Summary of papers on goodwill for the April 2020 ASAF meeting
Issues Paper

Objective

1 The objective of this papers is to provide EFRAG TEG and CFSS members with a summary of the papers and presentations provided for the April 2020 ASAF meeting. This includes:

(a) The IASB presentation *Discussion Paper: Business Combinations – Disclosures, Goodwill and Impairment*;

(b) The research paper *Goodwill: Improvements to Subsequent Accounting and an Update of the Qualitative Study* from the staffs of HKICPA and ASBJ;

(c) The FASB presentation *Identifiable Intangible Assets and Subsequent Accounting for Goodwill - Comment Letter and Roundtable General Feedback.*

2 In addition to the papers above, members will receive a presentation by Member of the EFRAG Academic Panel, Professor Thorsten Sellhorn on academic literature on goodwill. Any presentation will be made available as agenda paper 06-02 and any additional material as agenda paper 06-06.

The IASB presentation Discussion Paper (‘DP’): Business Combination – Disclosures, Goodwill and Impairment

3 The purpose of the presentation is to receive ASAF members input on:

(a) Whether any clarifications are needed on the contents of the DP;

(b) Suggestions on outreach activities for the project;

(c) Suggestions on the fieldwork approach;

(d) Any other comments.

4 The purpose of the session is not to obtain views on the technical positions that EFRAG will include in its Draft Comment Letter, as the focus will be to provide input to EFRAG Secretariat on the specific questions that the IASB is asking to ASAF members, which relate to process and not content.

5 The objective of the IASB’s project is to improve the information companies provide to investors, at reasonable cost, about the business those companies acquire.

6 The IASB decided to develop the following project objectives:

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

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

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

7 In the DP, the IASB is mainly seeking comments on:

(a) usefulness and feasibility of its new disclosure structure and content (Objective A); and

(b) any new evidence or new arguments on how goodwill should be accounted for in subsequent periods (Objective B).

Improving disclosures about acquisitions

8 The IASB has tentatively decided to require companies to disclose:

(a) managements' objectives for acquisitions in the year of acquisition;

(b) how acquisitions have performed against those objectives in subsequent periods.

9 The information about managements' objectives for acquisitions in the year of the acquisition would include:

(a) Strategic rationale for the acquisition;

(b) Objectives of the acquisition;

(c) Metrics for monitoring achievement of objectives.

10 After the acquisition date information should be provided on the performance against the objectives (see slides 11-14 of agenda paper 06-10 provided for this session).

11 Entities should disclose information the management (the chief operating decision maker (CODM) - as defined by IFRS 8 *Operating Segments*) uses internally to monitor acquisitions. Entities would thus not need to create information solely for external reporting purposes. But information would be given whether there is monitoring.

12 Disclosures on how acquisitions have performed against the objectives in the subsequent periods should only be required for as long as it is monitored, however, if monitoring ceases within two years, this should be mentioned (if monitoring ceases after two years it would not be required to mention this). If CODM does not monitor the acquisition, entities should disclose that fact and reason why.

13 Some specific disclosure would be required on:

(a) the amount, or range, of synergies expected from the acquisition;

(b) the amount of defined benefit pension liabilities and debt of the acquiree; and

(c) both actual and pro-form revenue, operating profit and cash flows from operating activities.

14 During the consultation period of the DP, the IASB plans to carry out the following activities related to the proposed disclosure requirements:

(a) Field test with 15 to 20 entities with diverse geographic and industry backgrounds. The purpose would be to help the IASB to understand:

(i) feasibility of preliminary view;

   (ii) usefulness of information;

   (iii) how management monitors acquisitions (or not);

   (iv) specific issues encountered during preparation.

(b) Volunteers preparing mock (simulated) disclosures based on actual acquisition. Follow up via Video Conference Call ('VC') or face to face meeting to discuss mock disclosure follow up questions could include:

   (i) How readily available was the information?

   (ii) Why was the CODM monitoring this acquisition?

   (iii) How did the CODM receive the information?

   (iv) Has there been any changes in the information used?

   (v) Are any of the metrics used based on combined business?

   (vi) Was any supplementary information needed?

   (vii) Is any of the information commercially sensitive?

(c) Sensitivity field test to address concerns on commercial sensitivity.

Improving accounting for goodwill

15 Having preliminary concluded that the impairment test cannot be made more effective at reasonable cost and that the shielding effect cannot be eliminated (because goodwill has to be tested for impairment with other assets) the IASB has tentatively decided:

(a) Not to reintroduce goodwill amortisation and to retain the impairment-only model.

(b) To remove the requirement to test CGU containing goodwill for impairment at least annually. Entities must still assess if there is any indicator of impairment and perform the test if there is.

(c) To simplify how value in use is estimated:

   (i) allowing the inclusion of future enhancements in the estimation of future cash flows in the calculation of value in use; and

   (ii) removing the explicit requirement to use pre-tax inputs and pre-tax discount rate to calculate value in use.

16 The IASB noted that if estimates of cash flows are too optimistic, this is best addressed by auditors and regulators, not by changing IFRS Standards.

17 The IASB's preliminary view is that it should retain the impairment-only approach because there is no compelling evidence that amortisation would significantly improve financial reporting. However, stakeholders are invited to provide new arguments to help the IASB how to move forward. In that sense, the Accounting Standards Board of Japan ('ASBJ') and Hong Kong Institute of Certified Public Accounts ('HKICPA') have prepared a research and have identified arguments in favour for reintroducing amortisation (See following section).

Other topics:

18 The IASB has tentatively decided to require entities to present on their balance sheets the amount of total equity excluding goodwill. In addition, the IASB has decided not to change the range of intangibles assets recognised in a business combination.

Stakeholders outreach and project fieldwork.

19 The IASB plans to set-up roundtables in various jurisdictions for all stakeholders and focused investors outreach activities to seek stakeholder's views on the DP.

Questions for EFRAG TEG/CFSS [these questions appear in the presentation from the IASB staff]

20 Does EFRAG TEG/CFSS have:

(a) Any clarifications or questions on the content of the Discussion Paper?

(b) Any suggestions on outreach activities for the project?

(c) Any suggestions on the fieldwork approach?

(d) Any other comments?

Goodwill: Improvements to Subsequent Accounting and an Update of the Quantitative Study - Accounting Standards Board of Japan ('ASBJ') and Hong Kong Institute of Certified Public Accounts ('HKICPA')

21 The paper *Goodwill: Improvements to Subsequent Accounting* is prepared by the staff of the HKICPA and the staff of the ASBJ. It includes:

(a) New findings from an update quantitative study based on work previously conducted by EFRAG and ASBJ[1].

(b) The views (an arguments for these) of the staff of the ASBJ and the staff of the HKICPA.

22 The paper analyses in detail quantitative evidences and develops the reasoning against and in favour of goodwill amortisation (see agenda paper 06-11).

Quantitative study

23 For the S&P Europe 350 index, the findings of the research, for example, show:

(a) 10.1% of the companies have recognised goodwill that exceed 100% of their net assets.

(b) Time to fully expense goodwill based on the impairment losses recognised from 2014 to 2018 would be 78 years.

(c) Total goodwill increased by 26% from 2014 to 2018.

Views of both the ASBJ staff and the HKICPA staff

24 The paper states: "We observe that, together with the increasing trend of the amount of acquired goodwill and the time to fully expense acquired goodwill, it is likely that the "too little, too late" issue exists with respect to the expensing of acquired goodwill under the existing impairment-only model."

25 Both the ASBJ Staff and the HKICPA Staff consider that acquired goodwill should be amortised over time on a systematic basis, and the CGU(s) to which acquired goodwill is attributed should be tested for impairment when there is an indication of impairment. They consider that acquired goodwill should be amortised using a single amortisation period for the entire acquired goodwill amount recognised for each business combination, rather than disaggregating acquired goodwill into components and using different amortisation periods for each component.

[1] In 2014, a Research Group of EFRAG, Organismo Italiano di Contabilità (OIC) and ASBJ issued a Discussion Paper to contribute to the debate: Should goodwill still not be amortised? Accounting and Disclosure for goodwill. In addition, in 2016 EFRAG published a study: What do we really know about goodwill and impairment? A quantitative study (A part of this study was carried out in collaboration with ASBJ)

26 However, the ASBJ staff and the HKICPA staff have different arguments for amortising goodwill and different views on the amortisation period.

ASBJ Staff arguments for amortising goodwill and views on the amortisation period.

27 The ASBJ Staff considers that goodwill is a wasting asset and financial statements need to reflect this value reduction. For example, the going concern element of goodwill, including the entity's reputation with customers would be replaced by updated reputation with customers. Similarly, the synergies element of goodwill is a wasting asset. If the synergies element is expected to generate excess returns, similar behaviours aiming to achieve such excess returns would be enhanced in the industry, and such excess returns would decrease over time assuming there is healthy competition. Impairment serves to signal the lack of recoverability of the carrying amount of acquired goodwill and amortisation signals the consumption of acquired goodwill. Both types of information are useful.

28 The ASBJ Staffs indicates that the amortisation period should be based on the period that management expects to generate incremental cash inflows arising from the acquisition with an established maximum period. However, a maximum amortisation period should be established by the standard setter to strike a balance between the provision of relevant information and the need to respond to the concerns over the "too little, too late" issue.

HKICPA Staff arguments for amortising goodwill and views on the amortisation period.

29 The HKICPA Staff considers acquired goodwill is a snapshot of "economic goodwill" (described as the difference between the fair value of an entity and the book value of its identifiable, recognised net assets) at the acquisition date. However, "economic goodwill" constantly changes over time. Accordingly, over time, the amount recognised as acquired goodwill becomes increasingly less reflective of the current fair value or current book value of the entity and hence more meaningless as a balance sheet item. Amortisation in combination with indicator-based impairment better reflects the nature of acquired goodwill. It provides a better opportunity to show how an acquisition is utilised ad it improves comparability between entities that grow organically and through acquisitions.

30 The HKICPA notes that after the acquisition if expectations are realised and the value of that acquisition is monetised, the cash flows associated with that acquisition will be accounted for as income that increases assets and equity. If acquired goodwill does not have an appropriate cost allocation method applied to it, the entity effectively starts double counting cash flows.

31 Finally, the HKICPA note that current goodwill accounting is pro-cyclical and research has found that nearly 70% of mergers have failed to achieve expected revenue synergies, and two thirds of acquisitions fail to create meaningful shareholder value. Increasing goodwill balances (see paragraphs 23(c) above) is therefore a problem.

32 In addition, the HKICPA indicates that amortisation ensures that increasingly large goodwill balances supported by the impairment-only model, which can contribute negatively to management incentives and misrepresent risks, will be allocated to expense on a timely basis.

33 The HKICPA Staff notes that the amortisation period should be determined in terms of the expected utilisation of an acquisition. This would benefit both management, as it will required to think critically about its post-acquisition plans before acquisition date, and users, as they will gain insight into management's expected timeline for an acquisition. There should be no mandatory maximum amortisation period, but there should be a rebuttable presumption that the amortisation period would not exceed a specified number of years (e.g. ten years).

Questions for EFRAG TEG/CFSS [these questions appear in the presentation from the HKICPA staff and the ASBJ staff]

34 What do EFRAG TEG/CFSS members think about the significant amounts of goodwill on entities' balance sheets?

(a) Is "too little, too late" a problem?

(b) Does this affect management incentives and/or misrepresent risks?

35 Does amortisation better reflect the nature of acquired goodwill and/or improve financial reporting? If yes, do EFRAG TEG/CFSS members agree in particular with any of arguments presented in the research paper prepared by the ASBJ Staff and the HKICPA Staff?

36 If acquired goodwill were to be amortised, how should the amortisation period be determined? What about the amortisation pattern? Should there be a maximum number of years or a rebuttable presumption?

Identifiable Intangible Assets and Subsequent Accounting for Goodwill - FASB

37 The FASB is also considering how to account for goodwill following the initial recognition. In July 2019 the FASB issued an Invitation to Comment (ItC) on Identifiable Intangible Assets and Subsequent Accounting for Goodwill.

38 The purpose of the FASB's presentation is to receive ASAF members input on public business entities on:

(a) the subsequent accounting for goodwill;

(b) the accounting for certain identifiable intangible assets;

(c) disclosures; and

(d) implications for comparability.

39 The FASB has received 101 comment letters from various stakeholders in response to its ItC. In addition, the FASB organised a public round table in November 2019 with several stakeholders. The input the FASB has received has been mixed. Some of the arguments for and against goodwill amortisation have been:

(a) A conceptual argument in favour of the current impairment only approach expressed by many valuators was that goodwill is not a wasting asset and that the going-concern element of a business is valued and projected into perpetuity.

(b) A practical argument in favour of the current impairment only approach expressed by some respondents was that the benefit of the impairment only approach outweigh the costs because processes and controls are currently working effectively. In addition, in the first few years post-acquisition, goodwill has essential information utility.

(c) A conceptual argument in favour of amortising goodwill was that it better reflects and entity's profit or loss after a business combination, net of the cost of investment. Other stakeholders state that goodwill is largely a wasting asset being carried on the books when cash flows may have already been realised.

(d) A practical argument in favour of amortisation expressed by some respondents is that the current impairment approach results in significant costs with limited information utility because goodwill is more often lagging and confirmatory. Old goodwill is not representative of the acquired goodwill.

40 Also, users presented mixed views whether a subsequent accounting change for goodwill is needed.

Questions for EFRAG TEG/CFSS

41 Does EFRAG TEG/CFSS have any comment on the feedback received by the FASB on its ItC?

Agenda Papers for this session

42 In addition to this paper, the following agenda papers are made available for the session:

(a) Agenda Paper 06-02 and any additional material as agenda paper 06-06. Presentation by Member of the EFRAG Academic Panel, Professor Thorsten Sellhorn on academic literature on goodwill.

(b) Agenda paper 06-05 – ASAF Paper 01C FASB ITC Comment letters and Feedback - April 2020 (overview of the feedback received by the FASB)– for background only.

(c) Agenda paper 06-10 – *ASAF Paper 01 Goodwill and impairment-April 2020* – (IASB's preliminary views to be included in the forthcoming DP) – for background only.

(d) Agenda paper 06-11 – *ASAF Paper 01A Goodwill HKICPA and ASBJ Research – Research paper* (joint paper on accounting for goodwill)– for background only.

(e) Agenda paper 06-12 - *ASAF Paper 01B Goodwill HKICPA and ASBJ Research – Presentation (slides) by Staff (*presentation of the above paper*)* - for background only.