedback to the DP.
- Possible amendments could include removal of some existing disclosure requirements in IFRS 3.
  - The possible deletions are discussed on slides 38 to 40.

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# Barriers to providing additional disclosure requirements

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# Barriers to providing additional disclosure requirements



- **Two main barriers identified** through stakeholder outreach:
  - **Commercial sensitivity**
  - **Integration** (ie acquired business combined with existing business after acquisition)

- Disclosure ideas where barriers arose:
  - **subsequent performance** of acquired business, or combined business (see slide 10)
  - amount (or range of amounts) of expected **synergies** arising from the business combination (see slide 11)

# Staff's initial thoughts about barriers



## Commercial sensitivity

- If information is material for users, concerns about commercial sensitivity should **not prevent** this information being disclosed
- However, information should be able to be provided in a way that **prevents disclosing commercially sensitive** information but still provides users with sufficient information (*exploring today*)

## Integration

- It can be difficult to **separately track the performance** of the acquired business after integration
- Where integration occurs, subsequent monitoring will often be of the **combined business**
- Information based on the combined business can still be useful (*exploring today*)

# Case studies

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# Breakout discussion guidelines



- During the 45 minutes break-out, we are asking the groups to answer questions on 2 case studies and 1 additional topic:

15 minutes

- Case Study 1 (See slides 20-28)
  - Company X acquires Company Y illustrating barriers due to commercial sensitivity
  - 2 Questions for CMAC members (See slide 28)
  - 2 Questions for GPF members (See slide 28)

15 minutes

- Case Study 2 (See slides 29-35)
  - Company X acquires Company Z illustrating barriers due to integration
  - 2 Questions for CMAC members (See slide 35)
  - 1 Question for GPF members (See slide 35)
  - 1 Question for both CMAC / GPF members (See slide 35)

15 minutes

- Possible deletions of existing disclosure requirements in IFRS 3 (See slides 37-40)
  - 2 Questions for both CMAC / GPF members (See slide 41)

# Breakout discussion on illustrative examples



- Using illustrative examples, staff will discuss with GPF/CMAC members how these barriers might impact the disclosures provided
- Staff would like to explore, based on the fact patterns provided, what disclosures preparers would provide and what information users need
- Two case studies examine two separate acquisitions undertaken by Company X
  - Case Study 1: Company Y illustrating barriers due to commercial sensitivity
  - Case Study 2: Company Z illustrating barriers due to integration
- In each acquisition, the staff provide examples of the disclosure that could be provided about subsequent performance and expected synergies
- Full IFRS 3 disclosures are not presented

# Background of Company X (acquirer)



- Overview of business
  - Tech-based consumer business
  - Product offerings include: social media app, online-shopping platform, mobile games and media consumption
- Overall business strategy
  - Aims to be one-stop online service provider for consumers
  - Achieves growth mainly through acquisition
  - Has had two well publicised customer data breaches in last five years
- Strategic plan
  - Grow mobile game offering both organically and through acquisition
  - Fully integrate all product offerings onto single platform and across all jurisdictions
  - Develop financial management product (payment and investment functionality)
  - Strengthen capability in IT security

# Case study 1

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# Acquisition Case 1
## Fact pattern – Target Company Y



- Company Y has developed an online payment service platform
  - Customers can deposit cash into the function and use this to pay for all Company X's products
  - Future development would add functionality to invest deposited cash and to pay other third party items (eg household bills)
  - Company Y is small but is well-known within the industry for its technical expertise and capability
- Company X acquires Company Y on the last day of 2018 to
  - acquire (rather than develop) an online payment service platform
    - direct competitors do not have similar functionality in current jurisdiction
  - gain access to technical expertise of Company X
    - utilise IT security expertise across existing architecture

# Acquisition Case 1
## Fact pattern – Target Company Y



- Key objectives for the acquisition are as follows:
  - integrate into existing IT platforms and across all existing products by Q4 2019
  - obtain regulatory licences to use payment service by Q1 2020 and launch Q2 2020
    - expect increase in customers using products
    - expect decrease in credit card fees charged by external providers for customer payments
  - roll-out Company Y's IT security capability across existing architecture by Q4 2019
    - assist in regulatory licence application for payment service
    - expect elimination of security breaches and penalties
    - expect reduction in external IT security maintenance spend
  - cost synergies, expect savings from redundancies and closure of Company Y offices and relocation to Company X premises, improving overall margins

# Acquisition Case 1
## Examples of disclosure in the year of the acquisition (1/2)



The acquisition of Company Y is consistent with the Board’s strategic plan to offer customers a financial management product. Company Y has developed an online payment service with leading edge IT security technology. Company Y’s specialist development team will add to our existing technical capability. The key objectives of the acquisition are to:

- improve customer experience by introducing integrated payment functionality across the user platform across all our products, enabling payment through a single login attracting new customers and reducing credit card transaction fees. The achievement of the objective will be measured by:
  - the extent to which key milestones of the integration plan are met:
    - Software integration – target end Q4 2019
    - Regulatory licences obtained – target end Q1 2020
    - Customer ‘go-live’ – target end Q2 2020;
  - Total customer numbers (Group KPI) increased by 2,000 in 2020, 8,000 in 2021; and
  - Credit card fees paid are expected to reduce by CU0.5 million in 2020 and by CU2 million per year from 2021 as 1 in 5 customer transactions (by 2021) are settled through the integrated payment service.

# Acquisition Case 1
## Examples of disclosure in the year of the acquisition (2/2)



- enhance security of our user platform by deploying Company Y’s blockchain technology, state of the art IT security technology to protect customers personal data. The achievement of the objective will be measured by reviewing progress towards meeting the following targets:
  - the integration of Company Y’s IT security technology into the Group’s existing systems by end Q4 2019;
  - zero reported customer personal data breaches; and
  - reduce external IT security maintenance spend by 25%, CU3 million pa from 2021.
- achieve cost savings from the combined business. The Group plans to integrate the operations of Company Y into its existing business and is targeting cost savings of CU3-4 million pa from the combined business from 2021, with one-off costs of around CU1.5 million to achieve these savings. These cost savings are planned to be achieved through redundancies of up to 15 heads in the combined IT Security and Development teams planned for 2020 once the integration and product launch is complete. In addition, Company Y’s premises are planned to be closed in the second half of 2020 and employees relocated to Company X’s office saving rent and utility charges. The achievement of this objective will be measured by the actual cost savings achieved compared to the cost savings targeted.

# Acquisition Case 1
## Fact pattern – in the subsequent year after the acquisition



**2019**

- Compatibility of the IT infrastructure in Company X with Company Y technology proved to be less than initially thought. Plans to complete the integration of the payment service and the IT security technology delayed as a result and additional integration costs of CU3 million required. New target date is set in Q2 2020.
- Given Company X's poor past IT security performance, newly implemented regulations now require more work to be performed in order to obtain regulatory approval, with additional one-off costs of CU2 million required.
- A number of key staff of Company Y left shortly after the acquisition completed. This has contributed to delays in the integration work and resulted in additional costs for contract staff cover, although largely offset by saved redundancy costs. Too early to say whether this will impact the ability of Company X to realise the full benefits of the acquisition.

# Acquisition Case 1
## Examples of disclosure in Year 1 after the acquisition (1/2)



In 2018, the Group acquired Company Y and its online payment service with leading edge IT security technology and specialist development team. The Group set four key objectives for the acquisition and has identified the relevant measures that management use to monitor the achievement of these objectives. The following table summarises the extent to which the objectives have been achieved in the current year:

| Objectives | Key measures | Current status |
|---|---|---|
| Launch payment service functionality | • Software integration end 2019; Regulatory approval Q1 2020; and Go-live Q2 2020<br>• Total customer numbers increased 2,000 (2020) and 8,000 (2021)<br>• Credit card fees reduced CU0.5 million 2020 and CU2 million pa from 2021 | • Expected completion dates delayed to Q2 2020 (Software integration), end 2020 (Regulatory approval) and Q1 2021 (Go-live)<br>• Total customer numbers increased 3,000 (2021) and 8,000 (2022) and credit card fees reduced CU0.8 million 2021 and CU2 million pa from 2022 |
| Enhance IT security | • Integration into current IT architecture end 2019<br>• Zero reported breaches<br>• Reduce spending on IT security maintenance by CU3 million pa from 2021 | • Expected completion date delayed to Q2 2020<br>• Reduced IT maintenance spending CU3 million pa from 2022 |

# Acquisition Case 1
## Examples of disclosure in Year 1 after the acquisition (2/2)



| Objectives | Key measures | Current status |
|---|---|---|
| Achieve cost savings | • Cost savings of CU3-4 million pa from 2021, CU1.5 million one-off costs to achieve | Timing of cost savings delayed by 9 months |

The Group is behind target in achieving the above objectives. This is due to greater-than-expected compatibility issues between the IT infrastructure of the Group and that of Company Y's technology, changes to Data Security Regulations requires the Group to submit to additional compliance testing by the Financial Authority to obtain regulatory approval and a number of key staff of Company Y leaving during 2019. Consequently, the timetable for integration has been revised with product launch now targeted for the first quarter of 2021, with a consequential delay to the timing of the cost savings being achieved. Additional integration costs of CU5 million are required. Notwithstanding the unforeseen delays, the Group continues to believe that the benefits from the business combination are still achievable.

# Questions for CMAC-GPF members



1. Which elements of the disclosures on slides 23, 24, 26 and 27 do CMAC members consider to be critical to their understanding of the business combination and the subsequent performance of the acquisition?
2. What elements of the disclosures would GPF members be uncomfortable in disclosing in the manner set out in slides 23, 24, 26 and 27 due to commercial sensitivity?
3. How would GPF members redraft the disclosures to avoid disclosing items they would consider to be commercially sensitive?
4. Do CMAC members still find the redrafted disclosures provide sufficient information on the business combination and its subsequent performance?

# Case study 2

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# Acquisition Case 2
## Fact pattern – Target Company Z



- Company Z is a mobile game developer with exclusive rights to a popular movie franchise and a series of developed games. Part of Company X's strategic plan is to expand its mobile game offering
- This acquisition seeks to create value through:
  - Expanding mobile game offering and attracting a new customer base
  - Integration of Company Z's development team improving game development
  - Develop additional movie franchise games
- Key objectives of the acquisition:
  - Retention and integration of Company X & Z's development teams
  - Annual mobile game releases (Group KPI) increased from 3 to 4
  - Incremental Mobile Game segment revenue and operating profit growth of 17% and 20% respectively in 2019 and 5% incremental growth in both from 2020 (plan growth without Z: revenue 3% (2019 & 2020) and operating profit 2% and 3% (2019 and 2020 respectively))
- Other facts
  - Acquisition completes on last day of 2018
  - Company Z's development team integrated into the existing operations
  - Remaining Company Z operations (sales, marketing, administration) closed

# Acquisition Case 2
## Examples of disclosure in the year of the acquisition (1/2)



Company Z is a well established mobile games developer with a range of 25 games including 8 associated with movie franchise BBB which Company Z has the exclusive gaming rights for. These mobile games compliment our existing mobile game portfolio and meet our strategy expanding our mobile game offering. Company Z’s development team are well respected in the industry and will add further development capability to our existing development team, helping to improve the quality of the mobile games we develop and increase our number of annual mobile game releases. The key objectives of the business combination are to:

- integrate Company Z’s existing product offering with our existing portfolio and maximise the sales of the new games and cross-selling opportunities;
- combine the two development teams and develop:
  - existing planned game releases;
  - new movie franchise BBB releases; and
  - other game releases.

# Acquisition Case 2
## Examples of disclosure in the year of the acquisition (2/2)



Management will monitor the success of the business combination using combined Mobile Games segment metrics as follows:

- Increase in annual mobile game releases (Group KPI) from 3 to 4 from 2019;
- Increase in segment revenue of 20% in 2019 and 8% pa from 2020; and
- Increase in segment operating profit of 22% in 2019 and 8% pa from 2020.

# Acquisition Case 2
## Fact pattern – in the subsequent year after the acquisition



**2019**

- Integration goes according to plan
- Mobile game releases of 4 achieved
- Mobile Game segment revenue increase of 23% (vs 20%)
  - sales of existing Company X products ahead of targets increasing segment revenue by 3%
  - sales of Company Y products ahead of targets increasing segment revenue by 2%
  - sales of jointly developed products behind targets reducing segment revenue by 2%
- Mobile Game segment operating profit increase of 21% (vs 22%)
  - higher than expected retention bonuses for Company Z employees and additional matching payments for Company X employees along with higher than expected market adjustments for all employees
  - increase in selling and marketing costs for all gaming products following renewal of existing Company X marketing agreement
  - offset by overall increase in sales of products

# Acquisition Case 2
## Examples of disclosure in Year 1 after the acquisition



In 2018, the Group acquired Company Z as part of its plan to expand its mobile games offering adding its range of 25 games, including 8 associated with movie franchise BBB which Company Z has the exclusive gaming rights for, to the Group's mobile game portfolio. Company Z's development team added further capability to our existing development team, and have helped to improve the quality of the mobile games we develop and increase our number of annual mobile game releases. The Group set 2 key objectives for the acquisition and management monitor the achievement of these objectives using Mobile Games segment measures. The following table summarises the achievement of those objectives in the current year:

| Objectives | Key measures | Current status |
|---|---|---|
| Integrate Company Z's game portfolio and maximise sales | • Increase in segment revenue of 20% in 2019 and 8% pa from 2020<br>• Increase in segment operating profit of 22% in 2019 and 8% pa from 2020 | Integration complete<br>Increase in segment revenue 23%<br>Increase in segment operating profit 21% |
| Combine development teams and develop new mobile games | • Increase annual mobile game releases (Group KPI) from 3 to 4<br>• Increase in segment revenue of 20% in 2019 and 8% pa from 2020<br>• Increase in segment operating profit of 22% in 2019 and 8% pa from 2020 | Integration complete<br>Increase in segment revenue 23%<br>Increase in segment operating profit 21% |

Management still believes that the Group's targets for 2020 are achievable.

# Questions for CMAC-GPF members



1. Do CMAC members think the combined measures still provide useful information about the business combination?
2. Given the facts provided, what additional information would GPF members provide in the disclosure?
3. Given the facts provided, what additional information would CMAC members like to see provided in the disclosure?
4. Do your responses change if:
   – Company Z represents 10% of Mobile Games segment?
   – Company Z represents 50% of Mobile Games segment?
   – Company Z represents 90% of Mobile Games segment?

# Possible deletions of existing IFRS 3 disclosure requirements

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# Limited review of IFRS 3 disclosures



- The staff have identified additional possible amendments (including deletion) to the existing disclosure requirements of IFRS 3.
- Possible amendments will be considered in the next phase of the project, following feedback to the DP.
- Possible amendments could include removal of some existing disclosure requirements in IFRS 3.

# Candidates for possible deletion (1/3)



| Existing disclosure requirements of IFRS 3 | Brief analysis |
| --- | --- |
| B64(q)(ii) the revenue and profit or loss of the combined entity for the current reporting period as though the acquisition date for all business combinations that occurred during the year had been at the beginning of the annual reporting period. | • There was considerable feedback from the PIR, mainly from preparers, questioning the usefulness of this requirement due to its arbitrary nature, lack of guidance on how to prepare it and cost to provide<br>• In the April and May 2019 Board papers, the staff suggest disclosure of the amounts of the acquiree's revenues, operating profit or loss, and cash flow from operating activities <u>since</u> the acquisition date and deleting its existing requirement for pro forma information<br>• Where the business combination occurs towards the end of the year and/or where a business is highly seasonal, the staff also recommend requiring additional information to allow users to understand the full-year effect of the business combination (for example, information on seasonality or one year of unadjusted historic financial information for the acquired business with a narrative explanation of major differences caused by using different accounting standards or accounting policies) |

# Candidates for possible deletion (2/3)



| Existing disclosure requirements of IFRS 3 | Brief analysis |
|---|---|
| B64(h) for acquired receivables:<br>i. the fair value of the receivables;<br>ii. the gross contractual amounts receivable; and<br>iii. the best estimate at the acquisition date of the contractual cash flows not expected to be collected. | • IFRS 7 *Financial Instruments: Disclosures* issued after IFRS 3 requires disclosure of information on credit risk of receivables similar to that provided by this requirement<br>• Feedback from the previous discussions with GPF and CMAC indicated that removing this requirement could reduce the costs to preparers without depriving users of useful information |
| B64(k) the amount of goodwill that is expected to be deductible for tax purposes. | • Feedback from preparers that this might be difficult to determine and also questioned why specifically required only for goodwill.<br>• Since IAS 12 *Income Taxes* does not permit deferred tax on goodwill to be recognised, this disclosure would enable users to understand whether goodwill is tax deductible or not.<br>• Questionable how useful information is. |

# Candidates for possible deletion (3/3)



| Existing disclosure requirements of IFRS 3 | Brief analysis |
|---|---|
| B67(e) the amount and an explanation of any gain or loss recognised in the current reporting period that both:<br>i. relates to the identifiable assets acquired or liabilities assumed in a business combination that was effected in the current or previous reporting period; and<br>ii. is of such a size, nature or incidence that disclosure is relevant to understanding the combined entity's financial statements. | • Paragraph 97 of IAS 1 requires an entity to disclose the nature and amount of income and expense that are material. |

# Questions for CMAC-GPF members



1. Do you have any comments or feedback on the possible deletions from the existing disclosure requirements of IFRS 3 identified by the staff set out on slides 38-40?
2. Do you have suggestions for additional deletions from the disclosure requirements of IFRS 3?

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