Applying IFRS

Business combinations: disclosures, goodwill and impairment

March 2020

Building a better working world

Contents

What you need to know

- In March 2020, the IASB published the Discussion Paper *Business Combinations: Disclosures, Goodwill and Impairment*.
- The Board intends to improve disclosures around the subsequent performance of a business combination.
- The Board proposes to retain the impairment only approach for goodwill, while proposing certain simplifications for the application of the impairment test.
- The Board has proposed that CGUs containing goodwill are only tested when there is an impairment trigger event, and not done annually.
- The comment period for the DP ends on 31 December 2020.

Overview

Following the feedback received during the Post-implementation Review (PIR) of IFRS 3 *Business Combinations*, the International Accounting Standards Board (IASB or the Board) decided to begin a research project to explore possible improvements to IFRS 3 and IAS 36 *Impairment of Assets*. In March 2020, the IASB published the Discussion Paper (DP) *Business Combinations: Disclosures, Goodwill and Impairment*.

Business combinations, such as mergers and acquisitions, are often large transactions for the entities involved, playing a key role in the global economy. Resulting goodwill balances are also significant, and each year, these balances have to be assessed by the entity for impairment.

Users of financial statements claim that disclosures required by IFRS standards about business combinations do not provide sufficient information for them to understand how the acquired business is performing post-acquisition. The research project investigates whether entities can, at an acceptable cost, provide investors with more relevant and useful information about businesses that have been acquired, and about the subsequent performance of the entities making the acquisitions. It should also help investors to hold management to account more effectively on their decisions to acquire businesses.

Some stakeholders report that the impairment of goodwill is not always recognised when it should be and the impairment test required for goodwill under IAS 36 is complex and costly. Some stakeholders debate therefore whether the amortisation of goodwill should be reintroduced. In addition, stakeholders find that the separate recognition and measurement of some intangible assets can be challenging.

The DP presents the Board's preliminary views on these issues. The comment period for the DP ends on 31 December 2020. The Board will then consider the comments received before deciding on whether to advance to the exposure draft (ED) stage of the project.

Summary of the key proposals

Improving disclosures about business combinations

The Board understands that stakeholders would like better quality information about how an acquired business is performing post-acquisition, which in turn, will help them to assess whether management made a good acquisition decision and would enable them to hold management to account for future decisions to acquire businesses. IFRS 3 does not currently require disclosure of information about the subsequent performance of an acquired business.

Therefore, the Board's preliminary view is that it should develop proposals to help investors to have more information about a business acquired, and to better understand the performance of the acquired business subsequent to its acquisition. The Board has also proposed some targeted improvements to some of the existing disclosures in IFRS 3.

The Board debated what metrics entities could provide to investors, to help them assess the performance of the acquisition over time. The Board did not think that there was one single metric an entity could disclose that would provide all the information required. However, the cost of an acquisition is often relatively large and therefore would be internally monitored. As such, the Board proposes that an entity should disclose the internal information that its management uses to measure and monitor an acquisition against management's objectives for that acquisition.

The Board proposes to amend paragraph B64(d) of IFRS 3, where instead of disclosing the primary reasons for an acquisition, the entity should rather disclose the strategic rationale for undertaking an acquisition and management's (Chief Operating Decision Maker (CODM)) objectives for the acquisition.

Specifically, therefore, the Board's preliminary view would be for entities to disclose the following:

- In the year that the acquisition happens, the metrics that management (CODM) will use internally to assess whether the business combination is meeting its objectives;
- How well the business combination's objectives are being met, using those objectives (for as long as management (CODM) monitors the business combination);
- If the objectives are not being monitored by management (CODM), that fact and why;
- If management (CODM) stop monitoring whether the objectives are being met before the end of the second full year after acquisition, that fact and why; and
- If management (CODM) changes the metrics being used to monitor the objectives of the business combination, that fact, the new metrics, and why.

How we see it

It may be challenging for entities to track how well a business combination is performing against its objectives, if that business has been integrated with the entity's existing operations soon after acquisition.

Goodwill: impairment and amortisation

Can the impairment test be made more effective?

During the feedback on the IFRS 3 PIR, some stakeholders commented that, generally, recognising impairment losses on goodwill does provide useful information. However, sometimes that information is not provided on a timely basis; entities tend to recognise impairment losses too long after the event that caused those losses. The impairment test is also considered difficult and costly to implement. Stakeholders believe that the impairment test in IAS 36 could be made more effective in flagging up whether a business combination is performing as expected.

The Board does not believe it can develop an impairment test that would be significantly more effective in recognising impairment losses on CGUs that contain goodwill, and it welcomes suggestions from commentators.

The Board considered two reasons why there may be a delay in recognising impairment losses on goodwill – management optimism and shielding – and whether anything could be done about these issues to make the current impairment test more effective. In terms of management optimism, the Board concluded that the risk of over-optimism is present in any impairment test of cash-generating units (CGUs) - not just those that contain goodwill – and it is an application issue that would not be solved by changing the standard.

On the issue of shielding, CGUs typically contain 'headroom' (the difference between the recoverable amount of the CGU and the carrying amount of its recognised assets), unless the CGU has recently been impaired. Headroom is typically made up of items not recognised on the balance sheet, such as internally generated goodwill and unrecognised assets. Headroom could shield goodwill from being impaired, because all reductions in goodwill are allocated against the unrecognised headroom buffer, and an impairment loss will only be identified when the headroom has been reduced to zero.

The Board considered whether it could incorporate the headroom in the design of the impairment test, to make it more effective, such as reducing the shielding effect, targeting the goodwill more effectively, and requiring entities to recognise impairment losses on acquired goodwill on a more timely basis. The Board's preliminary view, however, is that it does not believe it is feasible to develop an impairment test that would be significantly more effective in recognising impairment losses on CGUs that contain goodwill, and that it welcomes any suggestions from commentators as to how this may be done.

Should amortisation of goodwill be reintroduced?

The Board made the decision to implement an impairment-only model for goodwill, when it revised IFRS 3 in 2004, on the basis that it would provide more useful information to investors, and the impairment test would be rigorous and operational. During the IFRS 3 PIR, some stakeholders asked the Board to consider developing a proposal to reintroduce amortisation of goodwill. They believe that reintroducing amortisation could mitigate the problems with the goodwill impairment test (as discussed above), and the acquired goodwill balance would be directly targeted, instead of being assessed for impairment as part of a broader CGU. The Board considered arguments for retaining the impairment-only model, and for reintroducing the amortisation approach, both of which have their limitations. The views of the Board members were mixed between the two approaches, with a narrow majority favouring the impairment-only approach.

The Board is keenly aware that accounting for goodwill is a controversial topic, and also that it is not starting with 'a clean sheet' in terms of which would be the best approach. Rather, the Board decided to assess whether there is enough information to amend IFRS 3, and whether the benefits of a change would outweigh the cost and potential disruption of another change to accounting for goodwill.

Although the preliminary view of the Board in this DP is to retain the impairment-only model, the Board states that it welcomes new practical and conceptual arguments from constituents, so that it can assess whether there is sufficient evidence to persuade it to change its preliminary view and to consider re-introducing the amortisation approach.

Presentation of total equity excluding goodwill

The Board considered whether entities should present total equity excluding goodwill on the balance sheet, now that according to the proposal in its Exposure Draft, *General Presentation and Disclosures*, entities should present goodwill itself as a separate line item in the balance sheet. There are some presentation challenges in terms of fitting this within the structure of the balance sheet, so the Board's preliminary view is to present this net amount as a free-standing amount in the balance sheet. The Board believes that this would provide more transparency about goodwill and its relationship with other items in the financial statements.

How we see it

We agree with the Board's preliminary view that the possible solutions to address the shielding effect of existing headroom seem to introduce more complexities and would most likely not be effective.

The re-introduction of amortisation of goodwill has been a longstanding debate and we welcome the discussions of the Board on this topic. It would significantly reduce the cost of impairment testing, but would at the same, re-introduce the subjectivity of determining the useful life of goodwill.

Simplifying the impairment test

Relief from the annual impairment test

Some stakeholders have informed the Board that performing the impairment test is onerous because it is complex, costly and time-consuming, particularly because it has to be done every year, regardless of whether there are any indications of impairment. Morever, it is not considered to be effective in identifying impairment of the goodwill balance. These stakeholders believe that impairment testing of goodwill should be required only when there is a triggering event to indicate possible impairment.

The Board considered this feedback and its preliminary view is to develop some proposals to make the annual impairment test less costly and complex and to improve some of the information it provides. In reaching this preliminary view, the Board considered factors such as cost savings from providing relief from the annual impairment test, the impact on the robustness of the test of providing that relief, and also whether similar relief should apply for intangible assets with indefinite lives and intangible assets not yet available for use.

The Board proposes to remove the requirement for an annual goodwill impairment test, in the absence of any indicators of possible impairment.

The Board will therefore develop a proposal to remove the requirement for the goodwill impairment test to be performed annually, in the absence of any indicators of possible impairment. This proposal will also apply to intangible assets with indefinite lives and intangible assets not yet available for use. Because of this proposed move to an indicator-based approach, the Board plans to assess whether the indicators in paragraph 12 of IAS 36 need to be reviewed and updated.

Value in use – future restructuring or enhancement

When measuring value in use, IAS 36 requires an entity to estimate cash flow projections for an asset in its current condition. IAS 36 restricts these cash flow projections such that they must exclude estimated future cash flows expected to arise from future restructuring to which the company is not yet committed (IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* provides guidance on when an entity is committed to a restructuring), or that arise from improving or enhancing the asset's performance until these cash outflows have been incurred.

Stakeholders explained to the Board that this requirement to exclude cash flows can be complex and costly because management typically has to rework financial budgets and forecasts to remove the information, and it is not always straightforward.

The Board considered this request and its preliminary view is that it should develop a proposal to remove this restriction on cash flows from IAS 36, when an entity measures value in use for any asset and/or CGU (whether the CGU contains goodwill or not).

Value in use – post-tax inputs and discount rates

When measuring value in use (VIU), IAS 36 requires an entity to estimate pre-tax cash flows and to discount them using pre-tax discount rates, and to disclose those rates. Stakeholders have stated that determining these pre-tax discount rates is costly and complex, and that the rate is difficult to understand, not observable and does not provide useful information – not least because the current value of an asset is understood to be a post-tax measure and, generally, valuations of assets and businesses are done on a post-tax basis.

The Board's preliminary view is to develop a proposal to remove the explicit requirement to use pre-tax cash flows and pre-tax discount rates when calculating value in use. The Board would require an entity to use internally consistent assumptions for cash flows and discount rates and to retain the requirement to disclose the discount rates – but to remove the requirement that the discount rate disclosed should be a pre-tax rate. The proposal will apply to all assets and CGUs within the scope of IAS 36.

How we see it

An indicator approach for goodwill impairment could provide relief in the cost of performing an impairment test, but entities may need to spend more time and effort in setting up their impairment models, if after a few years of no indicators, such indicators would again arise.

Removing the restrictions on VIU would much better align the cash flows being used with the internal forecasts. However, rigour in the application hereof will be required.

The possibility to use post-tax discount rates and cash flows would much better align with general business valuation practices, but attention to the interaction with deferred tax assets and liabilties and related cash flows will remain a point of attention in practice.

Intangible assets

Paragraph B31 of IFRS 3 requires an acquirer to recognise all identifiable intangible assets acquired in a business combination, separately from goodwill. However, whether this provides useful information has been a subject of much debate over the years. Some think doing so gives a better picture of what was bought, and more information to investors about future cash flows. However, others think that it is difficult to reliably measure all intangible assets acquired in a business combination, and amortising intangible assets that are difficult to separate from the overall business could lead to double counting in the income statement, if subsequent costs to maintain such assets are also recognised as an expense.

The Board therefore considered whether to allow - or require - entities to include other categories of identifiable intangible assets acquired in a business combination in goodwill, for example, customer relationship assets, and intangible assets not already recognised in the acquired company's financial statements. The Board was seeking to reduce cost and complexity for entities by reducing the need to identify and value intangible assets. However, when considering a number of factors and taking into account views from preparers, investors and others, the Board was not convinced that there was persuasive evidence to allow or require some identifiable intangible assets to be included in goodwill.

The Board's preliminary view is therefore that it should not develop a proposal to change the recognition criteria for identifiable intangible assets acquired in a business combination.

How we see it

The relevance of identifying, recognising and, perhaps, depreciating other intangibles separately from goodwill may interrelate with the resolution of the goodwill amortisation and impairment test effectiveness issues.

Next steps

The DP is open for comment until 31 December 2020. Stakeholders are encouraged to to take this opportunity to provide feedback to the IASB, particularly if there are strong views about re-introducing amortisation of goodwill.

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