This paper provides the technical advice from EFRAG TEG to the EFRAG Board, following EFRAG TEG's public discussion. The paper does not represent the official views of EFRAG or any individual member of the EFRAG Board. This paper is made available to enable the public to follow the EFRAG's due process. Tentative decisions are reported in EFRAG Update. EFRAG positions as approved by the EFRAG Board are published as comment letters, discussion or position papers or in any other form considered appropriate in the circumstances.

Commercial sensitivity and placement Issues Paper

Objective of EFRAG Board paper

1 The purpose of this paper is to inform the EFRAG Board about the discussions of EFRAG TEG on:

(a) How to deal with the fact that preparers consider that many of the disclosures to be provided in accordance with the IASB's discussion paper *Business Combinations – Disclosures, Goodwill and Impairment* ('the DP') would be commercially sensitive (paragraphs 2 – 13).

(b) Whether the proposed disclosure (or part of it) would be better placed in the management commentary instead of in the financial statements (paragraphs 14 – 24).

Commercial sensitive information

2 During the consultation phase of EFRAG's draft comment letter ('the DCL') EFRAG has received input from preparers on the proposed new disclosure requirements. Preparers have generally noted that the proposed disclosure requirements would result in entities having to disclose commercially sensitive information[1]. While EFRAG User Panel members have not disagreed with this, they have noted that preparers could have a tendency to consider more information commercially sensitive, than what in reality is sensitive. It has thus been noted that competitors often know more about an entity than what the entity is disclosing in its financial statements. This is, for example, a result of employees changing jobs.

3 The information has been considered to be commercially sensitive as it, for example:

(a) Would require an entity to disclose the strategic rationale for an acquisition. This would provide competitors with information on the entity's strategy. Based on an interview, an entity with a limited number of players, would, for example, have had to disclose something similar to the following on the rationale for an acquisition:

We have acquired Entity X. For several years the industry has faced declining profitability. This is due to the fact that products are often made available illegally by private persons and this is currently difficult to prevent. However, we expected that within xx – yy years, because of legal changes and because of [other specific circumstances] this situation will change. We therefore take

advantage of the current situation under which we can buy smaller competing entities at a low price[2].

(b) Competitors that do not apply IFRS would have commercially sensitive information and would not need to disclose in a comparable situation. US and China were mentioned (in case these Chinese entities are not using IFRS) and large companies that are privately owned and not publicly listed.

(c) It would provide information on how much the entity is willing to pay for possible future targets. For example, an entity would base how much it would pay for a target based on the expected return on investment. This may be one of the metrics the CODM would monitor, however it was also mentioned that a lot of acquisitions are not monitored at all from a performance perspective (rather from an integration perspective) because of size or as a matter of policy. However, disclosing the figure would mean that possible future targets would know what price the entity would be willing to pay.

In this respect it was also discussed that to explain a transaction in detail and publish the purchase price and how it is financed in detail might prevent sellers to sell a business to a company that applies IFRS. Some sellers avoid that this is published and companies applying IFRS might have a disadvantage from doing so. It is noted this issue occurs already today, as other notes require disclosure by the seller of the consideration transferred yet the contract say that the price is not to be disclosed publicly. This is often addressed through aggregation or not disclosing based on materiality which implies there is a legal issue to be considered.

(d) It may be difficult to realise the benefits expected from an acquisition, if the entity would have to communicate about them. For example, if it would be clear from the information that cost synergies would be achieved by a layoff and employees/trade unions have not been informed/consulted on this before the information is provided in the financial statements. Another example is the possibility for increasing prices due to revenue synergies.

4 At its 3 December 2020, some EFRAG TEG members expressed the view that there are not so many sensitive situations that cannot be disclosed, and that many details about company acquisitions were public. One of these members indicated that avoiding disclosure requirements due to commercial sensitivity was a dangerous route.

5 Some EFRAG TEG members were in favour of the ‘comply or explain’ approach while others were in favour of the ‘comply or explain plus’ approach (which would require alternative information would the required information be commercial sensitive), although they noted, in some cases, that neither was their preferred approach.

6 Two EFRAG TEG members considered that a ‘comply or explain’ approach would be difficult as it is not clear what to comply with.

7 Two EFRAG TEG members were concern that, with the current requirements included in the DP, although entities would be required to present some information, some would not do so due to confidentiality issues.

8 One EFRAG TEG member indicated that he would prefer the IASB to reduce the disclosures, considering confidentiality.

9 Another EFRAG TEG member indicated that care should be taken not to lower the commercially sensitive information threshold.

[2] The entity stated to its investors that it had acquired Entity X to maintain its market share (which was not wrong – but at the same time not the complete rationale).

10 It was suggested that if EFRAG should address commercial sensitivity in its comment letter, it should do so by providing the IASB with ideas to consider rather than providing a position on how the issue should be solved. In this regard it is noted that EFRAG cannot consult on any position to be included in its comment letter to the IASB on this issue.

11 For the 16 December EFRAG TEG meeting, the EFRAG Secretariat suggested EFRAG TEG to include the following comment in the comment letter it would recommend for the EFRAG board on the ED (in the case EFRAG TEG thought the issue on commercial sensitivity should be addressed:

EFRAG assesses that the information required by the proposals could result in companies having to disclose information they would consider commercially sensitive (both internally and externally).

EFRAG notes that information might be considered commercially sensitive if it:

(a) Would require an entity to disclose "a secret strategy";
(b) Would provide information on how much the entity is willing to pay for possible future targets;
(c) Would result in difficulties in realising the benefits expected from an acquisition (for example, if it would be clear from the information that cost synergies would be achieved by a layoff and employees/trade unions have not been informed/consulted on this before the information is provided in the financial statements).

EFRAG notes that many current requirements, could have the same effect. For some companies, the profit margin appearing in the statement of financial performance could thus be commercially sensitive. EFRAG, however, also notes that entities seem to be most reluctant to provide commercially sensitive information that is forward looking and if disclosing the information is considered to provide a commercial disadvantage compared to entities preparing financial information under another set of requirements. If the proposed information is to be provided, a balance therefore needs to be struck. EFRAG thus disagree that commercial sensitivity could never be a reason to prevent disclosure of information that investors would find useful.

Accordingly suggests the IASB to address this issue. One approach could be a 'disclose or explain' approach under which an entity does not disclose specified information, if disclosing the information would seriously harm the entity's possibilities to achieve the expected objectives (or by other means result in a significant unfavourable position for the entity). This approach would be similar to the approach included in paragraph 92 of IAS 37 Provisions, Contingent Liabilities and Contingent Assets. Under a 'disclose or explain' approach, the IASB would have to consider how the approach should be applied when some information might be commercially sensitive while others might not to avoid that, for example, only the 'good' information is disclosed.

Another approach, the IASB could consider would be to require alternative information, if an entity would not provide the required disclosures, to allow users to make some assessment of the management's decisions to acquire a business. Such information could be:

(a) Clear information about the price (including non-cash transfers such as new shares in the acquirer issued to the vendor and assets injected by the acquirer into the new entity if the vendor retains a stake);

(b) Information about what has been bought (e.g. financial information relating to the acquired business – including information from the last audited balance sheet to the date of first consolidation by the new owner);

(c) Estimations (and supporting assumptions) of the stand-alone fair value of the acquired business as of the acquisition date.

It could, of course also be considered by the IASB to only require disclosure of information that would not be commercially sensitive (e.g. information like the information mentioned in the paragraph above).

12 With the paragraphs above, the EFRAG Secretariat also intended to capture the level playing field issue that could arise if entities that prepare financial statements

under IFRS would have to provide commercial sensitive information that competitors reporting under other requirements would not have to provide.

Question for the EFRAG Board

13 Does the EFRAG Board have any comments on the directions considered by EFRAG TEG (at the 17 December EFRAG Board meeting, the EFRAG Board will receive an oral update on futher developments in the position of EFRAG TEG)?

Placement of information

14 The disclosures proposed in the DP should be presented in the financial statements (including the notes). In its DCL EFRAG requested constituents input on whether the information should be presented in the financial statements or in the management commentary.

15 Academic research indicates that placement of information matters. It is not only because it is audited, it is that users take the information in the financial statements more into account. In addition, management commentary might not be audited or to a lower degree.

16 At the same time, feedback from users, including when discussing with the Intangibles User Panel about better information on intangibles, shows that users consider as equally informative the information presented in management commentary, investors' presentations and earnings' announcements.

17 When comparing the presentation in the notes with the presentation on the management commentary, one should consider that presentation in the management commentary is voluntary in nature, so it will not provide for a comparable solution to the existing users' need to receive information about the subsequent performance of an acquisition.

18 The proposed disclosures are partly non-financial in nature or forward-looking and they are including management perceptions. Such information might be considered crucial, as they are bound with a certain level of risk for both the entity and the users of the financial statements. Some potential audit issues were reported during the research related to such type of information. However, this is the information on which the management's decision to deploy financial resources is based and what the users request.

19 From the outreach activities performed by EFRAG it appears that there is a preference among preparers to place the information in the management commentary instead of the financial statements. However, it appears from a survey to preparers that it is particularly the information about synergies and the objectives of a business combination (particularly, the assessment of whether these have been met) that is considered to be better placed in the management commentary.

20 When EFRAG TEG discussed where the suggested disclosures should be reported at its 3 December 2020 meeting, some EFRAG TEG members considered that information related to the subsequent performance of an acquisition and forward-looking information should be included in the management commentary since it was conceptually more suitable.

21 One EFRAG TEG member noted that, if a cross-reference from the financial statements to the management commentary was included (similar to IFRS 7 B6), this information would also have to be audited.

22 Two EFRAG TEG members considered that the information should be included in the financial statements because, when information was spread over several places, it was less accessible to users.

23 As respondents to EFRAG's draft comment letter generally preferred that the information could be reported in the management commentary, the EFRAG Secretariat suggested the EFRAG TEG to consider including the following in its recommended comment letter:

> EFRAG notes that some consider some of the disclosures to be forward-looking and argue that the information would be better placed in the management commentary. EFRAG also understands that some consider that placing the information in the management commentary would reduce the risk of litigations based on the information. From a survey EFRAG has conducted, EFRAG understands that the concern is primarily related to the disclosures on the (specific) objectives of an acquisition and whether these objectives have been met and less related to the disclosures on the strategic rationale of a business combination. EFRAG also understands that at least some users of financial statements are indifferent about whether the information is placed in the financial statements or the management commentary.
>
> EFRAG acknowledges that the practice statement Management Commentary does not provide mandatory guidance. Accordingly, if the IASB included the guidance in the practice statement, the proposed disclosures might not be several entities. That could cause disadvantages/competition issues for jurisdictions in wich management commentary is mandatory.
>
> EFRAG accordingly suggests an approach similar to that used in IFRS 7 *Financial Instruments – Disclosures*. That is an entity can choose whether to present in the management commentary (if the entity would prepare a management commentary) or in the financial statements the information about the management's objective of an acquisition and the subsequent fulfilment of these objectives. If the information is places in the management commentary, reference to the information in the management commentary should be included in the financial statements.
>
> EFRAG acknowledges that there could be some auditing issues related to such an approach and considers that these should be discussed by the audit profession to find the best way to solve the issue.

Question for the EFRAG Board

24 Does the EFRAG Board have any comments on the directions considered by EFRAG TEG (at the 17 December EFRAG Board meeting, the EFRAG Board will receive an oral update on futher developments in the position of EFRAG TEG)?