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SHOULD GOODWILL STILL NOT BE AMORTISED?

ACCOUNTING AND DISCLOSURE FOR GOODWILL

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DISCLAIMER

This paper has been prepared by the following authors (collectively, the 'Research Group') to stimulate the discussion about accounting requirements of goodwill acquired in business combinations.

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The views presented in the paper are those of the Research Group's only. The ASBJ, EFRAG and the OIC have reviewed its content during the meetings in leading up to the publication of the paper and reached the view that the paper would stimulate useful debate. The Research Group expresses special appreciation for the helpful input from the Institute of Charted Accountants of India (ICAI).

Copies of the paper are available from the websites of those bodies issuing the paper. A limited number of copies of the paper will also be made available in printed form, and can be obtained from the ASBJ, EFRAG and the OIC.

*We invite comments on each of questions in pages 6 and 7. We would appreciate it if comments would be sent before **20 September 2014** to either of the following:*

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All comments received will be placed on the public record unless confidentiality is specifically requested.

Ten years after the IASB replaced the previous ‘amortisation and impairment approach’ with the ‘impairment-only approach’ in revising IFRS 3 *Business Combinations* and other related standards, discussion around accounting and disclosure regarding acquired goodwill has become increasingly lively. Many studies and reviews have been conducted on this area, and many of them have identified shortcomings in the application of the impairment-only approach to a varying degree.

In 2013, the International Accounting Standards Board (IASB) embarked on a post implementation review (PIR) on IFRS 3, and it has become apparent that there is a common view in Europe, Japan and other areas, that accounting and disclosure requirements regarding goodwill merit further consideration.

Against this background, members of the ASBJ, EFRAG and the OIC formed a Research Group to carry out the research on this area. As a first step, the Research Group performed a survey to seek for views on the usefulness of information resulting from the impairment-only approach, as well as challenges relating to preparing and auditing the resulting information. As a result, the Research Group learnt that many constituents questioned the usefulness of the information resulting from the impairment-only approach. It also found that preparers and auditors are concerned about the cost and subjectivity of the impairment testing in accordance with IAS 36 *Impairment of Assets* and whether impairment losses are recognised in a timely manner. Furthermore, many have indicated that the impairment-only approach may have played a role in the financial crisis. That is, since the current approach does not allow the depiction of yearly consumption of acquired goodwill, impairment losses often come too late. This effect has been made evident in recent years in which many entities recognised impairment losses of goodwill year after the financial crisis, when financial markets, possibly, had already taken them into account.

Based on the findings, the Research Group has explored possible approaches to remedy the shortcomings and decided to publish its research outcome in a form of the Discussion Paper (DP). The objective of this DP is to stimulate and progress the debate on this important subject, before the IASB formally considers a standard-setting initiative.

Chapter 1 of this DP outlines the history and recent developments regarding the discussion of accounting requirements for goodwill. This chapter also explains the shortcomings the Research Group has identified, based on the surveys conducted by the EFRAG-OIC and the ASBJ in 2012.

Chapters 2 to 4 explain the Research Group’s analysis of how to solve these shortcomings. In these chapters, the Research Group explores the following three different approaches, which are believed to be not mutually exclusive:

(a) Changing the accounting treatment of goodwill, including reintroduction of the amortisation (Chapter 2);

(b) Improving the requirements for impairment testing (Chapter 3); and

(c) Improving disclosure requirements in IAS 36 (Chapter 4).

As a result of its analysis, the Research Group 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 Research Group concluded that further improvement should also be considered in the area of disclosure requirements.

Chapter 5 provides the Research Group's observations if the IASB decides to reintroduce the amortisation and impairment approach. Specifically, the Research Group provides a brief analysis on whether to modify the current requirements of separating intangible assets from goodwill and to extend amortisation to other intangible assets with indefinite useful lives.

The Research Group hopes that this DP helps stimulate and progress the global discussion of accounting and disclosure regarding acquired goodwill. The Research Group plans to share the feedback received on the DP with the IASB and other relevant bodies, and consider further improvements in this area.

1. Do you agree that there should be a requirement to recognise goodwill as an asset and amortise it over subsequent periods? If so, do you support amortisation because:

    (a) goodwill existing at acquisition date is consumed and replaced with internally generated goodwill over time, thus it should be allocated to subsequent periods as part of the cost of acquiring an entity;

    (b) an impairment-only model is not sufficiently reliable due to the large use of assumptions in the impairment test (future cash flows, terminal growth rate and discount rate); or

    (c) amortisation of goodwill, in addition to the impairment test, achieves an appropriate cost-benefit balance.

2. Assuming that there was a requirement to amortise goodwill, do you think that the IASB should:

    (a) indicate what the amortisation period should be?

    (b) indicate a maximum amortisation period?

    (c) provide guidance on how entities should assess the amortisation period (for instance, by referring to the expected payback period or the useful life of the primary asset)?

    (d) allow entities to elect the amortisation period that they consider appropriate?

3. The DP suggests the need for improved guidance in a number of areas in IAS 36. Do you think that the IASB should improve and/or provide additional guidance in relation to:

    (a) the methods to determine the recoverable amount of the goodwill;

    (b) the application of the value-in-use method;

    (c) the identification of cash-generating units and allocation of goodwill to each unit; and

    (d) the choice of the discount rate.

    If not, please indicate why. Please state any specific suggestions for improvements if you have.

4. The DP suggests a number of possible new disclosures about impairment testing for goodwill. Do you think that the IASB should consider improving requirements to:

   (a) assist users in understanding the robustness of the modelling and the entity's current assumptions;

   (b) provide confirmation of the 'reasonableness' of the entity's past assumptions; and

   (c) assist users in predicting future impairment.

5. IAS 38 requires that intangible assets with indefinite useful lives are not amortised but tested for impairment at least annually. Assuming that there was a requirement to amortise the goodwill, do you think that the same requirement should be extended to other intangible assets with indefinite useful lives? In addition, assuming that there was a requirement to amortise goodwill, do you think that the current requirements of identifying intangible assets separately from goodwill should be reconsidered? If so, how?

OBJECTIVE OF THE DISCUSSION PAPER

1. The objective of this DP is to:

   (a) summarise the current and previous discussions around the accounting requirements for goodwill acquired in a business combination including the feedback from stakeholders on the surveys conducted by EFRAG/OIC and ASBJ (Chapter 1);

   (b) explore alternative approaches regarding the accounting and disclosure requirements of acquired goodwill (except for those relating to negative goodwill) and draw a tentative conclusion on how to address shortcomings identified by stakeholders (Chapters 2 to 4); and

   (c) provide additional considerations regarding the accounting treatment of intangible assets (Chapter 5).

CURRENT STATUS AND RECENT DEVELOPMENTS

2. Under IFRS 3 and IAS 36, goodwill acquired in a business combination (acquired goodwill) shall be tested for impairment. A cash generating unit (CGU) to which goodwill has been allocated should be tested for impairment at least annually, and whenever there is an indication that the unit may be impaired; an impairment loss is recognised when the carrying amount of the CGU, including the goodwill, is lower than its recoverable amount. However, the existing standard does not permit amortisation of goodwill (hereinafter referred to as the 'impairment-only approach'). In addition, IAS 28 *Investments in Associates and Joint Ventures* requires that goodwill relating to an associate or joint venture shall be included in the carrying amount of equity investments accounted for using the equity method, and does not permit the amortisation of goodwill.

IASB's PIR regarding Business Combinations Standards

3. At its July 2013 Board meeting, the IASB decided to adopt a comprehensive approach to the IFRS 3 post-implementation review (PIR), including reviewing experiences relating to changes in accounting requirements for goodwill that were modified in 2004.

4. In January 2014, the IASB published the Request for Information, *Post-Implementation Review: IFRS 3 Business Combinations*. The IASB's plan for the PIR can be summarised as following:

Activity	Timing
Phase I of the PIR	July 2013–November 2013
Publication of Request for Information	January 2014
Phase II of the PIR	
Public consultation (120 days)	Published in January 2014 with comment period ending May 2014
Analysis of public comments and extensive outreach	Undertaken during 1st half of 2014
Publication of Feedback Statement	3rd or 4th quarter of 2014

Developments in the U.S.

5. In January 2014, the FASB issued the Accounting Standards Update (ASU) No.2014-02, *Intangibles-Goodwill and Other (Topic 350), Accounting for Goodwill.* This ASU allows private companies an accounting option to amortise goodwill relating to each business combination or reorganisation event that results in fresh-start reporting (amortisable unit of goodwill), on a straight-line basis over 10 years or less if the entity demonstrates that another useful life is more appropriate[1]. An entity that chooses this accounting alternative may elect to test goodwill for impairment at either the entity level or the reporting unit level. In addition, the ASU requires that goodwill be tested for impairment when a triggering event occurs that indicates that the fair value of an entity (or a reporting unit) may be below its carrying amount. Further, when a triggering event occurs, an entity has the option to first assess qualitative factors to determine whether quantitative impairment testing is necessary.

6. In addition, the FASB initiated a project to review the accounting for goodwill for public business entities and not-for-profit entities, to consider the following alternative approaches: (a) the alternative approach permitted for private companies, (b) amortisation of goodwill over its useful life not to exceed a maximum number of years, (c) direct write-off of goodwill or (d) the simplified impairment test. In its meeting of March 2014, the FASB decided to defer further discussion until after the IASB has completed and issued its findings on the PIR of IFRS 3.

[1] These revised US requirements are broadly consistent with the relevant requirements in International Financial Reporting Standards for Small and Medium Sized Entities (IFRS for SMEs). IFRS for SMEs requires the acquirer of a business combination to measure acquired goodwill at cost less accumulated amortisation and accumulated impairment losses. It also requires an entity to allocate the depreciable amount of acquired goodwill on a systematic basis over its useful life, which is presumed to be 10 years if an entity is unable to make a reliable estimate of the useful life of acquired goodwill.

Chronology of requirements for goodwill

7. The following paragraphs summarise the history of accounting requirements for goodwill (including its amortisation) to help identify alternative approaches. The Research Group considered the history of U.S. accounting standards as well as IFRSs, because the discussion about whether to amortise goodwill was carried out as part of the convergence project between the IASB and the FASB[2].

Year	Category	Key Developments
1970	U.S. GAAP	The APB issued Opinion No. 17, which required the amortisation of goodwill over a period not exceeding 40 years.
1983	IASs	The IASC issued IAS 22 *Business Combinations*, which permitted systematic amortisation of acquired goodwill over its useful life not exceeding 20 years while also allowed goodwill to be immediately charged to equity on the acquisition date.
1993	IASs	The IASB revised IAS 22, to eliminate the option to immediately charge acquired goodwill to equity on the acquisition date.
1999	U.S. GAAP	The FASB issued an Exposure Draft, proposing to shorten the maximum amortisation period of goodwill from 40 years to 20 years.
2001	U.S. GAAP	The FASB issued SFAS 141/142[3], which prohibited amortisation of goodwill and required regular impairment testing, coupled with the abolition of the pooling-of-interest method.
2004	IFRSs	The IASB issued IFRS 3 and its related standards, through which the accounting requirements relating to goodwill were generally aligned with those in U.S. GAAP[4].
2013	U.S. GAAP	The FASB voted to permit amortisation of goodwill for private companies, and directed its staff to explore whether to permit the same approach for public business entities.

[2] Japanese accounting standards require an entity to amortise acquired goodwill over a period for which goodwill is expected to have an effect with a maximum period of 20 years, while requiring an entity to recognise impairment losses when a specified threshold is met.
[3] SFAS represents the Statement of Financial Accounting Standard in the pre-Codification standards.
[4] Requirements for goodwill in IAS 28 were amended to conform to the requirements of revised IFRS 3.

Publication of SFAS 142 by the FASB

8. Prior to the publication of FASB Statement No. 142, Goodwill and Other Intangible Assets (SFAS 142), APB Opinion No. 17, *Intangible Assets* required that goodwill recognised in a business combination be amortised systematically over a period not exceeding forty years.

9. In 2001, the FASB published SFAS 142, which introduced an impairment-only approach based on the following arguments:

   (a) many analysts stated that they ignored goodwill amortisation expense in their analysis, and many entities ignored goodwill amortisation expense in measuring operating performance;

   (b) the increases in reported earnings in periods after amortisation of goodwill is completed may not be considered to provide faithful representation, because such increases in earnings arise from the cessation of prior 'doubling-up' of expenses related to goodwill; and

   (c) non-amortisation of goodwill with adequate impairment testing and appropriate disclosure promotes transparency in financial reporting, and thus provides useful information to those who rely on financial statements.

10. However, there were considerable concerns over the FASB's conclusions, primarily because acquired goodwill is deemed to be a 'wasting asset' whose value will be consumed in subsequent periods. It was argued that the impairment-only approach in essence allows entities to capitalise 'internally generated goodwill[5]' created in the same reporting unit to which the goodwill has been allocated.

IFRS 3 (2004)

11. In 2004, the IASB amended IAS 22, primarily to achieve convergence with the US standards. In considering the subsequent treatment for goodwill, the IASB examined the following three approaches:

   (a) straight-line amortisation with an impairment test whenever there was an indication that the goodwill might be impaired;

   (b) non-amortisation but with a yearly impairment test or more frequent if events or changes in circumstances indicated that the goodwill might be impaired; and

   (c) an accounting option between approaches (a) and (b).

12. The IASB decided to adopt the impairment-only approach. The IASB rejected approach (c) because it felt that both comparability and reliability would be diminished.

[5] IAS 38 prohibits an entity from recognising internally generated goodwill. In some cases, expenditure is incurred to generate future economic benefits, but it does not result in the creation of an intangible asset that meets the recognition criteria. Such expenditure is often described as contributing to internally generated goodwill. Internally generated goodwill is not recognised as an asset because it is not an identifiable resource controlled by the entity that can be measured reliably at cost.

13. During the consultation process, stakeholders generally preferred an amortisation and impairment approach, primarily for the following reasons:

    (a) acquired goodwill is an asset that is consumed and replaced by internally generated goodwill. Therefore, amortisation ensures that acquired goodwill is recognised in profit or loss and not offset by internally generated goodwill, in accordance with the prohibition to recognise internally generated goodwill in IAS 38 *Intangible Assets;*

    (b) amortisation of goodwill is consistent with the approach taken for other intangible and tangible assets that do not have indefinite useful lives. Indeed, entities are required to determine the useful lives of items of property, plant and equipment, and depreciate the assets on a systematic basis over their useful lives. There is no conceptual reason for treating acquired goodwill differently; and

    (c) systematic amortisation provides a practical solution for the subsequent treatment of goodwill at an acceptable cost.

14. However, the IASB rejected the amortisation and impairment approach, primarily because it is not possible to reliably determine the useful life and the pattern of consumption of goodwill, so that the amortisation charge over any given period is only an arbitrary estimate.

OUTREACH TO CONSTITUENTS

15. Given the discussions around the accounting treatment of goodwill, the Research Group presented a research project plan in 2012 at the IFASS meeting in Kuala Lumpur. As a first step of the project, the OIC and EFRAG launched an international survey and the ASBJ launched a domestic survey on the topic. The results of the surveys conducted by OIC/EFRAG and ASBJ were discussed at the IFASS meeting of Sao Paulo in April 2013.

EFRAG and OIC survey

16. EFRAG and OIC received 47 replies. The results provided useful indications on existing views on the topic.

17. The survey was conducted through a questionnaire that included five parts. 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.

18. The responses show that respondents have different opinions on what goodwill normally consists of. The responses also show that some of respondents do not use the information on goodwill presented in financial statements, whereas others do.

19. Respondents provided many different reasons for using or not using information about goodwill. Some of the respondents that did not use the information thought that it was too uncertain (since it is unclear what goodwill includes, or the calculation was considered unreliable) or did not find the information useful for their projections. Other respondents used the reported goodwill or the goodwill disclosures when assessing risks, future cash flows and stewardship. A group of respondents suggested that goodwill should be both amortised and reviewed for impairment in order to make the information more useful. Other suggestions included additional disclosures, immediate write-off of goodwill against equity or measuring goodwill as the difference between the book value of equity and the (long-term) market value of equity.

20. Respondents were also asked about the usefulness of the accounting information on the impairment of goodwill. Some thought the information was useful, for example, because 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.

21. Part 2 considered the consistency of the discontinuation of the amortisation of goodwill with the treatment of internally generated goodwill and the effects of goodwill impairment in times of financial crises. This part was primarily targeted at standard setters and regulators.

22. A slight majority of respondents (including those from national standards setters) agreed that conceptually not recognising any reduction of value – other than that due to recognition of impairment losses – on the acquired goodwill means that internally generated goodwill is recognised to replace the acquired goodwill that had been 'consumed'. Moreover many thought that there were no significant conceptual reasons to adopt a different approach for other intangibles and goodwill.

23. In relation to the perceived effects of goodwill impairment in times of financial crises, a majority of respondents (including national standards setters) thought that it could have pro-cyclical effects. Different views were expressed on whether effect on the macro economy should be considered when developing accounting standards. However, those who thought that impairment requirements were pro cyclical explained that:

    (a) no amortisation would lead to higher prices for entities; and

    (b) impairment losses were usually recognised very late when business prospects had already worsened.

24. Part 3 enquired about the costs and complexity of the impairment test and was primarily targeted at preparers of financial statements.

25. A slight majority of preparers responding to this question thought that costs to comply with IAS 36 were significant. These costs were mainly due to the perceived complexity of IAS 36 requirements. Some thought the costs could be reduced by taking one or a combination of the following approaches:

    (a) allowing/requiring amortisation of goodwill;

    (b) limiting the impairment test to when there was an indication of impairment;

    (c) reducing the frequency of the impairment test;

    (d) only requiring an impairment test when the book value of equity compared with the market capitalisation of the company exceeded a given threshold;

    (e) introducing a less prescriptive approach or a standardised approach; and

    (f) clarifying the requirements.

26. Moreover, a slight majority of the preparers indicated that, according to their experience with the application of IFRSs, they considered 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).

27. Part 4 enquired about the auditability of the application of impairment testing and was primarily targeted at auditors.

28. Some respondents found that while it was possible to challenge management's assumptions, it was difficult to disprove them conclusively 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. Others thought it was not more difficult to challenge the impairment test than other types of estimates included in the financial statements. Different suggestions on how to improve the auditability were provided by respondents, with many suggesting more disclosures.

29. Part 5 enquired about academic or institutional research relating to the impairment of goodwill, and was primarily targeted at academics. Respondents provided some references.

30. A feedback statement is available at the following link http://www.efrag.org/Front/p265-1-272/Consultations---Questionnaire-on-goodwill-impairment-and-amortisation.aspx.

ASBJ survey

31. The ASBJ conducted its own survey using a similar format. However, the ASBJ's questionnaire[6] differs in the following respects:

    (a) the ASBJ's questionnaire was designed for those people who have sufficient knowledge and experience about Japanese accounting standards. Japanese accounting standards require an entity to amortise acquired goodwill over a maximum period of 20 years. It also requires an entity to recognise impairment losses when a specified threshold is met;

    (b) the ASBJ's questionnaire included a section designed for all stakeholders. In this section, questions were asked about stakeholders' views on general matters such as theoretical benefits and drawbacks of the amortisation and impairment approach as well as the impairment-only approach.

32. Notwithstanding a very short comment period, the ASBJ received twenty-six responses (12 from financial statement preparers, 8 from financial statements users, 4 from auditors, and 2 from academics), which demonstrates the strong interest in this topic among Japanese stakeholders. In parallel, the ASBJ organised a roundtable, and invited key stakeholders (4 financial statements users, 4 financial statements preparers, two auditors and one academic) to attend. The key findings from the questionnaire and round table are explained in the following paragraphs.

33. *Views as to the amortisation and impairment approach vs. the impairment-only approach:* Stakeholders expressed mixed views as to whether goodwill should be amortised. For example, a financial statement user stated that amounts of amortisation (a non-cash flow expense) were disregarded in his analysis, while others expressed concern that impairment charges were untimely. On the other hand, most financial statement preparers stated that non-amortisation did not properly portray the economic substance of acquired goodwill subsequent to the business combination, primarily because acquired goodwill would be consumed and replaced with internally generated goodwill over time, and non-amortisation failed to reflect the matching relationship between costs and incomes in subsequent periods.

34. *Use of financial information relating to goodwill:* Various examples were cited as to how the goodwill information is used. One user stated that the information was used to determine or confirm the entity's capital adequacy, the appropriateness of the management's judgment on the purchase consideration and the appropriateness of management's expectation about future cash flows from the acquired business. In addition, one user stated that sources of goodwill were carefully examined in determining whether an entity's capital was adequate, noting that adequate disclosures were important in this respect.

[6] The ASBJ's questionnaire consists of (a) Part 1: questions to all stakeholders, (b) Part 2: questions to financial statements users, (c) Part 3: Questions to financial statements preparers, (d) Part 4: Questions to auditors, (e) Part 5: Questions to academics.

35. *Cost and complexity of the impairment test:* Stakeholders were not particularly concerned about the cost and complexity, because the requirement in Japanese GAAP to amortise the goodwill over a period not exceeding twenty years lessened the burden and sensitivity of the test.

36. *Difficulties in auditing the impairment test:* Stakeholders noted a number of challenges due to the high level of judgment used in impairment testing and made several suggestions to improve auditability.

37. A feedback statement is available at the following link (available only in Japanese) https://www.asb.or.jp/asb/asb_j/press_release/domestic/sme21/sme21.pdf.

Other surveys

38. As requested by the Ministry of Corporate Affairs of India, the Institute of Chartered Accountants of India (the ICAI) conducted a study of goodwill recognised in consolidated financial statements in respect of the top 100 listed companies in India for the financial year 2012-2013. The relevant existing Indian Accounting Standard (AS 21) dealing with consolidated financial statements does not specifically require or prohibit amortisation of goodwill arising from the acquisition of a subsidiary. Under the existing Indian Accounting Standards the impairment of goodwill is covered by the Accounting Standard corresponding to IAS 36.

39. The observations are summarised hereunder:

(a) out of 100 companies included in the sample, data for 98 companies was available;

(b) 60 companies reported goodwill in their consolidated financial statements;

(c) 58 companies tested goodwill for impairment and 2 companies amortised goodwill;

(d) 8 companies recognised an impairment loss out of 58 companies that tested goodwill for impairment;

(e) only 1 company justified the basis for arriving at the impairment loss; and

(f) none of the 50 companies that did not recognise any impairment loss on goodwill, disclosed the basis for their conclusion.

40. In April 2014, KPMG published the report titled '*Who cares about goodwill impairment?*' The report identified challenges for the current impairment model in IAS 36, and suggested alternative approaches including reintroduction of the straight-line amortisation approach. The report explained that the reasons provided by interviewees included simplicity, prudence and reducing reliance on forecasting subjectivity.

Summary of messages

41. Although responses were not unanimous, the Research Group found that common themes emerged from the feedback. In particular, the results of the surveys showed a shared view that the informational content of impairment losses only has confirmative value (rather than being both confirmative and predictive), and that the impairment-only approach has conceptual shortcomings as it results in recognising internally generated goodwill. Further, some respondents believed that the impairment testing did not reflect timely the negative performance of an entity.

42. Some respondents found application problems. They believed that the current requirements are costly and involve much judgment due to the assumptions required and therefore the information is not relevant for users. Moreover, some respondents found it difficult to challenge management's impairment tests. In addition, preparers have indicated that costs to comply with IAS 36 are significant and that, according to their experience with the application of IFRSs, they 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).

43. Moreover, the surveys have shown that respondents were split on whether the impairment model for goodwill was pro-cyclical. Mixed views were presented on whether amortisation of goodwill would be beneficial or not. For example, some respondents believed that when the economic cycle is neither in recession nor in expansion, the impairment test is not able to identify any entity-specific negative effects. This would mean that the impairment losses are recognised only when the economic cycle has changed or when the entity is no longer able to restore its specific ability to create value.

44. In January 2013, the ESMA published a report titled "European enforcers review of impairment of goodwill and other intangible assets in the IFRS financial statements". ESMA's report indicated that in the financial crisis, market participants expressed concerns about the reliability of goodwill impairment tests. In addition, IASB Chairman Hans Hoogervorst at the IAAER conference in June 2012 recognised that goodwill impairment often came too late during the financial crisis.

CONCLUSION

45. The Research Group considered three different approaches to solving these issues:

    (a) changing the accounting treatment of goodwill, including the reintroduction of the amortisation;

    (b) improving the requirements for the impairment test; and

    (c) improving the disclosure requirements currently specified by IAS 36.

46. The Research Group notes that these approaches are not mutually exclusive, and it is likely that taking measures that consider all of the approaches would contribute to solving the problems identified.

47. In the following paragraphs, the Research Group will explore possible alternative approaches to the impairment-only approach, taking into account the approaches that have been considered previously as well as recent discussions relating to the accounting requirements of goodwill[7]. Alternative approaches are as follows:

(a) 'discernible-element' approach by separating goodwill into different components and applying different treatments thereto;

(b) 'direct write-off' approach by immediately charging the goodwill to *profit or loss* on the acquisition date;

(c) 'direct write-off' approach by immediately charging the goodwill to *equity* on the acquisition date; and

(d) 'amortisation and impairment' approach.

48. The Research Group thinks that cost-benefit is an important consideration in the development of accounting standards, but in this case decided to focus primarily on promoting the *relevance* of financial information relating to acquired goodwill that arises from business combinations.

DISCERNIBLE ELEMENT APPROACH

49. Acquired goodwill can be viewed from either of the following two general perspectives[8]:

(a) a 'top-down perspective', which views goodwill as being a component or subset of something larger. Following the perspective, goodwill is perceived as what is *left over*; or

(b) a 'bottom-up perspective', which views goodwill in terms of the components that make it up. According to this view, if the price paid by the acquirer exceeds the fair value of the net identifiable assets of the acquiree, presumably some other resources were acquired that have value to the acquirer. In this context, goodwill can be interpreted as the 'purchase premium', the premium paid by the acquirer over the book value of the acquiree's net assets.

50. Theoretically, under the bottom-up perspective, acquired goodwill should arguably be separated into different components and different accounting treatment should be applied to each component. For example, the Basis for Conclusions in IFRS 3 states that arguably goodwill consists of the following components:

[7] For example, see the Issue Paper, *Proposal of Alternatives for Goodwill Accounting*, which was presented by Shinhan Financial Group of Korea for the Emerging Economies Group meeting of May 2013.

[8] Paragraphs 49 to 52 of this paper draw extensively on *L. Todd Johnson and Kimberly R. Petrone "Commentary: Is Goodwill an Asset', Accounting Horizons, Vol. 12 (3), September 1998.*

(a) Component 1—The excess of the fair value over the book value of the acquiree's net assets at the date of acquisition.

(b) Component 2—The fair value of other net assets that the acquiree had not previously recognised (e.g., intangible assets that are not recognised due to measurement difficulties).

(c) Component 3—The fair value of the going concern element of the acquiree's existing business, reflecting on the ability of the acquiree as a standalone business to earn a higher rate of return on an organised collection of net assets than would be expected if those net assets had to be acquired separately (often referred to as the 'going-concern goodwill').

(d) Component 4—The fair value of the expected synergies and other benefits from combining the acquirer's and acquiree's net assets and businesses (often referred to as the 'combination goodwill').

(e) Component 5—Overvaluation of the consideration paid by the acquirer stemming from errors in valuing the consideration tendered.

(f) Component 6—Overpayment or underpayment by the acquirer.

51. Arguably, Components 1 and 2 are conceptually not part of 'core-goodwill' (which stakeholders refer to as 'excess earning power'). Specifically, Component 1 would not be an asset itself but it represents gains that were not reflected by the acquiree on its net assets; thus, it is part of other assets rather than part of core-goodwill. In addition, Component 2 would conceptually be part of the intangible assets that might have been separately identified and recognised as individual assets. In the Research Group's understanding, Components 1 and 2 may end up being included in goodwill, because some intangible assets are not recognised at acquisition date and some assets and liabilities are not measured at their acquisition date fair value.

52. Component 5[9] would not be an asset but rather a measurement error by the acquirer. Conceptually, the Research Group thinks that Component 5 should be charged to profit or loss immediately, because it would not meet the definition of an asset[10] under *The Conceptual Framework for Financial Reporting* (the Conceptual Framework). However, in practice any overvaluation is unlikely to be detectable or known. Component 6 would also not conceptually be an asset, but rather it simply represents a loss (in the case of overpayment) or a gain (in the case of underpayment) to the acquirer. In theory a rationale acquirer should not overpay on purpose but some argue that overpayment by acquirers occurs especially in the presence of multiple bidders, and accounting standards should not neglect such an overpayment.

[9] This might arise from the situation where value placed on the consideration is based on the current market price of the stock and the number of shares being traded is relatively small.

[10] Paragraph 4.4 of the existing Conceptual Framework states that *an asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.*

53. On the other hand, Components 3 and 4 would be considered as 'core-goodwill'. Component 3 would be considered as the excess earning power that existed in the acquiree before the acquisition, irrespective of the business combination. Component 4 would be considered as the newly generated excess earning power as a result of the business combination, because it enables the combination of the excess earning powers of the acquiree and the acquirer.

54. Conceptually, it might be possible to require different accounting treatments for the different components. The portion of goodwill relating to going-concern goodwill and combination goodwill (that is, Components 3 and 4), for example, could be amortised over the weighted-average useful life of these components, while Components 5 and 6 should be immediately expensed. However, the question is how complex it would be to apply the discernible element approach in practice.

55. The Research Group explored if it would be possible to separate goodwill into different components (including the possible way to identify any portion that represents an overpayment). For example, it might be possible to identify such a portion by comparing the valuation of an acquiree (for example, a valuation by an independent expert) to the consideration paid.

56. However, this approach would involve numerous subjective judgments in identifying discernible elements. In addition, requiring an entity to compare the amounts as suggested in the previous paragraph may be inconsistent with the principle in IFRS 13 *Fair Value Measurement* that an entity shall *maximise* the use of relevant observable inputs and *minimise* the use of unobservable inputs to meet the objective of fair value measurement. Furthermore, the benefit of requiring a third party valuation for this purpose may not in itself outweigh the cost, while existing accounting requirements are already criticised for being too complex and costly.

57. Therefore, the Research Group concluded that the discernible element approach would not be sufficiently practical to implement.

58. It should be noted that, with reference to Component 1, goodwill arises partly in relation to the recognition of deferred tax liabilities. This is because while other assets and liabilities are principally measured at fair value in business combinations, deferred tax assets and liabilities are required to be measured in accordance with IAS 12 *Income Taxes* (for example, without regard to the time value of money) and this component sometimes is significant. In theory, it would be appropriate to amortise this component in the same period in which the related deferred tax liabilities reverse.

DIRECT WRITE-OFF APPROACH: IMMEDIATELY CHARGING THE GOODWILL TO PROFIT OR LOSS

59. Some have argued that goodwill acquired in a business combination should be expensed at the time of acquisition because it does not meet the definition of an asset under the respective Conceptual Frameworks. In Financial Reporting Standard No.10, *Goodwill and Intangible Assets* (FRS 10) published in 1997, the UK Accounting Standards Board took the position that goodwill is neither an asset nor an immediate loss in value but is rather a bridge between the cost of investment shown as an asset in the acquirer's own financial statements and the value attributed to the acquired assets and liabilities in the consolidated financial statements. FRS 10 requires to determine if purchased goodwill has an indefinite or a limited useful life, and to amortise it when goodwill is deemed to have a limited useful life.

60. Prior to the issuance of FRS 10, UK Accounting Standards Committee's Statement of Standard Accounting Practice (SSAP) No.22 *Accounting for Goodwill* even permitted purchased goodwill to be immediately eliminated against reserves, because it was thought that an immediate write-off was consistent with the requirement to not recognise internally generated goodwill, and that goodwill itself is not a right to future economic benefits controlled by the entity.

61. However, many disagree with the approach because they believe that acquired goodwill meets the criteria for recognition of an asset under the Conceptual Framework. In the following paragraphs, the Research Group considers whether acquired goodwill actually qualifies for recognition as an asset under the existing Conceptual Framework and the proposed definition in the IASB's Discussion Paper *A Review of the Conceptual Framework for Financial Reporting* (the Conceptual Framework DP)[11].

Does acquired goodwill meet the definition of an asset?

Table 1: Relevant Definitions under the Conceptual Framework and the Conceptual Framework DP

Definitions	Existing definitions	Proposed definitions
Asset (of an entity)	A resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.	A present economic resource controlled by the entity as a result of past events.
Economic resource	[No existing definition]	A right, or other source of value, that is capable of producing economic benefits.

[11] For internally generated goodwill, paragraph 4.26 (e) of the Conceptual Framework DP explained that it should not be recognised because it does not meet the objective of financial reporting (paragraph OB7 of the Conceptual Framework).

62. The difficulty of the argument is due to the uncertain nature of goodwill. In fact, some believe that acquired goodwill does not meet the definition of an asset because they focus on components other than the 'core-goodwill'. For example, some are of the view that consideration amounts are often overpaid in business combinations, especially when consideration is paid in the acquiring entity's own equity instruments. In addition, some interpret the definition of an asset narrowly (for example, some believe that goodwill is not an asset because it cannot be sold separately).

63. However, the Research Group believes that it is reasonable to assume that the primary component of goodwill is 'core-goodwill', because IFRSs try to avoid the inclusion of Components 1, 2 and 5 in the initial measurement of goodwill by requiring an entity to make every effort:

(a) to recognise the identifiable net assets acquired at their fair values rather than their carrying amounts, thereby eliminating or reducing Component 1;

(b) to recognise all acquired intangible assets meeting the criteria in IFRS 3 so that they are not subsumed into the amount initially recognised as goodwill, thereby reducing Component 2; and

(c) to measure the consideration accurately, thereby eliminating or reducing Component 5.

64. In addition, exchangeability is not a criterion identified in the definition of an asset in the Conceptual Framework. Furthermore, consistent with paragraph 58 of IFRS 13, the Research Group believes that the transaction price should be deemed to equal fair value. IFRS 13 describes the situations in which the transaction price might not represent the fair value of an asset or a liability at initial recognition[12], but the Research Group believes that business combinations discussed in this paper do not meet any of the situations identified in the Standard. Above all, the Research Group considers that the transaction price should normally be deemed to be fair value (because business combinations are conducted at arm's length) and the presumption can only be rebutted in limited circumstances based on careful consideration of individual transactions.

65. Having presumed that acquired goodwill primarily consists of 'core-goodwill', the Research Group thinks that it meets the definition of an asset under the relevant definitions (see Table 1) in the existing Conceptual Framework, because:

(a) it is a resource controlled by the entity. The control is provided by means of the acquirer's ownership of a controlling interest in the acquired entity;

[12] Paragraph B4 of IFRS 13 describes the following situations:
(a) The transaction is between related parties.
(b) The transaction takes place under duress or the seller is forced to accept the price in the transaction.
(c) The unit of account represented by the transaction price is different from the unit of account for the asset or liability measured at fair value.
(d) The market in which the transaction takes place is different from the principal market.

(b) it results from a past event, that is the business combination; and

(c) although future economic benefits are not expected to flow to the entity from the core-goodwill itself, future economic benefits are expected to flow to the entity *in combination with* other assets and they will contribute *indirectly* to future cash flows. The Conceptual Framework explicitly supports this view.

66. The Research Group also thinks that the 'core-goodwill' meets the proposed definition of an asset in the Conceptual Framework DP (see Table 1), because:

(a) it is a present source of value, which is capable of producing economic benefit. This is because it is expected to produce economic *benefits in combination with* other assets;

(b) it is controlled by the entity. The control is provided by means of the acquirer's ownership of a controlling financial interest in the acquired entity's equity; and

(c) it results from a past event, which is the business combination.

Does acquired goodwill meet the recognition criteria?

Table 2: Recognition criteria of an asset under the Conceptual Framework

Criteria	Recognition of an asset
Existing criteria	An entity recognises an item that meets the definition of an element if: (a) It is probable that any future economic benefit associated with the item will flow to the entity; and (b) The item has a cost or value that can be measured with *reliability*.
Proposed criteria	An entity should recognise all its assets. However, the IASB might decide in developing or revising particular standards that an entity need not, or should not recognise an asset: (a) If recognising the asset would provide users of financial statements with information that is not relevant, or *not sufficiently relevant* to justify the cost; or (b) If no measure of the asset (or the liability) would result in a *faithful representation* of the asset and of changes in the asset, even if all necessary descriptions and explanations are disclosed.

67. With the presumption that acquired goodwill meets the definition of an asset, the Research Group thinks that it would also meet the recognition criteria under the existing Conceptual Framework (see Table 2), because:

(a) with the synergies embodied in the 'core-goodwill', it is presumed that future economic benefits associated with goodwill will flow to the entity; and

(b) acquired goodwill can be measured at cost (or residual) with sufficient reliability.

68. In addition, the Research Group thinks that the 'core-goodwill' would meet the proposed recognition threshold stated in the Conceptual Framework DP (see Table 2). This is because while internally generated goodwill is used as an example of an item that should not be recognised, none of the examples given in paragraph 4.26 of the Conceptual Framework DP (that explained limited situations where an asset should not be recognised, although it meets the definition of an asset) refers to the core-goodwill acquired in a business combination. Accordingly, the Research Group believes that the recognition filters with reference to relevance and faithful representation would not prevent an entity recognising 'core-goodwill'.

DIRECT WRITE-OFF APPROACH: IMMEDIATELY CHARGING THE GOODWILL TO EQUITY

69. Charging the goodwill immediately to equity on the acquisition date was one of the accounting treatments permitted under IAS 22. Under this approach, goodwill acquired in a business combination is immediately charged to equity[13], without charging the effect through the statement of profit or loss and other comprehensive income (OCI).

70. In the previous section, the Research Group concluded that acquired goodwill should be recognised as an asset. Therefore, the Research Group is of the view that charging the goodwill to equity is inappropriate.

71. In addition, the Research Group thinks that this approach is inappropriate because this may cause confusion regarding the nature of the business combination (that is a transaction with a third party), and result in inconsistencies with definitions of 'income' and 'expenses' in the Conceptual Framework. This is because this approach would require acquired goodwill (that is, the increase in economic benefit during the accounting period) to be accounted for directly as the decrease in equity; however, business combinations do not give rise to contributions from (or distributions to) equity participants. In addition, such a decrease cannot be explained as a capital maintenance adjustment.

72. Furthermore, if acquired goodwill were accounted for as a decrease in equity without charging an expense to profit or loss, the result of the business combination would not be faithfully represented in the statement of profit or loss and OCI, thereby impeding the proper reflection of financial performance.

[13] Paragraph 23 of IAS 22(1983) states that goodwill is not an independently realisable asset, that it has an indeterminate life for which any amortisation programme is arbitrary, and that, as self-generated goodwill is not recognised, it is inappropriate to recognise goodwill arising on acquisition.

Other considerations

73. The Research Group also thinks that the direct write-off approach has the following disadvantages:

    (a) if goodwill initially had value, virtually no event other than a catastrophe could subsequently occur in which it instantaneously became worthless;

    (b) although there are uncertainties associated with goodwill subsequent to initial recognition, such uncertainties are not unique to goodwill;

    (c) an acquirer's profit would be inflated in subsequent periods (including when all or part of the acquired business is impaired or disposed of), and users of financial statements may be misled without relevant disclosures. Many feel that this will reduce the usefulness of financial information especially in light of the stewardship perspective, because users have to adjust the financial figures when assessing how efficiently and effectively an entity's management and governing board have discharged their responsibilities to use the entity's resources. The immediate write-off of goodwill in all instances would imply that there is no difference between paying for the 'core-goodwill' or making overpayments in acquisitions;

    (d) an acquirer's financial performance would *always* be negatively impacted in the period when an entity acquires a business with premiums on it. Many feel this as counter-intuitive;

    (e) an entity's ability to pay dividends may be affected adversely, and its capital strength may be presented inappropriately;

    (f) the direct write-off approach creates an accounting arbitrage around identification and measurement of other intangible assets. This would risk moving the issue from the impairment of goodwill to the impairment of the identified intangible assets; and

    (g) if an entity writes off the goodwill immediately in its consolidated financial statements, it would be difficult to determine the treatment for the separate financial statements. It might be possible to require an entity to write off a portion of its investment immediately, but it does not seem to comply with the general principles in IFRS 9 *Financial Instruments or IAS 39 Financial Instruments: Recognition and Measurement.* If an entity were required to immediately write off part of the investment on acquisition, an entity that acquires a subsidiary would face risks of not meeting a minimum amount of shareholders' equity as required by some legislation or debt covenants, where the situation is essentially unchanged upon the acquisition. At the same time, the inconsistency that would arise if an entity were to immediately expense goodwill in its consolidated financial statements and treat it as part of an asset in its separate financial statements would be difficult to justify on a conceptual or practical level.

AMORTISATION AND IMPAIRMENT APPROACH

Background

74. As stated in paragraph 13 of this paper, many stakeholders acknowledged that the amortisation and impairment approach would be conceptually the most appropriate approach during the IASB's consultation leading up to the publication of IFRS 3 in 2004. This is because, in many cases, the excess earning power (which is essentially the 'core-goodwill') is presumed to decrease over time through competition with others. However, the IASB decided not to adopt this approach.

75. Some support the amortisation and impairment approach, primarily for the following reasons:

    (a) 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 periods;

    (b) even if the useful life of acquired goodwill or the pattern in which goodwill diminishes cannot be predicted with accuracy, the same argument would apply to property, plant and equipment, for which depreciation is required; and

    (c) 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.

76. On the other hand, others argue against the amortisation and impairment approach for the following reasons:

    (a) the useful life of acquired goodwill and the pattern in which it diminishes generally are not possible to predict, and the amortisation charge over any given period is only an arbitrary estimate of the consumption of acquired goodwill during that period;

    (b) many analysts stated that they ignored goodwill amortisation expense in their analysis, and many entities ignored goodwill amortisation expense in measuring operating performance; and

    (c) the increases in reported earnings in periods after amortisation of goodwill is completed may not be considered to be representationally faithful, because such increases in earnings arise from the cessation of prior 'doubling-up' of expenses related to goodwill.

77. In addition, others may argue that even if the amortisation and impairment approach were to be reinstated, the assessment of an appropriate amortisation period may differ depending on the emphasis on the 'stewardship' objective. Specifically, there is a view that a shorter period would be appropriate from the stewardship perspective. However, the Research Group is inclined to think that the decision of appropriate amortisation period would not differ based on which objective should be emphasised especially where an entity is required to review the amortisation period at least each financial year-end. The recent discussion of the Conceptual Framework indicates that accounting judgment would rarely differ depending on which objective is emphasised.

78. There might be a variation to the amortisation and impairment approach, which is to require (or permit) amortisation only in certain conditions. However, this approach has the following disadvantages:

(a) developing conceptual and operational criteria to identify these conditions would be highly complex and difficult; and

(b) allowing an option to amortise would impair comparability of financial information.

Review of academic literature

79. The Research Group believes that one of the major challenges for the amortisation and impairment approach is how to determine the appropriate period of time over which goodwill should be amortised[14]. In addition, some stakeholders have stated that excess earning power quickly becomes obsolete, particularly considering the speed of technological advancements. Therefore, the Research Group carried out a limited review of academic literature to identify any findings to the following questions:

(a) Is there any evidence that suggests that excess earning power diminishes (or does not diminish) over time?

(b) If excess earning power diminishes over time, is there any academic literature that identifies a specific period over which it would diminish?

[14] It is considered that if the pattern in which goodwill's future economic benefits are expected to be consumed by the entity cannot be determined reliably, the straight-line method may be used by analogy with an intangible asset having a finite useful life (paragraph 97 of IAS 38).

80. Although the findings were not uniform, the Research Group noted that several studies found that excess earning power diminished over time with the period varying from 3 to 10 years. Among others, the Research Group found the following papers particularly relevan[15].

(a) Jennings et al. (2001): This article discussed a study which surveyed data of the U.S. publicly traded companies that reported goodwill assets in the period of 1993 to 1998. The study reported that earnings before goodwill amortisation can explain the observed distribution of share prices better than earnings after goodwill amortisation. The study also found that goodwill amortisation adds noise to the analysis of share valuations based on earnings alone. The study stated that these results suggest that abolishing goodwill amortisation would not reduce the usefulness of earnings;

(b) Fama and French (2000): This article discussed a study that tested data in the period of 1964 to 1995. The study found evidence that profitability is mean reverting (in a simple partial adjustment model, the estimated rate of mean reversion is about 38% per year). The study also concluded that the rate of mean reversion is faster when profitability is below its mean and when it is far from its mean in either direction. The study also found that there is also a predictable variation in earnings; in particular, the study reported that negative changes in earnings and extreme changes tend to reverse faster;

(c) Bugeja and Gallery (2006): This article discussed a study that surveyed 475 Australian companies in the periods of 1995 to 1999[16]. The study classified goodwill into those acquired in the previous two years, and those acquired three or more years ago. The study reported that the analysis showed that goodwill acquired in the observation period and each of the prior two years were positively associated with entities' values, but there was no meaningful level of association between goodwill acquired more than two years ago and the entities' values. The study concluded that the absence of a meaningful relationship may suggest that goodwill recognised more than two years ago was not considered as an asset by investors;

(d) Ojala (2007): This article discussed a study that conducted analysis on 114 Finnish companies[17]. The study concluded that the evidence showed that the value of information about the goodwill balance, the amortisation expense and related impairment losses were more relevant if an entity applied an amortisation period less than 5 years than using a longer period as an amortisation period. The study concluded that the practice of goodwill amortisation provided relevant information to investors, when amortisation periods were kept sufficiently short in order to better reflect the economic life of the underlying assets;

[15] The Research Group notes that the summary of the articles in this paper is not intended to describe the whole story in the articles. Rather, it is the summary of the Research Group's understanding based on its reading.

[16] Prior to the adoption of IFRS in January 2005, under Australian accounting standards, acquired goodwill was subject to amortisation over a period not exceeding 20 years on a straight-line basis, and the balance of goodwill was required to be reviewed annually and written down to the extent that future economic benefits were no longer probable.

[17] The previous other literature often surveyed companies that were subject to US GAAP, which requires amortisation over period up to 40 years. To the contrary, Finish accounting standards required amortisation period up to 20 years.

(e) Obinata (2013): This article reported the outcome of his study which showed that the value of goodwill generally corresponds to the size of excess earning power over its mean in the industry. The study therefore concluded that goodwill should be amortised systematically, if the profitability is mean reverting and the excess earning power diminishes in a consistent manner. As a result of analysis on sample data of Japanese companies, this study further concluded that a positive goodwill balance should be amortised periodically over five to ten years, so as to reflect the underlying economic substance.

Discussion with stakeholders

81. The Research Group reached out to stakeholders to seek their views on whether the reasonable period over which excess earning power will diminish can be estimated. During the discussion, the Research Group heard the following comments:

(a) it is difficult to estimate the period with perfect accuracy, but it would be possible to *reasonably* estimate the period. This is because an entity usually goes through in-depth discussion and analysis about the period over which the investment will be recovered (or a pay-back period) and this would provide a good starting point to estimate the period over which the excess earning power will diminish;

(b) the 40-years period stipulated in APB Opinion No.17 would be too long, considering that the nature of business has changed significantly since then. A 20-years period may still be too long in many cases, considering the rapid changes in business environments (especially in the IT business industry), although there are cases where this presumption could be justified; and

(c) considering the uniqueness of each business combination, it would be arbitrary to stipulate a specific number of years over which acquired goodwill should be amortised. It may however be reasonable to include a maximum duration, while requiring an entity to estimate the period based on relevant facts and circumstances. Establishing a rebuttable presumption could also be explored.

CONCLUSION

82. As explained in paragraphs 49 to 78 of this paper, the Research Group investigated whether there are approaches that remedy shortcomings of the current impairment-only approach as identified in the responses to its survey. Based on its analysis, the Research Group concluded that:

    (a) the discernible-element approach would be impracticable to implement, although it has conceptual merits;

    (b) the direct write-off approach (immediate charge of the goodwill to profit or loss) implies that acquired goodwill is not an asset. Whilst it can be debated whether goodwill is or is not an asset, the Research Group concluded that it would meet the recognition criteria both under the existing Conceptual Framework as well as the proposal in the Conceptual Framework DP; and

    (c) the Research Group reached a similar conclusion in relation to the direct write-off to equity. Moreover, the Research Group identified additional conceptual problems with regard to the definition of incomes and expenses.

83. The Research Group therefore concluded in favour of an amortisation and impairment approach. Some may disagree with the re-introduction of amortisation for the reasons stated in paragraph 76 of this paper. However, in relation to these arguments, the Research Group believes that:

    (a) as explained in paragraph 81 of this paper, stakeholders has indicated that although it is difficult to estimate the period over which excess earning power will diminish with perfect accuracy, it would be possible to reasonably estimate the period;

    (b) in relation to the information content of the amortisation of goodwill, the input collected from analysts indicates that even if amortisation may have no information content, neither the recognition of impairment losses would have predictive value; and

    (c) although some may feel that amortisation expense and costs to maintain the excess earning power are doubled up, this is also the case for other assets, including intangible assets separately recognised in a business combination (e.g., those relating to customer relationship).

84. Based on the articles above and the results of the discussion with stakeholders, the Research Group thinks that the following requirements would enable entities to estimate the amortisation period of acquired goodwill in a reasonable way:

(a) establishing an overall principle that the goodwill should be amortised over the period in which the goodwill recognised from a business combination is expected to give rise to its effect;

(b) requiring that the entity base its assessment on relevant information that is available including information about current conditions and reasonable and supportable forecasts, but give greater weight to objective evidence of conditions that affect the period in which the goodwill recognised from a business combination is expected to give rise to its effect;

(c) providing guidance that an entity would normally consider the following factors in determining the amortisation period:

(i) the expected period in which the acquirer expects the acquired business to earn a higher rate of return as a standalone business. In addition, depending on the situations, the period over which synergies and other benefits from combining the acquirer's and acquiree's net assets and businesses will be realised may also be considered. Consideration of this factor does not mean that an entity should presume an indefinite amortisation period, if it uses terminal value in calculating the present value of an acquirer's ability to earn a higher rate of return;

(ii) the expected payback period of the investment on a business combination, which is normally estimated at the time when the business combination takes place. However, the payback period itself would not meet the definition of an amortisation period, and an entity would need to make the appropriate adjustments in determining the amortisation period; and

(iii) the useful life of the primary asset (or the weighted-average useful life of group of assets) which is the primary identifiable long-lived asset, including intangibles, from the use of which the entity is expected to derive its future cash flows. This may be especially valid when an entity's operation significantly relies on a particular asset (or a group of assets) and there is a reasonable correlation between the period over which the excess earning power diminishes and the useful life of the particular asset (or a group of assets); and

(d) requiring that the entity reviews the amortisation period when necessary by considering whether there have been significant changes in technology, commercial innovation, or market demand for products or services (both already occurred or reasonably expected in the future) since the business combination.

85. The Research Group also favours establishing a rebuttable presumption that the amortisation period should not exceed a maximum amount of years (for example, ten or twenty years). Some may argue that setting ten or twenty years seems too long, given the results of academic literature on the consumption of the excess earning power. However, in the Research Group's view, the presumption should capture a *maximum* period, while the academic literature focused on an *average* period of consumption of the excess earning power.

86. Based on the discussion above, the Research Group believes that the 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. The Research Group acknowledges the argument that the actual pattern of consumption of the benefits of the acquisition is difficult to predict and may not be constant over time. However, the Research Group thinks that overall systematic amortisation on a straight-line basis would meet an appropriate balance between faithful representation and cost.

87. Nevertheless, reintroduction of amortisation does not replace the need for a robust impairment model, its rigorous application and appropriate disclosure requirements[18]. These will be explored more in detail in the following chapters.

[18] For example, disclosure requirements that assist users to assess the quality of goodwill as of the period end.

BACKGROUND

88. As mentioned above, under IFRS 3 goodwill is not amortised and is subject to impairment testing at least annually, or whenever there is an indication that it is impaired. The impairment test requires comparing the carrying amount to the recoverable value. Paragraph 18 of IAS 36 defines the recoverable amount as the higher of an asset's or CGU's fair value less costs to sell (FVLCTS) and its value in use (VIU).

89. At the date of acquisition, paragraph 80 of IAS 36 requires allocating goodwill to each of the acquirer's CGU, or groups of CGUs expected to benefit from the synergies of the business combination. Each CGU or group of CGUs to which goodwill is allocated should represent the lowest level within the entity at which goodwill is monitored for internal management purposes.

90. Paragraphs 104 and 105 of IAS 36 require allocating any impairment loss first to the goodwill of the CGU (group of units) before it is allocated to other assets within the unit (or group of units) on a pro-rata basis, as long as it does not reduce any asset below the highest of its recoverable amount and zero. The impairment loss is recognised immediately in profit or loss. Paragraph 124 of IAS 36 does not allow reversing impairment losses for goodwill in subsequent periods.

91. The requirement in paragraph 107 of IAS 38 not to amortise intangible assets with indefinite useful lives was a radical change from the prior requirements. Previously, IFRS required amortisation of goodwill over its useful life. The reasons for discontinuing the amortisation of goodwill are described in paragraphs 11 and 14 of this DP.

RECENT DISCUSSIONS ABOUT THE CURRENT IMPAIRMENT TEST

92. Although IAS 36 requires an annual goodwill impairment test and a one-step impairment test, it still allows discretion in making a number of choices in relation to impairment. This view is supported by studies showing how principle-based standards could be applied in different ways and at different times. This is due to differences both in terms of accounting practices, i.e. the difference between *de jure* harmonization (harmonization rules) and *de facto* harmonization (harmonization practices), and in terms of country-specific factors such as legal, fiscal, cultural and political values (Ashiq and Lee-Seok 2000, Laghi 2006, Swanson, Singer and Downs, 2007; Glaum et al. 2013).

93. As mentioned above, the surveys conducted by OIC-EFRAG, the ASBJ's survey and the discussions on this project held at the recent IFASS meetings have highlighted the following issues related to the existing accounting treatment:

(a) the impairment-only approach leaves significant room for managerial discretion, interpretation, judgment and bias and in fact it may result in the entity failing to recognise an incurred impairment loss; and

(b) the financial crisis has shown that an improvement of the current standard may be necessary. Specifically, many respondents stated that the IASB should investigate whether the impairment test could be improved to ensure that entities use robust and reliable assumptions so that impairment losses are recognised on a timely basis.

94. In addition, other studies suggest how impairment losses may be recognised *too little and too late*. In particular, Laghi et al. (2013) considered a sample of 3,112 companies listed in the UK during the period 2008-2012, and showed that only 133 companies (4.2%) recognised an impairment loss higher than 5% of goodwill.

95. The same study considered a sample of 835 companies listed in the European Union that recognised an impairment loss in the period, and showed that only 53% recognised an impairment loss higher than 5% of goodwill, although financial markets were depressed during this period. Moreover, the impairment losses were recognised mainly in the period 2009-2011 later than the start of the financial crisis.

96. Finally, the results of this study show that the different European stock markets react differently to impairment losses. In particular, the authors pointed out that the correlation between impairment losses and stock price increases significantly during periods of negative stress in financial markets. Moreover, the authors evidence the fact that country-specific factors have a significant influence on the investment decisions of market operators.

97. Based on these considerations, the Research Group investigated possible solutions to ensure a more timely recognition of impairment losses and reduce the subjectivity and cost of the impairment test. This could be achieved in one of the following approaches, or with a combination of both:

(a) excluding from the assessment of the recoverable amount the effects of goodwill generated internally after the acquisition; or

(b) reducing the use of judgment in the current IAS 36 requirements.

DEVELOPING AN IMPAIRMENT TESTING MODEL THAT CONSIDERS ONLY ACQUIRED GOODWILL

98. As mentioned above, it is argued that an impairment-only approach allows entities to recognise internally generated goodwill, in conflict with the requirements in paragraph 48 of IAS 38. Such an issue arises because while the recognised amount of goodwill is determined based on the conditions at the date of the business combination, the impairment test refers to the value of the business at a subsequent date. Such a difference implies that, if no impairment loss is recognised, part of the newly internally generated goodwill replaces the economic consumption of the acquired goodwill. This would also give rise to comparability issues between entities that have undertaken business combinations, and as a consequence can recognise internally generated goodwill, and those that cannot do it.

99. To avoid this, IAS 36 could be amended to require reassessing the recoverable amount based on the conditions existing at the acquisition date, without considering the subsequent changes in the business acquired. However, this approach would effectively require a calculation of pro-forma future cash flows of a theoretical CGU.

100. Such an approach, if pursuable, would impose significant additional costs on the preparers because the *pro-forma* numbers would only be used for the impairment test, and could not be drawn from internal budgets and forecasts used for management purposes. Therefore, the Research Group believes that such a solution is impracticable. The Research Group is of the view that improving the impairment test model without introducing amortisation cannot in any case solve the issue related to the recognition of internally generated goodwill.

REDUCING THE USE OF JUDGMENT IN THE CURRENT REQUIREMENTS

101. Respondents to the surveys have noted that the current IAS 36 in some cases provides little or no specific guidance. Academic research (e.g. Glaum et al., 2013; Peterson et al., 2010) confirms that there is uncertainty as to how IAS 36's requirements are applied in practice.

102. In particular, respondents have identified the following areas of judgment:

(a) the choice of CGUs to which goodwill is allocated; and

(b) Inputs and methods to determine the recoverable amount of CGUs.

Identification of CGUs to which goodwill is allocated

103. In relation to the identification of CGUs, IAS 36 paragraph 68 says that: “an asset’s cash-generating unit is the smallest group of assets that includes the asset and generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets. Identification of an asset’s cash-generating unit involves judgment. If recoverable amounts cannot be determined for an individual asset, an entity identifies the lowest aggregation of assets that generate largely independent cash inflows.”

104. Size and composition of CGUs impacts the recognition and measurement of impairment losses, but IAS 36 offers limited guidance in identifying them. If a CGU is too broad, it may result in non-recognition of impairment because the gains of some units may offset the losses of another unit within the same CGU. Paragraph 80b of IAS 36 requires that a CGU should not be larger than an operating segment determined in accordance with IFRS 8 *Segment Reporting*, but some studies cast doubts on whether there are entities that do not comply with this requirement.

105. Based on empirical research, Ernst & Young (2006, 35) concludes that frequently entities identify only one CGU for each of their segments, even if they do not specifically disclose this fact. Contrary to that, Petersen and Plenborg (2010) on the basis of a survey conducted across all Danish listed companies, find that only 25% of the entities surveyed identify CGUs at the segment level. This may indicate that in some jurisdictions preparers are more rigorous in applying the requirements.

106. In relation to the allocation of goodwill to the CGUs, it should be noted that a different approach exists between IFRSs and US GAAP. Under US GAAP, goodwill is allocated to the reporting unit level whilst under IFRS it is allocated to the CGUs. Reporting unit is defined in US GAAP as an operating segment or one level below an operating segment (component).

107. The Research Group believes that to favour a consistent application of the standard a stricter guidance could be introduced to facilitate the allocation of goodwill to the smallest CGU.

Inputs and methods for estimating the recoverable amount of CGUs

108. In relation to the inputs and methods for estimating the recoverable amount, the Research Group believes that the areas in need of improvement are:

(a) the valuation approach;

(b) the calculation of the VIU;

(c) the discount rates and cash flows; and

(d) the forecast period and determining terminal value (TV).

109. As mentioned above, paragraph 18 of IAS 36 states that the recoverable amount is the higher of its FVLCTS and its VIU. On this point, the OIC-EFRAG survey shows that entities mostly use VIU in determining the recoverable amount. In all likelihood, the infrequent use of FVLCTS is due to the fact that it requires information on the market value of the unit.

110. Some have argued that the method applied to determine the recoverable amount should reflect the expected manner of recovery, and if the entity intends to recover the value by operating the unit, the recoverable amount should only be based on VIU.

111. To estimate VIU, paragraph 30 of IAS 36 requires applying the discounted cash flow model (DCF), including its variants such as the dividend discount model (DDM). However, there are studies that show that some entities apply other methods such as EVA-model (economic value added model) and multiples (Peterson et al. 2010).

112. IFRS 13 has clarified methods for the calculation of fair value in the absence of a primary market for the asset being valued. It has also explained that fair value of a non-financial asset should represent its highest and best use. Some question that in very few circumstances an entity could conclude that value in use may be higher than a fair value if the latter represents its highest and best use. Such an aspect may be considered by the IASB in revisiting the requirement of IAS 36.

Assessing the discount rate

113. A significant area of judgement in the calculation of the VIU is the determination of the discount rate. Paragraph 55 of IAS 36 requires that an entity must use a pre-tax discount rate to discount pre-tax cash flows so there is consistency between the discount rate and the cash flows. Paragraph 94 of the Basis for Conclusions of IAS 36 states that, conceptually discounting post-tax cash flows at a post-tax discount rate or discounting pre-tax cash flows at a pre-tax discount rate should give the same results. This could be understood as an indirect equivalence between pre-tax and post-tax discount rates. However, if the expected future cash flows are not evenly distributed over the period, the equivalence may not occur.

114. In addition, most academic books (e.g. Koller et al., 2005) estimate value in use on the basis of post-tax cash flows, discounted with a post-tax discount rate.

115. IAS 36 is not explicit as to how to estimate a pre-tax discount rate, and implicitly suggests using an iterative process in certain cases (see paragraphs 56, 57 and BCZ85). It would seem that VIU could be estimated starting from a post-tax calculation to arrive at an equivalent result through an iterative process. However, as said above, the iterative process depends upon the time distribution of the cash flows. Moreover, entities can be consistent with the concept stated in paragraph 94 of the Basis for Conclusions in IAS 36 only if the cash flows are uniformly distributed along the time period. More particularly, if the cash flows are variable and/or uneven, the discount factor will influence the results according to how the flows are distributed.

116. The examples and explanations in IAS 36 do not clearly explain how the iterative process should be applied when the cash flows are uneven and the entity is unable to reconcile between the post and pre-tax rate and flow. The reconciliation is possible when the flows and the growth rate are even, without the need for an iterative process but simply by grossing-up the post-tax rate and flow. The IASB should then clarify that using the formula [post-tax rate/(1 – corporate tax rate] to determine the pre-tax rate works only when no growth is assumed in the future periods. If the growth rate is positive, and the flows are assumed to be steady over the period, it is still possible to determine the pre-tax rate by grossing up both the post-tax rate and the growth rate.

117. The issue related to the calculation of the discount rate is not limited to the tax effect but also whether there is a consistency among entities using IFRSs in relation to the input used in determining the discount rate. To this end the Research Group looks favourably to the research work initiated by the IASB staff on the use of discount rates and is keen to be involved in the project.

118. Paragraph 33b of IAS 36 requires that projections based on budgets and forecasts shall cover a maximum period of five years, unless a longer period can be justified. The IASB intended limiting the explicit forecast period because the entity's ability to forecast beyond 5 years is presumed to be low. Yet IAS 36 does not provide any guidance on the methods to estimate the terminal value (e.g. Gordon's growth model, a value driver formula, or others). Studies show that some entities use multiples to estimate terminal value: Petersen and Plenborg examined a sample of Danish companies and found that some use methods other than a DCF model such as EVA (Evaluation Value Added model), multiples and other methods.

119. More specifically, these studies concluded that some preparers use a DCF model only for the explicit period and then add a terminal value calculated under a different method. Although IAS 36 does not prohibit this, it might be inconsistent with a DCF model. In all likelihood, it can be assumed that considering an infinite lifetime the majority of the recoverable amount can be attributed to the terminal value, and in such circumstances most of the value estimated is captured by the multiple.

CONCLUSION

120. The Research Group thinks that the following conclusion can be drawn from the above analysis:

(a) developing more prescriptive requirements and guidance to reduce the recognition of internally generated goodwill is impracticable. Such an issue can be addressed in part by improving the impairment test model but only if the improvement is combined with the re-introduction of the amortisation of goodwill. In any case, the impairment test needs to be retained even if amortisation of goodwill is reintroduced;

(b) there are a number of areas for possible improvements of IAS 36 in order to reduce the operational challenges. This applies to calculation of VIU and its relationship with fair value as well as the determination of the discount rate; and

(c) in relation to the concept and usage of discount rate, the Research Group is interested in the research work conducted by the IASB staff and is keen to be involved in the project.

CURRENT STATUS OF GOODWILL IMPAIRMENT DISCLOSURES

121. This part of the paper focuses on possible improvements in the disclosure around goodwill impairment, and not on how to enhance the application of existing requirements.

122. IAS 36 includes a number of disclosure requirements around impairment in general, and goodwill in particular. It requires an entity to disclose the following types of information:

    (a) for each class of asset, the amount of impairment losses and reversals in the period;

    (b) for each CGU that incurred a material impairment loss:

        (i) events and circumstances that led to the impairment loss or reversal;

        (ii) a description of the CGU to which the impaired goodwill is allocated (and any change in the composition of the CGU in the period); and

        (iii) the method used to calculate the recoverable amount of the CGU.

    (c) for each CGU that includes an amount of goodwill significant to the total goodwill:

        (i) the carrying amount of the goodwill allocated to the CGU;

        (ii) the method used to calculate the recoverable amount of the CGU;

        (iii) key assumptions in the calculation of the recoverable amount; and

        (iv) an analysis of the sensitivity of the recoverable amount to key assumptions (if a reasonably possible change would determine the recoverable amount to be higher than the carrying amount).

123. While recent Standards explain the objective of the disclosures required, IAS 36 does not indicate it explicitly. Paragraph 194 of the Basis for Conclusions states that non-amortisation of goodwill increases the reliance that must be placed on impairment tests. However, the nature of impairment tests means that the carrying amount of such assets and the related assertion that those carrying amounts are recoverable will normally be supported only by management's projections. Paragraph 198 of the Basis for Conclusions explains that the disclosure requirements are designed to improve the reliability of the impairment test.

Criticism of existing disclosures

124. Beyond the overall criticism that impairment of goodwill is untimely, there is a perception that users are not able to anticipate when impairment will occur or understand why it has not occurred based on the information provided in accordance with disclosure requirements of IAS 36.

125. Although impairment does not affect the amount or timing of cash flows, being able to predict it is an important input to users' assessment of the amount, timing and uncertainty of (the prospect for) future net cash inflows to the entity. It is an indication that the performance of the acquired business is deteriorating and that entities have lowered their previous forecast of future cash flows and returns.

126. It may seem that IAS 36 and IFRS 3 already prescribe extensive disclosure requirements. There are however claims that compliance is lacking or merely formal.

127. In January 2013, the European securities market regulator (ESMA)[19] concluded that "Although the major disclosures related to goodwill impairment testing were generally included, in many cases these were of a boilerplate nature and not entity-specific. This stems from a combination of a failure to comply with the requirements of the standard by issuers, as well as, arguably, a lack of specificity in the standard, especially in the area of sensitivity analysis. This also means that, in many cases, the user of the financial statements is not able to evaluate the reliability of the assumptions used from the disclosures given, which is the primary purpose of those disclosure".

128. Amiraslani, Iatridis and Pope (2013)[20] looked at entities across Europe and found that companies in different countries show different levels of compliance with IFRS requirements. While they recommend caution in generalising the results of the survey because of the small sample size, the impairment intensity seemed affected by certain country characteristics such as the strength of enforcement mechanisms.

129. Other studies have looked at the effectiveness of disclosures in existing Standards. Hayn and Hughes (2005)[21] conclude that "the results suggest that the ability to predict goodwill impairment based on information provided in the financial statements is limited". They attribute this to the paucity of information around the performance of the acquired business particularly when the goodwill is allocated to a CGU that differs from the entity's reported operating segments.

[19] *European enforcers review of impairment of goodwill and other intangible assets in the IFRS financial statements.*
[20] Amiraslani H., Iatridis G. and Pope, P. (2013). Accounting for asset impairment: a test for IFRS compliance across Europe (Cass Business School).
[21] Hayn C. and Hughes P. (2005). Leading Indicators of Goodwill Impairment.

130. Some preliminary remarks are listed below:

(a) the Research Group believes that explicit disclosure objectives in the Standard would be useful. This would assist preparers in the appropriate application of the requirements;

(b) entities need to consider the level of detail necessary so that the information is useful and that excessive detail does not obscure the usefulness of the information;

(c) some information could be disclosed not in the notes, but elsewhere in the financial reports, as far as the boundary of information disclosed other than in the notes is clearly identified. This may be the case for instance for explanations of the variances between budget/forecast and actual amounts. This paper does not discuss placement criteria further;

(d) during the development of IAS 36, the IASB conducted field-tests of the initial disclosure proposals. Participants in the field test expressed concern about disclosing the values assigned to, and the sensitivity of, each key assumption and argued that these requirements could cause significant commercial harm to the entity. It was noted that users might use the quantitative disclosures as a basis to initiate litigation against the entity or its directors in the likely event that those assumptions prove less than accurate. This factor will need to be considered before changes are introduced.

131. As mentioned above, disclosure requirements in IAS 36 and IFRS 3 already appear to be extensive. If new requirements were to be added, it could be appropriate to assess if all the existing requirements were still relevant or justified from a cost-benefit perspective. This paper does not discuss this, however the Research Group notes that, during the outreach, some constituents have expressed concern with the requirement to disclose the revenue and profit or loss of the combined entity as though the acquisition date had been at the beginning of the reporting period.

ENHANCED DISCLOSURE REQUIREMENTS

132. The IASB's Conceptual Framework states that existing and potential investors, lenders and other creditors need information to help them assess the prospects for future net cash inflows to an entity, and how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's resources[22].

133. Following the objectives stated in the previous paragraph, the IASB's Conceptual Framework DP states that the objective of the notes to the financial statements is to supplement the primary financial statements by providing additional useful information about:

(a) the assets, liabilities, equity, income, expenses, changes in equity and cash flows of the entity; and

(b) how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's resources[23].

134. To serve these objectives, the Research Group think that disclosures on impairment could, in theory, provide information that:

(a) enables users to understand the financial effects of impairment losses recognised in the period;

(b) assists users in understanding the robustness of the modelling and the entity's assumptions;

(c) provides confirmation of the 'reasonableness' of the entity's past assumptions;

(d) assists users in predicting future impairment; and

(e) allows users to perform their own impairment calculation, or re-perform the entity's calculation.

135. In the Research Group's view, the existing disclosure requirements in IAS 36[24] allow users to understand the financial effect of impairment losses. Also, the Research Group does not support the objective that disclosures should allow users to second-guess management's impairment test (see (e) of the previous paragraph).

136. In the following paragraphs, the Research Group explores whether the other objectives are adequately met in the existing requirements, as well as how they could be enhanced.

[22] Paragraphs OB3 and OB4, Conceptual Framework.
[23] Paragraph 7.33, Conceptual Framework DP.
[24] Paragraphs 126 to 131, IAS 36.

Disclosures to assist users in understanding the robustness of the modelling and the entity's assumptions

Timing profile of VIU

137. According to paragraph QC16 of the Conceptual Framework, faithful representation does not necessarily result in useful information. For example, an estimate of impairment can be a faithful representation if the reporting entity has properly applied an appropriate process, described the estimate and explained any uncertainty that significantly affects the estimate. Other things being equal, a longer time horizon is likely to increase the uncertainty embodied in the measurement.

138. Therefore it may be relevant for the reader to know how much the VIU is supported by cash flows expected in the short term or by cash flows expected in the longer term. Paragraph 134(d) of IAS 36 requires disclosure of the period over which management has projected cash flows based on financial budgets/forecasts approved by management.

139. A simple solution is to disclose the portion of the recoverable amount covered by estimates and the terminal value. If full disclosure is deemed prejudicial to the entity, the information could be limited to a simple breakdown in percentage terms with no indication of the total amount.

Inputs to the discount rate

140. One area where the quality of information could be enhanced is discount rates. The appropriateness of discount rates is often identified as an issue and it would be useful for users to understand better how the rates were determined. In a recent survey on the impairment of financial assets[25], users rated as highest importance the disclosures of assumptions and techniques used in estimating the allowance for credit losses, and the same argument may apply to impairment of non-financial assets.

141. Currently, IAS 36[26] requires an entity to disclose each key assumption on which management has based its cash flow projections for the period covered by the most recent budgets/forecasts. However, the choice of a proper discount rate and terminal growth rate has a significant impact on the VIU calculation, and some argue that the requirement should be more prescriptive. In fact, paragraph 55(b) of IAS 36 explicitly requires that the discount rate reflect current market assessments of the risks specific to the asset (or the CGU), while studies have found evidence that entities may use the same discount rate for different CGU.

142. Full disclosure and justification of the calculation would provide the maximum amount of information. On the other hand, especially if the entity has multiple CGUs, the disclosure could be voluminous – although preparing it would not involve significant additional work because the entity already has all the relevant data.

[25] CFA Institute (2013). Credit loss and impairment survey.
[26] Paragraph 132, IAS 36.

143. Alternatively, entities could be explicitly required to provide qualitative information on the calculation inputs – for instance, an entity would be asked to disclose if it has used separate rates for different periods or incorporated any liquidity premium in relation to country or size risk.

144. In addition, IAS 36 requires entities to re-assess the discount rate and the terminal growth rate at each reporting date and these are expected to change in response to changes in the market and risk profile of the CGU. Nevertheless, users may perceive a decrease in the discount rate as an attempt to compensate for a decrease in expected cash flows. Users would have a more nuanced understanding of the model if entities were required to disclose the time series of rates over a period of time and an explanation of circumstances that led to adjustments.

Disclosures to provide confirmation of the reasonableness of the entity's past assumptions

145. The Research Group believes that it is appropriate to use the term 'reasonableness' rather than 'accuracy' when referring to assumptions, because the calculation of VIU involves the use of forward-looking information. Management should use its best judgment and exercise a degree of caution in forming its estimates, but full precision cannot be reached and should not be expected by users of the financial statements.

<u>Analysis of variances</u>

146. In order to assess the prospects for future net cash inflows to an entity, users must be in a position to assess the entity's precision in forecasting. Therefore, information that has a confirmative value is relevant.

147. Users could benefit from the disclosure of variances between forecasts and actual results, and related explanations. It is not infrequent that cash flows are expected to be low, or even negative, in the first year of business operations and increase over time (the so-called 'hockey stick' forecast). When this continues for a number of years, it becomes an indication that original expectations failed to eventuate and that impairment may be needed.

148. The analysis may address only the variance in the current period or may be on a cumulative basis since the date of the acquisition. Analysis limited to the current period may be insufficiently informative, especially if the variance has a low impact or if it is caused by a specific event unusual in size and/or non-recurring in nature. A cumulative variance becomes burdensome to update after a certain number of years from the business combination. Also, variances that occurred in prior years may reflect conditions that no longer exist. An intermediate solution could be to disclose the variance over a limited period (such as the last 3 to 5 years).

149. The analysis could also be performed in relation to the initial forecast and provided only during the period covered by it, or on a rolling basis.

Disclosures to assist users in predicting future impairment

Information on performance of the acquired business

150. In theory, there would be a clear correlation between the performance of the acquired business and the timing of the impairment, so disclosure of a measure of profit or loss would have significant predictive value. Therefore, some argue that there should be a more prescriptive requirement to disclose the performance of the acquired business. However, there are a number of circumstances when the information will be either unavailable or irrelevant.

151. Firstly, the acquired business may be integrated immediately or over time into the acquiring entity's operations so that the CGU encompasses more than the acquired business. In that case, the results of the CGU are not solely attributable to the performance of the acquired business and it is likely that separate information for the acquired business will not be available.

152. Secondly, the goodwill may be allocated to multiple CGUs. In that case, the performance of the acquired business is not the only factor affecting the occurrence of impairment.

Expected timing of impairment

153. Accounting literature suggests a wide variety of explanations for the existence of goodwill. One theory postulates that goodwill arises because of the existence of a range of factors that, while favourable to an entity's performance, are not capable of being recognised and measured.

154. Within the discussion on the 'discernible element' approach, it was noted that according to paragraph 313 of the BC of IFRS 3 the 'core' goodwill should include the following:

(a) the fair value of the going concern element of the acquiree's business before the acquisition; and

(b) the fair value of the expected synergies and other benefits from combining the acquirer's and acquiree's businesses.

155. If available techniques allowed for a reliable measurement of the above, entities would not need to recognise goodwill in their statement of financial position, and possibly could amortise the amounts (although this is not certain, because goodwill is not the only asset that is deemed to have an indefinite economic life). Ideally, the residual value would be amortised over a specific period.

156. Paragraph B64(e) of IFRS 3 requires a qualitative description of the factors that make up the goodwill recognised, but does not ask entities to disclose the time period over which they projected the synergies to have an impact, or the value of the unrecognised intangibles to be consumed.

157. If an entity was required to disclose the time period over which it expects to consume the excess earning power from the synergies existing at the acquisition date, it may reduce the incentive to defer the recognition of losses because it would not be unexpected 'bad news'. The potential downside is that it could result in opportunistic timing of impairment as management could try to match the recognition with the initial assessment.

158. The Research Group expects that normally the acquirer would estimate an expected payback period (that is, the period in which it expects to recover the investment). In most cases, this payback period could be deemed to be the period in which it expects to consume the excess earning power existing at the acquisition date or could be used to estimate it.

Acquisition characteristics that point to future impairment

159. In cases where the acquirer overpays for the acquiree, the overpayment may end up in the initial measurement of goodwill, although IFRS 3 tries to avoid this by requiring that the entity provides a qualitative description of the factors that make up the goodwill (paragraph B64 (e))

160. When the goodwill includes an overpayment, impairment is more likely to occur. Some characteristics of the original acquisition may provide an indication of possible overpayment such as:

(a) goodwill is significant compared to the net identifiable assets of the acquiree;

(b) a significant portion of the consideration was represented by the acquirer's equity interests;

(c) the acquirer was bidding against other potential buyers; and

(d) the acquirer paid a significant premium over the acquiree's market price.

161. Beyond the amount of recognised goodwill, IFRS 3 requires an entity to provide information on the acquisition-date fair value of each major class of consideration, including equity interests of the acquirer (paragraph B64 (f)). No information is required on the characteristics listed at (c) an (d) in the paragraph above. While information on competitive bids would be difficult to provide, unless there was a public auction process, the acquirer could be required to indicate the amount of the premium paid over the market price.

Reconciliation of total goodwill

162. As mentioned above, IAS 36 requires disclosure of CGUs with a significant amount of associated goodwill. Entities are however not required to provide a full reconciliation of the total goodwill allocation to the CGUs. Providing a reconciliation of these figures would confirm the entity's compliance and make it easier for users to track the changes over time. This could prove useful in the case of frequent sales or disposals of businesses or modifications in the CGUs. The reconciliation would also clearly indicate the degree of detail applied by the entity in identifying its CGUs.

CONCLUSION

163. The Research Group believes that there is room for improvement in the disclosure requirements for the impairment test. This does not necessarily imply that each requirement discussed in paragraphs 137 to 162 above needs to be added to the disclosure requirements in IAS 36. Rather, it is a matter to reconsider what the information needs of users are in relation to the impairment test, and reach the appropriate balance among them.

BACKGROUND

164. In the March 2014 IFASS meeting, it was suggested that a decision regarding whether acquired goodwill should be amortised could have an effect on how intangible assets should be accounted for, and that these issues should be considered in parallel.

165. Under IFRSs, intangible assets shall be recognised separately from goodwill in a business combination, if intangible assets acquired in a business combination are identifiable (or, if they meet either the separability criterion or the contractual-legal criterion). Consideration of the probability recognition criterion and the reliable measurement criterion is not required under IFRSs, because the IASB believes that these criteria are always satisfied in a business combination.

166. In addition, IAS 38 requires that an intangible asset with *a finite* useful life should be amortised on a systematic basis over its useful life, while it should be tested for impairment only when there is any indication that an asset may be impaired. On the other hand, IAS 38 requires that an intangible asset with an *indefinite* useful life should be tested for impairment annually and whenever there is an indication that the intangible asset may be impaired, however it does not require or permit amortisation of such an asset.

167. Some argue that if amortisation of acquired goodwill were to be reintroduced, the existing accounting requirements relating to intangible assets acquired in a business combination should also be reconsidered in the following aspects:

(a) whether some intangible assets that are separately identified under existing IFRSs should be subsumed into goodwill; and

(b) whether the standard should continue to assume that some intangible assets have no foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity, and that amortisation should not be permitted or required for such assets.

SUBSUMING INTANGIBLE ASSETS INTO GOODWILL

168. During the outreach, some stakeholders suggested that the existing requirements of IAS 38 to separate intangible assets from acquired goodwill should be modified, because an entity should not have to recognise intangible assets that it did not intend to acquire in a business combination. In addition, these stakeholders advised that values of such intangible assets are not always measured with sufficient reliability, because the decision of whether to separate is often arbitrary and there is often no market for these assets. Therefore, they do not believe that such requirement provides relevant information to users.

169. In addition, for intangible assets such as customer-related intangible assets, it was noted that the costs of measuring them separately often outweighs the benefits of doing so, especially in a strict audit environment. This is because an auditor often requests that an entity supports its valuation with a valuation report from an independent expert, and an auditor also obtains an additional report. Further costs arise if the estimates provided by such valuation experts happen to diverge.

170. If goodwill was amortised, the impact of separating these intangible assets would be limited to a different amortisation period, and only if the entity assessed that they have a useful life different from goodwill.

171. In relation to this, the UK Financial Reporting Council published its staff research report: *Investor Views on Intangible Assets and their Amortisation* in March 2014. Among other findings, the report noted that the majority of the respondents expressed a preference for accounting treatments in the statement of financial position and in the income statement that were different from those currently required by IAS 38. They also considered that 'wasting' intangible assets (for example, the right to use wireless network services) should be separately identified and capitalised, while 'organically replaced' intangible assets (for example, customer lists and brands) should be subsumed into goodwill.

INTANGIBLE ASSETS WITH INDEFINITE USEFUL LIFE

172. Some stakeholders suggested that if acquired goodwill was amortised, the same treatment should be applied to all intangible assets. This is because the arguments used to support non-amortisation of intangibles with indefinite useful lives are generally consistent with those used for non-amortisation of acquired goodwill, but some believe that useful lives of intangible assets can always be estimated. Therefore, stakeholders suggested that if acquired goodwill were to be amortised, the IASB should also require an entity to estimate the periods over which future economic benefit are expected to consumed and allocate the amounts of intangible assets on a systematic basis over the useful lives.

173. At the same time others believe that reintroducing amortisation of acquired goodwill should not affect the accounting for intangible assets, because impairment testing of intangible assets would be more effective due to the clearer linkage between the cash flow projection and their carrying amounts, and that these intangible assets are directly measured, while goodwill is measured as a residual.

CONCLUSION

174. Although the Research Group has not formulated a view as to whether, and if so, how accounting requirements for intangible assets should be changed, it believes that they should, at least be investigated. The Research Group would be pleased to learn the views of constituents, so as to progress its research on this area.

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