Goodwill – previous findings

Objective

1 The aim of this paper is to present evidence previously considered by EFRAG in relation to goodwill.

2 This paper will thus summarise the information retrieved from previous consultations and papers of EFRAG in the area and other information collected on goodwill amortisation.

Previous consultations of EFRAG

3 Previous studies and discussion papers performed by EFRAG in relation to goodwill include:

(a) *Goodwill impairment and amortisation – questionnaire* issued in 2012. The study was performed in cooperation with the OIC. The results of this questionnaire showed:

(i) Respondents had different views on what goodwill normally consists of.

(ii) Some of the respondents did not use the information on goodwill presented in financial statements whereas others did. 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.

(iii) Respondents, using the goodwill information, used the goodwill figure differently in their analysis depending on what they thought goodwill included.

(iv) 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.

(v) 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.

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

- 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.

(vii) 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.

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

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

(x) Some respondents thought that under the current requirements, internally generated goodwill is recognised and that this is inconsistent with IAS 38.

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

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

(xiii) The questionnaire considered the effects of goodwill impairments in time of financial crises. Different views were presented in relation to effects of goodwill impairments through the economic cycle. Some thought that effect on the macro economy should not be considered when developing accounting standards. 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.

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

(xv) Respondents had different 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.

(xvi) 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;
- clarifying the requirements.

(xvii) 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'.

(xviii) Some respondents did not think the requirements should be changed as the information was valuable for users.

(b) EFRAG, OIC and ASBJ Discussion Paper (the 'DP') *Should Goodwill still not be amortised? – Accounting and Disclosure for Goodwill* issued in 2014. This DP concluded that reintroduction of goodwill amortisation would be appropriate, because it reasonably reflects the consumption of the economic resource acquired in the business combination over time, and can be applied in a way that achieves an adequate level of verifiability and reliability. In addition, the DP concluded that further improvement should also be considered in the area of disclosure requirements.

Most respondents agreed with the main conclusion of the DP that the impairment-only model for acquired goodwill did not provide the most appropriate solution for subsequent measurement of goodwill. These respondents agreed with the preliminary views of the DP that amortisation of goodwill should be reintroduced, but also pointed out that there are areas for improvement in the impairment testing. In commenting on this matter, they referred to various reasons including the fact that amortisation would reasonably reflect the consumption of the economic resources acquired in the business combination and allocate the costs of acquired goodwill to the periods it was consumed. Nonetheless, these respondents provided mixed views on whether the IASB should indicate a maximum amortisation period. Some respondents acknowledged the subjectivity and high level of judgement in determining the useful life of goodwill. However, they believed that the level of subjectivity and judgement was not higher than that in the impairment test. In general, respondents who supported the amortisation of goodwill considered that the IASB should develop guidance to help preparers determining the useful life of the acquired goodwill. In contrast, a minority of respondents, mostly users, were supportive of the current impairment-only approach. These respondents explained that the amortisation model was fairly meaningless and it would not be beneficial to users of financial statements. Improvements to the guidance and disclosures in IAS 36 *Impairment of Assets*

Many respondents considered that the impairment-only approach was a challenge in practice and that there was room to improve the guidance in IAS 36. These respondents identified a number of difficulties related to the current approach and provided some suggestions on what should be improved. When questioned about whether there was a need to improve disclosure requirements on impairment tests, respondents provided mixed views. Some considered that there was room for improvement, while others did not. Nonetheless, respondents emphasised that any additional disclosure requirements should be considered in the context of overall amount of disclosure requirements, which are already considered extensive. In addition, many respondents highlighted that the relevance of impairment testing for goodwill, and consequently the need for improved guidance and disclosures, would significantly decrease if the IASB reintroduced amortisation.

Many respondents considered that, if the IASB reintroduced amortisation of acquired goodwill, it should require the same for virtually all intangible assets (including those with indefinite useful lives). They also suggested that the IASB reconsider the requirement to recognise separately intangible assets in business combinations, especially when the IASB decides to reintroduce the requirement regarding amortisation of acquired goodwill.

(c) The quantitative study *What do we really know about goodwill and impairment?* issued in 2016. The study presented an analysis of a sample of 328 European companies. The data showed that:

(i) From 2005 to 2014 the total amount of goodwill recognised increased from 935 billion euros to 1.341 billion euros, with an increase of 43%;

(ii) A small number of companies account for a large share of the carrying amount of goodwill. The level of concentration has been decreasing slightly over time;

(iii) The goodwill to total assets ratio has remained fairly stable over the years at approximately 3,7%. The ratio is significantly higher when entities in Financials industry are excluded from the total. The ratio excluding Financials decreased gradually from 19,5% in 2009 to 16,6% in 2014;

(iv) The goodwill to net assets (or equity) ratio has been decreasing since 2008, but it was still significant in 2014 (29%);

(v) The amount of impairment losses recognised was at the highest level in 2008 and 2011, years when the performance of the financial markets was negative. On average, impairment losses represented 2,7% of the opening balance of goodwill. Although in 2012 the financial markets were already showing signs of recovery, the level of impairments in 2012 were similar to 2008;

(vi) Impairment losses were significantly concentrated in a small number of companies, particularly in the telecommunications and financials industries;

(vii) Absolute and relative levels of goodwill and impairment losses vary significantly across industries. The carrying amount of goodwill increased for most industries but decreased for telecommunication services. The ratios goodwill over total assets and goodwill over net assets also vary across industries, with telecommunication services and consumer staples being the leaders. The industries with the bigger impairment charges are telecommunication services, financials and materials.

Goodwill – previous findings

4 The EFRAG Discussion Paper [*Goodwill Impairment Test: Can It Be Improved?*] issued in 2017. The suggestions included in the paper and constituents' responses are summaries below.

(a) The paper suggested additional guidance on the allocation of goodwill to CGUs (e.g. allocation based on the pre- and post-acquisition fair value of each CGU (or group of CGUs) that is expected to benefit from the acquisition). Respondents provided mixed views on this suggestion. Some would welcome additional guidance as it would bring more direction and discipline to preparers on how to allocate goodwill. However, others considered that IAS 36 already allowed entities to use its judgement to determine an appropriate method to allocate goodwill to the CGUs and that EFRAG's proposals seem to be a rule-based and driven by anti-abuse concerns. Still, some suggested that the allocation methods proposed in the paper could become part of the illustrative and non-mandatory guidance accompanying IAS 36.

(b) The paper proposed additional disclosure of information on composition of goodwill (i.e. information (in amounts) about which acquisitions the total amount of goodwill is related to). Many respondents did not support additional disclosures as it would be difficult and onerous to track and assess each individual component of goodwill over time.

(c) The paper proposed to introduce a 'Step Zero' in the impairment test (a qualitative assessment of the likelihood of an impairment loss). The majority of the respondents generally welcomed the introduction of the Step Zero as the requirements in IAS 36 for the calculation of the recoverable amount are complex, costly and have to be performed at least annually even if there is no indication of an impairment and the CGU has a significant headroom. Those that disagreed with the Step Zero were mainly concerned that it would not significantly reduce the operational costs while likely delaying the recognition of goodwill impairments.

(d) The paper suggested a single calculation approach: fair value less costs of disposal ('FVLCD') or Value in Use ('VIU'). The majority of the respondents that replied to this question did not support the introduction of a single method for determining the recoverable amount as it would not result in a significant simplification (entities are not currently required to calculate both VIU and fair value less cost of disposal ('FVLCD')) and that both VIU and FVLCD were considered relevant for the calculation of the recoverable amount. Nonetheless, many respondents considered that the VIU was the most appropriate method to calculate the recoverable amount and considered that the VIU should be retained if a single method was to be introduced.

(e) The paper proposed to allow consideration of cash flows from future restructurings when testing for impairment. Most of the respondents supported EFRAG's suggestion as it would take into consideration management's views of the business and simplify the impairment test (it would allow entities to use directly their budgets and forecasts, which are likely to include the impact of future restructurings without making artificial adjustments to remove them). Nonetheless, a number of respondents called for some level of safeguard. For example, future restructurings would have to be approved by management and this should be a requirement.

(f) The paper proposed to allow the use of a post-tax rate when testing for impairment. Almost all respondents supported allowing the use of a post-tax rate since entities often conduct the impairment tests on a post-tax basis with an additional iteration simply to derive a pre-tax discount rate. Therefore, the introduction of a choice would simplify the calculation of the VIU and reduce costs.

(g) Finally, the paper proposed to deduct an accretion amount from the recoverable amount of a CGU for the purpose of the impairment test. The accretion amount would be calculated as the carrying amount of goodwill multiplied by an accretion rate (e.g. the discount rate used for the impairment test). In general, respondents acknowledged that the basic assumption underlying the goodwill accretion approach and its objective. However, the majority of the respondents did not support EFRAG's goodwill accretion approach as it would add complexity and subjectivity to the goodwill impairment model. In addition, respondents argued that if acquired goodwill is an asset that is being consumed and decreasing over time, then the discussion should be focused on the reintroduction of goodwill amortisation, which is a simpler approach. Nonetheless, two users' representative associations considered that the goodwill accretion approach could be a reasonable compromise to solve the issues related to internally generated goodwill and timeliness of impairments.

Arguments related to amortisation of goodwill

5 Some 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.

6 Arguments in favour of goodwill amortisation include:

(a) Goodwill is a wasting asset because, in many cases, the excess earning power (which is, according to the paper, essentially the 'core-goodwill') is presumed to decrease over time through competition with others. The acquired goodwill is an asset that is consumed and replaced with internally generated goodwill over time. Unless acquired goodwill is amortised over subsequent periods, it would not be possible to reflect the economics related to the acquisition transaction in the financial statements, because financial statements would fail to reflect the matching relationship between costs and incomes in subsequent period. Amortisation would thus reflect the consumption of goodwill over time. The fact that the useful life of acquire goodwill or the pattern by which goodwill diminishes cannot be predicted with accuracy is not a valid argument against amortisation as the same argument could then also be applied to property, plant and equipment, for which depreciation is required. In addition, although the amortisation charge may only be an approximate estimate of the actual decrease in acquired goodwill during the period, users can be expected to understand the limitations of the amount if it is presented separately in the income statement. (View presented in the Discussion Paper *Should Goodwill still not be amortised? – Accounting and Disclosure for Goodwill* (see paragraph 3(b) above). In addition, at its meeting in November 2018 EFRAG TEG and EFRAG CFSS expressed broad support for the IASB to consult on the reintroduction of amortisation of goodwill and to explore ways to determine an amortisation period that could reflect the consumption of economics benefits arising from acquired goodwill).

(b) Amortisation can be applied in a way that achieves an adequate level of verifiability and reliability. (View presented in the Discussion Paper *Should Goodwill still not be amortised? – Accounting and Disclosure for Goodwill* (see paragraph 3(b) above)).

(c) Amortisation of goodwill would also be consistent with the treatment of other intangible and tangible assets (reason provided by respondents in response to the Discussion Paper *Should Goodwill still not be amortised? – Accounting and Disclosure for Goodwill* (see paragraph 3(b) above).

(d) A goodwill amortisation-only approach would reduce the costs and complexity of performing impairment tests, and it would be useful from a practical point of view. For example, the amortisation over an arbitrary period (5-10 years) would be relatively easy to perform (View presented at November 2019 TEG meeting and at the October 2019 meeting of the EFRAG Academic Panel).

(e) Although amortisation of goodwill would not reflect a decline in value of goodwill, it could match the cost of the acquisition with the related benefits. (Response to the Discussion Paper *Should Goodwill still not be amortised? – Accounting and Disclosure for Goodwill* (see paragraph 3(b) above) and view presented at the October 2019 meeting of the EFRAG Academic Panel).

(f) The measurement of recoverable amount is often highly sensitive to unverifiable assumptions about the terminal growth rate. (View presented at the March 2017 meeting of the IASB Global Preparers Forum).

(g) The impairment testing methodology could be 'gamed' by manipulating the recoverable amount, and consequently the timing of recognition of impairment loss. (View presented at the March 2017 meeting of the IASB Global Preparers Forum).

(h) Amortisation of goodwill would better reflect the economics in some situations. (View presented at the March 2017 meeting of the IASB Global Preparers Forum).

(i) Goodwill impairment charges (or lack thereof) appear to be misunderstood by certain investors (for example some investors assert that the presence of a goodwill impairment is a sign of a poor capital allocation decision). (FASB Invitation to Comment *Identifiable Intangible Assets and Subsequent Accounting for Goodwill*).

(j) Amortisation of goodwill could reduce volatility and management discretion. (Response to the Discussion Paper *Should goodwill still not be amortised? – Accounting and Disclosure for Goodwill* (see paragraph 3(b) above).

(k) Entities would no longer have an incentive not to allocate consideration to other intangible assets subject to amortisation. (Response to the Discussion Paper *Should goodwill still not be amortised? – Accounting and Disclosure for Goodwill* (see paragraph 3(b) above).

7 Arguments against goodwill amortisation include:

(a) It can pre-empt impairment losses and mislabelling them as consumption. (Argument provided in IASB staff paper for IASB meeting).

(b) Amortisation is arbitrary. (Argument presented at the October 2019 Academic Panel meeting).

(c) Nearly all acquisitions are based on the intention to continue the acquired activities for an indefinite period. (Response to the Discussion Paper *Should Goodwill still not be amortised? – Accounting and Disclosure for Goodwill* (see paragraph 3(b) above).

(d) According to the enquiries by the IVSC goodwill is to its majority part not a wasting asset (see above) and therefore there is no reliable and consistent basis for the determination of an amortisation period. Such approach does not go together with deal economics.

(e) An amortisation model without an additional impairment test would be odd. It would therefore be necessary to supplement it by an impairment test which would mean that amortisation would not be less costly than the impairment model. (View presented at December 2019 EFRAG Board meeting).

(f) Research indicates that users often ignored the goodwill amortisation amounts and added them back to profit to derive an "Earnings Before Goodwill" ('EBG'). This practice was so common that EBG was a standard field used by the consensus collators such as ThomsonReuters. (Response to the Discussion Paper *Should Goodwill still not be amortised? – Accounting and Disclosure for Goodwill* (see paragraph 3(b) above).

(g) Some users have stated that although amortising goodwill is practical, it may eliminate decision-useful information, lead to complexity and/or inconsistency in application, or not properly capture the time period in which synergies related to the acquisition have been realised, depending on the amortisation period allowed and how that is determined. (FASB paper for roundtable on 15 November 2019).