Australian Government
Australian Accounting Standards Board

Staff Paper

Project:	**Removal of SPFS for FP entities**	**Meeting**	AASB April 2019 (M170)
Topic:	**Possible transition approach B3 – option to write off deemed goodwill**	**Agenda Item:**	6.4
		Date	16 April 2019
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		Project Status:	Developing Exposure Draft

Objective of this agenda item

1 The objective of this agenda paper is for the Board to **decide** whether to provide transitional relief by allowing entities, that apply the exemptions from retrospectively accounting for business combinations as per Appendix C to AASB 1 *First-time Adoption of Australian Accounting Standards* for previously unconsolidated subsidiaries, to immediately write off 'deemed goodwill' against retained earnings at the date of transition, rather than recognise the 'deemed goodwill' and subject it to day 1 and annual impairment testing.

Consideration of factors pertinent to considering introducing a practical expedient for certain entities by allowing them to immediately write off 'deemed goodwill'[1] against retained earnings at the date of transition

2 The practical expedient contemplated in this paper is particularly pertinent to parent entities that have previously not consolidated subsidiaries (i.e. who have previously prepared unconsolidated SPFS) **and** are now adopting the optional exemption of not restating past business combinations (that is available under Appendix C of AASB 1) on transition to mandatory consolidated GPFS-Tier 2 revised.

3 At the date of transition parent entities with previously unconsolidated subsidiaries have the option of either adopting the transition principles of AASB 10, which require retrospective adjustment as per acquisition accounting[2] or apply the principles of

1 See paragraph C4(j) of Appendix C to AASB 1.

2 Unless impracticable, in which case principles of acquisition accounting are applied at the beginning of the earliest period for which the application of AASB 3 is practicable. This could be the beginning of the current period [Para C4A (a) of Appendix C to AASB 10].

AASB 1, which does not require retrospective adjustment of the acquisition related accounting[3]. AASB 1 provides greater relief than AASB 10 as it does not require retrospective adjustment or application of acquisition accounting to past business combinations.

4 Before we elaborate on this practical expedient, here is a brief reminder of what the transition requirements under AASB 1 in relation to previously unconsolidated subsidiaries currently are:

- a parent entity (that did not consolidate subsidiaries previously but is now mandatorily consolidating) is required to determine and recognise the assets and liabilities of those subsidiaries as at the date of transition in accordance with AAS[4]. The difference between the parent's share of the subsidiaries' net assets so recognised and the cost of investment recognised in the parent's separate financial statements is then required to be recognised as 'deemed goodwill' in the consolidated financial statements (and subsequently subject to impairment testing).

Primary rationale for considering giving relief from the recognition of 'deemed goodwill'

5 ***Feedback from constituents:*** Feedback from Phase 2 submissions provided in response to AASB Invitation to Comment ITC 39 *Consultation Paper Applying the IASB's Revised Conceptual Framework and Solving the Reporting Entity and Special Purpose Financial Statement Problems* suggest the biggest hurdle to the proposals under ITC 39 relates to moving parent entities up from **previously unconsolidated SPFS to mandatory consolidated GPFS-Tier 2 revised**. Constituents requested the Board identify specific transitional relief for helping preparers transition to consolidated financial statements in as seamless and cost effective way as possible.

6 In response to these comments from constituents, staff explored possible ways to help ease the transition. In that process we identified one possible way could be to allow entities to immediately adjust (write off) the 'deemed goodwill' referred to in paragraph 4 above against retained earnings at the date of transition. This is similar to the requirement in paragraph 11 of AASB 1[5] that requires adjustments from events

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3 Refer Paras 71-72 of Agenda Paper 4.1 of February 2019 AASB Meeting for comparison of transition requirements of AASB 1 and AASB 10

4 If the subsidiary did not previously comply with all the R&M requirements in AAS, the carrying amounts of the subsidiary's assets and liabilities are determined using the exceptions and exemptions in AASB 1 as if the subsidiary were a first-time adopter of AAS.

5 Para 11of AASB 1 states, "The accounting policies that an entity uses in its opening Australian-Accounting-Standards statement of financial position may differ from those that it used for the same date using its previous GAAP. The resulting adjustments arise from events and transactions before the date of transition to Australian Accounting Standards. Therefore, an entity shall recognise those adjustments directly in retained earnings (or, if appropriate, another category of equity) at the date of transition to Australian Accounting Standards."

and transactions before the date of transition to be adjusted against retained earnings at the date of transition.

Secondary/contextual factors that are arguably pertinent to contemplating this type of relief

7 The thought process behind contemplating such a practical expedient might be influenced by:

- ***Deemed goodwill is not reflective of 'true' goodwill:*** for parent entities consolidating subsidiaries for the first time using the current AASB 1, the resulting goodwill recognised in their first consolidated financial statements will be a deemed amount and thus may not faithfully represent the amount the parent entity (acquirer) might have paid at the time of acquisition under the principles of acquisition accounting as per AASB 3.

- ***Reducing ongoing burden to justify or impair deemed goodwill when the amount does not reflect 'true' goodwill:*** since the deemed goodwill may not be reflective of actual synergies for which a premium was paid at the time of the acquisition, it might be difficult for entities that might want to avail themselves of the contemplated relief to undertake an annual impairment test for this goodwill and to justify the amount in their financial statements if not impaired. The impairment test might be particularly onerous for these entities as they may not have previously tracked past acquisitions and especially when such past acquisitions were made some time ago and may have since integrated with the rest of the business.

Impact of the contemplated practical expedient:

8 As mentioned in paragraph 1 above, this practical expedient is only being contemplated for parent entities affected by Phase 2 that would be consolidating subsidiaries for the first time by following AASB 1 transitional relief. This is because adoption of the requirements of AASB 1 for parents that are first-time consolidating subsidiaries may give rise to recognition of deemed goodwill at the date of transition[6]. The table of advantages and disadvantages below evaluates the suitability of this possible practical expedient for this particular group of entities. Despite its intended narrow application, we anticipate it could impact a large number of entities within this group[7]. This is because, although such parent entities have an option to apply the

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[6] This is also similarly applicable for past acquisitions of investments in associates, interests in joint ventures and interests in joint operations in which the activity of the joint operation constitutes a business, which may give rise to deemed goodwill at the date of transition if equity accounted or proportionately consolidated for the first time by adopting the principles of AASB 1 [Para C5 of Appendix C to AASB 1].

[7] Although we do not have the number of parent entities who previously did not consolidate and would now be transitioning to mandatory consolidated GPFS Tier-2 revised, anecdotally, we understand many parent entities do not prepare consolidated financial statements, and do not provide an explanation for not consolidating. It might be because the parent entity chose not to prepare consolidated financial statements on the basis it regarded itself and/or the group as not being subject to AASB 10 *Consolidated Financial Statements* on the basis it is not a 'reporting entity' or it is not purporting to be preparing

requirements of AASB 10 retrospectively, it is our expectation that because AASB 10 would be seen as too onerous, the transitional requirements under AASB 1 would be expected to be adopted by most transitioning parent entities.

Possible advantages and disadvantages of this practical expedient

Advantages/reasons for	**Disadvantages/reasons against**
Provides relief from accounting for goodwill as a result of adopting consolidation principles for the first time	This approach is different from AASB 1, and hence is inconsistent with the presumption that IFRS standards are an appropriate base as set out in *The AASB's For-Profit Entity Standard Setting Framework* **Staff consider that this would be significant divergence from IFRS Standards, especially given that it represents a change in recognition principles.** This could undermine comparability and result in information loss for users regarding past business combinations, which is a key reason for undertaking this project (further costs to users outlined below).
Cost effective as it saves cost of testing impairment at the date of transition and ongoing annually including difficulties of identification of CGU and measurement of recoverable amount and related disclosure requirements especially in case of deemed goodwill	**Writing off deemed goodwill immediately in retained earnings as a transition adjustment may cover genuine cases of impairment without much explanation for users.**
Beneficial for entities who have not tracked past acquisitions and/or who have multiple acquisitions in the past	Deemed goodwill is a suitable starting point to enable entities transitioning to AAS without the effort of retrospectively determining the amounts as per acquisition accounting. **However, it does not imply that underlying acquisitions are impaired**

'general purpose financial statements' ; or it might be because the parent entity and/or the group elected to apply AASB 10 but met one of the consolidation exemptions outlined in paragraphs 4 and Aus4.1 (and Aus4.2) of AASB 10.

Advantages/reasons for	Disadvantages/reasons against
	necessitating write off in retained earnings. **To address possible impairment, AASB1/IFRS 1 already has the requirement to test such an amount for impairment at the date of transition [Paragraph C4 (g)(ii) of Appendix C to AASB 1].**
	Adopting the practical expedient would not provide a level playing field for entities that transition from SPFS to mandatory GPFS-Tier 2 revised due to implementation of Phase 2 with other entities such as Significant Global Entities (SGEs) that would have recently adopted AASB 1 (without the additional relief contemplated in this paper) when mandatorily transitioning from SPFS
	Impairment is one of the highest focus areas of the regulators[8], thus, giving a blanket approval for all eligible transitioning entities (the impact of which is expected to be high as per paragraph 8 above) may be against the relevance placed by regulators (a significant user group) on this item and may be an information loss to them
	The issues with the current impairment testing model are equally applicable for all entities and the reform is underway by the IASB. Although it may take some time for reform to take place, giving relief before the reform may not be useful for users and regulators, as mentioned in the above points

8 https://asic.gov.au/about-asic/news-centre/find-a-media-release/2018-releases/18-364mr-major-financial-reporting-changes-and-other-focuses/

Staff recommendation

9 As noted in paragraph 47 of Agenda Paper 6.1, staff's overall recommendation is to not provide any additional transitional relief for entities required to transition from SPFS to GPFS-Tier 2, particularly given the doubling of the large proprietary company thresholds. Even if the Board decides to propose additional transitional relief to what already exists, staff do not recommend the Board adopts the relief contemplated in this paper. This is because, on balance, staff consider that the disadvantages outweigh the advantages as outlined in the table above.

Question for Board members

Q7 Does the Board agree with the staff recommendation that, even if the Board decides to provide additional transitional relief, parent entities that have not previously consolidated subsidiaries and who now apply the requirements of AASB 1 for consolidating such subsidiaries for the first time, should not be allowed to immediately write off the amount of deemed goodwill determined in accordance with paragraph C4 (j) of Appendix C in AASB 1 against retained earnings at the date of transition?