Better disclosures for business combinations and presentation of total equity before goodwill subtotal

Issues Paper

Objective

1 The objective of this paper is to seek views of EFRAG TEG on the IASB tentative decisions in respect of improvement of disclosure requirements for business combinations and of the presentation of a new subtotal ‘total equity before goodwill’.

2 During and after the Post-implementation Review (PIR) of IFRS 3 *Business Combinations*, the IASB received mixed feedback from users about the quality of information provided by entities on business combinations and goodwill and impairment together with the concerns about the effectiveness of the impairment test and not timely recognition of impairment. Users reported that the disclosures on business combinations were generally boilerplate and insufficient to provide a proper understanding of the rationale of the business combination and its overall success. Companies provide inadequate information on the subsequent performance of businesses acquired. Some stakeholders were concerned that the carrying amounts of acquired goodwill could be overstated.

3 Based on the work performed on this research project, the IASB tentatively decided to enhance disclosure objectives and requirements to improve the information provided to users about an acquired business, even if this information must be on a combined basis where the acquired business has been integrated into an existing business.

Disclosure requirements

4 In particular, the IASB staff proposed in relation to IFRS 3 improved disclosures that would enable investors to assess whether a business combination was a good investment decision and whether, after the acquisition, the acquired business is performing as it was expected at the time of the acquisition.

5 During its June meeting the IASB discussed the staff proposals and decided that it should develop a proposal:

(a) To improve the disclosure objectives of IFRS 3 with the aim of helping users of financial statements assess the performance of an acquired business after a business combination;

(b) To require entities to disclose information intended to indicate whether the objectives of a business combination are being achieved; and

(c) To require entities to disclose:

(i) the amount, or range of amounts, of expected synergies;

(ii) any liabilities arising from financing activities and pension obligations assumed; and

(iii) an acquiree's revenue, operating profit or loss before acquisition-related transaction and integration costs, and cash flow from operating activities, after the acquisition date.

(d) To require disclosure of the information the chief operating decision maker (as defined by IFRS 8 *Operating Segments*) uses to assess the extent to which the objectives of a business combination are being achieved;

(e) Not to replace paragraph B64(q)(ii) of IFRS 3 that requires disclosure of 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. The IASB also decided to include in the discussion paper the rationale for rejecting this proposal.

6 At the June 2019 IASB Joint CMAC-GPF meeting, members discussed a number of case studies that illustrated the proposed disclosures. The link to this presentation can be found here.

Improving disclosure objectives of IFRS 3

7 The IASB proposed adding the following disclosure objectives to provide users with information:

(a) To evaluate the strategic rationale for the business combination;

(b) To understand the amount of, and evaluate the rationale for, the total consideration transferred to obtain control of the acquiree; and

(c) To evaluate the extent to which the key objectives of the business combination are being achieved.

Additional disclosures on key objectives of a business combination (subsequent performance)

8 The IASB has tentatively decided to require entities to disclose information that explains whether the objectives of a business combination are being achieved.

9 This lack of information on 'subsequent performance' of a business combination has been a key concern noted by users. Users have advised that they need better information on the subsequent performance of the acquired business to monitor management's stewardship in making acquisition decisions, and to help investors decide whether they can trust management with further capital. Some users said they need the information to value the acquired business more accurately.

10 The IASB proposes to amend paragraph B64(d) of IFRS 3 to require an entity to disclose:

(a) the strategic rationale for undertaking the business combination, such as how the acquisition links to the acquirer's business strategy; and

(b) the key objectives of the business combination, being the targets management expect to achieve as a result of undertaking the business combination.

Amount, or range of amounts, of expected synergies

11 This disclosure would complement the existing requirement in IFRS 3 (paragraph B64(e)) to provide a qualitative description of the factors that make up the goodwill recognised, such as expected synergies from combining operations of the acquiree and the acquirer, intangible assets that do not qualify for separate recognition, or other factors.

12 The objective is to require the amount (or range of amounts) of the expected synergies to be disclosed rather than the value of (or amount paid for) those synergies. For example, an entity that expects cost synergies of between CU 100–150 million from an acquisition, but due to risks associated with achieving those synergies, the entity-specific nature of some of those synergies and/or good bid negotiation paid only CU 80 million for those synergies, would be expected to disclose a range of CU 100–150 million.

Liabilities arising from financing activities and pension obligations assumed

13 Some users view the amount of debt and pension obligations assumed in a business combination as part of the total capital employed in the transaction and would like to have this information separately disclosed. Currently IFRS 3 does not require separate disclosure of this information, and some entities include these obligations within another major class of liabilities assumed.

14 Feedback from outreach performed by the IASB staff indicated the users strongly support separate disclosure about debt and pension obligations assumed in a business combination, and preparers did not object to it.

Acquiree's revenue, operating profit or loss

15 The IASB has preliminarily decided to require disclosure of an acquiree's revenue, operating profit or loss before acquisition-related transaction and integration costs, and cash flow from operating activities, **after the acquisition date.**

16 Paragraph B64(q) of IFRS 3 already requires an entity to disclose (unless it is impracticable to do so):

(a) 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

(b) 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 (pro-forma information).

17 IFRS 3 does not explain how the information in paragraph B64(q) should be provided, and the lack of guidance has resulted in diversity. Users informed the IASB that information about the acquiree's revenue and profitability will help them predict the future performance of the acquired business and monitor its subsequent performance, or combined business.

CODM approach for additional disclosures on key objectives of a business combination (subsequent performance)

18 The IASB suggested that instead of using a materiality concept, the information on subsequent performance should be based on how the chief operating decision maker (CODM), as defined in IFRS 8, monitors and measures whether the key objectives of the business combination are being achieved in the entity's internal reporting.

Providing additional information to help users to estimate the potential full year effect of the business combination

19 The IASB decided that it should not propose replacing paragraph B64(q)(ii) of IFRS 3, that requires pro-forma information of 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. The IASB staff had proposed deleting this requirement on the basis that the information was based on subjective data that was often not observable.

20 The IASB paper can be found here.

Presentation requirements: introduction of total equity before goodwill subtotal

21 During the project the IASB has considered a number of alternatives to highlight the impact on the statement of profit or loss and/or the statement of financial position of goodwill only or of goodwill and some or all intangible assets.

22 The IASB staff developed 4 approaches to separate presentation of goodwill in the statement of financial position:

(a) Alternative 1: presenting a subtotal of total assets before goodwill, less total liabilities;

(b) Alternative 2: presenting a subtotal of total equity before goodwill;

(c) Alternative 3(a): presenting a subtotal of total assets before goodwill, less total liabilities, as a footnote, or free-standing disclosure, on the face of the statement of financial position; and

(d) Alternative 3(b): presenting a subtotal of total equity before goodwill as a footnote, or free-standing disclosure, on the face of the statement of financial position.

23 Nevertheless, the IASB staff highlighted (see IASB paper presented in June 2019) that a subtotal of equity before goodwill and all intangibles assets (also called 'tangible net worth'), could provide information that in some circumstances could be misleading, where, for example, entities operate in industries with large amounts of intangible assets with finite and well defined lives.

24 According to the feedback from the ASAF, if only some intangible assets were excluded from the subtotal, views would vary by users and by industries on which intangible assets should be excluded. This variety of views would limit the usefulness of this subtotal.

25 After considering the above, the IASB in its June 2019 meeting reached a preliminary view to propose that an entity should present in its statement of financial position a subtotal of total equity before goodwill. This could increase the prominence of acquired goodwill carrying amounts, given the nature of goodwill and the inevitable limitations of the impairment test. In addition, this could be a further response to the 'too late' feedback, with a limited impact on costs.

EFRAG Secretariat analysis

26 The additional disclosure requirements discussed are welcomed as they address one of the issues raised by Users. The requirements might likely be criticised by Preparers from a confidentiality perspective and rejected. The suggested disclosure requirements and the separate presentation requirements alone would not be sufficient to address all the overall concerns from constituents.

EFRAG previous research and discussions

EFRAG Research

27 In July 2014, EFRAG Secretariat together with the Accounting Standard Board of Japan (ASBJ) and the Italian Standard Setter (OIC) (the Research Group), published a Discussion Series Paper *Should Goodwill still not be amortised? – Accounting and Disclosure for Goodwill* ('July 2014 DP').

28 The Research Group concluded that there was a room for improvement in the disclosure requirements for the impairment test and the information needs of users in relation to the impairment test should be considered to reach the appropriate cost-benefit balance.

EFRAG TEG-CFSS

29 In its November 2018 meeting, EFRAG TEG-CFSS supported the overall IASB objective of providing the information helping the users to understand the subsequent performance of acquired business.

30 However, members expressed concerns about practical aspects of the provision of quantitative information if the acquired business was fully integrated with the existing business and if the initial performance targets against which the acquisition was assessed were to change.

31 Members also considered that some qualitative information would be better provided through Management Commentary.

EFRAG User Panel

32 In its July 2019 meeting, EFRAG User Panel discussed the IASB preliminary decisions in respect of disclosure requirements for business combinations.

33 Members expressed mixed views on the usefulness of the proposed disclosures, confidentiality and commercial sensitiveness of the information about the expected synergies and the reliability of the quantitative information required to be provided.

EFRAG Academic Panel

34 In its October 2019 meeting, EFRAG Academic Panel agreed that the enhancement of existing disclosures was necessary, highlighting the fact that goodwill was an item requiring a lot of management judgement and, therefore, more information was needed about its value and how it is preserved.

35 EFRAG Academic Panel members also highlighted some difficulties in providing the segment information disclosures required by IFRS 8 *Operating Segments* and allocation of goodwill to CGUs.

Questions for EFRAG TEG

36 What are your views on the IASB's tentative decisions to improve the disclosure requirements for business combinations?

37 Do EFRAG TEG members suggest any additional improvements to disclosure requirements proposed by the IASB? If yes, please describe.

38 What are your views on the IASB's tentative decisions to present in the statement of financial position a subtotal of total equity before goodwill?

39 Do you agree with the analysis by the EFRAG Secretariat? Do you have any other views or suggestions?