WHAT ARE THE VIEWS OF USERS?

BUSINESS COMBINATIONS: DISCLOSURES, GOODWILL AND IMPAIRMENT

SUMMARY REPORT

WEBINAR – 12 NOVEMBER 2020

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Introduction[1]

EFRAG with the European Federation of Financial Analysts Societies (EFFAS), the Belgian Association of Financial Analysts (ABAF-BVFA) and the IASB®, organised an outreach event covering the IASB's Discussion Paper *Business Combinations: Disclosures, Goodwill and Impairment* ('the DP'). This report has been prepared for the convenience of European constituents to summarise the user outreach event held online on 12 November 2020.

Saskia Slomp, EFRAG CEO opened the outreach event and welcomed participants. She explained that EFRAG was organising this webinar together with the European Federation of Financial Analysts Societies (EFFAS), the Belgian Association of Financial Analysts (ABAF-BVFA) and the IASB®. The focus in this event was therefore on the investment community.

Nick Anderson IASB Board Member, introduced the IASB Discussion Paper *Business Combinations, Goodwill and Impairment* issued in March 2020 and illustrated the IASB proposals. He noted that the DP is not just about goodwill but also about disclosures that companies will provide about M&A. The IASB Board started this project after review of the standard that deals with M&A, IFRS 3 *Business Combinations*. The objective of the project is to improve the information that is provided by companies at a reasonable cost about business they buy, helping investors holding managers accountable for acquisition decisions. This meeting is also an opportunity to hear what investors think whether goodwill should be amortised or not. The deadline for comments is 31 December 2020.

Chiara Del Prete, EFRAG TEG Chairwoman, noted how important goodwill was in accounting and referred to EFRAG research on the topic that was done in 2015 and 2018. She explained that the EFRAG views to be explained were still preliminary and subject to change following the outreach program and the comment letters that are welcome till end of November 2020. In general, EFRAG supports the proposals of the DP and agrees that users get insufficient information on goodwill today. Hence the disclosures are being supported.

However, EFRAG also considers that the accounting problem is to be addressed to find a solution for example for the shielding effect. In its Draft Comment Letter EFRAG provides some ideas how to address the measurement of goodwill. The Draft Comment Letter consults on a number of issues and some of the questions are addressed to users.

Chiara Del Prete noted that EFRAG agrees to disclose the views of the management and the KPIs used by the management to assess the acquisition. EFRAG opined that the disclosures are not related to the recoverability of the goodwill so the IASB is invited to consider the disclosures as a potential trigger for the impairment test. EFRAG also questions whether the CODM is the right level and whether the information provided on this level is granular enough, as EFRAG understand that this issue is a source of concerns already for IFRS 8 *Segment Reporting*. EFRAG has further questions on the practicability, auditability and reliability of the proposed disclosures. Some constituents think the disclosures should be better placed in the management commentary of the financial statements. EFRAG suggests further to have the information available longer than two years and also has questions the usefulness of pro forma information from operating cash flows.

Chiara Del Prete explained that EFRAG has put forward several questions in the DCL. On commercial sensitivity a trade-off will have to be found between preparers' reluctance to disclose information and the needs of users.

[1] Contributions may have been edited for length or clarity.

The second issue in the DCL refers to the accounting for goodwill, including the use of amortisation and how to make the test more effective. EFRAG broadly agreed with the IASB that it is not possible to arrive with a new model that is fundamentally different from the current one. However, EFRAG cautions that overoptimism is not necessarily best addressed by auditors and regulators. Hence EFRAG proposed some enhancements to the model in relation to shielding and some new disclosures to address the issue of management over-optimism. One proposal in EFRAG's DCL is to review the current guidance of allocating goodwill to CGUs, reducing the shielding effect with a more granular allocation. For example, a rebuttable presumption that a CGU is lower than a segment could be considered. It also is suggested to limit the possibility to reallocate the goodwill unless there is evidence there is a change in the cash flow structure and aligning the impairment test with the expected benefits at acquisition.

To address overoptimism, input is sought on the disclosures for example i) compare realised cash flows with predicted cash flows, ii) assumptions used for the period for which cash flows are projected based on budgets, iii) current level of cash flows, margins or earnings.

EFRAG is seeking views from constituents on the reversal of goodwill as the absence of this may play a role in not impairing timely. The IASB proposal to present equity net of goodwill is not supported by EFRAG as this would create confusion about the nature of goodwill, i.e. is it an asset or not.

Chiara Del Prete explained that on the issue of whether goodwill should be amortised or not EFRAG has not exposed a view. Views in Europe have been so far split on this topic and there are conceptual arguments in both camps which can be found in the DCL. One of the conceptual points discussed in the EFRAG working groups was whether in goodwill components can be identified that have economically limited useful life and could therefore be amortised. If goodwill is to be amortised there should also be a link between when an entity is going to benefit and the amortisation period.

In simplifying the test EFRAG TEG was against the switch to an indicator only approach except in those situations where it is obvious there is an absence of impairment. This because in accordance with users the test provides information about the future value of the company. Also, it is feared the issue of too little too late can be aggravated with an indicator only approach. The improvements to the value in use test are supported. Further guidance is requested on including restructuring cash flows as these may be estimated too optimistic.

Finally, EFRAG agreed that subsuming more intangible assets in goodwill is not an appropriate way forward. EFRAG invited the IASB to look at the comparability between internally generated goodwill and external goodwill but not in this project. Although if convergence is a good aspiration, EFRAG's preliminary view is formed independently from the future FASB work. EFRAG asked more guidance on goodwill allocation to divested business and re-organisations.

This introduction was followed by a panel discussion with the following panellists:

- **Steve Cooper**, Independent analyst, author of The Footnotes Analyst

- **Sue Harding**, Co-Founder - Bailey Network, member of EFRAG User Panel

- **Marisa Mazo**, Senior portfolio manager at GVC Gaesco

- **Wouter Verlinden**, Fund manager at Value Square.

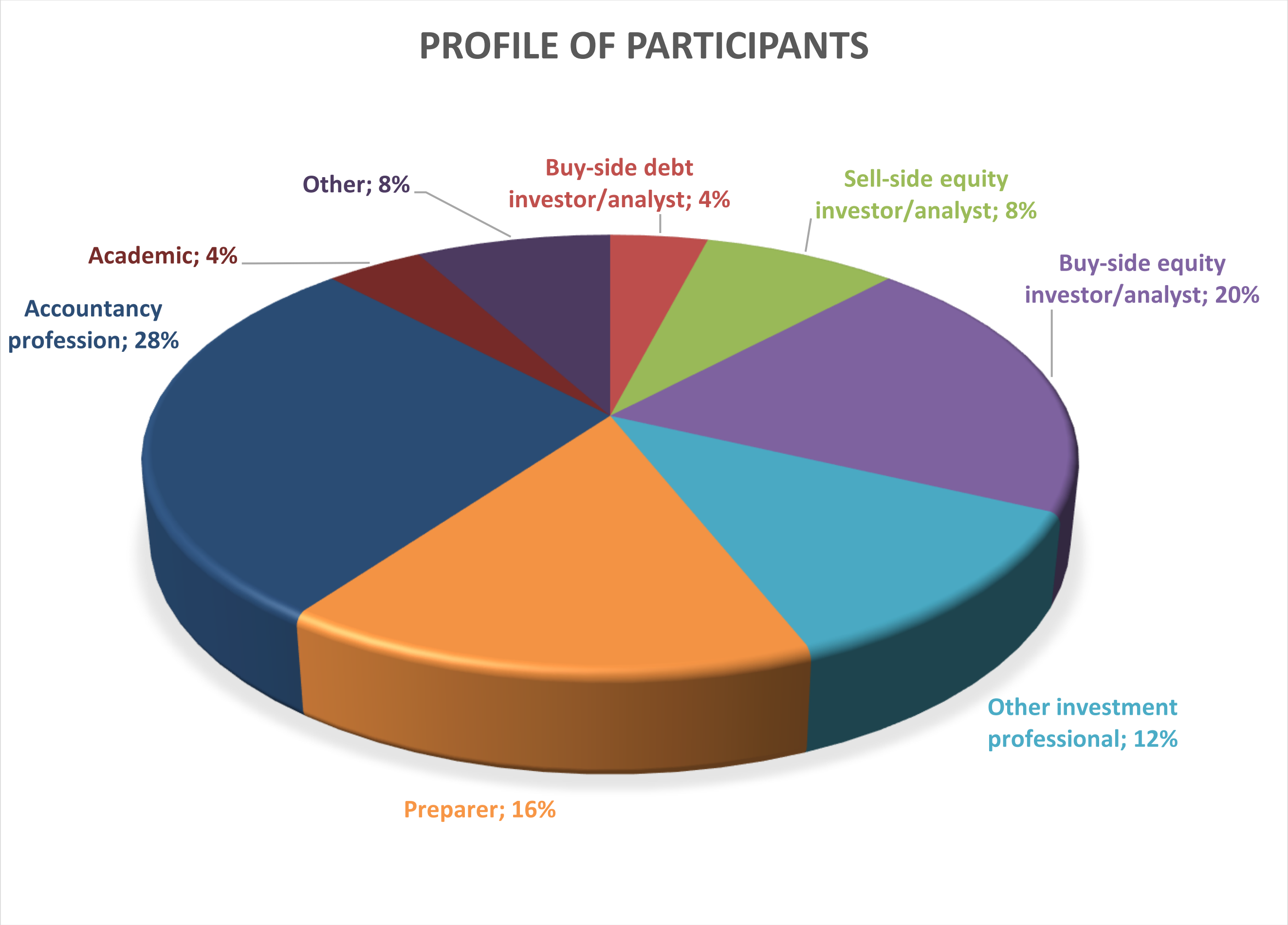
The panel was moderated by **Hans Buysse**, Chairman ABAF/BVFA, member EFFAS Executive Management Committee and EFRAG Board Vice-President.

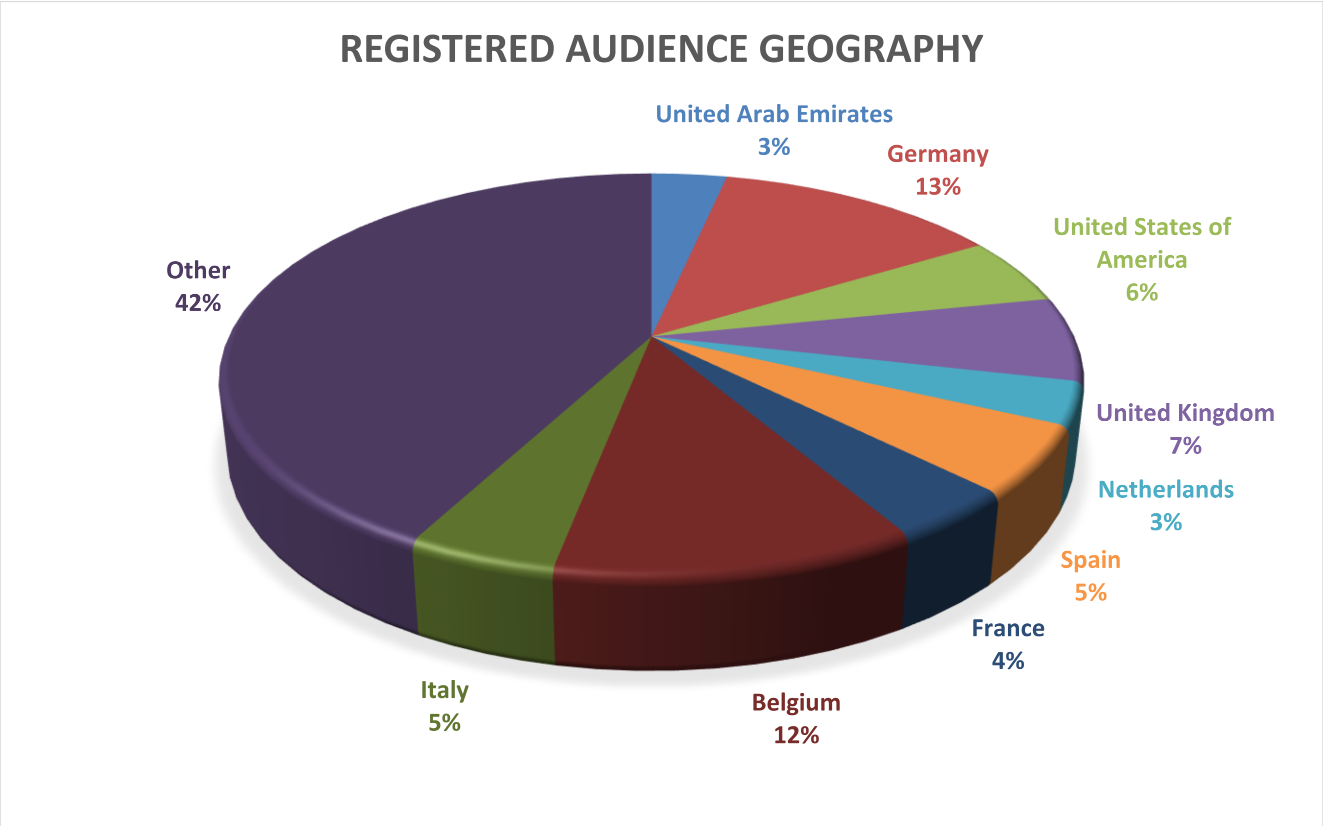
Serge Pattyn, member of EFFAS CFR (Commission on Financial Reporting) and of EFRAG User Panel summarised the feedback and presented his personal take-aways after the Round Table.

The biographies of speakers and panellists can be consulted here.

The detailed event programme is available - here, the slides for the presentation – here. The recording of the event can be consulted here.

The profile of the participants to the webinar and their geography are summarised below:

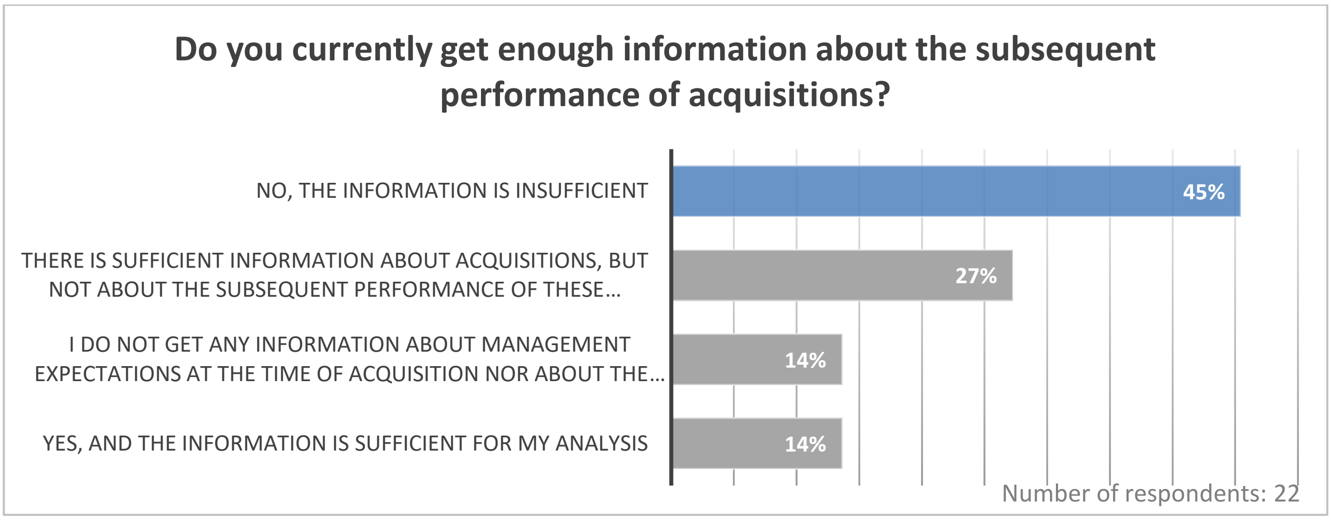




Panel discussion

1. Acquisition performance

Hans Buysse started the webinar with a polling question to audience and asked panel members how investors analyse acquisitions and use disclosures. What information they consider useful and what is missing?



Steve Cooper agreed with the IASB approach to analyse the acquisitions in two aspects: how the acquisition impacts the entity, its balance sheet and its cash flows and was an acquisition decision a right one. To assess an acquisition, investors have to update models, forecasts, cash flow projections, etc. To do this, in addition to financial statements, they also use other sources of information such as investor presentations and prospectus. In his opinion, it was important to provide the information about impact of acquisitions in financial statements, for example through the purchase price allocation and pro forma results disclosure which in turn could be improved.

He welcomed the new disclosures about synergies, noting that the IASB proposals go in the right direction. He further noted that it was more difficult to see if the acquisition was a good management decision as there is often little or no information about future performance. If the business acquired is reported as a separate segment, then the information can be found in disclosures, otherwise not.

He recognised the challenges if the acquired business is rapidly integrated with the existing business, noting that CODM approach is responding to it. He also found useful the EFRAG's proposal to go to the lower level than CODM. In his view, management commentary was a right place to provide the information about subsequent performance, but he acknowledged that the IASB cannot mandate what should be included in this document.

Sue Harding noted that on the one hand investors want acquisition accounting that fully reflects the value paid, on the other hand they are frustrated by acquisition accounting and systematically pick it apart. In large acquisitions there are comprehensive changes across the financial statements. Investors want to understand how the incremental changes will affect earnings, cash flows and balance sheet amounts. Normal accounting is disrupted by the purchase price accounting, including a step change in amounts for the acquisition. The needs of users break down in two areas: Firstly,assessing performance, i.e. understanding the past and forecasting the future and assessing operating performance that is reported after fair value adjustments. She noted that trend analysis is impacted by fair value adjustments that reduce the performance, such as inventory valuation increases and amortisation of new intangibles. That is why analysts want full information to adjust operational performance information and improve trend analysis. Secondly there is stewardship, where accountability for the full invested amount is important. Currently there is a gap in the disclosures, some of the information from the balance sheet and income statement impacts are presented but not all. Disaggregation is important and pro forma information can be important to look at trend analysis.

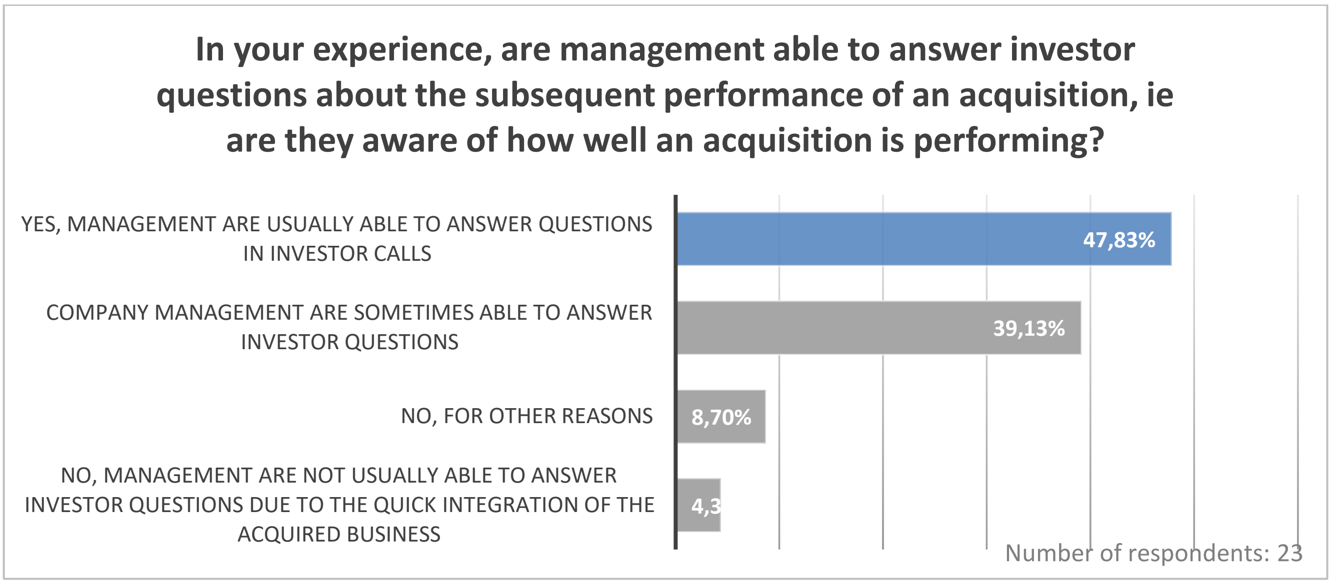
Hans Buysse presented two first polling questions. He further asked the panellists if, in their experience, management monitored whether acquisitions were successful and whether management have the information the investors needed?

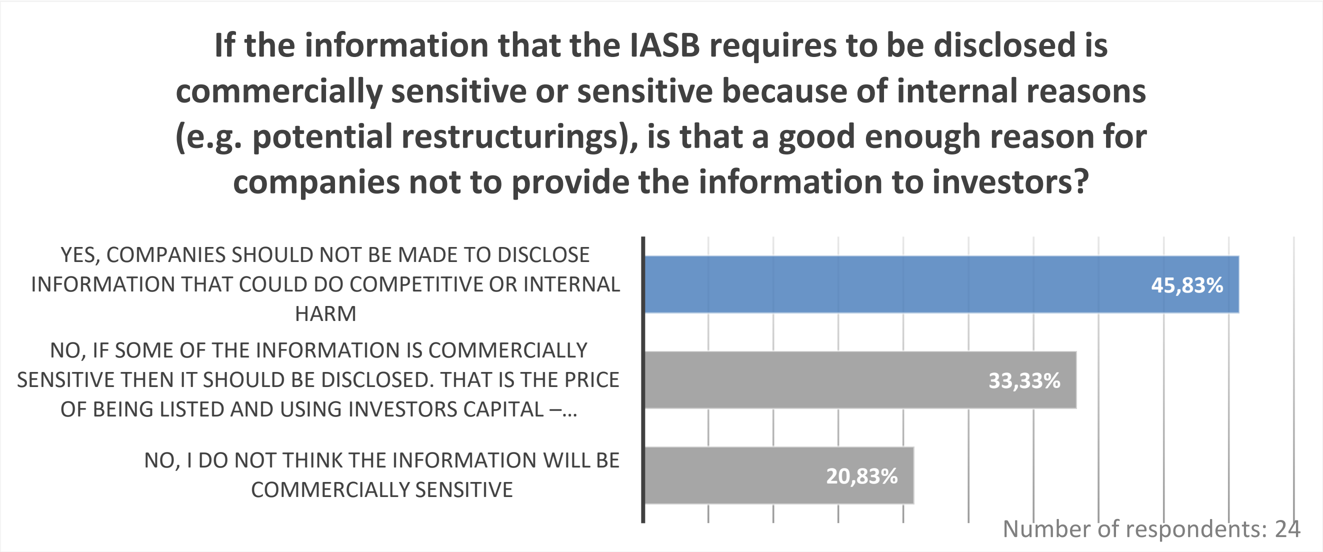
Wouter Verlinden noted that management often says that they monitor performance of acquisitions. He added that successful acquisitions often have good monitoring. Monitoring can mean different things. The situation of a conglomerate that is acquiring business that is sold after a few years is different from a buy and build strategy in an industrial company or a technology investor that does an acquisition for intellectual property reasons. Every acquisition requires a tailormade solution in monitoring. Having the information available for tailormade monitoring is determinative in assessing the quality of the management. Good management will have a few KPIs that match the criteria of the acquisition, a less performing management will only assess high level criteria. Most management teams have some monitoring in place of large acquisitions. Sharing of the information the management is using would not only provide information on how the acquisition is doing but also on the quality of the management.

Marisa Mazo noted in her view there were three different situations: i) large capitalisations vs small capitalisations, ii) regulated vs non-regulated entities and iii) very important acquisitions vs small acquisitions. In her experience larger regulated companies do monitor the acquisitions and have the information available. Another question is whether they share this information with the users. The information is included in investor presentations and not in the financial statements. Monitoring is done for one to two years depending on their aim.

Small capitalisations have less information available than large capitalisations and are reluctant to share the information. The situation here could be improved. Regulated entities produce excessive amounts of information, here the struggle is to find what is valuable information.

Hans Buysse presented the results of the next two polling questions.





Hans Buysse further asked the panellists how should the IASB balance concerns about commercial sensitivity and the needs of investor professionals?

Wouter Verlinden noted the main issue was the price for the acquisition and the valuation metrics being used. While the cash amount paid can be easily found, there is no information on leverage multiples, financing structure, debt and covenants used. Management is very reluctant to reveal the parameters used in the acquisition such as the EBITDA multiple, a discounted cash flow, growth rates in cash flows. In his view management may not wish to disclose those figures because the market may fear that the price paid is too high but that is the function of the market. It is a two-way communication between the market's assessment to what the management has done. However, in a buy and build strategy disclosing the numbers may have a negative impact on the price to be paid for a future acquisition. In general, he thinks that the benefit of the market being aware of the price is higher than the disadvantage that could exist for a specific company. Also, the use of public money is a cheaper way of financing, the opposite side of that being that some more information is to be publicly disclosed. In his view the values, metrics and growth rates in determining the values should be shared with the market.

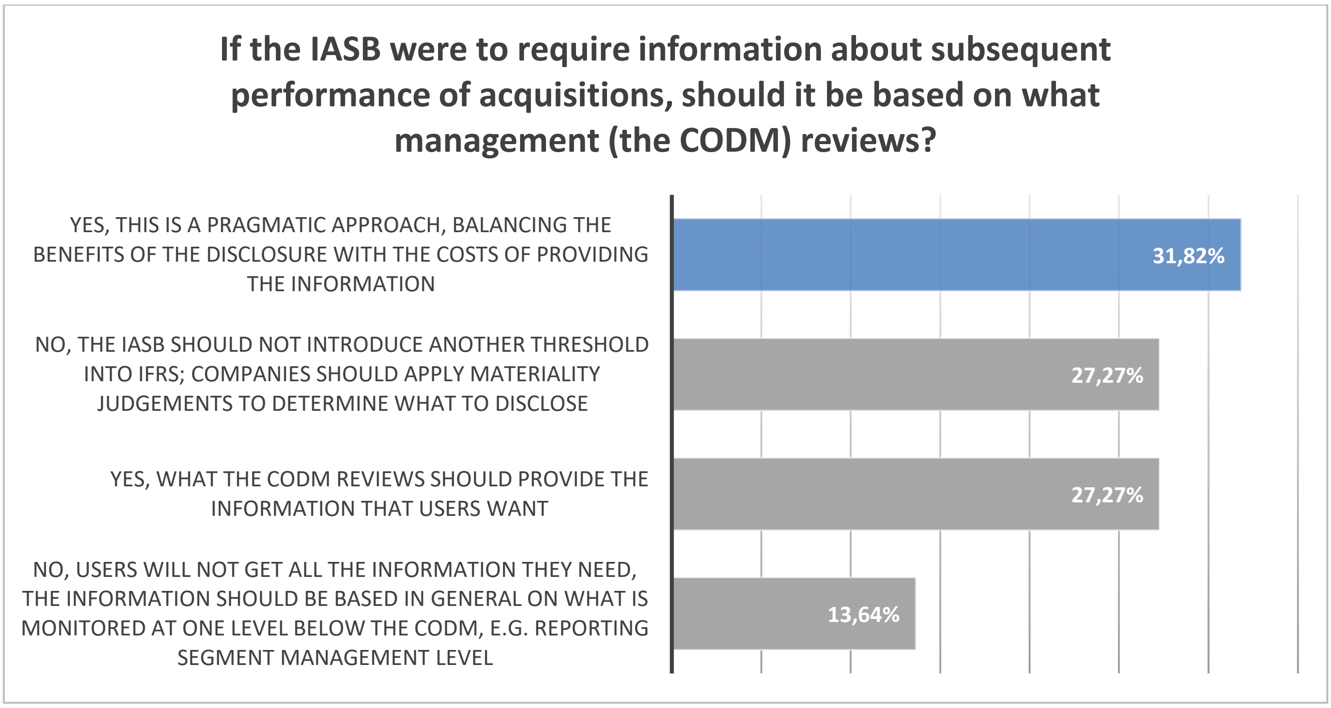
Sue Harding thought it has become increasingly normal to disclose strategy, business model, KPIs and targets. In her view the information asked for about acquisitions is not so commercially sensitive that it would be hurtful. The other disclosures around strategy can be taken as a lead on this, providing context. The overall price is important for accountability. Sometimes shareholders get a vote on the acquisition, the information that is allowing to make the decision is important. A comprehensive update on how the acquisition will change cash flows is very useful. Post-acquisition, it is in the context of the broader strategic goals that one can see whether the acquisition has paid off or not. Companies are able to find a way to share meaningful information with investors, information that is integrated into the overall picture of strategy and performance. Often commercially sensitive information is already known by the competition, so it is actually not that sensitive. She challenged that some information could be seen as commercially or internally sensitive.

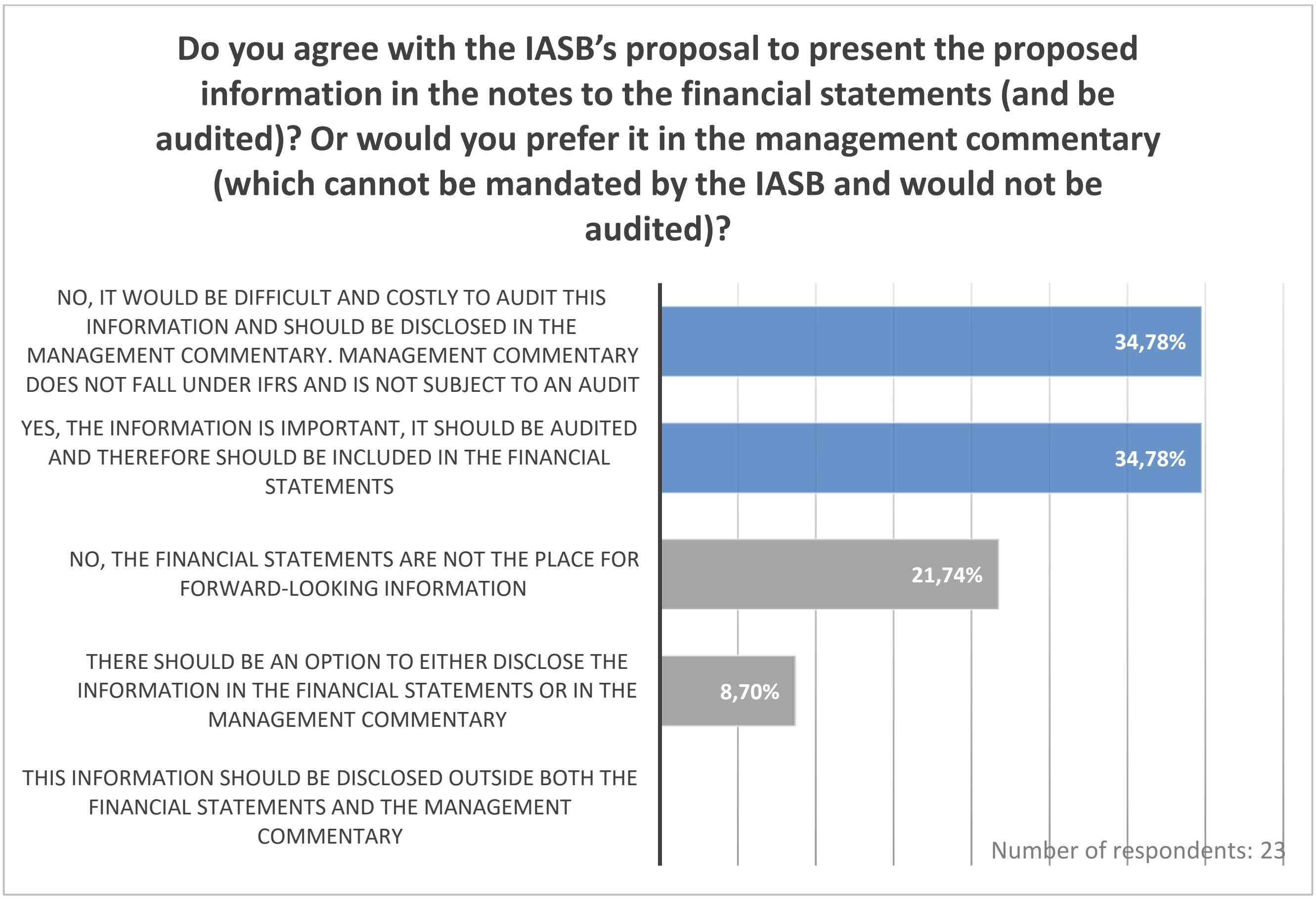
Hans Buysse asked whether such commercially sensitive information should be auditable.

Wouter Verlinden thought this would be very hard to audit because some of the data are based on normalised figures or on figures coming from the acquiree. Those figures are in the realm of management information not in the realm of audited figures.

Sue Harding would differentiate between disclosure of price paid and disclosure of more detailed information such as the normalised figures that were the basis for the price. It should be able to be solved without touching on information that is internal only, and on pricing, external parties will generally look to sector pricing norms.

Hans Buysse presented the responses to the following questions to the audience and asked **Nick Anderson** to comment on the responses.





Nick Anderson responded that investors are more interested in the economics of acquisitions and less in the accounting for goodwill, while accountants focus on the latter. This is the reason the IASB is looking at requiring information to be disclosed on performance following an acquisition. The IASB has heard users' request for more information on acquisitions the IASB cannot mandate the information that goes into a company's management commentary and the information is not always available there and so the only way for the IASB to respond to users' request is to require the provision of the information in financial statements.

***Question from the audience**: Regarding "information about subsequent performance". Does not this force the management to present earnings estimates (and other estimated KPI's) for the acquired company, or openly refer to how an acquisition performs compared to the estimates? Is it not easier and more useful to require the management to present estimates for the total group?"*

Nick Anderson noted that capital allocation is one of the most important things that management does. Before making an investment, investors need to have the opportunity to go back to the information provided on previous deals in order to assess whether it is a good company in allocating capital to M&A. Many of the IASB proposals are around providing a better answer to that question. Disclosing forward estimates of the whole group will not help with that. Rather it is about isolating information that helps to build a picture whether as an investor wants to give more capital to the management to deploy or not.

Steve Cooper pointed out that the DP is focusing on the acquisitions but there are many more strategic decisions that management is taking, for example not to sale, it does not mean that we should disclose the metrics of all these decisions.

2. Impairment, simplifications and potential improvements

Hans Buysse questioned if the panellists considered that there was a real problem with the current impairment requirements.

Marisa Mazo commented that for large capitalisation companies it was not a problem to perform a yearly test as they have enough resources to perform the test, while for small capitalisations it might be a problem as the costs may be higher than benefits they get from the impairment test. The prices on the market always come ahead of the management decision to make an impairment, either because of delay with presenting annual accounts or management unwillingness, but market anticipates it. Management often use bad years to make an impairment decision, for example now during the Covid pandemic, there are impairments which should have been done several years ago, but management took an opportunity to report them when everyone will be reporting bad results to start next year with a clean balance sheet. So, there is a problem with the timing of impairments.

Steve Cooper agreed with **Marisa Mazo** and added that there would always going to be a lag with impairment test, as financial statements look at the past. In his opinion, the fundamental problem was that this test was not testing goodwill even indirectly, instead it was testing carrying value of CGU and allocating any difference between its book value and recoverable amount to goodwill. In his opinion, if shielding effect is not dealt with, the impairment test is not testing goodwill at all. In his view it could not even be called a "goodwill impairment test" but renamed to "carrying value of CGU impairment test", as it is not testing goodwill, but just assuring that the balance sheet is not overstated. He further suggested to rename goodwill in "acquisition premium" to clearly describe its nature.

Hans Buysse noted that management over-optimism was often mentioned as one of the reasons for problems around impairment test and asked participants how they were coping with or adjusting to it in general and around impairment specifically?

Sue Harding responded that relevance of impairment was very hard to sell to investors and analysts as it is not a cash flow metric. Some say that assumptions and sensitivity analysis provided can be useful, but a lot of information already exists outside the financial statements at an overall entity level such as strategy, targeting, embedded growth assumptions, etc. Investors and analysts use their own views and assumptions, and she would be interested to know why auditors and regulators are not able to tackle management over-optimism.

Marisa Mazo explained that management is often acting as sales agent selling a product - their company - so over-optimism is inherent in such situations. The analysts have to use their judgement to evaluate how much of over-optimism could be included in the management projections. Outside of the financial accounts management provides some background of market estimates and other figures which analysts have to balance with the financial figures to see if they were realistic. The over-optimism, in her view, can delay the impairment and that is where auditors and regulators should take a responsibility to oblige management to use tougher forecasts and assumptions to avoid over-optimism.

Hans Buysse asked the panel if the indicator-only approach for impairment would improve the current situation.

Sue Harding questioned the conclusion that, if the impairment test cannot be improved, and is not providing relevant information and therefore is not used, that the solution might be to stop the annual impairment test. One of her colleagues advocates no impairment at all and to keep goodwill at its at acquisition value until the entity is sold or closes its doors. She would not agree with this approach as it would mean no r check on the over-valued assets. She would like to see further work on improving the test and how auditors and regulators can effectively challenge companies. The indicator-based system would at least provide some information about triggering events and management assessments which could help with over-optimistic assumptions. She would like to know if annual impairment testing on its own has led to significant impairment charges to help judge its effectiveness.

Steve Cooper was not in favour of moving to the indicator-only approach. Considering that usefulness of impairment test was questionable, the cost-savings could partially justify this move, but he would prefer to improve the existing impairment requirements. He considered that on balance it was a bad idea to move to the indicator-only approach as it would weaken the test. Following the Sue Harding's comment, he noted that he always liked the old UK approach of immediate write-off goodwill from the balance sheet. However, he suggested not to forget about goodwill entirely, but to keep it elsewhere, because impairment does not necessarily provide a signal for a bad acquisition. He further noted that due to the proposed changes, the value in use test and fair value would be brought closer to each other. He saw no need in keeping both of them, rather to choose one and apply that one consistently. He preferred the use of fair value as it would lead to more comparability and give management less room to manage results.

Wouter Verlinden agreed with **Steve Cooper** and considered that the goal of impairment test was to provide the information about how well management allocates capital in its acquisitions. In his view, the indicator-only approach could provide more incentives to management interpretation and could be more subjective. He considered that the quantitative test had more rigour and, therefore, was the best solution.

***Question from the audience**: "Often when companies change CEO, a goodwill impairment will follow. Does that not show that the impairment test is too subjective?"*

Wouter Verlinden commented that now with Covid crisis and in the situations such as the CEO or CFO change, the rule "when you clean-up a closet it is better to throw everything away" is often used by management. The liberty management can take with an impairment test means that the current rules are too loose. He recognised that the question was right and that there was a lot of playing around with the timing of recognition of impairment losses.

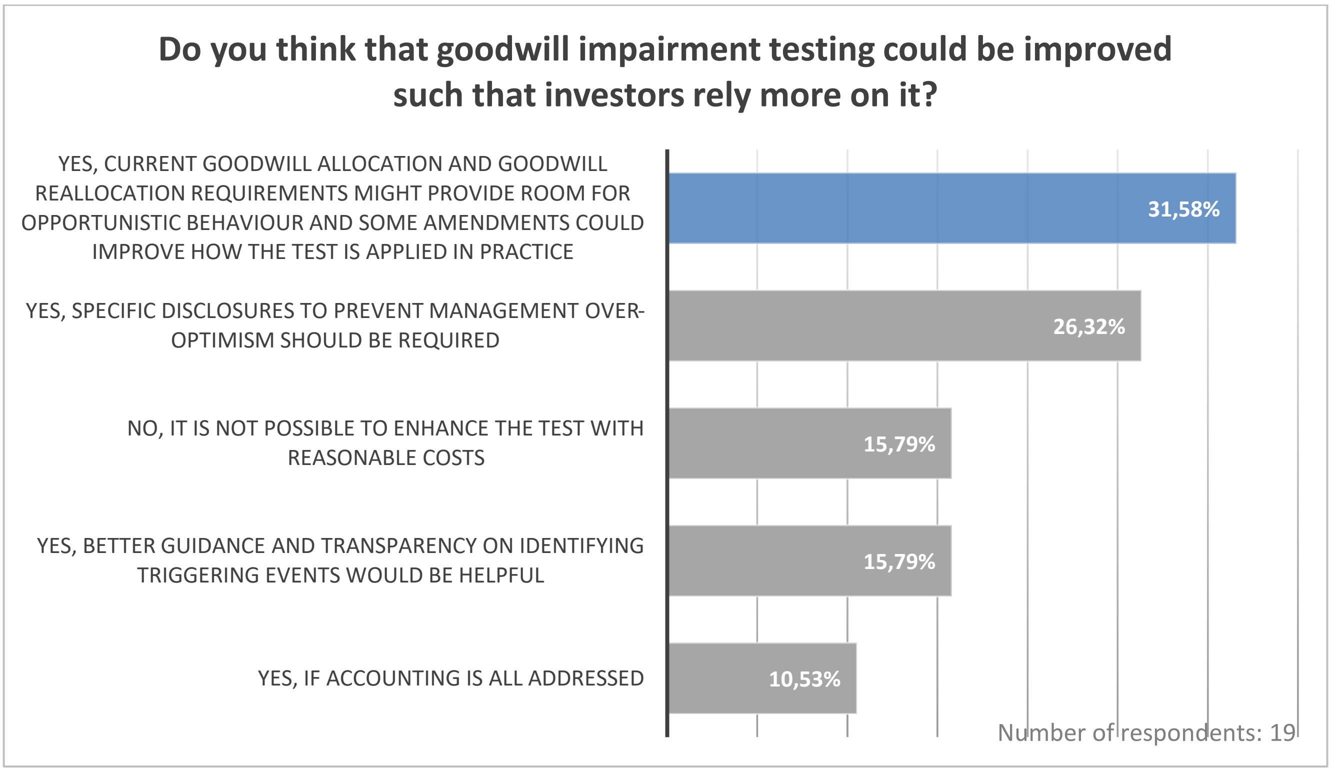
Chiara Del Prete argued that sometimes with the arrival of a new CEO comes a review of the strategy and approval of a new business plan which would, therefore, genuinely trigger an impairment.

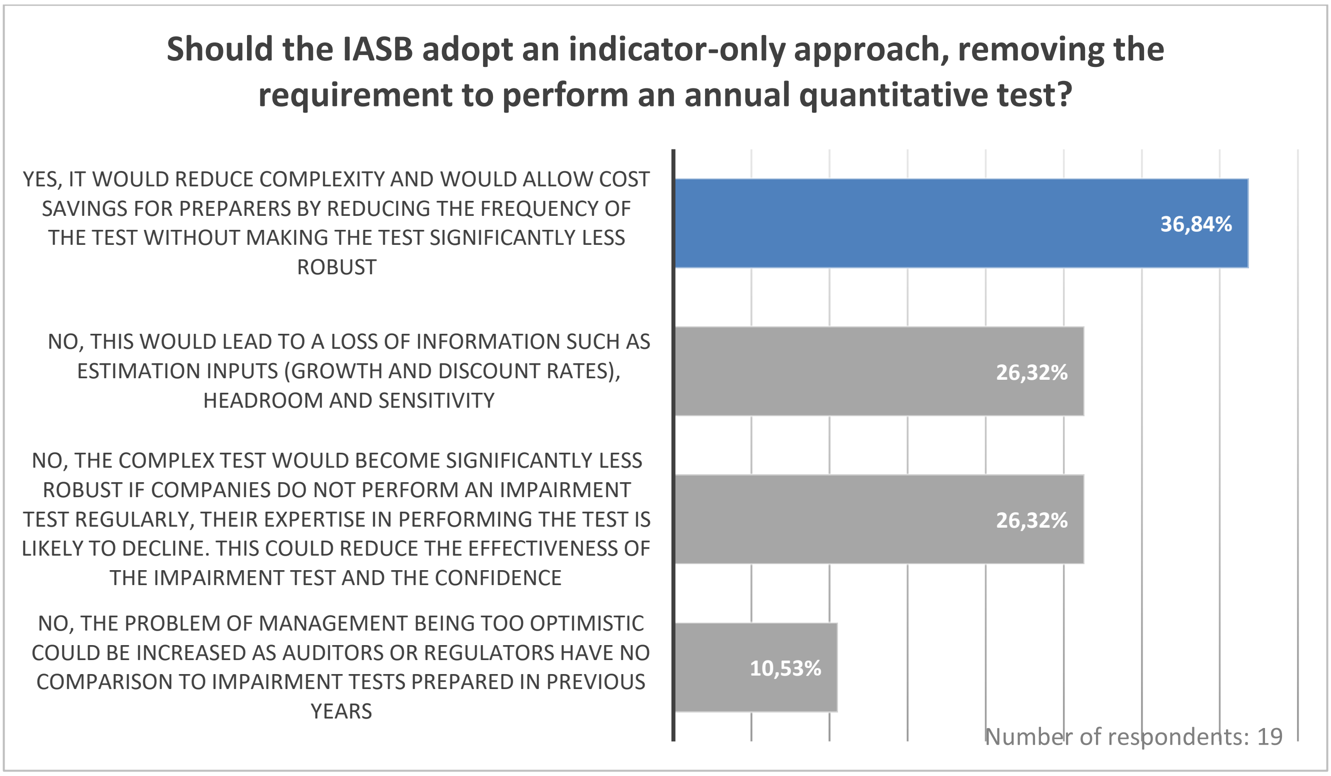
***Question from the audience:** "Would it make more sense for users if the level tested was a segment - with goodwill clearly allocated - so that users can check their own views about performance. CGUs never have enough visibility except for the notes around the impairment test. Too little too late and material inaccuracies would still be visible at the segment level in most cases."*

Marisa Mazo answered that it depends on the situation and particular acquisition. Sometimes in mergers it is difficult to use a segment approach when all the assets of both entities are combined. It could be more simple if a separate, for example foreign operation is acquired. To analyse the acquisition she, as an analyst, would ask for more information, to make her judgements, but acknowledged that it is not always possible to provide more information.

Nick Anderson added that many analysts used segments in their forecasts, but highlighted that in practice testing on a segment level rather than on an average CGUs would be at a higherlevel and would result in more shieldingThis would compound the 'too little, too late' problem instead of resolving it.

Hans Buysse introduced the results of the next two polling questions.





3. Goodwill amortisation

Hans Buysse introduced the following question to the panel: do all investors ignore goodwill and/or goodwill amortisation? Is the cost of the investment simply a sunk cost?

Marisa Mazo responded that investors do not take goodwill into account, for financial institutions goodwill is already deducted from CET1 and, therefore, ignored by the financial analysts. For other companies it is different, they might have to fulfil some requirements for issuance of debt or have some covenants regarding debt to equity relationships, however, analysts know it is not a cash flow item and the price paid for it. They do not care about goodwill amortisation, only if it is tax deductible, they use it to forecast taxes to pay.

Wouter Verlinden commented that in his opinion not all but most of investors ignored goodwill balances and it did not matter whether it was reflected on the balance sheet or in the level of share price. In general, most of the investors ignored amortisation as well. Normally, analysts expect that goodwill should be increasing over time, even if it is not reflected on the balance sheet but if one is willing to invest in a future cash flows of a company, the goodwill is ignored.

Steve Cooper noted the goodwill amortisation was ignored before and will be ignored after. He disagreed that the goodwill figure is ignored entirely, because it is capital invested and should be monitored. Although, in his view, the goodwill figure was not considered to be very useful by the investors, especially considering historical challenges and complications surrounding it.

Hans Buysse asked the panel how important for them was convergence with the FASB on this topic.

Steve Cooper replied that he was a supporter of global harmonisation of accounting but not in the case if FASB decides to introduce goodwill amortisation.

Wouter Verlinden responded that he did not have strong opinion on this topic as he was mainly working with the small cap companies.

Hans Buysse asked the panellists to provide a last message to the IASB or EFRAG.

Sue Harding supported the IASB work towards the ED and noted that there were gains for both investors and companies. For investors - gains in terms of the additional disclosures, aggregation and proforma information. Also better links to the non-financial information outside the financial statements could be made within financials. For companies - gains on clarity, simplifications and potentially indicator-only approach. So, if the proposals go through, they would benefit both parties.

Marisa Mazo pointed out that whichever decision is made it should be clear how much burden it brings for companies and what are the benefits. From the banking perspective she would write-off goodwill immediately, for the other companies it is less obvious, but she would also consider writing-off goodwill immediately against equity as it is now the case with badwill. Her message is – make things simple, many companies are reluctant to become public because of the reporting burden it involves. She also suggested that differentiating the requirements between small and large public companies could be a solution.

Steve Cooper welcomed the IASB proposals, especially on additional disclosures. He would like to see better purchase price allocation table, more details on goodwill, impairment test improved and shielding addressed. He suggested the IASB to have another look at headroom approach and if not, to drop a name of “goodwill impairment” because it did not reflect what the test was doing.

Wouter Verlinden welcomed the changes and the gradual move forward to the better accounting and reporting. He drawn the attention that in the European market the vast majority of the companies were small caps and often finance teams were very small, with only 3 or 4 people. Therefore, the rules for them should be simple or even separate set of rules could be envisaged, focusing more on strategic importance of an acquisition than on exact accounting treatment, on sufficient disclosure of strategic rationale and the fit for the company instead of accounting numbers.

Hans Buysse thanked the panel for the valuable remarks and gave a floor to **Serge Pattyn**.

Serge Pattyn summarised the discussion. He was not surprised to see that most respondents to polling question 2 did not receive enough information, not the right information or no information at all in relation to business combinations. This clarified why the user community welcomes this project.

He suggested the IASB to build the disclosures on the request of investors to have information about the impact of the acquisitions on profits and cash flows and whether the acquisitions create value or not. He agreed with Steve Cooper that more information on purchase price allocation was needed because it is often not clear how the purchase price is allocated or the information is at least often confusing. He suggested to go even further and consider e.g. the deal structure, contingent consideration, contingent liabilities, adjustments in the measurement period as – to give just one example – the "final" goodwill number may suddenly appear to be 20 or 25% higher than originally foreseen or announced. More information is therefore required in a transparent way.

Serge Pattyn also agreed with Sue Harding that information on whether the management is doing the right thing with the money of the shareholders is a crucial element to assess stewardship. From Wouter Verlinden he retained that companies generally follow up on their acquisitions. He agreed that the IASB could pay attention to the nature of the transaction as there is a difference between a conglomerate that is doing several acquisitions in order to sell them off later and a e.g. industrial company with a more outspoken buy and build strategy. Finally the difference between large and small caps, regulated or non-regulated entities could also play a role.

Panel members did not agree with the IASB's arguments against disclosing commercial sensitive information, the information is already in the market was the argument.

Serge Pattyn recalled the panel views on whether something is wrong with the impairment test. He recalled that Steve Cooper wanted a solution for the shielding aspect even if the IASB does not propose that now. To address over-optimism Sue Harding proposed to add a sensitivity analysis, but Serge Pattyn thought that could also be commercially sensitive to be disclosed.

Panel members found the indicator only approach as to see whether or not goodwill was impaired a bad idea. They were in favour of improving the test though. Strangely, this was aligned with the input from the public in the polling question, 37 % said yes however 26 % said no.

Finally, Serge Pattyn missed some conceptual thinking on goodwill. Goodwill can also go up as well as down. Many users ignore it, but then they shouldn't as it represents money invested on which the entity needs to earn a return. This relates also to the stewardship aspect that Sue Harding touched upon earlier on.

4. Closing of the event

Saskia Slomp thanked Serge, Hans for moderation, the audience and panellists for their participation. She noted that it was a fourth webinar on this topic and the next will be a Portuguese event on the 24 November, as well as the webinars with German and Italian Standard Setters. All of the events can be found on the EFRAG's website. She thanked the participants again and closed the meeting.