



DEUTSCHE PRÜFSTELLE FÜR RECHNUNGSLEGUNG
FINANCIAL REPORTING ENFORCEMENT PANEL

Impairment tests in Germany

critical issues

VI International Business Valuation Conference

Milano, December 4, 2017

WP StB Prof. Dr. Bettina Thormann

Agenda

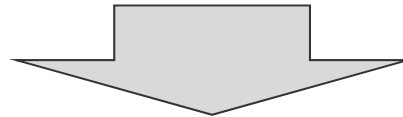
1. Overview of the two-tiered enforcement in Germany
2. Relevance of impairment testing in Germany
3. FREP's experience with impairment tests
4. Summary and outlook

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What is the goal of enforcement?

- To enhance the quality of financial reporting of listed companies
- To strengthen the capital market's trust in the accuracy of financial reporting
- To avoid future accounting errors (preventive effect)



Conduct enforcement examinations in order to identify material misstatements of financial statements

How is the German two-tiered enforcement system organised?

Tier I

- Performed by „Financial Reporting Enforcement Panel“
- A private sector body which is recognised and authorised by the Federal Ministries of Justice and Finance
- An independent body - FREP is funded through an annual fee to all companies which are subject to enforcement
- An effective body with up to 16 highly qualified panel members

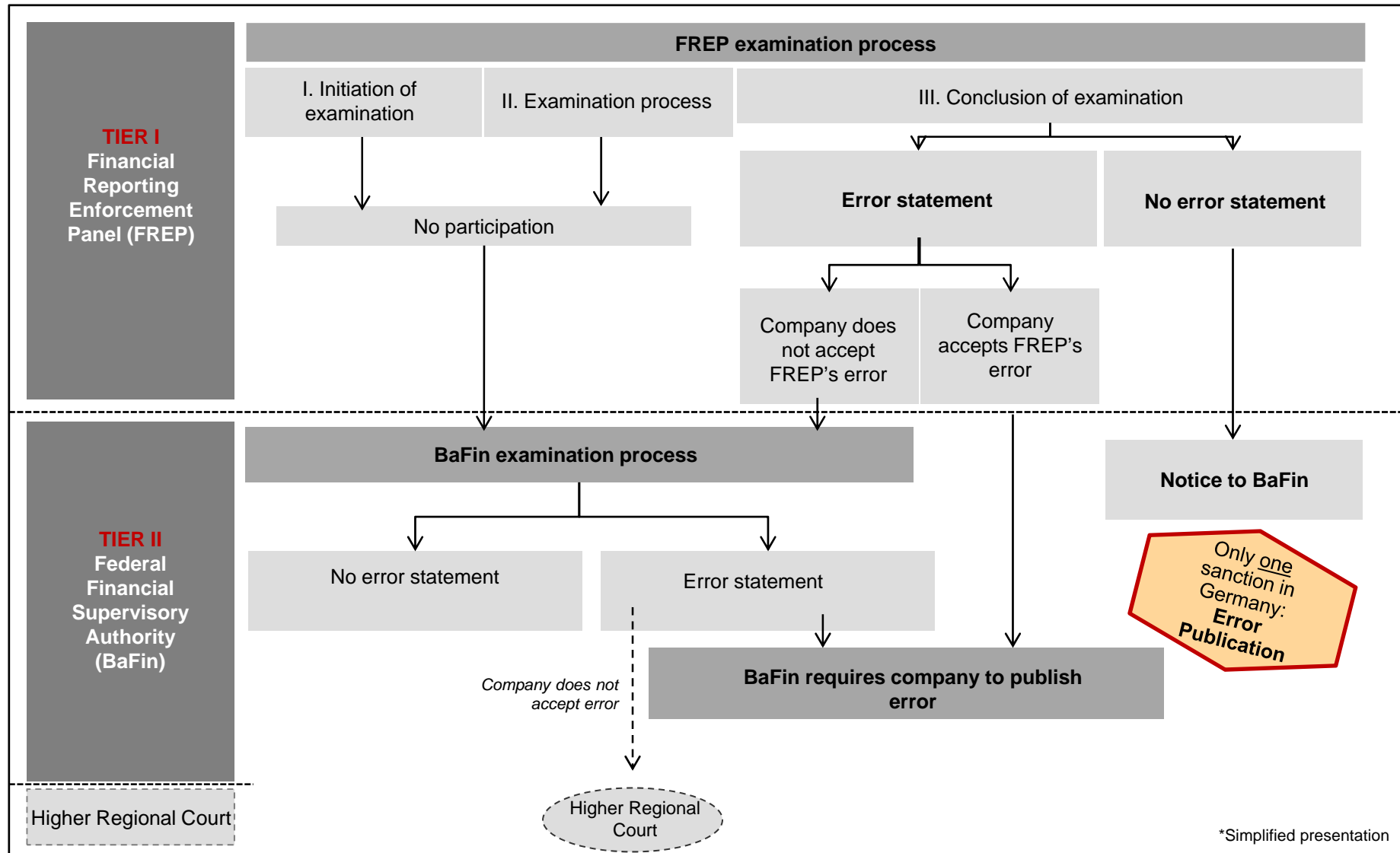


Tier II

- Performed by the public “Federal Financial Supervisory Authority” (in German: „Bundesanstalt für Finanzdienstleistungsaufsicht” – „BaFin”)
- Uses sovereign powers in enforcement if necessary
- Responsible for ordering issuers to publish identified errors

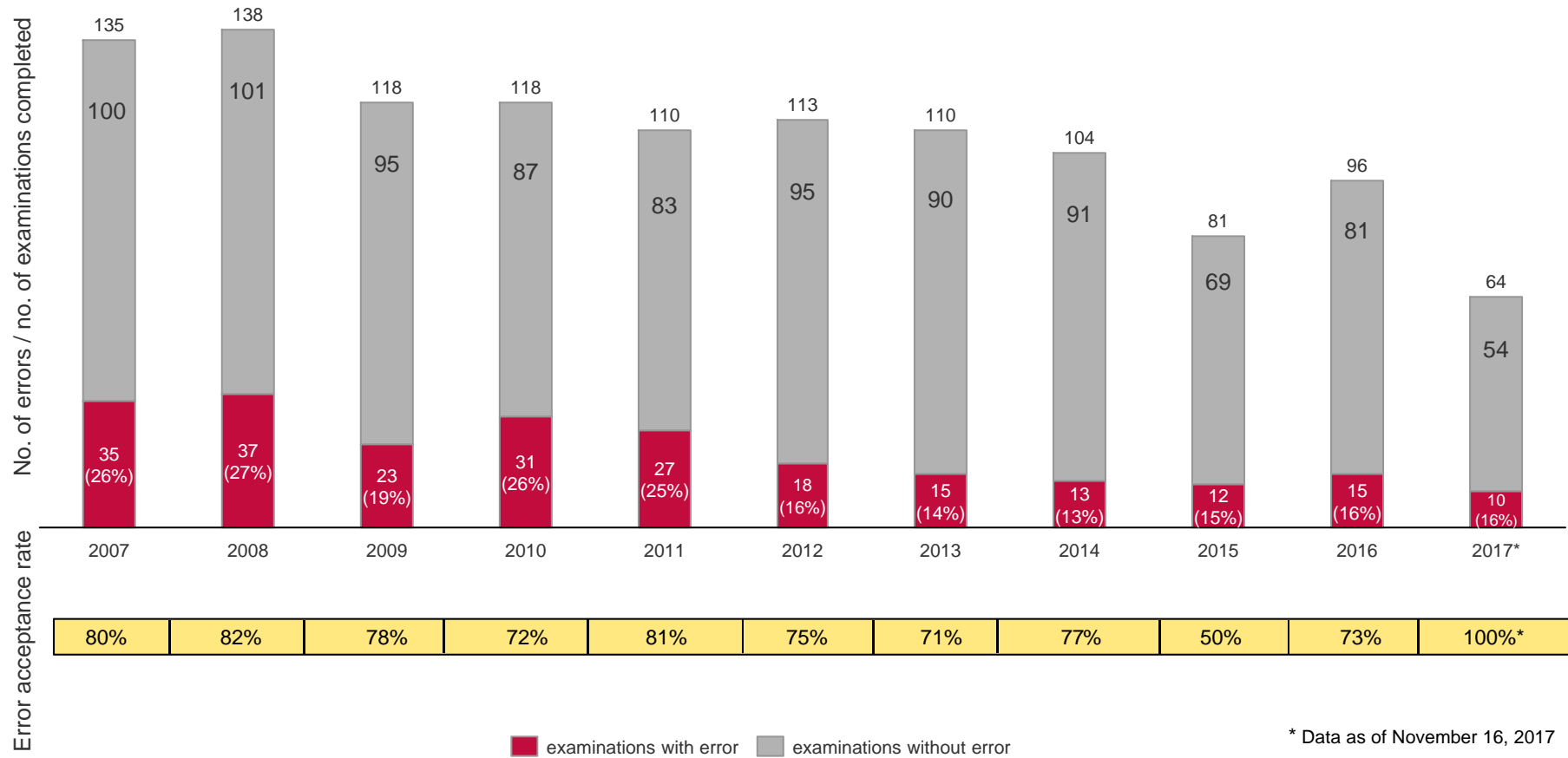


How does the two-tiered enforcement process work?*

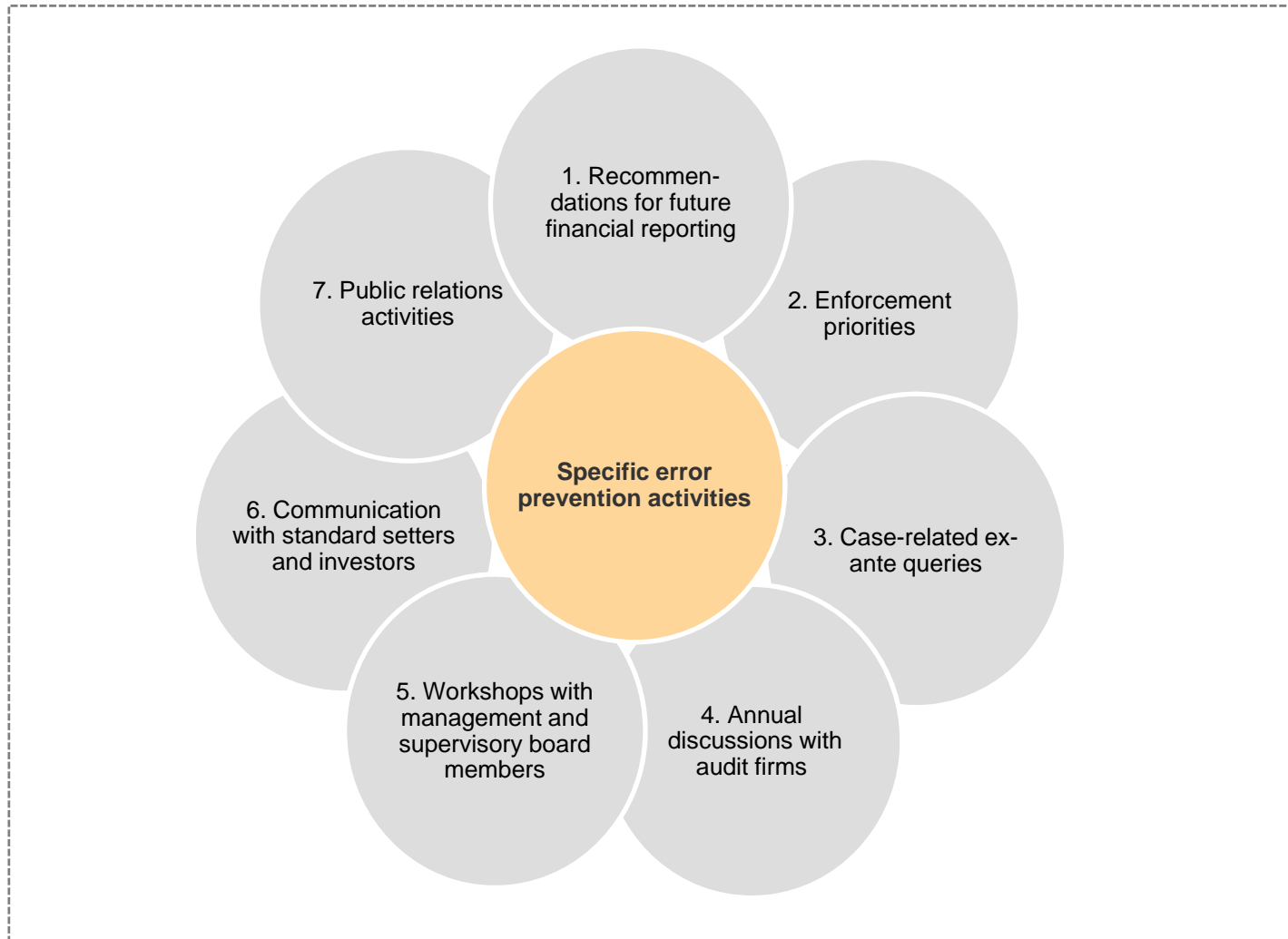


How high is the error rate and the error acceptance rate?

Basis: Completed FREP examinations, error rate and trend in error acceptance rate



What are FREP's error prevention activities?

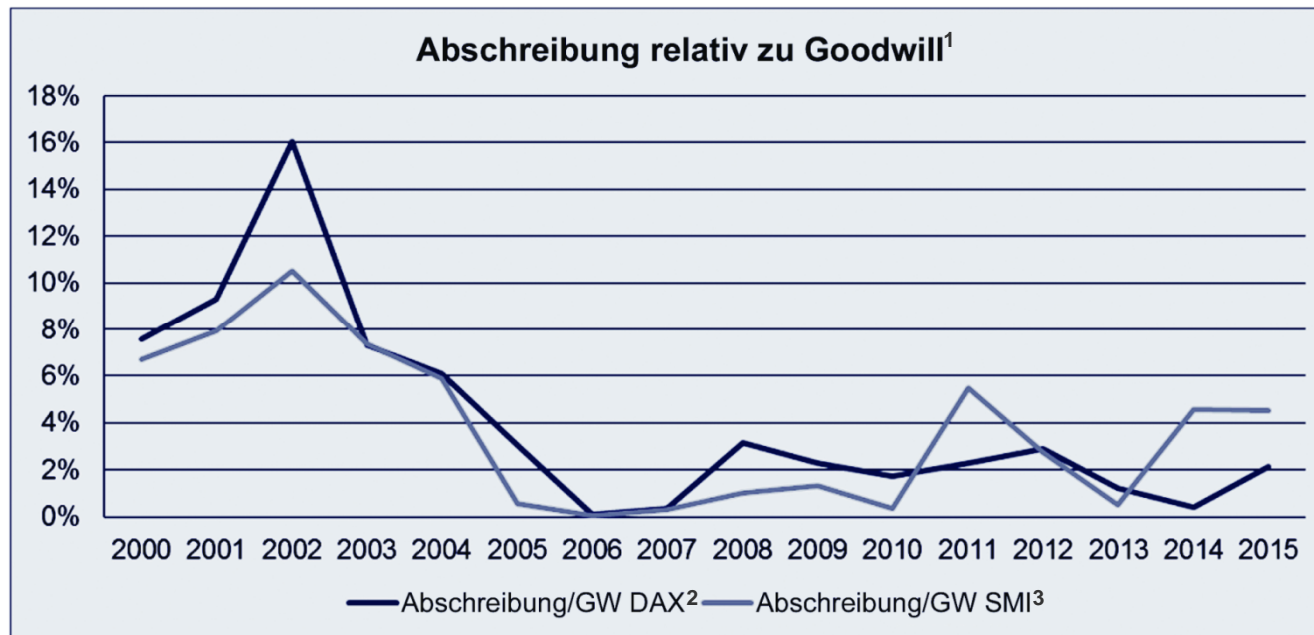


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Relevance of impairment testing in German enforcement (1/2)

There is only a minor percentage of goodwill impairment in relation to goodwill on the balance sheet:



Source: Leibfried,
IRZ 2016, P. 353

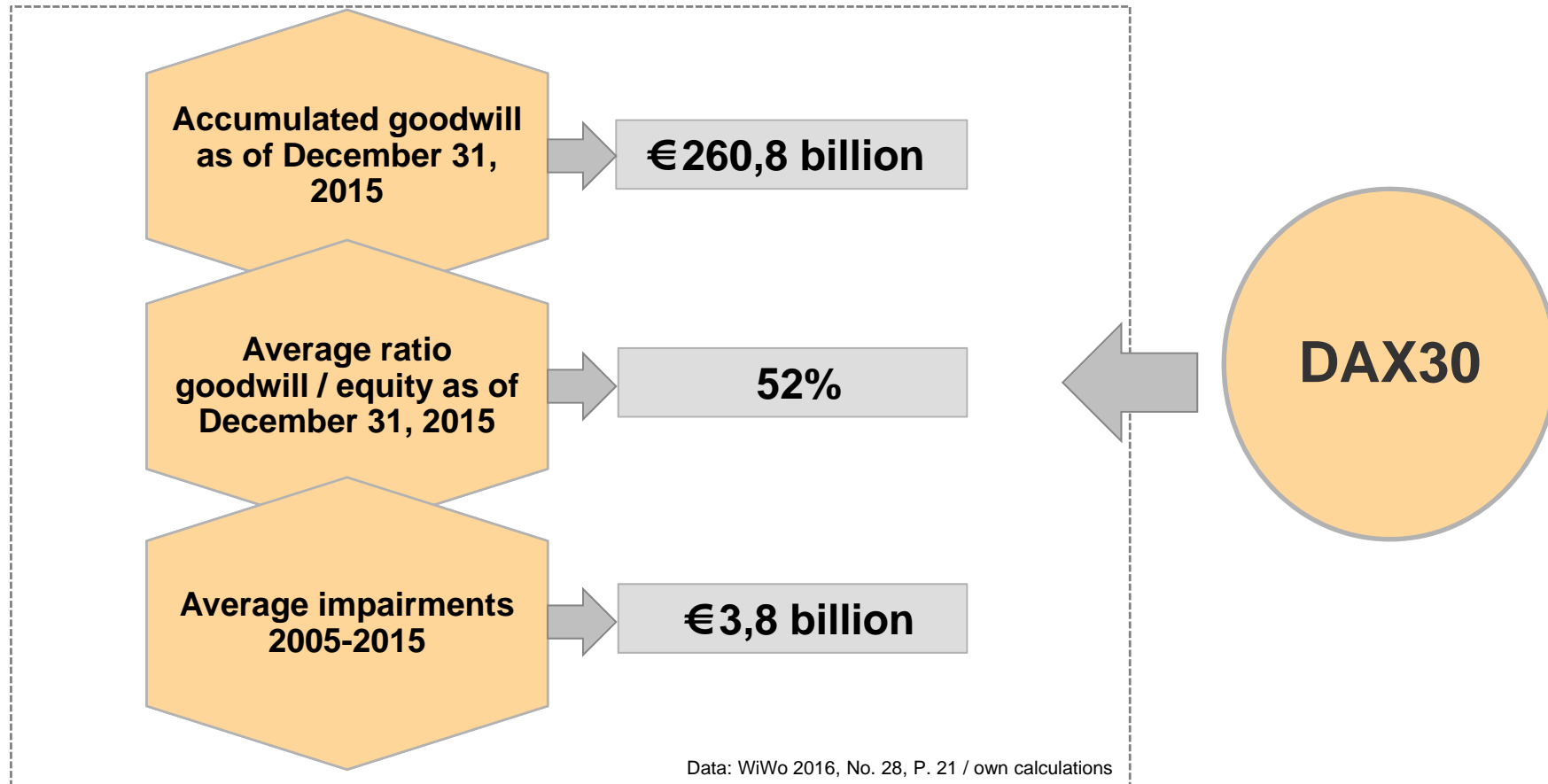
¹ Impairment relative to goodwill

² Impairment relative to goodwill (German Index (DAX - Deutscher Aktienindex))

³ Impairment relative to goodwill (Swiss Market Index)

Relevance of impairment testing in German enforcement (2/2)

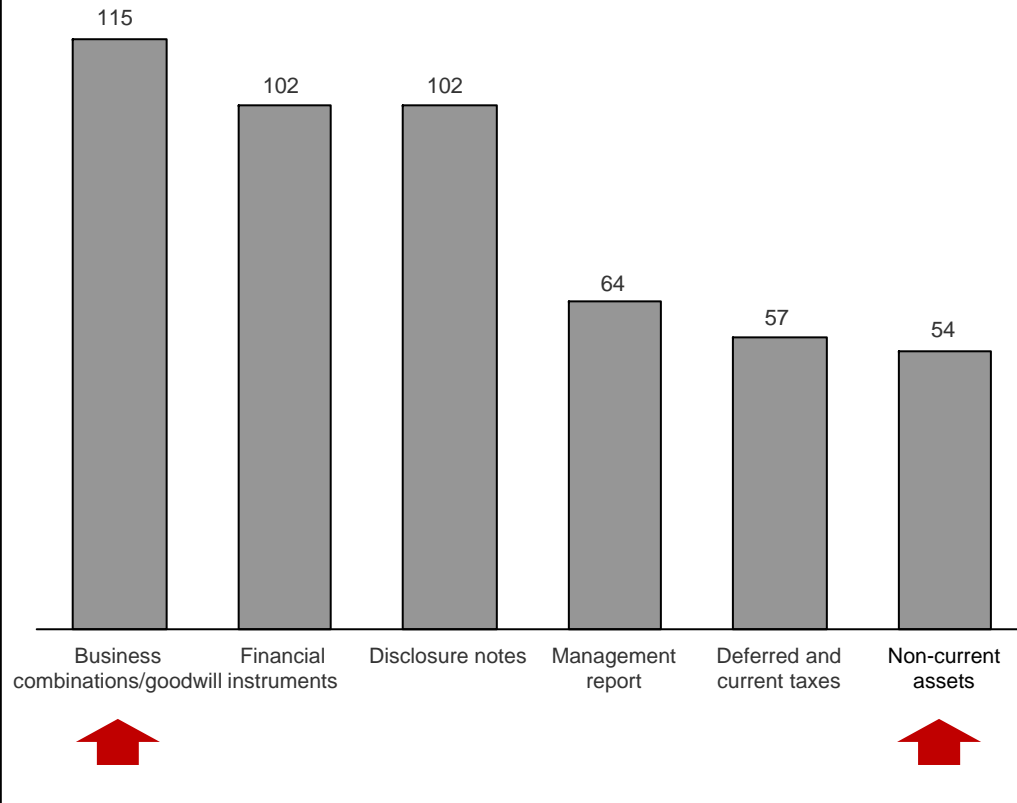
In most of the acquisitions 50-60% of the purchase price is allocated to goodwill!*



*Glaum, Goodwill Impairment – an academic perspective, IFRS Kongress, Berlin, Sept. 7, 2017

Relevance of impairment testing in Germany (2005 – Oct 2017)

Common error categories (2005 – Oct 2017)



Goodwill / PPE impairment test (2005 – Oct 2017)

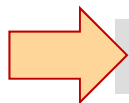
Error categories

Business combinations/goodwill

- thereof 27 errors related to goodwill impairment testing

Non-current assets

- thereof 7 errors related to impairment of property, plant and equipment
- thereof 6 errors related to impairment of equity accounted investees
- thereof 4 errors related to impairment of intangible assets

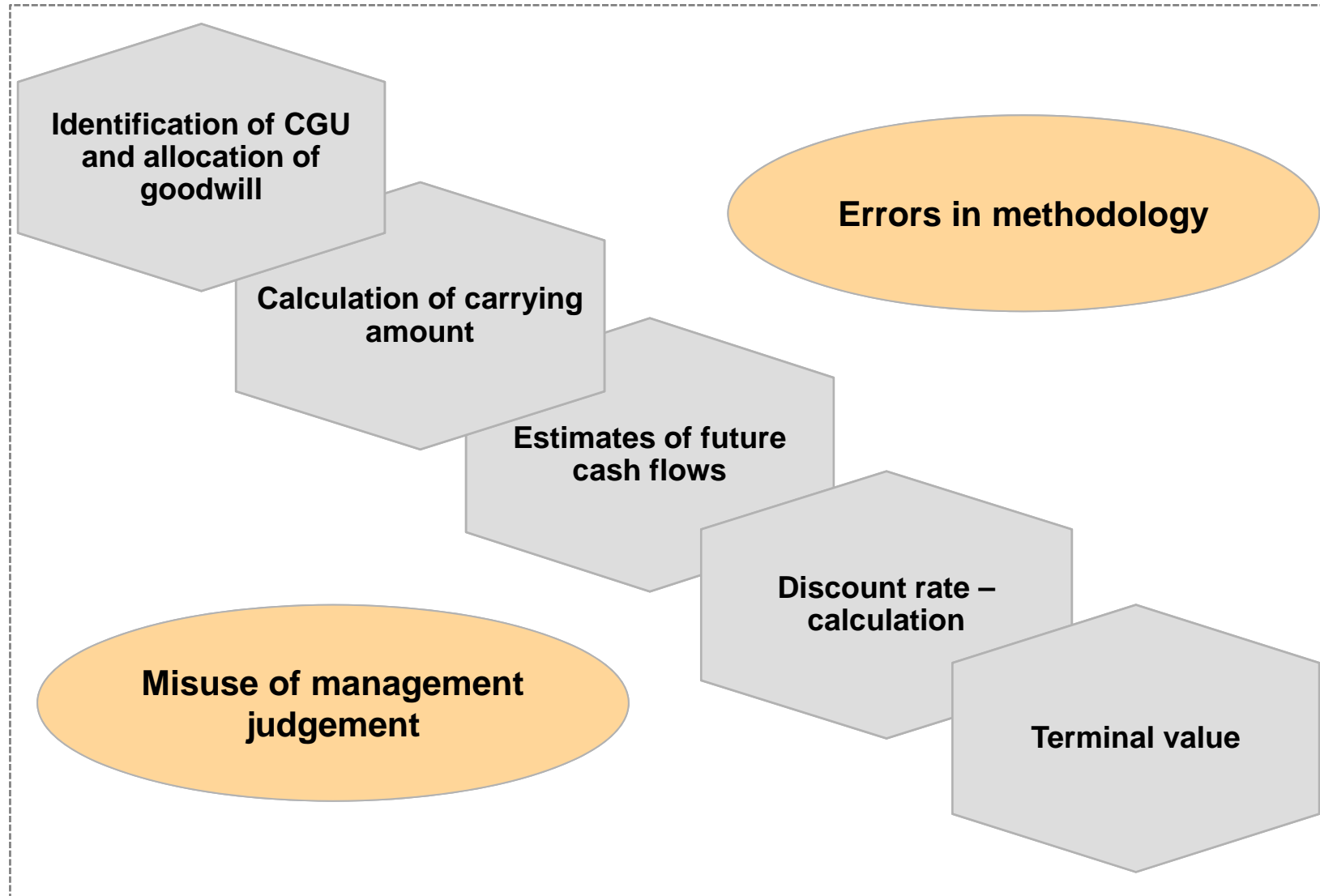


Impairment testing shows a high probability of an error

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Goodwill impairment test – identified areas for potential errors



Enforcement procedure – impairment test

- The company is responsible for documenting its accounting practice when preparing the financial statements. This documentation is requested by FREP if goodwill is a focus area
- Management judgement and estimates in an impairment test can only be verified by documentation of accounting decisions regarding measurement and the underlying assumptions
- This documentation is the starting point for enforcement procedures

FREP does not replace the companies' assumptions with its own assumptions, but analyzes whether the companies' assumptions are reasonable

⇒ High hurdle for the enforcer to conclude there is an infringement of IFRS



Misuse of management judgement

FREP examines whether there are methodical or systematic errors in the presented impairment test (inconsistencies, mathematical errors, infringement of IAS 36 requirements, etc.)



Errors in methodology

Identification of the CGU and allocation of goodwill (1/2)

Requirements in IAS 36

- **IAS 36.6 - CGU:** Smallest identifiable group of assets that generates independent cash inflows
- **IAS 36.80 - Allocation of goodwill** to CGU or group of CGUs expected to benefit from synergies of the business combination. Each CGU to which goodwill is allocated shall represent the lowest level within the entity at which the goodwill is monitored
- Cap: Operating Segment (IAS 36.80b)

FREP Finding

The recoverability of goodwill is not demonstrated at the balance sheet date because the impairment test is performed for CGUs that extend beyond the operating segments. If operating segments are considered to be at the country level, the CGUs may not be legal entities that operate transnationally.

Identification of the CGU and allocation of goodwill (2/2)

Observations of FREP

- There is a tendency to „merge“ existing operating segments and to create only one segment or only a few large segments

! This has to be reflected in internal reports that are reviewed by management on a regular basis in order to allocate resources to segments and to assess its performance (IFRS 8)

- There is a tendency to allocate a maximum percentage of acquired goodwill at the acquisition date to the most profitable CGUs with high internally generated goodwill

! It has to be demonstrated that this CGU benefits from the synergies of the business combination (IAS 36.80)

- There is a tendency to monitor goodwill at the highest level possible.

Calculation of carrying amount

Requirement of IAS 36.76

Carrying amount of a CGU includes only those assets that can be attributed directly, or allocated on a reasonable and consistent basis, to the CGU. Liabilities can only be recognised when the recoverable amount of the CGU cannot be determined without consideration of the liability.

Findings of FREP

- **Corporate Assets** (and related overhead cost) are not allocated to CGU's
- **Pension provision** is recognised although it is a financing activity
- **Deferred taxes - inconsistencies:**
 - Deferred tax liabilities on temporary differences are included in the carrying amount of a CGU although future tax payments in the DCF-calculation are based on IFRS EBIT or
 - Deferred tax assets on temporary differences are not included in the carrying amount of a CGU although future tax payments in the DCF-calculation are based on actual future taxable profits

Question: Is it reasonable to recognise deferred taxes in the carrying amount although they are undiscounted?

Estimates of future cash flows (1/3)

Requirement of IAS 36.50:

Estimates of future cash flows shall not include income taxes

But:

As parameters for the discount rate are post-tax (basis discount rate, market risk premium), taxes have to be included in the estimates of future cash flows

Finding of FREP

- Goodwill is impaired by ... €. The calculation of the value in use for impairment test purposes was erroneous because the cash flows and discount rates were determined based on different tax assumptions (pre-tax / post-tax).

Estimates of future cash flows (2/3)

Requirements of IAS 36.33 f. (extracts):

In measuring value in use an entity “shall base cash flow projections on reasonable and supportable assumptions that represent management’s best estimate of the range of economic conditions....”

“...shall exclude any estimated future cash inflows or outflows expected to arise ... from improving or enhancing the asset’s performance.”

“...by examining the causes of differences between past cash flow projections and actual cash flows...”

Findings of FREP

- Goodwill and retained earnings are overstated by ...Euro because recurring operational losses and deviations from plans in the past should have led to corresponding plan adjustments in the impairment tests in previous years.
- The cash flow assumptions relating to improved efficiency did not represent the present condition of the valuation unit and were not reasonable and supportable. The parameters for the cash flows included bundling purchases to reduce purchase prices, although these trading activities had recently been sold by the issuer

Estimates of future cash flows (3/3)

Observations of FREP

- There is a tendency that management's **best estimate** of future cash flow is the **best case scenario** in the range of future economic conditions.
- There is a tendency that sales and EBIT increase significantly within the detailed planning period (hockey stick planning).
- There is a tendency that a lack of planning accuracy in the past does not lead to more conservative estimates in the planning of future cash flows.

Management assumptions for financial reporting purposes - impairment testing - are very optimistic.

Difficult to enforce!

Discount rate

Requirement of IAS 36.55

Discount rate shall reflect the time value of money and the risks specific to the CGU.

As a CGU-specific discount rate generally is not available from the market IAS 36.A17 proposes the use of weighted average cost of capital (WACC) - Capital Asset Pricing Model (CAPM).

But:

Insufficient availability of appropriate companies for determination of the peer group

Findings of FREP

- Choosing a peer group with a lower risk level than the business unit leads to an unjustified reduction of the related WACC. The discount rate of XX% significantly underestimates the risks relating to the planning.
- The discount rates used were not maturity-matched and did not reflect the underlying target capital structure and the specific risks of the asset.

Terminal value

Requirement of IAS 36.33c

In calculating the terminal value an entity shall extrapolate “...the projections based on the budgets/forecasts using a steady or declining growth rate for subsequent years, unless an increasing rate can be justified. This growth rate shall not exceed the long-term average growth rate for the products, industries, or country or countries in which the entity operates...”

Findings of FREP

- The necessary working capital to achieve the expected growth is not included in the calculation
- Depreciation/amortisation and CAPEX are not consistent in perpetuity although that was the original assumption
- The growth rate applied for calculating the terminal value
 - does not reflect the local inflation rate of the CGU
 - does not reflect that in the long term a convergence of the planned rate of return to the cost of capital is generally assumed (IAS 36.37).

Examples of FREP findings other than goodwill

Impairment test – Property, Plant and Equipment

- No impairment testing was performed for property, plant and equipment of CGU X, which was acquired in 2008, even though there were clear indications of a triggering event. The CGU fell short of the expected return of investment at acquisition date and the budgeted returns for the years 2011 to 2013 were not achieved.

Impairment test – equity accounted investees

- Earnings before tax in the 2014 financial year are overstated since no impairment was recognised for an investee recorded at-equity. With a stock market value of approx. € 1.1 million as of December 31, 2014, the book value of the investment and the value in use were approx. € 2 million. The sale of the stake at the beginning of May 2015 resulted in a loss of € 1 million.
- Irrespective of the assessments as to whether the value in use was reliably determined and could be taken as a basis for impairment testing, the possible alternative for a direct or indirect sale of the shares was not considered (IAS 28 / IAS 36).

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Summary and outlook (1/3)

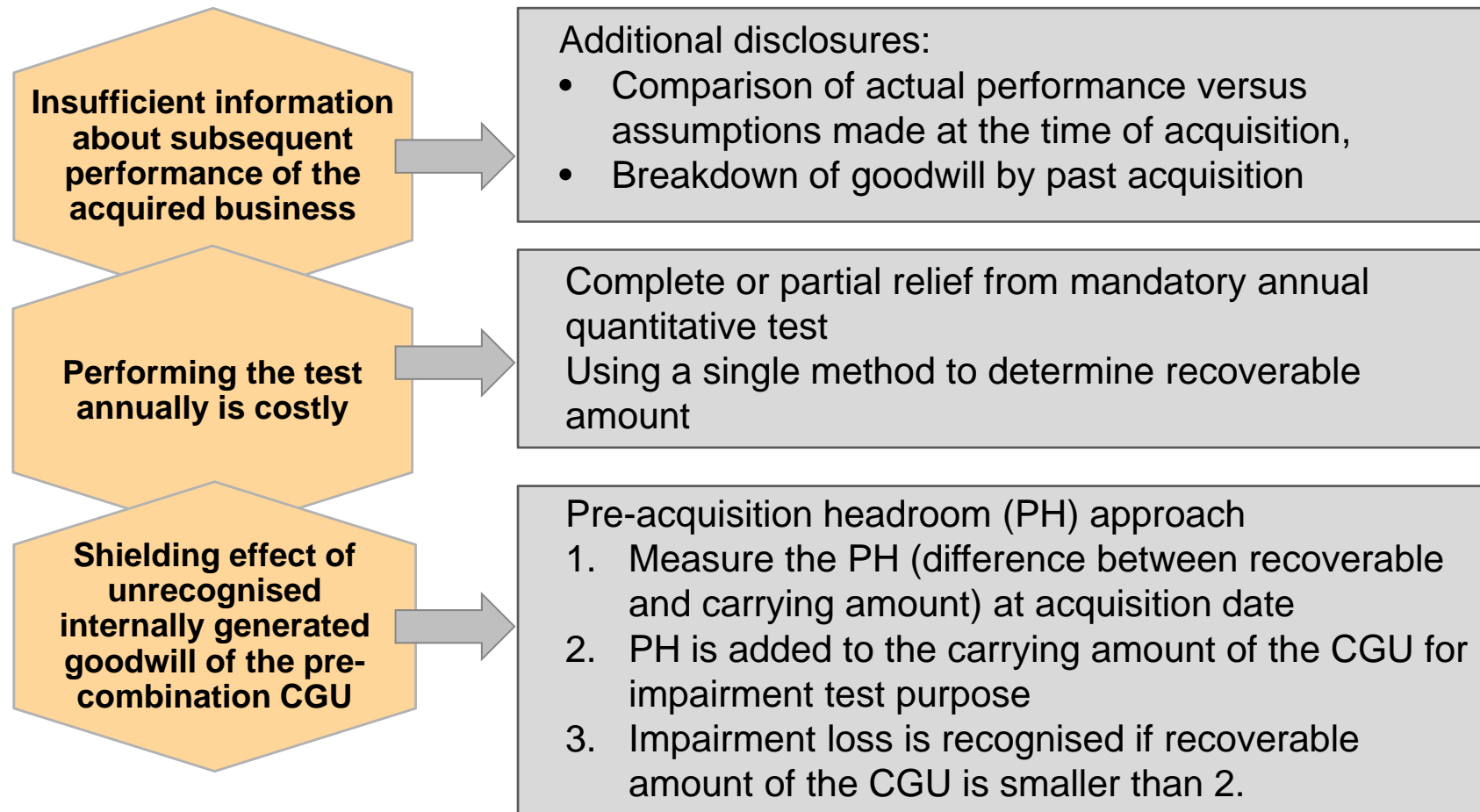
- Relatively few companies recorded impairment losses on goodwill since IFRS became mandatory in 2005
- Average annual impairment loss in the years 2006-2015 is approximately 2% of goodwill*

 Goodwill = High concentration of risk in the IFRS financial statements

„In practice, these impairment tests do not always seem to be done with sufficient rigour. Often, share prices reflect the impairment before the company records it on the balance sheet. In other words, the impairment test comes too late.” (Hoogervorst, The imprecise world of accounting, Amsterdam, 20.06.2012, P. 2)

*Data: WiWo 2016, No. 28, P. 21

Summary and outlook (2/3) IASB's ongoing research on impairment testing*



*Source: Martin Edelmann: IASB Update - a Board Member Perspective, IFRS Kongress, Berlin, 7 Sept. 2017

Summary and outlook (3/3)

- Impairment-only approach does not seem to be questioned by IASB
- Impairment testing is one of the major error categories of FREP

although

- IFRS gives room for management judgement and accounting policies
- not every finding of FREP leads to an error statement. If the headroom is large enough, FREP gives recommendations for future accounting (error prevention).



Impairment testing continues to be a major enforcement priority of FREP in all examinations where goodwill is high and performance is low!

At least in goodwill accounting the future seems to be always bright!

*Management should share optimistic assumptions with their investors -
disclosure in the notes is mandatory and enforceable*

Thank you for your attention!