Mr. Gauzès, EFRAG Chairman
35, Square de Meeûs, B-1000 Brussels
jean-paul.gauzes@efrag.org

Comments:
EFRAG's Draft Comment Letter. Re: IFRS: DP/2020/1 *Business Combinations-Disclosures, Goodwill and Impairment*

Sophienstraße 44 DE – 60487
Frankfurt am Main, Germany
Direct number: +49 69 98959519
Fax number: +49 69 98957529
E-mail: office@effas.com
Internet: www.effas.com

Contact: Ms. Raquel Zaragoza

November 30 - 2020

Dear Jean Paul:

The EFFAS Commission on Financial Reporting ("CFR", "Commission", "we") has reviewed EFRAG's Draft Comment Letter (the DCL) and we are pleased to share our comments.

We would like to acknowledge EFRAG's thorough review of the DP and would like to express the continued support for EFRAG's high quality comments. Albeit we also would like to stress the importance of preparing documents focusing on concreteness and avoiding repetition. Clarity and a direct terminology would be a very valuable addition to the high quality of EFRAG's documents.

The Commission is addressing the key points of the DCL that it considers relevant for investors.

1.- Introduction

We find it appropriate that the IASB has undertaken this project to improve disclosures and goodwill reporting particularly in light of the different results observed in the application of IFRS-3 *Business Combinations.* Although the DP is presented as a package, we think that the issues addressed can be analyzed independently.

2.- Improving disclosures about acquisitions

EFFAS CFR supports the proposal included in the DP aiming at improving disclosures to facilitate investors to assess management's rationale for an acquisition and further consolidation. For investors it is fundamental that companies provide useful information to (1) accurately analyse the value of the acquisition, (2) the resulting value of the entity and (3) to understand the amount of the recognised goodwill.

Some members however question the usefulness and relevance of providing additional information if this information is not satisfactory. These views are based on their experience related to the level of information provided by CODMs in IFRS-8[1]. Additional disclosures will increase the quantity of information and providing boilerplate information would not be useful.

[1] *EFFAS CFR has stated in several comment letters (regarding IAS 1 and IFRS 8) that the Management Approach should be improved to provide relevant information to investors.*

Users need transparent information related to the performance and evolution of the business combination.

CFR's comments on disclosures are as follows:

a) – Rationale – Objectives

For investors to have material information becomes essential to understand why a company decides to acquire another company. Investors have to be informed about what the strategic rationale for the acquisition is and if it is in line with the overall business strategy of the entity. Also, the appropriateness of the acquisition at that particular time is relevant. This information would facilitate a better understanding and monitoring of the performance of the acquisition.

b) – Metrics

The more specific the information the better for investors. We would like to know - in a quantifiable manner - what are the synergies and estimated contribution to results of the combined company. Companies should provide metrics that are relevant for investors such as estimates of consolidated revenues, operating profits, cost savings, net earnings and balance sheet items such as consolidated debt and ROCE. Other type of non-financial information such as (combined) market share and/or other information (e.g., number of retail stores if that is the case) would also be helpful.

On the contrary, general statements like to increase an entity's presence in a specific region with no quantification in terms of impact in the company's value should be avoided.

Thus, we agree with EFRAG's comments in page 11 that specific information from an entity will provide a better base for understanding and valuing the resulting entity. We also agree that the values of the metrics provided by the entity should be material to assess the merits of the acquisition.

c) – Price

When the price paid for an acquisition is larger than the fair value of the net assets acquired, a company is to recognise goodwill. Management should monitor the acquisition and has to support why the price paid is larger than the "net" fair value(s). The future performance of the acquired entity is part of the accountability of the management for the acquisition.

Regarding the cost of providing additional information, we consider that companies produce the information internally and it should not be onerous to disclose the same information.

d) - Monitoring

Management should monitor the evolution of an acquisition and the market would be surprised if a company does not follow closely the evolution of a consolidation. We agree with EFRAG's comments in paragraphs 27- 40 regarding the subsequent monitoring of the performance of an acquisition and particularly with paragraph 31.

We dissent with the DP's argument that an entity cannot provide information because the acquired business is integrated. Although in certain cases the size of an acquisition at the beginning might partly condition a company to present an adequate level of information, it does not imply that the information is not required. Investors need information related to synergies in terms of costs and in terms of revenues and contribution to the total value of the combined entity.

e) – Timing

We think that the information to be provided by a company after an acquisition should be in line with the time needed to complete the acquisition. Although our experience indicates that a company might take between 2 years and 3 years to fully integrate an acquisition, this will also depend on the pace of the integration and the size of the acquisition.

f) - Sensitive Information

We understand that companies cannot provide certain commercially sensitive information. However, companies under the caption of "sensitiveness" in many cases do not provide information that in fact is not that sensitive. We agree with EFRAG's comments on paragraph 51 that a balance should be reached. Also, we support the IASB conducting additional research to understand and provide guidance related to sensitive information.

Regarding the forward-looking approach to disclose information that could risk litigation, we think that information related to the evolution and execution of the acquisition should not compromise the transparency of the information. We support the Board's suggestion that companies provide information in a way that does not constitute forward-looking information, as noted in paragraph 2.31 of the DP.

g) - Comparability

Information provided by one company might differ from information provided by another company. Acquisitions' objectives are different and therefore comparability is not a key point. However, we have observed that entities present significantly different valuations when comparing acquisitions of similar assets. This implies a great deal of subjectiveness in the valuation of the assets. Room for this subjectiveness should be reduced.

h) - Management Commentary

Currently, information about the business strategy is included in the management commentary. It is important that management clearly presents the specific objective of an acquisition including information such as expected contribution to revenues and to the results of the company.

Moreover, reliability and auditability of the information in M&As should not depend on the circumstances. As the process of consolidation develops new or different information might appear but the information disclosed should be reliable. Investors need material information to gauge the evolution of the acquisition and understand the merit of the price of an acquisition.

3-4.- Goodwill amortization and impairment

The commission has discussed at length both approaches: goodwill amortization and the maintenance of the impairment-only test. The commission did not reach an agreement to unanimously support one approach, however the majority of members (5-2) support goodwill amortization.

The commission does agree that the impairment approach is not working properly. The impairment test is perceived as not providing sufficient information and as it is prepared by management the amount depicted is not completely trusted. Additionally, management frequently delays impairing goodwill and when reported analysts and investors have already adjusted the

underperforming asset. In fact, in most cases the share price of the company was not affected by the announcement of an impairment as the market had already discounted the adjustment in the share price[2] (*too little too late).*

The commission does not contemplate considering a "partial" amortization for goodwill or on "voluntary basis" as noted by EFRAG in paragraph 154 of the DCL. Some members noted that intangible assets should be amortized and also be subject to impairment.

The following are CFR's views on goodwill amortization and the impairment approach.

Why to have goodwill amortization

- As the base for the discussion, members supporting this position noted that goodwill is an asset and that it should be recognized on the balance sheet at the time of an acquisition. This recognition will allow investors to know the amount of capital invested at a certain date and at a certain price, a key element to properly assess the stewardship.
- It is also considered that the current standard of impairment-only approach is based on the view that the economic benefits of the goodwill are difficult to capture both in terms of timing and amount. Even assuming difficulties to predict inflows to be generated by the goodwill this argument should not preclude goodwill from being amortized. This situation could be applied to other assets including tangible assets.
- Some constituents' views should also be mentioned as they stated that *"…goodwill should be recognized as an asset with a definite useful life and therefore should be depreciated. Goodwill represents the extra-earning capacity obtained and the competitive advantage expected for the medium-long term in the market of activity..."*

  "From an economical perspective, goodwill is an investment that should be recovered in a reasonable period. Shareholders have the right to ascertain that the investment can generate a current, future and certain usefulness. Amortization expresses the return on investment within a limited time period that can be measured with an amortization plan." (1)[3].

  This is consistent with the way return on capital employed is computed for all other assets.
- The commission also argued that in an acquisition that creates goodwill, the acquired identifiable assets will generate cash-flow in addition to their potential revaluation. Since the additional cash-flow has been paid by the acquiree to present a proper assessment of the performance of the investment part of this goodwill cost needs to be allocated over a reasonable period of time. This period is considered to be between 10 and 15 years and 20 years as a maximum depending on the sector. (IAS 22 had a rebuttable presumption of 20 years maximum).
- The standard should request to disclose goodwill amortization separately from other depreciation and amortization. This will allow users to make adjustments as needed. Some members noted that the add-back approach is often used arguing that it allows one to make

[2] *This point was noted by EFFAS Commission on Financial Reporting in 2014 at the time of the PiR review of IFRS-3 https://effas.net/pdf/publications/EFFAS_FAC_Comments_PiR_IFRS-15-July-2014.pdf*

[3] *CL 27 AIAF: Discussion Paper "Should goodwill still not be amortised?"*

comparison with companies that have not made an acquisition. This, however, is not completely correct due to the complexity and differences between companies. Different choices (e.g., acquisitions vs organic growth), different amounts of capital invested, and different timing produces different results).

- Some members argued the non-amortization of goodwill resulted in companies reporting inflated shareholder equity causing analysts to no longer use some financial ratios such as the net debt/equity ratio, a key measure for assessing the financial strength of a group. This ratio, when computed properly becomes an important indicator of the relative amount of money at risk by capital providers and bondholders.

Views not supporting the impairment-only approach

- As noted above, the impairment test is seen by some users as providing little information and as it is prepared by management the amount depicted is not completely trusted. Also, when an impairment is announced investors had already adjusted its value and the adjustment is priced-in in the share price (*too little too late*).
- When applying the impairment test, this compares the acquired goodwill to the total of the acquired goodwill which includes the goodwill created since the acquisition and the unrecognized goodwill existing in the cash generating unit in which the acquired entity was allocated.
- The impairment test relies very often on the discounted cash-flow methodology which depends on the assumptions inputted or its calculation and therefore different assumptions provide different results.
- Since companies regularly implement reorganizations, realize additional acquisitions and disposals is very difficult to follow the evolution of the original goodwill. It becomes very challenging to follow goodwill over long periods of times.
- Also, the non-amortization approach has significantly cut the link between the cash flow statement, which includes goodwill paid, and the income statement. For users the cash flow statement is mostly used to complement the income statement and it is considered fundamental to keep the link between the two statements.

Views supporting the impairment approach

- Members supporting the application of impairment noted that goodwill generated in an acquisition should be considered an investment and not an asset that the entity “consumes” and that loses its value over the years. Hence, goodwill is not a wasting asset. If the business combination is successful, the value of the goodwill could rise, and the business acquired could even be sold at a higher price.
- The entity does not have to replace the goodwill after the so-called useful life period as with other type of assets (e.g., production facilities). Hence, the entity does not have to recover the cost of the goodwill over the so-called useful period.
- The entity has to earn a return on the money invested. If the return generated is above the cost of capital the business acquired could be sold for a higher price. The entity has created value and in turn the stock price would rise. The return on the invested capital in fact is considered a key parameter in analysis.

Improvements to the impairment test

The following points complement the previous comments on disclosures.

- Entities should explain and disclose the reasons for an impairment and impair the goodwill on a timelier basis. Entities should be more transparent in allocating the goodwill over the different operating segments which would facilitate users to understand and better assess the shielding effect.
- Performing the impairment test should be simplified and the cost and complexity of performing the test should be reduced. The impairment test should remain as the only-approach.
- The qualitative test should be sufficient when implemented under strict conditions if there is no indication that the goodwill will be impaired. However, it was also contended that the quantitative test should be applied on an annual basis and its methodology transparently disclosed.
- Users should be able to verify the methodology and the parameters used. This will permit assess if an entity is taking a realistic approach to justify not to apply an impairment test. Users want to know how reasonable and realistic the parameters are used.

5.- Goodwill excluded from equity

We agree with EFRAG's comments. We do not support requiring companies to present total equity excluding goodwill on their balance sheets. As noted in IASB DP (par.3.109), since the goodwill amount will be presented in a separate line on the assets side of the balance there is no need for introducing a further subtotal in a company's net worth that can be confusing.

Investors do not exclude in the analysis goodwill from equity as this is part of the acquired assets to be used potentially to generate additional value. If needed, it can be easily extrapolated from total equity.

6.- Intangibles assets

We consider that there is no need to change the recognition requirement of intangible assets acquired in a business combination transaction. Although certain information such as customer relationships and brands might be useful for investors it gives rise to the point of how objective its measurement is.

We already consider difficult to value identifiable intangible assets so we will not suggest trying to separate and value intangible assets incorporate in the goodwill. This will be particularly difficult if the intangible assets would have not been recognized in the acquirer's financial statements.

Regarding this issue, we disagree with EFRAG's comment that this can wait subject to a complete review of AIS 38. This point can be approached without reopening AIS 38

7.- Others

The commission appreciates and continues to support EFRAG's efforts to provide substantiated opinions from a European standpoint to the IASB.

If you would like to further discuss the views expressed in this letter, please do not hesitate to contact us.

Yours sincerely,

Javier de Frutos, Chairman
On behalf of EFFAS Commission on Financial Reporting

EFFAS was established in 1962 as an association for nationally based investment professionals in Europe. Headquartered in Frankfurt am Main, EFFAS comprises 15-member organizations representing more than 16,000 investment professionals. The Commission on Financial Reporting is a standing commission of EFFAS aiming at proposing and commenting on financial issues from an analyst standpoint. CFR members are Javier de Frutos (Chairman, IEAF-Spain), Jacques de Greling (Vice-Chairman- SFAF, France), Friedrich Spandl (ÖVFA, Austria), Henning Strom (NFF, Norway), Serge Pattyn (BVFA/ABAF, Belgium) Luca D'Onofrio (AIAF, Italy) and Dr. *Carsten Zielke (DVFA, Germany)*