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DATE 15.09.2014
RE Discussion Paper "Should goodwill still not be amortised?"

Dear EFRAG members,

Deutsche Telekom is pleased to respond to the discussion paper "Should goodwill still not be amortised? – Accounting and disclosure for goodwill", published by a Research Group (in the following referred to as "the Group") of ASBJ, EFRAG and OIC on 22 July 2014.

Please find below our answers on your questions to constituents. We would be pleased to discuss them with you at your convenience.

Yours sincerely,

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1. Do you agree that there should be a requirement to recognise goodwill as an asset and amortise it over subsequent periods? If so, do you support amortisation because:
 - (a) goodwill existing at acquisition date is consumed and replaced with internally generated goodwill over time, thus it should be allocated to subsequent periods as part of the cost of acquiring an entity;
 - (b) an impairment-only model is not sufficiently reliable due to the large use of assumptions in the impairment test (future cash flows, terminal growth rate and discount rate); or
 - (c) amortisation of goodwill, in addition to the impairment test, achieves an appropriate cost-benefit balance.

Answer:

We do agree that a mandatory goodwill amortisation over subsequent periods would be appropriate and we further believe that **all** of the reasons listed are valid and justify a reintroduction of this concept. Given the fact that in most business combinations an acquired goodwill will eventually deteriorate in value and given the uncertainties and judgments inherent to the impairment-only model, we are of the opinion that amortising the goodwill would be by far preferable to the current accounting. While determining a goodwill's useful life will inevitably be also a matter of judgment, we believe that any amortisation will better reflect the economic substance of a business combination than no amortisation at all. As the benefits arising from a goodwill will most likely be consumed over time, this fact should result in a periodical expense and not in a potential later one-off impairment loss being recognised only if an entity fails to generate new internal goodwill to compensate for the consumption of the originally acquired one.

2. Assuming that there was a requirement to amortise goodwill, do you think that the IASB should:
 - (a) indicate what the amortisation period should be?
 - (b) indicate a maximum amortisation period?
 - (c) provide guidance on how entities should assess the amortisation period (for instance, by referring to the expected payback period or the useful life of the primary asset)?
 - (d) allow entities to elect the amortisation period that they consider appropriate?



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Answer:

While we support the concept of a maximum amortisation period, we believe that an entity should elect the amortisation period which it considers appropriate based on specific guidance provided by the IASB. In that regard, we think that, depending on the facts and circumstances of the business combination, there may be several factors to be taken into account when determining the useful life of the acquired goodwill (as mentioned in the DP) and we would expect the IASB to elaborate on those factors in order to come up with a best estimate on the amortisation period.

We are of the opinion that prescribing an amortisation period for all entities would not reflect the fact that an entity's exposure to technological and commercial changes may significantly vary from one industry to another. Due to the expected disclosure requirements with regard to a goodwill's expected useful life we believe that there would be a tendency to harmonise amortisation periods within the same industry.

3. The DP suggests the need for improved guidance in a number of areas in IAS 36. Do you think that the IASB should improve and/or provide additional guidance in relation to:

- (a) the methods to determine the recoverable amount of the goodwill;
- (b) the application of the value-in-use method;
- (c) the identification of cash-generating units and allocation of goodwill to each unit; and
- (d) the choice of the discount rate.

If not, please indicate why. Please state any specific suggestions for improvements if you have.

Answer:

Regarding (a) and (b), we believe that the relationship between the value in use (VIU) of a CGU and its fair value less costs to sell (FVLCTS) can be quite confusing which, in our opinion, is due to the fact that the guidance in IAS 36 (and IFRS 13) might be adequate for the valuation of individual assets but does not always reflect the economic substance when the CGU comprises a whole business.

For example, in cases where the fair value of a CGU cannot be determined by referring to a quoted market price of its underlying shares we agree that there should be rare circumstances where a CGU's VIU exceeds its fair value because the fair value is based on using the CGU in its highest and best use (IFRS 13.27). In our opinion, the only conceivable situation would be the case where an entity can demonstrate that no other



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market participant would be able to run the business of the CGU as good and as efficiently as the entity itself. Besides, when determining a VIU an entity shall exclude any estimated future cash flows from future restructurings or from improving or enhancing the CGU's performance (IAS 36.33 (b)). It can be reasonably expected that any such investments or measures will result in a positive net present value in an entity's forecast (otherwise they would not be undertaken) and excluding those effects from VIU, but not from fair value measurement, will inevitably result in a VIU being lower than fair value. In our view, this leads to a conceptual inconsistency between VIU and fair value determination when it comes to valuing a combination of assets or a business. The fair value of an **individual** asset is determined for the asset in its current state. Therefore, to ensure a like-for-like comparison, it makes perfect sense to exclude potential future improvements from a VIU valuation as well. By contrast, the fair value of a **business**, whether derived from a quoted market price, valuation multiples or a discounted cash flow analysis, does include expected future improvements of such business and excluding those investments and its resulting benefits from a VIU calculation essentially means that the VIU and the fair value concept are not equivalent in terms of the underlying assumptions on the business to be valued.

For entities in technology-sensitive industries, a broad interpretation of improvements/enhancements would even lead to downright grotesque results. Consider a high-tech company where any future investments in innovations or the development of new products would be disregarded in a discounted cash flow valuation. Such company would most certainly not be competitive anymore in the near future, resulting in a negative terminal value or even serious doubts about its going concern assumption. As a result, depending on how broadly the guidance in IAS 36 is interpreted, the VIU of such CGU would be a purely hypothetical value of a static, slowly dying business, probably amounting to only a small fraction of its fair value. We believe that calculating such VIU would not serve any reasonable purpose and we cannot imagine that this was indeed the intention of the IASB when issuing this guidance on cash flow projections. Therefore, we strongly suggest to either

- abandon the guidance on excluding improvements/enhancements from future cash flow projections in cases where a CGU constitutes a business; or
- clarify that only those future cash inflows and outflows should be excluded which relate to the establishment of new lines of business. All other investments in an entity's operations are in effect measures to maintain an entity's market position in its current lines of business, irrespective of whether those investments relate to mere replacements of existing assets or to "improvements" and "enhancements".

When the Group states that entities mostly use VIU as the recoverable amount this can only mean that they reasonably interpret the guidance in IAS 36.33 in a narrower, not literal sense. Nevertheless, we believe that a clarification would be very beneficial.

On the other hand, in cases where the fair value of a CGU can be determined by referring to a quoted market price of its underlying shares, the problem arises how to deal with the fact that public companies as a whole

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are valued at a higher price than the sum of their individual shares (often referred to as a “control premium”). IFRS 13 does not explicitly cover this issue but a staff paper on fair value measurement (dated 21 Feb 2014) favours a strict limitation to the quoted market price multiplied by the number of shares, thereby disregarding the fact that the payment of control premiums on the purchase price of a company’s shares are an economic reality which is supported by historical evidence. If, under those circumstances, companies revert to the VIU as the recoverable amount, this is not because the VIU is truly higher than the fair value but because the fair value measurement as envisioned by the IASB does not truly reflect the market participants’ valuation for the company **as a whole**. In other words, the VIU would need to be used as a fallback amount in order to mend the failings of the fair value calculation. Therefore, we strongly suggest to reconsider the notion that the fair value of a publicly listed company shall never exceed the aggregated value of its individual shares.

Regarding (c), we are not quite sure about the Research Group’s intentions. In par. 89 of the DP it cites the current guidance of IAS 36.80 which states that the CGU to which goodwill be allocated should represent “the lowest level within the entity at which goodwill is monitored for internal management purposes”. However, when the Group discusses potential improvements to the existing impairment test it refers to IAS 36.68 which requires a CGU for purposes of asset impairment tests (other than goodwill) to be “the lowest aggregation of assets that generate largely independent cash inflows” (DP par. 107). It is our impression that the Group views IAS 36.68 as the guiding principle when proposing a stricter guidance to ensure that goodwill be allocated to the “smallest CGU”. If by “smallest CGU” the Group means the smallest CGU with independent cash inflows, does that mean that they advocate to abolish the current guidance that goodwill-carrying CGUs should be based on an entity’s internal management reporting and monitoring, i.e. on a group of (net) assets which does **not necessarily** equal the smallest group of (net) assets with independent cash inflows but, depending on the internal reporting structure, may even extend up to the level of an operating segment?

We are strongly in favour of maintaining the current guidance under IAS 36.80 with regard to the definition of CGUs for purposes of goodwill allocation and impairment testing. By linking the relevant goodwill-carrying CGU to an entity’s own management reporting, it is ensured that the data used for calculating the recoverable amount of that CGU (e.g. discounted future cash flows) are derived from internal forecasts consistent with those which are reported to the entity’s management. In contrast, testing goodwill for impairment on an “independent cash inflow level” below the entity’s internal reporting structure would require providing forecast figures for that level just for external accounting purposes. We believe that this would not reduce the judgment in determining recoverable amounts but rather significantly increase it.

Regarding (d), we would not object to a more detailed guidance with regard to the determination of the discount rate. However, in order to have any benefit for both users and preparers such further guidance would need to be quite extensive given the numerous input factors discussed in valuation literature. Furthermore, it should not be a “one size fits all” approach but still leave room for considering individual facts and circumstances. As far as the issue of calculating a pre-tax discount rate is concerned, we see little value in providing detailed guidance on how to use an iterative process for determining this rate. First of all, we do not see the benefit of using a pre-tax rate (on pre-tax cash flows) vs. a post-tax rate (on post-tax cash flows). Even if



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the recoverable amount may vary depending on the distribution of expected future cash flows, it seems to us that the Group aims for a level of feigned accuracy whose benefit seems questionable given the inevitable uncertainties surrounding the projection of future cash flows. That being said, the Group noted that most academic books estimate future cash flows on a post-tax basis using a corresponding post-tax discount rate and we recommend to apply this method also for determining the VIU under IAS 36. We do not understand why, from a conceptual point of view, a pre-tax calculation should be preferable and provide more useful information to users of financial statements.

4. The DP suggests a number of possible new disclosures about impairment testing for goodwill. Do you think that the IASB should consider improving requirements to:

- (a) assist users in understanding the robustness of the modelling and the entity's current assumptions;**
- (b) provide confirmation of the 'reasonableness' of the entity's past assumptions; and**
- (c) assist users in predicting future impairment.**

Answer:

As noted by the Group, the current disclosure requirements in IFRS 3 and IAS 36 are already quite extensive and we doubt that introducing even more disclosures would help the user in better understanding the key assumptions for determining the recoverable amount.

Regarding (a), we are of the opinion that making a user fully understand the process of calculating recoverable amounts for various different CGUs incl. explaining all the assumptions would go far beyond the scope of what should be externally reported. For example, what would be the benefit of describing all the input factors in calculating the discount rate? If we just listed all the factors it would only further produce disclosures of a generic, boilerplate nature which could have come straight from a valuation textbook. If, however, we described in detail how those factors are calculated this would basically mean presenting our complete internal WACC documentation to the public. We believe that disclosing some meaningful "middle ground" between those two extremes could prove to be quite difficult, especially given the fact that, due to specific facts and circumstances, the underlying assumptions for the input factors may vary between different CGUs in different countries.

Regarding (b), we oppose disclosing variances between forecasts and actual results as we believe that explaining such variances for all CGUs would be quite a lengthy and burdensome exercise. Furthermore, we



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already discuss in our Management Report variances between current and prior year results of relevant CGUs and we fear that presenting yet another comparison from a different angle might only cause confusion.

Regarding (c), we oppose the suggestions made by the Group as we doubt that they will provide additional useful information. We already provide a sensitivity analysis which enables users to determine potential future impairments in case of changing assumptions on future net cash flows or discount rates. By contrast, we do not see the benefit of disclosing an expected period of consuming synergies from a business combination unless a goodwill will be actually amortised over that period. It is not the exhaustion of acquisition-date synergies which typically causes a goodwill impairment but more pessimistic expectations about a CGU's future performance (or, if you will, the failure to generate new goodwill internally over time). Therefore we do not see any predictive value in such disclosure. We also do not understand the proposal for identifying an overpayment for the acquiree as a warning signal that a future impairment might be looming. The Group suggests that "the acquirer could be required to indicate the amount of the premium paid over the market price." What remains unclear is how such "market price" should be determined? Conceptually, this should be the price which other market participants would be willing to pay and which includes synergies that those other market participants would be able to generate from the acquisition. In other words, it is a fair value and in case of a not publicly traded company this fair value will be typically derived from a discounted cash flow analysis using management projections by the acquirer and taking into account the "highest and best use" assumption. Now if it turns out that the acquisition cost exceed such fair value, this indicates an immediate and not a possible future impairment.

5. IAS 38 requires that intangible assets with indefinite useful lives are not amortised but tested for impairment at least annually. Assuming that there was a requirement to amortise the goodwill, do you think that the same requirement should be extended to other intangible assets with indefinite useful lives? In addition, assuming that there was a requirement to amortise goodwill, do you think that the current requirements of identifying intangible assets separately from goodwill should be reconsidered? If so, how?

Answer:

While extending the amortisation requirement to other intangible assets with indefinite useful lives might be a reasonable and practical approach, we think that the facts and circumstances are a bit different here. Goodwill arises as a residual item in a business combination and, as the Group pointed out, it will be difficult to break it down into its discernible elements. By contrast, other intangible assets are identifiable assets meeting the specific additional recognition criteria under IAS 38. Conceptually, we think that, in limited circumstances, those assets do have a true indefinite useful life which, as we see it, is a different situation from synergies included in a goodwill for which there might only be an uncertainty **when** the benefits of those



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synergies are used up. For example, the useful life of a mobile spectrum license granted over an unlimited period of time would only end if the mobile telecommunications operator ceased its business operations. Thus, amortising those assets over a stipulated maximum useful life would be a mere accounting concept which, while possibly being considered appropriate given the judgments and uncertainties inherent in an impairment-only approach, does not reflect the consumption of the asset's benefits over that period of time.

We do not object to facilitating the identification of intangible assets separately from goodwill in a purchase price allocation under IFRS 3. However, we think it has to be made clear that this be either a voluntary practical expedient or a mandatory special rule in case of a business combination. It should be borne in mind that customer-related intangible assets such as brands or customer lists can also be acquired individually or together with other assets which do not constitute a business. We are of the opinion that in those cases the accounting for these kinds of assets should not change as they meet the definition of intangible assets under IAS 38.