Goodwill – Draft Comment Letter
Cover Note

Objective

1 The objective of this session is to discuss and to recommend for approval to the Board 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').

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, EFRAG is committed to make any additional time available to its constituents for comment, therefore the aim is to keep unchanged the initial planning.

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.

Technical discussions at EFRAG before the issuance of the DP

7 At the joint EFRAG TEG and User Panel meeting in March 2020 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).

8 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.

Changes made to the DCL since TEG webcast meeting on 26 March

9 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.

10 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).

11 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).

12 The input received by EFRAG TEG members (written input) and EFRAG User Panel (during its 1 April 2020 Webcast meeting – *see appendix II of this cover note for a short summary of the discussion*) has been considered in the redrafted version of the DCL provided for this session (see agenda paper 01-02).

13 The DCL uploaded as agenda paper 01-02 includes the proposed EFRAG's views drafted by EFRAG Secretariat for Questions 1 and Questions 11 to 14 that have not been previously discussed by EFRAG TEG, as well as the Cover Letter.

14 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*).

Questions for EFRAG TEG

15 Following the EFRAG Secretariat's request for written input by EFRAG TEG members, the EFRAG Secretariat amended the drafted draft comment letter. However, the EFRAG Secretariat did not reflect the following two comments:

(a) In response to Question 5 of the DP, the drafted DCL recommends the IASB to develop some guidance on how to prepare pro forma information that shows the revenue and operating profit or loss before acquisition-related transaction and integration costs of the combined business for the current reporting period as though the acquisition date had been at the beginning of the annual reporting period. Through the written comments one EFRAG TEG member disagreed with this proposal. He considered that this would end in generic boilerplate descriptions which is even more of limited use as the user does not know the set-up or architecture of the management information system.

(b) In response to Question 5 of the DP, the drafted DCL supports the proposal of the DP to replace the term 'profit or loss' with the term 'operating profit or loss before acquisition-related transaction and integration costs' in the requirement currently included in paragraph B64 of IFRS 3 *Business Combinations* to disclose the following information:

(i) the amounts of revenue and profit or loss of the acquiree since the acquisition date included in the consolidated statement of comprehensive income for the reporting period; and

(ii) the revenue and profit or loss of the combined entity for the current reporting period as though the acquisition date for all business combinations that occurred during the year had been as of the beginning of the annual reporting period.

One EFRAG TEG member disagreed with the proposal. He stated that the information would be costly/difficult to prepare. Unlike the suggested measure ('operating profit or loss before acquisition-related transaction and integration costs'), which was a defined GAAP measure. The term 'profit or loss' is more abstract and allows entities disclose non-GAAP measures and is accordingly possible to prepare.

Do EFRAG TEG members agree not to amend the drafted DCL, to reflect the comments above?

16 Do you have any comment on the proposed wording of the DCL?

17 Do you recommend the DCL for approval by EFRAG Board?

Agenda Papers

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

(a) Agenda paper 01-02 – redrafted version of EFRAG DCL on the DP (*clean version*);

(b) Agenda paper 01-03 – redrafted version of EFRAG DCL on the DP *(track-changed version from the DCL presented in the 26 March 2020 TEG meeting);*

(c) Agenda Paper 01-04 - Overview to the questions of the DCL; and

(d) Agenda Paper 01-05 – the DP (Background purposes).

Appendix I: Goodwill allocation level analysis

Introduction

19 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

20 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.

21 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**

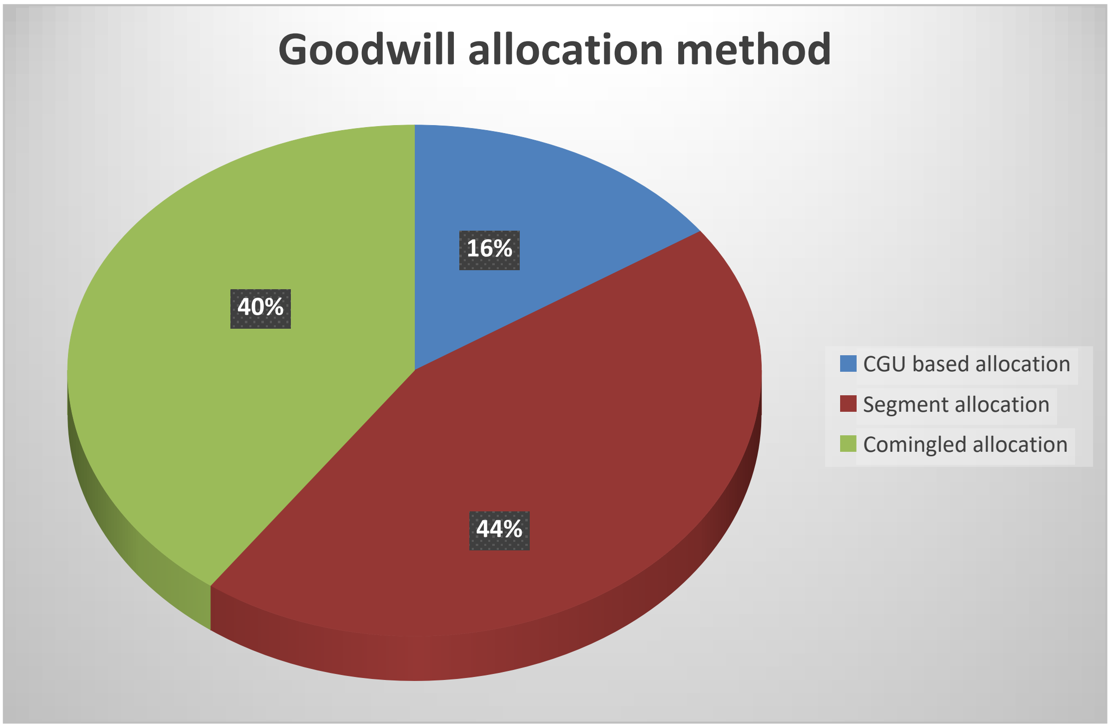
22 The total gross goodwill balance for these companies amounts to 762 bln EUR whereas the total equity amounts to 1.180 bln EUR and total assets – to 7.206 bln EUR. The table below presents the breakdown per country:

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%**

23 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.

24 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.

25 The following graph represents the results:



26 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

27 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.

28 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.

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

30 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.

31 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.

32 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.

33 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.

34 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.

35 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

36 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.

37 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.

38 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

39 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.

40 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.

41 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

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

(a) it would resolve 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.