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EFRAG

European Financial Reporting Advisory Group

Accounting for Goodwill – some fundamental questions

January 2017

EFRAG SECRETARIAT PAPER FOR PUBLIC JOINT
 EFRAG BOARD and EFRAG TEG MEETING

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Objective of this session

- Objective of this session is provide direction for the finalisation of EFRAG's proactive work by:
 - Summarising the background and work to date; and
 - Discussing the broad conceptual challenges that have proved to be obstacles to making progress.
- To provide this direction, EFRAG needs to form a view (or at least a working hypothesis) on these questions:
 - Does EFRAG want to express support for (or disagreement on) the reintroduction of amortisation, or be neutral? Are the arguments sufficiently robust to take a position (see slide 12)?
 - Additional questions on areas of improvement of the IAS requirements and application of annual amortisation in slides 11 and 12.

Where are we in the
debate?

The IASB PIR of IFRS 3

- The PIR (completed in June 2015) identified:
 - Mixed views on *impairment-only* vs *amortisation*
 - Concerns over complexity of IAS 36 impairment test.
- In February 2015 IASB added a follow-up project which is currently considering:
 - Whether changes should be made to the existing impairment test for goodwill;
 - Subsequent accounting for goodwill (including the relative merits of an impairment-only approach and an amortisation and impairment approach); and
 - Extent to which other intangible assets should be separated from goodwill.

Messages from academic research

- Several studies show goodwill and other intangible assets were positively associated with share prices while impairment expense was negatively associated.
- Some studies suggest correlation between impairment levels and management incentives or institutional environment.

ASBJ-EFRAG-OIC Research Team 2014 Paper

- In the 2014 paper, the joint Research Team:
 - Concluded that goodwill qualifies as an asset;
 - Agreed that on balance annual amortisation would be appropriate and could be applied with an adequate level of reliability;
 - Identified some areas of improvements in the impairment test for goodwill;
 - Discussed possible improvements to disclosure.
- Mixed views were expressed by respondents to the paper.

EFRAG current Research project

- Following the feedback on the 2014 Research team paper, EFRAG started a Research project with two objectives:
 - Identify ways to improve and/or simplify the impairment test; and
 - Discuss how annual amortisation could be applied to goodwill.
- The two objectives are seen as independent, but not mutually exclusive.

EFRAG quantitative study

- Between 2005 and 2014, goodwill increased 43% for a sample of major European companies;
- The ratio of goodwill to total assets (excluding Financials) is relatively high but decreased slightly between 2009 and 2014;
- On average, impairment losses amount to 2.7% of the goodwill on a yearly basis;
- Goodwill and impairment losses are concentrated in a relatively small number of companies in the sample;
- Significant differences across industries.

What is the consensus from EFRAG TEG?

- EFRAG TEG has so far reached consensus only on the following recommendations:
 - Entities should not be required to do two different calculations of the recoverable amount (both value in use and FVLCTS). One way, but not the only one, could be to require only the calculation that reflects the expected manner of recovery of the investment;
 - In a value in use calculation, entities should include the effects of planned restructuring;
 - Entities should be allowed to determine value in use either on a pre-tax or on a post-tax basis.

What is the consensus from EFRAG TEG?

- EFRAG TEG discussed the following topics about the existing impairment requirements without reaching consensus on any proposed change:
 - Whether the impairment test should be required annually;
 - How goodwill is allocated to CGUs and reallocated in the event of an internal reorganisation; and
 - Whether there should be a cap on the terminal growth rate in a VIU calculation.

Are there areas of improvement of the IAS 36 requirements that need to be addressed or re-discussed before finalising the EFRAG project ?

What is the consensus from EFRAG TEG?

- EFRAG TEG was not asked if it supported reintroducing amortisation. However, EFRAG TEG has discussed how amortisation might be applied to goodwill.
- EFRAG TEG did not reach a consensus on:
 - What should be the pattern of amortisation;
 - What should be the factors considered in determining the useful life; or
 - If and when the useful life should be reassessed.

If amortisation was re-introduced, are there elements of the possible requirements to be addressed or re-discussed before finalising the EFRAG project?



Question - initial recognition



□ What are the options on Day-1?

- Recognise goodwill as an asset
 - It is a resource controlled by the acquirer
 - But it does not produce future economic benefits on its own
- Recognise goodwill as a cost in profit or loss
 - If it is not an asset, it must be an expense
 - But this implies that there is no value in a business other than the value of the individual assets
- Recognise goodwill as a deduction from equity
 - But it is not a transaction with shareholders in their capacity as shareholders



Question - Subsequent measurement

Main arguments that support an impairment-only approach

- Straight-line amortisation of goodwill does not provide relevant information and users would simply ignore it.
- Goodwill is not (necessarily) consumed over time.
- Impairment of goodwill provides information on management stewardship, which could be lost if amortisation is reintroduced.
- Any amortisation period would be arbitrary.

Main arguments that support an amortisation (and impairment) approach

- The impairment-only approach may contribute to 'too little too late' and create systemic risk.
- Purchased goodwill is consumed over time (even if it might be replenished by internally-generated goodwill) so there should be a progressive reduction.
- The impairment-only approach allows to capitalise internally generated goodwill. Entities that grow organically are not allowed to do that.
- Impairment test is complex and judgemental (so is questionable that benefits exceed costs).

Some specific issues around impairment test

- Initial allocation to CGUs and reallocation in the event of internal reorganisations;
- Terminal value often represents a big portion of the recoverable amount;
- Shielding effects from:
 - unrecognised goodwill in pre-existing CGU; and
 - internally-generated goodwill.
- Pre-tax WACC is difficult to determine.



Other issues



Other issues around goodwill

- Initial measurement:
 - Separation of other unrecognised intangibles of the acquiree
 - Recognition and measurement of deferred taxes
 - Measurement of consideration paid in equity instruments
- Information on the performance of the acquired business; and
- Extent of disclosure around impairment test.

Thank you for your attention!



**And now ...
Questions?
... and answers...**

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