20 September 2023

Mr. Jean-Paul Servais
Chair
The Board of the International Organization of Securities Commissions

Re: Consultation on Goodwill

Dear Mr. Servais,

The Corporate Accounting Committee (CAC) of the Securities Analysts Association of Japan (SAAJ) is pleased to comment on "Consultation on Goodwill" (hereinafter referred to as the "Consultation Paper") published by the Board of the International Organization of Securities Commissions (IOSCO) on 22 June 2023.

The SAAJ is a not-for-profit organization for professionals in the areas of investment and finance, offering education and certification programs in these fields. Its certified member analysts (holding the CMA designation) number around 28,000.

The CAC is a standing committee of the SAAJ established in March 1977. It is composed of 12 members including equity and credit analysts, portfolio managers, and academics.

In this comment letter, we respond to *Question 1* under "4.1 General" and *Questions 2 - 9* under "4.2 Questions for Investors and other users of financial statements" in "Chapter 4 – IOSCO Consultation Questions for Stakeholders" of the Consultation Paper.

General Comments

On 28 December 2020, we submitted our comment letter on the Discussion Paper "Business Combinations - Disclosures, Goodwill and Impairment" published by the International Accounting Standards Board (IASB) on 19 March 2020[1]. The main points on our comment letter to the IASB are as follows:

- The IASB's package of preliminary views includes some proposals which help improve the information provided to investors, such as enhanced disclosure of performance after goodwill

[1] https://www.saa.or.jp/account/account/pdf/ikensho_201228en.pdf

acquisition. However, it also includes a lot of proposals such as providing companies with relief from having to perform an annual quantitative impairment test. These proposals could go against resolving and in fact rather exacerbate the problem that impairment losses on goodwill are recognized as "too late" which investors are most concerned about.

- The IASB's proposal to improve disclosure in order to ease investor dissatisfaction and to simplify impairment tests in order to eliminate preparer dissatisfaction would be an easy compromise and would not contribute to improved accounting for goodwill. Therefore, we strongly oppose the proposal.

- The IASB needs to recognize that the problem that impairment losses on goodwill are recognized as "too little, too late" became apparent after the 2008 financial crises that happened after 2004 when the IFRS changed the accounting of goodwill to non-amortization. The IASB needs to withdraw the preliminary view of "it should retain the impairment-only model and not reintroduce amortization" and fundamentally change its view on goodwill accounting treatments based on the premise of reintroducing amortization.

- In order to solve the problem that impairment losses on goodwill are recognized as "too late" which was identified in a Post-implementation Review and which investors are most concerned about, and in order to reduce the burden on preparers, the proposal to simplify impairment tests would be inappropriate as it would not resolve the problem. We hope that the IASB could more seriously consider reintroducing the amortization of goodwill and setting new IFRS Standards for a "regular amortization + impairment" approach to respond to the "too late" problem.

However, at its November 2022 meeting, the IASB tentatively decided to retain the impairment-only approach to accounting for goodwill. As a background for this tentative decision, the IASB stated that there is not a compelling case to explore reintroducing amortization of goodwill. The tentative decision of the IASB is consistent with the tentative decision of the Financial Accounting Standards Board (FASB) to deprioritize and remove the goodwill project from its technical agenda.

We still believe that, from the perspective of addressing the "too little, too late" issue and faithfully representing the economic substance of a company, the reintroduction of goodwill amortization is a better approach than the IASB's direction to simplify impairment tests and add disclosure requirements on an acquisition and its subsequent performance. On the other hand, we understand that the IASB's tentative decision makes the reintroduction of goodwill amortization no longer a short-term option. We therefore believe that the improvement of disclosure led by the IASB is useful as the next best approach.

In this context, we strongly agree with IOSCO's refocus on the "too little, too late" issue in the Consultation Paper. If IOSCO believes that the "too little, too late" issue is not just an issue for individual companies, but could have a significant impact on the overall economy and the financial system, we believe that IOSCO should examine the reasons why the accounting standard setters did not consider the "too little, too late" issue in the process of reviewing accounting for goodwill and raise the issue with them.

Below are our comments on each question.

Question 1: *Is there anything we can add in Chapter 1, 2 and 3, in order to adequately describe the background and issues surrounding goodwill?*

The impairment-only approach tentatively decided by the IASB cannot eliminate the risk that management may use overly optimistic assumptions in estimating the recoverable amount of goodwill. As a result, the "too little, too late" issue remains unaddressed, where impairment losses on goodwill are not recognized on a timely basis and insufficient. We strongly agree with IOSCO's refocus on the "too little, too late" issue in the Consultation Paper.

When the IASB began its review of accounting for goodwill, it had the perspective of addressing the "too little, too late" issue. However, we understand that this perspective gradually disappeared, and the focus shifted to improving disclosure regarding the subsequent performance of an acquisition and simplifying impairment tests, resulting in the IASB's tentative decision to retain the impairment-only approach to accounting for goodwill.

As goodwill accumulates and economic uncertainty increases, the "too little, too late" issue is not limited to individual companies, but could have an even greater impact on the overall economy and the financial system through increased stock market volatility[2] and procyclicality.

What should be added to the Consultation Paper is an examination of why the IASB and the FASB did not consider the "too little, too late" issue in the process of reviewing accounting for goodwill. Capital market authorities should not be directly involved in the process of setting accounting standards. However, if IOSCO believes that the "too little, too late" issue is not just an issue for individual companies, but could have a significant impact on the overall economy and the financial system, we believe that IOSCO should examine the reasons why the accounting standard setters did

[2] Under IFRS and U.S. GAAP, a goodwill impairment often results in a single large loss, which would have a significant impact on the stock market and increase stock price volatility.

not consider the "too little, too late" issue in the process of reviewing accounting for goodwill and raise the issue with them.

Question 2: *How can the impairment test for goodwill in IAS 36 be improved to address the concerns around the timely identification and recognition of an impairment charge?*

Two of the main reasons for the concerns that impairment losses on goodwill are not recognized on a timely basis are overly optimistic estimates by management and shielding.

As we stated in our comment letter to the IASB, the negative effect of overly optimistic estimates by management may not be limited to impairment losses on goodwill. In addition, goodwill that is not amortized on a regular basis could encourage acquisitions at inflated prices. We believe that there is no better approach to mitigate these overly optimistic estimates by management than the regular amortization of goodwill. Since a shielding effect is inevitable in impairment testing, we believe that this effect would make it very difficult to improve the effectiveness of impairment tests.

We do not believe it is possible to significantly improve the effectiveness of impairment tests.

Some suggested that in some cases, such as innovative businesses, it may be very difficult to support future projections used for impairment testing with objective data.

Questions 3 - 9 relate to improving disclosure. Before commenting on each question, we would like to provide our general comments on improving disclosure.

We believe that additional disclosure requirements on an acquisition and its subsequent performance led by the IASB are useful as the next best approach. We also believe that the improvement of disclosure regarding initial recognition of goodwill, impairment tests, etc., as suggested in the Consultation Paper, would complement the additional disclosure requirements led by the IASB and would further contribute to enhancing investor predictability regarding goodwill impairment risk.

However, the improvement of disclosure may only leave the decision of goodwill impairment risk to investors, which is unlikely to curb the accumulation of goodwill and the associated increase in uncertainty. As we stated in our comment letter to the IASB, the improvement of disclosure is not a fundamental solution to the "too little, too late" issue. It is just considered the next best approach.

In addition, companies should be permitted to reduce disclosure by applying materiality criteria in cases where the risk of impairment is low or the amount of goodwill is small relative to net assets.

Question 3: *Do disclosures around business combinations, including qualitative descriptions of what makes up the goodwill balance at acquisition (such as expected synergies from combining operations, intangible assets that do not qualify for separate recognition or other factors), currently provide decision useful information? If not, how can they be improved?*

We do not believe that the current disclosures are sufficient. In order for investors to be aware of indications of goodwill impairment, it is first necessary to clarify at the time of acquisition how the acquired business is (or is not) incorporated into the existing business and, consequently, how the results of performance and cash flows of the acquired business are included in each operating segment or cash-generating unit (CGU) of the acquirer. Then, disclosure of the future cash flows (including synergies), WACC and growth rates for each business segment or CGU as assumed at the time of the acquisition will enable investors to confirm the progress of the subsequent performance of the acquisition and any indications of goodwill impairment if disclosure continues in the same category in the next period and thereafter.

Question 4: *Do you agree with the IASB's tentative decisions about business combinations, particularly regarding the disclosure of the performance of business combinations after acquisition?*

We agree with the IASB's tentative decisions. In addition to qualitative information, quantitative disclosures, such as the subsequent performance of an acquisition, would facilitate the analysis of performance forecasts. In this case, as we comment in *Question 3*, the acquired business should be disclosed consistently in each business segment or CGU of the acquirer.

Question 5: *Do disclosures around the impairment tests of goodwill currently provide sufficient detail about the assumptions used and the sensitivity of the estimate to changes in those assumptions? If not, what is lacking?*

We do not believe that the current disclosures regarding the assumptions used in goodwill impairment testing and the sensitivity of the estimate to changes in those assumptions are sufficient. Specific quantitative information regarding them should be disclosed to the extent practicable.

In addition, there are many cases where the sensitivity analysis is not disclosed because the recoverable amount significantly exceeds the carrying amount. Even in those cases, the percentage of the excess should be disclosed. See our comment on *Question 8*.

Question 6: *Have you identified instances where the assumptions used in the impairment test of goodwill are inconsistent with other assumptions used for other financial and non-financial estimates? If yes, in what instances?*

Although we may not directly answer this question, the following are instances of inconsistent accounting between a subsidiary and the consolidated basis.

There was an instance where an overseas subsidiary of a Japanese company that voluntarily applied IFRS Accounting Standards recognized a huge impairment loss while the parent company did not do so on a consolidated basis. In this case, the parent company recognized a huge impairment loss on a consolidated basis several years later, and this became a serious problem.

Although instances of such huge impairment losses are rare, there are some instances where a subsidiary recognizes an impairment loss while the parent company does not do so on a consolidated basis because the impact on the consolidated financial statements is minimal. In such instances, there is a risk that investors may overlook the impairment of the subsidiary based solely on the disclosure of the parent company.

Question 7: *Do disclosures around the initial recognition of goodwill and the impairment tests of goodwill provide appropriate entity-specific information?*

Although it is depend on companies and cannot be generalized, as we comment in *Questions 3 and 5*, we do not believe that the current disclosures around the initial recognition of goodwill and impairment tests are sufficient.

We understand that many disclosures only describe general accounting procedures and do not provide any indication of the risk of goodwill impairment. Even for those companies that disclose their specific information, many disclose only growth rates and discount rates, which by themselves do not provide useful information to investors. See our comments to *Question 3* for additional information that investors may need.

Question 8: *How can disclosures around the goodwill impairment test be improved? What additional information would be useful? Would disclosure of the percentage by which the fair value or the value in use exceeds the carrying amount of the cash generating unit provide decision useful information?*

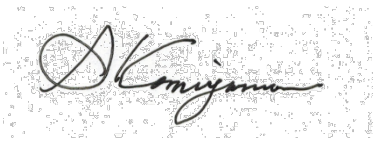
Disclosure of the percentage by which the fair value or the value in use exceeds the carrying amount of the cash generating unit is useful information in incorporating impairment risk into performance forecasts. At the same time, sensitivities such as assumptions and interest rates in estimating the fair value or the value in use should be appropriately disclosed. See our comments on *Question 5*.

Question 9: *When disclosed, do key audit matters (KAMs) related to impairment tests of goodwill provide sufficient entity-specific information to users of the financial statements? If not, what additional information could be provided to enhance transparency in KAMs?*

In cases where goodwill impairment testing is included in the KAMs, more detailed information is disclosed. However, there are few cases where key assumptions, sensitivities and margins are disclosed. As investors, we would like to request auditors to encourage audited companies to disclose such information so that auditors can include it in the KAMs.

In addition, audit reports will be more valuable if KAMs include the auditor's findings on impairment testing.

Sincerely yours,



Satoshi Komiyama
Chair
Corporate Accounting Committee