Valuation for financial reporting in Italy: critical issues

CONSOB
Commissione Nazionale per le Societa' e la Borsa

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The importance of valuations for IFRS financial statements

Measurements for Financial Reporting

Valuations are a pillar of Financial Reporting. Quantitative elements recognized in financial statements requires the selection of a **measurement basis**.

The draft of the new IFRS Conceptual Framework identifies two categories of measurement basis:

Measurement basis

Historical cost

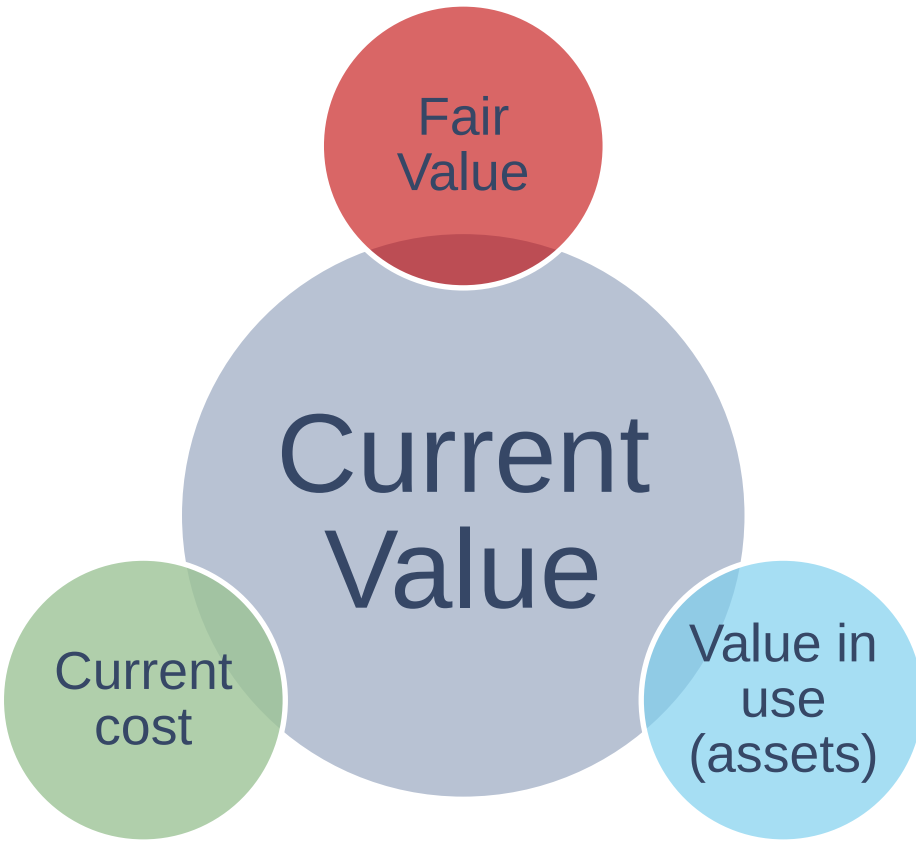
Measures based on historical cost provide monetary information derived, at least in part, from the transaction or other event that gave rise to assets, liabilities and related income and expenses

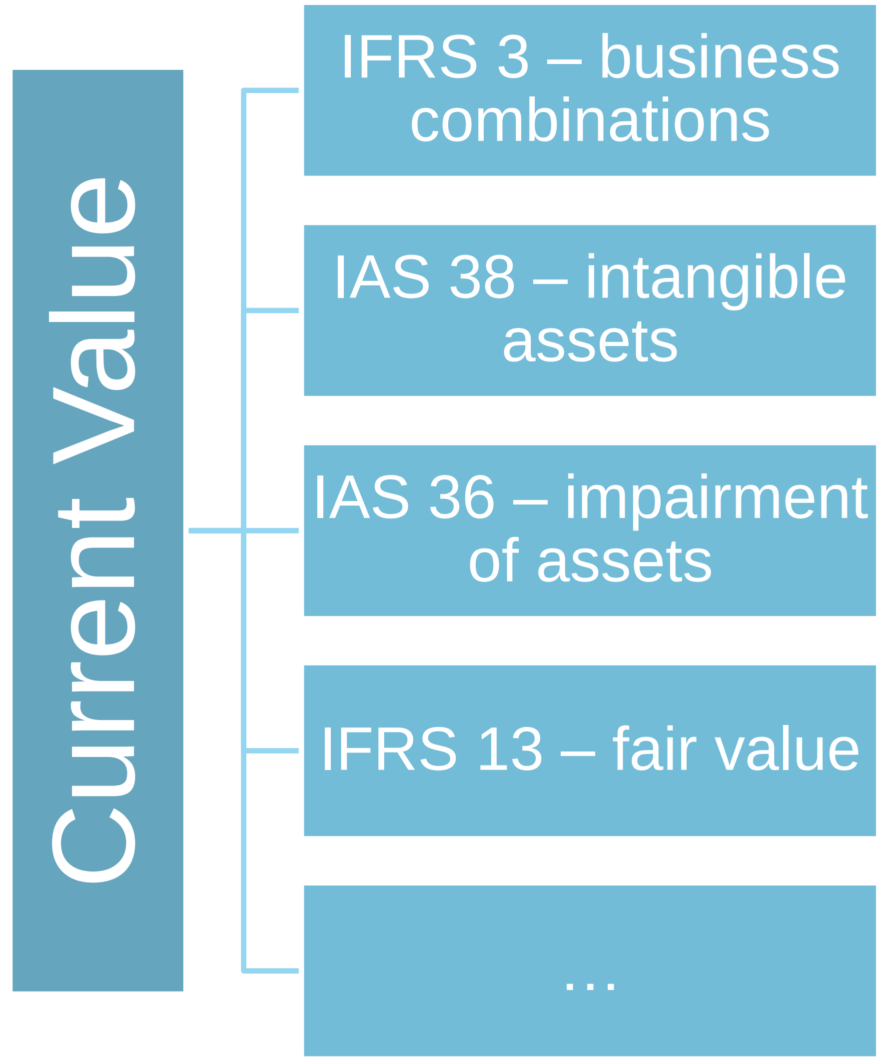
Current value

Measures based on current value provide monetary information about assets, liabilities and related income and expenses using information updated to reflect conditions at the measurement date.

Measurements for Financial Reporting - boundaries

Current value measurement bases include:





Measurements for Financial Reporting - boundaries

A particular measurement basis to be useful to users of financial statements must be **relevant** and must **faithfully represent** what it purports to represent.

In addition, the information provided should be, as far as possible,

comparable,
verifiable,
timely and
understandable.

E.g. - Current value could be more relevant information but has risk of being unreliable, while historical cost could be more reliable information but can be irrelevant.

Measurements for Financial Reporting - boundaries

The **relevance of a measurement basis depends on the characteristics** of the asset or liability, in particular, whether the cash flows are highly variable and whether the value is sensitive to market factors or other risks.

If the value of an asset or liability is sensitive to market factors or other risks, its historical cost might differ significantly from its current value. In this case the **current value** may provide information that is more relevant than historical cost for assessments by users of financial statements

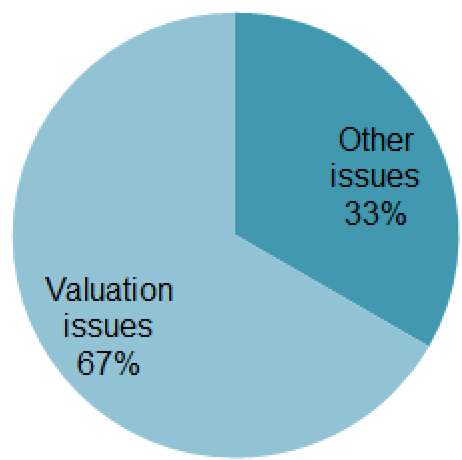
In some cases the **level of measurement uncertainty** is so high that information provided by a measurement basis may not provide a faithful representation. In this case it is appropriate to select a different measurement basis that results in relevant information.

If the fair value of an asset is observable in an active market, no (or very little) uncertainty is associated with the measurement of that fair value.

Enforcement actions from 2009

Over the last 6 years, 67% of enforcement actions were taken due to valuation issues

Enforcement decisions



Market alerts issued by Consob and ESMA on valuation issues

Main Market Alert on valuation

Consob, jointly with Bank of Italy and IVASS (former ISVAP), issued over the years some documents about main valuation issues.

ESMA published reports on impairment testing of goodwill, business combinations and fair value estimates.

2009
Consob, with Bank of Italy and ISVAP

2010
Consob, with Bank of Italy and ISVAP

2013
ESMA

2014
ESMA

2017
ESMA

Over last years, valuation issues were part of the enforcement priorities (European Common Enforcement Priorities and Consob alerts)

Consob Market Alert on valuation issues - *2009*

Document n. 2/2009 - Disclosure in financial reports on the going concern assumption, financial risks, tests of assets for impairment and uncertainties in the use of estimations

The "current environment of crisis", characterized by **significant volatility of all the main market indicators** and by deep uncertainty about economic expectations, makes it difficult to develop forecasts that can be declared "completely reliable".

Key topics

To draw the attention of the management and control bodies in charge, to the need to ensure disclosure that makes the effects of the crisis on the company's Profits and Losses and Financial Statements clear

- **Disclosure on going concern**
- **Disclosure on financial risks**
- **Disclosures on impairment test**
- **Uncertainties in the use of estimations**

Consob Market Alert on valuation issues - *2009 (cont'd)*

Document n. 2/2009 - Disclosure in financial reports on the going concern assumption, financial risks, tests of assets for impairment and uncertainties in the use of estimations

Disclosures on impairment test

It is necessary for the directors to pay special attention in the valuation of assets to be submitted to a test for impairment

Following the volatility of all the main market indicators, the assumptions used may no longer be valid

Information must be disclosed in the notes to the financial statements about assumptions of cash flows, discount rates and growth rate used for terminal value estimates.

Consob Market Alert on valuation issues - *2010*

Document n. 4/2010 - Disclosure in financial reports on the checks for reduction in value of assets (impairment test), on contractual clauses on financial debt, debt restructuring and the "Fair value hierarchy"

The environment of crisis still seemed to be significant and widespread in 2010. There was a large reduction in turnover and a marked deterioration in loan quality.
The quality of public disclosure was of fundamental importance for the users.

Key topics

- **Impairment test of goodwill and IA**
- **impairment testing of equity instruments**
- **Fair value hierarchy**
- **Debt restructuring**

Consob Market Alert on valuation issues - *2010 (cont'd)*

Document n. 4/2010 - Disclosure in financial reports on the checks for reduction in value of assets (impairment test), on contractual clauses on financial debt, debt restructuring and the "Fair value hierarchy" (cont.)

- The conformity of the impairment test procedure with the provisions of IAS 36 "**should" be subject to the formal and explicit approval by the board of directors**.

- Approval of the impairment test procedure by the directors "**should" be done separately and before the financial reports are approved**.

- Give **adequate consideration to any external signs** of impairment loss, such as those expressed by the financial market. The directors must look for the **reasons for any differences between the "external" assessments and the results of the impairment procedure**. This analysis, required under IAS 36, paragraph 12(d), must be fully documented as part of the procedure.

Consob Market Alert on valuation issues - *2010 (cont'd)*

Document n. 4/2010 - Disclosure in financial reports on the checks for reduction in value of assets (impairment test), on contractual clauses on financial debt, debt restructuring and the "Fair value hierarchy" (cont.)

- Effective disclosure of the process of evaluating goodwill must contain the following fundamental elements:

1. **Definition of "cash-generating units"**
2. **Allocation of goodwill to individual CGUs**
3. **Description of the method for estimating the recoverable amount**
4. **Description of the analysis of the sensitivity to changes in the key assumptions**
5. **Remarks on the presence of any external indicators of impairment loss in the absence of write downs**

Consob Market Alert on valuation issues - *2010 (cont'd)*

Document n. 4/2010 - Disclosure in financial reports on the checks for reduction in value of assets (impairment test), on contractual clauses on financial debt, debt restructuring and the "Fair value hierarchy" (cont.)

Equity Instruments

- It should be noted that IAS 39.61 , states that a "significant or prolonged decline in the fair value" of an investment in an **equity instrument** below its cost is objective evidence of impairment.
- The meaning of the expression "significant or prolonged decline in the fair value" has created numerous problems of interpretation. In July 2009 IFRIC clarified some aspects (e.g. IAS 39 does not require the concurrent presence of both criteria; the fact that the impairment loss of an AFS equity instrument is in line with a decline in its price in the reference market does not allow the company to conclude that the investment has not been impaired; etc.)
- The directors must use their judgment in making this evaluation. In any case, they must exercise their technical discretion in identifying the quantitative thresholds of "significant" and "prolonged"

Fair Value

- It is worth reminding companies of the importance of correctly defining the **three levels of fair value** and their consequent disclosure for financial instruments (see IFRS 7.27)

ESMA Market Alert on valuation issues

2013 ESMA European enforcers review of impairment of goodwill and other intangible assets in the IFRS financial statements

The report provided an overview of accounting practices related to impairment testing of goodwill and other intangible assets. It evaluated the appropriateness of the related disclosures in the 2011 IFRS financial statements of a sample of 235 issuers and as a result of this review five areas of concern emerged:

1. **Key assumptions of the management**
2. **Sensitivity analysis**
3. **Determination of recoverable amount**
4. **Determination of growth rates**
5. **Disclosure of an average discount rate**

ESMA Market Alert on valuation issues (cont.)

2014 ESMA Review on the application of accounting requirements for business combinations in IFRS financial statements

The report evaluated the consistency of application of key requirements of IFRS 3. The following expectations were highlighted:

1. **Recognition and measurement of goodwill and bargain purchase gains**
2. **Intangible assets and contingent liabilities**
3. **Disclosure of fair value measurement techniques**
4. **General observations on disclosures** *(understanding of the underlying transactions)*.

ESMA Market Alert on valuation issues (cont.)

2017 ESMA Review of Fair Value Measurement in the IFRS financial statements

The report provides an overview of the application of the fair value measurement and disclosure requirements provided for by IFRS 13.

The requirements of the Standard have generally been well incorporated in the financial statements of the issuers in the sample.
Room for improvement in the level of compliance and comparability in the application of the IFRS 13 requirements. IFRS 13 can be improved .

In particular, the review addressed the following key topics:

Fair value disclosures

Unit of Account

Level of Market Activity and Fair Value

Valuation adjustments to derivatives

ESMA Market Alert on valuation issues (cont.)

2017 ESMA Review of Fair Value Measurement in the IFRS financial statements

Fair value disclosures

ESMA's conclusions

- **Approach to preparing disclosures:** Remind entities that a 'tick the box' approach of the minimum disclosure requirements does not automatically imply compliance with the IFRS 13 disclosure objectives
- **Quality of disclosures:** Urge issuers to avoid the use of boilerplate language and the presentation of unnecessarily voluminous disclosures and to focus on providing information that is relevant for users
- **Location of disclosures:** As fair value measurement is pervasive in IFRS financial statements, issuers are encouraged to pay particular attention to the presentation of fair value disclosures to ensure that users can access clearly and easily the fair value information

ESMA Market Alert on valuation issues (cont.)

2017 ESMA Review of Fair Value Measurement in the IFRS financial statements

Unit of Account

ESMA's conclusions

- Information on the unit of account with respect to whether or not any premiums or discounts have been included in the measurements was limited in the financial statements reviewed
- ESMA urges issuers to provide sufficient entity-specific disclosure on how they estimated fair value when quoted prices are departed from and to explain the rationale

Level of Market Activity and Fair Value

ESMA's conclusions

- ESMA encourages issuers to disclose the processes followed and the specific situations where they have concluded that quoted or transaction prices did not represent fair value
- ESMA also draws the attention of issuers to the requirement for **further analysis** before concluding that transaction prices and quoted prices do not represent fair value (Appendix B of IFRS 13)

ESMA Market Alert on valuation issues (cont.)

2017 ESMA Review of Fair Value Measurement in the IFRS financial statements

Valuation adjustments to derivatives

ESMA's conclusions

- ESMA encourages issuers to explain the rationale and key determinants of the adjustments
- ESMA also recommends issuers to closely monitor market developments and ensure that derivative valuation incorporates these adjustments when they are necessary to reflect fair value as required by IFRS 13
- ESMA urges issuers that present information on adjustments outside the financial statements, to ensure that this information is clearly cross-referenced to in the financial statements

Market Alerts on valuation issues

In the last few years, valuation issues were identified by ESMA and Consob as European Common Enforcement Priorities (ECEP) because they usually have a significant impact when preparing and auditing the financial statements.

2017	Specific recognition, measurement and disclosure issues of IFRS 3.

ESMA draws issuers' attention to the treatment of the following aspects: intangible assets, adjustments during the measurement period, bargain purchases, mandatory tender offers (MTO), business combinations under common control (BCUCC), contingent payments and disclosures on fair value

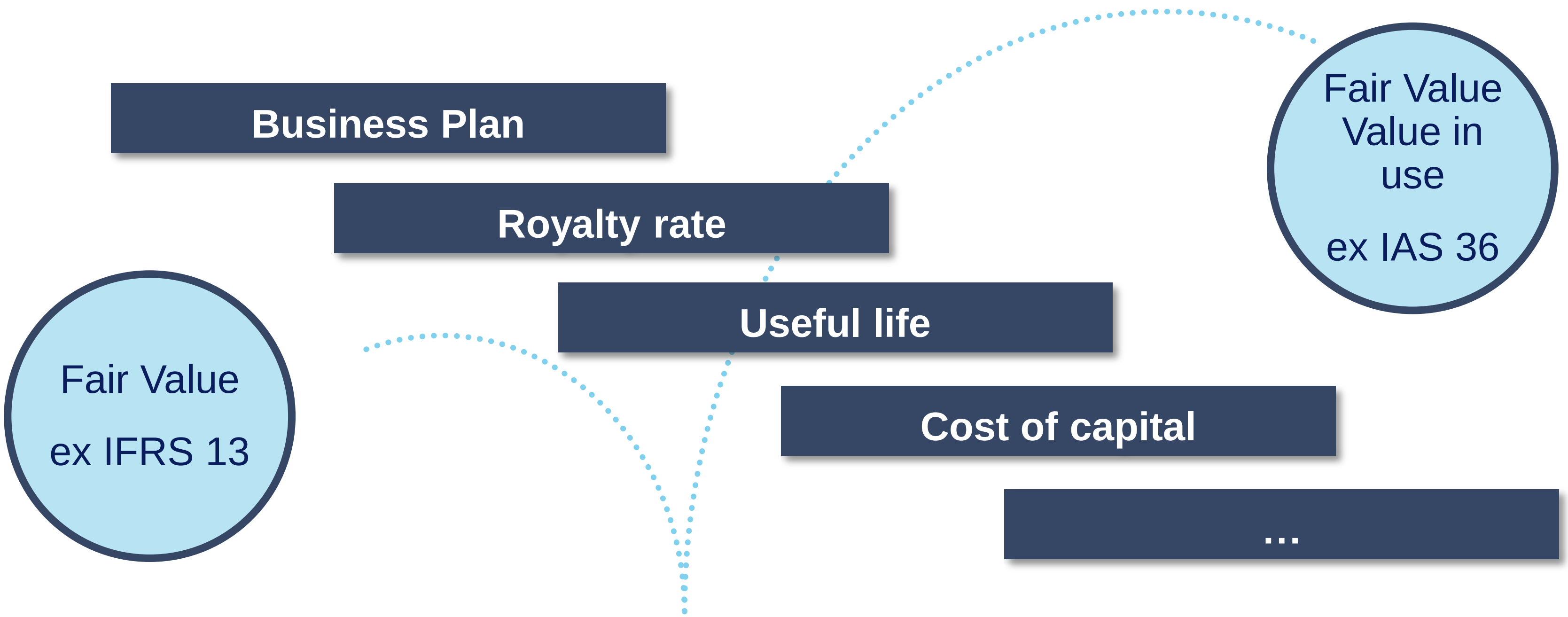
ESMA urges issuers to ensure consistency between the assumptions used to measure intangible assets at fair value for the purpose of a purchase price allocation (PPA) in a business combination and the assumptions applied for any impairment testing as well as for determining useful lives used for the amortisation

2013-2016	Fair value measurement and related disclosures, impairment of assets, etc.

Market Alerts on valuation issues

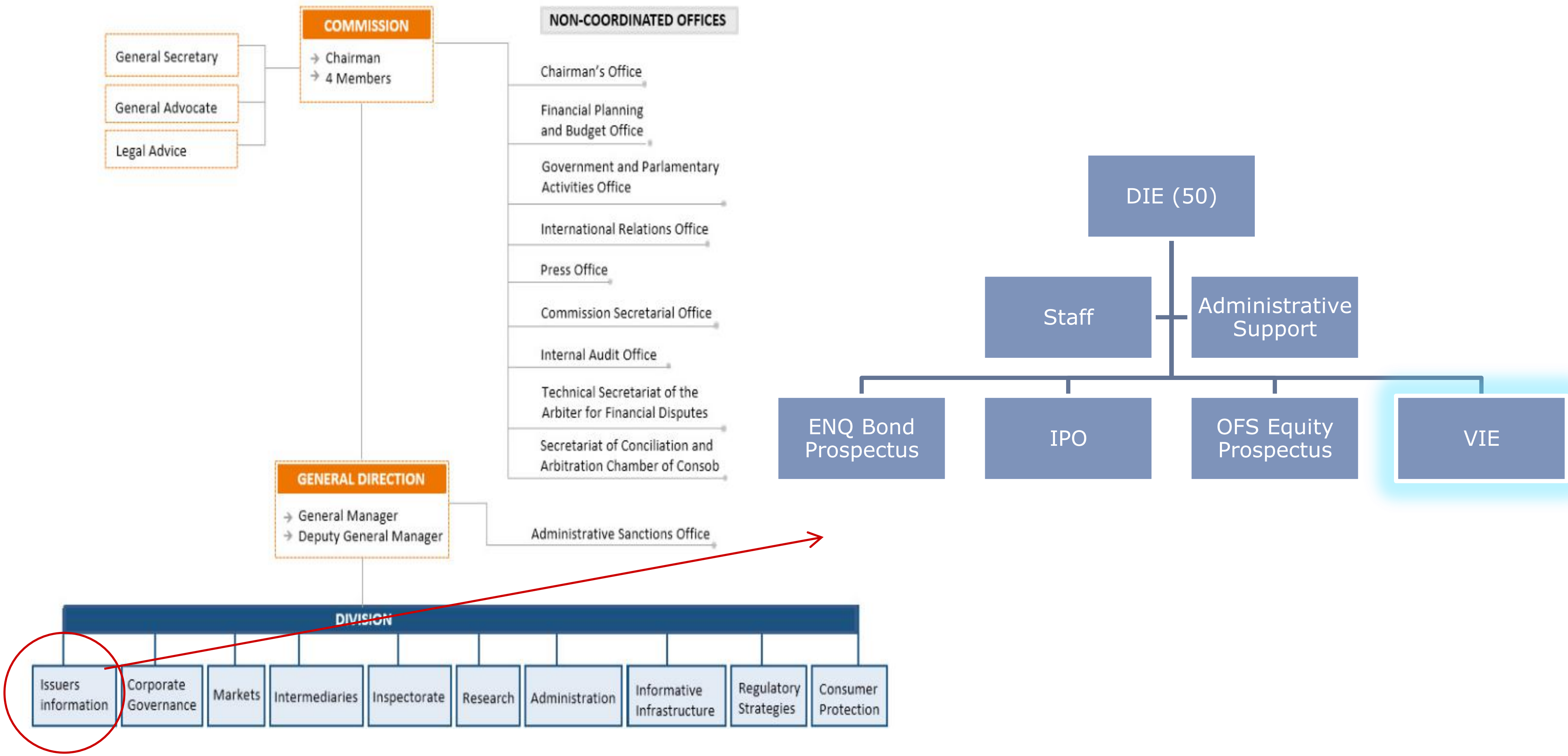
IAS 38 & IAS 36 – Intangible valuation

- **Consistency between the assumptions used to measure intangible assets at fair value** for the purpose of a purchase price allocation (PPA) in a business combination and **the assumptions applied for any impairment testing** as well as for determining useful lives used for the amortization (ESMA ECEP 2017).

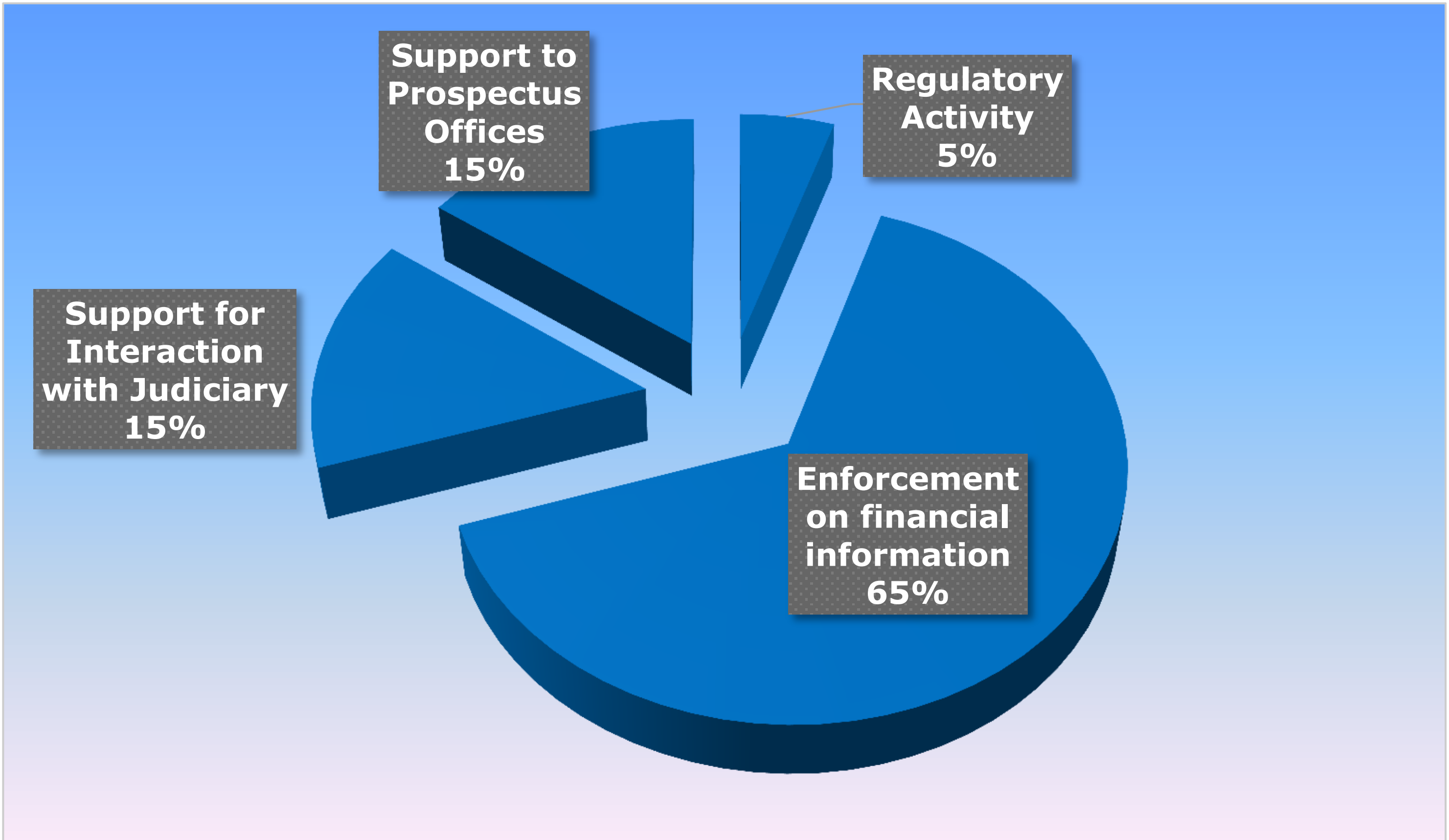


Supervisory tools

Consob Chart - Issuers Information Division



EFI Unit – MAIN FUNCTIONS



(*) "Regulatory Activity" main tasks: participation in International working groups (EECS, Esma PG, Iosco), collaboration and cooperation with Bank of Italy, IVASS, The Ministry of Economy and Finance, OIC for Accounting Issues

Supervisory tools (cont)

Pursuant to article 89-quarter of Consob Regulation no. 11971 of 14 May 1999 - Consob shall perform checks of the financial information contained in the documents made public by the issuers on **a sample basis**, in accordance with the relevant standards of the ESMA

Number of listed issuers whose documents shall be checked is no less than a fifth.

In order to determine the **risk** Consob shall establish its representative parameters **every year** by specific resolution, also taking into account:

a) the operating, cash flow and financial data of the companies involved;

b) the reports received by the issuer's control body and auditor;

c) the trading in the securities;

d) the significant information received from other administrations or persons concerned.

Other issuers are identified (no more than a fifth of the total number of sample) with random selection models.

News flow from the market can generate other in depth analysis
25-30% of the enforcement activity on financial information is performed on "extra sample" issuers.

Supervisory tools (cont)

According to **Article 115** of the Consolidated Law Consob may:

a) require listed issuers, the persons that control them and companies controlled by them to provide information and documents, establishing the related procedures;

b)gather information from directors, internal auditors, auditing firms and managers of companies

c)carry out inspections

CONSOBcan take the following actions

art. 114 (5)
Issuers have to publish information and documents needed to inform the public

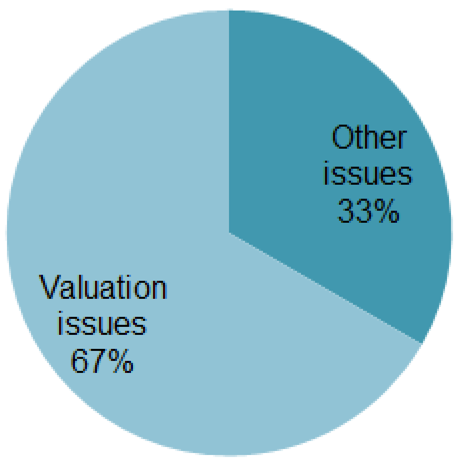
art. 154-ter (7)
where it is ascertained that documents comprising the financial statements pursuant to this article do not comply with drafting regulations, Consob may require that the issuer publishes this fact and arrange publication of supplementary information as necessary in order to reinstate correct market information

art. 157 (2)
Challenging the resolution of the shareholders meeting approving the annual accounts and asking the Court to verify the compliance of the consolidated accounts with proper accounting standards (only Italian issuers- restatement)

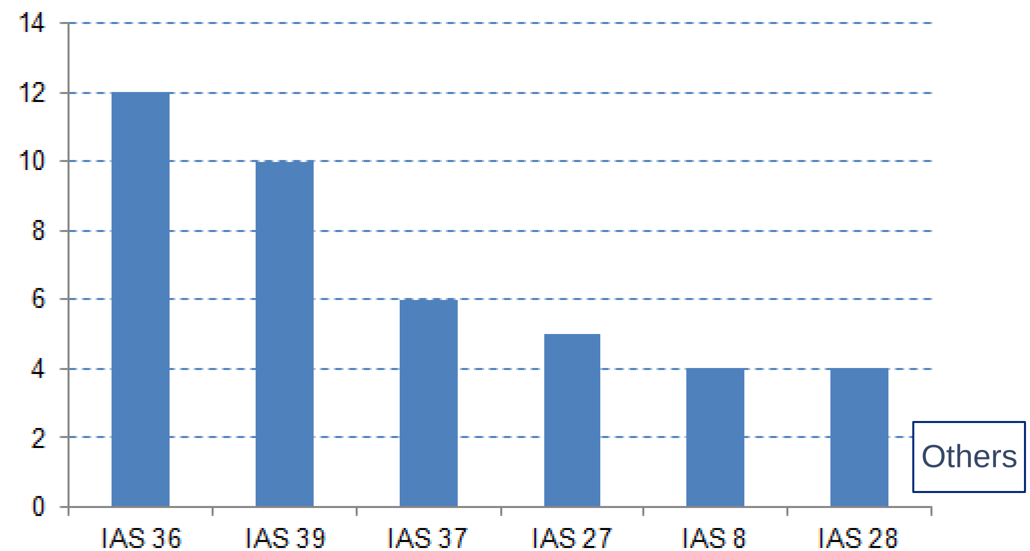
Supervisory tools – *enforcement actions from 2009*

The most frequent decisions related mainly to the application of the impairment test.

Enforcement decisions



Main enforcement issues



*Each decision could contain more than one issue

Examples of issues

Enforcement issues related to financial reporting

- This section sets out some examples* of valuation issues encountered as Security Regulator in the scrutiny of financial reports.

1	Level of fair value	IFRS 13 Level of FV
2	Value in use – improving performance	IAS 36 Business Plan
3	Value in use – reasonableness of the assumptions	
4	Value in use – supportable assumptions	
5	Value in use – wacc	IAS 36 WACC
6	Intangible valuation – inconsistent assumptions	IFRS 3/13 IAS 36 Intangibles' Fair Value
7	Intangible valuation – Disclosure	

*These samples are for illustrative purposes only.

Enforcement issues related to financial reporting

Case n.1

IFRS 13 – Level of Fair Value

Level of fair value

Description of the issue

The issuer invested in shares of listed and unlisted entities. They were accounted for as **AFS financial assets**.

The issuer measured the **fair value** of the listed securities on the basis of stock exchange prices when the shares were listed on an active market or based on valuation techniques when there was no active market

On the basis of the ***limited trading volume*** of the shares, the issuer considered that its investments in listed companies A, B and C were not traded in active markets (Milan's Stock Exchange) and measured the fair value of these investments using a valuation technique on the basis of **level 3 inputs**.

Enforcement issues related to financial reporting

Case n.1

IFRS 13 – Level of Fair Value

Level of fair value

Issuer approach

Decrease in level of activity:

Daily % of average value trades / capitalization

No weigh on transaction price.

Level 3 Fair Value

IFRS 13 approach

Decrease in level of activity

Factors in IFRS 13.B37

Orderly transaction?

YES

Transaction price is considered Fair Value

NO

No weigh on transaction price.

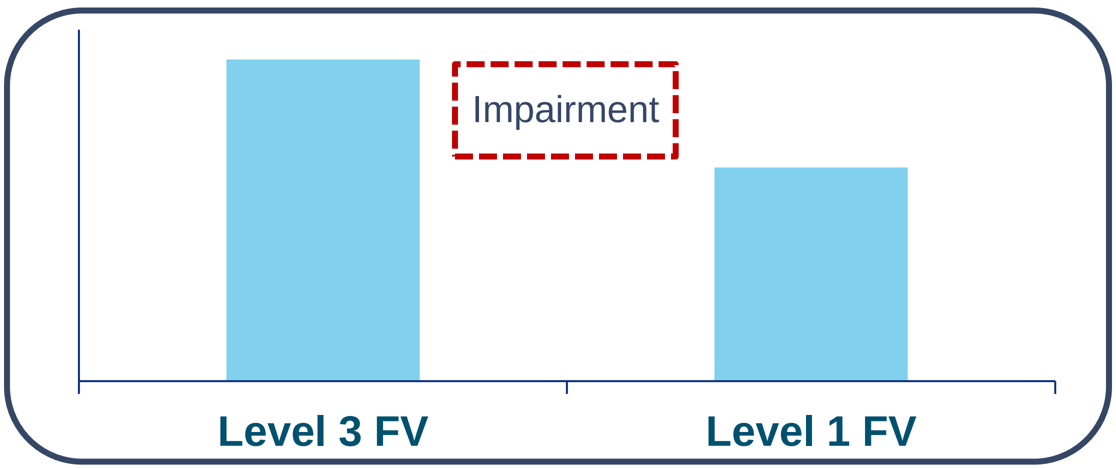
Enforcement issues related to financial reporting

Case n.1 | IFRS 13 – Level of Fair Value – Enforcer's view

Level of fair value

The enforcer considered that the indicators used by the issuer were insufficient to conclude that the transaction price did not represent fair value or that transactions occurred with insufficient frequency and volume.

Issuer accepted the remarks of Consob and no enforcement action was needed.



Enforcement issues related to financial reporting

Case n.2

IAS 36 – Value in use: business plan

Description of the issue

- The plan includes benefits **deriving from a new business**, activities for which the Company is not yet engaged and which results in an optimization of the performance of the asset.

IAS 36.44 - Future cash flows shall be estimated for the asset in its current condition.

Estimates of future cash flows shall **<u>not</u>** include estimated future cash inflows or outflows that are expected to arise from:

(a) a future restructuring to which an entity is not yet committed; or

(b) <u>improving or enhancing the asset's performance</u>.

Improving performance

Enforcement issues related to financial reporting

Case n.2 IAS 36 – Value in use: business plan – Enforcer's view

Improving performance

The enforcer considered that the approach followed by the issuer was not compliant to IAS 36.

Action taken according to art. 154-ter of CLF. A restatement was required

- The issuer has changed the cash flows for the determination of the value in use in compliance with Consob remarks.
- An impairment of the goodwill was accounted.

Enforcement issues related to financial reporting

Case n.3

IAS 36 – Value in use: business plan

Description of the issue

- The projections are based on the assumption that the company grows throughout the plan at an average annual rate of approximately 10%.
- Substantial differences between (1.a) the actual results achieved, (1.b) the market forecasts and (2) the projections of the cash flows reported in the plan both in terms of **turnover** and **margins** based on hypothesis to improve and optimize the CGU activity's performance.

IAS 36.33 - An entity shall base cash flow projections on reasonable and supportable assumptions. **Greater weight shall be given to external evidence**.

IAS 36.34 - Management assesses the reasonableness of the assumptions on which its current cash flow projections are based by **examining the causes of differences between past cash flow projections and actual cash flows**. Management shall ensure that the assumptions on which its current cash flow projections are based are **consistent with past actual outcomes**.

Reasonable assumptions

Enforcement issues related to financial reporting

Case n.3

IAS 36 – Value in use: business plan – Enforcer’s view

Reasonable assumptions

The enforcer considered that the approach followed by the issuer was not compliant to IAS 36.

Action taken according to art. 154-ter of CLF. A restatement was required

- The issuer has changed the model for the determination of the value in use in compliance with Consob remarks

Enforcement issues related to financial reporting

Case n.4 — **IAS 36 – Value in use: business plan**

Description of the issue

- The projections were based on the business plan of the Bank approved in may 201x-1. The impairment test was performed in march 201X.
- A significant worsening of the macroeconomic and financial perspectives of the banking sector was registered in that timeframe.

Supportable assumptions

IAS 36.38 - In using information from financial budgets/forecasts, an entity considers whether the information reflects **reasonable** and **supportable assumptions** and represents management's best estimate of the set of **economic conditions that will exist over the remaining useful life of the asset**.

The impairment test was based on some assumptions that did not reflect the economic scenario and the external evidences in place at that time.

Enforcement issues related to financial reporting

Case n.4 **IAS 36 – Value in use: business plan – Enforcer's view**

The enforcer considered that the approach followed by the issuer was not compliant to IAS 36.

Action taken according to art. 154-ter of CLF.

Supportable assumptions

- The issuer has not accepted Consob remarks.

Enforcement issues related to financial reporting

Case n.5

IAS 36 – Value in use: <u>wacc</u>

Description of the issue

- Post-tax 201X WACC was 2% lower than the post-tax wacc used in 201X-1 although, compared to 2011, the specific risks related to the CGU did not show any signs of attenuation. The changes in the market context did not justify such a reduction in the discount rate.
- Cost of capital was not coherent with risks included in cash flows.

IAS 36.51 - Estimated future cash flows reflect assumptions that are consistent with the way the discount rate is determined.
IAS 36.A.17 - a starting point in making such an estimate, the entity might take into account the following rates: (a) the entity's w**eighted average cost of capital** determined using techniques such as the **Capital Asset Pricing Model**; (b) the entity's incremental borrowing rate; and (c) other market borrowing rates.

WACC

Enforcement issues related to financial reporting

Case n.5 — **IAS 36 – Value in use: wacc (cont.)**

- On the basis of CAPM, the cost of equity is determined as the sum between the risk-free investment return and a risk premium depending on the systemic risk of the entity being assessed and measured using a **beta** coefficient.
- In the specific case, beta has been calculated **by reference to a panel of companies** operating in a business not directly comparable to the issuer's business.

Beta calculation - Bottom up approach

The bottom up beta can be estimated by doing the following:

- Find out the businesses that a firm operates in;
- Find the unlevered betas of other firms in these businesses;
- Take a (weighted) average of these unlevered betas;
- Lever up using the firm's debt/equity ratio.

Issues

- "Comparables" do not mainly operate in same business of the Issuer but mainly in a sector characterized by a different operational risk;
- "Comparables" have a much higher capitalization than the potential value of the Issuer;
- "Comparables" operate in countries with different regulations;
- Unlevered betas of the panel oscillate in a wide range (0.14 - 0.83).

Enforcement issues related to financial reporting

Case n.5

IAS 36 – Value in use: wacc – Enforcer's view

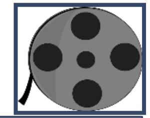
The enforcer considered that the approach followed by the issuer was not compliant to IAS 36.

Action taken according to art. 154-ter of CLF. A restatement was required

- The issuer has changed the assumptions and the approach for the determination of the wacc in compliance with Consob remarks

Enforcement issues related to financial reporting

Case n.6 — **IAS 38 & IAS 36 – Intangible valuation**



Description of the issue

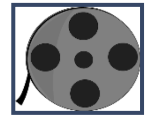
- To perform the impairment test of a *library* (*movies*), the issuer calculated the fair value according to the multi-period excess earrings.
- However the assumptions made in relation to the useful life of the library – more than 10 years - were **inconsistent with the characteristics of the asset**.

Inconsistent assumptions

Enforcement issues related to financial reporting

Case n.6

IAS 38 & IAS 36 – Intangible valuation



- According to IAS 38.90, many factors are considered in determining the useful life of an intangible asset, including:

a) the expected usage of the asset

b) typical product life cycles for the asset and public information on estimates of useful lives of similar assets that are used in a similar way

c) technical, technological, commercial or other types of obsolescence

d) the stability of the industry in which the asset operates and changes in the market demand […]

e) expected actions by competitors or potential competitors

f) the level of maintenance expenditure […]

g) […] limits on the use of the asset […]

h) whether the useful life of the asset is dependent on the useful life of other assets of the entity

The enforcer considered that the assumptions used by the issuer to estimate the useful file of the library in the valuation process were not consistent with the life cycle of the films, considering also the cash flow associated, the historical experiences, film reviews and observable expectations.

Inconsistent assumptions

Enforcement issues related to financial reporting

Case n.6 **IAS 38 & IAS 36 – Intangible valuation – Enforcer's view**

The enforcer considered that the approach followed by the issuer was not compliant to IAS 36 and IAS 38

Action taken according to art. 154-ter of CLF. A restatement was required

- The issuer has changed the assumptions to estimate the recoverable amount in compliance with Consob remarks

Inconsistent assumptions

Enforcement issues related to financial reporting

Case n.7 IFRS 3 & IFRS 13 – Intangible valuation - Disclosure

Description of the issue

- IPOs of entities with material intangible assets require **a in-depth analysis of the information provided in the prospectus**.
- In a recent case, following a business combination, the issuer recognized a brand, as an intangible asset. The year after the issuer went public.
- **Total intangible assets (half of which was the amount of the brand) represented more than 2x the Net Equity.**
- While for PPA purposes the entity measured the brand applying the Multi-period Excess Earnings Method, the impairment test performed later was based on the Relief-from-Royalties method.
- Limited information was provided in the first draft of the prospectus about **assumptions used to calculate the fair value** (e.g. royalty rates).

Disclosure

Enforcement issues related to financial reporting

Case n.7 **IFRS 3 & IFRS 13 – Intangible valuation – Enforcer's view**

- IFRS 3 requires issuers to disclose information that enables users to evaluate the nature and financial effect of business combinations.
- **If changing one or more of the unobservable inputs to reflect reasonably possible alternative assumptions would change fair value significantly, an entity shall state that fact and disclose the effect of those changes**. The entity shall disclose how the effect of a change to reflect a reasonably possible alternative assumption was calculated.

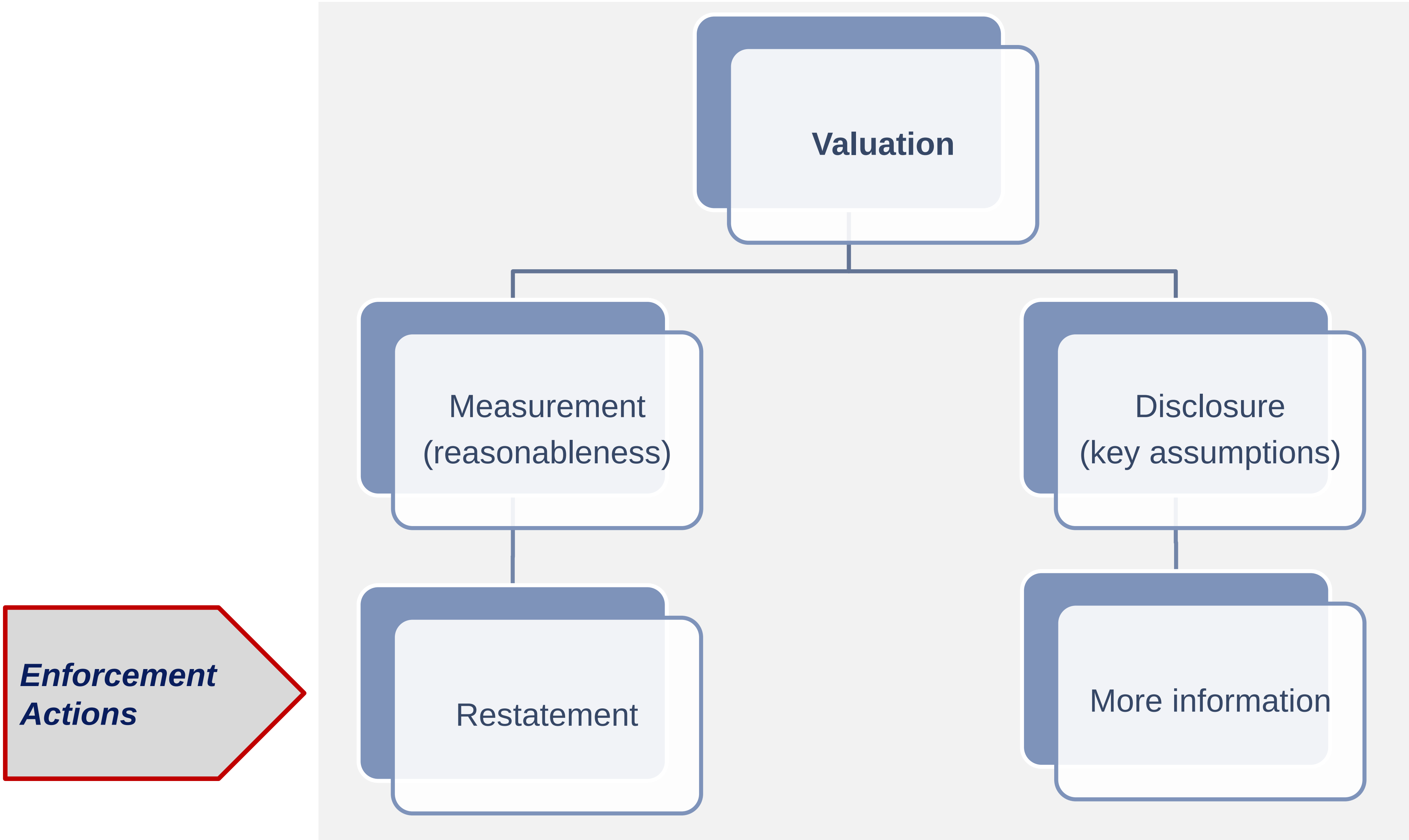
The enforcer considered that there was a need to increase the disclosure in the prospectus

Enforcer required to include the effects of changes in unobservable inputs (royalty rate, sensitivities…)

- The issuer has reported the information required.

Final remarks

Conclusions



Conclusions

- ✓ **Valuation issues will have an increasing impact for the financial information (i.e, IFRS 9).**

- ✓ **This is a significant risk because valuations could underpin the accuracy of many financial statements and hence the integrity of markets.**

- ✓ The enforcement experience found concerns about valuations and more specifically regarding valuation techniques and key assumptions. **Diversity in practice exists** about measurement in financial reports. The role in Italy of the OIV (Organismo Italiano di Valutazione) also through the Italian Valuation Standards (Principi Italiani di Valutazione) is welcomed as a contribution for defining procedures and standards for the financial measurements with the view to **reduce differences in financial valuation practices**.

- ✓ Valuations for financial reporting require the exercise of a judgment that should be formulated considering **all the material facts and circumstances** relevant to the specific measurement basis (*Italian Valuation Standards*).

- ✓ The increasing attention also to **non financial information** can contribute to the assessment of risk profile of the company.

Thank you