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Goodwill and Impairment – Issues Paper

Objective

- 1 The objectives of this paper are to obtain EFRAG TEG-CFSS members views on:
 - (a) an Accounting Standards Board of Japan (ASBJ) proposal on the subsequent accounting for goodwill;
 - (b) an ASBJ Staff [draft] Research Paper on analyst views on goodwill; and
 - (c) IASB Staff proposals on possible approaches to simply and improve goodwill impairment testing.

Agenda Papers

- 2 In addition to this paper, the following papers are provided for background only:
 - (a) agenda paper 11-02 ASAF paper 03 – Goodwill and Impairment – ASBJ paper on Possible Approach for addressing the “Too little too late’ Issue;
 - (b) agenda paper 11-03 ASAF paper 3A – Goodwill and Impairment – ASBJ [Draft] research paper on analyst views; and
 - (c) agenda paper 11-04 ASAF paper 3B – Goodwill and Impairment – IASB Staff proposals on possible approaches to simplify and improve goodwill impairment testing.

ASBJ proposal on the subsequent accounting for goodwill (ASAF paper 3)

What is the issue?

- 3 The objective of the ASBJ proposal is to address the perceived ‘too little too late’ issue relating to the impairment of goodwill.
- 4 The ASBJ indicates that for many years, standard setters in various parts of the world have tried to find ways to simplify the goodwill impairment model in IAS 36 *Impairment of Assets* without losing vital information for analysts and other users of financial statements. However so far, these attempts have not reached a satisfactory compromise for both preparers and users.
- 5 The ASBJ notes that the IASB project on goodwill and impairment is currently considering a pre-acquisition headroom approach (PH approach) in order to make the impairment test more effective. This approach ought to partly address the issue of ‘too little too late’ by reducing the capacity to shield the impairment of goodwill in some cases. However, the ASBJ argue that the PH approach involves a complex measurement process which is likely to lead to increased practical burden to preparers, and can only solve some of the issues.

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- 6 Finally, there is a division in views between those that support an impairment only model and those that support the reintroduction of amortisation of goodwill. Those who support the impairment only model believe that the only way to solve the issue is to improve the impairment model by making it simpler and more effective. The second group also support improvements to the impairment test as it would be in addition to amortisation.

Analysis of the issue?

- 7 The ASBJ paper considers the pros and cons of the following three alternatives as possible improvements to the subsequent accounting for goodwill:
- (a) Direct Write-off of goodwill;
 - (b) Amortisation and Impairment model; and
 - (c) PH Approach being developed by the IASB.
- 8 Alternative (a) is easy to apply. However, an immediate write-off goodwill would be difficult to explain from the perspective of providing relevant information to users of financial statements. Regarding (b), the ASBJ consider the PH Approach the IASB is developing to be overly complex and not fully addressing the issue.
- 9 The ASBJ see a lot of merits in having a combination of an amortisation and an impairment approach to account for subsequent measurement of goodwill. In their view, goodwill represents excess earnings power; the value of goodwill would normally deteriorate due to competition. Amortisation of goodwill would therefore appropriately reflect such deterioration and at the same time would avoid the recognition of what is effectively internally generated goodwill.
- 10 The ASBJ however note that a drawback of this approach is that goodwill impairment losses are less likely to be recognised. Some consider goodwill impairment losses to represent a signal that there has been a failure in the investment (that is, the business combination), which would be partly lost if amortisation was reintroduced.

The ASBJ proposed solution for an optional approach

- 11 The ASBJ proposes an **accounting policy choice** (optional approach) between an impairment only model and an amortisation and impairment approach. In their view, this approach would be more informative than the impairment only approach and would be consistent with analyst views, even if it is likely to reduce comparability for users of financial statements.
- 12 The ASBJ note two main advantages of having an optional approach:
- (a) management can choose the accounting model it thinks is useful to discharge its accountability responsibilities; and
 - (b) preparers and investors can communicate more effectively.
- 13 In relation to (a) the argument is that allowing an option to select the subsequent accounting for goodwill would provide management with different views to adopt the accounting they believe is useful to support accountability related to the results of their business combinations.
- 14 In relation to (b), having an option would provide an opportunity for preparers to communicate to investors how they evaluate and explain the results of the business combinations. This would improve make the communication between preparers and investors regarding the financial information prepared based on the selected accounting.

Concerns with the optional approach

- 15 Some may be concerned with the reduction in the comparability between entities and the effect this would have on users. However, the ASBJ thinks the advantages of having an optional approach would outweigh this additional burden. In addition, the concerns may be alleviated to a certain extent by adding disclosure requirements to allow for comparability.
- 16 The ASBJ note that if the amortisation of goodwill were to be reintroduced, one of the main issues that needs to be resolved is how to determine the amortisation period. The ASBJ paper does not specifically discuss this issue. It however reports on some past practices under IFRS Standards and US GAAP used to determine the amortisation period for goodwill.

EFRAG Secretariat preliminary views

- 17 The EFRAG Secretariat notes that EFRAG has consistently opposed accounting policy options. EFRAG's position is supported by recent discussions with the EFRAG User Panel that highlighted concerns with the number of accounting options in existing IFRS. In our view, having an accounting option on the treatment of subsequent measurement of goodwill, would result in a significant loss of comparability of information and is likely to significantly reduce users' ability to compare business combination success or failure across entities, as well as disrupt profitability and return on asset analysis of companies.
- 18 Furthermore, we note that the EFRAG Board, and other members of EFRAG, has explicitly opposed suggesting reopening the discussion on the amortisation of goodwill.
- 19 We think that, before jumping to a conclusion that an optional approach is the only solution, further work is needed to evaluate whether the PH Approach together with other alternatives that the IASB Staff is working on and the forthcoming EFRAG Discussion Paper is proposing, could work. On this basis, the EFRAG Secretariat does not support the ASBJ proposal.

Questions for EFRAG CFSS and EFRAG TEG

- 20 Do you agree with the EFRAG Secretariat that, at the ASAF meeting, we should not support the ASBJ proposal to permit an entity to choose either the impairment-only model under current IAS 36 or the amortisation and impairment model as an accounting policy?

ASBJ paper on analyst views (ASAF paper 3A)

- 21 The ASBJ Staff conducted in-depth interviews with eleven analysts¹ in Japan in order to understand how analysts use information about a business combination and obtain their views on the subsequent accounting for goodwill.
- 22 All analysts said that they used cash flow information in their analyses. However, some analysts placed more importance on analyses based on cash flow information in order to achieve comparability at the global level, and others focused more on

¹ The analysts interviewed included buy-side and sell-side equity analysts and one credit analyst that analysed companies from different industries reporting under Japanese GAAP, IFRS and US GAAP (one or a combination of these Standards). The ASBJ Staff note that Japanese GAAP currently requires the amortisation of goodwill and thus it was meaningful for the purpose of this research to include analysts that cover Japanese GAAP financial statements.

analyses based on accounting profit and net asset information as well as on cash flow information.

Main findings and conclusion²

- 23 The findings highlighted that analysts are divided in their views on the subsequent measurement for goodwill; with some analysts supporting non-amortisation of goodwill, others supporting a combination of amortisation and impairment and others remaining indifferent. Analysts made a number of suggestions to improve the disclosures of goodwill and impairment.
- 24 However, many analysts thought that impairment losses on goodwill were recognised later than when they thought the deterioration in the value of goodwill had occurred. As a result they incorporated the impairment of goodwill in their analyses before the impairment losses were recognised in the financial statements.
- 25 The ASBJ Staff concluded that the findings highlighted a need to reintroduce the amortisation of goodwill to address the delay in the recognition of goodwill impairment reported by analysts.

Questions for EFRAG CFSS and EFRAG TEG

- 26 Do you have any comments on the ASBJ paper presenting analysts' views?

IASB Staff proposals on possible approaches to simply and improve goodwill impairment testing

- 27 The IASB research project on goodwill and impairment has several strands which include improving the simplification and effectiveness of the impairment test, improving the disclosures about impairment of goodwill and looking at intangible assets in a business combination.
- 28 EFRAG has a research project to provide input to any future IASB proposals on its goodwill and impairment project. In September 2016, EFRAG published a quantitative study on Goodwill and Impairment. EFRAG also plans to issue a research paper in the summer of 2017 that considers some possible approaches to address the subsequent measurement of goodwill as its contribution to the work the IASB is doing on the subject.

Feedback so far

- 29 The IASB has discussed aspects of its research project at several IASB meetings (the last IASB meeting was in May 2017). So far, the IASB has not taken any decisions on its research project.
- 30 The project has also been discussed at the IASB's consultative groups including the Capital Markets Advisory Committee (CMAC), the Global Preparers Forum (GPF) and ASAF.
- 31 Feedback from the CMAC reported mixed views about amortisation of goodwill, with a number of analysts informing that the impairment test provides useful information, and suggesting that the impairment model should be made more robust rather than introducing other approaches. Some CMAC members asked for additional goodwill and impairment disclosures to help investors understand the key drivers that

² A summary of the detailed findings is included in Appendix 1.

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justified the consideration for the business combination. Another request was a breakdown of the carrying amount of goodwill by each acquisition.

- 32 Preparers represented at the GPF cautioned against asking companies to provide information about key assumptions and targets as this could give away an entity's competitive advantage. Furthermore, more disclosure on other aspects of goodwill would simply increase the existing disclosure overload problem. These preparers also noted that, although users would like to have information that tracks actual performance of each business combination to evaluate the success or failure of the business combination, such information was difficult to provide as the acquired business is generally integrated with existing businesses.
- 33 Previous discussions at ASAF have indicated support to find ways to improve the impairment test, given the perceived 'too little too late' issue.

Questions for EFRAG CFSS and EFRAG TEG

- 34 Do you think that feedback that the IASB has received as outlined above is broadly consistent with preparers' and investors' views in your jurisdiction?

Current IASB Staff proposals

- 35 The IASB Staff is currently working on the following proposals with the objective of improving simplicity and effectiveness of the impairment test in IAS 36:
- (a) One model approach – only FVLCD or only value in use (VIU)?
 - (b) Relief from the annual impairment test – indicator-only approach?
 - (c) Improving VIU calculations – pre-tax versus post-tax discount rate? Relax restrictions on the cash flows to be included?
 - (d) Guidance on allocating goodwill to cash-generating units (CGU's).

One model approach

- 36 The IASB Staff think that a single method might improve the effectiveness of the impairment test, make the test easier to apply and reduce concerns that the current test is able to hide impairment.
- 37 However, there are conflicting views from some investors and preparers about which of the two methods should be required. While some investors argue that a fair value based impairment model would be more objective, preparers seem to prefer a VIU method on the basis that it better reflects the fact that an entity holds the assets for continued use in the business. A VIU reflects a range of economic conditions and not just a best case scenario.
- 38 The EFRAG Secretariat acknowledge that from a practical standpoint, requiring or allowing only one method could simplify the impairment test. The question is which one to use/require.

Questions for EFRAG CFSS and EFRAG TEG

- 39 Do you think using a single method, ie FVLCD or VUI, to determine recoverable amount could improve the effectiveness of the impairment test?
- 40 In most of the situations, do you think FVLCD and VIU measurements produce significantly different values? If so, why?

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Indicator approach

- 41 IAS 36 requires a mandatory annual impairment test. Many preparers have said that this requirement is cumbersome and costly. To address this concern, the IASB Staff are looking into providing relief from the mandatory annual impairment test:
- (a) Complete relief – goodwill tested for impairment only when there is an indication of possible impairment; or
 - (b) Partial relief – mandatory quantitative test for the *first year after acquisition* and indicator-based impairment in later years OR mandatory quantitative test for the *first years after acquisition (3-5 years)* and indicator-based impairment in later years OR mandatory quantitative test, *say every 3 years*, and indicator-based impairment for the intervening years.
- 42 The IASB Staff also suggest that, in addition to the impairment indicators already in IAS 36 (paragraphs 12 and 14 of IAS 36), others could be introduced – for instance an indicator testing actual performance not being in line with key performance assumptions and targets.
- 43 The EFRAG Secretariat agrees that an indicator approach, providing relief from the annual testing, would reduce costs and complexity. However, as the IASB Staff indicates this approach would increase management judgement, and might not reduce the perceived “too little too late’ issue.

Questions for EFRAG CFSS and EFRAG TEG

- 44 Do you think the IASB should consider any of the relief approaches in paragraph 41? If yes which one(s) and why?
- 45 Could you suggest any impairment indicators that could be added to the list in IAS 36, especially indicators of overpayment? In particular, are there non-financial indicators of impairment that could be useful?

Improving VIU calculations

- 46 IAS 36 requires the use of a pre-tax rate. However, entities claim that they can observe only post-tax rates and that it is difficult to calculate an appropriate pre-tax rate.
- 47 IAS 36 requires that cash flow projections should relate to the asset in its current condition, and prohibits reflecting cost savings or benefits expected from future restructurings. Preparers (and others) generally disagree with this restriction as a buyer would typically incorporate future restructurings when agreeing on the price of the business combination.
- 48 The EFRAG Secretariat think that entities could be allowed to use a post-tax calculation. We also think that the VIU measurement could be changed to allow the effects of future restructurings to be included in the cash flows as this would align to ‘real-life’ scenarios.

Allocating goodwill to CGU's

- 49 IAS 36 requires goodwill to be allocated to CGUs or groups of CGUs that are expected to benefit from the synergies of the business combination. Many have expressed concerns with the high degree of subjectivity needed to identify CGUs and the lack of guidance in IAS 36 on how this should be done.
- 50 Furthermore, some have highlighted that entities may be inclined to allocate goodwill to those CGUs or groups of CGU with a generous pre-acquisition

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headroom in order to shield goodwill from future impairment. Also, repeated re-allocations of goodwill means that the 'original' goodwill loses its origin and becomes difficult to explain what it stands for. IAS 36 is silent on this matter.

Questions for EFRAG CFSS and EFRAG TEG

- 51 What are your preliminary views on making improvements/changes to VIU calculations and developing guidance on the allocation of goodwill to CGUs or groups of CGUs?

Appendix 1 – Detailed findings from ASBJ paper on analyst views

- 1 The analysts interviewed by the ASBJ Staff were asked the following questions:
 - (a) How do you use financial information regarding business combinations that is provided in the entity's financial statements when conducting business valuations or credit quality assessments?
 - (b) What type of disclosures are useful as disclosures related to goodwill?
 - (c) What is the most appropriate as the subsequent accounting for goodwill, impairment only, systematic amortisation with impairment testing, or direct write-off?
- 2 The research found that there were two groups of analysts:
 - (a) Group 1 - Equity analysts that placed importance on analyses based on cash flow information; and
 - (b) Group 2 - Equity analysts that placed importance on both accounting profit and net asset information as much as on analyses based on cash flow information.

Group 1 – Equity analysts that placed importance on analyses based on cash flow information

- 3 Analysts that focused on cash flow information used a discounted cash flow (DCF) model or the Return on Investment Capital (ROIC) to analyse each entity. These analysts explained that cash flow information was necessary when comparing entities at a global level as it was unaffected by the differences in accounting standards.
- 4 Many analysts in Group 1 noted that they assessed the price paid for a business combination at the time of the announcement or on the date of the business combination, and used this date to make projections about the increase in the ROIC by the business combination. They also continuously monitored, post-acquisition, whether the actual increase in ROIC met their projections.
- 5 Some analysts thought that impairment losses on goodwill were recognised after the value of goodwill had been impaired. These analysts considered such potential impairment delays in their analyses.
- 6 Within the equity analysts in Group 1 some supported the non-amortisation of goodwill because goodwill impairment had the signalling effect of indicating the failure in the investment. It also played a stewardship role because a mechanical amortisation of goodwill made management less conscious of the capital cost associated with the business combination.
- 7 Some analysts were indifferent between amortisation and non-amortisation of goodwill because they did not affect cash flows.
- 8 Regarding disclosures, analysts noted that information regarding how management determined when to recognise goodwill impairment would be useful for their analyses. For example, changes in the business environment, changes in the inputs when determining value in use including expected future cash flows and discount rates.

Group 2 – Equity analysts that placed importance on both accounting profit and net asset information as much as on analyses based on cash flow information

- 9 Analysts in Group 2 based their analysts on the relevant profit and net asset ratios such as Price Earnings Ratio (PER), the Return on equity (ROE) ratio, and Earnings Per Share (EPS). These also used cash flow information in their analyses.
- 10 Some analysts said that publicly reported financial information was useful as a predictor of share-price fluctuations and others said that when the precision of cash flow predictions was low, they would likely base their analyses on accounting profit information such as using the PER.
- 11 Other analysts indicated that they usually did not conduct analyses based on a single method or a single index but used multiple perspectives using multiple indices that were calculated using more than one method.
- 12 Analysts in Group 2 generally assessed the price paid for a business combination at the time of the announcement or on the date of the business combination.
- 13 Several analysts highlighted that impairment losses on goodwill were recognised later than they thought the deterioration in the value of goodwill had occurred. For the purpose of their analyses, they identified impairment in the value of goodwill by observing reduced profitability. However the delayed recognition of impairment of goodwill could mean incorrect valuations of share prices.
- 14 Some analysts highlighted that the allocation of goodwill used to perform impairment tests was problematic, with some entities avoiding recognition of goodwill impairment by undergoing restructuring activities for the purpose of enlarging the unit used to perform the impairment test. A further observation was that goodwill impairment was often recognised at the timing of management changes, meaning that the late recognition of goodwill impairment was a matter of management or audit and not a matter of accounting standards.
- 15 Some analysts in Group 2 supported the amortisation and impairment of goodwill for the following reasons:
 - (a) the value of goodwill cannot be maintained permanently; therefore there needed to be a way to reduce the carrying amount of goodwill to zero. Also non-amortisation of goodwill led to the recognition of internally generated goodwill;
 - (b) the non-amortisation of goodwill may induce imprudent business combinations; this is because an entity could achieve growth in both revenue and profit simply by acquiring a profitable entity. On the other hand, the amortisation of goodwill would force management to set a higher target to earn more profit from the investment than the amortised amount;
 - (c) impairment losses better represents the failure in the investment and thus provided more relevant information when such impairment losses were recognised *only when* the value of goodwill had become lower than the carrying amount of goodwill after amortisation; and
 - (d) the amortisation of goodwill had a higher information value as it achieved equal footing between growth by means of business combinations and organic growth.
- 16 In relation to the amortisation period, analysts informed that information about management's estimate of the period for which expected future cash flows would increase due to the business combination was useful. This period could also be used to amortise goodwill as profit or loss would be calculated by matching the

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increases in income arising from the business combination with the amortisation expense (based on the management's estimates) and thus provide useful information. However, goodwill may be amortised over a relatively long period when the synergies were expected to be realised over a long period of time.

- 17 Other analysts in Group 2 supported non-amortisation of goodwill for the following reasons:
- (a) given that both U.S. GAAP and IFRS require the non-amortisation of goodwill, there was no alternative but to converge with the approach that was most widely used internationally for the purpose of achieving comparability at the global level;
 - (b) having both an amortisation approach and the non-amortisation approach incurred additional costs to conduct their analyses; and
 - (c) in some industries, business combinations were essential for the sustainable growth of the entity operating in that industry and thus it was undesirable for management to become hesitant to make investments because the accounting required the amortisation of goodwill.
- 18 Analysts in Group 2 provided the following comments on disclosures:
- (a) disclosures of the initial amount of goodwill recognised, the carrying amount of goodwill, and the accumulated amortisation and impairment amounts of goodwill are needed for each business combination in order to assess each acquisition;
 - (b) disclosures of the expected growth rates and discount rates that management used for their estimates were considered important. Such disclosures are necessary not only to analyse whether the amount of impairment losses recognised were sufficient but also to examine whether there were any differences in the inputs analysts used for their analyses when the entity did not recognise goodwill impairment;
 - (c) the processes of stress tests conducted by the entity should be disclosed so that analysts could predict under what circumstances the entity would be recognising goodwill impairment; and
 - (d) the total of goodwill and intangible assets other than goodwill should be disclosed because the two are inter-related. It would be useful if the ratio of total intangible assets (that is, the total of goodwill and intangible assets other than goodwill) to net assets were disclosed, because the risk in the valuation of those assets would depend on this ratio.
- 19 Sell-side equity analysts whose industry focus were in the telecommunication services, foods, and pharmaceuticals industries stated that the valuation of intangible assets acquired as part of a business combination at fair value was often challenging. These included brands, trademarks, intellectual properties, licensing agreements, and customer relationships.
- 20 Some of these analysts further noted that it would be useful for entities to disclose how the fair values and values in use of the identified intangible assets were calculated.

The credit analyst

- 21 The credit analyst stated that he placed more importance on analyses based on accounting profit and net asset information, although he also conducted analyses based on cash flow information. For instance, for the analyses based on cash flow

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- information, future cash flows were estimated in order to estimate the debt repayment period.
- 22 The credit analyst stated that he focused on the impact of the acquisition on the creditworthiness of the entity (for example, the impact on the amount of interest-bearing debt, the debt repayment period, the capital structure, and the capital adequacy ratio). He added that large-scale acquisitions rarely had a positive impact on the credit rating, because synergies or growth potentials were generally ignored in evaluating the credit rating.
- 23 Particular attention was paid to the recognition of goodwill impairment, because it would deteriorate the value of net assets. Similar to many other equity analysts, he thought that impairment losses on goodwill were recognised in the financial statements later than when they thought the deterioration in the value of goodwill had occurred.
- 24 The credit analyst supported the amortisation and impairment approach for the following reasons:
- (a) because goodwill is initially recognised as a residual (rather than being measured at fair value), it should be viewed as an acquisition cost and thus the carrying amount of goodwill should ultimately be reduced to zero via amortisation; and
 - (b) because it is difficult to measure the fair value of the goodwill accurately and the process for measuring the value of the goodwill would inevitably be subjective, even if the impairment process is improved, goodwill should be systematically amortised from the viewpoints of financial soundness and the creditworthiness of the entity.
- 25 In the view of the credit analyst, the primary purpose of amortising goodwill was to ultimately reduce the carrying amount of goodwill to zero. The desirable amortisation period would be based on the management's estimate of the period for which the amount of goodwill would be recouped by the increase in expected future cash flows due to the business combination.
- 26 Disclosures about the initial amount of goodwill recognised, the carrying amount of goodwill, and the accumulated amortisation and impairment amounts of goodwill for each business combination were useful for the purposes of credit quality assessment.