QUESTIONNAIRE ON THE SUBSEQUENT MEASUREMENT OF GOODWILL

FEEDBACK STATEMENT

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Preparation of the feedback statement

Summary of the input received from questionnaires on subsequent measurement of goodwill

This note summarises the views and explanations included in the completed questionnaires on the subsequent measurement of goodwill. The questionnaires were distributed by the OIC and EFRAG staff on 30 July 2012.

This note does not comment on any of the arguments presented.

About the questionnaire

Public invitation to participate in the survey

The questionnaire was made available on the websites of EFRAG and the OIC and the general public (also respondents outside Europe) was invited to participate.

Different parts of the questionnaire were targeted:

- *users of financial statements;*
- *standard setters;*
- *preparer;*
- *auditors;*
- *and academics*

respectively

The questionnaires included five parts:

- **Part 1** included questions on the usefulness of the financial information based on the current requirements on subsequent measurement of acquired goodwill. This part was primarily targeted at users of financial statements.
- **Part 2** considered the consistency of the discontinuation of amortisation of goodwill with the treatment of internally generated goodwill according to IAS 38 *Intangible Assets*, and effects of goodwill impairments in time of financial crises. This part was primarily targeted at respondents involved in accounting standard setting and regulation.
- **Part 3** enquired about the costs of application of the impairment tests of goodwill, and was primarily targeted at preparers of financial statements.
- **Part 4** enquired about auditability of application of the impairment tests of goodwill, and was primarily targeted at auditors of financial statements.
- **Part 5** enquired about academic or institutional research relating to the impairment of goodwill, and was primarily targeted at academics.

Respondents

48 questionnaires were received

48 questionnaires were received. For the purpose of this feedback statement, the respondents were categorised as: preparers ('PRE') (20 respondents), auditors ('AUD') (10 respondents), users ('USE') (5 respondents), academics ('ACA') (4 respondents), accounting advisors ('AAD') (those that indicated themselves as such) (2 respondents) and standard setters ('STS') (7 respondents). Respondents working for a standard setter were considered as standard setters although the respondents would not have an official position as a standard setter.

Use of financial statements – responses to part 1

Part 1 included questions on the usefulness of the financial information based on the current accounting for the subsequent measurement of acquired goodwill. This part was primarily targeted at users of financial statements.

The questions in the first part of the questionnaire were considered by users of financial statements as well as some of the other respondents completing the questionnaire. Some preparers seem to have answered the first part of the questions because they either used financial statements of other companies in relation to acquisitions or because the businesses (the activities of subsidiaries) were evaluated based on financial statements. In addition a bank replied to these questions (from a user's perspective).

What goodwill normally consists of

The responses showed that respondents had different opinions on what goodwill normally consisted of.

The first question asked what respondents considered that goodwill would normally consist of. The questionnaire provided some examples (unrecognised assets that generate future economic benefits, recognition or measurement mismatches, overpayment for the target company, measurement errors of other assets and liabilities of the acquired company, synergies) and also allowed respondents to include other factors ('other').

Respondents had different views on what goodwill would normally consist of.

What does goodwill normally consist of?							
	ACA	AAD	AUD	PRE	STS	USE	Total
# Respondents	2	2	5	9	2	5	25
Unrecognised assets		2	3	7	2	4	18
Measurement mismatches		1	2	3		1	7
Overpayment	1	1	2	7		3	14
Measurement errors			1	4		1	6
Synergies		2	4	7	1	4	18
Other	1	2	3	2	1	2	11

In addition to the examples provided in the questionnaire, two respondents classified as users (i.e. respondents that only considered themselves as users of financial statements) noted that goodwill would normally consist of:

- Superior profitability (profitability above the weighted average cost for capital),
- Acquisition premiums.

Another user noted that it was not clear what goodwill consisted of.

A respondent noted that goodwill was the 'going concern element' of the entity acquired.

An academic did not think users knew what goodwill would normally consist of. This respondent also thought that the proper way of understanding goodwill would be by considering industrial dynamics.

An auditor noted that ideally, only the following factors should result in goodwill:

- An entity's ability to earn a higher rate of return on an assembled collection of net assets than would be expected if those net assets had to be acquired separately (going concern element),
- The synergies and other benefits from combining the acquirer's and acquiree's net assets and businesses.

Use of goodwill information

The responses also showed that some of the respondents did not use the information on goodwill presented in financial statements whereas others did.

The respondents were asked whether they used the information on goodwill presented in the financial statements when assessing the financial position and performance of an entity.

Do you use the information on goodwill presented in the financial statements when assessing the financial position and performance of an entity?

	ACA	AAD	AUD	PRE	STS	USE	Total
# Respondents	1	2	5	9	1	5	23
Yes	1	2	4	5	1	2	15
No			1	4		3	8

One user used the information as a supplement to calculating the

Respondents provided many different reasons for using or not using the goodwill information. Some of the respondents that did not use the information thought that it was too uncertain (unclear what goodwill consisted of or the calculation was considered unverifiable) or did simply not find the information useful for their projections.

Other respondents used the reported goodwill or the disclosures when assessing risks, future cash flows and stewardship.

debt to equity ratio for analysing an entity's financial position. He noted that a large portion of goodwill not necessarily implied that a company was risky, but if a company had a high goodwill to equity ratio as well as a high debt to equity ratio, the share price was very sensitive to earnings changes. The reason was that investors begin speculating that the bank will start renegotiating the loans, and this will either force the interest rate up, or force the company to issue shares. In a poor business cycle a share issue would most certainly depress the share price.

Another user used the reported goodwill figure to assess whether the purchase cost was appropriate or not; how goodwill was allocated to different CGUs; and the possibility that impairment losses would be recognised.

Three respondents classified as users did not use the information on goodwill included in the financial statements as they thought:

- The information on goodwill reported in the financial statement was unreliable (the information was excessively influenced by the assumptions applied by the entity and these assumptions could not easily be verified or examined),
- It was unclear what the reported goodwill consisted of (it was a mixture of old acquired goodwill, newly internally generated goodwill, potential reallocated goodwill among different cash generating units etc.) and there were potential reallocations of goodwill among cash generating units,
- Net profit and cash flows generated by the entity was more important information. Goodwill was only good as an indicator of how much the acquirer was overpaying for the net assets of the acquiree.

The same reasons for not using the goodwill information were provided by a bank.

One user explained that in for analytical purposes goodwill was offset against equity in order to remove any noise deriving from entity-specific expectations about future profits.

A preparer noted that users did not ask about goodwill impairment and concluded this was because the users did not consider the information important.

Some respondents that were not classified as users provided the following reasons for not using reported goodwill figures:

- Estimating future cash flows had little connection to historically recorded goodwill – and determining the price of a company was based on future cash flows.

- Modelling the value of a target company required own judgements – a synthetic value estimated by the target company's management of only part of the company was not helpful.

- The goodwill figure could only include part of the goodwill of an entity as impairment in one year followed by a later recovery would not result in reversal of goodwill impairment. On the other hand, an entity could limit goodwill impairment by allocating goodwill to more than one CGU.

- The goodwill figure would only include part of the goodwill of an entity as goodwill related to minority interest and internally generated goodwill would not be recognised.

- Goodwill and related information did not provide any additional information that was useful. The figures incorporated in the impairment test of goodwill could be useful, but they were available from market analyses which in addition included more detailed information. Cost of capital assumptions varied by the methods applied and sensitivity information was of limited information to users since the value of goodwill was an irrelevant figure for cash-flow estimations.

Other respondents used the reported goodwill and/or related disclosures:

- To assess whether capital adequacy (solvency) might be compromised if goodwill were to be impaired.

- For estimating an entity's future cash flows and its future business prospective – particular importance was given to the sensitivity analysis provided in the notes.

- To assess acquisitions – and for some respondents more particularly to assess the extent of any overpayment for an acquisition (stewardship).

- To obtain soft values such as the strength of the workforce.

- For calculating Economic Value Added (EVA), as goodwill was considered to be part of the invested capital.
- To assess the value creation capability of the management by considering disclosures about value in use and changes in this value.
- To assess performance of business segments.
- To assess cost of capital and long term growth rates.

A preparer of financial statements used the information provided in the notes by competitors for bench marking purposes and to evaluate the current market prices paid by competitors in acquisitions.

Relationship between use and the perceived content of goodwill

Some respondents, using the goodwill information, used the goodwill figure differently in their analysis depending on what they thought goodwill included.

Respondents using the goodwill information were asked whether they used the goodwill figure differently in their analysis depending on what they thought goodwill included.

Some respondents used the information differently, others did not.

Do you use the goodwill figure differently in the analysis of an entity depending on the perceived content of the goodwill?

	ACA	AAD	AUD	PRE	STS	USE	Total
# Respondents	1	2	4	5	1	3	16
Yes	1	1		1	1		4
No		1	4	4		3	12

One respondent eliminated goodwill against equity when it was assumed to result from overpayment (in other cases it was not eliminated). Another respondent thought that this would be the right approach, but noted that it could be difficult to assess whether goodwill resulted from overpayment as a company would not disclose this.

A third respondent did, in addition to overpayments, not consider accounting mismatches and errors to be part of ‘goodwill’. However, the respondent did not explain how reported goodwill was divided into different components.

Assessing the overall reliability of goodwill

Some respondents used

Respondents using the goodwill information were asked whether *specific criteria for assessing the overall reliability of the financial information on goodwill.*

they used specific criteria for assessing the overall reliability of the financial information on goodwill.

Some respondents did, some did not.

Do you use specific criteria for assessing the overall reliability of the financial information on goodwill?							
	ACA	AAD	AUD	PRE	STS	USE	Total
# Respondents	1	2	4	5	1	3	16
Yes	1	2	1	1	1	1	7
No			3	4		2	9

A user considered whether or not the reporting entity was listed, the auditors, the qualities of the entity's governance and the firm that executed the due diligence related to the acquisition.

Other respondents, that tried to assess the overall reliability of goodwill considered:

- Whether the process to test goodwill had been delegated to external parties (in this case the information was considered less reliable);
- Whether the reporting entity's financial statements had been audited;
- The entity's risks and the quality of management;
- The ratio of goodwill to sales revenue, cash earnings (EBITDA) and shareholder equity;
- The explanation of the content of the goodwill provided by the company.

Focus on the balance amount or changes

Respondents were split in their views on whether the amount of goodwill recognised in the balance sheet or the changes in the amount recognised provided the most relevant information.

Respondents using the goodwill information were asked what they thought provided the most useful information: The amount of goodwill recognised in the balance sheet or the changes in the amount of goodwill recognised in the balance sheet. Respondents were split on this issue.

Do you think the amount of goodwill recognised in the balance sheet or the changes in the amount of goodwill recognised provide the most relevant information?							
	ACA	AAD	AUD	PRE	STS	USE	Total
# Respondents	1	2	4	4	1	3	15
Amount		1	2	1		2	6
Change		1	1	3	1	1	7
Both	1		1				2

<u>Share-settled or cash-settled business combinations</u>

Most respondents using the goodwill information, did not treat goodwill acquired in a cash-settled business combination differently from goodwill acquired in a business combination settled by an exchange of shares.

Respondents using the goodwill information were asked whether they treated goodwill acquired in a cash-settled business combination differently from goodwill acquired in a business combination settled by an exchange of shares. Some respondents did.

Do you treat goodwill acquired in a cash-settled business combination differently from goodwill acquired in a business combination settled by an exchange of shares?							
	ACA	AAD	AUD	PRE	STS	USE	Total
# Respondents	1	2	4	4	1	3	15
Yes			1		1	1	3
No	1	2	3	4		2	12

A user thought that if a company constantly acquired other companies and was financing this activity by share issues, the debt to equity ratio would stay low. In this case a large goodwill to equity ratio would normally not force the company into negotiations with the bank, since the loans were low. The user therefore paid more attention to cash-settled acquisitions.

An auditor considered that goodwill generated by a share-for-share exchange transaction might be more volatile in the measurement, because generally the agreement between the parties in a business combination was reached at a previous date in respect of the ‘acquisition date’. As consequence, the consideration paid, based on the fair value of a stock would be different between these two dates. In addition, the measurement of the consideration paid was more complex where the exchanged equity instruments were not listed in an active market. In these circumstances, more detailed information would be necessary in order to understand the assumptions used to measure the consideration paid and the residual goodwill recorded.

A standard setter thought that goodwill arising from an exchange of shares was less reliable and would therefore more likely be eliminated by analysts.

Adjustments of reported figures

Some respondents considered other information together with reported goodwill figures or corrected the figures.

Respondents using the goodwill information were asked whether they considered other information together with reported goodwill figures or corrected the figures. Some respondents did while others did not.

For your analyses, do you make use of the reported goodwill figures together with other information or correct it to go beyond the accounting representation or to reflect your own assumptions, parameters or other data?

	ACA	AAD	AUD	PRE	STS	USE	Total
# Respondents		1	4	5	1	3	14
No			2	3		2	7
Yes		1	2	2	1	1	7
In the analysis of the entity's economic performance, I consider the gradual economic realisation of the acquired goodwill in the form of higher profits or lower costs		1	2				
I use analytical tools to identify and track over time – to the extent possible – the goodwill acquired in each single business combination		1					
I apply specific criteria for allocating goodwill to cash generating units other than those deductible from the entity's financial statements			1	1			
Goodwill is for accounting purposes considered as an asset with an "indefinite useful life". However, I have developed or use specific criteria to attach a useful life to goodwill allocated to different cash generating units				1			
Other		1			1	1	

One respondent compared the results of the impairment test of a company with the impairment losses recognised by the company's competitors.

Others made adjustments to the reported information. These adjustments included:

- Different allocation of goodwill to cash generating units than the allocation deductible from the entity's financial statements;

- Attaching a useful life to goodwill allocated to different CGUs.

Some respondents considered the gradual economic realisation of the acquired goodwill in the form of higher profits or lower costs in the analysis of the entity's economic performance.

One respondent used analytical tools to identify and track over time – to the extent possible – the goodwill acquired in each single business combination.

Another respondent was always considering goodwill to equity together with the debt to equity ratio and the trend in operating earnings (for example the trend in return on capital employed).

A third respondent carried out sensitivity analysis on the extent to which net income and shareholder equity/capital adequacy would be exposed to goodwill impairments.

Similarity to other intangible assets

Some respondents using the goodwill information treated the goodwill figure differently from information about other intangible assets.

Respondents using the goodwill information were asked whether they treated the goodwill figure differently from other intangible assets. Some did, some did not.

In the analysis of the entity, do you treat the goodwill figure differently from other intangible assets?

	ACA	AAD	AUD	PRE	STS	USE	Total
# Respondents	1	2	4	5	1	3	16
Yes		1	2	2	1	1	7
No	1	1	2	3		2	9

The different treatments applied by some of the respondents included:

- The goodwill balance was reduced when generation of cash inflow to the group was deemed insufficient at CGU level (this was not done for other intangible assets).

- Goodwill was analysed together with other assets belonging to the relating CGU, and not on its own as other intangible assets.

- Contrary to other intangible assets, goodwill was ignored.

One respondent thought that contrary to most other intangible assets, goodwill was not amortised. Therefore, unlike other intangible assets, it was not included in the earnings trend and the trend for return on capital employed.

Other ways to account for goodwill

Some respondents suggested these alternative methods for accounting for goodwill:

- *amortise goodwill (and review it for impairment);*
- *require additional disclosures;*
- *expense goodwill on acquisition;*
- *immediate offset of goodwill against equity;*
- *account for goodwill similarly to other intangible assets;*
- *permit recognition of internally generated intangible assets and;*
- *calculating goodwill as the difference between the book value of equity and the (long-term) market value of equity*

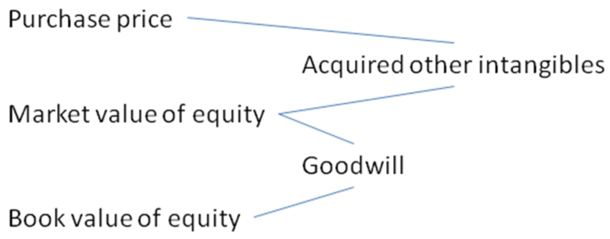
Respondents using the goodwill information were asked whether they thought there were other ways to account for goodwill, which could make the financial information more effective and useful.

Are there, in your opinion, other ways to account for the goodwill, than the way it is currently required, which could make the financial information more effective and hence more useful for users?

	ACA	AAD	AUD	PRE	STS	USE	Total
# Respondents	1	2	4	4	1	3	15
Yes	1	2	3	1	1	2	10
No			1	3		1	5

Some respondents thought that there were other ways to account for goodwill. The following suggestions were provided on how to account for goodwill or how to improve the current requirements:

- Permit recognition of internally generated specific intangible assets.
- Require note disclosure on:
  - The results of the last five impairment tests.
  - The decomposition of impairment losses for single business acquisitions.
  - The difference between budgeted data and actual data and the way the new budgets and plans have been corrected based on the difference. The information should be provided when the net book value of an entity's equity would be higher than the market capitalisation of the entity.
- Calculate goodwill as the difference between the book value of equity and the (long-term) market value of equity. Any residual should be recognised as other intangibles (see illustration below).



Acquired other intangibles should be calculated as the purchase price less the normal market value of equity. When calculating the normal market value, the long-term (approximately five years) relationship between market value of equity and book value of equity could be used if the company is listed.

If the acquired company is not listed a study of similar companies on the stock exchange can be used. For example, if it is assumed that the average company on the stock exchange has a market to book value of equity of 2.0. If this average company were acquired, the acquired other intangible asset should be calculated as the purchase price, less 2.0 times the book value of equity. This asset normally represents superior profitability. The asset should be amortised over a normal business cycle (approximately five years).

If the long-term relationship between the market value of equity and the book value of equity is unchanged on the stock market (2.0 in the example) the value of goodwill is kept constant. If the long-term relationship declines, an impairment loss should be recognised using the new long-term calculation between the market value of equity and book value of equity. For example, 10-15 years ago the average pharmaceutical company was valued at approximately 8-10 times the book value of equity. Today it is valued approximately 2-4 times since the profitability and growth prospects in the sector have declined. Goodwill from acquisitions in the sector taken place 10-15 years ago (at 8-10 times the EQ) should therefore be written down to fit the current key-ratio of 2-4 times the equity, if the acquired company develops in line with the pharmaceutical sector. If the acquired company performs substantially better or worse compared to the sector, the impairment must be adjusted.

- Expense goodwill on acquisition.
- Amortise goodwill, even if the useful life might be arbitrary to a certain extent. At least the amortisation reduces the income

earned from the goodwill by a related expense as the goodwill acquired dissipates over time (even if replaced by subsequently created goodwill).

- Amortise goodwill and make it subject to an impairment review. The amortisation reflects an 'expected loss model' and the impairment review covers 'incurred losses'.
- Account for goodwill as other intangible assets.

Impairment

Some respondents thought the accounting information on the impairment of goodwill was useful, for example, it provided information on key planning assumptions for each CGU.

Others noted that users had expected impairment losses before they were recognised in the financial statements, and the information was therefore considered of limited use.

Respondents using the goodwill information were asked whether they thought accounting information on the impairment of goodwill was useful for estimating future cash flows of the entity.

Some thought it was useful, others did not.

Do you think that accounting information on the impairment of goodwill is useful for estimating future cash flows of the entity?

	ACA	AAD	AUD	PRE	STS	USE	Total
# Respondents	1	2	4	3	1	3	14
Yes		2	3	3	1	2	11
No	1		1			1	3

Different arguments were provided for why the information was considered useful. The arguments mainly related to the benefits of having:

- An instrument to require management to consider future financial performance and the values of business units (to support decisions on maintaining/selling the units).
- Note disclosures on key management's planning assumptions for each CGU.

A user did not think the impairment information was useful as impairments normally took place a long time after the problems that had given rise to the impairment were discovered – often simultaneously with a change in the CEO, the respondent noted.

An auditor and an academic did not think the information was useful for estimating future cash flows. However, the auditor used the information to assess whether the acquirer originally overpaid for the business (i.e. the quality of management). The academic used the information to establish some risk measures and to assess the value at risk from adverse adjustments to net income, shareholder equity and market value.

Assessing whether impairment of goodwill has 'predictive' value

Two respondents using the goodwill information were using specific criteria in order to distinguish when the impairment of goodwill had 'predictive' value.

Respondents using the goodwill information were asked whether they were using specific criteria in order to distinguish when the impairment of goodwill had 'predictive' value. Two respondents did. One of these considered whether the impairment was recognised when a decrease in return on capital in the acquired entity was observed (however, the respondent noted that the necessary information was seldom presented). The other respondent considered how material goodwill was (and to what extent goodwill impairment could undermine key value drivers) by comparing it with gross revenue, net income and shareholder equity.

Have you developed or do you use specific criteria in order to distinguish when the impairment of goodwill has 'predictive' value?

	ACA	AAD	AUD	PRE	STS	USE	Total
# Respondents	1	2	4	3	1	3	14
Yes	1					1	2
No		2	4	3	1	2	12

Impairment losses that are considered

Some respondents using the goodwill information only considered impairment charges that were higher than a particular amount or were considered important by applying other specific criteria.

Respondents using the goodwill information were asked whether they only considered impairment charges that were higher than a particular amount or were considered important by applying other specific criteria.

Respondents were split. Some used specific criteria. Others did not.

Do you only consider impairment charges that are higher than a particular amount or are considered important by applying other specific criteria?

	ACA	AAD	AUD	PRE	STS	USE	Total
# Respondents	1	2	4	3	1	3	14
Yes	1	1	1			2	5
No		1	3	3	1	1	9

Effects of changing the assumptions

Most respondents considered the effects of changing the assumptions applied by the entity.

Respondents using the goodwill information were asked whether they considered the effects of changing the assumptions applied by the entity.

Respondents were split, however, most did.

In analysing the impairment test performed by the reporting entity do you consider the effects of changing the assumptions applied by the entity?							
	ACA	AAD	AUD	PRE	STS	USE	Total
# Respondents	1	2	4	3	1	3	14
Yes	1	2	3	3	1	1	11
No			1			2	3

One respondent noted that considering the effects of changing the assumption was a fundamental way to check earnings management practices. However, the respondent thought that the information given in the notes often was very opaque. The imprecise nature of the information was also noted by another respondent.

Future possible impairment losses

Most respondents reflected possible future impairment losses on goodwill in their analyses.

Respondents using the goodwill information were asked whether they reflected possible future impairment losses on goodwill in their analysis if, for example, the entity had reported significant economic losses in the past year, but had not recognised any impairment losses simultaneously.

Respondents were split on this issue. However, most reflected possible future impairment losses.

In specific circumstances, for example when the entity has reported significant economic losses in the past year but no impairment loss has been recognised simultaneously, do you reflect possible future impairment losses on goodwill in your analysis?							
	ACA	AAD	AUD	PRE	STS	USE	Total
# Respondents	1	2	4	3	1	3	14
Yes	1	2	3	3	1	2	12
No			1			1	2

Impairment and management change

Most respondents did not usually foresee an impairment loss to be recognised after a change in the management.

Respondents using the goodwill information were asked whether they usually foresaw an impairment loss to be recognised after a change in the management.

Two respondents did.

Do you usually foresee an impairment loss to be recognised after a change of the management of a reporting entity?							
	ACA	AAD	AUD	PRE	STS	USE	Total
# Respondents	1	2	4	3	1	3	14
Yes		1				1	2
No	1	1	4	3	1	2	12

More useful ways to account for goodwill

Some respondents that did not use the information on goodwill in the financial statements thought there were more useful ways to account for goodwill.

Those respondents that did not use the information on goodwill in the financial statements were asked whether they thought there were more useful ways to account for goodwill.

Do you think there are other ways to account for the goodwill, which could make the financial information more useful for users?							
	ACA	AAD	AUD	PRE	STS	USE	Total
# Respondents			1	5		3	9
Yes				3		2	5
No			1	2		1	4

One user believed that the straight-line amortization supplemented by an impairment test would provide users with more useful information than the frequent impairment test required under the current IFRSs. The user acknowledged that estimation of the economic life of the goodwill could be arbitrary, but thought this was also the case with the estimated recoverable amount of the goodwill required to conduct the impairment test. The respondent was concerned that difficulties with estimating the recoverable amount of the goodwill could give more opportunities and incentives to the reporting entities' management to manage earnings than the amortisation method.

An association of users noted that its members had split views, but some believed that a form of goodwill amortisation could provide more useful information if the amortisation period was relatively short (not more than ten years). These members considered that not amortising all acquired assets resulted in misleading performance figures.

Amortisation of goodwill was also suggested by some respondents that were not classified as users. One of these considered that straight line amortisation would simulate the conversion of acquired goodwill into going concern goodwill. Another noted that a systematic amortisation approach (with impairment review) was not a perfect solution, but better than an impairment approach as:

- Testing goodwill for impairment was challenging as it was very difficult, if not impossible, to separate external from internal goodwill.
- Amortisation was simpler and easier to understand.
- Under the impairment approach there was a chance that goodwill would never be written down and internally generated goodwill would therefore unintentionally be capitalised.
- It was easier to perform earnings management under the impairment approach.

Another respondent considers that goodwill should be deducted from equity. This would prevent internally goodwill being unintentionally recognised, be more aligned with the residual nature of goodwill, and would, according to the respondent, be more similar to accounting for the acquisition of additional subsequent interests in a subsidiary. The respondent envisaged that a separate reserve could show the deduction from equity in order not to lose track of invested amounts.

A respondent thought that it would be more consistent also to recognise goodwill of the acquiree. However, the respondent acknowledged that this could be very subjective.

Other matters

Some respondents had additional comments that might be useful in relation to the accounting for goodwill and impairment.

Respondents were provided with an opportunity to provide additional comments in relation to the accounting for goodwill and impairment.

An association of users noted that the current practice of impairment was partially useful only because companies usually provided additional information about the business plan related to the business area where the impairment took place. Apart from that, the association considered that most listed companies recognised impairment losses with a huge time lag. Therefore expectations had already been revised by investors and analysts before the information was published. The respondent also thought that the pro cyclical nature of goodwill impairment tended to create issues in company communication. Finally, in the cases where goodwill impairment could bring valuable information (which was considered to be the case for smaller companies and non listed companies issuing bonds), the details on the assumptions about discount rate and growth rate behind the impairment were generally not detailed enough to be useful.

Another user noted that both amortisation of the goodwill and impairment of goodwill required estimates. It should be considered which methods would allow most opportunities to manage earnings and the effects of this earnings management should be taken into account. An auditor considered that an amortisation approach combined with impairment test would best mitigate aggressive earnings management.

A preparer did not find the concept of impairment testing compatible with any kind of pricing of business. Pricing from the buyer side was based on 'value in use' assumptions, i.e. under the assumption of continuing use including all future possibilities resulting from continued use. Accordingly, all potential future restructurings and changes in the processes and investments were taken into account when determining the maximum price to be paid for a company. As these future possibilities could not be taken into account in the impairment test, this could result in an immediate impairment. Furthermore, the respondent thought it was inappropriate to base value in use on pre tax calculations as all empirically available interest rates that could be used as benchmark for cash flows would be post tax. Pre-tax rates were not available.

An auditor thought that the whole issue of accounting for goodwill had its political component. When the US was revising its accounting for goodwill it seemed as if it went for a political solution, due to the difficulty in getting constituents to agree on a technical solution. When the IASB later looked at the same topic it seemed as if the IASB wanted to arrive at the same result, but had to come up with technical reasons to justify the approach.

A preparer thought that the impairment standard was too complex and too restrictive. Goodwill impairment was only one aspect of that.

Finally a respondent did not consider that 'value in use' was useful for all industries.

Consistency of the discontinuation of amortisation of goodwill with the treatment of internally generated goodwill (IAS 38) and effects of goodwill impairments in time of financial crisis – responses to part 2

Part 2 of the questionnaire was targeted standard setters

Part 2 of the questionnaire included some questions on internally generated goodwill and effect of goodwill impairments in time of financial crisis. This part was directed towards standard setters.

Consistency of the discontinuation of amortisation of goodwill with the treatment of internally generated goodwill (IAS 38)

Internally generated goodwill

The first question asked whether internally generated goodwill replaced acquired goodwill in the impairment test.

The first question in part 2, of the questionnaire, asked whether or not recognising any reduction of value – other than that due to an impairment loss – on acquired goodwill, meant that internally generated goodwill was recognised to replace the acquired goodwill that had been 'consumed'. Respondents were split.

Some respondents thought it did.

Do you think that conceptually not recognising any reduction of value – other than that due to an impairment loss – on the acquired goodwill means that internally generated goodwill is recognised to replace the acquired goodwill that had been 'consumed'?

	ACA	AAD	AUD	PRE	STS	USE	Total
# Respondents	1	2	6	7	5	3	25
Yes		1	5	6	4	2	18
No	1	1	1	2	1	1	7

Respondents who thought that internally generated goodwill was recognised and that this was inconsistent with IAS 38 were asked for views on how the inconsistency could be solved.

Some standard setters thought that on balance it would be beneficial to require amortisation of goodwill combined with impairment testing. It was noted that it was very difficult, if not impossible, to separate internally generated goodwill from the acquired goodwill. Only testing goodwill for impairment would therefore not result in an allocation of the cost of the acquired goodwill over the relevant period. It was acknowledged that it was difficult to determine the period over which acquired goodwill was consumed and the depreciation pattern was difficult to predict. However, these difficulties were not necessarily specific for acquired goodwill. Choosing an appropriate depreciation period and depreciation pattern was equally difficult for property, plant and equipment, since it required judgments about not only expected physical wear and tear but also technical or commercial obsolescence of the asset.

Some standard setters considered that it was impossible to assess to what extent internally generated goodwill effectively replaced acquired goodwill over time. However, one standard setter noted that inclusion of future cash inflows from internally generated goodwill in the recoverable amount of recognised acquired goodwill was not the same as recognising internally generated goodwill. The standard setter thought that it should be considered whether goodwill should be recognised at all and whether internally generated goodwill should be recognised. Recognising internally generated goodwill could remove some of the concerns related to recognising acquired goodwill.

Non standard setters who were concerned that an impairment only test would result in the recognition of internally generated goodwill provided the following three solutions:

- Requiring amortisation to supplement the impairment test. One respondent noted that the amortisation period should be short (not longer than 10 years), as the goodwill recognised would otherwise represent decisions taken by the acquiree and not the acquired business.
- Requiring all goodwill to be expensed on acquisition or written off against equity.
- Considering the business not 'as is' but 'as was' at the acquisition date when performing the impairment test.

A non standard setter considered that the problem was not that the requirements could result in internally generated goodwill being recognised, but that internally generated goodwill could not be recognised according to the current requirements.

Amortising goodwill

Some respondents thought there would be conceptual reasons for adopting the same approach for goodwill as for other intangible assets.

The second question asked whether respondents thought there would be conceptual reasons for adopting the same approach for goodwill as for other intangible assets regarding amortisation.

Standard setters as well as other respondents were split.

One standard setter noted that IAS 38 did not require amortisation of intangible assets with indefinite useful lives, if there was no foreseeable limit on the period during which an entity expected to consume the future economic benefit embodied in an asset. This was because amortisation of that asset over, for example, an arbitrarily determined maximum period would not be representationally faithful. As goodwill largely represented an excess earning power, the value of goodwill would depreciate through competition with others over a period of time. Hence, there could often be a foreseeable limit on the period. Therefore if acquired goodwill would be accounted for consistently with intangible assets with indefinite useful lives, the effect of the decrease in the value might be dismissed in financial reporting. It might be difficult to predict the period over which the acquired goodwill would be consumed. At the same time, however, it would seldom be possible (if not impossible) to continuously identify the depreciated values through impairment testing. Therefore, on balance, it was considered more reasonable to require amortisation of acquired goodwill over the period it would be consumed in addition to impairment testing.

Do you think there are conceptual reasons for adopting the same approach for goodwill as for other intangible assets regarding amortisation?

	ACA	AAD	AUD	PRE	STS	USE	Total
# Respondents	1	2	6	8	6	3	26
Yes	1	1	5	7	4	2	20
No		1	1	1	2	1	6

Another standard setter disagreed and noted that it was not clear that amortisation of acquired goodwill would faithfully represent an economic phenomenon, namely, the consumption of that goodwill. This was because it was not evident that acquired goodwill had a finite useful life. This standard setter further argued that the IASB's Conceptual Framework required an element of financial statements to be reliably measurable in order to qualify for recognition. The standard setter was not convinced that the period and pattern of consumption of acquired goodwill (if it occurred) could be measured reliably. Therefore, it did not see amortisation of acquired goodwill being warranted (as it was for other intangible assets) for conceptual reasons.

A third standard setter considered that amortisation was a method of allocating the cost of acquired goodwill over the periods it would be consumed, and doing so would be consistent with that approach taken to other intangible and tangible fixed assets that did not have indefinite useful lives. The standard setter did not find any conceptual reason for treating acquired goodwill differently from other intangible assets that were amortised.

A standard setter noted that different requirements regarding the amortisation of goodwill and the amortisation of intangible assets could induce some accounting arbitrages during the process of the purchase price allocation.

Non standard setters, who thought that there were no conceptual reasons for adopting the same approach for goodwill as for other intangible assets regarding amortisation, noted that goodwill was different from other intangible assets as it was a residual asset and that unlike amortisation of other assets, amortisation (as a loss of utility) could not be verified for goodwill.

On the other hand a non standard setter who thought that there were conceptual reasons for adopting the same approach for goodwill as for other intangible assets regarding amortisation, considered goodwill to be quite similar to some (but not all) other intangible assets recognised in accordance with IFRS 3. Another non standard setter found it incongruous that acquired intangibles – which represented specific measurable benefits of an acquisition – were amortised over a period whereas the un-measurable benefits (goodwill) were assumed to exist indefinitely. The respondent also believed that not amortising goodwill contradicted the principle of 'matching' as the over-riding assumption was that the un-measurable component remained constant, whereas the measurable component was amortised to match the usage (i.e. the benefits) of the asset. In the same way as for intangible assets, the respondent would support that goodwill could be deemed to have an indefinite useful life (and therefore subject to annual impairment testing) but this would be the exception to the rule.

Reversing goodwill impairment losses

Different views were presented for and against reversing goodwill impairment losses.

Arguments against reversing:

- *impairment is just a cost allocation method;*
- *reversing can result in recognition of internally*

Respondents were then asked whether they had any concerns regarding the prohibition against reversing goodwill impairment.

Respondents were split.

Do you have any concerns regarding the prohibition against reversing goodwill impairment losses?

	ACA	AAD	AUD	PRE	STS	USE	Total
# Respondents	1	2	6	8	6	3	26
Yes			1	3	4		8
No	1	2	5	5	2	3	18

generated goodwill;

- *reversing could offer an increased amount of discretion to management;*
- *reversals would be too subjective;*
- *it may in practice be difficult to identify a specific event that increases the recoverable amount.*

Arguments in favour:

- *same requirements should apply for goodwill as for other tangible and intangible assets;*
- *prohibiting reversals can in practice delay the recognition of the impairment;*
- *prohibiting reversals would result in biased accounting.*

One standard setter thought goodwill impairment could be considered as a cost allocation method rather than remeasurement. For that reason impairment losses should not be reversed. In addition, reversing goodwill impairment losses could result in the recognition of internally generated goodwill as separating the extent to which a subsequent increase in the recoverable amount of goodwill would attributable to the recovery of the acquired goodwill and increases in internally generated goodwill was seldom possible.

Similarly, another standard setter considered that reversal of goodwill impairment losses could only be useful if the source for the reversal could objectively be attributed to the initial goodwill. The respondent did, however, not think this was the case and that a reversal would offer an increased amount of discretion to management. The respondent therefore thought reversals should be prohibited.

On the other hand, three standard setters did not think there were conceptual reasons for having a one-sided accounting effect and thought the same rules should be applied for goodwill as for all other tangible and intangible assets.

One of these standard setters noted that prohibition could in practice delay the recognition of impairment losses. The respondent, however, thought that in practice it could be difficult to reverse impairment on goodwill. This would require the identification of specific events that caused the impairment and the corresponding opposite event that explained the increase of the recoverable amount.

Non standard setters, who were in favour of prohibiting reversal of goodwill impairment losses, were concerned that reversal would result in recognising internally generated goodwill and that conditions giving rise to a write-down having changed would be too subjective to be in accordance with the concept of ‘neutrality’ in the IASB’s Conceptual Framework.

A non standard setter, who had concerns about prohibiting reversals, noted that there was no conceptual reason for having a one-sided accounting.

Effects of goodwill impairments versus amortisation through the economic cycle

The questionnaire considered the effects of goodwill impairments in time of financial crises.

The questionnaire asked whether impairment of goodwill, when amortisation was not permitted, could be considered pro-cyclical.

Respondents were split.

Different views were presented in relation to effects of goodwill impairments through the economic cycle.

Do you think that the impairment of goodwill, when amortisation i permitted, could be considered pro-cyclical?							
	ACA	AAD	AUD	PRE	STS	USE	Total
# Respondents	1	2	6	8	5	3	25
Yes	1		4	7	3	3	18
No		2	2		1		5
Both				1	1		2

Some thought that effect on the macro economy should not be considered when developing accounting standards.

One standard setter did not think the development of accounting standards should be influenced by possible macroeconomic effects including whether a particular accounting treatment had pro-cyclical effects on the macro economy. This standard setter noted that under the IASB's Conceptual Framework, the objective of general purpose financial reporting was to provide financial information about the reporting entity that would be useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity (paragraph OB2), since many existing and potential investors, lenders and other creditors could not require reporting entities to provide information directly to them and thus had to rely on general purpose reports for the financial information they needed (paragraph OB5). Although the Conceptual Framework acknowledged the cost constraint on useful financial reporting (paragraph QC35-QC39), macro-economic effects were broader concepts than those envisaged in the chapter. In addition, the IASB Due Process Handbook explained that the IASB weighed effect analysis considerations as a part of its deliberation when considering and drafting its analysis of likely effects, but it was rarely possible to make formal quantitative assessment of the effects of IFRSs. Consideration of macro-economic effects was not identified as one of the necessary steps in the explanation of the Handbook. Another standard setter agreed and noted that arguments for considering pro-cyclicality were essentially arguments against transparent reporting.

Some thought that the impairment requirements were pro cyclical as:

- *no amortisation would lead to higher prices for entities;*
- *impairment losses were usually recognised very late when business perspectives were already poor.*

A standard setter considered that the requirements were pro-cyclical as impairments were higher during downturns, which could worsen the economic downturns.

A third standard setter thought that impairment losses were 'neutral', in the sense that they were economic phenomena that occurred and were recognised as they occurred. Amortisation of acquired goodwill could not be measured reliably – and would therefore not be 'neutral'.

A fourth standard setter noted that impairment required compounding the future unfavourable expectations in one value, thus impairment added future expected losses to current operating losses.

A fifth standard setter thought that prohibition of goodwill amortisation resulted in front loading profit as the value included in the acquired goodwill was generally recognised a long time before the consumed goodwill was impaired. This could encourage overpayment of a business. In addition impairment losses were generally recognised very late when business perspectives were already poor.

Finally another standard setter noted that numerous factors that might be considered pointed in different directions. The standard setter therefore found it impossible to state whether the factors combined were pro cyclical.

Non standard setters thinking goodwill impairment losses were pro-cyclical explained:

- Goodwill impairment tests represented the outcome of a trend that was already observable by markets. Therefore, the tests did not impact the behaviour of knowledgeable users. Nevertheless goodwill impairment tests could lead to exaggerated reactions from the 'street'.

- When goodwill should not be amortised, and would therefore not automatically affect the income, a higher price could be paid for an entity – which resulted in higher goodwill. In economic downturns, when future cash flows looked less promising, the impairment losses would therefore become higher. Another respondent added that mega-mergers tended to occur around the peak of the boom-and-bust cycle while they tended to end up with subsequent gigantic write-downs. The issue seemed to be that management could not project expected cash flow as well as goodwill impairment losses accurately enough.

- Theoretically, if the expected loss approach worked perfectly, the goodwill impairment losses could represent the normal evolution of the economic cycle. However, the results of empirical studies did not seem to support this view. To the contrary, the management of the acquirer tended to be too optimistic during the boom and vice versa. Huge impairment losses reported by Vodafone after the burst of dot-com bubble seemed to be a good and classic example that the goodwill impairment losses could be pro-cyclical rather than counter-cyclical.

- While goodwill impairments should be neutral, they were, however, more likely to be pro-cyclical as a result of companies probably expecting any decline in economic activity to occur later then when it actually occurred; in addition the extent of any decline was difficult to predict and could be more severe than expected.

- Systematic amortisation represented the normal evolution of the economic cycle. In economic downturn the impairment based on an 'incurred loss approach' resulted in higher amount of impairment losses only after remarkable deterioration.

- Goodwill impairment followed, they did not precede, business downturns.

- Goodwill impairment losses were triggered by the crisis and not anticipated before.

- IAS 36 required the discount rate to be set based on current values and as a result these would not be able to pre-empt the impact of any downturn. Discount rates could fall in a downturn, although if the industry or country would be under stress these could actually increase overall, reflecting increased levels of equity risk premium which could outweigh falls in the risk-free rate. Therefore it was more likely that worsening economic conditions would trigger goodwill write downs than in more benign periods.

- Internally generated goodwill functioned as a shield which could result in impairment losses only being recognised when really bad things happened.

- Usually goodwill impairment was an 'add-on' to a downturn in the operating business of the reporting entity. Impairment tests were in many cases set-up on the most recent budget and planning figures which in turn were based on the actual environment and expectations on the future development. Especially in times of a persistent recessionary environment the trend was usually flat or downwards oriented with an increased probability of an impairment necessity. Accordingly, impairment losses were pro-cyclical.

Non standard setters thinking goodwill impairment losses were not pro-cyclical explained:

- Goodwill impairment losses, computed according to the requirements, were neutral because they were based on the future cash flows of the entity, which represented the normal evolution of the economic cycle.

- Solvency and liquidity of the entity was normally not affected by an accounting entry when the market had been regularly updated on business trends. A good example of this was the lack of market reaction when substantial write-offs were announced (Vodafone in Europe illustrated this perfectly). However, it was possible that impairments feed the irrationality of the market or that current practices (loan covenants, business transactions) or regulations rested upon the amount of recorded equity, therefore triggering additional economic effects.

- Studies showed that write off were always anticipated by the market.

Most respondents who thought that goodwill impairment losses were pro cyclical thought that amortisation could reduce the effect.

Those respondents who thought that goodwill impairment losses were-pro cyclical were asked whether amortisation of goodwill would reduce the effect or there were other solution to overcome pro-cyclicality.

Most of these respondents thought that amortisation could reduce the effect. Other remedies to pro-cyclicality mentioned by respondents were: immediate write off against equity in a separate reserve; and more timely recognition of impairment losses.

Do you think amortisation of goodwill would reduce the effect of pro-cyclicality?

	ACA	AAD	AUD	PRE	STS	USE	Total
# Respondents	1		4	8	3	3	19
Yes	1		4	8	3	2	18
No						1	1

Costs of application of the impairment tests of goodwill – responses to part 3

Respondents had different

Part 3 of the questionnaire enquired about the costs of application *views on whether the costs of performing the impairment test were significant and proportionate to the importance of the information.*

Some thought that it was costly and that the information was not particularly useful as:

- *it was too subjective;*
- *acquired goodwill turned into going concern goodwill/internally generated goodwill;*
- *it was not related to the operational performance and frequent impairment losses would just create noise when assessing performance;*
- *the supporting information in the notes was incomplete;*
- *it could result in unbeneficial behaviour of the management of an entity.*

of the impairment tests of goodwill, and was primarily targeted at preparers of financial statements.

The first question asked whether the costs of performing the impairment test of goodwill were significant. The next question asked whether the costs were considered proportionate to the importance of the information as given by financial analysts.

Respondents were split.

Are the costs of performing the impairment test of goodwill significant?							
	ACA	AAD	AUD	PRE	STS	USE	Total
# Respondents	1	2	4	19		2	28
No		1	1	6			8
Yes	1	1	3	13		2	20
Costs mostly related to complexity of IAS 36	1	1	3	7			12
Costs mostly related to the frequency of the impairment test				3			3
Both				3		2	5

Respondents thinking that the costs of performing the impairment test were significant were asked whether the costs were mostly related to the complexity of IAS 36 or the frequency of the impairment test.

Some respondents provided additional comments on why they thought the costs were not proportionate to the importance of the information as given by financial analysts. One respondent from a medium sized entity was mostly concerned with the costs of preparing the information. This respondent noted that the cost of the calculation amounted to 25% – 50% of the total accounting budget and thought that medium sized entities were often not in the public spotlights, in which case the impairment test was considered an expensive administrative burden. Other respondents were more concerned with the benefits of the information. Several respondents considered that the many assumptions used for the calculations were resulting in information that was too subjective to be useful for financial analysts. Others noted that:

- The acquisition goodwill transformed into going concern goodwill a couple of years after the acquisition and from an entity's perspective there was no need to justify going concern goodwill.
- Business analysts compared operational performance expectations with the actual value of capital stakes. Information

of goodwill impairment was of limited use for this assessment. Therefore, efforts in preparing goodwill impairment tests exceeded decision usefulness.

- Only the main drivers of the evaluation model were explained in the notes, this was not sufficient for financial analysts.
- Frequent impairment would likely just create noise when evaluating the performance of a business combination.
- The information about goodwill was not useful as it was a mixture of externally and internally generated goodwill.
- Goodwill was generally ignored by financial analysts. Analysts were focused on the underlying cash flow of the business. This had become more evident with the evolution of financial metrics such as tangible net asset value, which adjusted for goodwill and intangibles, and adjusted profit measures that striped out goodwill impairment and intangible amortisation. In addition, for financial institutions, capital regulations fully deducted goodwill and intangibles from core capital as it was not considered a source of capital.
- Financial analysts examined other indicators to evaluate the viability of future cash flows and focused more often on short-term cash flow indications. Goodwill was often supported by long-term cash flow indicators.
- Different assumptions for value in use, in contrast to fair value, caused errors and puzzlement.
- Definition of carrying amount and recoverable amount were not fully reconcilable (e.g. deferred taxes).
- The relevance of the information was questionable as users did not have further insight into the basic parameters and methods used by the reporting entity – especially the assumed expected cash flows from CGUs.

A preparer noted that external costs, including use of an external appraiser and auditor, were at least €1.5 million euro for approximately 30 CGUs. Internal costs to compute DCF and present them to external appraiser and auditors represented approximately 300 man days. Without being insignificant the respondent considered that these costs were relatively limited, however, the respondent did not consider the information to be useful and noted the following issues in addition to those mentioned above:

- Disclosing the basic principles on which management's estimates were based could force management to disclose and base estimates on ambitious targets.
- Disclosing estimates could result in management being responsible for predicting future cash flows of the entity.
- Goodwill impairment could be used for assessing stewardship, which would be unfortunate as:
  - There was a lot of 'noise' around goodwill.
  - An entity value was subject to estimation uncertainties which were rarely under 30%.
  - Impairment was one sided and internally developed businesses were not recognised.

Some thought the costs could be reduced by:

- *allowing/requiring amortisation of goodwill;*
- *limiting impairment test to when there would be an indication of impairment;*
- *reducing the frequency of the impairment test;*
- *only requiring impairment test when the book value of equity compared with the market capitalisation of the company would exceed a given threshold;*
- *introducing a less prescriptive approach;*
- *introducing a more standardised approach;*

Some respondents provided views on how it would be possible to reduce the costs of performing the impairment test of goodwill or increase the relevance of the accounting information on the impairment of goodwill.

Some suggestions related to amending the requirements. Seven respondents thus thought that goodwill should/could be amortised on a systematic basis and impairment test should be performed only when there would be an indication that goodwill might be impaired. Others thought that goodwill should be offset immediately against equity, possibly in a separate reserve.

In order to reduce the costs, others suggested reducing the frequency of the impairment test (for example, only to require the detailed impairment tests to be performed every five years) or only when there would be an indication of impairment.

One respondent suggested a simplified approach where the book value of equity (adjusted, for example, by a threshold of +20% would be compared with the market capitalisation of the company (not CGU). The entity would only need to perform a goodwill impairment test if the book value of equity would be too high.

One respondent did not provide many details, but thought that a more rigid, and less subjective, system would be better. Another respondent thought that a less prescriptive approach should be

- *clarifying the requirements.*

applied and another respondent considers that standard setters should establish a standard model for impairment testing with well-established drivers and methods.

One respondent thought the requirements should be clarified as this could reduce costs. Significant communication costs were caused by the lack of guidance provided in IAS 36 and IFRS 13 on whether for a publicly, listed, goodwill bearing CGU the value in use could exceed the market capitalization of this CGU. The same lack of guidance existed on the issue whether the total value of all CGUs of a publicly listed entity could exceed the market capitalisation of the entity. Due to the lack of guidance these issues were often viewed differently in different countries or even by different auditors in the same country. More specific guidance by the IASB could help to reduce the time and effort required for preparing and auditing goodwill impairment tests.

Some respondents suggested the information could be made more useful by:

- *disclosing total acquired and internally generated goodwill;*
- *decomposing changes in value in use;*
- *apply a hypothetical value for 'internal goodwill'.*

Some respondents focused on how the information prepared could be made more useful. They suggested that:

- The total of acquired and internally generated goodwill should be disclosed as this could indicate future impairment needs.
- The change in the value in use from one period to another should be decomposed into different significant components.
- A hypothetical value should be derived for 'internal goodwill' (similar to the concept used under FRS 11 in the UK prior to the adoption of IFRS[1]). This could mitigate the problem related to the external goodwill being transformed into internal goodwill and masking the true performance and assessment of the acquired goodwill.

Some respondents did not think the requirements should be changed as the information

Some preparers thought the requirements were right as they were. One preparer noted that estimating the recoverable amount was part of business management. Another preparer believed that the costs of performing the test were proportionate to the importance

[1] According to FRS 11, where an acquired business was merged with an existing business and resulted in an income-generating unit that contained both purchased an (unrecognised) internally generated goodwill, the value of the internally generated goodwill of the existing business should be estimated and added to the carrying amount of the income-generating unit for the purpose of performing impairment reviews. Any impairment arising on merging the businesses should be allocated solely to the purchased goodwill within the newly acquired businees. Subsequent impairments should be allocated pro rata between the goodwill of the acauired business and that of the existing business. Only the impairment allocated to the purchased goodwill should be recognised in the financial statements.

was valuable for users.

of the information given by financial analysts, since any impairment of goodwill generally was a key indicator on the performance of a segment or business unit. The existence of an impairment loss and to a lesser degree also the amount of this could provide valuable information to analysts. Even more important information, however, were provided by disclosures of key valuation assumptions and parameters required by IAS 36. This provided analysts and other interest groups valuable information on the expected future performance of the business.

The questionnaire also asked whether the estimation of the recoverable amount or estimation of the pattern of consumption (including the useful life) was the most burdensome. Respondents were split in their views.

From your experience with the application of IAS/IFRS standards, do you consider the estimation of the recoverable amount of goodwill more challenging – and burdensome – than the estimation of the pattern of consumption of goodwill (including estimation of the useful life)?							
	ACA	AAD	AUD	PRE	STS	USE	Total
# Respondents	1	1	3	16	1	2	24
Yes	1	1	3	11	1	2	19
No				5			5

Auditability of application of the impairment tests of goodwill – responses to part 4

Respondents had different views on whether it was difficult for auditors to challenge management assertions with regard to impairment of goodwill.

Some noted that the difficulties related to forward looking information as management were directly involved in the business and clearly had the best and most current and relevant knowledge about their industry and the entity's plans. They were therefore best placed to make judgements about the future. Whilst auditors could

Part 4 of the questionnaire was targeting auditors and asked whether it was considered difficult to challenge management assertions with regard to impairment testing which entailed goodwill.

Respondents were split. Most respondents found it difficult.

Do you find that it is difficult for auditors to challenge management assertions with regard to impairment testing which entails goodwill?							
	ACA	AAD	AUD	PRE	STS	USE	Total
# Respondents	1	2	9	3		1	16
Yes	1	1	8	2			12
No		1	1	1		1	4

One respondent noted that in the UK, the Audit Inspection Unit had consistently found failings by the larger audit firms in recent years in relation to impairment testing, particularly around growth rates, source date, methodologies, and lack of sensitivity analysis. The respondent considered that these findings suggested that auditors found it difficult to challenge management's assertions in these *challenge assumptions about the future of the business, it was difficult to disprove the management's assumptions.*

areas. The respondent thought that the difficulties arose for the following reasons:

- Many less sophisticated preparers of financial statements either had a lack of detailed knowledge of the requirements of the accounting standard or simply found it too onerous to interpret. Difficulties that often arose were:
  - identifying appropriate CGUs;
  - identifying the assets and liabilities belonging to the CGU;
  - allocating (and where necessary re-allocating) goodwill to CGUs;
  - incorporating corporate assets;
  - determining an appropriate discount rate;
  - determining an appropriate growth rate of being able to provide evidence to support the assumption on with the growth rate was based;
  - the inclusion of inappropriate cash flows and exclusion of appropriate cash flows.
- Often the production of the impairment review was left until the later stages of the audit, taking place post year rather than being integrated into the strategic plan and budgetary monitoring process of the entity. With looming deadlines, the timing of these reviews created pressure and practical difficulties for auditors. It was often overlooked that IAS 36 permitted annual impairment tests to be performed at any time during an annual period.
- Preparers of the financial statement could sometimes not support the assumptions used with appropriate explanations.
- Forward looking assumptions, such as growth rates and cash flows, were difficult for an auditor to 'verify' or 'corroborate' in terms of timing or amount. (Another respondent noted that it was often difficult to find comparable metrics in the market to compare with. Yet, other respondents noted that all required parameters were based upon estimates which were open for indefinite debate.)
- Whilst auditors could challenge assumptions about the future of

the business, it was difficult to 'disprove' or 'disagree' even when the assumptions seemed unduly optimistic or were not supported by historical performance. This was because management were directly involved in the business and clearly had the best and most current and relevant knowledge about their industry and the entity's plans and they were therefore best placed to make judgements about the future (this issue was also mentioned by other respondents).

- Auditors could compare the assumptions used to historical performance, observable inputs and comparable external date, and by considering their consistency with the entity's long term strategic plan and budgetary monitoring process. However, historical performance was not necessarily an indication of the future, and there could be practical difficulties in obtaining comparable external data for many of the assumptions needed. Preparers of the financial statements often found it difficult to obtain external data to support their assumptions which created additional work for auditors.

- On occasion, assumptions used in previous assessment did not work out as planned. However, this could be due to external factors over which management had no influence. Therefore the inability to meet last year's forecast could not be used by auditors to claim that the current forecast would also not be met. (This view was shared by another respondent that noted that often information used in the calculation assumed a rather smooth trend, which rarely occurred. However, it was difficult to argue that deviation from the trend would not reverse.)

- A review of the subsequent events period could provide some evidence about the reasonableness of assumptions; however, this was typically a very limited period of time and not necessarily representative of how things would turn out over the remainder of the much longer period covered by the assessment.

- The auditor's overall assessment as to whether the financial statements were materially misstated or not with regards to the valuation of goodwill often came down to whether the assumptions appeared 'reasonable'; how much headroom there was in the assessment; and whether the disclosures were adequate or misleading. In obtaining sufficient and appropriate audit evidence, auditors were often compelled to obtain management representations because certain assumptions were not independently verifiable.

- The requirements of the accounting standard were detailed and complex and as a result preparers of financial statements often fell into the trap of performing their assessment as a number of crunching exercises, frequently failing to provide the auditor with any qualitative analysis to support the carrying value of the assets.

Finally a respondent argued that it was difficult to justify the increased audit costs because of the challenges related to the impairment test.

Some respondents did not think it was more (or significantly more) difficult to challenge management assertions with regard to impairment testing than in relation to other types of information presented in the financial statements.

Some respondents did not think it was more difficult to challenge management's assertions with regard to impairment testing which entailed goodwill. One auditor noted that it was more difficult to challenge management's assertion in relation to 'value in use' compared with, for example, fair value less cost to sell. However, it was possible. Specialists could be used for some financial assumptions, as with many other financial data based on future expectations. Another auditor believed that auditors could challenge management based on the available evidence, including their analysis on the difference between the previous cash flow projection and its actual cash flow outcome and other evidences obtained from external sources. However, the estimation of the future outcome encompassed various subjective judgments by management. Therefore, when auditors could not determine that management's assumptions were clearly unreasonable, auditors often found it very difficult to challenge managements' subjective estimates when exercising their judgments thereon. Another respondent thought there was much evidence the auditor could make use of when assessing the reliability of an impairment test.

Some respondents thought the auditability of impairment tests could be enhanced by:

- *improving the structure of the standard and provide practical guidance;*
- *training auditors and involving experts;*
- *changing the requirements to include a ¨look-back test' and amortisation*

Some respondents provided their views on how the auditability of impairment testing could be enhanced. Generally the views provided dealt with how to improve the standard; how to improve the work of the auditors and preparers; how the requirements should be changed; how to enhance the auditability by requiring more disclosure; and how to specify the assurance provided by the audit.

One respondent thought that the auditability of impairment testing could be enhanced by addressing the difficulties experienced as a result of non-compliance with the accounting standard, considering the 'big picture', and to a limited extend addressing the subjectivity inherent in the use of assumptions. One of the enhancements proposed was to improve the structure of IAS 36 and to introduce a *requirements;*

- *requiring more disclosure;*
- *specifying the assurance provided by the audit as a reasonability test.*

look-back test as in the UK standard FRS 11 'Impairment of Fixed Assets and Goodwill'.

The respondent thought that the structure of IAS 36 could be improved so that it provided an easy to follow step by step guide to performing an impairment test (include main requirements in bold type; reduce number of paragraphs in the standard itself by moving the guidance into an appendix; separate guidance dealing with individual assets, CGUs and goodwill; and present the provisions of the timing of the impairment review to appear earlier). In addition more practical application guidance should be included. For example, guidance should be included on where to obtain external information that could assist when making assumptions; on how to put together an analysis of events in the intervening period and guidance on how long an intervening period could be; on the period of cash flows to be included in the assessment; and on the application of a terminal factor.

Two respondents thought that the auditability could be enhanced by training of preparers and auditors, increasing the involvement of experts in the impairment testing when estimating future cash flows (including the choice of a particular valuation technique) and determining the discount rate to be used in the valuation. Willingness to invest in IT and relevant research and development was considered by one respondent. Requiring an entity to document assumptions that would be used in impairment testing (for example, assumptions used in estimating future cash flows) at initial recognition of goodwill, and to establish the internal control thereon, such that the impairment testing would be carried out using consistent assumptions was considered by another.

Two respondents considered that the method to improve auditability was to change the requirements and relying less on impairment tests by also requiring goodwill to be amortised and specifying the consumption pattern.

Some respondents consider that the auditability could be enhanced by requiring more disclosures. The disclosures suggested were:

- A comparison or reconciliation of assumptions with parameters verifiable in the market. Differences with market parameters should be explained together with the reason why the impairment test was still considered to be reliable.
- Comparison of assumptions versus what actually occurred in a

later period.

- Comparisons of and explanation of differences between the management's assumptions about the future and economists' predictions.

- Sensitivity analyses showing how net income and shareholder equity would be affected under various scenarios using a range of discount rates.

- Information about how assets/business segments were linked with EBITDA.

- A justification for not recognising any impairment losses when there were indications of impairment.

Finally, a respondent considered that the work that should be carried out by the auditor in relation to the goodwill impairment test should only be a reasonability test.

Studies on goodwill measurement – responses to part 5

The last part of the questionnaire was directed to academics and asked for references to studies on the value relevance of the goodwill impairment and on the accounting for goodwill. Some respondents provided some references.

Participants

48 respondents participated in the survey. The list of participants included:

- Autorité des normes comptables (ANC)
- Garth Coppin
- Andreas Gaar (TUV SUD)
- Christian Grob
- Colin Haslam (Queen Mary University of London)
- Bart van der Heijden (Govers Accountants)
- Robert Keys (AASB staff)
- Peter Malmqvist (Malmqvist EQR)
- Roberto Mannozzi (Ferrovie dello Stato)
- Sven-Arne Nillson (Liu)
- Julie Norman (Baker Tilly)
- Nicolas de Paillerets
- Alberto Quagli (Università de Genova)
- Franco Riccomagno (ASSIREVI)
- Tomo Sekiguchi (ASBJ)
- Isabel Castelao Silva (Comissão de Normalização Contabilística (CNC))
- Charistan Steiner (Linde Group)
- Chris Innes Wilson (Standard Chartered Bank)
- Elissa Yeoh (Ambank (M) Berhad)

29 respondents wanted to remain anonymous.