STAFF PAPER

May 2022

IASB® meeting

Project	**Goodwill and Impairment**	
Paper topic	Potential consequences of transitioning to an amortisation-based model	
CONTACT(S)	Paolo Dragone	pdragone@ifrs.org
	Tim Craig	tcraig@ifrs.org

Purpose

1. As explained in Agenda Paper 18, this paper summarises feedback from our research on the potential consequences of transitioning to an amortisation-based model[1] were the International Accounting Standards Board (IASB) to reintroduce amortisation of goodwill. The paper also includes some of our initial observations on the feedback.
2. The potential consequences of transitioning to an amortisation-based model could arise from:
    (a) the derecognition of significant amounts of goodwill from entities' balance sheets as if an amortisation-based model had always been applied and the effect this has on entities' financial positions (for example, on net equity); and
    (b) the amortisation of significant amounts of historic goodwill over a useful life determined at the date of transition and the effect this expense would have on entities' earnings.

[1] For the purposes of this paper it is assumed that if the IASB decide to reintroduce amortisation of goodwill, it would be accompanied by an impairment test.

Structure of this paper

3. The paper is set out as follows:

   (a) Key messages (paragraphs 4–5);

   (b) Background and feedback to the Discussion Paper *Business Combinations—Disclosures, Goodwill and Impairment* (paragraphs 6–10);

   (c) Process (paragraphs 11–13);

   (d) Feedback (paragraphs 14–45);

   (e) Initial observations (paragraphs 46–52);

   (f) Appendix A—Process; and

   (g) Appendix B—Quantitative analysis.

Key messages

4. Most respondents highlighted potential consequences of transitioning to an amortisation-based model and many respondents said transition would significantly affect entities' financial positions and performance because of the size of historic goodwill balances. Some of these effects could be significant and more prevalent for entities in particular jurisdictions. We note that:

   (a) respondents from Asia-Oceania said entities in their jurisdictions risk failing to meet listing requirements and, eventually, being suspended from trading or delisted if they report negative equity and/or profit; and

   (b) respondents from Latin America said the amounts of dividends that entities in their jurisdictions could distribute would be affected.

5. However, many other respondents said the consequences of transition would be limited.

Background and feedback to the Discussion Paper

6. Although the IASB's preliminary view in the Discussion Paper was not to reintroduce amortisation of goodwill, a few respondents to the Discussion Paper commented on

transition if the IASB were to reintroduce amortisation. Many of these respondents (national standard-setters and accounting bodies) said goodwill represents a significant balance for many entities, and transitioning to an amortisation-based model would be a significant challenge because it could:

(a) result in negative equity and affect entities' access to capital markets.

(b) result in negative equity which might result in some entities being declared 'technically bankrupt' in some countries.

(c) affect entities' ability to pay dividends.

(d) affect existing contractual agreements. Respondents said the IASB should allow sufficient time to change those agreements.

7. One regulator group said transitioning to an amortisation-based model could create additional costs, temporary disruption and could confuse users. They recommended investigating the potential effects of transition on financial stability.

8. One accounting body said estimating the useful life of goodwill that has been generated by numerous acquisitions over a long period of time would be challenging.

9. Many of these respondents also commented on how an amortisation-based model should be implemented. In their view:

(a) retrospective application would be preferable because:

  (i) prospective application of an amortisation-based model would provide information with little relevance and the benefits derived from the business combination in previous periods would not be matched by amortisation expenses; and

  (ii) retrospective application would help entities align the accounting for goodwill in consolidated financial statements with the accounting for goodwill in separate financial statements prepared applying local generally accepted accounting principles (GAAP) which require amortisation of goodwill; or

(b) prospective application[2] would be preferable because retrospective application would significantly affect entities' balance sheets and the information needed to estimate the useful life of goodwill may no longer be available.

10. However, one respondent to the Discussion Paper said although the IASB should carefully consider potential consequences, transition should not be something that prevents the IASB from reintroducing amortisation of goodwill.

Process

11. As requested by the IASB, we researched the consequences—legal and regulatory—of transitioning to an amortisation-based model. We did not specifically research the practicality of applying different transition approaches (for example, retrospective or prospective). However, a few stakeholders commented on practicality and we included those comments in the feedback section.

12. In order to gather information on the potential consequences of transition, we:

(a) discussed the issue at the November 2021 Global Preparers Forum (GPF) meeting;

(b) sent an information request to national standard-setters, via the International Forum of Accounting Standard-Setters (IFASS); and

(c) sent an information request to regulators, via the International Organization of Securities Commissions (IOSCO).

13. Appendix A includes further details about the work we performed.

Feedback

14. We received 16 responses from national standard-setters, including one regional group of national standard-setters, and five responses from regulators. Of the 21

[2] Respondents that clarified what they meant by 'prospective application' said historic goodwill should be amortised prospectively over its remaining useful life.

responses, three were from North America, four from Latin America, eight from Europe and six from Asia-Oceania.

15. The feedback on the consequences of transition was mixed. Although many respondents said, in their view, the consequences of transition would be limited, many other respondents said, in their view, the consequences of transition would be significant. Feedback from our research on the consequences of transitioning to an amortisation-based model has been organised as follows:

    (a) entities' financial positions and performance (paragraphs 16–21);

    (b) access to capital markets and economic development (paragraphs 22–27);

    (c) capital maintenance (paragraphs 28–32);

    (d) dividend distribution (paragraphs 33–37);

    (e) debt covenants and credit ratings (paragraphs 38–41); and

    (f) other matters (paragraphs 42–45).

Entities' financial positions and performance

16. Many respondents said transitioning to an amortisation-based model would significantly affect entities' financial positions and performance because of the size of goodwill balances. For example, one respondent from Europe said goodwill represents 22% of the net assets/equity of listed entities applying IFRS Accounting Standards in their jurisdiction and another respondent, also from Europe, said goodwill represents 51% of the net assets/equity of listed entities applying IFRS Accounting Standards in their jurisdiction.

17. One national standard-setter from Europe asked a sample of the most important entities in their jurisdiction what the effect of reintroducing amortisation of goodwill would be if transition was retrospective and the useful life of goodwill was assumed to be 10 years. They reported that the equity of the sample would reduce by 6–60%, and the entities' measures of profit would reduce by 3–30%. If historic goodwill were to be amortised prospectively over a 10-year period, the entities' measures of profit would reduce by 11–80%.

18. This respondent also said transition could negatively affect an entity's income or equity-based key performance indicators (for example, debt-equity ratios, earnings per

share, return on equity, return on capital employed or price-to-book ratios) which could confuse users. They said entities might use non-GAAP measures (including measures that would meet the definition of management performance measures) to communicate information to the market which would reduce comparability between entities. Another respondent said there would be a need to educate users given the non-cash nature of the transition effect.

19. Appendix B includes further quantitative information about the effects of transition on entities' financial positions and performance.

20. Some respondents said because of these significant effects, transition should not be retrospective and one respondent said these effects could only be partially mitigated by additional disclosures.

21. However, some respondents said these effects are not compelling enough to prevent the IASB from reintroducing amortisation of goodwill. A few respondents said these effects could be managed if entities received sufficient time to transition. One respondent said the effects would be limited as long as there was adequate communication of the changes to users. A few respondents said the effects would be limited because users often eliminate the non-cash effects of goodwill and entities generally use non-GAAP measures (including measures that would meet the definition of management performance measures) to communicate their performance.

Access to capital markets and economic development

22. Many respondents said requiring entities to recognise an amortisation expense or adjust historical goodwill balances could limit an entity's ability to access capital markets and negatively affect economic development. For example, some respondents said reduced net assets and increased debt to equity ratios resulting from transition to an amortisation-based model could negatively affect an entity's ability to raise finance.

23. One regulator from Europe said listed entities in their jurisdiction could lose their status of 'high standard' entities on the local stock exchange in the event of reporting losses above a threshold based on equity.

24. Some respondents (mostly from Asia-Oceania), said a listed entity in their jurisdiction risks failing to meet listing requirements if transition would result in the entity

reporting negative equity[3] or a negative measure of profit (for example, net profit or operating profit). Failing to meet these listing requirements could result in an entity being suspended from trading or delisted.

25. However, many of these respondents said delisting or suspension may not necessarily be automatic. Most of the listing requirements assess the profit or equity measures over a specific timeframe (with two or three years commonly mentioned) or in conjunction with other indicators (for example, market capitalisation). Entities may also be granted a period of time over which they can rectify their financial position or performance, for example by replacing equity.

26. We reviewed listing requirements in other jurisdictions in Asia-Oceania and found other examples where an entity could be at risk of delisting under the local listing requirements if the entity had negative equity.

27. Feedback suggests the number of entities that risk failing to meet listing requirements following transition could be limited. One national standard-setter from Asia-Oceania said in their jurisdiction 14 (6%) listed entities applying IFRS Accounting Standards have goodwill that is over 100% of consolidated net assets (excluding non-controlling interests). Quantitative analysis we performed is consistent with this feedback (see Appendix B). For jurisdictions where we identified the potential for breaches of listing requirements, equity on transition would become negative for less than 1% of listed entities (using data extracted from Capital IQ for companies reporting a goodwill balance in the latest financial statements available as of April 2022) if we assume 50% of historic goodwill balances will be deducted on transition.[4]

Capital maintenance

28. Some respondents commented on the potential consequences of transition to an amortisation-based model on capital maintenance. In this section we discuss feedback on the effects of transition on safeguards to shareholders' interests, such as statutory minimum capital requirements and other related matters.

[3] Listing requirements may refer to different measures, for example, consolidated net assets, total equity or equity. For simplicity, we use the term equity in this paper to refer to these measures.

[4] Reducing historic goodwill balances by 50% makes a simple assumption that the acquisition dates of business combinations are evenly spread over time and therefore the average goodwill balance is 50% depleted.

29. Some national standard-setters from Latin America said a significant reduction in equity (see also paragraphs 16–21) could result in some entities being declared ‘in liquidation’ or ‘technically bankrupt’ in their jurisdiction. These respondents said this was one of the reasons they suggested a prospective transition approach whereby historic goodwill at the date of transition would be amortised prospectively over the remaining useful life as determined at the time the revised standard is adopted.

30. A few European national standard-setters said a significant reduction of equity could give rise to the need for additional capital from shareholders and additional guarantees being requested by banks due to changes in entities’ credit ratings.

31. One other national standard-setter said there could be legislative effects of transition. For example, that national standard-setter said there could be a need to clarify borrowing authority limits for state owned enterprises reporting using IFRS Accounting Standards as was the case when IFRS 16 *Leases* was implemented in their jurisdiction.

32. Some respondents also commented on the possible effect on prudential regulation. In their view, transition to an amortisation-based model would have a limited effect in terms of capital maintenance requirements. This is because goodwill balances are generally excluded from prudential capital maintenance calculations (for example, Solvency II tests).

Dividend distribution

33. Most respondents commented on the effects of transition to an amortisation-based model on an entity’s ability to distribute dividends. The feedback was mixed with many of these respondents and some members at the November 2021 GPF meeting saying transition would not have a significant effect, but with many other respondents and some GPF members saying transition would have a significant effect.

34. Those stakeholders who said transition would not have a significant effect said this is because dividend distributions are generally based on separate or statutory financial statements of the parent entity. These financial statements are usually prepared applying local GAAP. If those financial statements are prepared applying IFRS

Accounting Standards, any recognised goodwill from acquisitions of unincorporated businesses is generally insignificant.[5]

35. Those stakeholders who said transition would have a significant effect said transition would reduce amounts available for distribution despite dividend distributions in their jurisdiction being based on separate financial statements. Respondents provided the following explanations:

(a) Most respondents from Latin America said transition would significantly affect entities' ability to distribute dividends. One national standard-setter from Latin America said most entities in their jurisdiction use the equity method to account for their investments in subsidiaries in separate financial statements. We understand that applying the equity method, transition would result in same effect on net assets and profit or loss in separate financial statements as in consolidated financial statements. Consequently, in situations in which an entity applies the equity method to account for investments in subsidiaries in separate financial statements, dividend distributions would be affected similarly regardless of whether it is based on consolidated or separate financial statements.

(b) One national standard-setter from Europe provided quantitative information about IFRS separate financial statements of listed entities in their jurisdiction that highlighted significant amounts of goodwill in those separate financial statements as a result of past merger and acquisition (M&A) activity (for example from acquisitions of unincorporated businesses). Therefore, transition could affect the amounts available for distribution even when dividends are based on separate financial statements.

(c) One national standard-setter from Asia-Oceania said national company law in that jurisdiction allows entities to apply consolidated dividend regulations which, in particular circumstances, restrict the amount available for dividend distribution. These regulations reduce the amounts available

[5] If a business combination involves the transfer of an unincorporated business, the acquirer applies IFRS 3 *Business Combinations* in its separate financial statements and might accordingly recognise goodwill in its separate financial statements.

for distribution if the amount available for distribution calculated based on the consolidated financial statements is lower than that calculated based on the separate financial statements. Several entities applying IFRS Accounting Standards in that jurisdiction apply these regulations and therefore transition could reduce the amount available for distribution for these entities.

36. A few respondents from Europe and Asia-Oceania said although dividends are based on separate financial statements, dividend policies are often linked and communicated with reference to the financial position and performance reported in consolidated financial statements. One respondent said the effect of transition on financial position and performance could distort pay-out ratios and make them less meaningful. One national standard-setter from Asia-Oceania said this could reduce the attractiveness of entities to investors.

37. Despite concerns raised by respondents from Latin America, we note the comment letter on the Discussion Paper from the Group of Latin American Accounting Standard Setters reported that the consensus supported reintroducing amortisation of goodwill.

Debt covenants and credit ratings

38. Many respondents and some members at the November 2021 GPF meeting said the effects of transitioning to an amortisation-based model on entities' financial positions, financial performance and financial ratios (see also paragraphs 16–21) could affect compliance with covenants in debt agreements that are linked to these measures and ratios, unless these covenants use IFRS Accounting Standards that applied at the time the agreements were signed or at some point before the reintroduction of amortisation of goodwill (frozen GAAP).

39. One national standard-setter from Asia-Oceania said in their jurisdiction many entities have covenants in debt agreements that require maintaining debt to equity ratios below 300%. One national standard-setter from Europe said the effect on debt covenants could trigger early repayment of loans.

40. Some respondents and some members at the November 2021 GPF meeting said the consequences of transition would be limited because goodwill is generally excluded

from debt covenants, or loan covenants are generally based on local GAAP. One GPF member said although loan covenants could be affected, the renegotiation of these covenants would not pose any difficulty. One national standard-setter from Europe conducted a survey of entities applying IFRS Accounting Standards in their jurisdiction. Responses were evenly split between those that had covenants based on frozen GAAP and those not based on frozen GAAP. Most entities surveyed said their covenants do not explicitly allow for renegotiation when there are changes to IFRS Accounting Standards, but entities said covenants that do not use frozen GAAP would likely be renegotiated in the event of changes to IFRS Accounting Standards.

41. One respondent and some members at the November 2021 GPF meeting also said the consequences of transition on credit ratings would be limited because those ratings are generally assessed excluding goodwill.

Other matters

42. Respondents also commented on other matters:

(a) Measurement of income taxes (paragraph 43);

(b) Management compensation (paragraph 44); and

(c) Operational concerns (paragraph 45).

Measurement of income taxes

43. Many respondents said income taxes and related measures would not be affected by transition to an amortisation-based model because:

(a) goodwill is not tax deductible;

(b) goodwill is already amortised for tax purposes;

(c) income tax regulations and not accounting measures determine the amounts of tax payable; or

(d) income tax is based on separate financial statements prepared applying local GAAP.

Management compensation

44. A few respondents said management compensation schemes linked to measures specified by IFRS Accounting Standards could be affected by transition. However, one respondent said management compensation schemes can be amended.

Operational concerns

45. Although we did not specifically ask about how entities would practically transition to an amortisation-based model, a few respondents highlighted operational concerns associated with transition. For example, they said:

(a) entities may find it difficult to trace goodwill back to individual business combinations (for example, when there has been a reorganisation of the entity's reporting structure); and

(b) auditors may not be able to obtain sufficient evidence to support amounts of goodwill written-off on transition.

Initial observations

46. Most respondents highlighted potential effects of transitioning to an amortisation-based model and many respondents said transition would significantly affect entities' financial positions and performance because of the size of historic goodwill balances.

47. Our outreach highlighted that some of these effects could be significant and more prevalent for entities in particular jurisdictions. We note that:

(a) as discussed in paragraphs 24–27, respondents from Asia-Oceania highlighted entities in their jurisdictions risk failing to meet listing requirements and, eventually, being suspended from trading or delisted if they report negative equity and/or profit.

(b) as discussed in paragraph 35(a), respondents from Latin America highlighted that the amounts of dividends that entities in their jurisdictions could distribute would be affected.

48. Our research, although simplistic, suggests the number of entities that might be affected by the matter in paragraph 47(a) could be limited. However, we think the

potential effects of all the matters in paragraph 47 are something the IASB should consider when assessing the costs of reintroducing amortisation of goodwill.

49. Many of the other potential effects (for example, effects on debt covenants) were raised by respondents from various different jurisdictions. Although these could affect entities on transition, for example having to renegotiate debt covenants or amend management compensation agreements, feedback suggests entities should be able to do this if they receive sufficient time to transition.

50. We agree with respondents who said the significant effect of transition on entities' financial performance, financial positions and financial ratios could temporarily disrupt the market and confuse users.

51. Our findings highlight that for some entities, transition could result in significant costs and challenges. We agree with respondents who said these potential effects should not necessarily prevent the IASB from reintroducing amortisation of goodwill however, we think the potential effects of transition are an important consideration when assessing the costs of reintroducing amortisation. Although some respondents to the Discussion Paper in favour of reintroducing amortisation said amortisation is a simple method that would reduce costs (see Agenda Paper 18C to the May 2021 meeting of the IASB), we think the costs of transition could be significant for some entities.

52. If the IASB were to decide to reintroduce amortisation of goodwill the feedback in this paper could help the IASB decide how an entity should transition to an amortisation-based model (for example, retrospectively or prospectively). However, we think the IASB would need to perform further research on the practicalities of applying different transition approaches to make that decision, for example:

(a) do entities have the information available to estimate the useful life of historic goodwill at the time of the acquisition (which could be several years ago) without using hindsight?

(b) can entities identify the acquisitions that goodwill balances relate to?

(c) whether amortising goodwill balances prospectively over the remaining useful life determined at the date of transition could distort financial performance and confuse users?

Question for the IASB

Do IASB members have any questions or comments on the feedback discussed in this paper? Specifically:

(a) is any feedback unclear?

(b) are there any points you would like us to research further prior to deciding whether to reintroduce amortisation of goodwill?

Appendix A—Process

A1. In order to gather information about the potential effects of transition to an amortisation-based model, we:

(a) discussed the issue at the November 2021 Global Preparers Forum (GPF) meeting;

(b) sent an information request to national standard-setters, via the International Forum of Accounting Standard-Setters. Specifically, we asked about the potential effects of writing-off significant amounts of historic goodwill on transition and amortising the remaining historic goodwill balances, in terms of:

(i) financial position, financial loan covenants, distributable reserves and dividend distribution, capital maintenance and other similar measures;

(ii) capital markets and economic development, and whether entities would run the risk of failing to meet any market regulations (for example, listing requirements);

(iii) tax implications and whether the amortisation charge would be tax deductible; and

(iv) any other relevant local jurisdictional requirements.

(c) sent an information request to regulators, via the International Organization of Securities Commissions, to gather information on how transition might affect an entity's corporate governance. In particular, we asked whether there would be any risk of delisting in their jurisdiction or any effect on an entity's ability to declare dividends.

A2. We also:

(a) reviewed relevant research papers published since 2013 by national standard-setters; and

(b) analysed listing requirements in selected jurisdictions in Asia-Oceania where respondents said entities risk failing to meet those requirements as a result of transition.

A3. To help assess the magnitude of potential effects of transition we analysed data extracted from Capital IQ.[6] Appendix B summarises this analysis.

[6] Capital IQ is a financial intelligence database from Standard & Poor's. The database provides financial statement data for both public and private companies globally.

Appendix B—Quantitative analysis

Goodwill as a percentage of total equity and total assets

B1. According to data extracted from Capital IQ in April 2022, goodwill amounted to US$9.5 trillion for all public companies worldwide, accounting for around 18% of their total equity and 3% of their total assets.[7] These ratios are higher in some regions and lower in others. For example, in US & Canada, goodwill accounts for 37% and 7% of total equity and total assets respectively. In Asia, goodwill accounts for 5% and 1% of total equity and total assets respectively.

B2. The following tables summarise the trend of the goodwill to total equity and goodwill to total assets ratios in the period 2017–2022 using data from Capital IQ:

Goodwill as % of total equity	2022	2021	2019	2017
Africa / Middle east	7.2%	7.5%	6.7%	8.4%
Asia / Pacific	5.1%	5.4%	5.6%	5.3%
Europe	25.8%	26.7%	27.3%	27.2%
Latin America	10.9%	11.0%	11.1%	11.6%
US and Canada	36.5%	37.3%	37.6%	34.9%
Total	17.6%	18.2%	18.7%	18.3%

Goodwill as % of total assets	2022	2021	2019	2017
Africa / Middle east	1.6%	1.7%	1.6%	1.9%
Asia / Pacific	1.0%	1.0%	1.0%	0.9%
Europe	4.1%	4.0%	4.4%	4.1%
Latin America	2.8%	2.7%	2.5%	2.8%
US and Canada	6.7%	6.7%	7.2%	6.4%
Total	3.2%	3.2%	3.4%	3.2%

B3. Based on the above tables, the goodwill to total equity ratio grew at 1% per annum and the goodwill to total assets ratio grew by 3% per annum in the period 2017–2019 (using compound annual growth rates). Both ratios decreased in the period 2019–2022 (by 2% using compound annual growth rates), possibly as a consequence of the global economic downturn due to the covid-19 pandemic.

[7] The Discussion Paper provided similar information based on information extracted from Capital IQ in February 2020—Paragraph IN1 of the Discussion Paper notes that goodwill amounted to $8 trillion for all listed companies worldwide, accounting for around 18% of their total equity and 3% of their total assets.

Effect of transition on total equity

B4. We took from Capital IQ all 15,105 public entities that reported a goodwill balance as of April 2022, 11,457 applying IFRS Accounting Standards and 3,648 applying US GAAP and calculated the number of entities for which total equity would become negative on transition to an amortisation-based model. To calculate this number, we assumed 50% of an entity's goodwill balance would be written-off on transition (this assumes M&A activity is evenly spread and therefore the average goodwill balance is 50% depleted). Based on our analysis, total equity would become negative for 165 (1%) selected companies applying IFRS Accounting Standards and for 149 (4%) selected companies applying US GAAP on transition.