AP5B – Goodwill & Impairment slides notes

NOTES ON SLIDE 2

The staff is also seeking feedback from Global Preparers Forum (GPF) on identifying better disclosure at its meeting on 6 Nov 2018.

NOTES ON SLIDES 6-8

Background and introduction of the project

During the research project, the staff performed extensive work to understand the causes of ineffectiveness in the IAS 36 impairment testing model and to investigate ways to make the impairment test more effective at the timely recognition of impairments of goodwill, in order to improve the information provided by the impairment test about the subsequent performance of the acquired business. The staff developed the headroom approach, whereby the unrecognised headroom of a cash-generating unit (or groups of units) is an additional input in the impairment testing of goodwill, with the objective of removing the shielding effect of internally generated goodwill.

The Board observed that introducing the headroom approach would be a significant change. Having assessed the costs and benefits of applying the headroom approach and having discussed the headroom approach with some of the Board's consultative bodies, the Board became concerned that many stakeholders might not consider the headroom approach feasible in terms of cost-benefit considerations. The Board instead tentatively decided to provide investors with information about the acquired business and its subsequent performance through disclosures. Thus, the Board was no longer looking to improvements to the impairment test to provide the information that users want about the performance of the acquisition. Instead, the Board tentatively decided to pursue an objective of simplifying the accounting for goodwill and the impairment test which, according to the feedback from preparers, is costly and complex to perform.

Consequently, **in the July 2018 Board meeting**, on the basis of the key findings from the research project to date, the Board made the tentative decisions documented on slide 8 and further expanded in the appendix to these notes.

- **Next Steps for the project:** For the remainder of 2018, the Board will continue its discussions on how to achieve these objectives and work towards drafting a Discussion Paper.

1. **Focus of discussion at CMAC meeting (1 November 2018):** The staff are focusing on the objective of identifying better disclosures to enable users to assess whether a business combination was a good investment decision and whether the acquired business is performing after the acquisition as was expected at the time of the acquisition. The staff will seek your views about the new disclosure objectives and disclosure requirements being considered for business combinations.
2. The staff intend to discuss with you how investors use the carrying amount of goodwill in making decisions.

NOTES ON SLIDE 9

During and after the Post-implementation Review (PIR) of IFRS 3 Business Combinations, investors gave mixed feedback about the information provided by entities on business combinations, goodwill and impairment.

a) Some said the information currently provided by applying the requirements in IAS 36 *Impairment of Assets* is useful because it provides confirmatory value about the performance of the acquisition and provides an insight into the stewardship of management.
b) Some said the current information has limitations for the following main reasons:
    i. impairment losses are recognised too late;
    ii. impairment calculations are inherently very judgemental and the assumptions used in the calculations are subjective;
    iii. disclosures are not sufficient to assess whether the main inputs/assumptions are reasonable. However, some investors said that some of the current disclosures are useful; these included discount rates used, long-term growth rates, profit and capital expenditure assumptions and sensitivities; and
    iv. insufficient information is provided to help them understand the subsequent performance of the acquired business and whether the main targets/synergies of the acquisition are achieved.
c) Some investors focus more on the timing of the impairment write-down and its overall magnitude rather than the specific amount of impairment recognised.
d) Some said that the disclosures provided by entities applying the requirements in IFRS 3 do not provide sufficient information for investors to properly understand the effect of the acquisition on a group. For example, they said that:
    i. the qualitative description of the factors that make up the acquired goodwill is often generic and tends not to provide useful information;

ii. it is often difficult to ascertain what the total cost of an acquisition is. For them it is critical to calculate the total cost of an acquisition including cash paid, cash acquired, debt and pension obligations assumed, fees and restructuring costs, shares and notes issued to the vendor together with any deferred consideration; and
iii. they require clear information on the operating performance of the acquired business, specifically, revenue and operating profit over preceding periods and pro-forma prior year comparative information for the combined entity for the purposes of their trend analysis.

Investors appear to be particularly interested in understanding:

a) the key drivers that justified the consideration paid for a business combination (and hence the amount of goodwill) and
b) whether the acquisition has been successful.

Preparers generally think that the current disclosure requirements about goodwill and impairment are already excessive.

NOTES ON SLIDES 11-12

In the July 2018 Board meeting, the Board decided to pursue providing investors with information that would enable them to assess more effectively:

1) whether a business combination is a good investment decision; and,
2) whether the acquired business is performing after the combination as expected through better disclosures rather than through improvements to the effectiveness of the impairment test.

The first part of the improvement can be achieved by refining current disclosure requirements of IFRS 3 whereas the second part of the improvement, providing information on subsequent performance of acquired business, requires a new disclosure objective to be developed in IFRS 3 since the current disclosure objectives of IFRS 3 do not include this additional information need.

NOTES ON SLIDES 16-17

The staff received feedback from some users that they consider this information to be useful because this information is included by some investors to calculate the total amount of capital employed in each business combination in their valuations.

The staff would like CMAC members to confirm whether they would find this information useful and why.

NOTES ON SLIDES 18-19

The disclosure was intended to help users distinguish between organic and acquired growth in their analysis. Based on the feedback we received from the PIR of IFRS 3, many preparers have raised concerns relating to this requirement because:

1) the term “profit or loss” is currently not defined as to whether it is, amongst others, pre or post tax, pre or post intra-group elimination, pre or post acquisition accounting entries or adjusted for potential group level tax impacts.
2) there is practical difficulty in computing the amount, especially for the period prior to acquisition. This may be because, amongst other reasons, the acquiree may not prepare separate financial statements, the accounting policies of the acquiree may not be historically aligned to those of the acquirer, or that the acquiree may not be historically audited by the same auditor as the acquiror.

The staff also received feedback from stakeholders after PIR of IFRS 3 that disclosing the revenue and profit or loss of the acquired business could be misleading if it ignored synergies achieved in other parts of the business and it may be difficult to prepare this information if the acquirer has integrated the acquired business.

Topics the staff would like to discuss with CMAC members:

- To understand what profit or loss measure for the acquired business users use in their valuation and how they define it for this purpose.
- Additionally, the staff would like to understand whether historic information about the acquired business is better than information about the acquired business post-acquisition.

NOTES ON SLIDE 20

The staff are considering reviewing the existing requirements of IFRS 3 in conjunction with the feedback from the PIR and recommending targeted improvements to these requirements where these contribute to achieving the objective set at the July 2018 Board meeting to provide information to help investors assess whether a business combination is a good investment decision.

- **Potential future staff proposal:** As part of this review, certain disclosure requirements that do not contribute to the amended objectives are being considered for deletion as long as users do not find the information provided by those requirements useful.

NOTES ON SLIDE 22

Feedback received from users indicated that they appear to be interested in understanding whether the acquired business has been performing as expected, ultimately assessing the success of the acquisition and, as explained, the current impairment testing model does not always provide information about performance of the acquired business on a timely basis. Having said that, the test together with the disclosures, provides some information indirectly about performance of the unit.

Assuming that the acquired business is integrated with the existing business, the staff would like to understand:

- why users specifically need information on the subsequent performance of the acquired business, and
- why segmental information on the overall combined business is not sufficient.

For example, if the combined business is not performing as expected:

- do users need to know whether such underperformance is attributable to the acquired business or the existing business?
- what is it specifically about the acquired business that users need to understand (what is this information used for) and how do they currently obtain this information? eg
  - is it about the whole acquired business or just those elements that comprise goodwill?
  - is it for stewardship purposes or to help in predicting cash flows?
  - is it only needed for transformational acquisitions or all material acquisitions?

NOTES ON SLIDES 24-25

The disclosure requirement being considered is to provide users with information on subsequent performance of acquired business.

The population of acquisitions is diverse, acquisitions can vary in nature, companies acquire other companies for various reasons/objectives, there are various levels of integration and so on.

To address the concern about this diversity, the staff are considering an approach which is similar to that of IFRS 8 *Operating Segments*, which would require an entity to disclose the information on the subsequent performance of past acquisitions in the manner that the entity's own management uses internally to monitor and measure whether the key objectives of the business combination have been achieved.

The alternative would be to require companies to disclose a specific measure that provides users with the information they need on subsequent performance. However, it is difficult to define a single measure that will be relevant for all types of acquisition.

NOTES ON SLIDE 31

The period over which the disclosure is required is linked to the question of why users are requesting this information for the acquired business specifically.

Where the acquired business is integrated, preparers have said the information about the acquired business is often only reliably able to be separated from the existing business for a short period of time and sometimes the tracking of whether an acquisition has been a success is limited, with management focused on managing the combined business rather than separately monitoring the acquired business.

NOTES ON SLIDES 33-34

The feedback from stakeholders indicated that many investors generally ignore the carrying amount of goodwill in their analysis.

The staff believe that the notion of “goodwill is ignored” may be because:

- the carrying amount of goodwill is not meaningful on its own (eg. profit/goodwill may not be a meaningful ratio in assessing an entity’s performance).
- investors adjust the carrying amount of goodwill before performing any quantitative analysis.
- the carrying amount of goodwill provides little information about future cash flows.

The staff would like to know the extent to which goodwill is ignored in practice. The staff recognise the possibility that investors who stated that goodwill is not meaningful may have implicitly used this amount in their analysis by not making relevant adjustments to the balance sheet and income statement.

Based on our research, although the current goodwill impairment test is ineffective in ensuring that the carrying amount of goodwill represents only acquired goodwill, it is effective in ensuring that the carrying amount of the CGU is not overstated and that the carrying amount of the goodwill is supported by the expected cash flows of the overall CGU. The staff would therefore like to know whether the distinction between whether the carrying value of the goodwill is being supported by benefits associated with the acquisition or from benefits from internally generated goodwill would affect your investment decision.

The staff understand that there may be a knowledge gap between retail and institutional investors relating to the nature of goodwill.

Appendix – Summary of Board meeting for July 2018

Goodwill and Impairment (Agenda Paper 18)

The Board met on 18 July 2018 to continue its discussions on the Goodwill and Impairment research project. The Board discussed the objectives of its follow up work in the light of findings from the research.

In particular, the Board tentatively decided:

a. not to pursue the objective of removing the differences between accounting requirements for internally generated intangible assets and those for intangible assets acquired in a business combination.

   Eleven of 14 Board members agreed and three disagreed with this decision.

b. to explore whether disclosures could be improved to enable investors to assess more effectively whether a business combination was a good investment decision and whether the acquired business is performing after the acquisition as was expected at the time of the acquisition.

   All 14 Board members agreed with this decision.

c. to pursue improving the calculation of value in use by removing from IAS 36 *Impairment of Assets*:
   i. the restriction that excludes from the calculation cash flows that are expected to result from a future restructuring or from a future enhancement; and
   ii. the requirement to use pre-tax inputs in the calculation.

   Twelve of 14 Board members agreed and two disagreed with this decision.

d. to retain the existing model for impairment testing in IAS 36, instead of changing it to focus on assessing whether the carrying amount of acquired goodwill is recoverable.

   Nine of 14 Board members agreed and five disagreed with this decision.

e. in pursuing the objective of simplifying the accounting for goodwill:
   i. not to consider requiring an entity to write off goodwill immediately on initial recognition.

Ten of 14 Board members agreed and four disagreed with this decision.

ii. to explore whether to reintroduce amortisation of goodwill.

Eight of 14 Board members agreed and six disagreed with this decision.

iii. to pursue possible relief from the mandatory annual quantitative impairment testing of goodwill.

Ten of 14 Board members agreed and four disagreed with this decision.

The Board also tentatively decided to issue a discussion paper as the research project's next step. (The Board noted that this decision would not preclude it from issuing an exposure draft on, for example, targeted improvements to the value in use calculation.)

All 14 Board members agreed with this decision.

Next step

The Board will continue its discussions on how to achieve the objectives discussed in this meeting.