THE 100 GROUP

Financial Reporting Committee

IFRS Foundation
Columbus Building
7 Westferry Circus
Canary Wharf
London
E14 4HD

9 December 2020

Dear Mr Hoogervorst,

Please find enclosed our response to the Discussion Paper on Business Combinations – Disclosures, Goodwill and Impairment (DP2020/1).

This response has been prepared by the 100 Group Financial Reporting Committee and is intended to speak on behalf of the Group as a whole. The 100 Group membership represents around 87% of the FTSE100 market capitalisation as well as a number of equally significant sized unlisted businesses.

We note that whilst this letter expresses the views of the 100 Group as a whole, these views are not necessarily those of individual members nor their respective employers. We thank you for the opportunity to comment on your proposal and would invite any further dialogue which you would deem of value.

We are supportive of some of the proposals, particularly the use of post-tax cash flows when estimating value in use and the ability to better match to management forecasts by allowing for uncommitted future restructurings or asset enhancements. We do not have strong views on whether an impairment-only or amortisation approach to goodwill should be adopted, although note that, while undoubtedly arbitrary, amortisation has the advantages of predictability and reducing the risk of goodwill remaining on the balance sheet long after its identifiable value has been subsumed into the business. One option that could be considered would be to give companies an accounting policy choice to amortise or not, as with other identified intangible assets, based on their assessment of whether the goodwill has a limited life or an indefinite life.

We do, however, have significant concerns in relation to the proposed disclosure requirements.

As a Group we advocate for information that is relevant, reliable and comparable. Whist individually the additional disclosure requirements do not appear onerous, for acquisitive businesses the aggregate burden is likely to be significant, increasing the cost to preparers and resulting in lengthy disclosures that in our view will not necessarily enhance the transparency and comparability of financial statements taken as a whole.

The proposals appear to assume that acquisitions are typically made for a short-term financial benefit whilst in reality they are often made based on a long-term strategic rationale, to support the profitability of the business as a whole. As a result, objectives and associated KPIs are often intangible or non-quantifiable, for example expanding a product range or capability or enhancing a market-leading position. We believe that encouraging a prioritisation of financial or other quantifiable KPIs in these circumstances may lead to an increase in short-termism.

There is also a presumption within the discussion paper that material acquisitions are in general monitored either on a standalone basis or within a combined segment from the point of acquisition. However, the value of acquisitions is often achieved through rapid integration into the wider business, resulting in the acquired business becoming indistinguishable as a separate component. Management's objectives in these circumstances will focus on the success of the combined business or business segment, rather than the acquisition in isolation.

An alternative approach would be to explain the strategic rationale and management's objectives behind each major transaction, where this is not commercially sensitive. If the definition of success is financial this could be monitored for a short time period while the acquisition is operated independently, or if non-financial, a general commentary on achievements in the year of acquisition could be provided.

We propose clarifying that the disclosures are limited to very material transactions only. While the use of the CODM, which we support for this purpose, is intended to result in disclosures only being required for acquisitions considered by the organisation to be material, we are concerned that the interpretation of the requirement could be seen by auditors and regulators as requiring the information to be given for all acquisitions that an entity provides information about, or that the CODM monitors.

Finally, we have several practical concerns, particularly in relation to synergies, cash flows and audit. Further detail on these are included below.

Given that our comments are limited to a few key points we have chosen to elaborate on these in more detail in the Appendix, as opposed to providing responses to all of the detailed questions provided in the discussion paper.

We have sought to be clear and constructive in our feedback. We hope you find that they provide helpful insight as you move to the next stage of the project.

Please do contact our secretariat Hannah Maughan at secretariat@the100group.co.uk should you wish to discuss any of our comments in further detail and she will be very happy to put you in touch with us.

Yours sincerely,

Iain J Mackay,
Chair of the 100 Group Financial Reporting Committee

Appendix – further detail on key points where we have comments

The cost burden of additional disclosures

The discussion paper works on the basis that disclosing information already monitored by management minimises the cost of the proposed disclosures (as noted in paragraph 2.16). There is, however, always a cost to disclosing information that is already monitored by a business, being as a minimum the cost of gathering and verifying the information to the standard necessary for it to be audited and then of the audit itself.

Furthermore, additional disclosures for cash flows from operating activities of the acquired business after acquisition date, and of the combined business on a proforma basis for the current reporting period, and expected synergies in the year of acquisition are likely to require the preparation of new information and investment in ERP systems and consolidation tools to gather the data required. These disclosures will be particularly challenging and costly where the acquired business has been rapidly integrated into the wider business, resulting in the acquired business becoming indistinguishable as a separate component.

Whilst each additional disclosure is not onerous as an individual item, we believe that, combined, they will create a significant burden for acquisitive businesses. This cost burden is not, therefore, expected to be offset by the proposed simplifications to impairment testing.

Removing the annual quantitative impairment test could reduce costs for many companies but this cost saving will be at least partially offset by the costs of a new process to assess whether there is an indicator of potential impairment each year, and which could be argued to be more judgemental. Companies may simply default to performing their annual impairment testing processes instead and we believe this should be offered as an accounting policy choice so companies can manage their affairs in the most efficient manner.

Concerns on the proposed disclosure requirements:

General comments

The proposed disclosures would constitute a significantly higher level of detail than companies provide on the ongoing business or on other large transactions in their financial statements, including but not limited to restructuring processes, large capital expenditure programmes and internal research and development. For example, how a business or business segment has performed against its budgets or objectives is not required to be disclosed in the financial statements.

We also have concerns around the volume of disclosures. Individually the additional disclosure requirements are not onerous and are likely to be welcomed by the investor community individually or in isolation. However for acquisitive businesses the aggregate burden will be significant, resulting in lengthy disclosures that in our view will not necessarily enhance the transparency and comparability of the financial statements taken as a whole, this is contrary to IAS 1.30A which refers to obscuring material information with immaterial information. For example, if a company makes two material acquisitions a year and monitors them for five years, that would require ten acquisitions to be disclosed in the fifth year, with multiple metrics for each. Clarification will also need to be provided as to whether retrospective application will be required for historical acquisitions. We would not support retrospective application, as this would result in significant challenges and cost to prepare historical information to a standard suitable for external disclosure and audit.

Strategic rational linked to business strategy (paragraph 2.11)

When describing the strategic rationale for undertaking an acquisition the Board expects that a company would link that rationale to the company's overall business strategy (paragraph 2.11).

Financial statements do not currently disclose the business strategy, only the principal activities of the company. The business strategy is narrated in the front half of an annual report, which is not included within the audit of the financial statements. As such, we have concerns on how this linkage can be articulated given companies are not able to refer to the front half of the accounts from the financial statements.

Commercially sensitive information (paragraphs 2.27 – 2.28)

We oppose compulsory disclosure of commercially sensitive information, and strongly disagree with the statement that commercial sensitivity *"is not sufficient reason to prevent disclosure of information that investors need"* (paragraph 2.28).

Not only is this contrary to the approach taken by other standards but requiring such disclosures could be harmful to businesses and their investors by sharing detailed market and product information that would not typically be shared with competitors. This would also provide an inherent competitive advantage to non-acquisitive businesses who would not be required to give this level of disclosure about their businesses and products. These disclosures could potentially influence the price of future deals or force more short-term thinking rather than encouraging the best long-term strategic outcome.

Where businesses operate in sensitive industries this would be particularly challenging. For example, a defence contracts company will need to ensure that it is not disclosing information about customers, including expected future demand for products, as disclosure could be harmful or illegal.

Forward-looking information (paragraphs 2.29 – 2.32)

Question 2(e) asked for information about constraints on providing forward-looking information. We note as an example, our members who also file their annual report in the US are constrained by the US Private Securities Litigation Reform Act of 1995 which defines forward-looking information as follows:

> *"Certain information provided or stated, including statements regarding future financial performance and the expectations and objectives of management, is forward-looking. Forward-looking statements can be identified by the fact that they do not relate strictly to historical or current facts. They often include words such as "believes," "expects," "anticipates," "estimates," "intends," "plans," "seeks" or words of similar meaning, or future or conditional verbs, such as "will," "should," "could" or "may"."*

We strongly disagree with the contention in the Discussion Paper that providing future targets for an acquired business does not constitute forward-looking information. We have concerns about the provision of forward-looking information both due to potential legal liabilities in some jurisdictions, including the US, and the cost of auditing this information, detailed further under audit below.

Where acquisitions are integrated into the wider business (paragraphs 2.23 – 2.26)

Acquisitions are often quickly integrated into the wider business to deliver value from the acquisition. In these circumstances, the acquired business becomes indistinguishable as time progresses and any standalone reporting on the acquired business ceases. Management's objectives will focus on supporting the combined profitability of the whole rather than the acquired business or indeed a segment of the business into which the acquisition has been integrated.

In our view, proposals to present combined information in these circumstances (paragraphs 2.25 and 2.26) would promote short-termism and result in companies needing to provide detailed segmental information over and above standard disclosure requirements, including IFRS 8 which already requires additional disclosures by segment.

We note that earn-out clauses are used within the discussion paper as an example of when businesses monitor the subsequent performance of acquisitions independently (paragraph 2.24). In response to this we would highlight that where significant integrations are expected to take place businesses can take a commercial decision to exclude earn-out clauses from purchase negotiations. Furthermore, it is not necessarily the case that earn-out metrics (typically revenue and profitability) align with management's objectives for the acquisition, indeed in certain instances these are a requirement of the vendor not the acquirer.

Expected synergy disclosures in the year of acquisition (paragraphs 2.62 – 2.68):

The proposals appear to assume that synergies are a core part of all acquisitions, whilst in reality acquisitions are often made based on a long-term strategic rationale to support the profitability of the business as a whole, for example to expand a product range or capability or enhance a market-leading position. In our view mandating disclosure of synergies will force companies to make this a key objective of acquisitions, even when commercially this would not have been the case.

There are multiple sources of synergies that may be achieved on an acquisition, whether within the acquired business, the acquiring business or the enlarged group.

The calculation of these synergies involves significant judgement and forward-looking strategic thinking, particularly when sources such as buying power or cross-selling are considered. On this basis we have concerns about requiring these calculations to be performed to a standard suitable for external disclosure, and about the ability of auditors to provide cost-effective assurance on the result.

We also have concerns that the disclosure some synergies and the expected costs to achieve synergies would result in the disclosure of commercially sensitive information, such as the announcement of proposed restructuring processes prior to communication with employees affected.

We note that it is proposed that synergies only be disclosed in the year of acquisition and question the value that this information provides as a one-off stand-alone disclosure, if subsequent reporting against the target is not also required.

Replacement of the term "profit or loss" with the term "operating profit before acquisition-related transaction and integration costs" for both the Proforma information and information about the acquired business after the acquisition date (paragraph 2.77)

We welcome the amendment of "profit or loss" for IFRS 3 disclosures of performance since acquisition to "operating profit before deducting acquisition related costs and integration costs". There is, however, a need for clarification on a number of significant judgements including whether acquisition fair values should be assumed to be unchanged or rolled back to the start of the period and for acquired entities that have not previously reported under IFRS , how the conversion to IFRS should be managed for the purpose of the disclosure.

Cash flows from operating activities of the acquired business after acquisition date, and of the combined business on a proforma basis for the current reporting period (paragraphs 2.77 and 2.81)

We strongly oppose the proposals to disclose cash flows from operating activities of the acquired business after acquisition date, and of the combined business on a proforma basis for the current reporting period. In many large groups, cash flows are often only monitored closely by senior management on a consolidated basis.

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 ERP systems and consolidation tools to gather this data separately and analyse it in a cash flow statement. Also, this requirement may not be achievable if integration of the acquired business has taken place and would cause significant difficulties where acquisitions are carve-outs as opposed to the purchase of stand-alone legal entities or groups. The assumptions required in these instances would result in meaningless outputs which are not actually "cash". For example, splitting receivables and cash receipts where a customer purchases from both the ongoing and acquired product ranges would require significant judgement and system investment.

As with synergies we also have concerns about the auditor's ability to provide cost effective assurance on these calculations where they involve significant judgement.

Audit of proposed disclosure requirements

We have concerns on the ability of auditors to audit the proposed financial and non-financial objectives, results, synergies and proforma cash flows in a cost-effective way.

In addition to the points raised on the ability of auditors to comment on synergies and concerns regarding the auditor's interpretation of the scope of disclosures, raised above, internally monitored information on which disclosures are based may not be in a system or format on which the auditors can readily place reliance.

We would also expect auditors to face challenges opining on forward-looking information. Currently their consideration of forward-looking information is generally limited to impairment testing or valuation of intangibles where the underling pro-forma information itself is not disclosed in the financial statements. This work is already challenging, and we would expect significantly more work to be required if the forward-looking information itself is to be disclosed within the audited financial statements.

We note that the Board expects the information to be "*verifiable*", including whether *"the information faithfully represents what it purports to represent"* (paragraph 2.17), however, auditors are required to work to "free from material misstatement" and to opine on whether the accounts provide a "true and fair" view which is a more challenging standard to meet.

Scope of disclosures - limiting disclosures to acquisitions monitored by the CODM

We are supportive of the suggestion by Investors to limit the transactions for which disclosure is required to only *"'major' or 'fundamental' transactions"* (paragraph 2.35).

While the use of the CODM (Chief Operating Decision Maker), which we support, for this purpose is intended to result in disclosures only being required for acquisitions considered by the organisation to be fundamental, we are concerned that the interpretation of the requirement could be seen as having to give information on a far more extensive basis. This could be from a wider interpretation of the requirements by auditors and regulators, accepted "best" practice resulting in all acquisitions or metrics reviewed by the CODM requiring some form of disclosure, or the CODM in their management role reviewing information that is not material for investors.

It is important that over time the CODM and management's approach does not begin to be adapted to meet the prescribed needs of disclosure requirements, in particular that the information that is reviewed by the CODM is not constrained so as to avoid having to provide certain disclosures rather than being focussed on the needs of the business.

Proposals will also need to address that acquisitions are not always consistently monitored by the CODM (for example pharmaceutical acquisitions may not be reviewed by the CODM immediately after the acquisition, but only many years later, once the drug's research and development programmes have progressed to a specific point),that those that are reviewed by the CODM are not always material to the business and that the CODM may be provided with an array of metrics with multiple purposes, not just those used to determine whether acquisition objectives are being achieved.

Consideration should be given to the availability of exemptions or practical expedients to the proposed disclosures in the single entity accounts of a subsidiary for inter-group acquisitions accounted for under IFRS 3, where such transactions arise purely through internal group re-organisations and the provision of such information would add little to no benefit. Further, while such information may be of benefit to users of the financial statements of public companies, we challenge whether such disclosure would be relevant or necessary for certain private companies.

Quantitative annual impairment testing (paragraphs 4.32 – 4.34)

If the requirement for annual quantitative impairment tests is removed companies will need to introduce an annual process to consider qualitatively whether an indication of impairment has occurred, and many audit committees and boards are likely to require testing to continue to be performed.

We believe that companies will have different perspectives on whether the annual quantitative impairment tests or processes to assess indicators of impairment provide better governance or are more cost efficient. We would therefore suggest making this an accounting policy choice, allowing companies to choose between the two options.