European Financial Reporting Advisory Group

Goodwill – Draft Comment Letter
Cover Note

Objective

1 The objective of this session is to consider the EFRAG draft comment letter ('DCL') in response to the IASB Discussion Paper *2020/1 Business Combinations—Disclosures, Goodwill and Impairment* issued on 19 March 2020 (the 'DP') - approved by EFRAG TEG on in the webcast meeting on 8 April - and to and approve its publication.

2 The IASB published the DP on 19 March 2020 and asks for comments on the DP by 15 September 2020. Despite being possible that the IASB delays the closing of the comment periods (see section 'comment period'), EFRAG is committed to make any additional time available to its constituents for comment.

Background on the DP

3 The IASB is investigating how companies can provide users of financial statements with better information about business combinations at a reasonable cost. The project responds to concerns reported during the IASB's post-implementation review (PIR) of IFRS 3 *Business Combinations* related to the current annual impairment test.

4 Users have indicated that they want to understand the factors that determine the amount a company has paid for an acquired business and whether that acquisition has been successful subsequently.

5 In addition, the IASB learned from stakeholders that:

(a) goodwill impairment losses are being recognised 'too little too late';

(b) the goodwill impairment test is costly and complex;

(c) the separate recognition and measurement of some intangible assets is challenging; and

(d) some stakeholders would like to see amortisation reintroduced.

6 The IASB's preliminary view is that it would not be possible to make the impairment test significantly more effective. Accordingly, the IASB has decided to refocus the objectives of the project. Thus, the IASB decided to develop the following project objectives:

(a) Objective A - Identifying disclosures to enable investors to assess management's rationale for the business combination; and whether the subsequent performance of the acquired business, or combined business, meets expectations set at the acquisition date;

(b) Objective B - Exploring whether to simplify the accounting for goodwill by permitting an indicator-only approach to determine when an impairment test is required; and/or reintroducing amortisation of goodwill; and

(c) Objective C - Exploring whether to improve the calculation of value in use by permitting cash flow projections to include future restructurings and future enhancements to an asset, and the use of post-tax inputs in the calculation of value in use.

7 In its June 2019 meeting the IASB expressed its tentative views on the above project objectives:

(a) IASB supported requiring disclosures of subsequent performance of the acquired business, and targeted improvements to existing requirements.

(b) IASB agreed moving to an indictor-only approach requiring impairment testing of goodwill only when there are indicators of possible impairment.

(c) A close majority of the IASB members (8/14) agreed to retain impairment-only approach. However, they agreed to explore in the discussion paper both approaches providing arguments in favour and against.

(d) IASB agreed to allow the inclusion of cash flows from future restructurings or future enhancements in the calculation of value in use.

(e) IASB agreed to remove the explicit requirement to use pre-tax inputs to estimate value in use.

Technical discussions at EFRAG before the issuance of the DP

8 **EFRAG TEG** discussed the IASB tentative decisions in its meeting in **January 2019**:

(a) EFRAG TEG members supported the objectives of the suggested disclosure requirements, however they had some reservations about practical aspects of the requirements.

(b) EFRAG TEG did not support the indicator-only approach to save costs. A majority of EFRAG TEG members would support this proposal, but only if goodwill amortisation is introduced.

(c) A majority of EFRAG TEG members have previously stated that if the discussion about amortisation would be reopened, they would be in favour of reintroducing goodwill amortisation (in combination with an impairment approach – indicator).

(d) EFRAG TEG supported to allow the inclusion of cash flows from future restructurings or future enhancements in the calculation of value in use.

(e) EFRAG TEG agreed to remove the explicit requirement to use pre-tax inputs to estimate value in use.

9 The **EFRAG TEG and User Panel** members in its **March 2020** joint meeting, discussed the tentative views expressed by EFRAG TEG in January 2020. EFRAG User Panel members indicated that the current impairment model was broken among other things due the shielding effect creating the too little and too late issue. Members listed some possible solutions in addition to reintroducing goodwill amortisation (on which different views were expressed, should the issue be reopened) as for example improving the guidance on goodwill allocation to CGUs, reallocating goodwill to another unit of account and on derecognition in case of a disposal.

10 EFRAG TEG and EFRAG User Panel members generally agreed that additional disclosures can help assessing whether a business combination was a good

investment decision and whether, after the acquisition, the acquired business was performing as expected. However, members highlighted that these disclosures would only be relevant for a short period after the acquisition (e.g. for the three first years). Lastly EFRAG TEG and EFRAG User Panel members considered that the IASB's tentative proposal to include a subtotal of equity before goodwill would not provide any added value.

11 The **EFRAG Board** discussed the directions of EFRAG's draft comment letter at its meeting in **March 2020**.

(a) The EFRAG Board discussed whether EFRAG TEG should form a view on whether goodwill should be amortised. The EFRAG Board expect that constituents raise the issue in their comment letters to EFRAG. As such, they consider appropriate that a question is asked to constituents, in particular whether compelling evidence exists to support such a relevant change. Some members observed that on the topic strong views exist but there is no real new evidence that a change is needed. The EFRAG Board agreed not to include a tentative position in EFRAG's draft comment letter on whether goodwill should be amortised or not. Instead the draft comment letter should include a question to constituents on their views and additional evidence in support of their views.

(b) EFRAG Board members agreed with the views expressed by EFRAG TEG on the additional issues related to the allocation of goodwill to cash generating units, tracking of goodwill and guidance in relation to reorganisations and disposals that were considered by EFRAG TEG; they agreed to include those views in the DCL. One member mentioned the opportunity to comment on auditability of the disclosures.

(c) The EFRAG Board recommended that the EFRAG Secretariat further examine whether introducing goodwill amortisation could have economic consequences especially in relation to tax consequences or implications on solvency for financial institutions. An outreach with M&A professionals has been done and the inputs used in the preparation of the DCL. In addition, Questions to constituents have been added in the DCL on possible economic consequences of changing the accounting for goodwill, including interaction with local tax and prudential rules. A survey has been launched with the CFSS members to collect further inputs to this end; the results will be considered when preparing the final comment letter.

Technical discussions at EFRAG after the issuance of the DP

12 The IASB published the DP on 19 March 2020. The ERAG Secretariat prepared a draft comment letter based on EFRAG TEG previous discussion that was discussed by EFRAG TEG in its 26 March Webcast meeting. However, as the exact wording of the DP was unknown at the time EFRAG TEG had its previous discussions, the drafted comment letter included sections that have not been discussed by EFRAG TEG.

13 Therefore, **EFRAG TEG** discussed in the webcast meeting on **26 March** the drafting proposed by EFRAG Secretariat for questions 2 to 10 of the DP and made several drafting suggestions. During the meeting only questions 2 to 6 were covered. EFRAG TEG members were invited to provide their written input on the questions that were included in the initial version of the DCL but were not discussed at the meeting due to time constraints (Questions 7 to 10).

14 With reference to the disclosure proposals (Questions 2 to 5) EFRAG TEG's comments and proposed wording changes agreed during the webcast meeting on 26 March were further considered in a discussion with **EFRAG User Panel**, at its **1**

April 2020 Webcast meeting. User Panel members provided also input to the initial drafting by the EFRAG Secretariat of Question 12 (separation of Intangible assets). A short summary of the 1 April 2020 User Panel Meeting is provided as Appendix II of this cover note.

15 Lastly, **EFRAG TEG** members discussed in its **6-8 April 2020 Webcast meeting** the amended version of EFRAG's DCL according with the input received from them in its 26 March TEG Webcast meeting and with the feedback provided by User Panel members in its 1 April Webcast meeting. EFRAG TEG proposed some drafting changes and recommended the DCL as drafted in agenda paper 07-02 to its approval by EFRAG Board.

16 Additionally, the EFRAG Secretariat has performed an analysis to obtain evidence on the level of goodwill allocation used by the companies in practice with large goodwill balances. The analysis has been prepared with sample selection of 30 European publicly traded companies with largest goodwill balances from Thompson Reuters database (*see appendix I of this cover note*).

Comment period

17 The IASB asked for comments on the DP by 15 September 2020. However, due to the uncertainty and evolving nature of the crisis caused by Covid-19, the IASB is considering whether to extend this comment period. The IASB Staff proposes to extend the comment period approximately 3 months until December 2020 (see IASB Staff's proposal). The IASB will discuss this proposal in its 17 April 2020 Webcast meeting. Therefore, the EFRAG Secretariat at this stage cannot propose a determined comment period because it will depend on the IASB decision. However, the EFRAG Secretariat suggests to fix a comment period ending on 12 August 2020 and to extend the same period as the IASB decides (for example if the IASB agreed with the IASB Staff in the 3-months period of extension, the EFRAG comment period would end at 12 November 2020).

Questions for EFRAG Board

18 Does EFRAG Board have any comment on the proposed wording of the DCL?

19 Does the EFRAG Board approve the draft comment letter as drafted in agenda paper 07-02?

20 Does EFRAG Board agree with the comment period suggested by EFRAG Secretariat in paragraph 17?

Agenda Papers

21 In addition to this cover note, the following papers have been provided for this session:

(a) Agenda paper 07-02 –EFRAG DCL on the DP;

(b) Agenda Paper 07-03 - Initial feedback received in response to EFRAG's M&A consultation; and

(c) Agenda Paper 07-04 – the DP (*Background purposes*).

Appendix I: Goodwill allocation level analysis

Introduction

22 The objective of the analysis performed by EFRAG Secretariat was to obtain the view on the level of goodwill allocation used by the companies in practice with large goodwill balances.

The details

23 To get an overview on which level goodwill is allocated to CGUs for impairment test purposes, EFRAG Secretariat has made a sample selection of 30 European publicly traded companies with largest goodwill balances from Thompson Reuters database.

24 The companies selected represent the following split by country:

Country	Number of companies
Belgium	1
France	7
Germany	6
Italy	2
Netherlands	4
Switzerland	4
United Kingdom	6
Grand Total	**30**

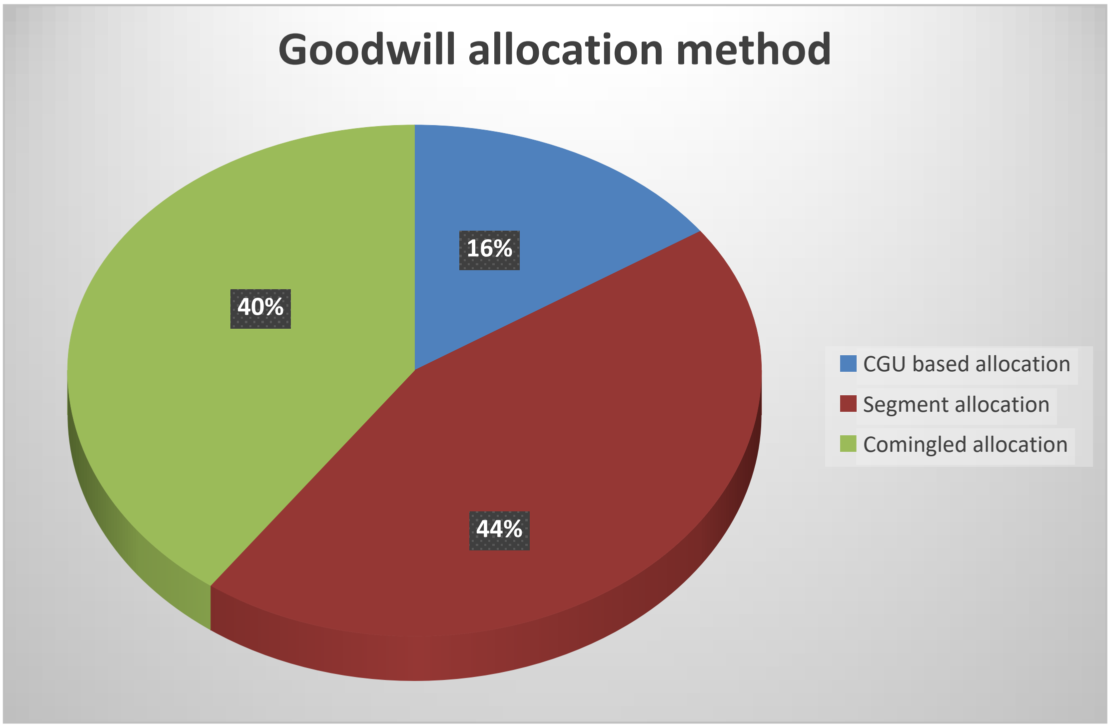
25 The total gross goodwill balance for these companies amounts to 762 bln EUR whereas the total equity amounts to 1.180 bln EUR and total assets – to 7.206 bln EUR. The table below presents the breakdown per country:

Country	Total assets	Total equity	Gross g/w balance	Net g/w balance	Percentage of net g/w to total assets	Percentage ofnet g/w to total equity
Belgium	211.104.214.880	67.548.567.320	114.289.835.140	114.285.374.840	54%	169%
France	732.589.000.000	202.745.000.000	139.679.000.000	113.908.000.000	16%	56%
Germany	1.016.019.000.000	288.623.000.000	168.406.000.000	145.400.000.000	14%	50%
Italy	953.145.000.000	85.744.000.000	37.109.000.000	18.436.000.000	2%	22%
Netherlands	304.613.800.000	33.218.600.000	55.066.500.000	53.064.300.000	17%	160%
Switzerland	353.855.523.332	153.963.525.239	84.712.733.968	73.795.361.354	21%	48%
United Kingdom	3.634.541.217.573	348.084.051.174	163.651.409.984	60.822.499.400	2%	17%
Grand Total	**7.205.867.755.785**	**1.179.926.743.733**	**762.914.479.092**	**579.711.535.594**	**8%**	**49%**

26 The analysis shows that also on overall for 30 companies selected net goodwill (after impairment charges) represents almost 50% of total equity, for some countries like for example Belgium and Netherlands net goodwill could be more than 150% of equity of these companies.

27 In addition, EFRAG Secretariat has analysed the financial statements of these 30 companies in order to find the information about goodwill allocation level for the goodwill impairment purposes. The result of the analysis showed that for 16% of companies' goodwill was allocated on CGU level, for 44% - on segment level and for the rest – the allocation was done partly on segment, partly on CGU level.

28 The following graph represents the results:



29 The results show that almost half (44%) of the companies selected allocate goodwill on a segment level which is the maximum level permitted by IAS 36. Only 16% of them perform goodwill allocation at the level lower than a segment. This could be one of the reasons of “too little too late” issue as the larger the CGU is, the more headroom it could potentially contain, which in turn might delay the timely recognition of goodwill impairment.

Appendix II– Summary of EFRAG User Panel Discussion

Description

30 On 1 April 2020 EFRAG User Panel (EFRAG UP) discussed the IASB DP *2020/1 Business Combinations— Disclosures, Goodwill and Impairmen*t issued on 19 March 2020 (the 'DP'). The discussion was limited to the questions on improving disclosures on acquisitions (Section 2 of the DP) and on whether to allow some identifiable assets acquired in a business combination to be included in goodwill.

Summary of the discussion

Question 2 (Section 2 – Improving disclosures about acquisitions) - to add new disclosure requirements about the subsequent performance of an acquisition.

31 The members of EFRAG UP generally welcomed the IASB decision to require additional disclosure requirements about the subsequent performance of the acquisition as this information was currently missing in the financial statements. They considered the IASB decision as a step forward.

32 However, members also expressed concerns as to the usefulness and reliability of the information to be provided.

33 Some members considered that additional disclosures will not help users if the solution to remove goodwill from balance sheet by amortising or impairing it will not be found. Currently in some industries one can find goodwill balances of 20 years old. In addition, these disclosures will be costly and onerous which contradicts with the IASB objective to reduce costs and complexity for prepares.

34 Regarding the **level of monitoring by the CODM**, the EFRAG UP members provided the following views:

(a) not necessary to set the level, if the acquisition is monitored at a lower level it could also be very useful;

(b) the concerns about the objectivity of the information provided, as the independency of CODM, who usually decides on an acquisition is questionable.

35 Regarding the **duration of a monitoring of an acquisition,** EFRAG UP members expressed the following views:

(a) Two years period was considered too short. If an entity is acquired in the middle of the year, it might become one financial year of disclosures. The period of three-four years was considered more reasonable;

(b) If goodwill amortisation would be required, it would be amortised over a longer than two years period, therefore it is not reasonable to accept such a short period of management monitoring; and

(c) Several UP members questioned why management should stop monitoring a major acquisition and even considered that if monitoring stops, the goodwill should be impaired.

36 Regarding **commercial sensitivity of information** to be provided, one EFRAG UP member noted that the most useful information is commercially sensitive and therefore doubted the usefulness of new disclosure requirements.

37 Regarding **forward-looking information**, members commented that progress and success of an acquisition is monitored against business plans, budgets and other forward-looking management information which is only used internally and might not consider all the circumstances.

Question 3 (Section 2 - Improving disclosures about acquisitions) - to add disclosure objectives about the benefits expected from an acquisition and how an acquisition meets management objectives.

38 The EFRAG UP members expressed concerns about the independency of CODM and hence the objectivity of the information provided about meeting the objectives set-up by CODM itself, as well as forward-looking nature of the information used for internal purposes as discussed above.

Question 4 (Section 2 - Improving disclosures about acquisitions) – Synergies

39 The EFRAG UP members highlighted that information about the synergise was an important point and that NPV of expected synergies is calculated for every acquisition.

40 However, they expressed concerns about the assumptions used to calculate the synergies, such as timing horizon (it is often assumed that they would last forever) or not including other important information, such as loss of market share for example. It was also noted that the share price of an entity could fall despite the forecasted synergies.

41 Members also noted that synergies are not defined as an accounting term and are thus subject for interpretation.

Question 5 (Section 2 - Improving disclosures about acquisitions) – Pro-forma information

42 The EFRAG UP did not have comments on this question.

Question 12 (Section 5 – Intangible Assets) - not to develop a proposal to allow some intangible assets to be included in goodwill.

43 The majority of EFRAG UP members have agreed with this proposal on the grounds that otherwise many conceptual and practical points would be needed to address and it would delay the progress of this DP. Members also noted that this question would be more relevant if the amortisation of goodwill or some of its components would be reintroduced.

44 However they pointed out the difference in accounting treatment between acquired and internally generated intangible assets and that solution to resolve this mismatch would be useful.

Goodwill amortisation vs impairment

45 Several EFRAG UP members expressed their support towards revised goodwill amortisation approach. In their opinion:

(a) it would resolve (part of) the issue with too little too late;

(b) goodwill is an investment which should be recovered over a specific period of time and therefore amortised;

(c) sending money outside a company is a cost and should be reflected in profit or loss;

(d) the same approach as for PPE should be adopted;

(e) if the system (impairment test) is not working, one cannot disregard it as it represents already a new evidence by itself.

One EFRAG UP member favoured goodwill impairment as in his opinion goodwill amortisation charges are disregarded for management compensation purposes, might result in double counting of expenses and goodwill (or at least some of its components) organically replaced and therefore results in infinite useful life.