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Purpose and structure

1. The purpose of this paper is to provide the International Accounting Standards Board (Board) with our analysis of feedback and recommendation on the Board's preliminary views expressed in the Discussion Paper *Business Combinations—Disclosures, Goodwill and Impairment* to amend the requirement in IFRS 3 *Business Combinations* to disclose information about the revenue and profit or loss of:
   (a) an acquired business from the acquisition date; and
   (b) the combined entity for the current reporting period as if the acquisition date had been at the beginning of the annual reporting period (sometimes referred to as pro forma information).

2. The paper is structured as follows:
   (a) summary of staff recommendations (paragraph 3);
   (b) background (paragraphs 4–6);
   (c) feedback summary, staff analysis and recommendation on:
      (i) retaining the requirement for entities to disclose pro forma information (paragraphs 8–18);
      (ii) providing guidance on preparing pro forma information (paragraphs 19-37);
      (iii) clarifying 'operating profit before acquisition-related transaction and integration costs' (paragraphs 38–53); and

(iv) adding a requirement to disclose cash flows from operating activities (paragraphs 54–59).

Summary of staff recommendations

3. We recommend that the Board:

   (a) retain the requirement in paragraph B64(q) of IFRS 3 to disclose pro forma information;

   (b) explain the objective of pro forma information and not provide guidance on how to prepare that information;

   (c) does not add an explicit requirement for an entity to disclose the basis used to prepare pro forma information;

   (d) replace the term 'profit or loss' in paragraph B64(q) of IFRS 3 with 'operating profit or loss'. Operating profit or loss would be defined as in the Board's Primary Financial Statements project; and

   (e) does not add a requirement to disclose information about cash flows arising from operating activities.

Background

4. Paragraph B64 of IFRS 3 states:

> B64 To meet the objective in paragraph 59, the acquirer shall disclose the following information for each business combination that occurs during the reporting period:
>
> …
>
> (q) the following information:
>
> (i) the amounts of revenue and profit or loss of the acquiree since the acquisition date included in the consolidated statement of comprehensive income for the reporting period; and

(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 as of the beginning of the annual reporting period.

If disclosure of any of the information required by this subparagraph is impracticable, the acquirer shall disclose that fact and explain why the disclosure is impracticable. This IFRS uses the term 'impracticable' with the same meaning as in IAS 8 *Accounting Policies, Changes in Accounting Estimates* and Errors.

5. As noted in paragraph 2.74 of the Discussion Paper, during and after the Post-implementation Review (PIR) of IFRS 3, stakeholders commenting on pro forma information said:

   (a) the information is not useful because it is hypothetical;

   (b) there is a lack of guidance on how to prepare the information and therefore entities prepare the information in different ways; and

   (c) information about the revenue and profit of the acquired business before the business combination is not always readily available.

6. In response to this feedback, the Board's preliminary view is that it should:

   (a) replace the term 'profit or loss' in paragraph B64(q) of IFRS 3 with the term 'operating profit before deducting acquisition-related costs and integration costs'. Operating profit or loss would be defined as in the Exposure Draft *General Presentation and Disclosures*;

   (b) add to paragraph B64(q) a requirement to disclose cash flows from operating activities; and

   (c) after the revisions in (a) and (b), retain the requirement for the information to be disclosed for the combined entity as if the business combination had occurred at the start of the reporting period.

Feedback summary, staff analysis and recommendations

7. We provide analysis of feedback and recommendations on:

   (a) retaining the requirement to disclose pro forma information (paragraphs 8–18);

   (b) providing guidance on how to prepare pro forma information (paragraphs 19–37);

   (c) replacing 'profit or loss' with 'operating profit before acquisition-related costs and integration costs' (paragraphs 38–53); and

   (d) adding a requirement to disclose the cash flows from operating activities (paragraphs 54–59).

Retaining the requirement for entities to disclose pro forma information

Feedback summary

8. Most respondents to the Discussion Paper agreed with the Board's preliminary view to retain the requirement for an entity to disclose pro forma information.

9. Some respondents, including many preparers, disagreed. Those respondents repeated much of the feedback the Board received in the PIR of IFRS 3, notably that pro forma information is:

   (a) costly to produce;

   (b) not useful because it is theoretical and judgemental. It therefore might not appropriately reflect the future performance of the combined entity; and

   (c) difficult to audit—a few Japanese respondents said such information is not audited in Japan, even when it is included in financial statements.

10. Some respondents in the insurance sector said preparing pro forma information when applying IFRS 17 *Insurance Contracts* would be highly complex and time-consuming.

11. One respondent said the Board could consider using an alternative disclosure, drawing on a previous requirement in UK Generally Accepted Accounting Principles (FRS 6 *Acquisitions and Mergers*), which required disclosure of:

(a) the actual revenue and profit of the acquired entity from the start of the financial period till the acquisition date (based on the accounting policies the acquired entity applied prior to the acquisition date); and

(b) the contribution of the acquired entity to the combined group since the acquisition date.

Staff analysis

12. We think the Board should proceed with its preliminary view to retain the requirement to disclose pro forma information.

13. The Board has received consistent feedback from users of financial statements (users) that pro forma information is useful. For example:

(a) at the June 2019 joint meeting between the Global Preparers Forum (GPF) and Capital Markets Advisory Committee (CMAC), CMAC members disagreed with our recommendation to remove the disclosure requirement for pro forma information from IFRS 3. CMAC members said such information is useful in their analysis of the business combination.

(b) all users who responded to the question in the Discussion Paper about pro forma information said the Board should retain the requirement because such information is useful.

14. The information required by paragraph B64 of IFRS 3, including pro forma information, is intended to help an entity meet the disclosure objective in paragraph 59 of IFRS 3—that is, to help users evaluate the nature and financial effect of a business combination.

15. Users said pro forma information helps them determine a ‘baseline’ performance level against which to compare the future performance of the business. The information also helps users forecast future performance and assess whether the forecasted future performance justifies the price paid for the business combination. One investor group suggested requiring entities to provide pro forma information on a consistent and more-timely basis (such as in interim financial statements) to be more decision-useful to investors.

16. Having said that, we acknowledge the concern of many preparers who said preparing pro forma information is costly. In addition, a few respondents said the information is difficult to audit. However:

    (a) a few preparers agreed with the Board's preliminary view to retain the requirement to disclose pro forma information, indicating that entities are generally able to prepare this information.

    (b) in some jurisdictions, local regulations require entities to disclose pro forma information.

17. The alternative described in paragraph 11 could reduce some costs. For example, it might reduce the need to adjust historical information of the acquired business to comply with the accounting policies applied by the combined entity. However, such information would be less useful in forming an expectation of the combined entity's future performance. In addition, it would not fully reduce costs in all situations—for example, in situations in which the acquiring entity does not have access to financial information from before the acquisition date.

Conclusion

18. Based on our analysis, we think the Board should proceed with its preliminary view and retain the requirement in paragraph B64(q)(ii) of IFRS 3—that is, the requirement to disclose pro forma information.

Question 1 for the Board
Does the Board agree with our recommendation to retain the requirement in paragraph B64(q)(ii) of IFRS 3?

Providing guidance on preparing pro forma information

Feedback summary

19. Many respondents suggested providing guidance on how to prepare pro forma information. Respondents said guidance is needed, for example, on how to address:

    (a) circumstances in which the acquirer and acquiree's accounting policies differed prior to the business combination;

(b) upstream and downstream transactions;

(c) inclusion of cost or revenue synergies; and

(d) financing of the business combination.

20. A few respondents suggested specifying the objective of the requirement to disclose pro forma information instead of providing detailed guidance. Those respondents said doing so could assist entities make appropriate judgements when preparing pro forma information.

21. Some respondents, including many national standard-setters and accounting firms, said providing guidance on preparing pro forma information should not be a priority. A few respondents said in many jurisdictions, other organisations, like securities regulators, provide guidance on the preparation other similar information which entities could apply in preparing pro forma information.

22. A few respondents said providing detailed guidance could reduce the flexibility for an entity to tailor such information to its facts and circumstances and therefore to provide users with useful information.

23. Many respondents who said detailed guidance is unnecessary nonetheless suggested requiring an entity to disclose material judgements and estimates made in preparing pro forma information. This would help users better understand and analyse pro forma information. A few of those respondents said such an approach might impair comparability across entities however, they did not consider this to be a major concern because comparability is less important than the predictive value of information.

24. A few preparers said, in their view, information about how an entity prepared pro forma information would not be useful.

Staff analysis

25. Paragraph 2.87 of the Discussion Paper says the Board would consider whether to provide guidance on how to prepare pro forma information once it has reviewed the feedback on the Discussion Paper and has understood better the information investors need and how best to provide that information. Our analysis considers whether, based on feedback, the Board should:

(a) clarify the objective of pro forma information (paragraphs 26–29);

(b) provide application guidance on preparing pro forma information (paragraphs 30); and

(c) require entities to disclose the basis used to prepare pro forma information (paragraphs 31–36).

Clarifying the objective of pro forma information

26. Paragraph B64 of IFRS 3 says the requirement for an entity to provide information about the contribution of the acquired business helps an entity meet the disclosure objective in paragraph 59 of IFRS 3:

> 59 The acquirer shall disclose information that enables users of its financial statements to evaluate the nature and financial effect of a business combination that occurs either:
>
> (a) during the current reporting period; or
>
> (b) after the end of the reporting period but before the financial statements are authorised for issue.

27. In considering users' needs, the Board's preliminary views were to add the following disclosure objectives to IFRS 3, being to provide information to help users understand:

    (a) the benefits that an entity's management expected from a business combination when agreeing the price to acquire a business; and

    (b) the extent to which management's objectives for a business combination are being met.

28. Paragraph 2.60 of the Discussion Paper says pro forma information could help an entity meet the disclosure objective in paragraph 27(b). However, user feedback (see paragraph 15) suggests such information may also help meet the disclosure objective in paragraph 27(a).

29. Accordingly, we think the Board should clarify that the requirement in paragraph B64 of IFRS 3 helps meet both disclosure objectives in paragraph 27 of this paper. As noted by a few respondents, clarifying the objective of pro forma information might help resolve some of the diversity noted in paragraph 19. For example, if the Board

were to clarify that the objective of pro forma information is to help users forecast future performance of the combined business, that might also clarify that the accounting policies applied in preparing pro forma information should be consistent with those applied by the combined entity.

Providing application guidance

30. We think the Board should not provide application guidance on specific matters identified by respondents in paragraph 19. As explained in paragraph 29, we think clarifying the objective of pro forma information will help resolve some of the application questions. Such an approach would also be more consistent with the principles-based approach used in IFRS Standards. Whilst we acknowledge some application questions might remain, we think given the variety in the nature and scale of business combinations, it would be neither feasible, nor cost-beneficial to provide application guidance on every question that could arise in preparing pro forma information.

Disclosing the basis of preparation

31. Paragraph 2.87 of the Discussion Paper says the Board would consider whether to require entities to disclose how they have prepared pro forma information after reviewing feedback from respondents and better understanding the information investors need and how best to provide that information.

32. As noted in paragraph 23 many respondents said that if the Board decides not to provide application guidance on preparing pro forma information, then the Board should require an entity to disclose how it prepared the pro forma information.

33. Paragraph 117 of IAS 1 *Presentation of Financial Statements* (as amended by *Disclosure of Accounting Policies* published in January 2021) states:

> 117 An entity shall disclose material accounting policy information (see paragraph 7 [of IAS 1]). Accounting policy information is material if, when considered together with other information included in an entity's financial statements, it can reasonably be expected to influence decisions that the primary users of general purpose financial statements make on the basis of those financial statements.

34. Accordingly, we think that to the extent pro form information is material, IAS 1 would already require the entity to disclose information about the basis used to prepare that information.

35. As explained in paragraph 29, if the Board agrees with our recommendation to clarify the objective of pro forma information, this could reduce diversity in the basis of preparing pro forma information thereby reducing the need for disclosure about the basis of preparation of that information.

36. Based on our analysis, we think the Board should not add an explicit requirement for an entity to disclose the basis used to prepare pro forma information.

Conclusion

37. We recommend that the Board:

(a) clarify the objective of pro forma information and not provide detailed application guidance on preparing pro forma information; and

(b) not add an explicit requirement for an entity to disclose the basis used to prepare pro forma information.

Questions 2 and 3 for the Board
Does the Board agree with our recommendation to: (a) clarify the objective of pro forma information and not provide detailed application guidance on preparing pro forma information; and (b) not add an explicit requirement for an entity to disclose the basis used to prepare pro forma information.

'Operating profit before acquisition-related transaction and integration costs'

Feedback summary

38. Most respondents agreed with the Board's preliminary view to replace the term 'profit or loss' in paragraph B64(q) of IFRS 3 with the term 'operating profit before

acquisition-related costs and integration costs' for the reasons set out in the Discussion Paper. Some respondents disagreed because:

(a) doing so would not address feedback about pro forma information the Board received in the PIR of IFRS 3 (see for example, paragraph 5).

(b) they also disagreed with the Board's proposals in the Exposure Draft *General Presentation and Disclosures* (Exposure Draft) regarding operating profit or loss.

(c) they disagreed with adjusting operating profit or loss as defined in the Exposure Draft for integration or acquisition-related costs. These respondents said having different definitions could be confusing.

(d) in their view, profit or loss is a clearer and better understood term.

39. Some respondents, including those who agreed and disagreed with the Board's preliminary view, said if the Board proceeds with its preliminary view, it should clearly define 'acquisition-related costs and integration costs' to help comparability and consistency. Some respondents acknowledged that paragraph 53 of IFRS 3 defines 'acquisition-related costs' but said IFRS 3 does not define 'integration costs'.

40. A few respondents said an entity might incur significant integration costs after the year of the business combination. In that situation, pro forma information that excludes integration costs would lack predictive value.

41. A few respondents suggested requiring an entity to disclose acquisition-related costs and integration costs separately from operating profit or loss. Those respondents said information about acquisition-related costs and integration costs is useful.

Staff analysis

42. Our analysis considers whether to:

(a) amend paragraph B64(q) of IFRS 3 to replace the term 'profit or loss' with 'operating profit or loss' (paragraphs 43–46); and

(b) require entities to exclude acquisition-related transaction and integration costs from operating profit or loss (paragraphs 47–52).

Replacing the term 'profit or loss with 'operating profit or loss'

43. The Report and Feedback Statement to the PIR of IFRS 3 identified that:

    (a) some users require pro forma information for trend analysis; and

    (b) many entities find it difficult to prepare pro forma revenue and profit or loss of the combined entity because information prior to the acquisition is not always readily available.

44. We acknowledge replacing the term 'profit or loss' in paragraph B64(q) of IFRS 3 with 'operating profit or loss' as defined by the Exposure Draft will not completely address feedback the Board received in the PIR of IFRS 3. However, we think proceeding with the Board's preliminary view will improve comparability and understandability of pro forma information. A measure based on operating profit or loss would:

    (a) decrease diversity because it would result in entities disclosing a consistent measure of profit or loss, rather than different measures of profit or loss (for example, we understand some entities disclose operating profit or loss and some disclose net profit or loss); and

    (b) reduce the cost of preparing pro forma information by avoiding the need for entities to make subjective allocations of finance costs and tax expenses as if the business combination had been as of the beginning of the annual reporting period.

45. We acknowledge that some respondents who disagree with the Board's preliminary view also disagree with the Board's proposal to define 'operating profit or loss' in the Exposure Draft. The Board is redeliberating its proposals in its Primary Financial Statements project. If the Board defines 'operating profit or loss' in that project, we think it is helpful to use the same term in paragraph B64(q) of IFRS 3 for the reasons noted in paragraph 44. We agree with the Board's expectation as discussed in paragraph 2.78 of the Discussion Paper that a measure based on operating profit or loss would provide users with information about the operating performance of the main business activities of the acquired business that is independent of how the entity financed the acquisition.

46. Accordingly, we think that if the Board were to define 'operating profit or loss' in its Primary Financial Statements project, the Board should replace the term 'profit or loss' in paragraph B64(q) of IFRS 3 with 'operating profit or loss' as defined by the Primary Financial Statements project.

Excluding acquisition-related costs and integration costs

47. Paragraph 2.80 of the Discussion Paper says:

> both types of cost [acquisition related and integration] directly relate to an acquisition that has already occurred, and once incurred those costs cannot recur for that acquisition. Thus, excluding them would provide a more suitable base for comparison with operating profit for future years.

48. The Board's preliminary view would apply to both components of paragraph B64 of IFRS 3. Paragraph B64(q)(i) requires an entity to disclose the profit or loss of the acquiree since the acquisition date. One respondent said acquisition-related costs and integration costs are likely to be incurred by the acquirer or by the combined business (the subject of the requirement in paragraph B64(q)(ii)) and not by the acquiree. We agree with this observation and recommend that the Board amend its preliminary view such that B64(q)(i) refers only to operating profit or loss, without reference to acquisition-related or integration costs.

49. Acquisition-related and integration costs are relevant to the pro forma information required by paragraph B64(q)(ii) of IFRS 3.

50. Some respondents said integration costs may also be incurred in the years after the acquisition and not just in the year of acquisition. This feedback is consistent with feedback from our fieldwork, which indicated that integration of an acquired business can take several years. Accordingly, deducting integration cost from operating profit or loss might not provide users with useful information to allow them to forecast operating profit or loss for the first few years after the acquisition. Accordingly, we think the Board should not require an entity to exclude integration costs from operating profit or loss.

51. We also think it is unnecessary to require an entity to exclude acquisition-related costs. Paragraph B64(m) of IFRS 3 already requires an entity to separately disclose

acquisition-related costs and accordingly, this information would already be available to users who could adjust the pro forma operating profit or loss for these costs if they think it would be appropriate to do so in their analysis.

52. To help meet the objective of pro forma information (see paragraph 29) and help users forecast future performance of the combined entity, we considered whether to propose permitting or requiring entities to exclude other items of income and expenses included in operating profit or loss that might not have predictive value. We think doing so would be impractical and unnecessary because:

    (a) it would not be possible for the Board to identify all possible items that might not have predictive value and views on whether particular items have predictive value might differ.

    (b) the Exposure Draft *General Presentation and Disclosures* proposed requiring entities to disclose ‘unusual income and expenses’ as defined in the Exposure Draft. While the Board has not yet redeliberated these proposals, we think that to the extent the Board decides to require entities to disclose information along these lines as part of its Primary Financial Statements project, users would have information they need to make necessary adjustments.

Conclusion

53. Based on our analysis, we think the Board should replace the term ‘profit or loss’ in paragraph B64(q) of IFRS 3 with the term ‘operating profit or loss’ if the Board defines ‘operating profit or loss’ in its Primary Financial Statements project. Operating profit or loss in paragraph 64(q) of IFRS 3 would be as defined as in the Board’s Primary Financial Statements project.

Question 4 for the Board
Does the Board agree with our recommendation that the Board should replace the term ‘profit or loss’ in paragraph 64(q) of IFRS 3 with ‘operating profit or loss’ if the Board defines ‘operating profit or loss’ in its Primary Financial Statements project? Operating profit or loss in paragraph 64(q) of IFRS 3 would be as defined as in the Board’s Primary Financial Statements project.

Disclosing cash flows from operating activities

Feedback summary

54. Many respondents, including almost all preparers, said it would be costly to prepare information about cash flows from operating activities of the acquired business after the acquisition date, and of the combined business on a pro forma basis. Such costs would arise because:

    (a) depending on how the financial reporting function is organised, information may be available only for profit or loss, but not for balance sheet and cash flows. For example, entities preparing the statement of cash flows using the direct method applying paragraph 18 of IAS 7 *Statement of Cash Flows* may not track cash flows at this level of disaggregation. Entities preparing the statement of cash flows using the indirect method might have to prepare additional statements of financial position of the acquired business to be able to prepare this information.

    (b) preparing cash flow information for individual businesses or sections of a group would involve significant additional effort and is likely to require configuration changes to systems and consolidation tools.

55. Some preparers expressed concerns about an auditor's ability to provide cost effective assurance on this information in situations in which preparing this information would require significant judgement.

56. Many respondents said the usefulness of this information would be limited. In particular, many financial services preparers who responded said information about cash flows from operating activities would be irrelevant to their organisations. Some other respondents said cash flows from operations can be heavily affected by cash collection policy in the period before the acquisition and information about operating cash flows might not provide useful trend information. Some also said users would likely need incremental information for this cash flow measure to be considered useful—for example, information about working capital balances of the acquired business at the beginning and end of the year.

57. A few respondents said information about financing and investing cash flows would also be of interest to users.

Staff analysis

58. Paragraph 2.81 of the Discussion Paper says the Board expected the disclosure of cash flows from operating activities to help those investors who use cash flow measures in their analysis. However, feedback indicates that preparing pro forma cash flow information would:

(a) be costly for entities to prepare; and

(b) not provide useful information.

59. Based on our analysis, we think the Board should not proceed with this preliminary view.

Question 5 for the Board
Does the Board agree with our recommendation to not proceed with its preliminary view to add a requirement to disclose pro forma information about cash flows arising from operating activities?