BNP PARIBAS

Chief Financial Officer

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EFRAG
35 Square de Meeûs
1000 Brussels, Belgium
commentletters@efrag.org

Comments on EFRAG's Discussion Paper on Goodwill impairment test:

Can it be improved? (June 2017)

We are pleased to provide BNP Paribas' comments on the EFRAG's Discussion Paper Goodwill impairment test: Can it be improved?

We appreciate the IASB and EFRAG's efforts to understand the concerns raised in the Post Implementation Review of IFRS 3 ('IFRS 3 PIR') which began in 2014 and the proactive work performed by EFRAG to gather feedbacks on some possible improvements of goodwill impairment test.

Indeed, the main feedbacks expressed by stakeholders on IFRS 3 PIR were on complexity and cost of impairment test, delays in recognition of impairment, inadequate disclosures and whether separation of specific intangibles is always relevant.

Our main comments, as a preparer, on EFRAG's Discussion Paper are the following:

- For regulated banking entities, Goodwill and intangible assets are deducted from prudential own funds, a key element in the assessment of the financial structure of banking entities. As a consequence, the delays in the timing of recognition of impairment on Goodwill might not be as prevalent as in other industries. However, it nevertheless affects our P&L and thus our performance which remains a key indicator.

- We are not in favor of EFRAG's 'Goodwill accretion method' proposal, targeting internally generated goodwill in the impairment test. If conceptually the Goodwill initially recognized in a purchase accounting should not be replaced by internally generated goodwill, it implies that this purchased Goodwill should decrease over time as any intangible assets with a definite life. In that case, and although not in the scope of this Discussion Paper, we would rather support an amortization model of the goodwill than the accretion method proposed.

- If the IASB were to pursue an objective to improve impairment testing of goodwill, we would agree with EFRAG's proposal to introduce an initial qualitative assessment in order to remove unduly burden related to systematic goodwill testing in some circumstances.
  We would however be opposed to any amendment that would remove the possibility to use a Value in use method to test impairment.
  Furthermore, we would be supportive of the inclusion of cash flows from future restructurings in the calculation of the value in use and would agree with EFRAG's proposal to allow the use of a post-tax discount rate to discount cash flows.

Should you have any questions regarding our comments, please do not hesitate to contact us.

Yours sincerely,

Lars Machenil

Question 1: How an entity should allocate Goodwill

In paragraphs 2.3 to 2.22 of Chapter 2, EFRAG discusses additional guidance on the allocation of goodwill to CGU and the disclosures on the break- down of goodwill by cash- generating unit

Q1.1 Do you agree with the additional guidance on how an entity should allocate goodwill?

Q1.2 Do you have any other suggestions to improve this area of the goodwill impairment test?

Comments

EFRAG is proposing amending IAS 36 with additional guidance on goodwill allocation to CGU:

- Either based on the pre- and post-acquisition fair value of each CGU
- Or on the basis of the difference between the fair value of the portion of the acquired business to be included in a CGU and the fair value of the net assets of the acquired business that have been assigned to that CGU.

We have some reserves on EFRAG's proposals as they both somehow constitute rule-based approaches which would not necessarily enable to faithfully represent the economy of transactions and expected synergies or benefits. In particular, the fair value of the net assets of the acquired business assigned to CGU's do not necessarily reflect a correct allocation of expected benefits from the acquisition.

IAS 36 enables to use its judgment to determine an appropriate method to allocate goodwill to CGU, which seems relevant to enable a faithful representation of the transactions according to facts and circumstances. This judgment is submitted to auditors review and appropriate documentation.

EFRAG is also seeking for feedbacks on its suggestion to add information on composition of goodwill in the notes to the financial statements.

While we acknowledge that these disclosures could bring interesting additional information to users, we nevertheless draw EFRAG's attention on the fact that the structures or organisations of groups may evolve over time through acquisitions, reorganisations, mergers and disposals, and impairment may occur years after acquisitions, making it difficult potentially to trace the origin of goodwills without arbitrary rules, which could question the relevance and usefulness of such information for users..

Question 2: When an entity should determine the recoverable amount

In paragraphs 2.3 to 2.37 of Chapter 2, EFRAG discusses the introduction of a "Step Zero" to the impairment test

Q2.1 Do you agree with the introduction of an initial qualitative assessment?

Q2.2 Do you have any other suggestions to improve this area of the goodwill impairment test?

Comments

EFRAG suggests introducing an initial qualitative assessment, similarly to US GAAP requirements, to assess if there is a need to determine the recoverable amount of a CGU.

We are rather favorable to EFRAG's proposal to introduce an initial qualitative assessment as IAS 36 requirements are demanding (value in use shall be based on budgets or forecast cash flows projections that represent management's best estimate) and not necessarily useful if there is some important room before an impairment trigger can be reached.

If this Step Zero approach was to be implemented, we think that the thresholds triggering an impairment test should be harmonized with those existing under US Gaap.

Question 3: How an entity should determine the recoverable amount

In paragraphs 2.38 to 2.78 of Chapter 2, EFRAG discusses how an entity determines the recoverable amount

Q3.1 Do you agree with having a single method for determining the recoverable amount?

Comments

In accordance with IAS 36, a CGU to which goodwill has been allocated is impaired when the carrying amount of that CGU exceeds its recoverable amount. The recoverable amount of the CGU is the higher of its:

a) fair value less costs of disposal ('FVLCD'), which reflects the assumptions of market participants; and
b) value in use ('VIU'), which reflects the effects of factors that may be specific to the entity and not applicable to entities in general.

We would disagree having a single method for determining the recoverable amounts.

As highlighted in IAS 36 BCZ17 we agree with the IASB that:

"*No preference should be given to the market's expectation of the recoverable amount of an asset (basis for fair value when market values are available and for net selling price) over a reasonable estimate performed by the individual enterprise that owns the asset (basis for fair value when market values are not available and for value in use*)" and that,

"*market values are a way to estimate fair value but only if they reflect the fact that both parties, the acquirer and the seller, are willing to enter a transaction*" and that,

"in assessing the recoverable amount of an asset, it is the amount that an enterprise can expect to recover from that asset, including the effect of synergy with other assets, that is relevant".

Indeed, we have reserves on using only a fair value method for determining the recoverable amount in cases where there are neither deep nor active markets for an asset (namely the CGU) which corresponds to most cases in practise.

We think that fair value should not be given more prominence at the detriment of other measurement basis such as the intrinsic value (related to the ability of the instrument to generate cash flows). We understand that for assets with no observable market price it is likely that the recoverable amount determined on the basis of the value in use may be similar to the recoverable amount based on the fair value of these assets. However, the concepts of highest and best use of IFRS 13 combined with the issue of the unit of account, and the primacy of observable data embedded in IFRS 13 could create some differences between value in use and fair value.

Value in use reflects the manner in which an entity expects to use an asset, independently from the view of market participants, by considering the management expectations in terms of the use of the asset. We think it is more appropriate for impairment testing to consider a unit of account and its related synergies from the perspective of the management expectations rather than from the perspective of market participants' as the business model of acquisitions and their related goodwill is not to sell the acquired business but to use it to generate value and cash flows according to already existing assets and businesses of the entity.

Consequently, we would be opposed to any amendment that would remove the possibility to use a Value in use method to test impairment.

Q3.2 Do you agree with the inclusion of future restructurings in the calculation of the value in use?

Comments

EFRAG suggests allowing an entity to take into account the effect of future restructuring only if it has a formal plan (although not yet made public) and/or the restructuring is expected to be completed in the foreseeable future

We would agree to include future restructurings in the calculation of the value in use, consistently with assumptions of the management.

The inclusion of future restructurings effects in a context of impairment should not be as constraining as are criteria defined to recognise restructuring provisions in accordance with IAS 37 since, as highlighted in EFRAG's consultation, a buyer would incorporate future restructurings and changes in the processes when determining the maximum purchase price to be paid. The recoverable amount of an asset is the amount that an enterprise can expect to recover from that asset, including the effect of synergy with other assets[1]. Synergy will be achieved through the use of an asset including future restructurings.

Q3.3 Do you agree with allowing the use of a post-tax discount rate?

Comments

EFRAG suggests changing the requirements in IAS 36 to allow entities to elect either a pre-tax or post-tax calculation. Entities would need to disclose the basis chosen.

We understand that the requirements to use a pre-tax rate is considered by the IASB as a way to avoid a double counting of future tax consequences of temporary differences between tax base of assets and their carrying amount already recognised as deferred tax assets or deferred tax liabilities (cf. IAS 36 BCZ82) and also justified by the fact that the fair value of an asset takes into account market participants' assessment' of the future cash flows that would result if the tax base of the asset was equal to its recoverable amount (cf. IAS 36 BCZ83).

From an operational perspective we use post tax rate and symmetrically consider post tax cash flows to assess value in use of CGU. We are therefore supportive of EFRAG's proposal to allow entities to choose a pre-tax rate or a post -tax rate and to disclose the rate used.

Q3.4 Do you agree that the impairment test should target internally generated goodwill? Is the goodwill accretion an acceptable way to do so?

Comments

EFRAG is proposing an approach which would require entities to make an adjustment when testing purchased goodwill in order to eliminate the effect of the internally generated goodwill ('the accretion method'). Each year, the entity would determine an accretion amount by applying a rate to the opening balance of goodwill. This amount would be added to the carrying amount of the CGU.

We are not in favor of this EFRAG's 'accretion method' proposal as it indirectly questions the framework of IAS 36 which currently implicitly admits mutualisation effects of acquired goodwill with internally generated goodwill.

1 Cf. IAS 36 BCZ17

Indeed, as highlighted in IAS 36 BC 44:
"*In many cases, it will not be possible in practice to distinguish future cash inflows from the asset initially recognised from the future cash inflows from internally generated goodwill or a modification of the asset. This is particularly true when businesses are merged or once an asset has been enhanced by subsequent expenditure.*"

That is the reason why IAS 36 focuses on whether the carrying amount of an asset will be recovered rather than on whether the recovery stems partly from internally generated goodwill.

IAS 36 BC 135:
"The Board concluded that because it is not possible to measure separately goodwill generated internally after a business combination and to factor that measure into the impairment test for acquired goodwill, the carrying amount of goodwill will always be shielded from impairment by that internally generated goodwill.
Therefore, the Board took the view that the objective of the goodwill impairment test could at best be to ensure that the carrying amount of goodwill is recoverable from future cash flows expected to be generated by both acquired goodwill and goodwill generated internally after the business combination."

The accretion method puts into question the fact that internally generated goodwill can potentially "shield" purchased goodwill. Such an accretion method would recognise from a conceptual standpoint that initial goodwill is consumed over time, and as a consequence, it would simply question the non-amortisation of goodwills.

Furthermore, this approach would raise significant operational complexities.

If conceptually the Goodwill initially recognized in a purchase accounting should not be replaced by internally generated goodwill, it implies that this purchased Goodwill should decrease over time as any intangible asset with a definite life. In that case, and although not in the scope of this Discussion Paper, we would rather support an amortisation model of the goodwill than the accretion method proposed.

Q3.5 Do you have any other suggestions to improve this area of the goodwill impairment test?

Please refer to our comments on question 3.4.