EFRAG
European Financial Reporting Advisory Group

IASB project on goodwill
Key messages for EFRAG DCL

Objective

1 The objective of this agenda paper is to receive the comments of EFRAG User Panel members on some of the tentative views expressed by EFRAG TEG in relation to the IASB's project on goodwill.

Background on the IASB Project

2 The IASB is investigating how companies can provide users of financial statements with better information about business combinations at a reasonable cost. The project responds to concerns reported during the IASB's post-implementation review (PIR) of IFRS 3 *Business Combinations* related to the current annual impairment test.

3 Users have indicated that they want to understand the factors that determine the amount a company has paid for an acquired business and whether that acquisition has been successful subsequently.

4 In addition, the IASB learned from stakeholders that:

(a) goodwill impairment losses are being recognised 'too little too late';

(b) the goodwill impairment test is costly and complex;

(c) the separate recognition and measurement of some intangible assets is challenging; and

(d) some stakeholders would like to see amortisation reintroduced.

5 One of the causes of the 'too little too late' goodwill impairment issue is the shielding effect created when acquired goodwill is replaced by internally generated goodwill. Another potential cause is that the impairment test does not directly measure the recoverable amount of the goodwill (but the measurement is based on the recoverable about of the CGU(s) to which it is allocated).

6 Some also believe that a reason for the impairment test not working appropriately is that entities intentionally are not monitoring goodwill at the lowest level possible. IAS 36 *Impairment of* Assets requires that for the purpose of the impairment test, each unit or group of cash-generating units to which the goodwill is allocated to, shall:

(a) Represent the lowest level within the entity at which the goodwill is monitored for internal management purposes; and

(b) Not be larger than an operating segment as defined in IFRS 8 *Operating Segments* before aggregation.

7 By allocating goodwill to an operating segment instead of a single lower cash-generating unit, the chances of an impairment loss can be reduced.

8 In order to further reduce the chances of an impairment loss, an entity which is only testing goodwill at segment level, could enlarge its segments (reduce the number of segments) by e.g. selecting to aggregate the level on which operating results are regularly reviewed by the entity's chief operating decision maker[1] or such entity could restructure the internal reporting to combine business with a chance of an impairment loss and business which has a very low level of impairment loss. Such an approach could, in addition to lowering the chances of an impairment loss, result in less useful segment information.

9 In order to address the 'shielding effect', the IASB developed an approach called 'the headroom approach'. However, this approach was considered overly complex and has not been explored further by the IASB. The IASB has also not indicated that it would change the requirements on how to allocated goodwill to cash-generating units.

10 Accordingly, after concluding that it would not be possible to make the impairment test significantly more effective, the IASB decided to refocus the objectives of the project. Thus, the IASB decided to develop the following project objectives:

(a) Objective A - Identifying disclosures to enable investors to assess management's rationale for the business combination; and whether the subsequent performance of the acquired business, or combined business, meets expectations set at the acquisition date;

(b) Objective B - Exploring whether to simplify the accounting for goodwill by permitting an indicator-only approach to determine when an impairment test is required; and/or reintroducing amortisation of goodwill; and

(c) Objective C - Exploring whether to improve the calculation of value in use by permitting cash flow projections to include future restructurings and future enhancements to an asset; and the use of post-tax inputs in the calculation of value in use.

11 The IASB plans to issue a discussion paper on these matters by mid-March with a comment period of 180 days. The IASB will try to develop a set of disclosure requirements that can significantly improve the information provided to users on business combinations.

12 In addition to the IASB, the FASB is also considering how to account for goodwill following the initial recognition. In July 2019 the FASB issued an Invitation to Comment (ITC) on *Identifiable Intangible Assets and Subsequent Accounting for Goodwill*. One of the questions asked in this consultation was whether goodwill should be amortised. FASB has received mixed views on this issue.

13 A short summary was provided as background for the November 2019 EFRAG TEG meeting. Some of the comments received by the FASB in response to the ITC from the big audit firms and some other respondents were provided in the January 2020 EFRAG TEG meeting.[2]

14 EFRAG User Panel discussed in February 2017 the (potential) impact on goodwill of deferred tax liabilities arising in a business combination and considered whether this is an issue the IASB should address in its goodwill project. In addition, members received in December 2018 and in July 2019, an update on the project. Members expressed mixed views on whether or not goodwill should be amortised, and some

[1] See paragraph 5 of IFRS 8 *Operating Segments*.
[2] A short summary of the FASB's ITC was provided as background for the November 2019 EFRAG TEG meeting. Some of the comments received by the FASB in response to the ITC from the big audit firms and some other respondents were provided in the January 2020 EFRAG TEG meeting.

members supported the indicator-only approach with a strong list of indicators. Members generally supported permitting the use of post-tax inputs, post-tax discount rates and the inclusion of cash flows from future restructuring in the estimates of value in use. They had mixed views on whether more disclosures were necessary.

Disclosure requirements

15 The IASB's forthcoming discussion paper (the 'DP') would discuss whether disclosures for business combinations should be improved. The IASB tentatively decided to improve disclosures that would enable investors to assess whether a business combination was a good investment decision and whether, after the acquisition, the acquired business is performing as it was expected at the time of the acquisition.

16 EFRAG User Panel in its July 2019 meeting and EFRAG TEG in its January 2020 meeting discussed the IASB's tentative decisions on disclosure requirements and overall concurred in their views. Members generally welcomed the enhanced disclosures; however, they had some concerns.

17 Members expressed reservations about practical aspects, such as a potential sensitivity of a required information, its reliability (for example if the acquired business was fully integrated with the existing business or in case of multiple acquisitions) and the balance between cost and benefits of the proposed requirements. More specifically, members questioned the usefulness and reliability of the quantitative information about the expected synergies that management would be required to provide.

Approaches to amortisation and/or impairment

18 The DP is not expected to suggest reintroducing amortisation of goodwill. It will, however, suggest that the impairment test for goodwill is only carried out when there would be an indication of an impairment. The objective of introducing such an 'indicator only approach' is to reduce the costs for preparers.

19 Although the DP is not expected to suggest reintroducing amortisation of goodwill, the EFRAG Board wishes to examine whether a change to the current impairment only approach would be needed. Such possible change should be based on well analysed reasons and should serve in the European public interest and be conducive to the European public good.

20 EFRAG TEG members have discussed what solution they would support in the case a change to the goodwill impairment and amortisation approach would be considered necessary. EFRAG TEG members did not support the approach suggested by the IASB under which goodwill would not be amortised and only tested for impairment when there is an indication of an impairment.

(a) The majority of (but not all) EFRAG TEG members supported an amortisation plus indicator-only impairment approach. That is an approach under which goodwill would be amortised and tested for impairment if there is an indication of impairment.

(b) Some (a minority of) EFRAG TEG members supported maintaining the annual impairment test and introducing requirements regarding amortisation.

(i) Some of these EFRAG TEG members thought that it should be considered what goodwill in a particular case would consist of. If it was a wasting asset (or parts of it would consist of wasting assets), it (those parts) should be subject to amortisation while it (or the parts) should not be amortised if it (they) would have an indefinite life (similar to other assets under IAS 38 *Intangible Assets*).

(ii) The other some EFRAG TEG members who supported maintaining the annual impairment test, and introducing amortisation thought that goodwill should always be amortised.

(c) Some (a minority of) EFRAG TEG members did not support changing the current requirements (impairment only approach).

21 The following arguments in favour of (a) the amortisation plus indicator-only impairment approach were provided by EFRAG TEG:

(a) Although there are academic studies that show that goodwill impairments are not used opportunistically, most academic studies show that they are. Goodwill impairments e.g. seem to take place when there is a change in the management. Accordingly, goodwill impairment information is currently not particularly useful.

(b) Although the impairment only approach might in theory be the right model, the current impairment only model does not work. Amortising goodwill would therefore be preferable from a practical perspective.

(c) Goodwill is payment for future profits. The costs should therefore be allocated to the periods in which the additional profits will incur[3].

(d) Goodwill is a wasting asset. Sometimes it is argued that e.g. a market share would be perpetual, however, it would generally be necessary to maintain this position, and accordingly to bear costs of doing so. The market share is accordingly not perpetual.

(e) Goodwill consists of many elements. Many of these elements would not be assets. The goodwill figure is therefore a 'plug'. The purpose of recognising goodwill is that it is helpful for assessing stewardship (i.e. to assess whether the management had paid too much for the acquired business). In the first few years after an acquisition, the goodwill figure would be useful for that. However, as time passes, acquired goodwill would be replaced by internally generated goodwill. After the first few years, the goodwill figure is therefore not useful. It is therefore better to have it removed from the statement of financial position by amortising it.

(f) The fact that it could be difficult to determine the amortisation period is not a good excuse for not amortising goodwill. It is also difficult to determine the amortisation period for many types of tangible assets, and still these are subject to depreciation.

(g) Most academic studies show that the goodwill figure has become more relevant after the impairment only approach has been introduced. However, this could be explained by the fact that the impairment test after the introduction of the impairment only approach had become more rigorous and the impairment information thus became more relevant. It was not because the amortisation made information less relevant[4].

(h) Amortising goodwill would enhance comparability between entities growing organically and entities growing by means of acquisition (in both cases the cost of goodwill would be included in the statement of profit or loss).

(i) For assessing managements' stewardship, it is preferable that the costs of a business combination, including the cost of goodwill, is recognised in profit or loss (which would often not happen under the impairment only approach).

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[3] An EFRAG TEG member who thought that in some cases goodwill could be a wasting asset and should be amortised in these cases, added that when goodwill would then be amortised, it should be regarded as a genuine cost, and thus not added back in e.g. EPS calculations for compensation plans.

[4] The EFRAG TEG member who provided this argument thus also believed that the requirement of a yearly impairment test should be kept.

22 Members supporting accounting for goodwill similarly to other intangibles under IAS 38 (the view presented in paragraph 20(b)(i) above), noted that under the current regime goodwill impairment losses are interpreted by analysts as representing an investment failure. However, if goodwill is a payment for excess future profits for a limited time period, goodwill would naturally diminish over time. In order not to give the impression that the investment was a failure, it would be more informative to present the decline in the value as amortisation expense, and hence to amortise goodwill. However, when goodwill would not be a wasting asset, it should be subject to the impairment test only. An argument provided for keeping the impairment test was that after the current impairment model had been introduced, impairment losses had become more relevant.

23 Members supporting a mandatory annual impairment test and amortisation of (all) goodwill noted that goodwill is a plug and consisted of different items, some of which might have a finite life (but considering what elements it consists of would be complex). The impairment only approach accordingly did not work appropriately, and amortising goodwill would take the pressure off the annual impairment test.

24 Members that did not support changing the current requirements noted that:

(a) It was unnecessary to do unless there would be specific arguments demonstrating that the current accounting is flawed.

(b) Introducing amortisation would not result in (significantly) less impairment as the risk of impairment is highest in the first years after an acquisition in which the amortisation has little impact.

(c) Introducing amortisation would have a significant effect on financial statements.

(d) Issues identified with the impairment model (i.e. the shielding effect) are caused by internally generated intangibles not being recognised.

(e) Although goodwill may consist of elements that are wasting assets, goodwill in itself is not a wasting asset.

25 At its July 2019 meeting, EFRAG User Panel members expressed different views on whether goodwill should be amortised and whether the impairment test could be carried out only when there is an indication of an impairment.

Question for EFRAG User Panel

26 What are the views of EFRAG User Panel on the arguments provided in paragraphs 21, 20 and 21 above (e.g. do EFRAG User Panel members agree more with some of the arguments than with others)?

27 Would EFRAG User Panel members have additional arguments in favour of an amortisation plus indicator-only impairment approach?

28 From a user perspective, what would be the arguments against an amortisation plus indicator-only impairment approach?

Value in use calculation

Future enhancements in the estimation of future cash flows in the calculation of value in use

29 Currently, IAS 36 *Impairment of Assets* states that when calculating the value in use for the impairment test, future cash flows shall be estimated for the asset in its current condition. Estimates of future cash flows shall accordingly not include estimated future cash inflows or outflows that are expected to arise from improving or enhancing the asset's performance.

30 In accordance with a suggestion previously made by EFRAG, the DP is expected to suggest allowing the inclusion of future enhancements in the estimation of future cash flows in the calculation of value in use. This proposal could eliminate an inconsistency in IAS 36 in the sense that it would capture within the value in use the cash flows that will arise from any existing potential to restructure or enhance an existing asset (or CGU) rather than ignoring this potential, and align with the way restructuring cash flows are considered when determining fair value.

31 However, as this proposal could increase the use of unjustifiable optimistic inputs and therefore create a potential for earnings management, EFRAG TEG has considered that it would be necessary to develop further guidance on when to include restructuring cash flows in the calculation.

Question for EFRAG User Panel

32 Would EFRAG User Panel have any reservations regarding including future enhancements in the estimation of future cash flows in the calculation of value in use?

Use of pre-tax inputs and pre-tax discount rate to calculate value in use

33 Currently IAS 36 requires the discount rate and the future cash flows to be determined on a pre-tax basis when calculating value in use for the impairment test.

34 In accordance with a suggestion previously made by EFRAG, the DP is expected to suggest removing the explicit requirement to use pre-tax inputs and pre-tax discount rate to calculate value in use. It has previously been EFRAG's position that this proposal would reduce the cost of the goodwill impairment test; provide more useful information; and make the test more understandable. In addition, using post-tax discount rate and post-tax inputs would be more consistent with other IFRS Standards.

35 However, EFRAG recommends that the IASB develops further guidance to avoid double counting of tax cash flows in estimates of value in use, where the tax cash flows included in the measurement of deferred tax assets or deferred tax liabilities are also included in the recoverable amount of an asset.

Question for EFRAG User Panel

36 Would EFRAG User Panel have any reservations regarding including future enhancements in the estimation of future cash flows in the calculation of value in use?

Other topics to be considered

Total equity before goodwill subtotal

37 The DP is expected to suggest that a subtotal of total equity before goodwill should be presented in the statement of financial position.

38 EFRAG TEG considered that such a subtotal will be more harmful than beneficial. In the view of EFRAG TEG, presenting the subtotal would create confusion as to whether goodwill is an asset or not. If goodwill is presented separately in the statement of financial position, it would be possible for every user to calculate total equity before goodwill, if the user would find that useful, without creating confusion about whether goodwill is an asset or not.

Question for EFRAG User Panel

39 Does EFRAG User Panel considers that presenting a subtotal of total equity before goodwill in the financial position would be useful?

Allocation of goodwill to the cash-generating units

40 At its July 2019 meeting, members of EFRAG User Panel noted that impairment losses are often late and inadequate. EFRAG TEG has considered whether this is a result of inadequate allocation of goodwill to the cash-generating units ('CGUs') (either at too high level or due to its constant reallocation to the most profitable CGU). EFRAG TEG members have, however, presented different views on whether the guidance on how to allocate goodwill to CGU's should be amended.

41 The current guidance in IAS 36 states that each unit or group of units to which goodwill is allocated shall:

(a) Represent the lowest level within the entity at which the goodwill is monitored for internal management purposes; and

(b) Not be larger than an operating segment as defined by paragraph 5 of IFRS 8 *Operating Segments* before aggregation.

42 Some EFRAG TEG members have argued that it is difficult to find a better alternative than what is currently required. Other EFRAG TEG members have considered that the guidance could be clarified to ensure that goodwill would be allocated to the lowest level possible.

Question for EFRAG User Panel

43 Does EFRAG User Panel consider that the guidance on how to allocate goodwill to cash-generating units could be improved (see paragraphs 40 - 42 and the discussion in paragraphs 6 - 8)?

Conversion with FASB decisions

44 IFRS 3 *Business Combinations* was a joint project with the FASB and resulted in requirements that were similar, but not identical, in many respects. In July 2019, the FASB issued an Invitation to Comment (ITC) on how the subsequent accounting for goodwill and certain intangibles could be simplified, while still providing decision-useful information to users. The comment deadline was 7 October 2019. Views were mixed on e.g. whether goodwill should be amortised or not.

Questions for EFRAG TEG and EFRAG User Panel

45 How important is it that requirements in IFRS regarding the subsequent accounting for goodwill are similar to those in US GAAP?

46 How important is it that IFRS and US GAAP include similar disclosure requirements regarding goodwill (and goodwill impairment)?