



June 16th 2014

Mr Hans Hoogervost
Chairman
International Accounting Standard Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Request for information on IFRS3, Business Combination

**Comments by the French Society of Financial Analysts (SFAF)
Financial Analysis and Accounting Commission**

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 International Accounting Standards Board (IASB) for the request for information in view of the Post Implementation Review of IFRS 3.

SFAF represents more than 1,600 members in France and is itself a member of the European Federation of Financial Analysts Societies (EFFAS) which comprises 29 member organizations representing more than 16,000 investments professionals. Its Accounting and Financial Analysis Commission intends to represent analysts and fund managers 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.

For this reason, our Society, through its Accounting and Financial Analysis Commission, is keen to respond to your consultation on business combinations. We would like to stress that our Society has already made some detailed comments to the Board on the previous Exposure Draft of IFRS 3 in April 2003, and to the proposed revision in October 2005, to which you may refer.

To answer the questions included in the Request for information, the Commission decided to express the views of its members by reporting the conclusions of their debates on the most important points on IFRS 3 for users of financial statements, covering most of the questions.

NON-AMORTIZATION OF GOODWILL

Regarding the current non-amortization of the goodwill we note that the IASB originally concluded that goodwill should not be amortized as its useful life is indefinite, ie difficult to set. We believe that this argument is not acceptable, as many other assets have useful lives that are very difficult to assess: a tangible asset like a new generation of equipment (for instance, a 4G mobile network equipment) might, in some cases, be very tricky to assess. The current practice for these cases is to make reasonable guesses on the useful lives, usually on looking at past practice and experience. *We strongly believe that having difficulties in assessing the useful lives of some assets with finite life should not result in stopping all amortization.*

We believe that the management should make a reasonable estimate (and disclose it) of the useful life of any goodwill acquired in a business combination. As we doubt that any company can reasonably make investment decisions with a pay-back period longer than 20 years, an upper limit of 15 or 20 years (perhaps rebuttable, as in the former IAS 22) would be a good safety rule.

The recent return of the possibility of goodwill amortization in the US GAAP, for private companies, is a simple demonstration that making an amortization over a limited period (in this case, a maximum of 10 years) is a very workable choice.

One of the main arguments regarding non-amortization of goodwill is that acquired goodwill is later replaced by internally generated goodwill. We found this argument completely inconsistent with the current IFRS standards that, in fact, are preventing companies to recognize internally generated goodwill. We cannot see any reason why internally generated goodwill should be recognized for a subsidiary acquired, and not for the businesses developed internally. We consider indeed that in many or most cases, the goodwill acquired is by essence not the same as the one observed a number of years later, as the purpose of the management is to improve the profitability of a company and generate new goodwill, while goodwill identified at the acquisition date is set to erode over time. Our position is therefore more an accounting issue than a valuation one.

Another argument regards the meaning of goodwill amortization expense. We believe that a group needs to include an expense (goodwill amortization) in reporting its financial performance as goodwill was a part (and sometimes, a very significant part) of the original investment in the new subsidiary. In an extreme example, if a profitable subsidiary is purchased for a value that represents only goodwill (no other tangible or intangible assets), the group will include in its consolidated income statement only the acquired operating profit and the financial expense associated with the business combination, and no expense related to an asset that represents 100% of the initial investment. As demonstrated by this example, non-amortization of goodwill makes any calculation of dilution/accretion irrelevant in all cases involving significant goodwill amount.

Should the Board consider returning to goodwill amortization, an option we fully support, financial analysts need to have information disclosed about the amount included in the D&A expense (perhaps as a separate line) in the consolidated income statement. We also need to have a similar disclosure at each segment reported to better assess the performance of each business segment when it includes a new acquired subsidiary.

IMPAIRMENT TESTS

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) from the internally generated (and never recognized) goodwill: this failure makes the impairment test inoperable in some instances. Secondly, following allocation of goodwill acquired to various cash generating units, after a disposal of part of some activities, a merger with newly acquired activity, or any reorganization inside the group becomes very difficult: we believe, that over the years, following goodwill in these kinds of situation is highly unrealistic and might open the door to significant accounting arbitrage.

A key point regarding impairment tests is that this regular calculation is done by the company itself, using its own assumptions (most of them not being disclosed). All seasoned analysts know how flexible are some valuation methods like discounted cash flows, relying on numerous different assumptions. With this process, where the buyer of an asset later decides which "fair value" this asset is then worth, there is systematic temptation to inflate valuation. In some instances, we have encountered impairment test where, just a rule of three, or even a simple rule of thumb, indicates that the implied fair values used are patently inflated. In a recent report examining a large sample of European companies, ESMA pointed that even some of the disclosed assumptions (ie, discount rates, and terminal growth rates) seems to be pretty optimistic. This is one of the key reasons why financial analysts never spend too much time at impairment test information.

This very limited interest for impairment test from analysts is also due to the fact, in many occasions, goodwill impairments are realized years after the market became fully aware of the overvaluation of the original investment, and in fact, this announcement is not providing any new information to the market. We also believe that many of these delayed goodwill impairments are only announced when the management of a group (sometimes the one that decided the business combination) is being replaced. There is a profusion of examples in the European capital markets demonstrating this point over the ten years where IFRS 3 has been applied. In such situations, the announcement of a goodwill impairment, does not provide any new information to the market.

The general practice of delayed impairments has also, in some cases, inflated significantly the reported equity. As a consequence, the gearing (usually defined as net debt / total equity), a very basic, and important, measure of the leverage of a group, has, in these situations, partially or completely lost its signification.

As a conclusion on these two subjects, we note that SFAC Accounting Commission in its comment letter on the ED 3 (CL 64) in 2003, i.e. 10 years ago, stressed that "the replacement of goodwill amortization by an impairment test [...] would in practice, lead to no impairment being recognized". We unfortunately have to admit that this prediction has fully materialized, and that the information provided by the new standard on acquired goodwill to financial analysts has been mostly irrelevant.

OTHER INTANGIBLES

We are reluctant to the current practice of identifying additional intangible assets (brands, customer relations,...) beyond goodwill.

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 assets that are non-amortized are highly questionable, ie in a 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 sanity check, we also note that making comparisons between similar acquisitions, groups have identified different kinds of intangible assets, with very significant valuations for similar assets, thus demonstrating how subjective the valuations of these assets are.

Lastly, we doubt that it really provides a useful information for users of financial statements, as there is no separate market (not even requesting an active market) for such assets. We are not aware, over the ten 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 challenge that these assets are really separable.

As a consequence, the valuation of these intangible assets provided with IFRS 3 is mostly irrelevant for users of financial statements. SFAC accounting commission, its 2003 comment letter already stressed these points.

FULL GOODWILL / NON-CONTROLLING INTERESTS

As users, we strongly believe that the full goodwill is not useful for users of financial statements. In spite of the academic attractiveness of the entity approach, there is an overwhelming majority of users of financial statements that have a parent approach¹: full goodwill is thus irrelevant for users.

Another point of the full goodwill approach is that the valuation of goodwill that could be allocated to non-controlling interests is highly subjective. In a business combination with non-controlling interests, one could argue that the price paid by the group to acquire control includes a control premium, or on the opposite, that the group could not acquire the remaining part of the capital because the valuation was not high enough for the minority shareholder. Analysts thus look at full goodwill valuation as highly unreliable.

Finally, the fact the revision of the standard blocked the valuation at the date of control, is inconsistent with what investors want to follow, i.e. capital invested. If we assume that a group acquires control with 51% of the capital for €10bn, and ten years later, while the acquired business has developed very successfully, the 49% are bought out for €30bn, in the financial statements, the amount of capital invested in the subsidiary would remain unchanged in spite of the very significant additional amount of investment. We don't think this is the kind of reporting image users need.

We also stress that this approach has very disturbing consequences (that were perfectly identified when the standard was revised). In the above example, after buying the non-controlling interest of in a very successful business, most probably the group will report a significant dent in the parent company equity: making a good investment thus destroys equity! Similarly, recording a profit on the consolidation of a company previously treated as an associate is meaningless for an investor. This kind of effects, from a user perspective, is not acceptable. We also believe that the choice made by numerous companies to use full goodwill, instead of the more relevant partial goodwill, is due to the fact that the latter option might lead to destroying more equity at a later stage should the non-controlling interests be bought out.

From an investor perspective (with a parent company approach) we fully support adjusting the valuation of a controlled subsidiary with each change in ownership percentage. This can be done through an increase /decrease in reported goodwill, or an increase / decrease of the valuation of controlled assets. This approach has also the benefit of being centered on the concept of invested capital (and not on estimated value unchanged over 10 years, in spite of change of ownership percentage at very different valuations), a key concept for investors.

¹ We note that CRUF in its 2003 comment letter made exactly the same statement.

As a conclusion, the members of the Accounting and Financial Analysis Commission of the French Society of Financial Analysts (SFAF), while fully supporting the elimination of pooling overwhelmingly believe that the current underlying concept of indefinite useful life of the goodwill recorded at acquisition is flawed and are much in favor to the return to goodwill amortization. They also consider that the cornerstone mechanism that is supposed to guarantee no overvaluation of the reported goodwill is simply not working (as we expected, ten years ago), as demonstrated by the general practice. Finally they consider that the concept of full goodwill is not working and provide disturbing consequences. .

We thank you for the opportunity given to us to provide our view on such important aspects of financial reporting and remain available for any further information.

Yours faithfully,



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