

European Financial Reporting Advisory Group
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Brussels Belgium

Via website: (<https://www.efrag.org/News/Project-300/REMINDER-Please-provide-input-to-EFRAGs-consultation-on-goodwill-impairment-testing>)

22nd December 2017

Dear members of EFRAG

Discussion Paper: Goodwill and Impairment test: Can it be improved?

The Corporate Reporting Users' Forum welcomes the opportunity to comment on the Discussion Paper, *Goodwill and Impairment test: Can it be improved?* (The "DP"), issued by the European Financial Reporting Advisory Group (EFRAG) in June 2017. Two EFRAG representatives, Filipe Alves and Saskia Slomp, attended the UK CRUF meeting on 6th December and we had a lively debate. The aim of this letter is to put the views expressed by various CRUF participants at the meeting into writing. As always, this letter represents the views of the signatories; the CRUF generally does not seek to form a consensus. All signatories are signing in a personal capacity.

The CRUF's guiding principles state that "the purpose of the balance sheet should be to reflect the capital invested in the business...along with stewardship" and that the "purpose of the profit and loss statement should be to identify the returns generated from the capital invested in the business". The comments in this letter are based on those principles.

We have numerous concerns about the creation, amortisation and impairment of intangible fixed assets when a business is acquired and consolidated. Acquisitions often represent the single biggest use of shareholders' capital yet the disclosure is frequently opaque and unhelpful. Our high level concerns are:

- The lack of ongoing disclosures of the performance of acquired entities and assets makes analysing delivery from both inorganic and organic operations difficult. We acknowledge the frequent difficulty of separating operations as integration progresses, but it is in the context of this broader opacity that we consider questions about goodwill and its impairment.
- The purchase price allocation (PPA) process where values are ascribed to intangible fixed assets that companies are not allowed to capitalise when internally generated is subjective and unhelpful. It can be impossible to separate internally generated intangibles from artificially created acquired intangibles without voluntary additional disclosure. The resulting PPA amortisation charge therefore is often seen as having minimal economic significance and is ignored by many investors. This is a concern for many in CRUF as too little is made of the difference between organically replaced acquired intangibles (customers) and those which are genuinely wasting where the amortisation is an economic cost (patents).

- The value of the resulting goodwill is simply the residual of the consideration paid less the fair value of the acquired assets and PPA intangibles that we think are of dubious value. The calculation of the goodwill is therefore inherently much less robust than it appears.
- The goodwill impairment test is not based on the goodwill itself but on the Cash Generating Unit (CGU) that the acquired business has been allocated to. The CGU is selected by management in a process that is 1) subjective and 2) not disclosed. The CGU can also be changed, for example by enlarging the CGU to help a borderline impairment case clear the test. The very existence and manipulability of confidential CGUs severely undermines the credibility of impairment tests.
- When goodwill is impaired, it is almost always as a result of poor operating performance that was visible long before the impairment was announced. We can think of no example, ever, of an impairment that came as a bolt out of the blue.
- The 'new' value of goodwill after an impairment test is just as robust as before, i.e. not robust at all.
- When goodwill is impaired, it disappears from the statement of financial position, which restricts the ability of investors to assess the capital invested in the business. This is inherently undesirable and breaches our guiding principles.
- There is however a very useful psychological aspect to impairments. It is embarrassing for companies to stand up and say in effect "we overpaid for this business". It is therefore perhaps unsurprising that impairments are often associated with management change, even though we are not aware of a management change formula in the test itself. Management change is often sparked by a board recognising deteriorating performance, though it is only after management change that this reality is in fact publicly recognised through impairment.

In short, we think that the debate on the maths of impairment testing misses the point. We have some radical suggestions that would be simpler, cheaper and more transparent:

- When a business is a true going concern, goodwill should be on the statement of financial position for ever unless the associated business is closed or sold. This would make it easier to assess returns over time and reduce the incentive for the incoming management to write off assets. It would also eliminate the arcane debate about how impairment tests are conducted.
- If goodwill is impaired, then the notes should state the total cumulative value of impaired goodwill so that investors can see how much has been invested over time. This is simply good stewardship. The same comment applies to PPA intangibles, which, unless wasting assets, are often just goodwill in disguise. The notes should include total cumulative amortised and impaired PPA intangibles so investors can see invested capital.
- The identity of the CGU should be disclosed, especially if it has changed, so investors can see whether the test is being 'passed' simply because management has decided to enlarge the CGU.

We realise that we have slightly strayed outside the brief but these issues are all related. One cannot have a satisfactory debate about goodwill impairment without considering the bigger picture of how goodwill is calculated and what investors are really looking for.

To be clear on a narrower set of questions:

1. We see no benefit from goodwill amortisation, and believe that it would not reflect economic reality. We thus welcome EFRAG's focus purely on impairment.
2. We would favour the abolition of organically replaced PPA intangibles; all consideration not attributable to tangible or other wasting assets should be deemed goodwill.
3. We support the idea of further guidance on the allocation of goodwill to CGUs, and greater disclosure on the composition of goodwill, particularly a reconciliation of goodwill allocated to each CGU.
4. Presuming that impairment is retained, we would welcome a step zero in the process so that time is not expended in detailed impairment testing when substantial headroom remains.

About the Corporate Reporting Users' Forum (CRUF)

The CRUF was set up in 2005 by users of financial reports to be an open forum for learning about and responding to the many accounting and regulatory changes that affect corporate reporting. In particular, participants are keen to have a fuller input into the deliberations of accounting standard setters and regulators. CRUF participants include buy and sell-side analysts, credit ratings analysts, fund managers and corporate governance professionals. Participants focus on equity and fixed income markets. The Forum includes individuals with global or regional responsibilities and from around the world, including Australia, Canada, France, Germany, Hong Kong, India, Japan, New Zealand, South Africa, UK and USA.

The CRUF is a discussion forum. Different individuals take leadership in discussions on different topics and in the initial drafting of representations. In our meetings around the world, we seek to explore and understand the differences in opinions of participants. The CRUF does not seek to achieve consensus views, but instead we focus on why reasonable participants can have different positions. Furthermore, it would not be correct to assume that those individuals who do not participate in a given initiative disagree with that initiative. This response is a summary of the range of opinions discussed at the CRUF meetings held globally. Local country differences of opinion are noted where applicable.

Participants take part in CRUF discussions and joint representations as individuals, not as representatives of their employer organisations. Accordingly, we sign this letter in our individual capacity as participants of the Corporate Reporting Users' Forum and not as representatives of our respective organisations. The participants in the Forum that have specifically endorsed this response are listed below.

(Signatures)

Peter Reilly
Jefferies International



The Corporate Reporting Users' Forum

Anna Czarniecka

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