This paper has been prepared by the EFRAG Secretariat for discussion at a public meeting of EFRAG TEG. The paper forms part of an early stage of the development of a potential EFRAG position. Consequently, the paper does not represent the official views of EFRAG or any individual member of the EFRAG Board or EFRAG TEG. The paper is made available to enable the public to follow the discussions in the meeting. Tentative decisions are made in public and reported in the EFRAG Update. EFRAG positions, as approved by the EFRAG Board, are published as comment letters, discussion or position papers, or in any other form considered appropriate in the circumstances.

IVSC proposals for enhancing the goodwill impairment framework

Issues Paper

Objective

1 The objective of this session is to ask for EFRAG TEG's views on opportunities for enhancing the goodwill impairment framework suggested by the International Valuation Standard Council Board ('the IVSC'). EFRAG TEG's input will be used when finalising EFRAG's comment letter in response to the IASB Discussion Paper *Business Combinations – Disclosures, Goodwill and Impairment* ('the DP').

Background

2 The IVSC has issued three Perspective Papers on goodwill. The publications are a response to questions from IVSC's constituents about whether principles underlying business valuations are compatible with the concept of goodwill amortisation. The IVSC Boards have discussed the topic and published a three-part article series to explore respectively the following questions:

(a) Is goodwill a wasting asset with a readily determinable life, or an indefinite lived asset?

(b) What is the information value of the current goodwill impairment process to financial statement users?

(c) Can the current impairment test be improved to increase the information value for users with little or no incremental costs for preparers?

3 The first two papers were considered by EFRAG TEG at its January 2020 meeting (Agenda Paper 08-04) when preparing EFRAG's draft comment letter in response to the DP ('the DCL'). A short summary of the papers is presented in the Appendix.

4 In the first article, the IVSC concludes that **evidence indicate that goodwill is not a wasting asset** and therefore that it is best tested through regular impairment assessments rather than amortised. Among the evidence considered is the financial models used to price deals, prepare fairness opinions, obtain board of directors' approval and ultimately determine the prices paid in transactions. According to the article, these models almost always reflect a perpetual growth assumption of cash flows. It is argued that the identified tangible and intangible assets, with the exception of certain indefinite lived intangibles, represent the identifiable finite lived assets of the business. The residual amount paid for the business (e.g., the goodwill) must therefore at least represent the going concern (i.e. perpetual growth) portion of the acquired business. If one were to assume goodwill is a finite lived and wasting asset, it would be inconsistent with the premise of going concern inherent in the consideration paid to acquire nearly all businesses.

5 The paper recognises that some have the view that while goodwill may be an indefinite-lived asset, it requires ongoing investment to maintain its value[1] and indefinite life and amortisation would therefore be appropriate. However, the IVSC concludes that the components of goodwill would generally have an indefinite life.

6 When discussing EFRAG's DCL, EFRAG members had different views on the extent to which goodwill (or parts of goodwill) is a wasting asset. The DCL includes different arguments and a question to constituents on this. In addition, one of the questions in a survey EFRAG has launched for preparers addresses the issue.

7 In the second article, the IVSC notes that academic studies show that while in certain instances goodwill impairments are a leading indicator of an expectation of a decline in future cash flows, impairments do not appear to consistently serve as a leading indicator of future cash flows and returns. The article examines four potential reasons for the persistent timing lag in the disclosure of goodwill impairments: impairment shielding; artificial headroom[2]; the fact that impairment triggers are overly broad and outward looking; and behavioural considerations.

Opportunities for enhancing the goodwill impairment framework

Potential solutions to improve the current impairment test

8 The third article explores some options to mitigate information shortfalls currently coming from the current impairment model. The article first notes that potential solutions could be (i) to recognise internally developed intangible assets and goodwill or (ii) to require the impairment test to be carried out at a lower level than currently required for the allocation of goodwill. The article, however, does, not explore these alternatives further. In relation to the possibility to perform the impairment test at a lower level, the article does not consider suitable to set the granularity of the test at the level of each separate acquisition and to track and test it on a like-for-like basis to the operations acquired. Such a solution could, according to the article, be impractical in the longer term due to the fact that most acquired businesses are merged with legacy operations.

9 Instead, the article considers the following solutions:

(a) Step-up approach: The purpose of this approach is to **capture the internally generated headroom of the legacy business** that existed at the time of acquisition. This is done by either determining the value of the tested unit legacy business (the part of the cash generating unit ('CGU') that relates to the legacy business) and subtracting its carrying amount, or by determining the value of the entire CGU and then subtracting the legacy operations carrying amount and the purchase price of the acquired business. The internally generated headroom would not be presented in the statement of financial position, but when testing for impairment, the internal headroom amount is netted against the value of the CGU (or equivalently added to the carrying amount of the CGU). According to the article, to make the model simple, any impairment should be allocated fully to acquired goodwill (and recognised in the statement of profit or loss). In other words, an entity should not (and would not be allowed to) consider any impairment to relate to unrecognised intangible assets (which would not be reflected in the statement of profit or loss). Under the approach, the internally generated headroom would be recalculated upon a reorganisation of CGUs that contain goodwill.

(b) Direct value comparison*:* The IVSC notes that the Step-up approach would not take into account headroom created after the acquisition date by

[1] In the IVSC article and in this paper 'value' refers to the recoverable amount.

[2] That is headroom resulting from the amortisation of acquired intangible assets and not recognising new internally generated intangible assets.

unrecognised internally generated intangible assets. The IVSC notes that a possible solution could include an adjustment to the carrying amount, or value, that considers the cumulative amortisation of the acquired assets subsequent to the acquisition as well as impacts to related accounts such as deferred taxes. However, the IVSC considers that a method that would be more intuitive and less costly to apply would be a direct value comparison. Under this approach, at each testing date, the value of the CGU would be compared with the static value of the CGU at acquisition. As long as the value of the CGU is higher or equal to the value at acquisition, no impairment loss is recognised. The IVSC considers that the Direct value comparison would reduce overall costs and complexities with the impairment test as it would eliminate the need to derive carrying amounts for the CGUs at each testing date.

Better disclosure / potential solution for impairment triggers

10 The article also explores the opportunity to some improvements on disclosures currently provided for business acquisitions such as the disclosure of:

(a) Financial metrics

(i) Deal metrics: They may include:

- the internal rate of return of a deal, resulting from the price paid for an acquisition and the expected cash flows. This can be compared to the company's cost of capital to determine if the transaction is expected to be accretive to overall value.
- EBITDA (which can also be compared to that of the acquirer, and to multiples of public companies that operate in the same industry).

(ii) Projected financial information ('PFI'): They may include: revenues growth rate, expected margin expansion, capital expenditures, synergies and long-term growth and margin assumptions. It is the IVSC's opinion that, while only few of these information are currently disclosed by preparers, their consistent disclosure may provide invaluable information to investors to assess the relative value creation of the transactions. However, the IVSC recognise that a full disclosure of these measures may trigger commercial sensitivity issues.

(iii) Key performance indicators*:* The article states that with all acquisitions, management relies on certain metrics that they use internally to justify the purchase and later to assess whether a transaction is successful. Such KPIs may be both internal (e.g. deal economics or PFI considerations) and industry-based. The IVSC considers that more disclosure of these KPIs that were used to assess the deal would provide investors with key insights with which to independently prepare financial models to assess intrinsic value.

(b) Tested unit structure: This would include information on whether the acquisition will be combined with an existing CGU or will be standalone. If combined with legacy operations, disclosures could be useful on what other assets and operations are included in the CGU, the relative size or value of the existing CGU, the amount of internal headroom contained in the CGU, and whether the CGU contains other prior acquisitions. The article notes that this information could be useful for assessing claims on the expected synergies.

(c) Goodwill disclosures. This would include information to investors on how a company plans to create and maintain its value creation advantages beyond the life of the identified tangible and intangible assets.

11 The article then suggests that the KPIs identified and disclosed by management at acquisition, should form the basis for effective trigger-based test criteria. For example, in the periods immediately following the acquisition, actual performance should be compared to the PFI at the time of the acquisition to see if expectations have been met.

12 When goodwill is impaired, the article suggests that the cause of the impairment should be disclosed together with the KPI(s) that triggered the impairment test and specifics on how the KPI(s) missed expectations.

Comments of the EFRAG Secretariat

13 Some of the suggestions for disclosure improvements are similar to the suggestions included in the DP (e.g. disclosure of the metrics that are used to justify the purchase and later to assess whether a transaction is successful). However, other suggestions are new and may be considered commercial sensitive and/or forward-looking by entities (which the article also notes).

14 Similar to a comment made in EFRAG's DCL, the article notes that the KPIs identified and disclosed by management at acquisition, should form the basis for effective trigger-based test criteria. In its DCL EFRAG notes that if the objective of an acquisition would not be met, this could indicate that the acquired goodwill would be impaired (but because of the shielding effect an impairment loss might not be recognised).

15 The Step-up approach suggested by the IVSC has some similarities with the 'headroom approach' previously considered by the IASB. The IASB concluded that the approach would only partially mitigate the shielding effect and would increase cost of the impairment test. The Step-up approach considered by the IVSC would be less costly as, to make the model simple, any impairment would be allocated fully to acquired goodwill. On the other hand, as noted above, this would also mean that any impairment related to unrecognised intangible assets would be reflected in the impairment of acquired goodwill (and be reported in the statement of profit or loss).

16 For the Direct value comparison, the article acknowledges that certain events would require an adjustment to the static value of the CGU at acquisition. For example, an impairment of long-lived assets held within the CGU would require the same amount be subtracted from the static value of the CGU at acquisition to prevent a double count of impairments. Similarly, a significant cash infusion (dividend) into (out of) the CGU would require a corresponding increase (decrease) to the static value of the CGU at acquisition. The approach could seem to be least complex to apply when CGU's are quite ring-fenced in relation to (cash) flows – for example, if a CGU is a separate legal entity.

Questions for EFRAG TEG

17 What is EFRAG TEG's view on the Step-up approach suggested by the IVSC (see paragraph 9(a))?

18 What is EFRAG TEG's view on the Direct value comparison suggested by the IVSC (see paragraph 9(b))?

19 What is EFRAG TEG's view on the disclosures suggested by the IVSC (see paragraphs 10 –12)?

Appendix: The IVSC's Articles

Is goodwill a wasting asset?

20 In the first article the IVSC considered whether goodwill is a wasting asset. In the paper the IVSC concluded that goodwill in aggregate is not a wasting asset. The arguments provided were:

(a) The components of goodwill are generally non-wasting assets. According to the IVSC the components of goodwill are:

(i) Going Concern Goodwill (reputation (customer loyalty), future intangible value, workforce) which is, at least to a large extent indefinite in its nature;

(ii) Goodwill Created by the Acquisition (synergies and assemblage value (the concept that a collection of assets is worth more than the sum of the individual asset values) which is indefinite rather than wasting in nature.

(b) An analysis of how deals are priced and specific assumptions within deal models shows that if one were to assume the synergistic portion of goodwill was a wasting asset realised only over the discrete period, it would imply that either 1) market participants systematically overpay for businesses, or 2) that the capital asset pricing model (CAPM) systematically overestimates the cost of equity and resulting WACC.

(c) Empirical evidence shows that almost all impairments represent large irregular charges resulting from a discrete event or short series of discrete events, rather than smaller regular impairment charges that consistently occur over time.

(d) Notwithstanding the conclusion that goodwill is not a wasting asset, the paper discusses the useful life for amortisation, if one were to assume goodwill was a wasting asset.

Information value of the current impairment test: leading or lagging indicator

21 In the second article, the IVSC considered the information value of the current impairment framework. The article reviewed some academic articles that show that while in certain instances goodwill impairments are a leading indicator, impairments do not appear to consistently serve as a leading indicator of future cash flows and returns. The article examined four potential reasons for the persistent timing lag in the disclosure of goodwill impairments:

(a) Impairment Shielding – Acquired goodwill can be shielded from impairment by unrecognised headroom of the legacy business that becomes part of the tested unit post acquisition. Internally generated headroom primarily consists of self-generated and unrecognised intangible assets and goodwill of the legacy business of the tested unit;

(b) Artificial Headroom – resulting from amortisation of [some] acquired intangible assets while new intangibles are not recognised on the balance sheet. The amortisation of intangible assets has a greater tendency to shield impairments as time passes, thus leading to decreased information value of the goodwill.

(c) Impairment Triggers – overly broad and outward looking. A review of the example triggers cited in accounting standards shows them to be overly broad and primarily focused on external market and industry conditions. In some cases, such as stock price, the triggers themselves are a lagging indicator.

(d) Behavioural Considerations – A reluctance to take impairment. Anecdotal evidence shows that goodwill impairment charges are often accompanied by a change in management, overall strategy and/or a decision to restructure or sell all or a part of an acquired business.

Is goodwill a wasting asset?

https://www.ivsc.org/files/file/view/id/1599

Information value of the current impairment test: leading or lagging indicator

https://www.ivsc.org/files/file/view/id/1675

Opportunities for enhancing the goodwill impairment framework

https://www.ivsc.org/files/file/view/id/1755