

Mr Hans Hoogervorst
Chairman
International Accounting Standards Board
7 Westferry Circus
Canary Wharf
London
E14 4HD

29 January 2021

Dear Mr Hoogervorst

**Invitation to Comment: *Discussion Paper DP/2020/1 Business Combinations—
Disclosures, Goodwill and Impairment***

This letter sets out the comments of the UK Endorsement Board secretariat on the above Invitation to Comment.

Following the UK's exit from the European Union, the Department for Business, Energy and Industrial Strategy (BEIS) is setting up the UK Endorsement Board (UKEB) to fulfil statutory functions of influencing the development and subsequent adoption of International Accounting Standards for use in the UK. The UKEB secretariat has begun influencing activities in preparation for the delegation of those statutory functions to the UKEB. This letter forms part of those influencing activities and is intended to contribute to the International Accounting Standards Board's (IASB) due process. The views expressed by the UKEB secretariat in this letter are separate from, and will not necessarily affect the conclusions in, any endorsement and adoption assessment on new or amended International Accounting Standards to be provided to the Secretary of State or the UKEB, once powers have been delegated.

We welcome the opportunity to contribute to the debate on this significant topic and our main points on the consultation are outlined below. For detailed responses to the questions in the Discussion Paper (DP) please see appendix 2. Our initial research findings are included in appendix 1.

A mixed model

1. We propose a mixed model for accounting for goodwill, in which an annual amortisation charge is supported by indicator-based impairment testing.
2. We recommend a mixed model because:

- a. Our research shows that goodwill is a significant and increasing balance for UK companies. Between 2005¹ and 2019 for FTSE 350 companies², goodwill increased by 69% from £227bn to £383bn. Our research also shows that goodwill balances did not fluctuate as might have been expected given changing economic conditions between 2005 and 2019.
 - b. The widespread concern about the reliability of increasing goodwill balances is evidenced by the DP's proposal to present a subtotal of total equity less goodwill in the balance sheet. The DP's rationale for the proposal is that there are unavoidable limitations of impairment testing when goodwill is allocated to groups of cash-generating units.
 - c. We believe that addressing the measurement of goodwill in conjunction with providing useful information about it would be a better solution than highlighting its riskiness.
 - d. The risks of shielding and management optimism which are inherent in the impairment-only model have the potential to cause over-inflation of balance sheets. Without the introduction of amortisation as part of a mixed model, we anticipate that goodwill balances will continue to grow, risking faithful representation through the potential overstatement of goodwill.
 - e. A mixed model would provide more reliable measurement of goodwill than an impairment-only model because:
 - i. amortisation is applied to individual goodwill balances, thus removing the shielding effect.
 - ii. a sufficiently robust impairment test would ensure that balances are not carried above their recoverable amount.
3. A mixed model would provide a more faithful representation by showing goodwill as a wasting asset and amortising goodwill through profit or loss over the period in which benefits are consumed.
 4. Combining an annual amortisation charge with impairment testing supports faithful representation, whereas an amortisation-only model could mask risk by simply applying a mechanical amortisation charge over a set period. A further potential benefit would be reduced risk of financial shock caused by delayed recognition of impairment.

¹ IAS 36 *Impairment of Assets* became effective in the UK in 2005.

² Our research work was focused on companies listed on the FTSE 350 in 2019. We intend to conduct further analytical work on reported goodwill and will be happy to share this information with the IASB's project team over the coming months.

5. When combined with our recommended disclosure of goodwill movement, which would provide insight into the age of goodwill balances and the acquisitions they relate to, a mixed model would improve the usefulness of information for investors.
6. A mixed model requires an estimate of the period over which the benefits of the goodwill acquired will be consumed by the business. Whilst it could be argued that this would be a subjective estimate, it is no more subjective than the judgements in the value in use calculation.
7. Some options would be to amortise over:
 - a. The period which the P/E multiple on acquisition implies is the period of benefit.
 - b. The period over which synergies can reasonably be expected to be realised.
 - c. The average expected service period of the assembled workforce.
 - d. The time period which can reasonably be expected to elapse before a competitor will replicate or supersede the know-how, expertise, formulation or innovation which has been acquired.
8. Goodwill could be split into various components in the same way as PPE to allow greater accuracy in the overall amortisation charge by allowing useful life to be estimated for each component.

Indicator only impairment testing

9. If a mixed model is adopted, we support the proposal to replace the requirement for an annual quantitative impairment test for goodwill with a quantitative test only when there is an indicator of impairment because:
 - a. Under a mixed model headroom would increase and the need for a full quantitative impairment test would be reduced.
 - b. The accounting treatment would be consistent with tangible assets whose recoverable amount cannot be determined separately, and there is no clear conceptual basis for treating goodwill differently.
10. Absent a mixed model, we would not support the proposal because it would increase the risk of overstatement of goodwill balances. We believe that without a mixed model, a quantitative test would be required to maintain some robustness and that robustness should take precedence over cost-savings.
11. We believe that the potential cost savings of moving to an indicator only test for goodwill would not be significant because:

- a. an annual quantitative test incurs minimal marginal cost, since the inputs used in the value in use calculation are typically derived from the most recent budgets that were approved by management.
- b. an indicator-only test increases costs due to the significant judgement required to prepare and audit it.
- c. costs are already minimised by the existing practical expedient where there is unlikely to be an impairment.³

Improvements to the quantitative impairment test

12. We recommend the following improvements to reduce the risk that shielding leads to overstated goodwill balances:
 - a. Explore options for testing goodwill for impairment at a more disaggregated level so that testing can target individual goodwill balances more effectively.
 - b. Disclose how CGUs have been identified and whether that has changed from prior period.
 - c. Disclose where goodwill is more likely to be shielded, for example if it is allocated to a CGU where the acquisition has been integrated with an existing business.
13. We recommend the following improvements to ensure cash flow projections are reasonable:
 - a. Disclose how discount rates have been derived, differentiating between CGUs with different risk profiles.
 - b. Disclose possible changes to key assumptions in the recoverable amount calculation and the impact of those changes on recoverable amount.

Disclosures

14. The principle of improved disclosures on acquisitions to support stewardship and accountability is one we support.

³ IAS 36 Impairment of Assets paragraph 99. The most recent calculation of recoverable amount of a CGU to which goodwill has been allocated may be used provided certain criteria are met. The criteria are: a) assets and liabilities making up the unit have not changed significantly since the most recent calculation; b) the most recent recoverable amount calculation resulted in an amount that exceeded the carrying amount of the unit by a substantial margin; c) based on an analysis of events that have occurred and circumstances that have changed since the most recent recoverable amount calculation, the likelihood that a recoverable amount determination would be less than the current carrying amount of the unit is remote.

15. However, we recommend that disclosures would need to be made for all material acquisitions to support the usefulness of information for users and comparability across entities.
16. We also recommend illustrative examples and field-testing to assess the practicality of the proposals for preparers and their usefulness for investors.

If you would like to discuss these comments, please contact the project team at BCDGI@endorsement-board.uk.

Yours sincerely

Pauline Wallace
Chair
UK Endorsement Board

- Appendix 1 Results of initial research on UK FTSE 350 companies
Appendix 2 Questions on DP/2020/1 *Business Combinations—Disclosures, Goodwill and Impairment*

Appendix I: Results of research on UK FTSE 350 companies

A1.1 Our research analysed market data and annual reports from 2005 to 2019 for the current population of the UK FTSE 350. We found that:

- a. Goodwill is a significant and growing component of company balance sheets.
- b. Despite significant changes in market conditions since IAS 36 became effective in the UK in 2005, goodwill has not fluctuated as might have been expected.
- c. 55% of entities exhibiting indicators of a potential impairment charged an impairment, and 45% did not.
- d. Goodwill exceeds net assets for a significant proportion of entities.

The basis for these conclusions is given below.

A1.2 Goodwill is a significant and growing component of UK balance sheets. Between 2005 and 2019, goodwill increased by 69% from £227bn to £383bn for the FTSE 350⁴. The sharpest rise occurred between 2014 and 2019, when goodwill increased by 48% from £259bn to £383bn.

A1.3 Goodwill has not fluctuated as might have been expected since the introduction of the impairment-only model for goodwill for listed companies in the UK given the significant changes in economic conditions during that period. These changes include the 2007 subprime mortgage crisis, the 2008 global financial crisis, the 2015 Greek debt crisis, and the 2016 Brexit vote.

A1.4 For the UK FTSE 350, from 2008 to 2009 during the global financial crisis, market capitalisation fell by 25% to £1.1tn, while goodwill increased by 2% to £275bn. From 2014 to 2016, when the effect of the Greek debt crisis and the Brexit vote were felt, market capitalisation fell by 7% to £1.8tn while goodwill increased by 32% to £328bn. From 2018 to 2019, market capitalisation dropped by 10% to £2.2tn, while goodwill dropped by 4% to £383bn.

A1.5 It is possible that these findings are explained by high acquisition volumes and high relative growth in sectors with high price : book ratios. However, our research might also indicate the possibility that goodwill impairments are not charged on a timely basis.

A1.6 Goodwill represented approximately 18% of total assets for the FTSE 350 in 2019. Goodwill has remained broadly constant as a proportion of total assets for the FTSE 350 between

⁴ Population consists of entities in FTSE 350 in 2019.

2005 and 2019. During the 14-year period, goodwill represented the lowest proportion of total assets at 16.7% in 2006 and the highest proportion at 18.8% in 2017.⁵

A1.7 Greater fluctuation in goodwill as a proportion of total assets over the 14-year period could reasonably be expected given the changing economic conditions.

A1.8 55% of entities exhibiting indicators of a potential impairment charged an impairment, and 45% did not. We identified 4 indicators⁶ that a goodwill impairment may exist and identified occurrences of UK FTSE 350 entities displaying all 4 indicators simultaneously at any balance sheet date between 2005 and 2019. We identified twenty occurrences, which related to 14 entities.

A1.9 In 9 of the twenty occurrences, or 45%, impairments were not charged. All 9 of these occurrences experienced falls in market capitalisation, in addition to the 4 indicators of impairment.

A1.10 Goodwill exceeds net assets for a significant proportion of entities. Goodwill exceeded net assets for approximately 11% of FTSE 350 companies in 2019. The proportion of FTSE 350 entities whose goodwill exceeds net assets has remained broadly constant at approximately 11% between 2005 and 2019 and is not restricted to a particular sector.

A1.11 Further research could test the following hypotheses:

- a. Goodwill has increased because M&A activity has increased.
- b. Goodwill has remained broadly constant as a percentage of total assets but this masks the equal and opposite effects of acquisitions and impairments.
- c. Goodwill is typically allocated to large CGUs or groups of CGUs where it is more likely to be shielded.
- d. Goodwill impairments have been infrequent and low in value for FTSE 350 entities between 2005 and 2019.
- e. The average age of goodwill on FTSE 350 balance sheets is greater than the period over which the benefits of the acquisition would be expected to be realised.
- f. Goodwill impairments lag the market. Where impairments are reported, the share price has already reflected the bad news.

⁵ Further research could consider: Are impairments and subsequent acquisitions masked in the average figures?

⁶ The indicators were: negative operating cash flow, negative return on assets, negative return on equity, and current ratio below 1.

Appendix 2: Questions on DP/2020/1 *Business Combinations—Disclosures, Goodwill and Impairment*

Question 1: Project objectives and overall package of preliminary views

Paragraph 1.7 summarises the objective of the Board's research project. Paragraph IN9 summarises the Board's preliminary views. Paragraphs IN50–IN53 explain that these preliminary views are a package and those paragraphs identify some of the links between the individual preliminary views.

The Board has concluded that this package of preliminary views would, if implemented, meet the objective of the project. Companies would be required to provide investors with more useful information about the businesses those companies acquire. The aim is to help investors to assess performance and more effectively hold management to account for its decisions to acquire those businesses. The Board is of the view that the benefits of providing that information would exceed the costs of providing it.

- (a) Do you agree with the Board's conclusion? Why or why not? If not, what package of decisions would you propose and how would that package meet the project's objective?
- (b) Do any of your answers depend on answers to other questions? For example, does your answer on relief from a mandatory quantitative impairment test for goodwill depend on whether the Board reintroduces amortisation of goodwill? Which of your answers depend on other answers and why?

- A1 The package of measures proposed by the IASB contributes to meeting the project's objective.⁷ However, we recommend a mixed model, where impairment testing is supported by an annual amortisation charge. We believe that a mixed model would meet the project's objective more fully, because of the difficulty encountered in ensuring timely recognition of impairment charges.
- A2 If a mixed model is introduced, we support the move to an indicator-only impairment test. If the impairment-only model is maintained, we do not support the move to an indicator-only impairment test, because we do not think it would address the concerns of users that impairment losses are almost always recognised too late.

⁷ The board's overall objective is to explore whether companies can, at a reasonable cost, provide investors with more useful information about the acquisitions those companies make. Better information would help investors assess the performance of companies that have made acquisitions. Better information would also be expected to help investors more effectively hold a company's management to account for management's decisions to acquire those businesses. IASB's DP/2020/1 *Business Combinations—Disclosures, Goodwill and Impairment*, paragraph 1.7.

Question 2: New disclosure requirements about the subsequent performance of an acquisition

Paragraphs 2.4–2.44 discuss the Board’s preliminary view that it should add new disclosure requirements about the subsequent performance of an acquisition.

- (a) Do you think those disclosure requirements would resolve the issue identified in paragraph 2.4 - investors’ need for better information on the subsequent performance of an acquisition? Why or why not?
- (b) Do you agree with the disclosure proposals set out in (i)–(vi) below? Why or why not?
 - (i) A company should be required to disclose information about the strategic rationale and management’s (the chief operating decision maker’s (CODM’s)) objectives for an acquisition as at the acquisition date (see paragraphs 2.8–2.12). Paragraph 7 of IFRS 8 Operating Segments discusses the term ‘chief operating decision maker’.
 - (ii) A company should be required to disclose information about whether it is meeting those objectives. That information should be based on how management (CODM) monitors and measures whether the acquisition is meeting its objectives (see paragraphs 2.13–2.40), rather than on metrics prescribed by the Board.
 - (iii) If management (CODM) does not monitor an acquisition, the company should be required to disclose that fact and explain why it does not do so. The Board should not require a company to disclose any metrics in such cases (see paragraphs 2.19–2.20).
 - (iv) A company should be required to disclose the information in (ii) for as long as its management (CODM) continues to monitor the acquisition to see whether it is meeting its objectives (see paragraphs 2.41–2.44).
 - (v) If management (CODM) stops monitoring whether those objectives are being met before the end of the second full year after the year of acquisition, the company should be required to disclose that fact and the reasons why it has done so (see paragraphs 2.41–2.44).
 - (vi) If management (CODM) changes the metrics it uses to monitor whether the objectives of the acquisition are being met, the company should be required to disclose the new metrics and the reasons for the change (see paragraph 2.21).
- (c) Do you agree that the information provided should be based on the information and the acquisitions a company’s CODM reviews (see paragraphs 2.33–2.40)? Why or why not? Are you concerned that companies may not provide material information about acquisitions to investors if their disclosures are based on what the CODM reviews? Are you concerned that the volume of disclosures would be onerous if companies’ disclosures are not based on the acquisitions the CODM reviews?
- (d) Could concerns about commercial sensitivity (see paragraphs 2.27–2.28) inhibit companies from disclosing information about management’s (CODM’s) objectives for an acquisition and about the metrics used to monitor whether those objectives are being met? Why or why not? Could commercial sensitivity be a valid reason for companies not to disclose some of that information when investors need it? Why or why not?
- (e) Paragraphs 2.29–2.32 explain the Board’s view that the information setting out management’s (CODM’s) objectives for the acquisition and the metrics used to monitor progress in meeting those objectives is not forward-looking information. Instead, the Board considers the information would reflect management’s (CODM’s) targets at the time of the acquisition. Are there any constraints in your jurisdiction that could affect a company’s ability to disclose this information? What are those constraints and what effect could they have?

A3 We support the stewardship objective underlying the disclosure proposals, and we acknowledge the views of many users that the existing disclosure requirements relating to acquired businesses do not meet their needs. Therefore, we recommend illustrative examples and field-testing to assess the extent to which the proposals meet user information needs and are practicable.

A4 We agree in principle with the proposals because:

- i. They would allow users to better assess management's stewardship of the entity's economic resources.
- ii. They allow entities to choose their own metrics, supporting understandability and relevance, and providing investors with further insight into management's stewardship. Whilst this may reduce comparability with other entities, given every acquisition is unique, we do not see this as a valid objection. The disclosures would be comparable for the same entity year on year.
- iii. Including the disclosures in the notes to the financial statements brings them within the scope of audit, providing additional assurance about their faithful representation.
- iv. It is sometimes argued that disclosures on acquisitions would not be useful where integration is rapid, but we do not see this argument as valid. If rapid integration was planned, the objectives for the acquisition would reflect this. If rapid integration occurred but was not planned, and monitoring stopped or objectives changed, disclosures would also be required. In both scenarios, useful information would be provided to users.

A5 However, we recommend:

- i. That the IASB undertake field-testing to explore whether the proposed disclosures would provide sufficient information to support users in their assessment of management's stewardship of the entity's economic resources.
- ii. That disclosures should be required for all material acquisitions, rather than only those whose performance is reviewed by the CODM, in order to provide more consistency of disclosure across entities and reporting periods. We note that the proposal for disclosures based on information reviewed by the CODM assumes this is a cost-efficient approach because the information already exists. However, we believe that such information would typically need development to be presented in a form suitable for disclosure, so we do not think that cost efficiency is a valid reason for restricting disclosure to those entities monitored by the CODM.
- iii. That the requirement is to disclose the metrics chosen to monitor subsequent performance of the acquisition (*e.g. market share growth, number of product innovations*) rather than to disclose targets in place to monitor subsequent performance of the acquisition against those metrics (*e.g. 5% market share growth, 6 product innovations*). We believe that disclosure of quantitative targets would not be practical, since it is more likely to include confidential or commercially sensitive information.
- iv. That the requirement is for qualitative disclosure of performance against chosen metrics (*e.g. 'The acquisition of laundry powder brand X is exceeding targets for number of product innovations, market share growth and operating profit margins'*)

rather than disclosure of the quantitative targets in place to track progress and actual performance against those targets (*e.g. 'We exceeded our target of 5 new product innovations in the first two years after acquiring laundry powder brand X by introducing 9 product innovations in the first 18 months'*). We believe that a requirement to disclose quantitative performance against targets would not be practical, since it is more likely to require disclosure of confidential or commercially sensitive information.

- v. That disclosure is required when monitoring of material acquisitions stops, together with an explanation of why it has stopped. We do not support the proposal to require disclosure of reasons why management has stopped monitoring the acquisition if management stops monitoring within two years. This proposal seems arbitrary given the differing timescales required to integrate acquisitions in different sectors and at different stages in the business lifecycle.

A6 That failure to meet an objective or target identified at acquisition is treated as an indication of an impairment of goodwill in the cash-generating unit to which it has been allocated, unless the entity can provide a valid explanation of why it has not been treated as an indicator of impairment.

A7 We agree with the IASB's view that the proposed disclosure of CODM's objectives for the acquisition and the metrics used to monitor progress in meeting those objectives is not forward-looking information.

Question 3: New disclosure requirements on management's objectives for acquisitions

Paragraphs 2.53–2.60 explain the Board's preliminary view that it should develop, in addition to proposed new disclosure requirements, proposals to add disclosure objectives to provide information to help investors to understand:

- the benefits that a company's management expected from an acquisition when agreeing the price to acquire a business; and
- the extent to which an acquisition is meeting management's (CODM's) objectives for the acquisition.

Do you agree with the Board's preliminary view? Why or why not?

A8 We agree with the Board's preliminary view, because the proposed additional disclosure objectives would allow users to assess management's stewardship of the entity's economic resources.

A9 However, we note that there is duplication of the disclosure objectives in Q2bii, which proposes disclosure of whether management's objectives for an acquisition are being met. We recommend that if the Board's preliminary views are developed any duplication is removed.

A10 We repeat our recommendations from paragraph A5 above.

Question 4: Targeted disclosure improvements on anticipated synergies and major classes of liabilities acquired

Paragraphs 2.62–2.68 and paragraphs 2.69–2.71 explain the Board’s preliminary view that it should develop proposals:

- to require a company to disclose:
 - a description of the synergies expected from combining the operations of the acquired business with the company’s business;
 - when the synergies are expected to be realised;
 - the estimated amount or range of amounts of the synergies; and
 - the expected cost or range of costs to achieve those synergies; and
- to specify that liabilities arising from financing activities and defined benefit pension liabilities are major classes of liabilities.

Do you agree with the Board’s preliminary view? Why or why not?

A11 We support the Board’s objective in providing better information for investors on management’s rationale for acquisitions as it contributes to the stewardship objective of the financial statements.

A12 However, we do not support the proposed disclosures on synergies because:

- i. They would require the disclosure of commercially sensitive or confidential information.⁸
- ii. Given the significant judgement involved, the proposed disclosures may be difficult to verify, leading to significant increase in costs of verifying and auditing them.
- iii. The audit expectation gap may increase as public perception may be that auditors are confirming that predicted synergies will be realised.
- iv. The costs may be disproportionate to the benefit. If the proposed new disclosure requirements discussed in Question 2 are developed, we would expect little marginal benefit from these additional disclosures on expected synergies.
- v. The proposal is for a one-off disclosure at the date of acquisition, leading to brief and limited increase in management accountability.

A13 If these proposals are developed we recommend:

⁸ We do not agree with IASB’s position that commercial sensitivity is not a valid reason for lack of disclosure. We believe that commercial sensitivity and confidentiality are valid reasons for lack of disclosure, as they contribute to confidence in transactions and markets. In addition, disclosure of commercially sensitive information could create commercial disadvantage if it is not required under other financial reporting regimes.

- i. Synergies are defined by the IASB, in order to support consistency and comparability.
- ii. Illustrative examples are developed and field-tested to assess whether and how the objectives of providing useful information and protecting confidential or commercially sensitive information can be successfully combined.

A14 The DP states that *'investors have said that the requirement for a company to provide a qualitative description of the factors that make up goodwill often results in companies providing a generic description that is not useful. Investors have said the information they want is not about goodwill itself, but information that gives them a better understanding of why a company paid the price it did for the acquired business.'*⁹ The proposals in the DP focus heavily on the synergies component of goodwill. We recommend that further consideration is given to other areas of disclosure which would meet also contribute to meeting user objectives, for example intangible assets not currently recognised on acquisition.

A15 We support the proposal to disclose debt and defined benefit pension liabilities acquired separately for each acquisition, subject to usual materiality constraints, because:

- i. Disclosures about the debt assumed in the acquisition will be more consistent and comparable across different entities and will provide useful information about debt acquired as part of the acquisition.
- ii. We expect the marginal cost of this disclosure to be low as debt and defined benefit pension liabilities are required to be recognised and measured at the date of acquisition.

Question 5: Pro-forma disclosures

IFRS 3 Business Combinations requires companies to provide, in the year of acquisition, pro forma information that shows the revenue and profit or loss of the combined business for the current reporting period as though the acquisition date had been at the beginning of the annual reporting period.

Paragraphs 2.82–2.87 explain the Board's preliminary view that it should retain the requirement for companies to prepare this pro forma information.

- (a) Do you agree with the Board's preliminary view? Why or why not?
- (b) Should the Board develop guidance for companies on how to prepare the pro forma information? Why or why not? If not, should the Board require companies to disclose how they prepared the pro forma information? Why or why not?

IFRS 3 also requires companies to disclose the revenue and profit or loss of the acquired business after the acquisition date, for each acquisition that occurred during the reporting period.

Paragraphs 2.78–2.81 explain the Board's preliminary view that it should develop proposals:

- to replace the term *'profit or loss'* with the term *'operating profit before acquisition-related transaction and integration costs'* for both the pro forma information and information about the acquired business after the acquisition date. Operating profit or loss would be defined as in the Exposure Draft *General Presentation and Disclosures*.

⁹ IASB's *Business Combinations Disclosures, Goodwill and Impairment* DP, paragraph 2.62.

- to add a requirement that companies should disclose the cash flows from operating activities of the acquired business after the acquisition date, and of the combined business on a pro forma basis for the current reporting period.
- (c) Do you agree with the Board's preliminary view? Why or why not?

A16 We agree with the Board's preliminary views because:

- i. Pro-forma information enhances the comparability of financial information.
- ii. Greater consistency and comparability will result from specifying that 'operating profit before deducting acquisition related transaction and integration costs' must be used in pro-forma information and in disclosing results of the acquired business after the acquisition date.
- iii. The proposed disclosures of cash flows from operating activities will enhance understandability.

A17 We recommend that the IASB:

- i. Define '*related transaction and integration cost*,' to support consistent application.
- ii. Develop disclosure requirements for the basis on which pro-forma information is prepared, to support understandability and comparability.
- iii. Field test the proposals to ascertain expected practicalities and costs of providing pro-forma cash flow information.

Question 6: Feasibility of making the impairment test for cash-generating units containing goodwill significantly more effective at recognising impairment losses on goodwill on a timely basis.

As discussed in paragraphs 3.2–3.52, the Board investigated whether it is feasible to make the impairment test for cash-generating units containing goodwill significantly more effective at recognising impairment losses on goodwill on a timely basis than the impairment test set out in IAS 36 Impairment of Assets. The Board's preliminary view is that this is not feasible.

- (a) Do you agree that it is not feasible to design an impairment test that is significantly more effective at the timely recognition of impairment losses on goodwill at a reasonable cost? Why or why not?
- (b) If you do not agree, how should the Board change the impairment test? How would those changes make the test significantly more effective? What cost would be required to implement those changes?
- (c) Paragraph 3.20 discusses two reasons for the concerns that impairment losses on goodwill are not recognised on a timely basis: estimates that are too optimistic; and shielding. In your view, are these the main reasons for those concerns? Are there other main reasons for those concerns?
- (d) Should the Board consider any other aspects of IAS 36 in this project as a result of concerns raised in the Post-implementation Review (PIR) of IFRS 3?

A18 We agree that it is not feasible to make the impairment test for cash-generating units containing goodwill significantly more effective at recognising impairment losses on

goodwill on a timely basis than the existing test in IAS 36 *Impairment of Assets*. However, we make some recommendations which we believe will improve its rigour below.

A19 We agree that optimistic estimates and shielding are the main reasons that impairment losses on goodwill are not recognised on a timely basis.

Optimistic estimates

A20 UK stakeholders are concerned that optimistic estimates lead to lack of timely impairment of goodwill because:

- i. Optimism is a quality often associated with successful leadership vision when making acquisitions, yet neutrality is needed when estimating recoverable amounts for accounting purposes.
- ii. Confirmation bias and illusion of control can encourage management optimism when estimating recoverable amounts.
- iii. Estimating future cash flows and allocating them to CGUs involves significant judgement, even though IAS 36 requires value in use cash flows to be reasonable and supportable.¹⁰

A21 We recommend the following targeted disclosure improvements to improve the predictive value of financial statements and to reduce the risk that optimistic estimates cause delayed impairments:

- i. Disclose how discount rates have been derived, differentiating between CGUs with different risk profiles (in addition to the current disclosure of the discount rate applied to the cash flow projections¹¹) to provide a greater focus on the appropriateness of the discount rates applied to the underlying cash flow projections.
- ii. Disclose possible changes to key assumptions in the recoverable amount calculation and the impact of those changes on recoverable amount (replacing the current disclosure of key assumptions and the amount by which the key assumption would need to change if a reasonably possible change to it would cause carrying amount to exceed recoverable amount¹²). In addition, this information will be of use to investors in understanding the sensitivities in the valuation of the goodwill balance.
- iii. Additional disclosures are currently required for each CGU or group of CGUs with allocated goodwill whose carrying amount is significant in comparison with the entity's total carrying amount of goodwill.¹³ We agree with the proportionality of this approach. However, we recommend that the additional disclosures should also be required for each CGU or group of CGUs with allocated goodwill with a significant

¹⁰ IAS 36, paragraph 33a.

¹¹ IAS 36, paragraph 134.d.v.

¹² IAS 36, paragraph 134.f.iii.

¹³ IAS 36, paragraph 134.

carrying amount when compared to the entity's total net assets excluding goodwill. This would maintain a proportionate approach by limiting additional disclosures to areas where greater insight into the robust valuation of goodwill is more valuable.

Shielding

A22 Shielding causes concerns that the impairment of goodwill is not timely because:

- i. Goodwill is currently allocated to the acquirer's CGU or group of CGUs that are expected to benefit from the synergies of the combination. The CGU or group of CGUs to which goodwill is allocated represents the lowest level within the entity at which the goodwill is monitored for internal management purposes and must not be larger than an operating segment.
- ii. The allocation of goodwill to CGUs depends on the level at which goodwill is monitored internally. If goodwill is not monitored internally, or is monitored at a high level, impairment testing will carry a greater risk of shielding than in entities where goodwill is monitored at a lower level.

A23 Given that many criticisms of the current model focus on shielding, we believe there would be merit in fuller exploration of approaches which tackle the impact of shielding. We recommend that the IASB develops and consults on proposals which would require entities to:

- i. Disclose how CGUs have been identified and whether that has changed from the prior period, in order to provide insight to users of the accounts of the judgements made by management in accounting for goodwill. These disclosures are currently only required for CGUs for which an impairment has been recognised or reversed during the period.¹⁴
- ii. Disclose where goodwill is more likely to be shielded, for example when goodwill has been allocated to a CGU where the acquisition has been integrated with an existing business.
- iii. Explore options for testing goodwill for impairment at a more disaggregated level, so that testing is more targeted. One option to explore would be to require allocation of goodwill to CGUs which represent the lowest level within the entity at which the results of the acquired business are monitored for internal management purposes. This would increase cost in comparison to the current model. The assessment of whether the increase in cost is reasonable needs to be made with reference to the costs and consequences of delays in recognition of goodwill impairments.

¹⁴ IAS 36, paragraph 130d.

Question 7 Reintroduction of amortisation

Paragraphs 3.86–3.94 summarise the reasons for the Board’s preliminary view that it should not reintroduce amortisation of goodwill and instead should retain the impairment-only model for the subsequent accounting for goodwill.

- (a) Do you agree that the Board should not reintroduce amortisation of goodwill? Why or why not? (If the Board were to reintroduce amortisation, companies would still need to test whether goodwill is impaired.)
- (b) Has your view on amortisation of goodwill changed since 2004? What new evidence or arguments have emerged since 2004 to make you change your view, or to confirm the view you already had?
- (c) Would reintroducing amortisation resolve the main reasons for the concerns that companies do not recognise impairment losses on goodwill on a timely basis (see Question 6(c))? Why or why not?
- (d) Do you view acquired goodwill as distinct from goodwill subsequently generated internally in the same cash-generating units? Why or why not?
- (e) If amortisation were to be reintroduced, do you think companies would adjust or create new management performance measures to add back the amortisation expense?

(Management performance measures are defined in the Exposure Draft General Presentation and Disclosures.) Why or why not? Under the impairment-only model, are companies adding back impairment losses in their management performance measures? Why or why not?

- (f) If you favour reintroducing amortisation of goodwill, how should the useful life of goodwill and its amortisation pattern be determined? In your view how would this contribute to making the information more useful to investors?

A24 We disagree with the Board’s decision not to explore arguments for the introduction of goodwill amortisation.

A25 Our initial research provides new evidence that goodwill is a significant and growing component of UK balance sheets. Between 2005 and 2019, goodwill increased by 69% from £227bn to £383bn for the FTSE 350. The sharpest rise occurred between 2014 and 2019, when goodwill increased by 48% from £259bn to £383bn.¹⁵

A26 Without the introduction of amortisation, it is likely that goodwill balances will continue to increase. Continued growth caused by the build-up of aged goodwill balances does not provide useful information to lenders and investors because it does not show that these balances are wasting assets whose benefits are consumed over time.

A27 We recommend a mixed model in which an annual amortisation charge is supported by indicator-based impairment testing. The benefits of a mixed model are:

- i. Faithful representation in recording goodwill as an asset, because goodwill meets the Conceptual Framework definition of an asset. Alternative treatments such as writing goodwill off to reserves or through the statement of profit or loss would not apply the Conceptual Framework definition.

¹⁵ More details are included in Appendix 1.

- ii. Support for the stewardship function of financial statements by recognising goodwill as an asset. Recognising goodwill as an asset highlights management's accountability for the price paid for the acquisition, in contrast to alternative treatments such as writing goodwill off to reserves or through the statement of profit or loss.
- iii. Faithful representation in treating goodwill as a wasting asset¹⁶. Acquired goodwill represents the value of the business over and above the value of its separable net assets at acquisition. We believe this is a wasting asset and its value declines over time, for example as a skilled workforce retires or competitive forces erode it. Subsequent expenditure to maintain a company's reputation and competitiveness generates new internal goodwill, rather than maintains the acquired goodwill.
- iv. Faithful representation of the consumption of economic benefits by applying the matching principle, thereby holding management to account for the cost of the acquisition through a charge against profits.
- v. Reduced risk of overstated goodwill, because goodwill arising on each acquisition would be amortised, thereby mitigating the risk of shielding.
- vi. Reduced risk of overstated goodwill, as its carrying value would be less dependent on subjective estimates of future cash flows.
- vii. Reduced risk of financial shock from the delays in recognising impairments.
- viii. Relevant information where the amortisation charge accurately reflects the consumption of the benefits the goodwill represents.
- ix. Relevant information provided by timely impairment of goodwill, where this occurs, would be retained.
- x. The accounting treatment for acquired goodwill would be more consistent with the treatment of tangible assets whose recoverable amount cannot be determined separately. There is no compelling conceptual basis for treating goodwill differently.
- xi. Less time and cost would be spent in measuring aged goodwill balances whose economic benefits have long since been consumed by the acquirer.
- xii. It is straightforward to adjust for amortisation in MPMs and other models if some users do not see it as relevant for assessing management performance, in the same way that many MPMs are currently adjusted for impairment charges.

A28 We recommend that in developing the mixed model the IASB consider:

¹⁶ See discussion in IASB *Business Combinations: Disclosures, Goodwill and Impairment* DP paragraph 3.63.

- i. Conducting research to assess whether data analytic techniques could be used to assess the pattern of consumption of goodwill and to address the questions of the amortisation period and pattern of consumption of benefits of goodwill.
- ii. Conducting research to assess the feasibility of componentisation of goodwill for amortisation purposes, in a similar way to the componentisation of tangible fixed assets for depreciation purposes.
- iii. Exploring whether goodwill could be amortised over:
 - the period over which synergies from the acquisition are expected to be realised.
 - the period which could reasonably be expected to elapse before a competitor could copy a formulation, know-how, technology or other intellectual capital acquired.
 - the remaining term of employment for an assembled workforce.
 - the period over which the acquired entity is monitored and managed separately from the acquiring organisation, before integration.
 - the period implied by the acquisition price earnings multiple.
- iv. Field testing separate disclosure of the amortisation charge to allow it to be easily adjusted by users of the financial statements.

Question 8: Presentation of total equity excluding goodwill on the balance sheet

Paragraphs 3.107–3.114 explain the Board’s preliminary view that it should develop a proposal to require companies to present on their balance sheets the amount of total equity excluding goodwill. The Board would be likely to require companies to present this amount as a free-standing item, not as a subtotal within the structure of the balance sheet (see the Appendix to this Discussion Paper).

- (a) Should the Board develop such a proposal? Why or why not?
- (b) Do you have any comments on how a company should present such an amount?

A29 We do not support the Board’s suggestion to develop proposals to present ‘*total equity excluding goodwill*’ on the balance sheet as we do not believe it would provide additional useful information about the goodwill balance.

A30 IASB’s rationale is that ‘*presenting the amount of total equity excluding goodwill would provide further transparency about the effect of goodwill and so contribute further to investors’ understanding of a company’s financial position.*’ However, we think it creates potential for confusion rather than transparency. Financial statements are prepared on a going concern basis and so the view in the DP that ‘*goodwill is different from other assets because it cannot be sold separately and, because its value often disappears quickly when*

*a business is in difficulty, it is harder to convert into cash than many other assets on liquidation*¹⁷ may be true but is not relevant if the entity is a going concern.

- A31 The Board's further rationale is that '*goodwill is often allocated to groups of CGUs for impairment testing whereas other assets are tested for impairment individually or as part of a single cash-generating unit. Some of the unavoidable limitations of the impairment test occur when goodwill is allocated to groups of cash-generating units.*'¹⁸ This seems to acknowledge that where goodwill is tested for impairment as part of a group of CGUs, the impairment test is not reliable. We believe that the solution to this problem is to address the issue with the impairment test, rather than to require an additional disclosure. We make recommendations in paragraph A23 to improve the impairment test.
- A32 We suggest that additional disclosures may be a better way to meet the objective of making the goodwill balance more understandable and providing greater insight into its measurement. We recommend disclosure of goodwill carrying amounts, analysed by material acquisition and showing:
- i. the date of acquisition
 - ii. the amount capitalised
 - iii. the accumulated amortisation or impairment
 - iv. the carrying balance at the reporting date

Question 9: Replacement of the annual quantitative impairment test with a quantitative test only when there is an indicator of impairment.

Paragraphs 4.32–4.34 summarise the Board's preliminary view that it should develop proposals to remove the requirement to perform a quantitative impairment test every year. A quantitative impairment test would not be required unless there is an indication of impairment. The same proposal would also be developed for intangible assets with indefinite useful lives and intangible assets not yet available for use.

- (a) Should the Board develop such proposals? Why or why not?
- (b) Would such proposals reduce costs significantly (see paragraphs 4.14–4.21)? If so, please provide examples of the nature and extent of any cost reduction. If the proposals would not reduce costs significantly, please explain why not.
- (c) In your view, would the proposals make the impairment test significantly less robust (see paragraphs 4.22–4.23)? Why or why not?

- A33 If a mixed model is adopted, we support the proposal to replace the requirement for an annual quantitative impairment test for goodwill with a quantitative test only when there is an indicator of impairment because:

¹⁷ IASB DP2020/1 paragraph 3.107b.

¹⁸ IASB DP2020/1 paragraph 3.107c.

- i. Under a mixed model headroom would increase and the need for a full quantitative impairment test would be reduced.
- ii. The accounting treatment would be consistent with tangible assets whose recoverable amount cannot be determined separately, and there is no clear conceptual basis for treating goodwill differently.

A34 Absent a mixed model, we would not support the proposal because it would increase the risk of overstatement of goodwill balances. We believe that without a mixed model, a quantitative test would be required to maintain some robustness and that robustness should take precedence over cost-savings.

A35 We believe that the potential cost savings of moving to an indicator only test for goodwill would not be significant because:

- i. an annual quantitative test incurs minimal marginal cost, since the inputs used in the value in use calculation are typically derived from the most recent budgets that were approved by management.
- ii. an indicator-only test increases costs due to the significant judgement required to prepare and audit it.
- iii. costs are already minimised by the existing practical expedient where there is unlikely to be an impairment.¹⁹

A36 The annual quantitative test should be retained for intangibles which are not amortised, because of the higher risk associated with them. Therefore we do not support the proposal to move to an indicator-only test for intangible assets with indefinite useful lives and intangible assets not yet available for use.

Question 10 Removal of restriction on including some cash flows in estimating value in use
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The Board's preliminary view is that it should develop proposals:

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| <ul style="list-style-type: none"> • to remove the restriction in IAS 36 that prohibits companies from including some cash flows in estimating value in use—cash flows arising from a future uncommitted restructuring, or from improving or enhancing the asset's performance (see paragraphs 4.35–4.42); and • to allow companies to use post-tax cash flows and post-tax discount rates in estimating value in use (see paragraphs 4.46–4.52). |
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The Board expects that these changes would reduce the cost and complexity of impairment tests and provide more useful and understandable information.

¹⁹ IAS 36 Impairment of Assets paragraph 99. The most recent calculation of recoverable amount of a CGU to which goodwill has been allocated may be used provided certain criteria are met. The criteria are: a) assets and liabilities making up the unit have not changed significantly since the most recent calculation; b) the most recent recoverable amount calculation resulted in an amount that exceeded the carrying amount of the unit by a substantial margin; c) based on an analysis of events that have occurred and circumstances that have changed since the most recent recoverable amount calculation, the likelihood that a recoverable amount determination would be less than the current carrying amount of the unit is remote.

- (a) Should the Board develop such proposals? Why or why not?
- (b) Should the Board propose requiring discipline, in addition to the discipline already required by IAS 36, in estimating the cash flows that are the subject of this question? Why or why not? If so, please describe how this should be done and state whether this should apply to all cash flows included in estimates of value in use, and why.

A37 We support the proposal to remove the requirement to exclude any estimated future cash inflows or outflows expected to arise from future restructures or from improving or enhancing the asset's performance from the value in use calculation, subject to some recommendations which are outlined below.

A38 The benefits of this proposal are:

- i. It is more logical to assess value in use after factoring in planned restructuring activities, since these may be central to the rationale for the acquisition and are also likely to have been factored into the purchase price.
- ii. Removing the requirement for the impacts of restructuring to be excluded from the value in use calculation may make the calculation less onerous and costly, as fewer adjustments to internal cash flow forecasts may be needed.

A39 However, as discussed above, there is a risk of a bias towards optimism in the value in use calculation. If the proposal is developed, we recommend that:

- i. expected values are used to incorporate risk into the cash flows, for example to recognise that there is typically greater risk associated with revenue cash flows than cost cash flows.
- ii. The proposal is redrafted so that entities are *required* to include cash flows from uncommitted restructuring or asset improvements. The proposal is to *remove the restriction* on including cash flows arising from uncommitted restructuring or asset improvements, rather than to require their inclusion, and this could lead to inconsistent treatment and lack of comparability. The potential lack of consistency and comparability could also be addressed by a requirement to disclose where recoverable amount includes cash flows from uncommitted restructuring or asset improvements.

A40 We support the proposal to allow either a pre-tax discount rate or a post-tax discount rate to be used in the value in use calculation, provided that the rate chosen is consistent with the cash flows. We anticipate that removing the explicit requirement for pre-tax cash flows and a pre-tax discount rate to be used will save time and cost for preparers.

Question 11 Further simplification of the impairment test

Paragraph 4.56 summarises the Board's preliminary view that it should not further simplify the impairment test.

- (a) Should the Board develop any of the simplifications summarised in paragraph 4.55? If so, which simplifications and why? If not, why not?

- (b) Can you suggest other ways of reducing the cost and complexity of performing the impairment test for goodwill, without making the information provided less useful to investors?

A41 We agree with the board that the following simplifications for the impairment test should not be developed:

- i. More guidance on the difference between entity specific inputs used in value in use and market participant inputs used in fair value less costs of disposal (DP paragraph 4.55 (a).)
- ii. Mandating only one method for estimating the recoverable amount of an asset or requiring a company to select the method that reflects the way the company expects to recover an asset (DP paragraph 4.55 (b).)
- iii. Allowing companies to test goodwill at the entity level or at the level of reportable segments (DP paragraph 4.55 (c).)

A42 However, we recommend that the board develops principles on 4.55 d *'adding guidance on identifying cash-generating units and on allocating goodwill to cash-generating units.'* We make recommendations on how these principles might be developed in paragraph A23.

Question 12 IASB's preliminary view is that it should not develop a proposal to allow some intangible assets to be included in goodwill

Paragraphs 5.4–5.27 explain the Board's preliminary view that it should not develop a proposal to allow some intangible assets to be included in goodwill.

- (a) Do you agree that the Board should not develop such a proposal? Why or why not?
- (b) If you do not agree, which of the approaches discussed in paragraph 5.18 should the Board pursue, and why? Would such a change mean that investors would no longer receive useful information? Why or why not? How would this reduce complexity and reduce costs? Which costs would be reduced?
- (c) Would your view change if amortisation of goodwill were to be reintroduced? Why or why not?

A43 We support the IASB's preliminary view not to develop proposals to change the recognition criteria for intangible assets acquired in a business combination as part of the current project. The current regime provides useful information on intangibles acquired as part of a business combination.

A44 However, we recommend that IASB undertake a separate future project to review accounting for intangibles more broadly. That future project should also consider the following themes from the FRC's research report, *Investor Views on Intangible Assets and their Amortisation*²⁰:

- i. Better disclosures of intangibles acquired in different acquisitions.

²⁰ Investor Views on Intangible Assets and their Amortisation, FRC, 2014.

ii. Recognition of internally generated intangibles.

A45 Our view would not change if amortisation of goodwill were to be reintroduced.

Question 13 US GAAP Convergence

IFRS 3 is converged in many respects with US generally accepted accounting principles (US GAAP). For example, in accordance with both IFRS 3 and US GAAP for public companies, companies do not amortise goodwill. Paragraphs 6.2–6.13 summarise an Invitation to Comment issued by the US Financial Accounting Standards Board (FASB).

Do your answers to any of the questions in this Discussion Paper depend on whether the outcome is consistent with US GAAP as it exists today, or as it may be after the FASB's current work? If so, which answers would change and why?

A46 Whilst we recognise the benefits of convergence with US GAAP for some UK stakeholders, our answers take into account a full range of relevant considerations for UK stakeholders and are not solely dependent on consistency with current or future US GAAP.

Question 14 Other comments

Do you have any other comments on the Board's preliminary views presented in this Discussion Paper? Should the Board consider any other topics in response to the PIR of IFRS 3?
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A47 We have no other comments.