Goodwill – status of the debate

Objective

1 The aim of this paper is to present recent evidences collected by the EFRAG Secretariat related to goodwill and how to account for goodwill.

2 This paper will thus summarise the information retrieved from:

(a) Academic studies;

(b) Recent discussion papers of the International Valuation Standards Council (IVSC);

(c) Recent evidence related to the discussion about amortisation of goodwill.

Academic studies

3 Members of the EFRAG Academic Panel and members of the EFRAG Academic Network have identified some relevant academic studies and literature reviews related to goodwill accounting. In addition, a member of the academic panel prepared for the October 2019 meeting of the Academic Panel a short literature review on goodwill amortisation versus goodwill impairment. This literature[1] provides some evidence that:

(a) A high proportion of the cost of acquisitions are allocated to goodwill, despite the IFRS (or, for the studies conducted on US data, the US GAAP) rules for the recognition of acquired intangible assets. 48.9% for 632 transactions by European companies using IFRS between 2005 and 2008, but larger for some industries. (US 2010[2], US 2011, EU 2010, EU 2011). Some studies find that the proportion of the cost of acquisitions that companies allocate to goodwill is correlated with the 'bonus intensity' of the CEO's remuneration. (US 2011, EU 2012). One study finds that when the likelihood of future impairments is low a higher portion of the costs of acquisition is allocated to goodwill. Other studies indicate that the age of the CEO and bonuses affect the amount allocated to goodwill (US 2011, 2017). One study indicates that companies that have a greater tendency to identify intangible assets also are companies with more relevant financial statements overall. However, the relevance for the financial statement user does not increase by separating intangible assets from goodwill (Swe 2012).

(b) Most companies allocate goodwill on the level of their segment reporting format (i.e. to the highest level allowed under IAS 36 *Impairment of Assets*),

[1] The literature summarised is listed in the section 'References' at the end of this section.

[2] The references indicate the jurisdictions from which data was collected and the year of the publication of the study – which can be several years after the period from which data was collected.

and goodwill often appears (based on studies on entities voluntary disclosures or surveys) to be concentrated in only relatively few CGUs. (EU 2007, EU 2009, EU 2011, US 2011).

(c) Generally, investors consider that goodwill is linked to future economic benefits (/ goodwill is an asset) (US 1995, US 1996, US 2000, International 1993, International 1996, EU 2009, US 2008, UK 2009, US 2011, US 2012, 2014). There is also evidence that lenders believe goodwill is informative and provides an efficient means of limiting agency costs (US 2008). A study, however, shows that recognising goodwill does not force better acquisition decisions (UK 2016). Another study indicates that 'older goodwill' does not have information content (Aus 2006).

(d) Goodwill charges have decreased markedly after the introduction of the impairment-only approach (resulting in goodwill constituting a higher proportion of total assets) (AUS 2010, SWE 2011, US 2017). Some studies have showed that impairment loss reporting is less strongly/not only associated with economic factors and more strongly associated with "big bath" accounting, income smoothing or other non-economic factors such as the tenure of the CEO or analyst coverage (US 1988, US 1992, US 1996, US 2004, Swe 2011, UK 2011, EU 2009, US 2012, US 2017, 2019). Some studies have thus showed that entities are more likely to impair goodwill when earnings are unexpectedly high or unexpectedly low. In addition, some studies show that companies are less likely to write off goodwill if they face binding debt covenants (US 2012). The setting of the growth-rate is often used to avoid or reduce goodwill impairment (2015). However, not all studies have confirmed that goodwill impairments are used opportunistically (EU 2013). Evidence has thus also been found that US firms record impairments (generally – not specifically goodwill impairments) in a timely fashion to disclose private information in order to show their commitment to a conditionally conservative reporting strategy (US 2018).

(e) Entities located in countries with stronger enforcement structures are more likely to report impairment losses than entities domiciled in countries with weaker structure (EU 2009). One study suggests that when a country's enforcement regime is relatively week, private monitoring through institutional investors can substitute for public enforcement (US 2018).

(f) Credits to goodwill are not only resulting from impairments but are also due to disposals. One study has found that disposals account for 20 percent of all credits to goodwill and decreases in goodwill by means of disposals were correlated with goodwill impairments and poor performance of entities (UK 2018).

(g) The value relevance of goodwill has increased after the introduction of the impairment-only approach (US 2007, AUS 2008, Portugal 2010, UK 2010, EU 2010, US 2011). However, in many studies the alternative to the impairment-only approach was not just an amortisation model, but an amortisation model and a pooling-of-interest accounting model.

(h) Goodwill impairment announcements generally seems to provide new information to investors (US 2002, US 2006, US 2011, US 2012, EU 2012, 2016) (however, there are some studies that do not show this effect (SWE 2014)). The reaction depends on the level of legal protection (stronger reaction when legal protection is low - i.e. investors account for higher management discretion and management incentives) (EU 2012). However, in some studies, the short-term effect on the entity's market price seems to be modest. Although goodwill impairments provide new information, analyst earnings forecasts for firms that report goodwill impairment are less accurate and more dispersed than those for matched control firms (2015). Some studies also show that goodwill impairments are associated with lower future operating cash flows, lower sales growth and lower growth in operating income (US 2009, US 2011, 2016). However, there is also a study that shows that impairments are weakly associated with increases in earnings and cash flows in the next two years (US 2012).

(i) Goodwill impairment lag behind the economic impairment of goodwill (US 2008, US 2017) and are often too small. Investors anticipate the economic losses one to two years before the impairment announcements. A recent study (US 2017) finds evidence that after the implementation of the impairment-only approach in the US (and the elimination of periodic amortisation, along with the difficulty in verifying the fair value of goodwill) goodwill impairments have become relatively less timely. US entities may recognise impairments before European entities (EU US 2016). This could be due to the characteristics of the capital markets and different requirements for the impairment review. There is both evidence that the time lag is only present in low enforcement countries (2018) and that it also exists in high enforcement countries (US 2012, US 2016, AUS 2016).

(j) Overpricing of acquisitions is a root cause of impairments, although, as one study points out, stating that overpricing is a root cause of impairments may sound like ex post rationalisation as academic studies would have to determine this by means of proxies (US 2012). Overpricing tend, according to some studies, to be more frequent when the acquisition is paid for the acquirer's stocks. There is also some evidence that when the firm's stocks are overpriced, there is a strong and positive association with the intensity of corporate acquisitions and the growth of accounting goodwill (US 2011, US 2011). Other papers, however, do not find a relationship between the payment method and overpricing (EU 2005).

(k) When goodwill should be amortised under US GAAP over up to 40 years, the average amortisation period was around 30 years (US 1992, US 1993, US 2000, US 2003). The determined useful life might not always have reflected goodwill's economic useful life but might have been influenced by capital-markets related, contracting or political motives. For example, evidence has been found that entities with accounting-based bonus plans and high leverage tended to have longer amortisation periods than other entities (US 1993). One study has found that amortisation periods of 20 – 40 years results in amortisation expenses that are smaller than the decline in economic value perceived by investors (US AUS 1996).

(l) It is unclear whether goodwill amortisations are value relevant. According to some studies performed on US data it is (US 1996, US AUS UK 1996). However, one study shows that this is only the case for the part of goodwill that is not related to going concern and synergy components (2000). One explanation for this could be that these components are non-wasting assets. Another reason could be that the amortisation does not adequately reflect the depletion of economic value. Some studies have shown that goodwill amortisations are not relevant (2001, 2001, EU 2007, UK 2013) or less relevant than goodwill impairments. Some studies have considered whether amortisation or impairment better reflect the underlying economic attributes of goodwill. One study shows that impairment does by comparing the association between goodwill accounting charges against income and firms' economic investment opportunities (2011).

(m) Disclosures are (or at least, have been (as recent data may indicate that compliance levels are steadily increasing (Spain 2019)) incomplete, uninformative, erroneous or of limited use because they are difficult to compare. Non-compliance with disclosure requirements tend to be related to managerial and firm-level incentives and to the strength of national enforcement systems and country culture (EU 2018). The differences in the level of disclosures may have effects on information asymmetry, dispersion of analysts' forecast, analysts' forecast accuracy and the cost of capital. (EU 2008, US 2009, EU 2011, EU 2012, EU 2013, Fra 2015, EU 2017, Ital 2018, 2019).

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Discussion papers of the IVSC

4 The International Valuation Standards Council (IVSC) is considering in a series of three articles whether the principles underlying business valuations are compatible with the concept of goodwill amortisation. So far, the IVSC has published three articles.

5 In the first article, the IVSC is considering whether goodwill is a wasting asset. In the paper the IVSC concludes that goodwill in aggregate is not a wasting asset. The arguments provided are:

(a) The components of goodwill are generally non-wasting assets. According to the IVSC the components of goodwill are:

(i) Going Concern Goodwill (reputation (customer loyalty), future intangible value, workforce) which is, at least to a large extent indefinite in its nature;

(ii) Goodwill Created by the Acquisition (synergies and assemblage value (the concept that a collection of assets is worth more than the sum of the individual asset values) which is indefinite rather than wasting in nature.

(b) An analysis of how deals are priced and specific assumptions within deal models shows that if one were to assume the synergistic portion of goodwill was a wasting asset realised only over the discrete period, it would imply that either 1) market participants systematically overpay for businesses, or 2) that the capital asset pricing model (CAPM) systematically overestimates the cost of equity and resulting WACC.

(c) Empirical evidence shows that almost all impairments represent large irregular charges resulting from a discrete event or short series of discrete events, rather than smaller regular impairment charges that consistently occur over time.

(d) Notwithstanding the conclusion that goodwill is not a wasting asset, the paper discusses the useful life for amortisation, if one were to assume goodwill was a wasting asset.

6 In the second article, the IVSC considers the information value of the current impairment framework. The article reviews some academic articles that show that while in certain instances goodwill impairments are a leading indicator, impairments do not appear to consistently serve as a leading indicator of future cash flows and

returns. The article examines four potential reasons for the persistent timing lag in the disclosure of goodwill impairments:

(a) Impairment Shielding – Acquired goodwill can be shielded from impairment by unrecognised headroom of the legacy business that becomes part of the tested unit post acquisition. Internally generated headroom primarily consists of self-generated and unrecognised intangible assets and goodwill of the legacy business of the tested unit[3];

(b) Artificial Headroom – resulting from amortisation of [some] acquired intangible assets while new intangibles are not recognised on the balance sheet. The amortisation of intangible assets has a greater tendency to shield impairments as time passes, thus leading to decreased information value of the goodwill.

(c) Impairment Triggers – overly broad and outward looking. A review of the example triggers cited in accounting standards shows them to be overly broad and primarily focused on external market and industry conditions. In some cases, such as stock price, the triggers themselves are a lagging indicator.

(d) Behavioural Considerations – A reluctance to take impairment. Anecdotal evidence shows that goodwill impairment charges are often accompanied by a change in management, overall strategy and/or a decision to restructure or sell all or a part of an acquired business.

7 In a forthcoming article, the IVSC will explore practical solutions to enhance the current goodwill impairment framework.

Arguments related to amortisation of goodwill

8 Some recent evidence and arguments, *in addition* to those presented above, that have been collected and relate to whether or not goodwill should be amortised are presented below. In addition, the appendix includes some of the views provided by the big four accounting firms, user organisations and standard setters to the FASB's Invitation to Comment *Identifiable Intangible Assets and Subsequent Accounting for Goodwill* (the 'ItC'). Among other things, this ItC consult on whether goodwill should be amortised.

9 In the article *The Challenges of Accounting for Goodwill* (The CPA Journal 2019), the goodwill balances of S&P 500 companies are examined. The study finds that there would be a noticeable decline in companies' earnings and earnings-based financial ratios if amortisation of goodwill was reintroduced. The study focuses on two ratios, Return on assets (ROA) and Earnings per share (EPS). The study shows an average ROA decrease of 2.6% (from 6,2% to 3,6%) and EPS decrease of $1.20 per share (from $3.84 per share to $2.64 per share). Overall, a change in the accounting guidance that reintroduces amortisation as a part of the subsequent measurement of goodwill would result in the median S&P 500 company reporting a ROA that is 42% lower and an EPS that is 31% lower on an annual basis.

10 This study also provides a list of the S&P 500 companies with largest goodwill balances in relation to total assets going as high as to 61% for some companies providing technology related products. The more goodwill balances grow in the absence of the amortisation or impairment, the more sensitive the financial situation of the entity becomes. There could be situations where goodwill becomes higher than equity with an unpredictable impact on a financial stability in case of a financial crisis or similar events.

[3] This effect has also been recognised by both EFRAG and the IASB. The issue was thus mentioned and addressed in one of EFRAG's discussion papers, but the proposed solution received little support (see paragraph **Error! Reference source not found.** above). The IASB similarly developed the "headroom approach" which was also considered overly complex and not explored further by the IASB.

Appendix: Feedback to the FASB's ITC

1 The following table summarises the main views on amortisation versus impairment from the big audit firms, main users' organisations and standard setters to the FASB's ITC

Respondent	In favour of amortisation approach?	Arguments
KPMG	**The respondent supports an approach to accounting for goodwill that includes both amortisation and impairment testing if such an approach improves the cost-benefit equation.** If the FASB decides goodwill should be amortised, the respondent believes that an amortisation period based on the **weighted average life** of the identifiable assets acquired may be the most operable approach because it provides an objective measure primarily based on information an entity already needs to calculate. The respondent does not support an amortisation-only model because it believes that goodwill, like all other assets in GAAP, should be subject to an impairment test.	**Practical reason: cost-benefit equation** However, the respondent recommends considering the following issues: • A model with a long amortisation period may not meaningfully reduce the time and effort to perform the impairment test because the amortisation may not create enough headroom (i.e. difference between the carrying amount and fair value of a reporting unit). • A model based on management's best estimate of an amortisation period without a robust framework for determining that period would be inherently subjective and challenging to apply, which would add complexity. • A model with a default period for amortization may not provide useful information relevant to the transaction.

PWC	Historically, the respondent has believed that an impairment-only model, if properly designed, could be superior to amortisation of goodwill, but such a model has been elusive. **The respondent supports the FASB's consideration of a mandatory goodwill amortisation model** given that there is inherent complexity in the current accounting model for goodwill, including the identification of certain intangible assets separate from goodwill, the ability to discern value diminution, if any, and the ability to track goodwill once integrated.	In performing impairment testing, preparers often incur significant **costs** to determine the key assumptions inherent in the goodwill impairment model and to ensure that they have controls around the impairment process. However, certain stakeholders may see benefits to the current model. In particular, certain users may believe there is informational value in an impairment charge, especially when the charge reflects entity-specific factors rather than the impact of broader sector trends that are readily observable by market participants. These concerns are mitigated by financial statement disclosures, which may provide insights into any changes in strategy related to the affected business and MD&A disclosures, which may provide foreshadowing of impairments. Finally, some users may assert that the potential for an impairment serves as a mechanism to assess management's ability to achieve the objectives that underpinned the acquisition. There may be challenges in implementing an amortisation model. For example, if companies are allowed to use a life other than a default period, the inability to specifically identify the components of goodwill may make justifying a reasonable estimate of a useful life too difficult. The respondent considered the various amortisation period proposed by the FASB for the appropriate goodwill amortisation period and supported a default period. Subject to feedback received through the ItC process and any additional outreach and analysis, a cap on amortisation period (potentially coupled with a floor), and justification of an alternative amortisation period other than a default period may also have merit.

Deloitte	The respondents support the FASB's consideration of further changes to the current impairment-only model to achieve additional simplification, **including the amortisation of goodwill**. A final determination should take into account the conceptual merits as well as the costs and benefits of both approaches and should be performed in conjunction with an assessment of relevance and faithful representation. We believe that the amortisation period should reflect the costs and benefits of the different characteristics. **For example, a default period would cost the least since entities would not need to apply judgment in determining it**. The cost of using alternative periods that might vary among preparers would need to be evaluated relative to the benefits that such differing periods would provide to users.	**Practical reasons: cost-benefits analysis** The respondent believes that additional input from users and preparers about the costs and benefits of the impairment-only model and the amortisation model will be useful in the evaluation of alternative approaches. If the FASB pursues the retention of an impairment-only model, the respondent believes that it should consider additional amendments to reduce the burdens associated with the test. When determining the test's unit of account, the FASB could consider levels between the reporting unit and the entity level, such as the reportable or operating-segment level.
EY	**The respondent supports adopting an accounting model that would require goodwill amortisation over a default period and only require goodwill impairment testing if there is a triggering event.**	The basis for this support is because **acquired goodwill diminishes in value over time and the costs of the current model outweigh the benefits.** The respondent does not believe the current annual goodwill impairment test provides information that would enable users of the financial statements to assess how an acquired business is performing relative to management's expectations. In recommending that the FASB reduces the complexity of the subsequent accounting for goodwill, the respondent also considered the costs associated with performing an annual impairment test. This is often a complex and time-consuming exercise, and the respondent questions whether the benefits of providing information about the annual impairment of goodwill under today's guidance justify the costs. The respondent suggests requiring management to test goodwill for impairment if there is a triggering event.

ANC	From a general standpoint, ANC is in favour of a stable accounting platform if no new and substantial issues are at stake. As regards goodwill and its evaluation, ANC observes that it is not considered that the current model is broken and therefore **ANC is not in favour of amending again accounting standards by reintroducing goodwill amortisation.**	From a relevance perspective, **there is neither compelling conceptual evidence for or against goodwill amortisation, nor clear-cut argument regarding the cost/benefit analysis**. In addition, ANC notes that the introduction of amortisation would not remove the potential need for impairment, in particular in the period immediately following an acquisition which is the most critical and sensitive. Allowing alternative accounting treatments for the same accounting phenomenon, such as amortisation or impairment for goodwill evaluation, might introduce a risk on comparability. From a preparer's or user's point of view, many consider that the annual impairment test is a relevant exercise that is generally useful not only for proper accounting and financial information purposes, but also for management purposes.
CFA	**CFA worries that implementing amortisation rewards poor or untimely impairment testing and will reduce the behavioural benefits of impairment testing and disguise the failure to monitor the performance of acquisitions**. Overall, moving to amortisation – especially without impairment – is more than simply an exercise in cost efficiency. It has the effect of eliminating the key forward-looking assessment of the prospects of a business and the forward-looking value of a key asset. In CFA's view, if there were to be amortisation, the amortisation period would need to reflect the period over which the cash flows were estimated to be realised at deal acquisition and this period would be updated based upon performance of the deal. Such amortisation period would need to be disclosed as such disclosure has information content to investors. The information content of such a disclosure is that it conveys	**The consequence will be an even greater use of non-GAAP measures and the need for every investor to adjust earnings to remove the amortisation each quarter.** A CFA's research demonstrates how US GAAP and IFRS will be less relevant each quarter with amortisation. It is essential the FASB highlight that both amortization and impairment are added back because investors are attempting to normalise cash flow projections – not because the information content in impairment and amortization are equivalent. Amortisation does not facilitate an investors ability to differentiate between good and bad acquisitions and good and bad managers.

	management's expectation and in that way is far more useful than a default period that has no meaning. If a default period is considered, the CFA believes that the FASB should consider immediate write-off of goodwill as doing so will eliminate the need to adjust earnings in each future period to remove goodwill amortisation.	
ASBJ	ASBJ believes that acquired goodwill is an asset whose value deteriorates. ASBJ also believes that acquired goodwill is a cost that would be expensed corresponding to the effects of excess earning power that are expected to crystalize after the business combination. Accordingly, ASBJ believes that **acquired goodwill should be amortised** over a certain period to provide relevant information about the entity's performance after the business combination. If acquired goodwill were to be amortized, we believe that the amortisation period should be based on **management's estimates, with a maximum period of 10 years.**	**Goodwill is a wasting asset and is a cost that would be expensed corresponding to the effects of excess earning power that are expected to crystalize after the business combination**
AICPA	The respondent supports **goodwill amortisation with trigger-based impairment testing.**	It does not appear that the current impairment model is providing decision-useful information to users of financial statements. It also appears that an amortisation model would provide questionable benefit to the users of financial statements. As such, the respondent believes **simplification and cost reduction is the best path forward**. Therefore, the respondent believes a simple approach to determine an amortisation model is most appropriate including the default 10-year amortization period with trigger-based impairment and the option to test impairment at the entity level.

DUFF & PHELPS	The respondent **opposes the idea of reintroducing goodwill amortisation.** Goodwill is not a wasting asset. From a measurement perspective, the expectation of ongoing value is evidenced in the terminal (continuing) value calculation. There is generally no limit to the period over which cash flows are projected; the essence of a terminal value calculation is that it captures the present value of cash flows grown into perpetuity. The economic benefit pattern of these cash flows is one of continuous growth.	Reasons: • Losing of information through goodwill amortisation versus impairment. • Significant costs have already been taken out of the system while keeping the signalling effect of a goodwill impairment (by first introducing Step 0, and then eliminating Step 2 of the goodwill impairment test). • The current goodwill impairment only model is more suited to providing users with information helpful to their capital allocation decisions. In this regard, the respondent refers to the Basis for Conclusions of the relevant US GAAP requirements stating that "*not only do many users of financial statements ignore goodwill amortization expense in making investment and credit decisions, entities often do not consider goodwill amortization expense in evaluating the performance of management.*" • A potential lack of comparability with IFRS, if a goodwill amortisation model is reinstituted in US GAAP, is counterproductive in globalized capital markets. • FASB has performed a significant amount of work in the area of accounting for goodwill and identifiable intangibles in the not-so-distant past. • While the current impairment-only model should be retained, the respondent thinks that FASB should consider certain simplifications of this model.