Evaluation of company’s value in acquisition & ideal disclosure

——How investors analyse and what managements need to explain——

11th IFRS Digital reporting Workshop
Date and time：26 May 2017, 18:30-20:30 (Tokyo time)
Venue: IFRS Foundation Asia Oceania office

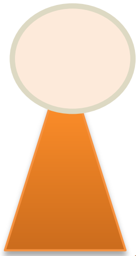
M&A of Japanese companies and IFRS Disclosure

We have been discussing about comparability issue and line item classification issue from users' point of view in the past workshops. At the last workshop, we discussed on whether "share of profit/loss of associates" is "operating" or "investing" may differ by company or its business, focusing on the point that "What is really comparable? Does same account name mean same substance? Which is same in substance?".

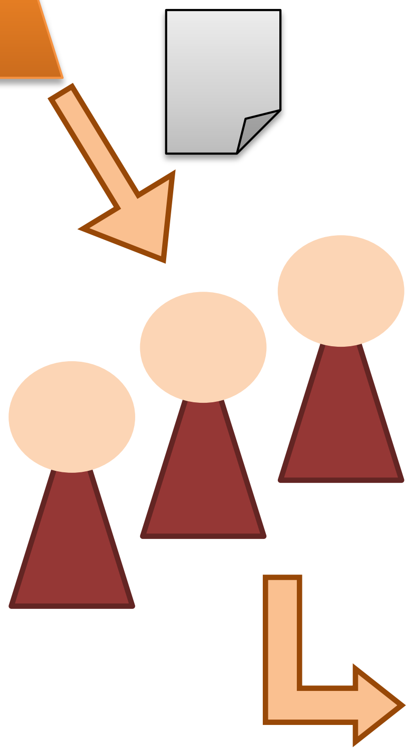
The way of business for companies are changing nowadays, that we should focus on the point that more M&A is happening in place of building factory and hiring people in old times. Last workshop touched on the topic that (even without M&A) companies do business not only by themselves but through subsidiaries and associates. This time, we focused on the point how investors should evaluate companies' value in acquisition and what companies need to explain in our discussion.

Number of attendees	26th Friday 46 attendees from Japan, 3 from London
Categories Include IASB, KASB, HKICPA	10 Investors (including Pension fund, Stewardship Forum Japan), 9 Information provider/Media/Researcher, 4 Sell-side/credit analyst/insurance, 6 CPA, 5 Company side, 3 Academic, 9 Regulator/Accounting setter/CFA Japan.
Participants overseas by phone & WebEx	Investors ,regulators, CPAs from London, HK, Indonesia, Vietnam.
22th Pre-session (for attendees who couldn't join 26th)	2 Investors, 2 sell side & credit analyst, 3 information provider/Researcher, 6 CPA, 2 Regulator/Accounting setter

Comment from foreign investor for this workshop



Sent draft agenda to overseas investors before this workshop



One organization had similar discussion before. We got this message for our discussion.

A Member of Financial Reporting Analysis Committee CFA UK
(Former CMAC member)

“More important in many countries that use IFRS is the overall issue of acquisition accounting.

As with your discussion, the extent to which goodwill should be amortised is among the biggest of the controversies. It is related to the (in my view dubious) tendency of some analysts to ignore amortisation - if you believe that the intangible asset is wearing out then you should take these costs seriously, as you would depreciation. Alternatively, if all or most of the acquisition's cost is carried on the balance sheet, it is easier to see whether the management is getting the return on the investment that it promised. Failure to so is captured by the impairment test, which is also, therefore, a test of management's stewardship of shareholders' assets.

Our main concern about impairment tests revealing losses in value is that they come too late - the market tends to have discounted the drop in value already (indeed a fall in market value is a sign that an asset is impaired). So we have pressed for more timely testing. The disclosures around the test can also be very useful for analysts, whereas amortisation is a routine process. Another issue here is whether analysts (like managements) prefer smoothed accounting, or whether they want to grapple with the much more lumpy underlying economic reality.

Your discussion also reflects the most important question: did the management overpay for the acquisition (the answer according to studies on whether M&A creates value is probably yes). For this important information should be preserved from the acquisition process, including not only what was paid for the equity and how much debt (net of cash) was taken on - the EV - but also how much it will cost to integrate the company and how much was paid in fees to the investment bankers and other advisers. The return on this total amount needs to be greater than the acquirer's cost of capital. For valuing the synergies (effectively the cost savings) that are claimed, not only the restructuring costs should be disclosed but the forecast timetable for achieving the savings.”

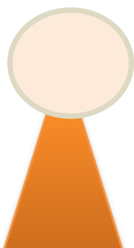
Having “wrong” incentive

Recently, there are cases where companies indicating to apply IFRS have just done major M&A, and together with lack of explanation, causing sense of distrust among investors.

One Japanese company with JPY 9 billion assets had MBO resulting in 19 billion goodwill. They chose to apply IFRS when relisting. They prepared reference IFRS FS which is not required for company having no subsidiary, and use only IFRS for summary submitted to stock exchange. English FS is not prepared.

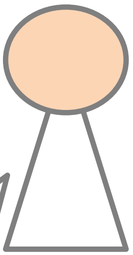
		30th Nov 2016 3Q Thousand yen
	J-GAAP (amortization of goodwill)	IFRS
Net income	962,640	1,599,905
Total Asset	23,023,095	25,682,087

Recently many companies with abundant cash tend to say “we are planning M&A” easily when investors ask their growth plan, though they cannot explain business strategy or synergy. There may be wrong incentive to think it better to apply IFRS.



Writer of Financial news service

One of the ways to test if the standard is to provide more discipline in the market, more comparability, make it more difficult for companies to present their earnings better, to provide honest information, may be whether preparers get irritated when new standard is issued. Like lease standard, which makes BS look worse, and preparers were not enthusiastic.
There is a reason to be suspicious when company elect IFRS because it makes their earnings look better. Although most companies apply IFRS for better comparability or communication.



What investors want to know when M&A takes place

Our requirement to the company (1) "What they should explain to investors"

■ Without synergies, this project might cause 7 billion yen loss for corporate value?

Acquired company value − **Price of acquisition** = **Corporate value produced: negative 7 billion yen (value destruction)**

Original value of acquired company
XXX Billion yen

\+

Value of synergy
?

shareholders cannot evaluate this accurately

■ Considering the value of the acquired company on a public basis

■ Synergy creation cannot be predicted

Market capitalization of acquired company
\+
premium
\+
other expenses

XXX Billion yen

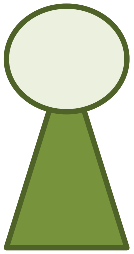
Confirmed information

■ Estimated to pay mostly in cash

We want to know the growth strategy, what the companies are planning for their future. Companies need to explain that M&A is necessary for growth strategy, and they are purchasing necessary company at appropriate price, or if bought at higher price they will be producing synergy.

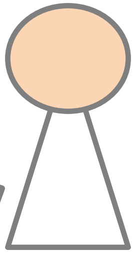
I want to see disaggregation of technology assets in financial report. When certain amount is paid for M&A, difference between purchase price and book value at acquiree is usually allocated as intangible assets and then what is not identifiable becomes goodwill. Technology assets should have evidence to support capitalization, so I want to request standards to require explanation on what it consists of, how it is evaluated, how it is going to produce future cash flow. Another point is, lack of explanation on business strategy. Amount of goodwill and expected increase in profit are disclosed, but no explanation on justification.

IASB working to improve standards



There were many comments such as request for disclosure on performance of acquired business after acquisition received at Post-implementation Review of IFRS 3 conducted by IASB from 2014 to 2015.
Some comments suggested that there are many boilerplate disclosures and they cannot see the reason why acquired the company/ what was expectation/ performance of the acquiree.
Also there are comments on disclosure of impairment test.

In current discussion at IASB on goodwill and impairment research project, one of the most important point is insufficient disclosure. We are considering to require disclosure on what is the reason for paying premium in acquisition, or disaggregation of goodwill, to have management explain their investment is recoverable by disclosing performance after acquisition.
However, some pointed out that current IAS 36 already require a lot of things. Therefore, reason for having insufficient disclosure is not only because of low level of requirement but because of non-compliance. Preparers claim it difficult to disclose key performance for investments because it will be giving away secrets to competitors, ending up in boilerplate disclosure. It is difficult because even if accounting standard required them, it would lose meaning if companies do not comply. In addition, even if new disclosure requirements are added, it is still up to companies to judge “material” acquisition, therefore there is still possibility to not disclose.



(Reference) Summary of comments and Report on Post-implementation Review of IFRS 3:
http://www.ifrs.org/Current-Projects/IASB-Projects/PIR/PIR-IFRS-3/Documents/PIR_IFRS%203-Business-Combinations_FBS_WEBSITE.pdf
http://www.ifrs.org/Meetings/MeetingDocs/IASB/2014/September/AP12F-IFRS%20IC%20Issues-PIR%20IFRS%203.pdf

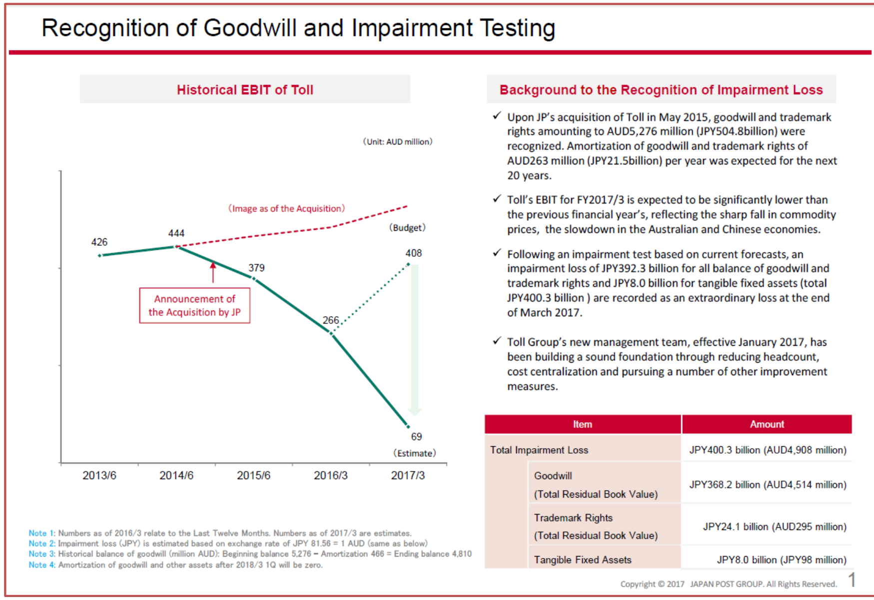
Disclosure on business combination cannot be separated from explanation of their background. When it is not explained, FS users do not understand justification for large premium and cannot assess if it is reasonable. This leads to having huge impairment suddenly and result in sharp drop of market price. Therefore, these disclosure should be improved first.

Acquisition of Toll Holdings by Japan Post

Japan Post became listed in November 2015, and it was May 2015 that they acquired Toll Holdings, logistics business in Australia, for JPY 620 billion. Metrics for valuation at the time was EBIT of AUD 444 million (JPY 41.2 billion). However as shown in the line chart, expectation at acquisition is dotted line showing few percent growth whereas actual results are on downhill, and finally resulted in JPY 400 billion impairment loss in FY2017/3.

Japan Post was a company difficult to show growing scenario in the first place, and supposedly they wanted to show growing scenario with M&A.

One good thing is, earnings of Toll was separately disclosed in segment information as International logistics business. Therefore, decline in profit could be identified. Depending on a case, sometimes we cannot see how business is going at all after acquisition and impairment loss is announced suddenly, so this case was better than that, but it is necessary to communicate with investors by continuous disclosure after M&A. If they disclosed before business went this bad, and with investors voice started effort to improve, the result would not have been so worse.



Recognition of Goodwill and Impairment Testing

Historical EBIT of Toll

Note 1: Numbers as of 2016/3 relate to the Last Twelve Months. Numbers as of 2017/3 are estimates.
Note 2: Impairment loss (JPY) is estimated based on exchange rate of JPY 81.56 = 1 AUD (same as below)
Note 3: Historical balance of goodwill (million AUD): Beginning balance 5,276 – Amortization 466 = Ending balance 4,810
Note 4: Amortization of goodwill and other assets after 2018/3 1Q will be zero.

Background to the Recognition of Impairment Loss

- ✓ Upon JP's acquisition of Toll in May 2015, goodwill and trademark rights amounting to AUD5,276 million (JPY504.8billion) were recognized. Amortization of goodwill and trademark rights of AUD263 million (JPY21.5billion) per year was expected for the next 20 years.
- ✓ Toll's EBIT for FY2017/3 is expected to be significantly lower than the previous financial year's, reflecting the sharp fall in commodity prices, the slowdown in the Australian and Chinese economies.
- ✓ Following an impairment test based on current forecasts, an impairment loss of JPY392.3 billion for all balance of goodwill and trademark rights and JPY8.0 billion for tangible fixed assets (total JPY400.3 billion) are recorded as an extraordinary loss at the end of March 2017.
- ✓ Toll Group's new management team, effective January 2017, has been building a sound foundation through reducing headcount, cost centralization and pursuing a number of other improvement measures.

Item		Amount
Total Impairment Loss		JPY400.3 billion (AUD4,908 million)
	Goodwill (Total Residual Book Value)	JPY368.2 billion (AUD4,514 million)
	Trademark Rights (Total Residual Book Value)	JPY24.1 billion (AUD295 million)
	Tangible Fixed Assets	JPY8.0 billion (JPY98 million)

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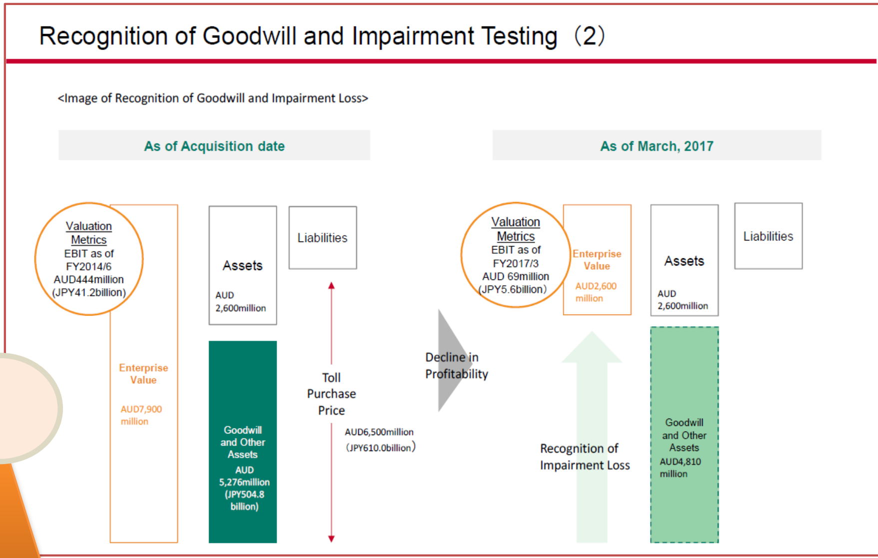

Or if disclosure after M&A (accountability) is demanding, it may reduce easy judgement regarding M&A by management.

Investor’s Opinion for disclosure of Acquisition

Investor (Long-term Concentrated investment, mid and large Japanese equities; over *1.5 billion* USD)

We invest in companies whose PBR is lower than 1.0. Considering accuracy of asset, we discount the value of goodwill in PBR calculation. Because we are taking “Engagement method”, we sometimes recommend companies which are recognized as having the risk of impairment by market to recognize impairment early. Our requests for disclosure of M&A are,1. Reasonableness of purchase price, 2. Capital structure of the acquired company, especially the structure of BS for taking over its debt, 3. Way of raising funds. We want companies to explain the propriety of the purchase price, it could be EV / EBITDA multiple, or based on past performance, and how to recover acquisition premium, such as expected synergies (cost synergy, or increasing sales) .

In addition, though goodwill from consolidated companies are presented, **goodwill from associates under equity method are not disclosed** in many cases. We are often surprised to face a big impairment of those goodwill without any sign. After M&A, many companies do not disclose the reason of allocation for PPA, as well as the reason for grouping of CGU. Though the acquired company's performance were obviously bad, if it becomes a part of the whole business, it turns out to have no need for impairment even in CPA’s view. Then they have to hold the risk of future impairment for long time. Although it may be difficult to capture the performance for only the part of the acquired company, but I want to see them for at least about three years. We also want to know the history of the company's M&A and PMI. We know that Japan Post did not have experience at all. Information on whether the company has good experience or not, non-financial information such as past PMI, or managements’ background are also helpful.

Some companies take business segment as CGU being maximum, in which case impairment loss is hardly booked.

Difficulty of impairment test and appropriate CGU

CPA Mr. Y

Impairment test is difficult. Since it is based on future cash flow, we need to know business well to see if it is reasonable. However, auditor is looking at the company's process of testing impairment (internal control) rather than looking only at cash flow. Purchase at inflated price may happen in business. But we focus on the process of why they decided that way.

Whether accounting standard can act as a deterrent for purchasing at inflated price, is not an issue of impairment or amortization, rather depend on enhancing disclosure or impairment process. Disclosure of fair value was introduced to financial institution previously, and had the effect of making internal management better. Disclosure may change company's behavior.

Impairment is judgmental/estimate therefore required to disclose when material, but not disclosed when company considers it immaterial. Therefore, alert system within company is important.

Rakuten Inc.（e-commerce business）

Our year-end is December, and until FY 2015 impairment test was done on subsidiary-basis. From March 2016, in one of the two segments, Internet Services Segment, we decided make it one CGU and have impairment test on that basis. The reason for the change is, there is what we call "Rakuten Ecosystem" which is a system where varieties of services are provided through membership, and the aim is to have members use different services there, so our strategy is to produce synergy within the Ecosystem. Therefore, if impairment test of goodwill is done on subsidiary-basis, there arises a gap between actual business, for example, a subsidiary is bought on the assumption of having negative profit, but needs to impair when actual result goes little below expectation.

It was good that we changed. Impairment test is done by calculating DCF based on future cash flow/revenue, but purpose of acquisition is not only its profit but if the company contributes to other business, it is valuable as well. We acquired a company, Viber, which we thought was difficult to earn profit, but the purpose was to have members of Viber hold Rakuten ID (and shop at Rakuten), this is an example of what is not shown on PL but produces value and become purpose for M&A. We have changed the CGU, but what level is appropriate for CGU and how to divide segment is still a very difficult issue, and it is true that companies can change intentionally. We are suffering to make judgement.

CPA Mr. I

Auditors may know business to certain extent from past experience or by studying peers of same industry, and knowing business is important for auditor when facing company. Some companies are too aggressive, but we as auditor have to challenge them and strictly question if there plans are feasible. We also focus on backtesting, comparing what they estimated at first and there may be change in business environment and how it came out.

Is impairment Bad? What is synergy?

Mitsui & Co is a company of JPY 10~12 trillion assets, and 300~400 billion PAT. Amount disclosed as goodwill is 60~70 billion. However, investment premium is also booked as investment in associates, PPE, and intangible assets through PPA not only goodwill. We have booked impairment loss of 300 billion in FY16/3. The largest in goodwill disclosure is 20 billion on oilfield in Italy. Nevertheless impairment amounted this much, means that looking at goodwill is not enough. Looking at movement of market price of Mitsui's share, it has already started to drop before disclosure date of 23 March, meaning the market has already reflected decrease of equity of Mitsui. 90% of our net profit is from Resource business, so people knew before we disclosed because of falling price of resources. Additional disclosures IASB is considering to require (1. Reason for premium, 2. Assumptions for recovering premium, 3. comparison of actual vs targets) all seem reasonable by itself, however, even with current requirements, in many cases, market can tell the symptom of.
Investors may think impairment is bad and inexcusable, but I think there are two factors within. One is management skill of investment and other is honest disclosure. Former is out of scope of accounting standard. Even if management is bad at investment and purchases at inflated price, if it is disclosed as it is, disclosure is excellent. I think our disclosure on impairment was not bad.

Investor's opinion :
Mitsui& Co always has adequate explanation in disclosure and feel relieved to see attitude to communicate with us. Sometimes impairment can be inevitable. We don't like loss but explanation is important.

Case of Disclosure of non-life insurance Tokio Marine (Reinsurance company's point of view)

Tokio Marine was said to be paying huge premium, every time they acquired companies. In the latest HCC case, they paid 35% premium, goodwill being 5600 billion yen, and they were said to have purchased at inflated price. But it was because of synergies. I think that a reasonable price differs depending on who to buy. Tokio Marine's synergy strategy is buying companies that have risks not correlating with Japanese-centered risks. In addition, HCC originally had ROE of about 12%, whereas Tokio Marine's ROE at the time of acquisition was about 6%. And their adjusted-ROE increased to 11% in 2016. If their ROE is low, it makes sense to buy high ROE company with high premium.
In the background of the argument whether goodwill should be amortized or impaired, there is a common understanding recently that "IFRS which does not require amortization is good for activating M&A". But it should be more challenging because companies will keep having the risk of impairment from premium of the purchase price.

Discussion points

Opinion of Asset Owner / former management in manufacturing industry

M & A is the corporate strategy itself, it is one way to increase dealerships by taking in peer company to make the same business bigger. This strategy is relatively easy to understand.
In the manufacturing industry, there is a case that a company without necessary skills of technology buys a company which has that certain skill, to strengthen themselves. This case is difficult and need to have solid strategy for their business.
However, first of all, you need to have business strategy, then you should think about next step as management including accounting measures. Having wrong order would not work out.
Investors need to communicate that to companies' managements strongly.

Opinion of former standard setter

Accounting is transferring information from management who has information to investors to resolve asymmetry of information, but especially for M&A, sometimes there <u>are managements who get into M&A without understanding and they lack information of M&A themselves</u>, so integrity of management should include ability to estimate future cash flow. Main theme of today, whether enhancing disclosure will have effect of restraining inflated price purchase, may not lead to anywhere but <u>at least investors are in position to aim at improving disclosure</u>. Many of the requests raised today are very reasonable, therefore setting aside the point whether they should be audited or to be in non-financial section or not, first collect what are the requests and discuss which of those are really important, and increase such information. Lastly, I had a sense that information difficult for auditors to audit is the part that is most important. I understand standard-setting is very difficult and require a lot of effort, but I will leave it for IASB…

Message to IASB

Regarding M&A, requests from investors on disclosure are

- Without adequate disclosure (explanation) when M&A takes place, investors will not understand business circumstances and cannot assess management following M&A
- FS of acquired company, especially information on debt is important. Also, disaggregation of technology asset, explanation to support PPA is required.
- Verification of purchase price. If possible, DCF based on future cash flow. Reason for goodwill (premium) and how to recover that. Need to explain strategy and synergy.
- Continuous disclosure of acquired entity after acquisition
- Problem is that impairment test is not working, and disclosing results of impairment tests may help improve
- Inadequate explanation on how CGU is determined
- Disclosure of goodwill equivalent of associates

Investors want that explanation required by accounting standard, together with communication between investors, will work as deterrent to stop management from purchasing companies at inflated price.

Investors are wanting to know accurate, true picture of company, therefore do not want companies to have wrong motive to "show better profit", and prefer companies to explain at early stage if they were to expect impairment.

It is important for investors and companies to discuss with IASB "what is needed for better understanding", setting aside whether disclosure needed should be reflected in financial or non-financial.