

This paper has been prepared by the EFRAG Secretariat for discussion at a public meeting of EFRAG TEG. The paper forms part of an early stage of the development of a potential EFRAG position. Consequently, the paper does not represent the official views of EFRAG or any individual member of the EFRAG Board or EFRAG TEG. The paper is made available to enable the public to follow the discussions in the meeting. Tentative decisions are made in public and reported in the 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, materiality and placement Issues Paper**

### **Objective**

- 1 The purpose of this paper is to receive the directions 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 – 18).
  - (b) Whether the disclosures required in the DP should be based on what the chief operation decision maker ('the CODM') monitors, a lower level than the CODM or a general materiality threshold (paragraphs 19 – 25).
  - (c) Whether the proposed disclosure (or part of it) would be better placed in the management commentary instead of in the financial statements (paragraphs 26 – 33).

### **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<sup>1</sup>. 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 (see also the summary of the views of users on commercial sensitivity in Paper 04-02).
- 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

<sup>1</sup> A comprehensive summary of the input received is provided in Paper 04-02 and Paper 04-05.

advantage of the current situation under which we can buy smaller competing entities at a low price<sup>2</sup>.

- (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.
  - (d) In this respect it was 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.
  - (e) 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 This paper presents the following two proposals on how to deal with concerns of preparers and at the same time provide users with information on acquisitions:
- (a) A 'conditional comply or explain' approach (paragraphs 6 - 10); and
  - (b) A 'conditional comply or explain plus' approach (paragraphs 11 – 12).
- 5 The approaches would work on specifically identified requirements of the DP (see Paper 04-06) (e.g. the requirements to disclose the objective of a business combination, whether these objectives have been met and the expected synergies as of the acquisition date).

*Conditional comply or explain*

- 6 Under the conditional comply or explain approach, 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 (in case EFRAG TEG would also consider e.g. the reason stated in paragraph (c))). It is noted that this approach may lead to a situation that many disclosures are not made.
- 7 Under the conditional comply or explain approach an entity can thus not choose not to provide required disclosures unless a serious harm can be identified (the condition).

---

<sup>2</sup> 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).

- 8 A conditional comply or explain approach is currently applied in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. Paragraph 92 of IAS 37 states:

In extremely rare cases, disclosure of some or all of the information required [...] can be expected to prejudice seriously the position of the entity in a dispute with other parties on the subject matter of the provision, contingent liability or contingent asset. In such cases, an entity need not disclose the information, but shall disclose the general nature of the dispute, together with the fact that, and reason why, the information has not been disclosed.

- 9 In relation the proposed disclosures in the DP, the approach would mean that an entity would have to provide the reason why it would seriously harm the entity to disclose the information. The reason could be one of those explained in paragraph 3 above.

- 10 In relation to the application of a conditional comply or explain approach for specified disclosures of the DP, it would have to be considered that the disclosure of, for example, some objectives might be commercially sensitive, while the disclosure of other objectives might not. There could be several approaches for such a situation:

- (a) To require the objectives that would not be commercially sensitive to be disclosed while those that would be commercially sensitive would not be disclosed. Such an approach could, however, result in only “half of the story” being disclosed, or in extreme cases, an entity would disclose the good information only, but not e.g restructuring and price synergies. The information would accordingly not be (particularly) complete and hence a (particularly) faithful representation. Following an example presented in Paper 04-06, it could, for example, be that objectives about marketing expenses would be commercially sensitive, but information about sales would not. However, whether the entity would achieve an objective regarding sales would depend on how much it uses on marketing.
- (b) Not to disclose any information relating to a particular requirement if some of the information that would have to be disclosed would be commercially sensitive. Such an approach would avoid presenting only “half of the story” – but would also not result in helpful information.
- (c) The best approach would probably therefore be to require the information that would not be commercially sensitive to be disclosed and including a requirement for the entity to explain as much as possible related to the information that is not disclosed. In the example mentioned in (a) above, the entity should thus mention that it is also monitoring marketing expenses (and in subsequent years state whether these have been on the level as per the estimate as of the acquisition (or higher or lower)).

*Conditional comply or explain plus*

- 11 The ‘Conditional comply or explain plus’ approach would be based on the ‘Conditional comply or explain’ approach explained in paragraphs 6 - 10. However, in case an entity would not comply with the requirements, alternative disclosures would have to be provided to provide users of financial statements with some useful information that would allow them to make some assessment of for example the management’s stewardship.

- 12 Such information could be:

- (a) Financial information relating to the acquired business (such information may not always be available to the user) that would allow users to estimate the standalone fair value of the acquired business. The users could thus make own estimates on the premium the entity has paid.

- (b) Estimations (and supporting assumptions) of the stand-alone fair value of the acquired business as of the acquisition date. Similar to the information about this could make the user able to estimate the premium the entity has paid.

**Questions for EFRAG TEG**

- 13 Does EFRAG TEG have comments on the above proposals?
- 14 Does EFRAG TEG has other suggestions on how commercially sensitivity could be considered than the suggestions listed above?
- 15 Which approach would EFRAG TEG find most beneficial (the conditional comply or explain approach, the conditional comply or explain plus approach, or any other approach following from the discussion included in paragraph 13)?
- 16 If EFRAG TEG prefers a conditional comply or explain approach, which of the approaches mentioned in paragraph 10 would EFRAG TEG prefer?
- 17 If EFRAG TEG prefers a conditional comply or explain plus approach, what additional information should be required?
- 18 The EFRAG Secretariat notes that EFRAG has not consulted constituents on any of the approaches. Would EFRAG TEG consider that any position presented on how to take commercially sensitivity into account should be presented as an EFRAG position or more as an idea the IASB could consider in its further work?

**Disclosures based on CODM-level**

- 19 The DP proposes that an entity should provide disclosures on the chief operating decision maker's ("the CODM's) objectives for an acquisition as at the acquisition date. Subsequently an entity should provide information about whether it is meeting those objectives and the information should be based on how the chief operating decision maker monitors and measures whether the acquisition is meeting its objectives. If the chief operating decision maker does not monitor an acquisition, the entity should be required to disclose that fact and explain why it does not do so. If the chief operating decision maker stops monitoring whether the objectives of an acquisition are being met before two years after the acquisition, the entity should be required to disclose that fact and the reasons why it has stopped the monitoring.
- 20 In its DCL, EFRAG stated that "if the information is to be provided, it should be based on what is available at a lower level than the CODM". Accordingly, where applicable, the information to be provided could be based on the information the segment management reviews or it could be required to provide the information that is used to monitor the acquisition at the level in the organisation that managerially monitors the acquisition, such as the chief decision maker in charge of monitoring the profit or loss of the specific CGU.
- 21 In its DCL EFRAG "acknowledges that there are advantages of referring to the information used by the chief operating decision maker, as this term is already defined in IFRS 8 Operating Segments. However, EFRAG considers that it should also be possible to define a lower level on which the disclosures on the success (or failure) of acquisitions should be based."
- 22 During Outreach EFRAG received mixed views on the requirement to be one level below CODM. Some participants in particular mentioned that material acquisitions would be in any case monitored at CODM level and asking to go one level below might be either not relevant or not able to capture the right level of materiality. They suggested that the information should be based on what the CODM monitors or based on a general materiality concept. Other shared EFRAG's concerns and suggestion.

- 23 Therefore, a proposal could be that if an acquisition is material, information about it should be provided based on the information used to monitor the acquisition internally by the relevant decision maker. The relevant decision maker may correspond to the CODM or to a lower level, depending on the entity's strategy and organization.
- 24 In case the company undertakes many small acquisitions (as part of an overall strategy) which are monitored together and are material for the assessment of stewardship these should be included in the scope of the proposals.

**Questions for EFRAG TEG**

- 25 Does EFRAG TEG have comments on the above preliminary proposal (which could be amended following the views expressed in the comment letters to EFRAG, which would be considered at a later EFRAG TEG meeting)?

**Placement of information**

- 26 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.
- 27 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.
- 28 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.
- 29 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.
- 30 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.
- 31 From Paper 04-02 it appears that there is a preference among preparers to place the information in the management commentary instead of the financial statements. However, as it appears from EFRAG's survey to preparers (Paper 04-05) 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.
- 32 To ensure that the information is provided by preparers of financial statements and that those of them that have to prepare a meaningful management commentary do not duplicate the information a cross-reference similar to the one in IFRS 7 B6 could be incorporated in the requirements.

**Questions for EFRAG TEG**

33 Based on the input collect so far, does EFRAG TEG consider that:

- (a) some of the proposed disclosures would be better placed in the management commentary than in the notes to the financial statements or
- (b) that to ensure that the information is provided to request to present it in the notes (with a potential cross reference comparable to IFRS 7 B6)?