31 December 2020

Mr. Hans Hoogervorst
Chairman
International Accounting Standards Board
Columbus Building
7 Westferry Circus
Canary Wharf
London E14 4HD
United Kingdom

Discussion Paper "Business Combinations—Disclosures, Goodwill and Impairment"
Comments by the Financial Analysis and Accounting Committee of the
French Society of Financial Analysts (SFAF)

Dear Sir,

The French Society of Financial Analysts, SFAF (Société Française des Analystes Financiers), is pleased to submit its contribution as part of the consultation undertaken by the IASB on the Discussion Paper "*Business Combinations—Disclosures, Goodwill and Impairment*".

SFAF represents more than 1,400 members in France and is itself a member of the European Federation of Financial Analysts Societies (EFFAS), which comprises 18 member organizations representing more than 15,000 investments professionals. Its Accounting and Financial Analysis Committee was created to represent analysts, fund managers and professional investors in the debate on accounting standards. Financial analysts are among the principal users of corporate financial statements and therefore wish to express their opinion on the implementation of new or revised accountings standards.

General comments and consolidation-related matters:

As a starting point, we would like to reiterate that we consider that goodwill is an asset and that it should be recognized on the balance sheet at the time of an acquisition. This recognition is of the utmost importance because it allows investors to capture the total amount of capital that has been invested by the management, at a certain date and a certain price. This is at the heart of stewardship principle on which IFRS's are built, and this is even more critical as

acquisitions often represent the most important investment realised by many groups, whether paid in cash or through issuance of new shares. We believe that previous practices in many jurisdictions (pooling of interest, goodwill immediately deducted from equity) have structurally failed to reflect the total capital invested, and also delivered very poor results from a practical point of view.

Furthermore, we do not believe that in subsequent periods, the amount of the goodwill on the balance sheet should provide a current valuation for the acquired business: it stands on the balance sheet to reflect capital invested by management that has not been re-imbursed ("consumed"), and to allow an assessment of the return on investment, a situation similar to other operating assets. Valuation of the various business units of the group is to be made by investors themselves, not by the company accountants/management. The separation of these two roles is of the utmost importance to allow proper functioning of the capital markets.

We would like to add that in our opinion the changes introduced in IFRS 3 in 2008 (step-up acquisition and full goodwill) are considered to be mostly irrelevant as it can result in displaying in the balance sheet an amount of goodwill that does not reflect accurately the right amount of capital invested, a key feature for users. It also resulted in many unrealistic accounting presentation for some transactions, like a capital gain when taking control of an entity previously reported as an equity investment, that most users fails to consider as a reasonable and useful presentation. We hope that those issues will be revisited in a future Post-Implementation review.

As an introductory comment to the proposals in the Discussion Paper on Business Combinations—Disclosures, Goodwill and Impairment, we see that the accounting treatment of goodwill has been, for many years, a major source of frustrations for users of financial information, since the IASB followed the FASB on the non-amortization, at a time when convergence was the key target of the IASB. We stated at this time that convergence could not be an excuse for standards whose foundations are incorrect, and anticipated that the "Board is proposing techniques that in practice will justify the value given to goodwill and will not lead to recognition of impairment losses"[1] as stated in SFAF Comment letter to IASB – 4 April 2003.

As expected by users, application of IFRS 3 has resulted in an almost systematic delayed recognition on goodwill impairments, a situation well captured by the "too little, too late" formula. In these cases, when the impairment is finally booked, the investors are already aware of the underperforming asset for years, and in most cases share prices are not influenced by the (delayed) negative announcements, proving that this loss in value was already well-known by investors for years.

All these points have been well-identified by users, leading them to ask for an improvement or reshuffle of the current standard, as illustrated by the letter the SFAF (dated 16 June 2014)[2] send when the IASB did its first Post-Implementation Review of IFRS 3 in 2014. This PIR

[1] http://www.sfaf.com/download/29/

[2] http://eifrs.ifrs.org/eifrs/comment_letters//34/34_3817_GrelingAllardBellonSFAFFrenchSocietyofFinancialAnalysts_0_SFAFCommentletteronIFRS3PIR2014.pdf

resulted in no material change, in spite of the well-documented flaws and failures of the standard identified by users. We note that the Italian Association of Financial Analysts (AIAF)[3] and the European Federation of Financial Analysts Societies (EFFAS)[4] made very similar comments back in 2014. These failures have been continuing since, accumulating more and more examples of failures, and we are surprised to see the Board recommending, once again, almost no fundamental change to the standard nowadays.

Disclosures (question 1 to 4 of the Discussion Paper)

The Discussion Paper suggests that upon an acquisition the company should disclose information on the objectives of the acquisition and afterwards, how the acquisition is delivering against those objectives based on performance measures used by the CODM. Similarly, the Board considered to disclose the expected synergies.

Obviously, any investor is keen to understand the rationale behind an acquisition, how it has performed or if it has performed as expected. To a large extent, it is linked to stewardship.

The requirement to disclose information about whether the acquisition is meeting its objectives (Question2) is laudable, but the effectiveness of the disclosure depends on how well the management follows the performance of its acquisition, and is likely to be limited by its willingness to provide sensitive information.

Our experience with information provided to CODM in IFRS 8 is that is has, very often, resulted in poor quality information to users: this was clearly pointed in SFAF comment letters on IFRS 8 and on the project Improvements of IFRS 8 – Operating Segments[5] as we stressed that the management approach is failing to provide relevant information. Regarding the disclosures of expected synergies (question 4), we believe that, although they can help to understand the rationale behind an acquisition price, we will end with figures that users will be unable to reconcile with the financial reporting provided by groups. This is also due to the fact that we expect that companies will be reluctant to make public sensitive information to their competitors. We believe that such additional disclosures would be simply add a few paragraphs of boilerplate comments to the current information. This is not a new position as EFFAS's Commission on Financial Reporting in its comment letter in 2014 on the IFRS 3 post-implementation review stated: "*Firstly, this kind of disclosure would increase significantly the size of notes which is not a priority from a users' perspective. This is particularly true for large groups where the number of cash-generating units can be higher than the number of operating segments identified in the financial statements. Secondly, we believe that it would end disclosing sensitive information for each business concern and this could clearly become a dangerous approach for companies not to mention potential regulatory and compliance issues.*

[3] http://old.efrag.org/files/Goodwill%20Impairment%20and%20Amortisation/CL27_-_AIAF_-_translation_from_Italian_original.pdf

[4] https://eifrs.ifrs.org/eifrs/comment_letters//34/34_3915_JavierdeFrutosEuropeanFederationofFinancialAnalystsSocietiesEFFAS_0_EFFAS.pdf

[5] http://eifrs.ifrs.org/eifrs/comment_letters//241/241_19130_BertrandAllardLaSocitFranaisedesAnalystesFinanciersSFAFTheFrenchSocietyofFinancialAnalysts_0_SFAFCommentletterIFRS8improvements31072017.pdf

Thirdly, we think that even if such a level of disclosure was to be required, users will simply end with a much larger amount of boilerplate information." We believe that these views are still valid.

We therefore seriously doubt that this additional information would provide helpful and relevant information for users.

It seems that the Discussion Paper mainly proposes to introduce new disclosures to avoid the failures of the current standard. As a final point on proposed disclosures, we believe that adding information on a test that has extensively demonstrated its conceptual and practical flaws (see comments below) looks like a rather optimistic approach.

There are however some simple ways to improve disclosure. Financial analysts are, in many cases, frustrated by the level / transparency / understandability / relevance of information provided on goodwill. **We would very much welcome to introduce a table detailing the amount of goodwill (gross and net) per segment and to which material acquisition it is related (and its date)**. This kind of simple summary would be, in many cases, much more relevant for users than the extended information, often irrelevant and never summarized properly, that we have today.

Impairment test (questions 6, 9 & 11)

The impairment test is unanimously seen by users as providing little or no information, and there is a wide consensus view among users that this test offers so many ways to deliver the result that the management wants to display that it brings absolutely no guarantee that the goodwill acquired is not overvalued. To illustrate some the clearer cases we have encountered, we would like to make reference to the following (real) cases:

- Company A has transferred most of its goodwill to a business unit that has been created internally. The acquired business, that has lost most of its value, was kept as a separate business and later sold, and the group thus recorded a capital gain.

- Company B, following an opportune reorganization, has transferred the goodwill from business unit X to business unit Y benefiting from the very significant headroom goodwill existing in business unit Y, avoiding any goodwill impairment.

- Company C has a goodwill and a shareholder equity of similar levels, but several times higher than its market capitalization over the last years. Despite, it has not reported any significant impairment.

- Company D, for the purpose of the impairment test of the goodwill of one its acquired foreign subsidiary, disclosed a WACC of 5% and a growth rate of 2%, implying an exit multiple of 33 times, when, at that time, the average PE multiple for the sector was 11 times.

- Company E, acquired an entity, overbidding a competitor during a market bubble. The market value of listed comparable companies quickly declined by almost 80%. Company E made an impairment only 12 years later, wiping out only 25% of the goodwill acquired. And the

same year, the company recorded a major capital gain, the gain being about the same amount of the goodwill impairment.

This short list of examples demonstrates how blatantly weak are the goodwill impairment tests in real life and the wide variety of misuse. Financial analysts do not accept the argument that this is the result of poor implementation and enforcement, but rather believe that the impairment test required by IFRS 3 has fundamental flaws, both conceptually and practically, that were well identified when the standard was proposed.

The fundamental flaw of the test is that it is comparing the acquired goodwill to the sum acquired goodwill, plus goodwill re-created since the acquisition, plus the unrecognized goodwill pre-existing in the cash generating unit in which the acquired entity was allocated. In such a case, it is quite unrealistic to expect the test to deliver any fair result.

This mix of three different goodwills was clearly identified by financial analysts when IFRS 3 was to be introduced (2003), and they anticipated that it would result in no goodwill impairment. SFAF in its comment letter of the post-implementation of IFRS 3[6], in 2014, stressed that "*Regarding impairment test, we doubt that it can work properly. This is a very central point as goodwill non-amortization is supposed to be guaranteed by this safety mechanism. First, the impairment test mechanism cannot, in a single cash generating unit, separate properly the acquired (and recognized) goodwill from the internally generated (and never recognized) goodwill: this failure makes the impairment test inoperable in some instances*". The European Federation of Financial Analysts Societies (EFFAS) made a similar assessment of the weakness of the impairment test[7]. And the PIR resulted in no change to the standard. In 2016, the IASB staff researched the idea of introducing "pre-acquisition headroom" in order to avoid shielding the acquired goodwill, but the project was later abandoned, as unworkable. This is reflected in the current Discussion Paper in paragraphs 3-31 to 3.50. The fact the IASB researched this pre-acquisition goodwill is a clear recognition that the current test fails to deliver what it supposed to guarantee. Similarly, EFRAG in a research paper published in 2017[8] considered to introduce the "goodwill accretion" in order to avoid confusion between acquired goodwill, and goodwill created at a later stage. This research is also a testimony of the fundamental flaws of the current test.

We believe that because of this fundamental flaws, the whole standard relies on a test that will structurally fail to measure properly what it supposed to measure, and will prevent IFRS 3 to deliver any relevant and solid result for the users of financial statements.

Beyond this conceptual flaw, the standard has several practical flaws that also prevent the test from working properly:

- The test is done by the management itself, after deciding the acquisition that created the goodwill to be tested. Is it reasonable to expect the test to deliver unfavorable results? We note also that very often, significant impairment is done at a time when there is a change of

[6] http://www.sfaf.com/download/29/

[7] Page 3 of https://eifrs.ifrs.org/eifrs/comment_letters//34/34_3915_JavierdeFrutosEuropeanFederationofFinancialAnalystsSocietiesEFFAS_0_EFFAS.pdf

[8] https://efrag.org/Assets/Download?assetUrl=/sites/webpublishing/Project%20Documents/261/Goodwill%20Impairment%20Test%20Can%20it%20be%20improved.pdf&AspxAutoDetectCookieSupport=1

management, as the new one feels comfortable in recognizing that the previous team made underperforming investments which they failed to recognize. This a clear failure of the stewardship principle.

- The test relies very often on Discounted Cash Flows, a valuation method that requires a lot of assumptions and inputs, which results in allowing the test to justify almost whatever is needed. This weakness is well recognized by seasoned financial analysts. In spite of the very limited information on the underlying assumptions available to users, the example of Company D above is a clear illustration of the weakness of the valuation method in a real case.

- Following the “accounting life” of goodwill in a group that goes through different re-organisations and other business acquisitions (and disposals) is an unsurmountable task even for the most serious accountants and auditors, moreover over long periods. This difficulty is fully recognized by the IASB in the Discussion Paper when it discusses for how long the disclosures on acquisitions objectives should be provided (paragraphs 2.41 to 2.44) .

We consider that the present impairment test could only work in a group that would keep all acquisitions as individual cash generating units indefinitely, and apply the test in an independent and transparent manner, even in situation of stress. Such conditions are almost never met. But, here again, the measured goodwill would be a mix of acquired goodwill and goodwill created since the acquisition. We thus conclude that the test at the center of the impairment-only approach under IFRS 3 is unable to work properly.

We note that in spite of a 2013 report by ESMA[9] pointing at many weak aspects of impairment test of goodwill, including the overoptimistic rates (both discount and growth) assumptions, we consider that the practice in Europe has not evolved in a noticeable manner.

We believe that this general failure of impairment tests to deliver proper results has also caused some loss of credibility of financial information, accountants, auditors, boards and audit committees.

We are aware that, should the Board decide to move towards goodwill amortization, it will not remove the necessity of an impairment test of the goodwill, possibly not in a systematic manner, but only in specific situations when triggers are met. Such an impairment test would be, in fact, just be similar to any impairment test for all existing assets (tangibles, intangibles, financial, inventories, receivables) in specific situations. These tests are also unperfect, as demonstrated, for instance, by the fact that a company may record, from time to time, a loss when selling an asset after an impairment. But in these cases, the whole bookkeeping during the asset life is not based on a single, and completely unreliable, test.

Besides, we are not convinced at all by the proposal of the Board to remove the requirement to perform a quantitative impairment test every year (Question 9), should it decide not to go with the amortization of goodwill, a direction we are not supporting (see next paragraph). It would be very contradictory to reduce the requirements to perform such tests, at a time when the “too little, too late” issue has been widely highlighted by many investors to the Board,

[9] https://www.esma.europa.eu/sites/default/files/library/2015/11/2013-02.pdf

without proposing any improvements to such tests. The cost factor does exist but should not be given priority over the reliability of financial reporting.

On the contrary, we consider with the Board, that the impairment test should not been simplified (question 11). Simplifying a test that is already not working would not make it more efficient at all.

Amortization (question 7)

The starting point for the current standard of impairment-only approach is that the economic benefits associated with the goodwill are difficult to capture both in terms of timing and amount of realization. This difficulty has been captured in the word “indefinite”. We stress that the current standard never says that the goodwill benefits are “infinite” (i.e. is non-wasting asset), but in practice, it has resulted in goodwill being treated has an asset with infinite economic benefits.

First, we believe that the goodwill resulting from an acquisition[10] is an asset that is going to be consumed over time, in other terms, the goodwill is a wasting asset. This is implicitly recognized by the Board which differentiates such goodwill from internally generally goodwill. The P&L and the balance sheet are intended to reflect the consumption of such assets, not to estimate their market value.

The fact that it is difficult to predict the timing and the amount of inflows that will be generated by the goodwill is not an acceptable argument to stop amortization, as this could be the case with many other (if not all) assets, including tangibles ones. For instance, with some new technology equipment which has never been operated yet, it is quite difficult to predict what will be the expected economic life and how the related revenues and profit will be spread over the period: in this situation, nobody would seriously argue that depreciation of the new machine or equipment should be stopped. This is the very fundamental flaw of the use of “indefinite” concept. We also note the current French standards (used for the groups not reporting in IFRS) has required to amortize goodwill since 1986, and we are not aware of any major impossibility in determining a reasonable amortization period.

Even if we would accept this argument, the acquired goodwill is supposed to be rigorously tested every year in order to avoid being overstated. And this test is supposed to be the cornerstone that allows to treat goodwill differently from all other assets, i.e. not making it subject to amortization.

We do believe that in a reasonable and profitable acquisition where goodwill is recognised, this acquired asset will generate benefits in addition to the ones created by the collection of all identifiable (revalued) assets in a business combination. This expected future additional profit has been paid by the acquiree, and to allow for a proper assessment of the performance of the total investment, this goodwill cost need to be allocated to P/L over a reasonable period. In an extreme case, if we assume that the acquired company price is made up 100% goodwill, if the new subsidiary reports just a 1€ profit, the group will thus be able to report an increment in the

[10] Except in situations where there was an overpayment at the time of the acquisition and goodwill is not justified by future economic benefits.

profit (accretion) if no goodwill amortization is done, a measure of performance that seems unacceptable from an investor point of view. As demonstrated by this example, non-amortization of goodwill makes any calculation of dilution/accretion irrelevant in all cases involving significant goodwill amount.

Financial analysts do not need to see reflected on the balance sheet the current value of the goodwill on the acquired business, contrary to what we often hear, and certainly not in order to make a valuation. Indeed, financial analysts make very little use of balance sheet as a starting point for valuation purposes: their starting point is always an income statement sub-total (EBITDA, EBIT, net profit) or cash-flow statement sub-total (CFO, OpFCF). And the book value of goodwill will never be used by a financial analyst as a starting point for valuation purposes. This is consistent with the conceptual framework stating that "general purpose financial reports are not designed to show the value of a reporting entity; but they provide information to help existing and potential investors, lenders and other creditors to estimate the value of the reporting entity".

Additionally, we believe that the non-amortization approach has significantly cut the link between the cash flow statement (which de facto includes goodwill at the time of the acquisition and when paid in cash) and the P/L which will never incur an expense for the amount paid in goodwill. And we believe that for users of financial information, the cash flow statement is mostly used to complement the P/L, and cutting the link between these two statements is a fundamental flaw.

In addition, we do not agree with some arguments stating that internally generally goodwill is not recognized. This is neither the case for many internally generated intangibles assets, a situation we support. We are also not convinced by the fact that, once the goodwill is fully amortized, the profitability of the company will suddenly increase. Such is also the case with tangible assets, and no one complains about this, provided this situation is properly disclosed.

The argument saying that some investors will ignore a goodwill amortization and add-back the corresponding amount to their performance measures, and that the standard should thus reject systematic amortization, is not relevant, according to us. Many investors often make all sorts of adjustments to their reported figures, for instance, excluding some capital gains, or deferred tax income, and nobody is seriously arguing that these capital gains or deferred taxes should not be reported. The situation is similar for goodwill impairment.

We believe that the revised standard should require to disclose properly goodwill amortization (and present it clearly separately from other depreciation and amortization), and allow financial analysts to make the adjustments they want to do, or not. We note also that this add-back approach is often used arguing that it allows to make comparison with companies that have not made any acquisition. But this a complete misunderstanding of the complexity and differences of the real world: where companies have made different choices (acquisitions vs organic growth), different amounts of capital need to be invested at different time, producing thus different results. The reported figures should not pretend to offer simplistic comparison between entities that follow different strategies. A similar argument could be that we should add-back stock-option expense at company A because there are no stock-option at company B (and ultimately, that the standard on stock-option expense should be removed).

We also believe that the non-amortization of goodwill, combined with ineffective impairment tests, as resulted in many companies reporting inflated shareholders equity and led analysts to no longer use the net debt/equity ratio, a key measure for assessing the financial structure of a group. This ratio, when computed with proper figures (i.e. not distorted by goodwill non-amortization), is an important indicator of the relative amount of money at risk by two classes of capital providers (bondholders / shareholders). The fact that the Discussion Paper suggests to disclose the amount of shareholder equity minus the goodwill is, in fact, a recognition by the Board of this inflated shareholder equity figure in many cases. We do not support a systematic publication of shareholders equity minus goodwill as it is computed by a user very easily with the existing financial statement presentation, and it would cause additional confusion as to the nature of goodwill.

Finally, we feel very much frustrated when we hear that we should provide a new argument to re-introduce amortization: the mere fact that the current standard is simply not working is a very real, and important, argument that the Board has to consider to fulfill its mission. Our 15 years' experience with the problems encountered with non amortization of goodwill in itself a true and convincing argument. We also stress that, at the time of the introduction of IFRS 3, we warned against all the flaws and the poor results it would deliver. We simply cannot accept that these arguments, that have proved to be right, are to be ignored.

Other Intangibles (question 12)

With IFRS 3, it was decided to require better and more systematic recognition of other identifiable intangibles in business combinations, in order to minimize the value of the remaining goodwill that would no longer be amortized but tested for impairment on a yearly basis, an exceptional approach for assets.

We are reluctant to the current practice of identifying separately additional intangible assets specific to business combinations (brands, customer relations…) beyond goodwill as it provides no real information for users. In particular, the valuations of these assets are highly subjective, and in fact, open to significant arbitrage opportunities for companies during business combinations. We also believe that impairment tests for those indefinite-life assets that are not amortized are highly questionable, i.e. in a very similar situation to goodwill. We note that the FASB, when designing FAS 141-142, originally requested that there should be an active market to identify and value these assets; this pre-requisite was later removed as it would have prevented to recognize most of these intangible assets.

As a reality check, we also note, after making comparisons between similar acquisitions, that groups have identified different kinds of intangible assets, with very significant different valuations for similar assets, thus demonstrating how subjective the identifications and the valuations of these assets are.

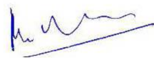
More importantly, we doubt that it really provides a useful information for users of financial statements, as these assets have no separate cash flow identifiable, and as there is, in most cases, no separate market (not even requesting an active market) for such assets. We are not aware, over the almost twenty years of application of IFRS 3, of any significant transactions where a group sold separately one of these intangible assets identified in a business

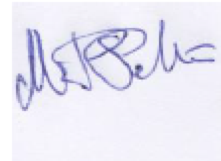
combination. We thus strongly doubt that these assets are really separable. We note that, similarly to goodwill, the book value of these intangibles assets are never used as a starting point for valuations purposes by financial analysts.

As a consequence, the recognition and valuation of these intangible assets provided with IFRS 3 is mostly irrelevant for users of financial statements. As stated in our 2014 comment letter on IFRS 3 PIR, we believe that most analysts are simply not looking at the values allocated to these intangibles.

We thank you for the opportunity given to us to provide our view on such important aspects of financial reporting for users. If you would like to further discuss the views expressed in this letter please do not hesitate to contact us.

Yours faithfully,





Jacques de Greling
Co-Chairman of Accounting and Financial Analysis Commission
jdegreling@sfaf.com

Bertrand Allard
Co-Chairman of Accounting and Financial Analysis Commission
ballard@sfaf.com

Marie-Pascale Peltre
Vice-Chairwoman of Accounting and Financial Analysis Commission
mppeltre@sfaf.com

SFAF – Société Française des Analystes Financiers
135, boulevard Haussmann 75008 PARIS
France
Tel : +33 (0) 1 56 43 43 10
www.sfaf.com