

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

Ref: IASB's Discussion Paper *Business Combinations—Disclosures, Goodwill and Impairment*

Dear Mr Hoogervorst,

The European Securities and Markets Authority (ESMA) thanks you for the opportunity to contribute to EFRAG's due process regarding the IASB's Discussion Paper (DP) *Business Combination: Disclosure, Goodwill and Impairment*. We are pleased to provide you with the following comments, in order to improve the enforceability and consistent application of IFRSs.

ESMA supports the objective of the DP to provide investors with more useful information about the acquisitions of businesses. In particular, ESMA agrees that requiring issuers to improve the information provided to investors about an acquisition and its subsequent performance would be beneficial.

However, ESMA is concerned that the DP proposed by the Board and the preliminary views expressed therein do not sufficiently address the underlying problems ESMA observes with regards to the existing accounting for goodwill. ESMA urges the Board to further assess potential improvements to the existing impairment model. If, upon further assessment, the IASB confirms its preliminary conclusion that the current impairment test cannot be significantly improved at a reasonable cost for issuers, ESMA thinks that the Board should explore the possible re-introduction of goodwill amortisation.

ESMA also believes that a relief from the mandatory yearly impairment test for goodwill should be considered only if the Board reintroduces amortisation, since in an impairment-only model the yearly impairment test is an essential tool for auditors and enforcers to challenge issuers' accounting, as well as for Supervisory Boards and Audit committees to challenge management internally.

Furthermore, ESMA believes that convergence between IFRS and US GAAP in this area is of utmost importance and encourages the IASB to closely engage with the FASB and give due consideration to its ongoing parallel project.

More detailed comments on the DP are set out in the Appendix to this letter. In case you have any questions or comments please do not hesitate to contact me or Evert van Walsum, Head of the Investors and Issuers Department (Evert.vanWalsum@esma.europa.eu).

Yours sincerely,

A handwritten signature in blue ink, appearing to be 'S/M' with a flourish.

Steven Maijor

ANNEX

Question 1 - the Board's research project

1. ESMA supports the objective of the Discussion Paper to provide investors with more useful information about the acquisitions of businesses. In particular, ESMA agrees that requiring issuers to improve the information provided to investors about an acquisition and its subsequent performance would be beneficial since nowadays it is challenging to assess the performance of the acquired business compared to the expectations of management. This is a key issue, which is independent from the conclusions reached on other proposals included in this DP.
2. However, ESMA is concerned that the requirements proposed by the Board and the preliminary views expressed therein do not sufficiently address the underlying issue ESMA observes with regards to accounting for goodwill, which is that currently goodwill impairment is sometimes recognised too little and too late.
3. ESMA urges the Board to further assess potential improvements to the existing impairment model. ESMA is not convinced that the impairment model cannot be significantly improved at a reasonable cost for issuers. The responses to questions 6 and 7 (which are interdependent) provide detailed suggestions on potential improvements, on which ESMA encourages the IASB to further reflect upon.
4. If, upon further assessment, the IASB confirms its preliminary conclusion that the current impairment test cannot be significantly improved at a reasonable cost for issuers, ESMA thinks that the Board should explore the possible re-introduction of goodwill amortisation. Our answer to question 7 further explains ESMA's position in these regards.
5. ESMA thinks that a relief from a mandatory quantitative impairment test for goodwill should only be considered if the Board reintroduces amortisation of goodwill, as further discussed in our answer to question 9.

Question 2 – disclosure requirements about subsequent performance

6. ESMA agrees with the proposal to enhance the information provided to investors about the subsequent performance of an acquisition. ESMA also supports that the IASB requires the disclosure of information about the strategic rationale and management's objectives for the acquisition, and about whether those are being met.
7. ESMA thinks that this information could be largely based on the information monitored by the Chief Operating Decision Maker (CODM) as defined by paragraph 7 of IFRS 8 *Operating Segments*, but that some core metrics should be defined by the Board and disclosed even if not monitored by the CODM.
8. In ESMA's views, in fact, at least some key disclosures should be required for all the acquisitions which generate a material amount of goodwill, regardless of whether they

are monitored by the CODM. It would be paramount that such key disclosures are both simple to understand and to communicate. ESMA highlights that without such disclosures it will be difficult for investors to assess whether the original objectives of an acquisition are being met. These disclosures should include, *ad minima*, information about the estimated payback period, the expected profit arising from the integration of the new business(es) and the expected integration costs.

9. In addition, ESMA thinks that a company should stop providing disclosures about whether it is meeting its objectives only when the synergies expected to derive from the acquisition have been realised or when those objectives have been abandoned (ESMA notes that in paragraph 2.91 of the DP the IASB proposes that the expected timeline for realisation of synergies is disclosed). ESMA thinks that this normally corresponds to the time when an acquired business is fully integrated into the acquiring business (and after which therefore discrete metrics would not be of interest to users and difficult to calculate for preparers).
10. ESMA agrees with the IASB's view that, in line with the existing approach in IAS 36 *Impairment of Assets*, information on management's objectives for the acquisition and the relevant metrics do not constitute forward looking information but rather reflect management's targets at the time of the acquisition.
11. ESMA thinks that it would be appropriate to disclose the proposed information in the financial statements instead of providing the information as part of the management commentary, as this will ensure that such information is audited and enforceable. Similar to some of the information required by IFRS 7, some of this information could be provided in the management report and incorporated in the financial statements by cross reference in order to avoid duplication.
12. In addition, ESMA thinks that generally commercial sensitivity is not a valid reason for not informing investors. ESMA notes that the metrics proposed by ESMA in paragraph 8 are normally not considered commercially sensitive.
13. Last, but not least, ESMA highlights that disclosure requirements would largely resolve investors' need for better information on the subsequent performance of an acquisition. However, as further discussed under Question 6, ESMA believes that the IASB should further explore whether failure to meet the reported objectives should be linked to, and have an effect on, the impairment testing. In the context of the current model (i.e. where an annual test is required), if set objectives fail there could be a rebuttable presumption of impairment; in the context of a reintroduction of an amortisation model, instead, that could be considered as an indicator of impairment, thus triggering an impairment test. Such linkage would increase the usefulness of the disclosures significantly.
14. ESMA also suggests that the IASB takes this opportunity to further align disclosure requirements between IFRSs and US GAAP with regards to business combinations and goodwill.

Question 3 – disclosure objectives

15. ESMA agrees with the Board's preliminary view that it should develop, in addition to the proposed new disclosure requirement, proposals to add disclosure objectives to provide information to help investors to understand the benefits a company's management expects from an acquisition and the extent to which an acquisition is meeting the CODM's objectives.
16. ESMA notes that this approach is consistent with the feedback from the DP *Disclosure Initiative - Principles of Disclosure* (March 2017). We strongly agree that it is important that users are enabled to understand why management is acquiring a certain business.

Question 4 – disclosures about synergies

17. ESMA agrees with the IASB proposals to require a company to disclose (i) the synergies expected from combining the operations of the acquired business with the company's business, (ii) when the synergies are expected to be realised, (iii) the estimated amount or range of amounts of the synergies and (iv) the expected costs or range of costs to achieve those synergies. ESMA thinks that this information would be useful for users of financial statements.
18. ESMA thinks that the IASB could explore whether it would be appropriate to require issuers to disclose information relating to amounts of goodwill which are *individually* non-material but collectively material (in particular if several business combinations are related), as it is foreseen for other types of disclosures by IFRS 3 paragraph B65.
19. ESMA believes that it is essential that the disclosures provided are not boilerplate, but rather specific and informative, and encourages the IASB to ensure that the future disclosure requirements are clear and enforceable.
20. In addition, ESMA agrees that liabilities arising from financing activities and defined benefit pension liabilities should be disclosed separately when those are acquired as part of an acquired business. ESMA agrees that this information is not expected to be an additional cost to issuers since normally it is readily available at the date of acquisition.

Question 5 – proforma information

21. ESMA agrees to retaining the requirement to prepare and disclose, in the year of acquisition, information that shows the revenue and profit or loss of the combined business for the current reporting period as though the acquisition date was the

- beginning of the annual reporting period. ESMA suggests, however, that the IASB could consider using an alternative term rather than “proforma information”, as this is a term used in the context of prospectus issuances in the EU and may cause confusion for preparers and users.
22. ESMA recommends that the IASB provide additional guidance on the way issuers should prepare this information, for example on the following questions: (i) should the financing of the acquisition be considered? (ii) should intercompany transactions be eliminated? (iii) how should the preparer deal with accounting policy differences between the acquirer and the acquiree? Furthermore, ESMA is of the opinion that disclosures should be provided on the significant assumptions used in the preparation of the pro forma financial information.
 23. ESMA agrees with the Board’s preliminary view to replace the term ‘profit or loss’ with the term ‘operating profit before deducting acquisition-related costs and integration costs’ as this provides investors with relevant information about the operating performance of the main business activity, independently of how the acquired business is financed. Furthermore, ESMA recommends that all definitions in IFRS 3 and in the future standard which will replace IAS 1 *Presentation of Financial Statements* (now under development) are fully consistent.

Question 6 – improvements to the impairment test

24. ESMA urges the IASB to further explore possible ways to make the current impairment test for cash generating units containing goodwill significantly more effective at recognising impairment losses on goodwill on a timely basis. As discussed in question 7, should the IASB confirm its preliminary conclusions that such significant improvements are not achievable at an acceptable cost for preparers, then ESMA thinks that the IASB should further explore amortisation of goodwill.
25. In light of the enforcement experience of European accounting enforcers, ESMA highlights that the current model relies too heavily on estimates and variables which depend to a large extent on management judgement on the basis of company-specific projections and inside knowledge, which enforcers struggle to challenge.
26. ESMA agrees that management over-optimism in the estimation of future cash flows and the so-called shielding effect are among the most significant causes leading to the non-recognition (or non-timely recognition) of goodwill impairment.
27. In order to address these two issues, ESMA suggests that the IASB should further explore the following in order to create more discipline around the application of valuation techniques:

On overoptimistic cash flows:

- a. providing more guidance on what is a “reasonable and supportable” cash flow projection (IAS 36 paragraph 33). The IASB could explore providing further detailed guidance / additional requirements for example on:
 - i. the expected link between cash flow predictions and external evidence; for example, the IASB could provide guidance on the fact that revenue estimates higher than the industry average should normally be supported by convincing evidence, such as significant investments or would not be expected in a starting-up or declining phase of the entity’s business cycle;
 - ii. the expected link between capital expenditures and revenues / margin forecasts; for example, the IASB could provide guidance that an increase in revenue or margin forecasts should normally be supported by convincing evidence, such as a committed increase in capital expenditures;
 - iii. the types of risk that should be included in the discount rate; for example, should an execution risk premium be included in the cost of capital?
 - iv. how to reflect the less optimistic scenarios (i.e. downturn) in cash flow predictions, for example by requiring issuers to use a multi scenario model and calculate a weighted average of three case scenarios – for example, the worst, the base and the best-case scenarios. This is also relevant with regards to terminal value, which currently tends to be estimated based only on the last forecasted year’s cash flows, which are normally the highest cash flows and often already include an overoptimistic expectation of growth;
 - b. strengthening the disclosure requirements in IAS 36 paragraph 134 (i) and (ii). For example, the IASB could consider:
 - clarifying what are the consequences if the key metrics on management expectations on integration of new business (see paragraph 7) are not met or costs exceeded, while keeping in mind the risk of shielding;
 - requiring further disclosure of the growth rate used in the projected period on which cash flow projections are based (in addition to the other disclosures required in IAS 36 paragraph 134); this is because often a “hockey stick” growth is observed in the year before the terminal value is established.
28. ESMA also thinks that requiring stricter governance around cash flow projections could induce companies to have more sound assessments in these regards. ESMA acknowledges that this might be beyond the scope of IFRS standard setting but could be a subject to further discuss in relevant fora dealing with corporate governance and with the International Valuations Standards Committee (IVSC).
29. In addition, the IASB could further explore:

On the shielding effect.

- a. requiring an allocation of goodwill and therefore the impairment test at a lower level than nowadays required by IAS 36 paragraph 80, in particular if the test is done at operating segment level and providing more guidance on how to determine the relevant level of goodwill allocation; ESMA notes that paragraph 80 of IAS 36 is currently extremely difficult to enforce because the test can be done at a very high (too high) level and the enforcer has limited tools, if any, to challenge the allocation level of goodwill. Further explaining what is meant by “benefit from synergies” and “monitoring of goodwill” and in what circumstances goodwill can be allocated at a level which is higher than the CGU would be helpful as it could make the testing more disciplined, by creating less room to “play” with cash flows and or the headroom;
- b. providing further guidance to ensure that CGUs are set at the right level. In this regard ESMA thinks that it would be helpful for the IASB to provide further guidance on the notion of ‘largely independent’ cash flows included in IAS 36 paragraph 6. In ESMA’s view the standard does not sufficiently explain what it takes for cash flows to be independent. For example, are cash flows of a retail store largely independent from an online channel when the issuer has a multichannel approach and customers are influenced by the information on the website in their final purchase? Additionally, the notion of ‘independent’ cash *in*flows is also used when determining whether an asset is a corporate asset. Further guidance on how to determine whether cash flows are independent could improve the identification of a corporate asset;
- c. requiring that the parts of goodwill which are allocated to specific components / parts related to certain events or with a definite useful life are identified and measured separately, and thereafter de-recognised when a certain event occurs or when the useful life ends. Examples of such components are the difference between the fair value and the nominal value of deferred tax, contingent assets that could not be recognised in accordance with IAS 37¹, other assets or liabilities that are not recognised at fair value, etc.
- d. identifying more intangible assets separately / outside of goodwill, as part of a future project on IAS 38 *Intangible Assets*.

Question 7 – amortisation of goodwill

30. In theory impairment-only might be a more theoretically sound approach, albeit not a perfect one. However, ESMA sees strong evidence that the existing impairment-only model has serious shortcomings in practice, such as those discussed in answer to question 6. The result is that the existing impairment approach is failing to hold

¹ For example, goodwill linked to a court case should be derecognised once the court case is settled

- management to account when it comes to timely and accurate recognition of goodwill write-downs and cannot be properly audited and enforced.
31. The consequence of the failures of the existing model is that impairments are sometimes recognised too little, too late, often upon changes of management. Whilst there might be some added value in the current impairment test having confirmatory value or predictive value, this could come at the risk of the goodwill impairment test being performed at too high a level or with too optimistic cash-flow projections and so not reflecting the performance of the acquired business.
 32. ESMA is therefore sceptical that the existing impairment-only approach should remain unchanged and that improvements to disclosures (although very important) could suffice, because these alone cannot address the existing shortcomings. ESMA believes therefore that significant improvements such as those proposed in answer to Question 6 are a necessary condition for maintaining the impairment-only model and that, as acknowledged by the DP itself, the existing proposals do not constitute significant improvements to the impairment test.
 33. Should the IASB confirm its preliminary conclusions that such significant improvements are not achievable at an acceptable cost for preparers, then ESMA thinks that the IASB should further explore amortisation of goodwill. ESMA highlights in particular that the existing impairment-only model is not sufficiently enforceable and auditable.
 34. ESMA acknowledges that amortisation would raise some practical difficulties and that a transition from the current impairment-only model to amortisation might create additional costs for companies and temporary disruption and it cannot be ruled out that some users will be confused. If the IASB decides to explore the reintroduction of amortisation of goodwill, ESMA recommends that an assessment of whether this may have an impact on financial stability be carried out.
 35. However, the argument that the useful life of goodwill cannot be estimated and the amortisation expense would be arbitrary is also valid for other assets that are depreciated or amortised (for example, acquired technology and client lists). ESMA expects that, at the acquisition date, management could define the useful life on the basis of an estimation of the payback period of the investment and the amortisation pattern on the basis of the realisation of the expected synergies. Even if these may be subject to revision afterwards, this is also the case for other assets that are amortised or depreciated.
 36. ESMA thinks however that, if the IASB decides for a return to amortisation, then a maximum non-rebuttable useful life should be established. For example, the IASB could explore whether a maximum useful life of ten years in case there is no reliable estimate of the useful life could be set, as is currently established for entities under the remit of the EU Accounting Directive (Directive 2013/34/EU). Alternatively (i.e. if the IASB considers that it is not practicable to set a non-rebuttable maximum useful life), ESMA

suggests that when goodwill is amortised over a period of more than ten years, an annual impairment test should be required in addition to amortisation.

37. If amortisation is introduced, goodwill should continue to be tested for impairment in case of indications of impairment, as it is the case for other assets.
38. Whilst there are probably few, if any, new arguments in relation to this discussion, ESMA notes that new evidence with regards to the possible functioning / malfunctioning of the existing impairment-only model could arise from the ongoing COVID-19 pandemic and from observing whether it will have an impact on the recognition of goodwill impairments in industries strongly impacted by the crisis. In that regard, ESMA encourages the IASB to also assess whether the existing impairment-only model might have an impact for the stability of financial markets in light of its possible pro-cyclicality.

Question 8 – equity minus goodwill subtotal

39. ESMA does not have strong views on the proposal to require disclosure of total equity excluding goodwill as a separate item in the balance sheet as a free-standing item. This is regardless of whether this potential new line item is required on the face of the financial statements or in the Notes.
40. In fact, if on the one hand this would draw investors' attention to companies whose goodwill constitutes a significant portion of net assets and would acknowledge the unique nature of goodwill as an asset, on the other hand the resulting line item could be easily calculated by users since both total equity and goodwill are already disclosed as free-standing items.
41. ESMA does not think that this new line item would solve any of the concerns raised with regards to goodwill. On the other hand, it would not create significant issues and would not be an additional cost for preparers.

Question 9 – yearly impairment test

42. ESMA is strongly opposed to the proposal to remove the requirement to perform a quantitative impairment test each year in a context in which the IASB will retain an impairment-only approach. ESMA notes that requiring a quantitative impairment test only if there is an indication of impairment would further increase the level of subjectivity and of management discretion in recognising impairment of goodwill. ESMA believes there can be significant judgement in determining whether there has been a trigger, for example if the operating performance is deteriorating slowly. ESMA considers that the annual impairment test could be removed only in case of reintroduction of amortisation.
43. In addition, removing the yearly impairment test would make the audit and enforcement even more difficult, since it would create an additional step for auditors and enforcers to

challenge management decisions with regards to goodwill impairment (i.e. first, enforcers would need to challenge the absence of indications of impairment, and secondly they would have to challenge the assumptions made). The current compulsory annual impairment test, while demanding for preparers, provides an essential tool for auditors and enforcers to challenge the recoverable amount. ESMA thinks that this tool is also relevant for Supervisory Boards and Audit Committees to challenge management internally.

44. ESMA strongly disagrees that “*over-optimism would be addressed more effectively by auditors or regulators*” because the difficulties in enforcing the existing impairment test are largely linked to a lack of unambiguous and enforceable guidance.
45. ESMA is also sceptical of the argument that removing the yearly impairment test would decrease costs for issuers, since issuers under the proposals in the DP will need to continue to assess the cash flows generated by assets as part of their monitoring process, and therefore no significant saving of costs are to be expected.

Question 10 – value in use estimation

46. ESMA agrees with the Board’s preliminary view that it should develop proposals to allow companies to use post-tax cash flows and post-tax discount rates in estimating value in use. ESMA supports these simplifications since they are less complex (i.e. since preparers would use existing internal forecasts) and also conceptually sound (i.e. since they would harmonise the calculation method of ‘value in use’ and ‘fair value’).
47. However, ESMA disagrees with the proposal to remove the restriction in IAS 36 that currently prohibits companies from including cash flows arising from a future uncommitted restructuring or from improving or enhancing the asset’s performance some cash flows when estimating value in use.
48. ESMA thinks that the determination of value in use is already a rather subjective estimation and this proposal would create further room for judgements and estimates in the cash flow, thus further increasing the challenges to audit and enforce IAS 36 requirements. *Uncommitted* restructuring, in particular, would be extremely difficult to enforce against because an enforcer is hardly in the position to challenge management’s (sometimes) optimistic plans when these do not even need to be grounded in a concrete commitment.
49. ESMA also highlights that the IASB’s proposal would further decrease the possibility of goodwill impairment since future restructurings and enhancing performance create value which is unrelated to the original goodwill recognition. These should therefore not be used to keep acquired goodwill on the balance sheet.
50. Furthermore, in ESMA’s view the IASB’s proposal may be conceptually problematic as the impairment test is required to test the value of the asset at the reporting date. By including uncommitted material restructurings, enhancements or improvements, the

value of that asset is not tested at the reporting date but it would be the value of a possible altered asset or group of assets at a later date. To the contrary, ESMA believes that restriction on including cash flows from improvements and enhancements are sound. Planned improvements and enhancements may give rise to assets that would be separately recognised in the future in accordance with the appropriate standard (e.g. IAS 16). These future assets, once they are acquired, would be subsequently subject to measurement themselves (i.e. impairment testing).

Question 11 – simplification of impairment test

51. ESMA agrees with the Board's preliminary view that the impairment test should not be further simplified. Indeed, given that the issue with goodwill is that impairments are sometimes currently being recognised too little, too late, simplifying the impairment test further might worsen the existing situation.

Question 12 – separate recognition of intangible assets

52. ESMA agrees with the IASB's views that it should not develop a proposal to allow some intangible assets to be included in goodwill. ESMA thinks that the recognition of intangibles assets separately from goodwill provides useful information and increases the possibility to detect impairment losses as it reduces the probability that unrealised gains compensate unrealised losses.
53. Allowing some intangible assets to be included in goodwill will create additional complexity and room for judgement, thus giving management further discretion over goodwill recognition and increase.

Question 13 – convergence with US GAAP

54. ESMA thinks that goodwill is an area in which convergence between IFRSs and US generally accepted accounting principles (US GAAP) is of very high importance.
55. ESMA urges the IASB to maintain the existing level of convergence. This is especially so when it comes to decisions about the maintenance of the existing impairment-only approach or the possible reintroduction of amortisation, where, in ESMA's view, alignment between IFRS and US GAAP is a must.
56. In addition, as already mentioned in answer to question 2, ESMA also highlights that the IASB should take this opportunity to align IFRSs and US GAAP disclosure requirements as much as possible.

Question 14 – other comments

57. ESMA recommends that the IASB provides further guidance on situations in which business combinations involve the acquisition of an entity owning only one, or just a few, assets that have a tax base significantly lower than its (their) fair value. Such a business combination results in a Deferred Tax Liability (DTL) being recognised with a corresponding amount recognised in goodwill.
58. In our experience, it is not clear in the existing standard whether those DTLs should be taken into account to determine the carrying amount of the CGU against which the recoverable value should be compared. If the goodwill, including the DTLs, is allocated to the acquired entity (the relevant CGU), a 'day one' goodwill impairment could occur when applying the impairment requirements under IAS 36.