CHANGES TO ACCOUNTING FOR BUSINESS COMBINATIONS—DISCLOSURES, GOODWILL AND IMPAIRMENT

Reflections from Norway

9 NOVEMBER 2020

EFRAG
European Financial Reporting Advisory Group

Norsk RegnskapsStiftelse

NORSKE FINANSANALYTIKERES FORENING

IFRS

OVERVIEW

- ❖ Project background and overview
- ❖ Improving disclosures about business combinations
- ❖ Improving impairment testing
- ❖ Goodwill: its nature and componentisation

Project background & overview

Before we start

Housekeeping

The views expressed are those of the presenters, not necessarily those of the International Accounting Standard Board (Board) or the IFRS Foundation.

The Discussion Paper is available for download on the Goodwill and Impairment project webpage at www.ifrs.org/projects/work-plan/goodwill-and-impairment/.

The Discussion Paper

Objective

To improve the information companies provide to investors, at a reasonable cost, about the acquisitions those companies make

Timeline

2004	2013–2015	2015–present	March 2020
IFRS 3 issued*	PIR of IFRS 3	Goodwill and Impairment project	Discussion Paper

Feedback

The Board is mainly seeking comments on:

- the usefulness and feasibility of its new disclosure ideas; and
- new evidence or arguments on how to account for goodwill

Comment deadline 31 December 2020

* IFRS 3 introduced the impairment-only approach and replaced IAS 22 which required amortisation.

The Board's preliminary views

1 Improving disclosures about acquisitions	Require companies to disclose: • management's objectives for acquisitions; and • how acquisitions have performed against those objectives subsequently Some targeted improvements to existing disclosures	
2 Improving the accounting for goodwill	A Can the impairment test be made more effective?	Not significantly, and not at a reasonable cost
	B Should goodwill be amortised?	No, retain the impairment-only model
	C Can the impairment test be simplified?	Yes, provide relief from the annual impairment test and simplify value in use
3 Other topics	• Present on the balance sheet the amount of total equity excluding goodwill • Do not change recognition of intangible assets separately from goodwill	

DISCLAIMER

The views expressed in this presentation are those of the presenter, except where indicated otherwise. 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.

EFRAG initial position

EFRAG due process and general position

- EFRAG published its draft comment letter on 29 May 2020.
- Comments requested by 30 November 2020 (draft comment letters are accepted and helpful).
- Until 30 November 2020 EFRAG is performing outreach activities, conducting field tests, interviews and has launched a survey for preparers.
- Supports the objective of exploring whether companies can, at a reasonable cost, provide investors with more useful information about the acquisitions those companies make. However, there would be some practical issues to consider in relation to the proposed disclosures.
- EFRAG's draft comment letter includes some proposals for how to remediate some of the shortcomings of the current impairment model.
- EFRAG is seeking views from its constituents on some of the proposals included in the DP, an answer to the question on whether the proposals in the DP, as a package, meet the objectives of the DP, will only be provided after receiving this input.
- No preliminary position on reintroducing amortisation of goodwill.

DISCLOSURES

Improving disclosures about business combinations

What is the issue?

Investors do not get enough information about acquisitions and their subsequent performance

- Such information would allow investors to hold management to account (stewardship)
- IFRS Standards do not specifically require companies to disclose information about the subsequent performance of acquisitions

Board's preliminary view: require disclosures

At the acquisition date:

- Strategic rationale for acquisition
- Objectives for the acquisition
- Metrics for monitoring achievement of objectives

After the acquisition date:

Performance against objectives

Improving disclosures about business combinations

Board's preliminary view: Companies should disclose information management uses internally to monitor acquisitions

What metrics should be disclosed?

- No single metric suitable, because business combinations are all different
- Management approach:
  - Less costly to produce
  - Insights into how management manages acquisitions
- Can be operational or financial metrics
- Might be information about combined business where integration occurs

Should all material acquisitions be disclosed?

- Disclosure of all material acquisitions could be onerous for serial acquirers
- Preliminary view: define 'management' as 'chief operating decision maker' (CODM) (IFRS 8 *Operating Segments*)
- Are these the acquisitions that investors would like to know more about?

Further improvements to IFRS 3 disclosures

	Message from stakeholders	Preliminary view of the Board
Expected synergies	• Synergies are often an important part of an acquisition • Help investors better understand the factors that contributed to the acquisition price	Require companies to disclose in the year of acquisition the amount, or range of amounts, of synergies expected from an acquisition
Defined benefit pension liabilities & debt	• Some investors consider these liabilities to form part of the capital employed for acquisitions • Needed to assess return on capital employed	Require companies to disclose the amount of defined benefit pension liabilities and debt of the acquiree at the acquisition date, separately from other classes of liabilities
Pro-forma information	• Existing disclosure requirements lack guidance, resulting in diversity in practice • Preparers question the usefulness of the information, while investors think that the information is important	Require companies to disclose both actual and pro-forma revenue, operating profit and cash flows from operating activities

Improving disclosure about business combinations (1/3)

EFRAG preliminary views

- Disclosures on:
  - the strategic rationale and objectives for an acquisition;
  - whether the acquisition is meeting those objectives (based on how management monitors and measures the acquisition);
  - synergies (including estimated amount or range of amounts;
  - costs of achieving the synergies and when they are expected to be realised);
  - pro-forma revenue and operating profit before acquisition-related transaction and integration costs

would be useful.

✓ EFRAG's draft comment letter supports the preliminary view of the IASB.

✗ EFRAG's draft comment letter does not support the preliminary view of the IASB.

Improving disclosure about business combinations (2/3)

EFRAG preliminary views

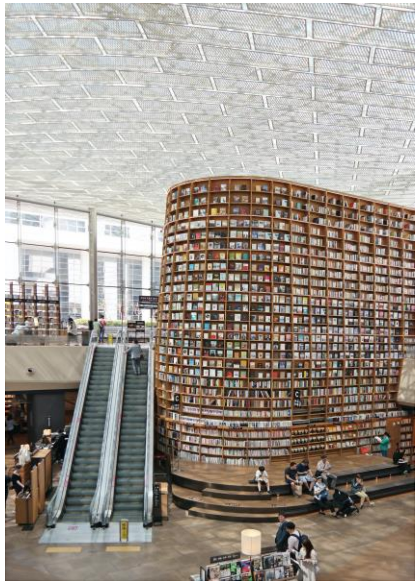
- Does not solve the issues related to goodwill accounting, as this managerial disclosure is disconnected from the book value of the goodwill.
- Should be based on a level lower than what the 'chief operating decision maker' monitors.
- Questions practicability (e.g. auditability) and reliability: would the benefits of the disclosures outweigh the costs?
- Not yet formed a view on whether the information should be in financial statements or management commentary.
- An entity should disclose if it stops monitoring an acquisition after three years instead of two (as suggested in the DP).
- Pro-forma information on cash flows from operating activities would not be particular useful.

Improving disclosure about business combinations (3/3)

EFRAG requests input on

- Whether the proposals would result in entities having to disclose commercial sensitive information.
- Whether the disclosures should be presented in the management commentary instead of in the financial statements.
- Operational implications of DP proposals, its cost, reliability and whether there are any constraints within jurisdictions.
- Whether it would be feasible (at a reasonable cost) and useful to disclose figures excluding acquisition-related transaction and integration costs and the effects of the revaluations to fair value.
- Whether the information that an entity is not monitoring a significant acquisition would affect users.
- Input on whether any of the current disclosure requirements in IFRS 3 could be removed without depriving investors of material information.

PANEL DISCUSSION



Disclosures – a preparer's perspective

- What is good disclosures at acquisition – depends on the acquisition
  - Size, complexity, industry
- Strategic rationale and management targets makes sense
- Announcement information
- How to report on targets and expectations
  - Strategic vs operational targets
  - Quantified or qualitative
  - Commercially sensitive?

- What is good disclosures after acquisition – depends on how the business is managed
  - Stand-alone business or integrated
- Relevant measures to use depends – many variables
- Companies monitors acquisitions for some time
- Reporting on stated targets at acquisition makes sense
  - Period
  - Subsequent changes
- Pro forma information and information about actual performance of acquired businesses can be challenging
- Materiality
- Period
- How can disclosure requirements be regulated?
  - Clear disclosure objectives rather than specific requirement
  - Avoid requiring specific information

Topic 1: Disclosures for acquisitions, comments to IASB's preliminary views

<u>**IASB's proposals and our comments*:**</u>

- **Strategic rational for acquisition:**
  - » For user of financial information: Maybe less important (?) as 1) many investor's in any case will have their own opinion and 2) the requirement may lead to less precise disclosure and general comments for competitive reasons

- **Objectives for the acquisitions:**
  - » Our view : same as above

- **Metrics for monitoring performance:**
  - » Very important! If relative size of acquired business is meaningful.
  - » May provide information around how much confidence one should have to management's value creation skills and have direct impact on valuation multiples and markets required return.
  - » May also reduce losses related to unsuccessful acquisitions (more focus from investors, analysts, media. E.g. Equinor / US activities)

Why metrics for monitoring performance are important:

'Scandal' losses in US haunt Equinor

May 11, 2020

SHARE

It's being called Norway's "largest industrial scandal ever:" a documented combination of big spending, management chaos, executive greed and a lack of internal control at state oil company Equinor's operations in the US. It all contributed to huge and "embarrassing" losses previously unknown to Norwegian state officials or oil analysts, revealed just as Equinor and other oil companies are seeking tax relief after oil prices collapsed.

Newspaper *Dagens Næringsliv (DN)* has detailed wild times at the Norwegian oil company's offices in Houston and Austin, Texas after oil prices soared roughly a decade ago. They continued even after internal accountants and auditors started sending out alarms in 2014, when oil prices fell.

Newspaper *DN* has published a lengthy documentary headlined "The Secret Equinor Reports" about oil company Equinor's Houston-based operations in the US. They have generated enormous losses amidst a highly "un-Norwegian" culture of high spending, chaotic management and executive greed. FACSIMILE: DN screen grab

In a 16-page report in Saturday's edition of *DN*, its team of journalists detailed how executives at the company, then known as Statoil, did not conduct

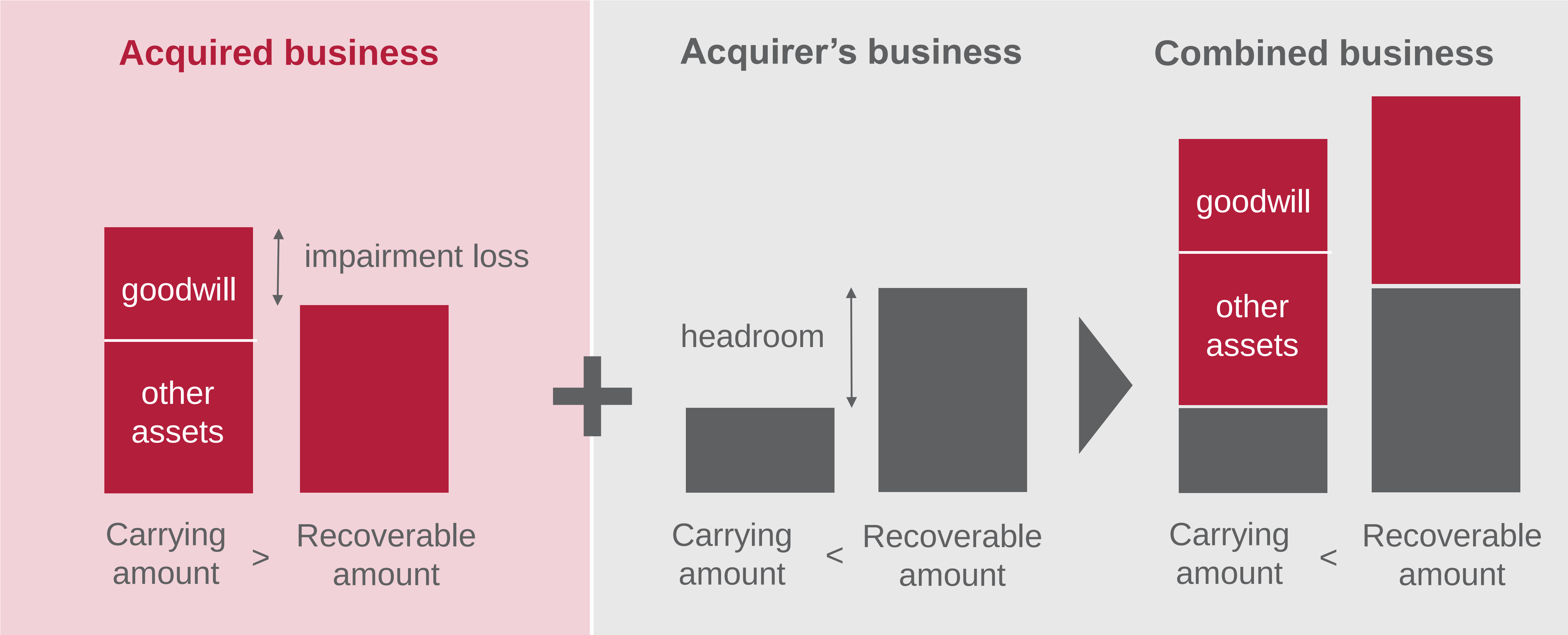
* Sell side equity analyst's view

IMPROVING THE IMPAIRMENT TEST

Improving the accounting for goodwill

What are the issues?	Research undertaken by the Board
Impairment losses on goodwill are recognised too late Could be due to: • too optimistic cash flow estimates; or • shielding of goodwill from impairment by headroom (see next slide)	A Can the impairment test be made more effective? B Can the impairment test be simplified?
The impairment test is complex and costly for companies	C Should goodwill be amortised?

Background—shielding



If acquired business is run separately:
→ tested for impairment separately
→ impairment loss

If acquired business is integrated with acquirer's business:
→ combined business is tested for impairment
→ no impairment loss

Can the impairment test be made more effective?

Board's preliminary view

No feasible alternative test	The test is not intended to test goodwill directly	Disclosure solution
• It is not feasible to make the impairment test for goodwill significantly more effective at a reasonable cost to companies • Shielding cannot be eliminated because goodwill has to be tested for impairment with other assets	• The test cannot always signal how an acquisition is performing, but that does not mean that the test has failed • When performed well, the test ensures that the carrying amount of the CGU as a whole is recoverable	The disclosure requirements discussed on slides 10–11 could provide information that investors need about the performance of acquisitions

Simplifying the impairment test

Relief from an annual impairment test

Having to perform the test annually, even when they have no reason to suspect an impairment has occurred, adds unnecessary cost

- Remove requirement to test CGUs containing goodwill for impairment at least annually
- Companies must still assess whether there is any indicator of impairment, and perform the impairment test if there is

Simplifying value in use estimates

IAS 36 contains certain restrictions on value in use that add cost and complexity to the test, and deviates from common industry practice

- Remove restriction on including some cash flows in value in use estimates
- Cash flow forecasts still need to be reasonable and supportable
- Allow use of post-tax discount rates and post-tax cash flows

Improvements to the goodwill impairment test (1/3)

EFRAG preliminary views

- EFRAG shares the IASB's reservations to develop a different and more effective impairment approach.
- However, EFRAG believes that is possible to improve the guidance such as:
  - on allocation of goodwill to CGUs (rebuttable presumption that it is allocated to a lower than a segment level)
  - not allowing reallocation absent a change in the cash flow structure, and
  - aligning the test better with expected benefits at acquisition.

Improvements to the goodwill impairment test (2/3)

EFRAG preliminary views

- Might not completely agree that over-optimism is best addressed by auditors and regulators.

- Suggestions for possible disclose solutions on how to address over-optimism:
  - compare realised cash flows with predictions
  - assumptions used for the period for which cash flows are projected based on financial budgets
  - current level of cash flows, margins or earnings

Improvements to the goodwill impairment test (3/3)

EFRAG requests input on

- Whether the IASB should improve guidance on allocation and reallocation of goodwill to CGUs.
- Whether management over-optimism is best addressed by auditors and regulators and not by changing IFRS Standards.
- Usefulness and practicability of EFRAG's suggestions to address management over-optimism.
- Whether the IASB should consider introducing reversal of impairments in general and specifically in the case of impairment losses recognised in an interim period.

Simplifications (1/2)

EFRAG preliminary views

- Reservations regarding the removal of the requirement to test annually and adopt an indicator-only approach (unless it is obvious from the indicator analysis that there is no need for impairment – in such cases the approach might play a role).

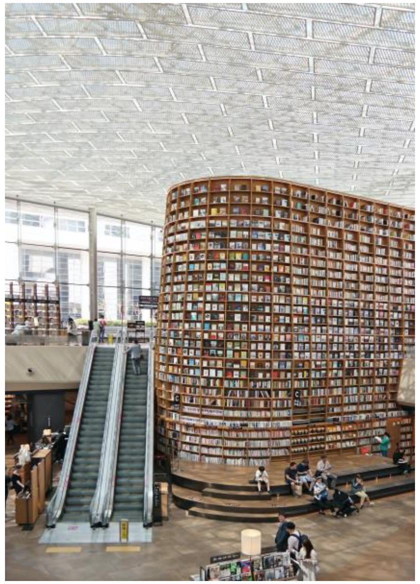
- Support for removing the explicit requirement to use pre-tax inputs when calculating value in use and removing the prohibition from including cash flows arising from a future uncommitted restructuring of from improving or enhancing the asset’s performance.
- However, additional guidance would be required on when to include restructuring cash flows in the calculation

Simplifications (2/2)

EFRAG requests input on

- Whether they agree with EFRAG’s concerns regarding the introduction of an indicator-only approach and, if so, if they have any suggestion about how to mitigate this issue.
- Whether they think that there are other cash flows (others than those included in previous slide) that should also be allowed to be included in the VIU calculation.
- Whether they consider significant the risk of impairment losses going undetected when post-tax inputs are used that would have been recognised had pre-tax inputs being used
- Whether they identify any other risk factor that could arise from the use of post-tax inputs.

PANEL DISCUSSION



Impairment testing

- A challenging starting point – goodwill is the unallocated residual
  - A mix of wasting and long-lived elements
  - Includes effects of measurement differences
    - Different from fair value (deferred tax)
    - Timing differences – when we don't know what it is it is hard to find out what to do with it …
  - Does it make sense that the only way out of the balance sheet is through impairment => perceived failure

- Impairment test focus – value of the CGU
  - It may or may not contain goodwill
  - It may or may not support corporate assets or goodwill at group of CGUs
  - Many of the challenges are the same with and without goodwill
- Annual impairment test
  - Costly
  - Indicator based testing would be less costly with limited loss of robustness
  - Focus would move from CGUs with goodwill to high-risk CGUs independent of goodwill
- Improvement proposals
  - Include effects of improvements or enhancement – remove difference to business logic and internal planning
  - Impact of tax and other government take is complex – pre-tax and post-tax discount rates both have challenges

Topic 2: Improving the accounting for goodwill

Our comments*:

- **A) Can the impairment test be made more effective?**
  - » IASB's view: "After extensive work, the Board's preliminary view is that significantly improving the effectiveness of the impairment test for goodwill at a reasonable cost to companies is not feasible.
  - » Our view: Partially agree. However, we observe substantial variation: Some companies books impairment mainly in Q4, while others apparently have a more active view on their book value through the calendar year.

- **B) Impairment-only vs. amortization**
  - » IASB's view: The impairment-only model should be retained.
  - » Our view: No strong view, but some support for the idea that goodwill should be amortized: 1) valuation multiples across companies (M&A vs organic growth) probably more comparable, 2) the only was goodwill can be removed I through impairments, 3) reduced probability for inflated book values (?)

- **C) Simplifying the impairment test**
  - » IASB's view: The Board's preliminary view is that it should no longer require a company to carry out an annual quantitative impairment test of cash-generating units containing goodwill if the company has no indication that an impairment has occurred.
  - » Our view: Disagree. What is a triggering event? E.g., assumed sales price reduced 5% every years due to slow (but consistent) structural changes: When is the triggering event. (oil price, SMS price, subscription services becoming free)

* Sell side equity analyst's view

GOODWILL

Amortisation of Goodwill vs Impairment-only

Amortising goodwill	Retaining the impairment-only model
some say…	others say…
Goodwill is overstated, so management is not held to account	The impairment-only model provides useful confirmatory information to investors
Amortisation is simple and targets acquired goodwill directly	Amortisation is arbitrary and would be ignored by many investors
The impairment test is not working as well as the Board intended	If applied well, the impairment test works as the Board intended, ensuring that, as a group, goodwill and other assets of a business are not overstated
Goodwill is a wasting asset. Amortisation is the only way to show the consumption of goodwill	The benefits of goodwill are maintained for an indefinite period, so goodwill is not a wasting asset
Amortisation would ultimately make the impairment test easier and less costly to apply	Amortisation would not significantly reduce the cost of impairment testing, especially in the first few years

Amortisation of Goodwill vs Impairment-only

Board's preliminary view

There is no compelling evidence that amortisation would significantly improve financial reporting

→

Retain the impairment-only approach

The Board majority was small

Stakeholders are invited to provide new arguments to help the Board decide how to move forward on this topic

Other approaches considered

Immediate write-off of goodwill	Should goodwill be componentised?
Immediate write-off could be as: • an expense in profit or loss, or in other comprehensive income; or • directly in equity The Board rejected this approach because: • it would be inconsistent with the Board's conclusion that goodwill is an asset and management's view it has paid for future economic benefits; and • information about goodwill would be lost	Some say goodwill can be componentised and that different accounting treatments could be applied to each component, reflecting the nature of that component The Board rejected this approach because: • it increases complexity and subjectivity of the subsequent accounting of goodwill; and • goodwill isn't directly measurable and so components of goodwill could probably not be measured reliably

Goodwill and amortisation

Components of goodwill

- The DP could have included a more comprehensive discussion on the unit of account when accounting for goodwill, including how the guidance of the Conceptual Framework for Financial Reporting for selecting the unit of account had been considered by the IASB.
- EFRAG notes that in IFRSs literature the general approach when accounting for non-current assets is to consider components with different useful lives separately (however, there could be good arguments for not doing so for goodwill – the DP is just not providing those).
- EFRAG's preliminary view is that it could have been considered whether amortisation could be performed on components of goodwill considered wasting assets.
- If goodwill were to be amortised there should be a link between the information provided on when the entity is expected to benefit from the synergies and the amortisation period of goodwill (or the part of goodwill related to the synergies).

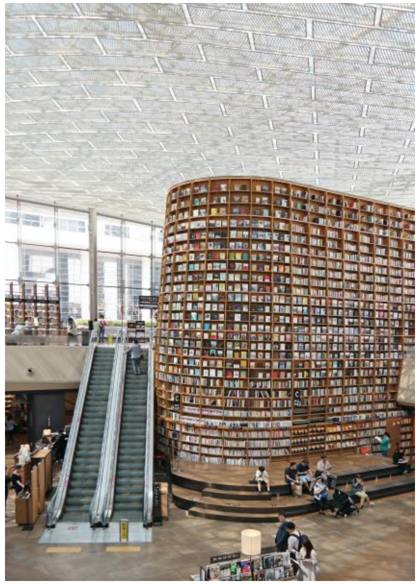
Goodwill and amortisation

EFRAG requests input on

- Whether, in relation to goodwill amortisation, there are any new evidence, new arguments or new assessment of the existing evidence that would support a major change in goodwill accounting.
- Whether goodwill is a wasting asset and therefore it should be amortised.
- Whether goodwill is an accounting construct and, as such, neither impairment losses nor amortisation provide a conceptually sound answer that will be useful to users.
- Whether users would add back goodwill amortisation expenses when calculating performance measures (if goodwill amortisation were reintroduced)?
- Whether it would be useful (for users) and feasible (for preparers) to provide information about the age of goodwill (if amortisation were not reintroduced).

EFRAG has not yet formed a view on reintroduction of amortisation.

PANEL DISCUSSION



Goodwill – what is it?

- Business value – not easy to grasp and value
- Assembled work force – is that less controlled that customer relationships?
- Synergies
- Valuation issues
  - Overpayment
  - Value changes
  - Tax

- Other alternatives
  - Components
  - Amortization
  - Immediate write-off
  - Subsequent amendments
- Challenges with all discussed alternatives
- Fundamental problem: I don’t know what it is, so I can’t find a conceptual argument for subsequent accounting

Topic 3: Goodwill - its nature and componentisation

- IASB view: The Board's preliminary view is that companies should present on the balance sheet the amount of total equity excluding goodwill.
  - » Our view:
    - No strong view, probably disagree
    - E.g. shell company makes debt financed reversed takeover and books substantial goodwill. Adjusted equity may become negative –> less meaningful

- IASB view: "The Board's preliminary view is that it should retain the requirements in IFRS 3 and IAS 38 Intangible Assets."
  - » Our view: Agree

Appendix—Other preliminary views

Other topics

Presenting total equity excluding goodwill	Intangible assets
Goodwill is different from other assets because it: • can only be measured indirectly; and • cannot be sold separately	Some believe that recognising these assets separately helps explain what the company has bought in an acquisition. Others think that the information is of limited use
Presenting **total equity excluding goodwill** on the balance sheet helps to make this amount **more prominent**, drawing investors' attention to companies whose goodwill constitutes a significant portion of their net assets	In the Board's view: • there is no compelling evidence to change existing requirement; and • aligning the accounting treatment for all intangible assets is beyond the scope of this project

A balanced package

		Objectives		Board's preliminary view
		More useful information	Reduce cost	
1	Improve disclosures about acquisitions	✓	✗	Yes, change
2	Amortise goodwill	✗	✓	No, do not change
	Provide relief from annual quantitative impairment test	...	✓	Yes, change
	Amend how value in use is estimated	✓	✓	Yes, change
3	Present total equity excluding goodwill	✓	...	Yes, change
	Include some intangible assets in goodwill	✗	✓	No, do not change

✓ In line with objective ✗ In conflict with objective ... No significant impact

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Comment on EFRAG’s draft comment letter

EFRAG’s draft comment letter is available here on EFRAG’s website: www.efrag.org.

Comment deadline: 30 November 2020.

Questionnaire/interview request for preparers is available here.

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Recommendation	Percent
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Sell	20.9%

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EFRAG
Aisbl - ivzw
35 Square de Meeüs
B-1000 Brussel
Tel. +32 (0)2 207 93 00
www.efrag.org