BUSINESS COMBINATIONS: DISCLOSURES, GOODWILL AND IMPAIRMENT – PERSPECTIVES FROM PORTUGAL

SUMMARY REPORT

WEBINAR – 24 NOVEMBER 2020

EFRAG European Financial Reporting Advisory Group

Ordem dos Contabilistas Certificados

CNC Comissão de Normalização Contabilística

Ordem dos Revisores Oficiais de Contas

IFRS®

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Introduction

EFRAG, together with the Comissao de Normalizaçao Contabilistica (CNC-Portugal), the Ordem dos Revisores Oficiais de Contas (OROC), the Ordem dos Contabilistas Certificados (OCC) and the IASB® organised a joint online outreach event *Business Combinations: Disclosures, Goodwill and Impairment – Perspectives from Portugal*. This event addressed the IASB Discussion Paper *Business Combinations: Disclosures, Goodwill and Impairment* ('the DP') and EFRAG's preliminary views. This report has been prepared for the convenience of European constituents to summarise the event held online.

The panellists' and speakers' biographies can be found here. The detailed event programme is available - here, the slides for the presentation – here. The recording of the event can be consulted here.

Participants and panellists were welcomed by **Lucia Lima Rodrigues**, CNC-Portugal Vice-President. She mentioned that it was the second joint event with EFRAG and welcomed the IFRS Foundation which participated this year.

Lucia Lima Rodrigues introduced the panellists, the preparers of accounting information and the CNC-Portugal colleagues:

Maria de Fátima Santos,

Head of Global Financial Services, Sogrape;

Patricia Silva,

Head of Control, Consolidation and Incentives, NOS Comunicações, SA;

Pedro Coimbra,

CFO, Banco CTT;

Pedro Dias,

Chair CNC Portugal, Private Sector Accounting Standards Committee; and

Luisa Anacoreta,

CNC Portugal, Professor of Accounting at Católica Porto Business School.

She noted a record participation of around 300 people in this webinar and highlighted the importance of this topic which continues to raise concerns in accounting society.

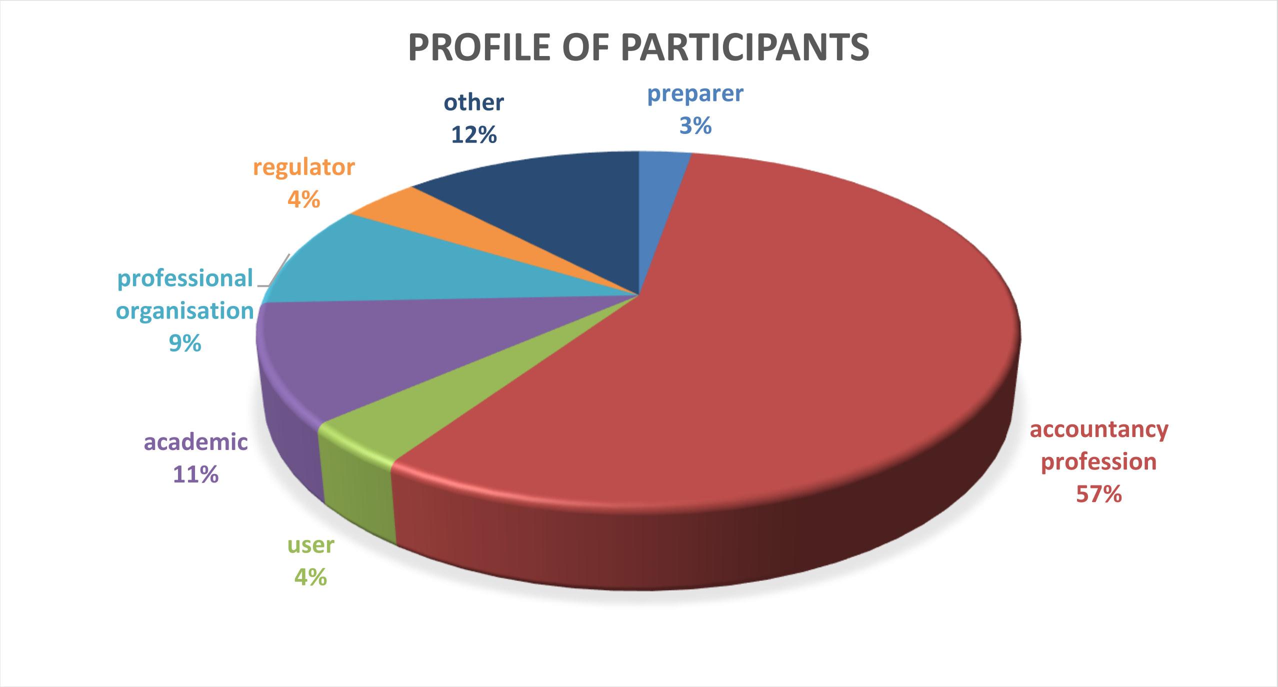
Zach Gast, IASB Board member, presented the IASB DP. He noted that investors were keen to receive better information to understand the subsequent performance of an acquisition. He highlighted the polarised views on subsequent accounting for goodwill, effectiveness and complexity of impairment test and timeliness of the recognition of impairment. He encouraged stakeholders to respond to the DP, the deadline for comments being the end of this year.

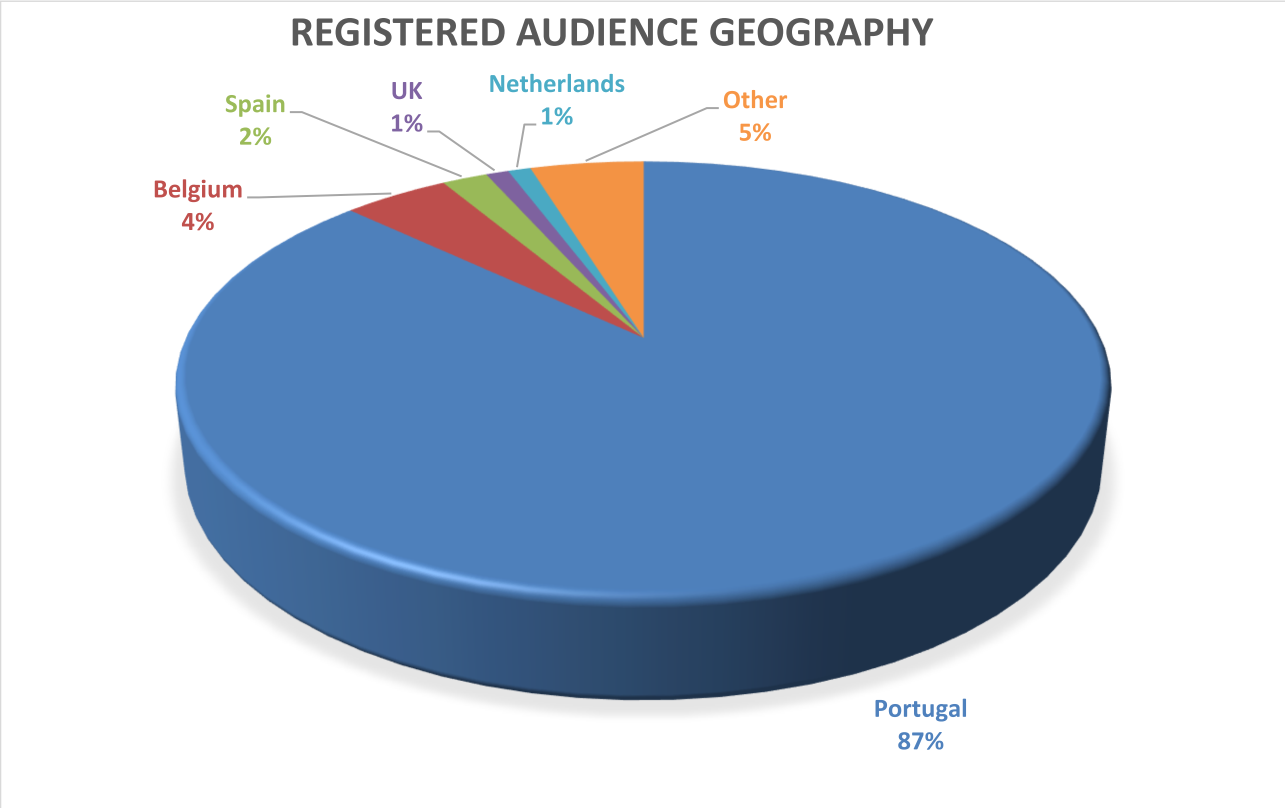
Zach Gast further noted that the objective of the project was broader than simply accounting for goodwill, it was about improving the information provided to the users of financial statements about the acquisitions at the reasonable cost. He continued that the IASB would like to hear from its stakeholders how useful and feasible the new disclosures were and if there were any new evidence or arguments on how the best account for goodwill. He further presented the IASB preliminary views on new disclosures, improving accounting for goodwill and proposed simplifications to impairment test.

Saskia Slomp, EFRAG CFO, on behalf of EFRAG welcomed participants of this Portuguese event. She noted that according to responses to the first polling question, main part of the audience had an accounting background and was very familiar with the topic.

She mentioned that the EFRAG DCL was published end of May and that the comment letters were expected by the end of November, which was one month earlier than the IASB deadline. This represented a challenge to get the comment letters but was needed to provide the informed response to the IASB. She presented various activities EFRAG was conducting on this project, such as field tests, interviews and surveys. She noted that in its DCL, EFRAG did not take a view on the major topic of reintroduction of amortisation and, therefore, was particularly interested to hear the views of participants.

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





1. Better disclosures about acquisitions

Presentations by speakers

Craig Smith, IASB Staff, presented the IASB proposals on improving the disclosure about subsequent performance of acquisitions by providing strategic rationale, key objectives and actual performance based on the management metrics and targets. The IASB concluded that no single metric would be suitable for every business combination and, therefore, explored a management approach. The IASB proposed to define management using the term Chief Operating Decision Maker ('the CODM') as this term was already defined in IFRS 8 *Operating Segments*. The IASB hope that using this term will result in companies disclosing the information about the most important acquisitions.

Craig Smith noted that the IASB was aware about preparers' concerns: for example, if the business was integrated, the IASB did not expect companies to create new disclosures but to disclose the information management already used internally. The DP included the discussion of other issues, such as commercially sensitivity of information, its verifiability and whether to include disclosure in Management Commentary or in financial statements. He explained that the IASB decided to put it as a disclosure requirement, as a guarantee that investors will get the information investors say they need.

He further presented targeted improvements to existing IFRS 3 *Business Combinations* disclosures.

Fredré Ferreira, EFRAG Senior Technical Manager, presented the EFRAG preliminary views on the IASB DP. She welcomed the IASB proposals for additional disclosures on business acquisitions, however, noted that these proposals would not solve the issues around accounting for goodwill. She explained that disclosures were focused on management objectives and were not necessarily tied to the goodwill book value in financial statements.

Fredré Ferreira expressed EFRAG's concerns that the level of the CODM might be too high and to consider information monitored at a level below CODM might be better to ensure that all significant information was covered. She further noted that EFRAG did not yet form a view on whether these disclosures should be better placed in Management Commentary or in financial statements. EFRAG also proposed a longer period to disclose if an entity stopped monitoring an acquisition (three years instead of two years, as proposed in the DP). EFRAG was also interested to get views from constituents on commercial sensitivity. Furthermore, operational aspects, costs, and legal constraints of the IASB proposals should be considered.

Discussion

Pedro Dias welcomed the guest speakers and asked the panellists if companies could, at a reasonable cost, provide more useful information about the acquisitions to investors.

Pedro Coimbra expressed the views of the banking sector. He agreed with the IASB that further information on acquisitions and on subsequent performance would be useful for investors. In his experience, material acquisitions had always been addressed by management with metrics and targets. In his view, there were merits for high level metrics for material acquisitions, and it was feasible to provide this information without unreasonable costs. He pointed out that success of the acquisition was not only limited to the goodwill discussion, as it would be oversimplified.

In his opinion, it was possible to provide subsequent information about the acquisition for no longer than 2-3 years, as after this period the objectives and target might often change. He expressed caution not to be too prescriptive on how the subsequent performance should be disclosed and suggested to give a flexibility to companies how to address investors community.

Patricia Silva agreed with **Pedro Coimbra** that it was possible to provide more useful information to investors on businesses acquired. She noted the need to think about the costs, complexity, and reliability of information to provide in subsequent periods. She expressed concern that if a business were integrated on a segment level it could be difficult to keep track of its success or failure.

Pedro Dias further asked the panellists how the transparency of the success or failure of an acquisition can be improved.

Pedro Coimbra stated that looking only at goodwill to evaluate the success of an acquisition would be too narrow and simplistic. There could be multitude of goals for an acquisition, such as the need for diversification, acquisitions of a talent or culture, etc. Therefore, there was a need to look at a company as a whole and goodwill might not the most important for understanding the reasons of an acquisition and its business evolution.

Pedro Dias asked the panel what was a practical way to proceed, considering confidentiality.

Fatima Santos stated that she understood the rationale behind the proposed requirements. She pointed out that IFRS Standards also apply for non-listed companies. These companies are small and do not have the same capacities as large companies. Sometimes an acquisition could be a first step for another acquisition and management have concerns to disclose the next steps to competitors, as they might lose a competitive advantage. Another concern could be acquisition-related restructuring plans and their impact on employees if disclosed before internally communicated and negotiated. Obtaining necessary information for disclosures may also increase costs for preparers.

Patricia Silva shared a point of view of a listed company which already provided a lot of information about acquisitions. She noted that management was very careful not to disclose commercially or internally sensitive information and, therefore, it might have negative impact on comparability between different companies.

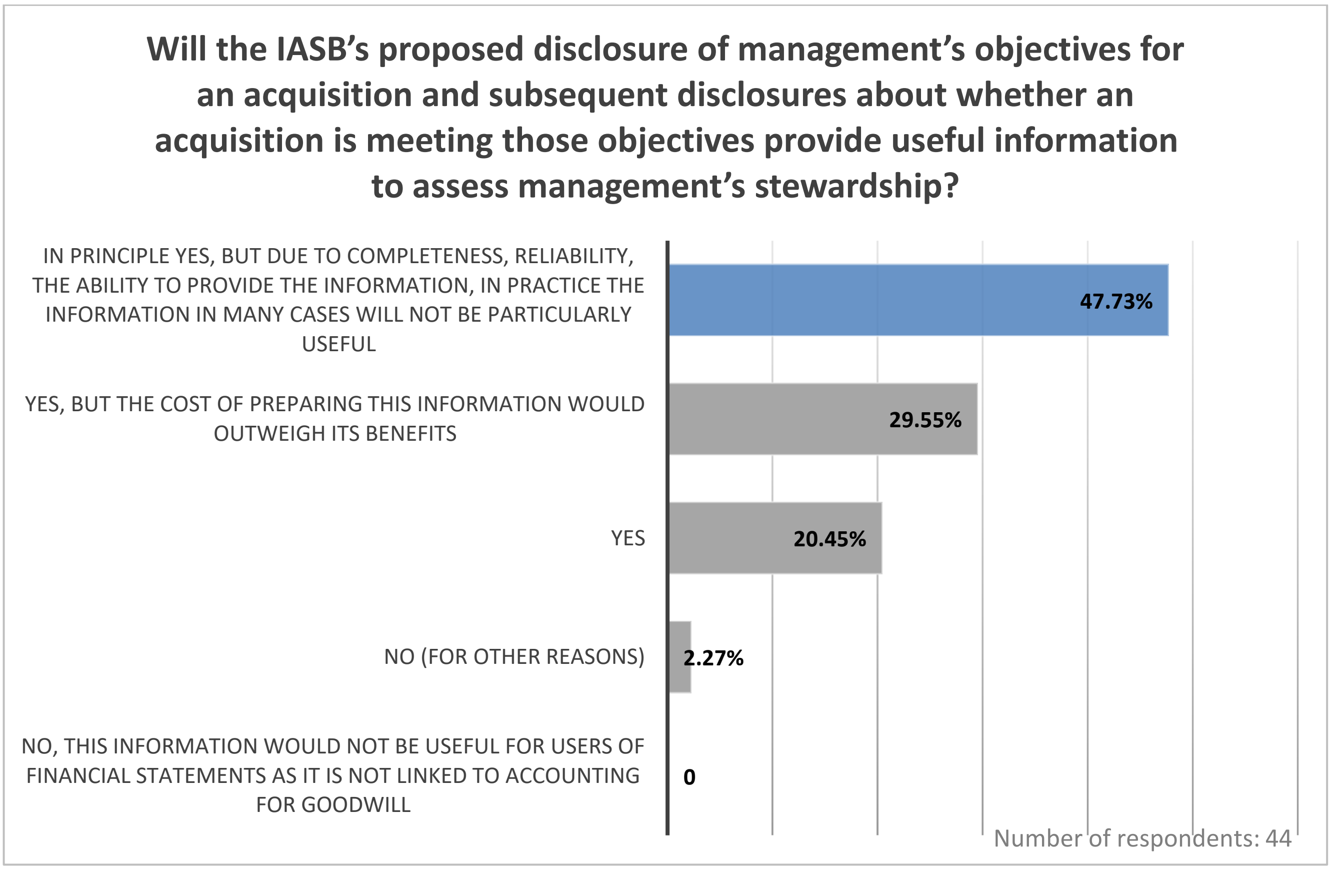
Pedro Dias further asked the views of panellists whether the information should be placed in the Management Commentary rather than the financial statements.

Patricia Silva responded that, in her view, it should be placed in the Management Commentary. The main indicators were in many cases not financial, such as market share, market growth, some operational indicators and even when financial indicators were provided, they were often not IFRS compliant and there was no link to financial statements or book value of goodwill. She considered that Management Commentary was better suited for this type of information, although she acknowledged the concerns that it was not obligatory.

Fatima Santos agreed with Patricia Silva. In her opinion non-GAAP metrics and the explanations about strategy, risk and acquisition performance should be provided in the Management Commentary. She acknowledged the arguments that this information had to be audited and verified, but the correct place for this information in her view was Management Commentary.

Pedro Coimbra agreed that Management Commentary was an appropriate place for this information.

Pedro Dias presented the audience responses to the second polling question and asked the panellists for their comments.

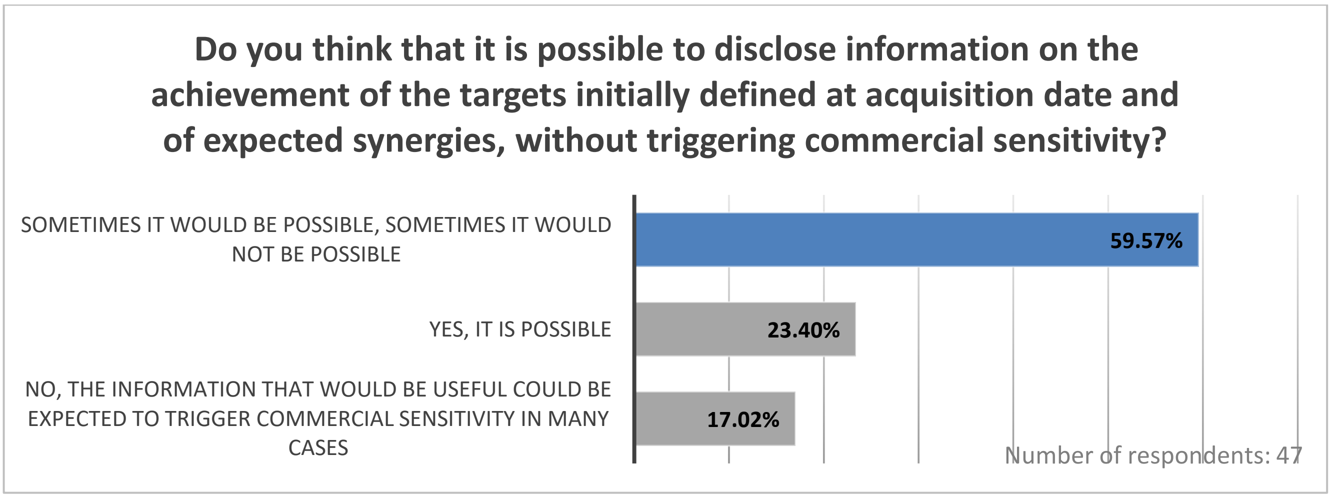


Pedro Coimbra noted an alignment between the panel and respondents.

Patricia Silva agreed with the need to provide more information but noted that it could be difficult in practice.

Fatima Santos confirmed that to provide this disclosure was easy in theory but a lot of concerns could arise in practice.

Pedro Dias presented the responses of the audience to the next polling question and asked for panellists' comments.

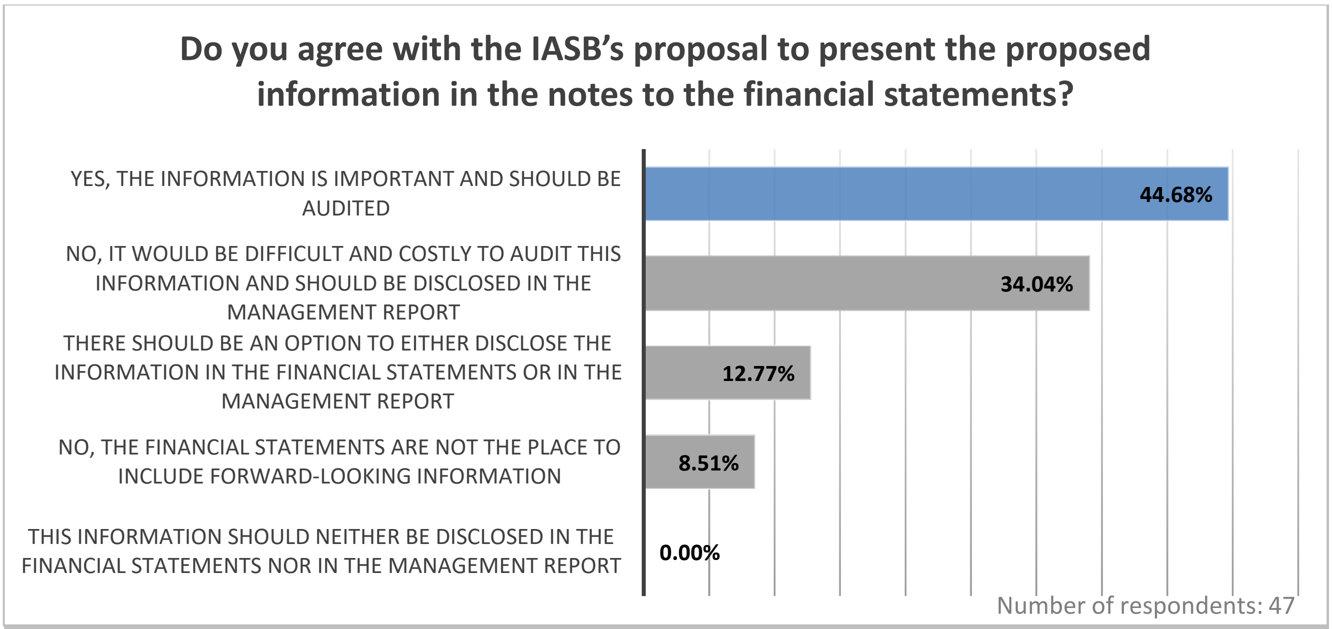


Pedro Coimbra agreed that there could be different circumstances, and some judgement had always to be made and it was up to the management to exercise it.

Fatima Santos agreed with a concern about the sensitivity of information. She noted that it was difficult to set rules for acquisitions, related disclosures and for information to prepare. Every acquisition was different, as every company was different, the users were also different and had different information needs. She confirmed that the audience response was aligned with her views.

Patricia Silva considered that the information was already prepared and easy to disclose but noted that sometimes management see the information not with an IFRS view and this might add additional complexity for disclosures.

Pedro Dias presented the results of the next polling question, noted that majority of the audience responded that information was important and should be audited and asked comments from the panel.



Fatima Santos explained that Management Commentary was the right place for this information because it provided strategic rationale, non-GAAP metrics and additional information to help investors understand the rationale for an acquisition. Not because this information should not be audited.

Patricia Silva agreed with **Fatima Santos**, that the information should be placed in Management Commentary. She explained that when an acquisition was announced, the information provided was not linked to financial statements and subsequent disclosures should be linked to this original information. She also acknowledged the importance to have this information audited and verified.

Pedro Coimbra commented that audience had a different perspective compared to the panel. He noted that this disclosure was not only GAAP numbers, and although he agreed the information should be audited, it reflects a too narrow view of an acquisition just to look at GAAP numbers.

Pedro Dias asked the following question from audience about pro-forma cash flows.

Question from the audience: *Pro-forma information on cash flows from operating activities would not be particularly useful according to EFRAG. This seems to miss the importance of CASH instead of (accounting driven) profit. E.g. pushing the revenues by "stuffing the channel" results in both higher revenues but also higher debtors. However, this is just shifting revenues which is missed if you do not disclose the cash flow.*

Fredré Ferreira explained that the disclosures of operating cash flows required by the IAS 7 *Statement of Cash Flows* would not change. In this context EFRAG considered the specific proposals of the IASB not particularly useful. The concerns raised in this question will therefore be addressed by the existing IAS 7 requirements.

Fatima Santos questioned how the cash flows could help investors in analysing the acquisition and noted that it was difficult to provide proforma cash flows. She acknowledged that sometimes cash flows were necessary in addition to profit or loss information but highlighted that it was very complicated to get them and had doubt on the cost-benefit relationship.

2. Accounting for goodwill

Presentations by speakers

Craig Smith introduced the IASB preliminary views on the subsequent accounting for goodwill. He noted the investors' concern that impairment losses were recognised too late. The IASB identified two possible reasons for this: cash flows being too optimistic and the shielding effect. The IASB's preliminary view was that management overoptimism was an implementation issue to be dealt with by regulators and auditors. On the shielding issue he pointed out that impairment test was not a direct test of goodwill which could only be tested with other assets, cash-generating unit ('CGU') or group of CGUs and briefly explained how shielding effect was created.

Craig Smith further presented the IASB's preliminary view to remove the requirement to perform an annual quantitative impairment test and instead to perform the test only when indicators of impairment exist (indicator-only approach). He noted the mixed views on the potential cost reduction as well as on the robustness of the test.

He further presented the simplifications to the test by removing some existing restrictions of how value-in-use was calculated, using post-tax cash flows and discount rates. He noted that during the post implementation review of IFRS 3 *Business Combinations* several stakeholders suggested the IASB consider reintroducing amortisation of goodwill. The IASB preliminary decided not to reintroduce amortisation as there was no compelling evidence that a change was needed.

Kathrin Schoene shared the IASB reservations on the possibilities to improve the impairment test, but suggested some collateral areas for improvement: enhancing guidance on goodwill allocations to CGUs on the lowest level possible, rebuttable presumption to allocate goodwill on one level below segment and enhancing guidance for reallocation of goodwill.

In addition, she explained that the EFRAG DCL included suggestions to address management overoptimism. To make the overoptimism more transparent EFRAG suggested to perform a kind of back-testing of previous metrics which would make the deviations more obvious or to better disclose assumptions in the detailed budgeting period like overall growth rate in that period or to disclose the current level of cash flows or earnings to allow users estimate future cash flows by themselves. The questions on the usefulness and practicability of these proposals were addressed to constituents. Another possible point for improvement would be to permit the reversal of impairment. It could remove the pressure from the impairment test by timely recognition of impairment losses.

Kathrin Schoene noted that EFRAG concurred with the IASB on potential cost savings from the indicator-only approach. However, EFRAG was concerned about the robustness of the test and potentially increased management overoptimism. The indicator-only approach could result in a lower reliance of users on the results of impairment test, that could accentuate the 'too little to late' issue and result in further loss of information on governance and management stewardship and, consequently, a loss of reliance on such test.

EFRAG welcomed other simplifications proposed by the IASB and was asking the views of constituents on some of these simplifications.

She continued that EFRAG had not yet formed a view on reintroduction of amortisation and was seeking the views of constituents. The questions to discuss were: the unit of account for goodwill and the related guidance in Conceptual Framework, whether goodwill or some parts of it were wasting in nature and could be amortised (component approach), a link between a period when synergies were expected to be realised with amortisation period of goodwill, and whether the information about the age of goodwill could be useful.

Kathrin Schoene further noted that conceptual arguments existed in both approaches and the views were divided. She suggested that if there were no solutions from a conceptual point of view the practical aspects might be considered.

Discussion

Pedro Dias noted that accounting for goodwill was a big issue, especially in Europe.

He asked the panellists if it was possible to make the existing impairment test more effective. Would improving the guidance on goodwill allocation and reallocation to CGUs help to address shielding? Is there a role for disclosure to mitigate the risk of management overoptimism?'

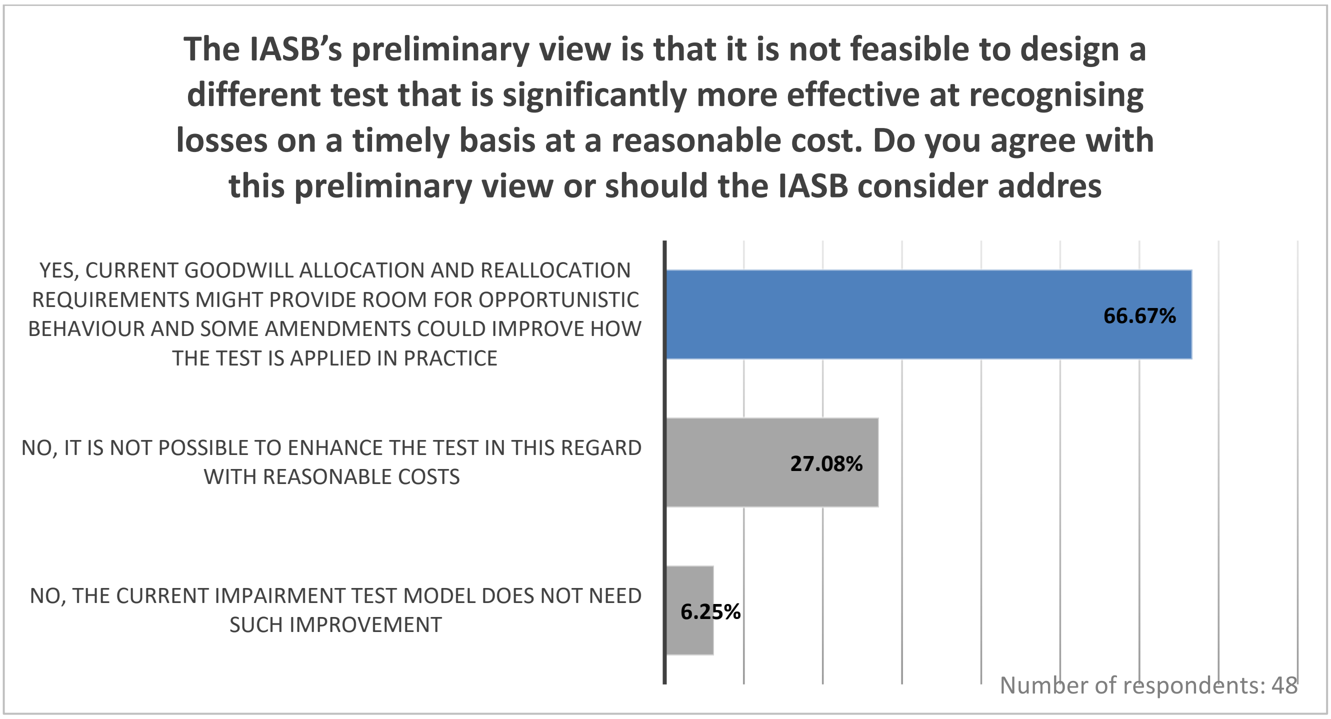
Fatima Santos agreed that it was not possible to make the impairment test more effective. However, she agreed that the test was not working well. She confirmed that the reasons were shielding and management overoptimism. She did not agree with the IASB that management overoptimism was best addressed by auditors and regulators, as this topic was already heavily discussed between auditors and management. She commented that companies created and used business plans as a management tool and not for impairment test. Business plan should be ambitious as it should serve as a target for management, and many external factors could affect the final result. She considered that back-testing of business plan could be very objective and simple and much more useful disclosure compared to the goals of an acquisition. She found the headroom approach proposed to combat the shielding effect overly complex. In addition, she would welcome more guidance on allocation of goodwill to CGUs as there was currently too much room for judgement.

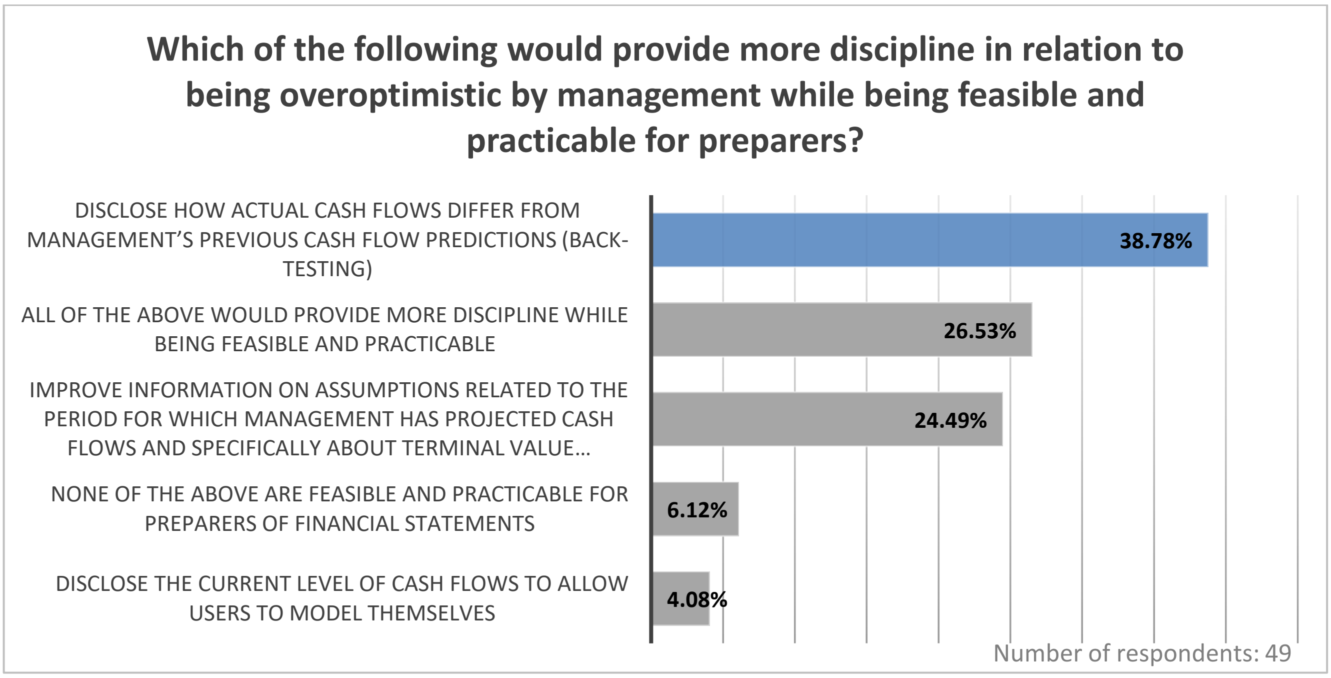
Patricia Silva agreed with the IASB that it was difficult to improve the impairment test without additional costs. However, she acknowledged the concern. However, she doubted whether more guidance on allocation of goodwill, or the comparison with previous projections would be useful. When reorganisations are made, the allocation of goodwill could be very complex, and it was often difficult to explain if goodwill resulted from the original acquisition or from integration of both businesses. She agreed that business plans and budgets were ambitious, and it was not easy to exclude these impacts from the projections for the impairment test.

Fatima Santos noted that there were always difficult discussions with auditors and regulators about business plans' assumptions and when comparing the business plans with actual results.

Pedro Coimbra agreed that it was impossible to make the test better at a reasonable cost. He considered that if we move forward in this area it would become even more costly and more judgemental. He suggested that if it was deemed impossible to tackle the shielding directly, the focus should be on whether the asset was recoverable or not. From his point of view, it was impossible to regulate and set standards on what overoptimism is. He noted that business plans in the banking sector represented management view and agreed with the IASB that it was up to regulators and auditors to decide if they were overoptimistic or not.

Pedro Dias presented the results of the next two questions and asked for comments:





Fatima Santos commented that responses were aligned with her views but pointed out that explanations for the results of the back-testing would be needed. Nevertheless, she considered it to be a simple and objective measure. She noted that there was room for judgement in goodwill allocation or reallocation and it could be possible to allocate it to the CGUs with large headroom, and noted that the response of the audience showed the same concern.

Pedro Coimbra added that although back-testing looked like a good proposal, more precision was needed, for example what cash flows to use: free cash flow or operating cash flow. At the same time being too prescriptive could be risky. He stated that goodwill was a long-term asset and the companies were being acquired for cash flows of multiple years, therefore, in the first year it was difficult to evaluate and back-testing would be judgemental.

Pedro Dias asked the panellists if goodwill should only be tested for impairment when there was an indication of impairment.

Pedro Coimbra was not in favour of changing the annual impairment test. He did not see much improvement with indicator-only approach which raised the question what indicators should be used: short or long term, foreseen or unforeseen factors. In his view it would be judgemental anyway. Annual quantitative testing was the way to defend such 'difficult' asset as goodwill. There were benefits of performing the test periodically as the changes could be followed, making the whole exercise more robust. Too little too late issue was also aligned with annual testing, if the test were not performed annually the chances to recognise impairment too late increased. He saw merits in innovating approach of componentisation of goodwill, appealing conceptually but stressed that it could be difficult to split in practice. To summarise, he would prefer to keep the annual quantitative impairment test.

Patricia Silva agreed with **Pedro Coimbra** that introducing indicators would bring another judgement, performing annual review of indicators could be as costly as performing the impairment test. She explained that her company would still perform a valuation for internal purposes. She added that if goodwill were not amortised and was often a material asset on the balance sheet, it would be better to perform quantitative impairment test annually.

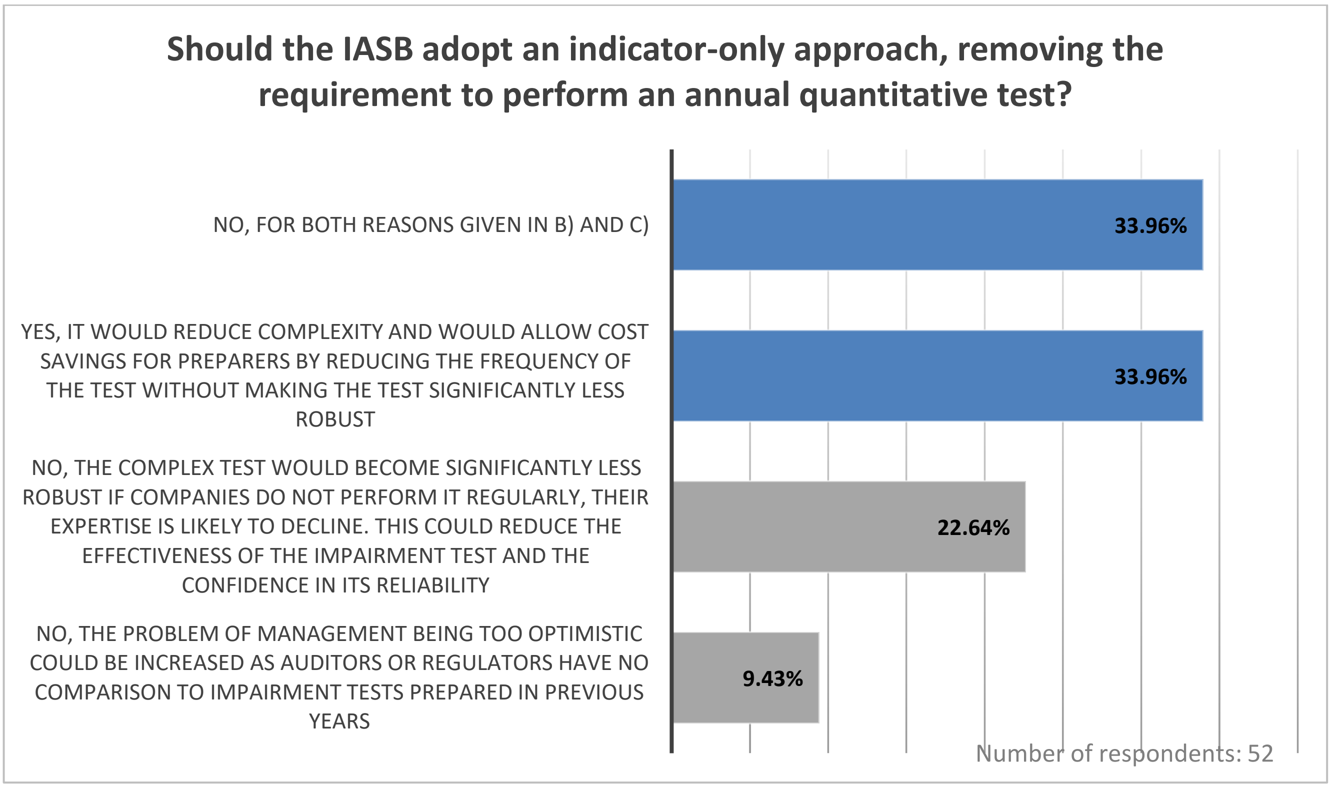
Pedro Dias further questioned the panellists if they considered the suggested simplifications in relation to the calculation of value in use useful.

Patricia Silva agreed with the IASB proposals and noted that the pre-tax rate was difficult to understand as it was not directly observable and did not provide useful information. She supported the IASB suggestions on including the future restructurings in the calculation of value-in-use, because it was the way how management sees the business. She highlighted that it was costly to differentiate two approaches (management approach for internal purposes and value in use calculation for impairment test) and therefore supported the proposed simplification.

Fatima Santos agreed with **Patricia Silva** and welcomed the IASB proposals. She stated that it was not feasible in practice to do pre-tax calculations as the main assumptions on discount rate were not pre-tax. She also supported the IASB proposals to include future restructurings in the cash flows for value in use calculation and highlighted the importance of alignment with cash flows used for internal purposes.

Pedro Coimbra agreed with the views expressed above.

Pedro Dias presented the results of the next two polling questions and asked the panellists to comment.



Pedro Coimbra confirmed his alignment with a majority of the audience and expressed the preparers' view that performing the impairment test annually was a benefit for investors.

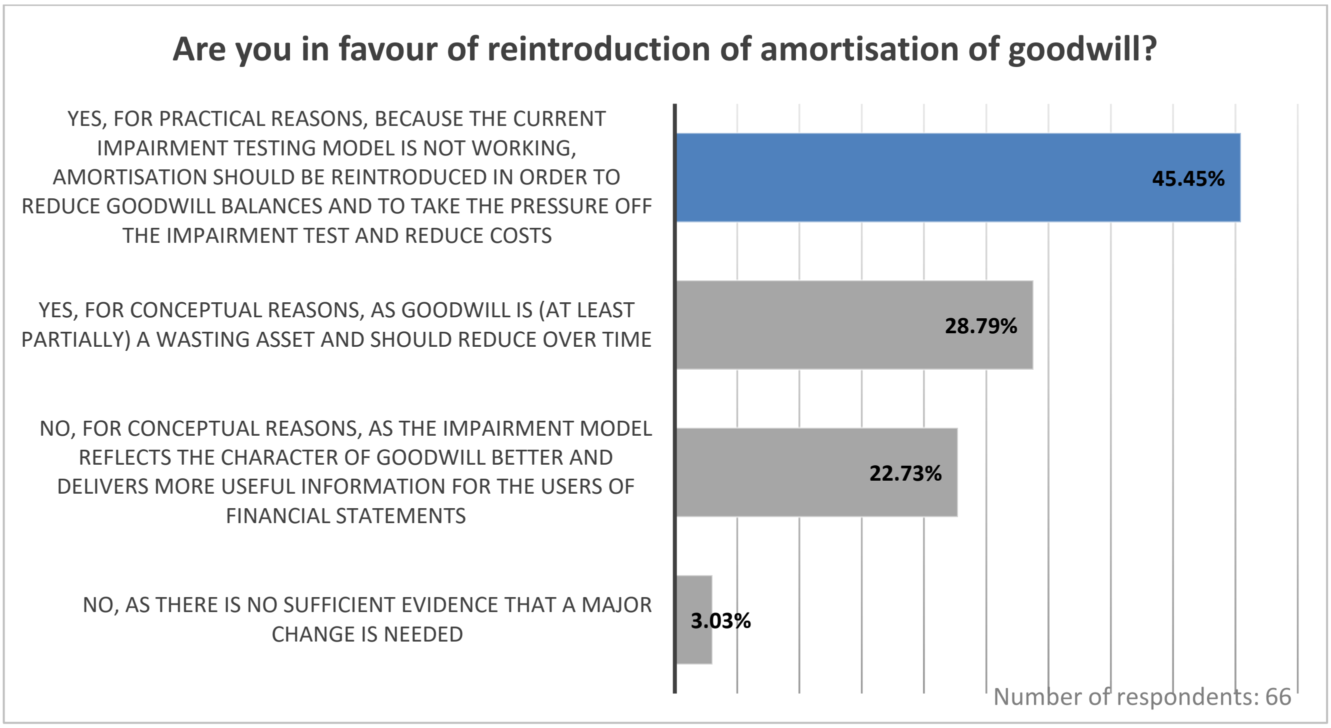
Pedro Dias asked the panel if there was new evidence or arguments that amortisation of goodwill should be reintroduced.

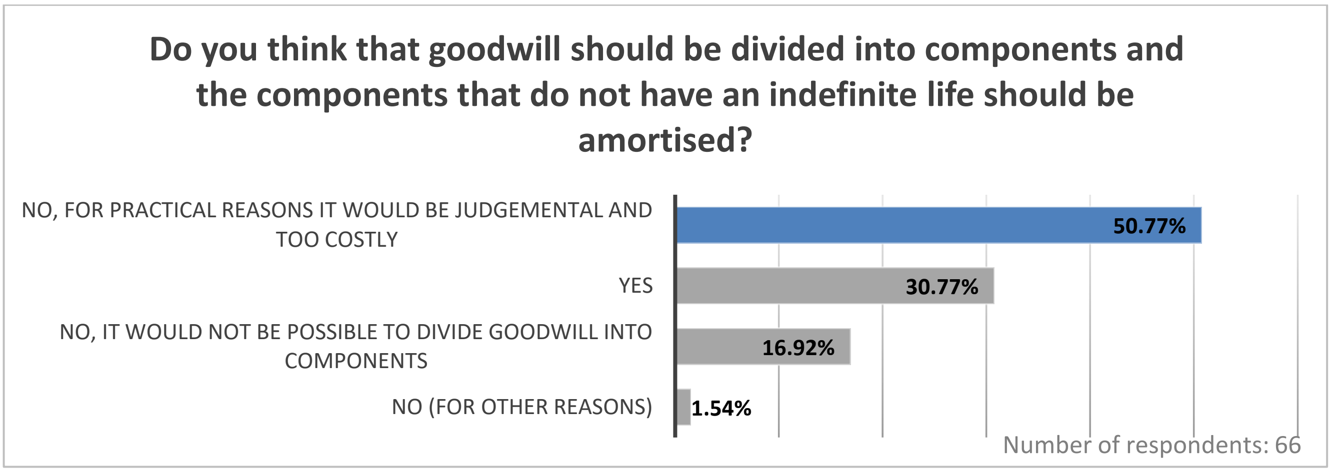
Pedro Coimbra responded that this discussion was going on for several years with the arguments on both sides and agreed that there was no compelling evidence to change the existing model. He highlighted that mergers and acquisitions activities were important worldwide and introducing amortisation would have negative impact on the profit or loss, which can also negatively impact the level playing field between IFRS and non-IFRS entities. If the amortisation would be reintroduced other questions would arise, such as over which period should goodwill be amortised, are all of its components wasting, etc. As a whole he did not see the compelling evidence to change the existing rules.

Fatima Santos added that her only strong argument in favour of amortisation was that the impairment test was not working, being highly complex and judgemental. She did not consider goodwill to be a wasting asset, but if synergies would be obtained at some point, they will be realised through profit or loss over time. From her point of view, it was better to focus the discussion on the useful life of goodwill.

Pedro Dias noted that looking back to the last 30 years we could see different cycles of goodwill accounting: amortising, impairment testing. This showed the importance of trying to understand what the nature of goodwill was.

He further presented the results of the polling questions and asked the panel to comment.





Patricia Silva acknowledged the temptation to amortise goodwill as an easy way to take it off the balance sheet but expressed concerns about the difficulties to determine its useful life. She was not sure if introducing the amortisation was the right decision and considered that an impairment test should be at least kept in parallel with the amortisation. She also noted that the accounting rules should not be changed regularly, highlighted the judgements about the useful life, and on balance preferred not to reintroduce amortisation.

Pedro Dias presented a question from the audience.

***Question from the audience**: How to include Covid-19 uncertainty in 3-5 years business plans?*

Patricia Silva stated that the impact of pandemic was very important and now business plans could only use the sensitivity analysis as it was difficult to predict how the situation would evolve.

Fatima Santos confirmed that it was very difficult to do the planning now, some of the businesses were very affected, for example restaurants, hotels, tourism channel. The main question was when the recovery should be expected and in which years the main impacts would be. This would require a lot of judgement and sensitivity analysis would be needed.

Pedro Coimbra noted that the planning was very important, in his bank the scenario analysis was conducted since July depending on different, mostly short term macro-economic scenarios.

Pedro Dias thanked all the panellists for their valuable contributions and gave word to **Luisa Anacoreta.**

3. Closing of the event

Luisa Anacoreta thanked EFRAG, the IASB, Portuguese organisers and participants and presented her takeaways of the event.

She noted that it was a very important event for the Portuguese community and the responses to polling questions showed the strong views on the need for objectiveness on goodwill accounting, by considering the costs of preparing and difficulties to get some of the information and on whether this information should be audited. She also reminded about the IASB project *Primary Financial Statements* dealing with management performance measures, where the discussion on the location of disclosure (Management Commentary versus financial statements) may become important.

Management overoptimism should not be an accounting issue in her view. Management must be optimistic and ambitious, and auditors and accountants should not demand management to be less optimistic as it is not their role.

She questioned why it was possible to reverse impairment loss on brands but not on goodwill. In her opinion, it could be one of the reasons of delay in recognition of impairment losses, because when you decide to impair, you need to be sure that this is an irrecoverable loss.

On goodwill amortisation **Luisa Anacoreta** noted that the reason to buy another business was to get future earnings, and companies only pay for goodwill because they believe that it will generate earnings. She suggested that some multiples calculated on acquisition could be used to determine useful life of goodwill. One example could be a price-earnings ratio that could be indicative for a useful life of goodwill.

Finally, she thanked the IASB, EFRAG, panellists and all the participants of the event for sharing their views on this important topic.

Paula Franco on behalf of Ordem dos Contabilistas Certificados (OCC) thanked the IASB, EFRAG, CNC and OROC, speakers and participants for organising this joint event and their very interesting inputs. OCC as a professional regulator always focuses its activities on the continuous accounting professional development. The financial report is a key piece of a big puzzle which we call economy and society. She further stated that OCC was always available for organising the events with multiple stakeholders and to have the sessions where the important topics were discussed.

Oscar Figueiredo on behalf of Portuguese Institute of Auditors thanked the IASB, EFRAG, CNC and OROC for organising this important initiative to discuss with Portuguese stakeholders and other interested parties the proposals of the IASB DP. He especially thanked the three panellists from different industry sectors who shared their views on the subject. He noted that accounting and reporting on business combinations, assessing fair value of goodwill and disclosing information about acquisitions and their subsequent performance had always been challenging as it involved a significant degree of judgement. He further welcomed the efforts of international standard setters and European organisations to make the reporting more transparent, bearing in mind that the costs of achieving it should not overcome the benefits. He noted that the discussion showed different technical views and management sensitivity to the topics discussed and expressed assurance that the final decisions would be in interest of the market participants.

He thanked again the presenters and panellists and closed the meeting.