September 2019

In brief

Better information about business combinations

Goodwill and Impairment: Project update

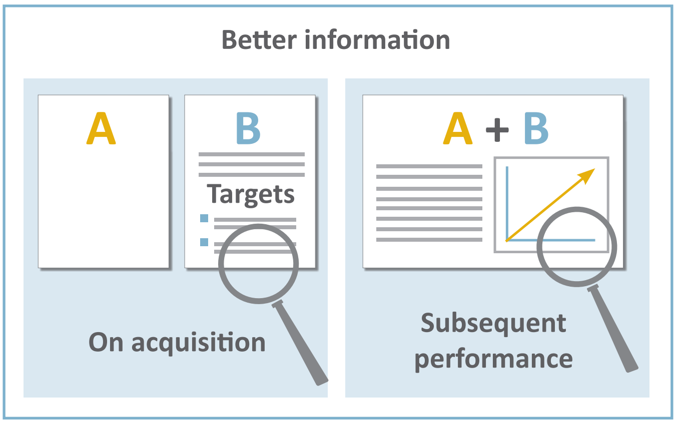
The International Accounting Standards Board (Board) is carrying out a research project on goodwill and impairment following its Post-implementation Review (PIR) of IFRS 3 *Business Combinations*.

The Board is investigating how companies can provide users of financial statements (users) with better information about mergers and acquisitions (business combinations) at a reasonable cost. This investigation includes the challenging question of how companies should account for goodwill after the business combination.

In this update, Tom Scott, a member of the Board, discusses the Board's preliminary views and how stakeholders can help the Board by commenting on its forthcoming discussion paper.

What is the objective of the project?

The Board is exploring whether companies can, at a reasonable cost, provide users with more useful information about the businesses they acquire. Better information should help users assess the performance of companies making acquisitions and hold management to account more effectively for their decisions to acquire those businesses.



What has the Board heard?

The Board learned from stakeholders that:

- companies provide inadequate information on the subsequent performance of businesses they acquire;
- impairment losses of goodwill are often not recognised on a timely basis;
- the impairment test is costly and complex to perform;
- some stakeholders would like to see amortisation reintroduced; and
- the separate recognition of some intangible assets can be challenging as it is often difficult for companies to identify these assets and assess their value, and many users think the values are too subjective.

What is a PIR?

As part of the Board's due process, a PIR is performed after a new Standard or major amendment to a Standard has been applied internationally for at least two years.

The purpose of a PIR is to identify whether the Standard or amendment is working as intended by the Board.

What are the Board's preliminary views?

The Board's preliminary views are that:

- we should enhance disclosure objectives and requirements to improve the information provided to users about an acquired business and its subsequent performance, even if that information must be on a combined basis where the acquired business has been integrated into an existing business;
- it is not feasible to make the impairment test significantly more effective at recognising impairment losses of goodwill;
- reintroducing amortisation of goodwill would not provide significantly better information to users;
- we should reduce the cost and complexity of the impairment test by providing relief from the mandatory annual quantitative impairment test for goodwill;
- we should also reduce the cost and complexity of the impairment test by simplifying some of the requirements for estimating value in use;
- we should not allow more intangible assets to be included in goodwill; and
- we should enhance transparency by requiring companies to present total equity before goodwill in their balance sheets.

What is goodwill and how is it accounted for?

When the amount a company pays (consideration) for a business exceeds the fair value of the identifiable assets and liabilities acquired, the difference is called goodwill and is reported in the company's balance sheet.

An acquirer is willing to pay for goodwill because it expects to derive other future economic benefits from the acquisition, such as future synergies, or benefits from resources that are not reported in the balance sheet separately on acquisition, for example, an assembled workforce.

When the Board issued IFRS 3 in 2004, it replaced the requirement to amortise goodwill over its useful life with a requirement to test goodwill for impairment annually.

Disclosures

Users have told the Board that they want to understand the factors that determined the amount a company paid for an acquired business and whether that acquisition has been successful subsequently. Our preliminary view is that we should require companies to disclose:

- the amount of synergies it expected from a business combination;
- management's objectives for that business combination;
- what metrics management will use in its internal reporting to monitor whether those objectives are being achieved; and
- progress in subsequent reporting periods in achieving the objectives using those metrics.

Because the capital outlay for acquisitions is often large, we presume that companies would monitor acquisitions internally and would be aware of how well they are performing. The Board would like companies to provide users with the information their management uses to monitor these acquisitions. And if companies do not monitor these acquisitions, we believe users should be aware of that fact.

We will be particularly interested in receiving evidence from stakeholders to help us understand which acquisitions are monitored, and how. We would also welcome evidence to help us assess possible concerns about these proposals, notably that:

- acquired businesses are often integrated soon after acquisition—integration can make it hard to isolate the impact of the acquisition;
- disclosing information about a business combination may be useful to users for only a limited period of time;
- a company that makes several acquisitions might be required to disclose a large volume of information;
- some information could be commercially sensitive; and
- some information could be forward-looking and disclosing it could pose a risk of litigation.

Could the impairment test be made more effective?

The Board has heard from stakeholders that goodwill impairment losses are generally not recognised on a timely basis. Reasons for this lack of timeliness could include:

- estimates of cash flows may sometimes be too optimistic (however, if this is a problem in practice, it is largely an application issue that would best be addressed by other means, rather than by changing the Standard);
- goodwill is 'shielded' from impairment by, for example, the headroom[1] of an existing business with which an acquired business is integrated; and
- there may be confusion about the purpose of the impairment test of goodwill (see below).

We investigated whether it was possible to make the impairment test more effective by directly targeting the acquired goodwill thus reducing the effect of shielding. However, after extensive work, we concluded that we are not able to make significant improvements to the impairment test.

What is the purpose of the impairment test of goodwill?

The requirements for the impairment test are included in IAS 36 *Impairment of Assets*. The objective of IAS 36 is to ensure that a company's assets are carried at no more than their recoverable amount[2].

Goodwill does not generate cash flows independently of other assets or groups of assets; indeed, in many cases it contributes to the cash flows of several groups of assets. The impairment test of goodwill therefore compares the carrying amount of the group of assets containing the goodwill to the recoverable amount of that group of assets.

If the carrying amount of the group of assets exceeds its recoverable amount, an impairment loss is recognised. The impairment loss is allocated first, to reduce the carrying amount of the goodwill allocated to the group of assets and then, to the other assets included in that group of assets. If the recoverable amount of the group of assets exceeds its carrying amount, the goodwill allocated to that group of assets is not impaired, and so no impairment loss is recognised.

The impairment test therefore does not test goodwill directly. Any goodwill impairment loss is an *allocation of the overall impairment loss* of the group of assets to goodwill rather than a *directly measured impairment loss* of goodwill.

The impairment test of goodwill is not designed to provide information about the success of a business combination. Hence, we are exploring whether to enhance disclosure objectives and requirements to provide better information about an acquisition and its subsequent performance.

1 The headroom of an existing business is the amount by which the recoverable amount of the existing business exceeds the carrying amounts of the assets and liabilities of the existing business.

2 The recoverable amount of an asset is the higher of the value from the continuing use of the asset in its current condition by the owner of the asset (value in use) and the value from selling the asset (fair value less costs of disposal).

Reintroduction of amortisation

Given the inherent limitations of the impairment test, the Board considered whether to develop a proposal to reintroduce amortisation[3]. Amortisation could provide a simple mechanism for reducing the carrying amount of acquired goodwill, thereby reducing the risk of potential overstatement arising from the unavoidable limitations of the impairment test.

We reached a preliminary view that we should retain the impairment-only model and not reintroduce amortisation. However, the majority for this decision was small (eight of 14 Board members voted in its favour) and we will therefore be very interested in stakeholders' views on this topic. Many stakeholders already hold firm views that have been well known for many years. Simply repeating these arguments is unlikely to move the debate forward, but feedback that provides new practical or conceptual arguments, and feedback on the evidence that stakeholders think we should place more weight upon, will be particularly welcome. Such feedback will help us reach a more conclusive answer to this question.

> *The question we will need to answer is whether we have received sufficient information to conclude that a change to the Standard is appropriate. Board members will not be deciding which approach they would favour if they were starting from scratch.*

In considering this question some Board members, favouring the reintroduction of amortisation, are concerned that we have not found a way to make the impairment test more effective at recognising goodwill impairment losses on a timely basis. Therefore, they believe acquiring companies' management may not be held accountable for acquisition decisions—an acquisition may perform poorly but no impairment loss may be recognised if goodwill is shielded.

An amortisation charge in the companies' income statements could help to hold management accountable and prevent companies from providing users with misleading information about the performance of acquisitions and companies' financial positions.

Other Board members, favouring the impairment-only approach, suggest that although the impairment test is subject to unavoidable limitations, it provides more useful information than would amortisation—those Board members believe the impairment charge is confirmatory and does help hold management to account. This information could be weakened or even lost if amortisation is reintroduced. It is, in their view, difficult to estimate reliably the expected life of goodwill and how its value will diminish over time.

Accordingly, any amortisation charge would be arbitrary and therefore would not hold acquiring companies' management to account. Informing users whether a business combination has been a success is not the intended purpose of an impairment test.

Thus, the absence of a signal that an acquired business is not meeting the expectations that an acquiring company's management had at the acquisition date does not mean that the test has failed. To provide users with the information about the success, or otherwise, of an acquisition we are exploring whether to require disclosures on the subsequent performance of an acquisition.

> *We acknowledge that both approaches—impairment-only and amortisation—have limitations.*

3 If the Board were to reintroduce amortisation, it would still be necessary to test whether goodwill is impaired.

The impairment test is not designed to test goodwill directly and for amortisation it is difficult to estimate the expected life of goodwill and how its value will diminish over time. We will therefore ask stakeholders whether they can provide further evidence to help us find a more conclusive answer to the question of whether to retain the impairment-only approach or return to an amortisation approach. In particular, we want to explore the basis of stakeholders' concerns that recognition of goodwill impairment losses may not be timely (and whether amortisation can and should address that concern). We would also like feedback on what information best helps users to hold companies' management accountable for their acquisition decisions.

Relief from the annual impairment test

The Board's preliminary view is that it should remove the mandatory annual quantitative impairment test of goodwill. Instead, companies would need to perform quantitative tests only when there is an indication that impairment may have occurred. We expect that relief of this kind would reduce the cost of testing goodwill for impairment.

Some Board members would favour providing such relief only if the Board were also to reintroduce amortisation of goodwill. In their view, removing the requirement for an annual quantitative test of goodwill would make impairment tests less robust.

Nevertheless, a small majority of Board members favours providing this kind of relief even if the Board does not reintroduce amortisation. In the majority's view, providing relief would reduce the cost of the test while making the impairment test only marginally less robust; the majority suggests that the change would achieve an appropriate balance between the benefits and costs because the frequency of performing the test does not significantly affect its robustness.

We will ask our stakeholders to provide evidence to help us understand to what extent:

- costs would be saved if the requirement for an annual quantitative impairment test was removed; and
- the impairment test would be less effective if a quantitative test was performed less often.

Value in use

The Board's preliminary view is that it should amend the way value in use is estimated:

- to include cash flows from a future restructuring or from improving or enhancing an asset's performance in cash flow projections; and
- to allow companies to use post-tax inputs and post-tax discount rates.

These changes should reduce the cost and complexity of performing impairment tests and provide more useful and understandable information.

Include some intangible assets in goodwill

IFRS 3 broadened the range of intangible assets recognised separately in a business combination, rather than being included in goodwill. The Board thought the usefulness of financial statements would be enhanced if intangible assets were separated from goodwill.

Stakeholders have mixed views on recognising intangible assets separately. Some say that separate recognition helps to explain what companies have acquired; others question the usefulness of this information given that similar internally generated intangible assets are not recognised and given the concerns about the reliability of the valuations of some intangible assets.

Because of the mixed views on how useful and costly this information was, we did not find persuasive evidence that we should revisit the decisions made by the Board in developing IFRS 3. Therefore, our preliminary view is that we should not make any changes to the range of intangible assets recognised.

What happens next?

The Board is preparing a discussion paper on these matters which it expects to publish around the end of 2019.

We look forward to developing a set of disclosure requirements that can significantly improve the information provided to users on business combinations. We also look forward to engaging with stakeholders to reach a definitive conclusion to retain the impairment-only model or to reintroduce amortisation of goodwill.

What is the FASB doing?

IFRS 3 was developed in a joint project with the US Financial Accounting Standards Board (FASB) and is converged in many respects with US GAAP on this topic.

In July 2019 the FASB issued an Invitation to Comment on the accounting for some intangible assets acquired in a business combination and the subsequent accounting for goodwill. The Invitation to Comment includes several topics that will also be covered in the Board's own discussion paper. The Board and the FASB have been monitoring each other's projects. The Invitation to Comment is a FASB staff document and does not express any preliminary views of the FASB. Comments are due by 7 October 2019.

To read further information about the proposals or to receive project updates

Visit the Goodwill and Impairment project page on the IFRS Foundation website.

To get in touch

Contact Tim Craig at tcraig@ifrs.org.

Follow @IFRSFoundation on Twitter to keep up with changes in the world of IFRS Standards.

The views expressed in this article are those of the author as an individual and do not necessarily reflect the views of the International Accounting Standards Board (Board) or the IFRS Foundation (Foundation). The Board and the Foundation encourage members and staff to express their individual views. This article has not undergone the Foundation's due process. The Board takes official positions only after extensive review, in accordance with the Foundation's due process.