DPR FREP

DEUTSCHE PRÜFSTELLE FÜR RECHNUNGSLEGUNG
FINANCIAL REPORTING ENFORCEMENT PANEL

Valuation for Business Combinations and Impairment Testing

Enforcement Perspective

Business Valuation International Conference

Milano, 23 October 2012 **Dr. h.c. Axel Berger**

Agenda

1. Structure and enforcement in Europe, current environment

2. Examination of Goodwill impairment testing – FREP‘s approach
   - Cash flow projections (see examples)
   - Assumptions terminal Value
   - Calculation of discount rate

3. Selected examples of FREP findings

Enforcement in Europe

- Recommendation of the Lamfalussy working group
- EU regulation 1606/2002, § 16
- Transparency directive 2004/109/EG

Enforcement in Germany

- **Companies subject to examination:**
  - approximately 900 publicly-listed companies in Germany
  - including 150 foreign-based companies listed in Germany
- **Examination frequency (excluding examinations with cause):**
  - Companies in the DAX, MDAX, SDAX, TecDAX
    - Examination every 4-5 years
  - All other companies
    - Examination every 8-10 years

Examples for differences of the national enforcement institutions: Examination approach and its consequences

Principles of the examination process

- Basis for the enforcement examinations in Germany is, in addition to the annual report of the company, the long-form auditor report as well as the summary of unadjusted audit differences
- In the Netherlands the enforcer can conduct its examinations solely based on publicly-available information
- In the UK examination is mainly focused on information provided in the disclosures
- Spain: all published company announcements are reviewed

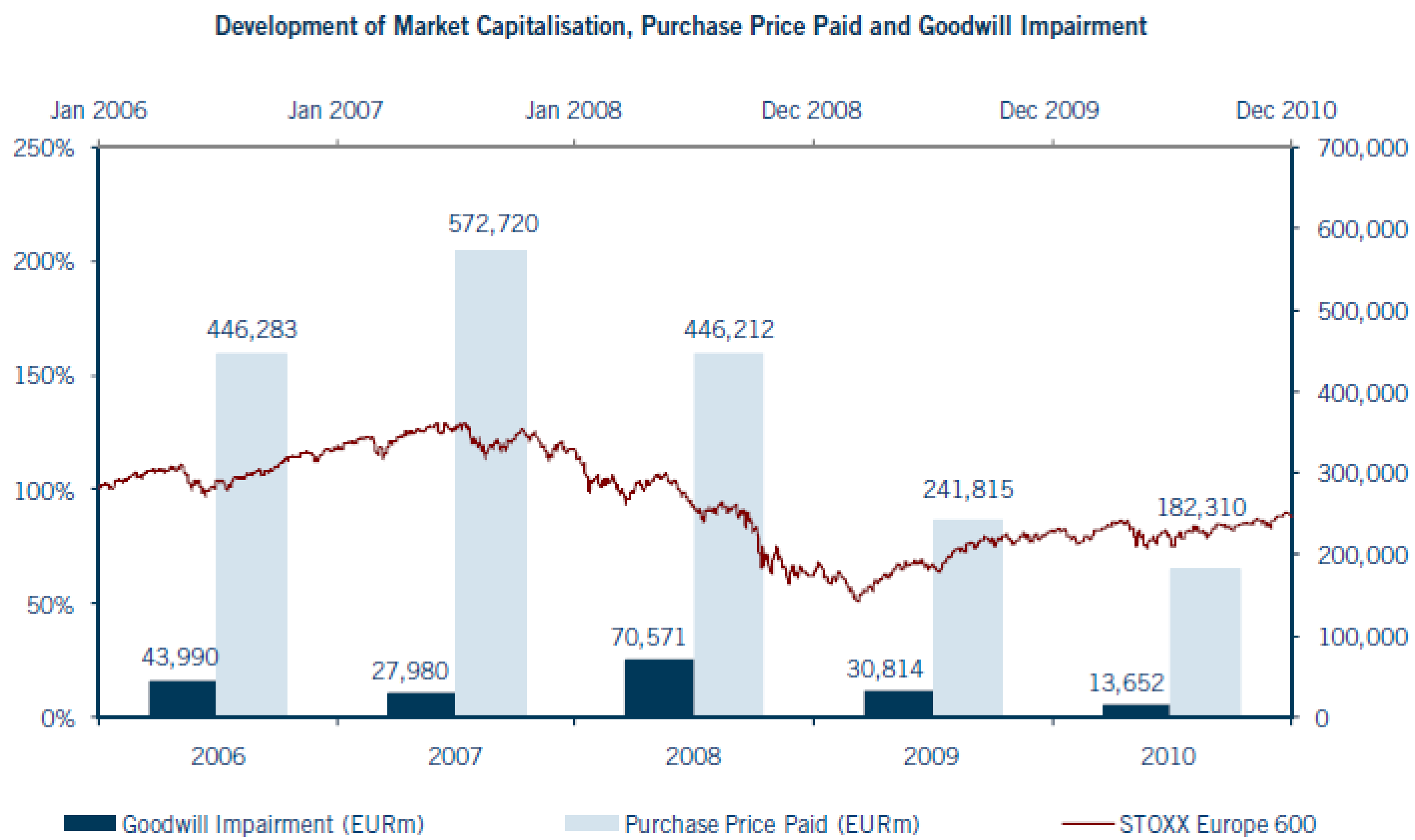
Consequences of detected erroneous accounting extremely different

- Complete correspondence with the companies is made publicly available after the examination (Spain and Norway)
- Error publication und restatement of the financial statements (Greece, Ireland)
- Error publication (Germany, Denmark, Portugal)
- “Notifikationen“ not subject to publication and “Recommendationen“ subject to publication (Netherlands)

Current environment: Goodwill impairment testing

- Main application for business valuation in financial accounting
- Valuations are usually not performed by outside valuation experts, but rather internally or by auditors
- Specific requirements for valuations in IFRSs such as pre-tax calculations or requirement to eliminate specific investments in estimating value in use
- Impairments of goodwill less than expected despite the financial crisis
- Especially publicly listed companies tend to show few impairments, while non-listed companies tend to write off more goodwill (see KPMG, study on cost of capital, 2011/2012).

What´s the Problem?



Source: The European Impairment Study 2011-2012, Houlihan Lokey

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Approach of the FREP

- Valuations of CGUs are necessarily judgemental
- It is the preparer who has to demonstrate and furnish evidence for the recoverability of the CGU or the goodwill
- Evidence for recoverability is given only by proper and appropriate documentation of the valuation approach and the underlying assumptions
- This documentation is FREP's starting point
- FREP does NOT replace management's assumptions with its own assumptions (second guessing), but examines whether management's assumptions are **reasonable und supportable as well as consistent**
- **FREP therefore examines whether recoverability can be demonstrated and evidenced!**

Commonly used assumptions for calculation of terminal value

- Estimates beyond forecast/budgets as the basis for the calculation of terminal value reasonable and supportable?
  - Cash flow projections have to reflect the economic life circle of the assets Difficulties in exceeding the average historical growth rate because new competitors will enter the market (IAS 36.36-37)
- The probable change in working capital should be considered
- Accumulation of earnings/capital not sufficient for estimated growth
- Use of expected growth based on industry studies without critical review of the company´s market position
  - low performer growth expectations using higher rates than the market indicates
    - Often higher growth rates than the market average: Where are the market performers?
    - Incorrect assumptions regarding growth rate (see 12th Extract from EECS Database, para. 80)

Calculation of discount rate – subject to management judgement

– Interest rate derived from surrogates -> difficulty: CGU often not traded on public markets (IAS 36.55-57, Appendix A)

– A starting point for the estimate of the discount rate is the CAPM including Peer Group Analysis (IAS 36.A17); however, these rates must be adjusted to reflect the market assessment of entity-specific risks (IAS 36.A18)

– The discount rate should be independent of the entity´s capital structure and should be a pre-tax rate (IAS 36.A19+20)

– Wide range of judgement on deviation of beta factors (peer group, duration)

– Point of Interest: What is the correct market risk premium in the environment of capital market crisis?

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3. **Selected examples of FREP findings**

Errors identified by the FREP

- Incomplete or erroneous disclosures regarding goodwill impairment tests:
  - Missing disclosure of main premises and assumptions on which the cash flow projection within the detailed planning period is based
    - Infringement of disclosure requirements (IAS 36.134 (d) (i) and (ii))
  - Example: The notes to the consolidated financial statements as of 31.12.2010 do not contain the disclosures required by IAS 36.134 (d) regarding the goodwill impairment test. Especially the description of the key assumptions on which management has based its cash flow projections, the description of management‘s approach to determine the value assigned to each key assumption, the period over which management has projected cash flows, the growth rate used to extrapolate cash flow projections beyond the period covered by the most recent budgets/forecasts and the discount rate used have not been disclosed. This is an infringement of IAS 36.134 (d).
  - Missing sensitivity analysis (in case impairment is likely to occur in the future)
    - Infringement of disclosure requirements (IAS 36.134 (f))
  - Allocation of goodwill and intangible assets with indefinite useful life to CGUs not disclosed
    - Infringement of disclosure requirements (IAS 36.134 (a) and (b))

Errors identified by the FREP

- Allocation of “corporate assets“:

  Examples:

  - Goodwill is allocated to CGUs based on revenues.
  - Trademark is being tested for impairment on a stand alone basis, using the “relief from royalty“-method, but is not allocated to the CGUs that use the trademark.
    - This is not “consistent“ in the sense of IAS 36.102.

  Or:

  - Trademark is being tested for impairment on a stand alone basis, using the “relief from royalty“-method, but is allocated to the CGUs based on an earnings measure.
    - This is not “consistent“ in the sense of IAS 36.102.

Findings of FREP

- Deficiencies recognized within FREP's examinations of impairment tests:
  - Cash flow projections applied do not conform with reasonable and justifiable assumptions
    Example from year 2010: A US subsidiary has disclosed losses for many years, and revenues have been declining since 2001/2002. The cash flow projections applied which did not result in an impairment do not conform with reasonable and justifiable assumptions. Thus, the rules of IAS 36.33, IAS 36.59 seq. and IAS 36.104 are violated.
  - "Non-reliable" horizon for cash flow projections of more than five years
    - Link to management report, impairment test and deferred taxes
  - Impairment test was not conducted, although a "triggering event" existed (in interims).
- Inappropriate accounting for disposal and reallocation
  - "Impaired" goodwill is reallocated prior to impairment
  - Goodwills in various CGUs are merged before reallocation and thus allocated according to the related financial strength

Errors identified by the FREP

An impairment test that is not based on reasonable and supportable assumptions would be as follows:

– Test of an identical CGU in two subsequent years:

(in CU)	X1	X2	X3	X4	X5	TV
Gross sales	228,5	261,5	300,6	306,2	327,1	
EBITDA	28,2	40,9	51,0	59,7	71,0	
Depreciation/Amortization	18,5	19,1	19,7	19,0	19,5	
EBIT	***9,6***	***21,8***	***31,3***	***40,7***	***51,4***	***60,4***

(in CU)	X2	X3	X4	X5	X6	TV
Gross sales	201,9	224,8	262,0	306,2	327,1	
EBITDA	29,4	37,8	47,8	59,4	70,1	
Depreciation/Amortization	17,0	17,5	17,5	17,9	18,2	
EBIT	***12,4***	***20,3***	***30,3***	***41,6***	***51,9***	***60,4***

– Reported gross sales in X1 were 202.8 CU; moreover continuing differences between projected and actual figures in the past.

Findings of FREP

Forward-looking information used by companies has to be consistent:

- Forward-looking information e.g. in:
  - Management report / forecast report,
  - Impairment tests and
  - Tax projections.
- Forward-looking information has to be
  - materially transformable within each other and
  - formally consistent.
- A constrained forecast report due to stated uncertainty has to be justifiably reflected within the impairment test, either by adjusted cash flows or risk premiums in the discount rate

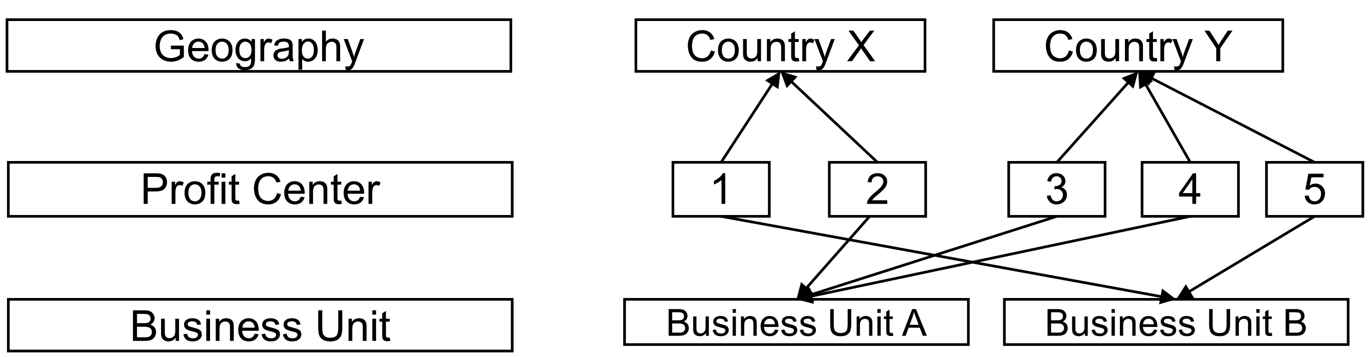
Findings of FREP

Issue

- Company A has a reportable segment with two business units (A and B)
- Company A allocates goodwill to two geographical CGUs, country X and country Y

Question

- Does management have to define CGUs for goodwill impairment testing consistently with segment reporting if a matrix organisation exists?



Findings of FREP

- Allocation of goodwill has to follow the layout of business segments according to IFRS 8: There is a price to pay for “through the eyes of management“.
- “Not be larger than an operating segment“ (IAS 36.80b); **for purposes of goodwill impairment testing, CGUs are not allowed to exceed the boundaries of business segments**
- Companies with a matrix organization cannot arbitrarily decide upon the definition of CGUs. There is no reason for monitoring goodwill differently from segment reporting, as the latter has to observe the primary level of the matrix
  - This would not comply with the management approach
- Regardless to IAS 36.80, IASB is concerned by the monitoring of goodwill on aggregated level (in this case: countries or business segments)
  - Allocation based on profit center level would be in line with IAS 36.

Findings of FREP

Methodical errors/principle of equivalence (IAS 36.75 seq.)

- Deduction of (deferred tax) liabilities from book value
  - Basis for discounting: EBIT
  - Possible exception: Tax amortization benefit (TAB) which was reflected in the valuation of intangibles
- Within a purchase price allocation: Providing extensive provisions for warranties followed by a deduction from CGU's net book value
  - Basis for discounting: EBIT
  - Deduction from book value within the calculation of working capital is generally acceptable
  - Error: If EBIT is not adjusted, this would reflect an additional cash outflow