Invitation to Comment:
Draft Comment Letter – IASB's DP 2020/1 *Business Combinations: Disclosures, Goodwill and Impairment*

Deadline for completion of this Invitation to Comment:
Close of business 25 January 2021
Please submit to: BCGDI@frc.org.uk

Introduction

The objective of this Invitation to Comment is to obtain input from stakeholders on the draft comment letter on the IASB's DP 2020/1 *Business Combinations: Disclosures, Goodwill and Impairment*.

Who should respond to this Invitation to Comment?

Stakeholders with an interest in the quality of accounts that apply IFRS.

How to respond to this Invitation to Comment

Please download this document, answer any questions on which you would like to provide views, and return to BCDGI@frc.org.uk by close of business on 25 January 2021.

Brief responses providing views on individual questions are welcome, as well as comprehensive responses to all questions.

The UK Endorsement Board

The UK leaves the EU at the end of the Transition Period on 31 December 2020.

Until the end of the Transition Period, the European Commission will continue to endorse IFRS for use in the UK.

At the end of the Transition Period, UK-adopted international accounting standards will consist of all international accounting standards already adopted in the EU. New and amended standards, not already adopted in the EU, will be considered for endorsement and adoption in the UK. The Secretary of State for the Department for Business, Energy and Industrial Strategy will undertake this function from the end of the Transition Period until the endorsement and adoption functions are delegated to the UK Endorsement Board (UKEB). This delegation is currently expected to occur during 2021.

The requirements for UK endorsement and adoption are set out in the Statutory Instrument 2019/685[1].

[1] The International Accounting Standards and European Public Limited-Liability Company (Amendment etc.) (EU Exit) Regulations 2019: https://www.legislation.gov.uk/uksi/2019/685/made

The UKEB is currently being established and will be responsible for endorsing and adopting IFRS for use in the UK once these functions have been delegated to it by the Secretary of State. The UKEB will also be responsible for influencing the development of IFRS.[2]

During the establishment of the Endorsement Board, the staff are undertaking influencing activities with the support of Financial Reporting Council (FRC) infrastructure and resource.[3]

This Invitation to Comment forms part of these influencing activities.

Privacy and other policies

The data collected through submitting this Invitation to Comment will be stored and processed by the FRC/EB. By submitting this Invitation to Comment, you consent to the FRC/EB processing your data for the purposes of influencing the development of and endorsing IFRS for use in the UK. For further information, please see our Privacy Statements and Notices[4] and other Policies (e.g. Consultation Responses Policy, Data Protection Policy and Freedom of Information Policy)[5].

The FRC's policy is to publish on its website all responses to formal consultations issued by the FRC unless the respondent explicitly requests otherwise. A standard confidentiality statement in an e-mail message will not be regarded as a request for non-disclosure. The FRC does not edit personal information (such as telephone numbers or postal or e-mail addresses) from submissions; therefore, only information that you wish to be published should be submitted.

2 For more information on the UK Endorsement Board, please see https://www.gov.uk/government/groups/uk-endorsement-board-ukeb#contents

3 For more information on the Endorsement Board's interaction with the FRC, please see https://www.frc.org.uk/endorsement-of-ias

4 These can be accessed here: https://www.frc.org.uk/about-the-frc/procedures-and-policies/privacy-the-frc

5 These policies can be accessed here: https://www.frc.org.uk/about-the-frc/frc-operational-policies

Part B: Questions

Recommendation for a mixed model for accounting for goodwill

1. Do you support our recommendation for a mixed model, where impairment testing is supported by an annual amortisation charge? (Draft comment letter, appendix 2, paragraph A1). Please explain why or why not.

   From a conceptual perspective, we continue to support the use of an impairment only model. However, from a practical perspective we acknowledge the difficulty encountered in ensuring that impairment charges are not recognised too late. In this context, we support the UKEB's recommendation for a mixed model.

2. Do you support our conclusion that if a mixed model is introduced, impairment testing should be on an indicator-only basis. (Draft comment letter, appendix 2, paragraph A2). Please explain why or why not.

   We agree that if a mixed model is introduced, then it would be appropriate to consider the need to carry out an impairment test only where there were indicators of impairment.

3. Do you support our conclusion that if a mixed model is not introduced, an annual quantitative impairment test should be retained? (Draft comment letter, appendix 2, paragraph A2). Please explain why or why not.

   In the absence of a mixed model approach, we do not consider that carrying out an impairment test only where there are indicators of impairment would serve to meet the concerns of users that impairment losses are almost always recognised too late. Therefore, we are supportive of the UKEB's conclusion.

Disclosures on strategic rationale, objectives and metrics

4. Do you support our recommendation for illustrative examples and field-testing of the proposed disclosures on acquisitions? (Draft comment letter, appendix 2, paragraph A3). Please explain why or why not.

   We acknowledge the views of many users that the existing disclosure requirements relating to acquired businesses do not meet their needs. Therefore, it would be sensible for the IASB to develop illustrative disclosures and seek the feedback of users as to whether they meet their information needs.

5. Do you support our recommendation that disclosures should be required for all material acquisitions, rather than only those whose performance is reviewed by the CODM? (Draft comment letter, appendix 2, paragraph A5 ii). Please explain why or why not.

   We agree that disclosures should be required for all material acquisitions. Such an approach should lead to greater comparability between entities and reporting periods such is the diversity seen amongst entities with the definition of the CODM as set out in IFRS 8, 'Operating Segments'.

6. Do you support our recommendation that the requirement is to disclose the metrics chosen to monitor subsequent performance of the acquisition rather than to disclose targets in place to monitor subsequent performance of the acquisition against those metrics? (Draft comment letter, appendix 2, paragraph A5 iii). Please explain why or why not.

   We agree with the UKEB's recommendation that entities should disclose the metrics that they have chosen to monitor the subsequent performance of the acquisition. This, in our view, should lead to the disclosure of meaningful information thereby avoiding the need for preparers to try and find ways to avoid providing information that could, in certain situations, be commercially sensitive.

7. Do you support our recommendation that the requirement is for qualitative disclosure of performance against chosen metrics, rather than disclosure of the quantitative targets in place to track progress and actual performance against those targets? (Draft comment letter, appendix 2, paragraph A5 iv). Please explain why or why not.

Consistent with our response to question 7 above, we agree with the UKEB's recommendation for qualitative disclosure of performance against the metrics that the entity has chosen to monitor the performance of the respective acquisition.

8. Do you support our recommendation that disclosure is required when monitoring of material acquisitions stops, together with an explanation of why it has stopped? (Draft comment letter, appendix 2, paragraph A5 v). Please explain why or why not.

   We agree with the UKEB's recommendation that entities should disclose when they have stopped monitoring the performance of an acquisition and why this has occurred. We agree that making reference to a two-year period is somewhat arbitrary and consequently linkage to the approach used by management for monitoring acquisitions would be sufficient.

9. Do you support our recommendation that failure to meet an objective or target identified at acquisition is treated as an indication of an impairment of goodwill in the cash-generating unit to which it has been allocated? (Draft comment letter, appendix 2, paragraph A6). Please explain why or why not.

   We agree that the failure to meet an objective or target set by management at the acquisition date should, on balance, be identified as an indication of impairment of the goodwill in cash generating unit to which it has been allocated.

10. Do you agree that the proposed disclosure of CODM's objectives for the acquisition and the metrics used to monitor progress in meeting those objectives is not forward-looking information? (Draft comment letter, appendix 2, paragraph A7). Please explain why or why not.

   We also agree with the IASB's view that the disclosure of both the CODM's objectives for the acquisition and the metrics used to monitor the achievement of said objectives does not constitute forward-looking information.

Disclosures on synergies

11. Do you agree with our conclusion not to recommend the proposed disclosures on synergies? (Draft comment letter, appendix 2, paragraph A12). Please explain why or why not.

   No, we support the IASB's preliminary view for companies to disclose a description of the synergies expected from the combining of the operations of the acquired business with the company's existing business. We also support disclosing when the synergies presented in the business combination are expected to be realised. In our view, this would be decision useful information for users of the accounts.

   However, we are concerned about disclosing the amount (or range of amounts) of the synergies as well as the expected cost, or range of costs, to achieve those synergies. This information is forward-looking information and therefore we have concerns about including these amounts in the financial statements. We would much prefer to see the disclosure of this information in the management commentary. This approach would avoid the potential difficulties associated with obtaining sufficient audit assurance on such judgemental amounts and avoid contributing to the potential audit expectation gap.

12. Do you support our recommendation that if the proposals on synergies are developed, synergies should be defined? (Draft comment letter, appendix 2, paragraph A13i).

We are supportive of the proposal to define what is meant by synergies in the context of the standard to support both comparability and consistency.

13. Do you support our recommendation that if the proposals on synergies are developed, illustrative examples and field-testing are required? (Draft comment letter, appendix 2, paragraph A13ii).

    We are supportive of the UKEB's recommendation that illustrative disclosures should be developed and flied-tested with both prepares and investors to ensure that the proposed disclosures meet their objectives.

Disclosure of debt and defined pension liabilities acquired

14. Do you agree with our support of the proposal to disclose separately defined pension liabilities and debt as major classes of liability? (Draft comment letter, appendix 2, paragraph A15).

    Yes

Pro-forma information

15. Do you support our recommendation that '*related transaction and integration cost*,' is defined? (Draft comment letter, appendix 2, paragraph A17 i).

    Yes

16. Do you support our recommendation that disclosure requirements for the basis on which pro-forma information is prepared are developed, to support understandability and comparability? (Draft comment letter, appendix 2, paragraph A17 ii).

    Yes

17. Do you support our recommendation to field test the proposals to ascertain expected practicalities and costs of providing pro-forma cash flow information? (Draft comment letter, appendix 2, paragraph A17 iii).

    Yes

Improving the impairment test

18. Do you support our recommendation to disclose how discount rates have been derived, differentiating between CGUs with different risk profiles (in addition to the current disclosure of the discount rate applied to the cash flow projections)? (Draft comment letter, appendix 2, paragraph A21i). Please explain why or why not.

    We support the UKEB's proposal for additional disclosure as to how management have derived discount rates, explaining how the different risk profiles of CGUs have been taken into account. We believe that this will lead to greater focus on the appropriateness of the discount rates applied to the underlying cash flow projections.

19. Do you support our recommendation to disclose possible changes to key assumptions in the recoverable amount calculation and the impact of those changes on recoverable amount (replacing the current disclosure of key assumptions and the amount by which the key assumption would need to change if a reasonably possible change to it would cause carrying amount to exceed recoverable amount)? (Draft comment letter, appendix

2, paragraph A21ii). Please explain why or why not.

We agree with the proposed disclosure changes recommended by the UKEB. In our view, this additional information may lead management to reassess the appropriateness of their assumptions and could lead to a reduction of over-optimistic cash flow forecasts. In addition, this information will be of use to investors in understand the sensitivities in the valuation of the goodwill balance.

20. Do you support our recommendation that additional disclosures should also be required for each CGU or group of CGUs with allocated goodwill with a significant carrying amount when compared to the entity's total net assets excluding goodwill? (Draft comment letter, appendix 2, paragraph A21 iii). Please explain why or why not.

We agree with the UKEB's proposal to extend the disclosure requirements to identify the amount of goodwill allocated to a CGU or group of CGU's that is material when compared to the entity's net assets excluding goodwill. We do not consider that this will be particularly onerous for preparers and will provide users with a better understanding of the allocation of goodwill.

21. Do you support our recommendation to disclose how CGUs have been identified and whether that has changed from the prior period? (These disclosures are currently only required for CGUs for which an impairment has been recognised or reversed during the period). (Draft comment letter, appendix 2, paragraph A23i). Please explain why or why not.

We support the recommendation for this additional disclosure requirement as this should provide insight to users of the accounts of the judgements made by management when accounting for goodwill.

22. Do you support our recommendation to disclose where goodwill is more likely to be shielded, for example when goodwill has been allocated to a CGU where the acquisition has been integrated with an existing business? (Draft comment letter, appendix 2, paragraph A23 ii). Please explain why or why not.

We acknowledge the concerns of the effect of shielding that can occur and are supportive of the requirement for more explicit disclosure where this may be the case.

23. Do you support our recommendation to explore options for testing goodwill for impairment at a more disaggregated level, so that testing is more targeted? One option to explore would be to require allocation of goodwill to CGUs which represent the lowest level within the entity at which the results of the acquired business are monitored for internal management purposes. (Draft comment letter, appendix 2, paragraph A23 iii). Please explain why or why not.

We are supportive of the UKEB's recommendation to explore options for testing goodwill for impairment at a more disaggregated level. In our experience, it is not uncommon for the results of acquired entities to be monitored internally but for goodwill to be apparently monitored internally at a more aggregated level.

Amortisation methods and disclosures

24. Do you support our recommendations for areas to be explored for developing a model for amortising goodwill? (Draft comment letter, appendix 2, paragraph A28). Please explain why or why not.

Consistent with our support for the development of a mixed model, we consider that it is important to establish a model that can be used to reliably estimate the consumption of the goodwill balance to avoid the default to some arbitrary period.

25. Do you support our proposed disclosures on goodwill balances? (Draft comment letter, appendix 2, paragraph A32). Please explain why or why not.

We agree with the proposal to provide additional disclosures as recommended by the UKEB and that they would not be onerous for preparers to provide and should make the goodwill balance more understandable for users.

Indicator-only impairment test

26. Please provide your views on anticipated cost savings from the IASB's proposal to move to an indicator-only impairment test (Draft comment letter, appendix 2, paragraph A35).

We do not believe removing the annual test obligation would significantly reduce costs because the impairment test mainly relies on inputs/figures (for instance when determining the value in use) that management already need to produce for internal reporting purposes.

For example, we do not agree with paragraph 4.13 in the DP which states that costs incurred as a result of the test may be associated with the need of 'gathering inputs used in the valuation model to determine the recoverable amount'. This is because inputs to build up the cash flows used in the computation of the value in use are supposed to be sourced from the most recent budgets that were approved by management.

We are certainly not expecting a significant amount of additional effort to source the required inputs because those forecasts are required to operate a successful business and we do not believe that budgets should be prepared solely for the purpose of performing the impairment test.

27. Do you support our conclusion that the quantitative impairment test should be retained for intangibles which are not amortised? (Draft comment letter, appendix 2, paragraph A36). Please explain why or why not.

No, we are not supportive of the UKEB's proposal. This is because we believe an indicator type approach could be applied that is similar to the capitalisation of development costs set out in paragraph 57 of IAS 38, 'Intangible Assets'. What we like about this statement is that it requires a company to continue assessing whether they are still in a position to keep the amounts recognised as an asset. We further believe the IAS 38 criteria we have just referred to could also be used as the mandatory test under IAS 36.

Including cash flows from uncommitted restructurings and asset improvements

28. Do you support our recommendation that, if cash flows from uncommitted restructurings and asset improvements are included in the value in use calculation, expected values are used to incorporate risk into the cash flows? (Draft comment letter, appendix 2, paragraph A38i). Please explain why or why not.

We welcome the proposal for removing the constraints on restructuring and enhancements when determining the value in use even though testing an asset should mean, in principle, testing the asset in its current condition without trying to predict what it would be in the future. However, we are also aware that when testing goodwill, an entity should inherently take into account future activity which includes investments and potential measures that affect how the business is organised or operated.

We agree with the UKEB's proposal that to counter the risk of management optimism in the underlying cash flows that the effects of uncommitted restructurings and asset improvements should be incorporated using their expected values.

29. Do you support our recommendation that, if cash flows from uncommitted restructurings and asset improvements are included in the value in use calculation, the proposal is redrafted so that entities are *required* to include cash flows from uncommitted restructuring or asset improvements? (Draft comment letter, appendix 2, paragraph A38ii). Please explain why or why not.

We support this proposal to minimise the risk of inconsistency and a lack of comparability due to how these matters may have been treated.

30. Do you agree with our support of the proposal to allow either a pre-tax discount rate or a post-tax discount rate to be used in the value in use calculation, provided that the rate chosen is consistent with the cash flows? (Draft comment letter, appendix 2, paragraph A39). Please explain why or why not.

We support the proposal to move from a 'pre-tax cash flows and discount rate' basis to a 'post-tax cash flows and discount rate' basis, as this requirement has been an area with considerable practical issues on how tax cash flows are allocated to assets and CGUs. Besides the fact this is more in line with the data and inputs the market provides and therefore easier to document, it would improve consistent application amongst preparers. We agree that the rate chosen must be consistent with the cash flows.

31. Do you agree with our support for the IASB's preliminary view not to develop proposals to change the recognition criteria for intangible assets acquired in a business combination as part of the current project? (Draft comment letter, appendix 2, paragraph A42). Please explain why or why not.

Although we acknowledge the difficulties encountered with the measurement of intangible assets, we support the IASB's preliminary view not to develop a proposal that would allow some intangible assets to be included in goodwill.

Our view is that the separate recognition of intangibles assets in a business combination transaction is relevant because it permits a user of financial statements to understand what has been acquired for the consideration paid. This information is also important as it is usually the intangible assets that permit a business to run. Finally, separate recognition of intangible assets would make it easier to account for if one of them is sold separately.

32. Do you agree with our conclusion that our answers to the IASB's consultation should take into account a full range of relevant considerations for UK stakeholders and should not be solely dependent on consistency with current or future US GAAP? (Draft comment letter, appendix 2, paragraph A45). Please explain why or why not.

We are of the opinion that convergence of US GAAP and UK-adopted IFRS over time is a desirable outcome for all stakeholders. However, this is not to say that the outcomes of decision-making processes should be predicated on a goal of convergence with US GAAP.

While there should be some consideration of the relative cost to disparate reporting outcomes under either framework for entities reporting under both US GAAP and UK-adopted IFRS, especially where US securities law requires that books and records be maintained in US GAAP, our considered opinion is that the standard-setting process of the UKEB should not be predicated on outcomes of the FASB standard setting process.

33. Do you have any other comments?

We are of the opinion this DP is a preliminary step in addressing multiple issues as it relates to IFRS 3 and IAS 36 and the bridging of information gaps as it relates to goodwill and intangible assets and impairment testing thereof.

We consider the following matters, which arose frequently in discussion, as potentially requiring revisiting for either clarification or reconsideration:

- Clarity of definition of a CGU, particularly as a result of paragraphs such as IAS 36.80 and the reference to 'the lowest level within the entity at which goodwill is monitored for internal management purposes'. A strict reading of this sentence indicates that the lowest level at which goodwill is reported upon and measured as an asset – whereas it is often interpreted as being the lowest level at which performance of goodwill is measured.

- Disclosures relating to impairment testing are extremely detailed in certain respects and mere 'recommendations' in others. There is also a lack of clarity available as to what is meant by 'key assumptions' in the context of IAS 36.134 such that information provided is generally insufficient to understand the drivers of outcomes. It is our belief that revisiting mandatory disclosures and to ensure they are robust may address other concerns raised in the DP.

- Other areas where additional clarity which arose from discussions include:

    - Required inputs when utilising the value in use model, as defined by IAS 36.33, include the use of the 'most recent management budgets/forecasts'. Such budgets may be biased towards optimism and, as a result, result in bias being inherent in the calculation of value in use

    - Step acquisitions while under control may result in overstatements of goodwill – for instance, due to paying a premium to acquire non-controlling interest – resulting in an overstatement of the fair value of the underlying operation and thus excessive goodwill

    - Examples given should be updated for real-world situations, including the impact of IFRS 16 'Leases' and leases with lease terms beyond the forecast period, and

    - The use of the value in use model where a non-controlling interest is in place, including the apportionment of cash flows to controlling and non-controlling interests.

Thank you for completing this Invitation to Comment