UKEB UK Endorsement Board

Dr Andreas Barckow
International Accounting Standards Board
7 Westferry Circus
Canary Wharf
London
E14 4HD

17 December 2021

Dear Dr Barckow,

Subsequent accounting for goodwill

The UK Endorsement Board (UKEB) is responsible for endorsement and adoption of IFRS for use in the UK and therefore is the UK's National Standard Setter for IFRS. The UKEB also leads the UK's engagement with the IFRS Foundation on the development of new standards, amendments and interpretations. 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 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 undertaken by the UKEB.

There are currently approximately 1,500 entities with equity listed on London Stock Exchange that prepare their financial statements in accordance with IFRS Standards[1]. In addition, UK law allows unlisted companies the option to use IFRS and approximately 14,000 such companies currently take up this option.

We are pleased to support the IASB's further research on the subsequent accounting for goodwill. We welcome the opportunity to contribute to the ongoing exploration of this significant area in international financial reporting, and to provide relevant information to support the IASB as it redeliberates the feedback received on its Discussion Paper 2020/01 *Business Combinations: Disclosures, Goodwill and Impairment.*

In developing our response, we conducted desk-based research and outreach to UK IFRS reporters. Outreach to UK IFRS reporters included a public survey. The 23 respondents to that survey represent 17% of the FTSE 350 by market capitalisation, covering a range of sectors including: fast-moving consumer goods, banking, energy, utilities, construction, technology, retail, pharmaceutical, medical technology, insurance, airlines, B2B, and manufacturing. Of these respondents, 22 had made acquisitions in the last five years.

We also conducted desk-based research and outreach to ascertain how the useful life of goodwill is determined for amortisation purposes under UK GAAP.

[1] UKEB calculations based on LSEG and Eikon data. This calculation includes companies listed on the Main market as well as the Alternative Investment Market (AIM).

Our research identified that:

1. A potential transition to a hybrid model[2] for subsequent measurement of goodwill could have a material impact on the financial position of UK IFRS reporters, if amortisation of existing goodwill balances is required on transition. However, we do not believe this is a compelling reason to defer any potential transition because, if the growth trend in goodwill continues[3], transitional impacts will only increase in future.

2. A potential transition would be unlikely to have a major impact on financial stability of UK IFRS reporters.

3. The majority of UK IFRS reporters responding to our survey do not anticipate major operational changes if there were to be a transition.

4. Most UK GAAP reporters consider specific and appropriate factors when determining the useful life of goodwill for amortisation purposes.

More detail on these findings is provided in appendix 1 and our answers to the IASB staff questions are in appendix 2.

We intend to conduct field-testing to further explore possible consequences of potential changes to the subsequent measurement of goodwill. We would be happy to share the output from our field-testing with the IASB, if it would be of interest to the future development of the project.

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

Yours sincerely

Pauline Wallace
Chair
UK Endorsement Board

[2] The UKEB Secretariat's response to the IASB's DP recommended a hybrid model for the subsequent measurement of goodwill. Under a hybrid model, an annual amortisation charge would be supported by indicator-based impairment testing.

[3] Goodwill increased by 69% from £227bn to £383bn for the FTSE 350 between 2005 and 2020.

Appendix 1: Summary of research findings

1. A potential transition to a hybrid model for subsequent measurement of goodwill could have a material impact on the financial position for UK IFRS reporters, if amortisation of existing goodwill balances is required.

a) Goodwill is a significant balance for UK IFRS reporters and potential changes to the subsequent measurement of goodwill are likely to have material impacts, if adjustment of existing balances is required on transition to the new requirements. In 2020, goodwill for FTSE 350 and AIM entities totalled £391.3bn, representing 50.9% of FTSE 350 and AIM net assets.

b) However, even if changes to the subsequent accounting for goodwill lead to material impacts on transition, we do not support deferral of those changes because if the growth trend in goodwill continues at the current pace[4], transitional impacts will only increase in future.

2. A potential transition would be unlikely to have a major impact on the financial stability of UK IFRS reporters.

a) According to our survey results, potential changes to the subsequent measurement of goodwill are associated with an increased risk of breach of covenants if adjustment of existing goodwill balances is required on transition. However, we understand from discussions with respondents that in practice such breaches are unlikely.

b) Our desk-based research to date and survey results suggest that potential changes to the subsequent measurement of goodwill would not have a significant impact on distributable profits for UK IFRS reporters. Distributable profits are not affected by amortisation or impairment of goodwill arising on consolidation in the UK, because distributions are made by individual companies and not by groups under UK law. However, we are continuing to gather evidence on the prevalence and size of goodwill balances arising from trade and assets business combinations in single entities and their potential impact on distributable profits.

c) Under current UK tax legislation, tax payable by UK IFRS reporters and their UK-based subsidiaries would not be directly impacted by changes to the subsequent measurement of goodwill under IFRS.

d) Our outreach and review of the Financial Conduct Authority (the FCA)[5] handbook have not identified an increased risk of failing to meet market regulations if there were changes to the subsequent measurement of goodwill.

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[4] Goodwill increased by 69% from £227bn to £383bn for the FTSE 350 between 2005 and 2020.

[5] The FCA is the UK's listing and markets regulator.

3. The majority of UK IFRS reporters responding to our survey do not anticipate major operational changes as a result of a potential transition.

a) The majority (71%) of respondents to our public survey said that they would not anticipate significant operational changes if there were a transition to a hybrid model[6] for the subsequent measurement of goodwill.

4. Most UK GAAP reporters consider specific and appropriate factors when determining the useful life of goodwill for amortisation purposes.

a) The evidence we collected through desk-based research and outreach suggests that in many cases specific and appropriate considerations are applied by entities when determining the useful life of goodwill. Auditors are required to gain sufficient and appropriate audit evidence on the useful life of goodwill by applying ISA 540 *Auditing Accounting Estimates and Related Disclosures,* which was revised for accounting periods beginning on or after 15 December 2019 in order to provide more extensive guidance on the audit of accounting estimates.

[6] The UKEB Secretariat's response to the IASB's DP recommended a hybrid model for the subsequent measurement of goodwill. Under a hybrid model, an annual amortisation charge would be supported by indicator-based impairment testing.

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Appendix 2: Responses to IASB staff questions

Question 1: Determination of the useful life of goodwill for amortisation purposes under UK GAAP
Based on your experience: (A) If the applicable local accounting framework in your jurisdiction requires goodwill to be subsequently amortised, how is the useful life determined and, in particular whether: (i) a default period is provided in local GAAP (for example: 10 or 20 years) and the reasons for setting a default period and how that default period was determined; (ii) entities can deviate from a default period based on specific facts and circumstances (rebuttable presumption) and, if so, whether in practice entities tend to rebut that presumption and deviate from the default period, and what evidence is provided to support any deviation; (iii) useful life is established on the basis of management's best estimate and, if so, whether a list of indicators/factors to be considered is provided (for example: cash flow streams, synergies, payback period), how entities are making these estimates and whether auditors and regulators can, and do, challenge these assumptions.

A1 We understand that the FRC, as the UK's domestic GAAP standard setter, has responded to you on questions A i and A ii and the first part of A iii. We share below the insights we gained from additional desk-based research and stakeholder outreach to understand how the useful life of goodwill amortisation is determined for UK GAAP purposes, and whether auditors and regulators can and do challenge these assumptions.

A2 To understand how the useful life of goodwill is determined under FRS 102 *The Financial Reporting Standard Applicable in the UK and Republic of Ireland* (FRS 102), we analysed the financial statements of the UK's 100 largest private companies[7]. 48 of those companies report under FRS 102, and of those 48 companies, 34 reported goodwill in their most recent financial statements. The highest reported goodwill was £628m and the average was £48m.[8] By comparison, the average goodwill reported by FTSE 350 and AIM entities in 2020 was £366m. Therefore, the larger private company goodwill balances are comparable in size to those reported at the smaller end of the listed market.

A3 Analysis of goodwill balances and related disclosures in those annual reports showed:

a) Of the 34 companies whose disclosures on goodwill we reviewed:

[7] Sunday Times Top Track League Table of UK private companies, ranked by turnover, published July 2020. Such companies have a similar financial profile to some IFRS reporters at the lower end of the listed market.

[8] Source: UKEB staff calculations on financial statements.

(i) 16 companies amortised goodwill on the same straight-line basis for all acquisitions. The periods over which goodwill was amortised were 10 years (9 companies), 20 years (5 companies) and 5 years (2 companies).

(ii) 10 companies determined the useful life of goodwill for each acquisition within an overall range. The ranges were: 4 – 20 years (1 company), 5 – 20 years (5 companies), 10 - 20 years (2 companies), and up to 20 years (2 companies).

(iii) 4 companies disclosed the specific useful life of goodwill determined for individual acquisitions. These specific useful lives were 1 year, 7 years, 19 years, and 50 years. This implies that specific factors are, in at least some cases, considered in the determination of the useful life of goodwill.

(iv) 4 companies did not disclose the period over which goodwill was amortised.

(v) Where the useful life was determined for individual acquisitions, disclosures indicated that a range of relevant factors was considered in that determination.

b) 17 companies determined a useful life of goodwill that exceeded ten years for at least some of their acquisitions. Under UK GAAP, if management cannot reliably estimate the useful life of goodwill, goodwill must be amortised over a period of ten years or less. Only where management can estimate the useful life of goodwill reliably and auditors can obtain sufficient and appropriate audit evidence in relation to that estimate can a useful life exceeding ten years be used for goodwill amortisation. The evidence therefore suggests that, although estimating the useful life of goodwill includes an element of judgement, in half of the cases we reviewed, management can reliably estimate the useful life of goodwill.

c) Disclosures indicated that a broad range of factors is used to determine the useful life of goodwill. These included: strength of brand, products and services provided, competition and expected future performance, expected use of acquired assets, any legal, regulatory, or contractual provisions that may limit the useful life, strategic plans and expected life of the operating unit or line of business to which the goodwill relates.

d) The useful life was typically longer for the food retail and motor services sectors, while the entities in the construction, retail, leisure, and hospitality sectors had shorter useful lives. The useful life was typically longer in the luxury goods sector and where acquisitions had delivered technological capability or online presence. Whilst not conclusive, this evidence suggests that specific and appropriate considerations are applied by each entity when determining the useful life of goodwill.

A4 From our financial statement analysis, we identified 14 entities with goodwill disclosures which suggested that particular rigour had been applied to the determination of the useful life of goodwill. We have approached these entities to gain further insight into their approach to determining the useful life of goodwill. At the time of writing, we are awaiting their responses.

A5 Our outreach to the relevant team at the FRC indicated that it does not generally receive queries on how to determine the useful life of goodwill under FRS 102. It appears, therefore, that the application of FRS 102 on goodwill is not generally problematic.

A6 We conducted structured interviews with auditors of FRS 102 reporters to ascertain the types of audit evidence they seek on management's estimate of the useful life of goodwill, and how that evidence is challenged. Auditors gain sufficient and appropriate audit evidence on the useful life of goodwill by applying ISA 540 *Auditing Accounting Estimates and Related Disclosures,* which was revised for accounting periods beginning on or after 15 December 2019 to provide more extensive guidance on the audit of accounting estimates. Audit firms highlighted to us that since the revision of the ISA and consequent increased audit challenge in this area, there has been increased use of expert input from business valuation specialists as audit evidence on the useful life of goodwill.

Question 2: Potential changes to subsequent measurement of goodwill
(B) If the Board decides to reintroduce goodwill amortisation and transition to an amortisation model requires adjusting historical goodwill balances, what are 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 local jurisdictional requirements that might be relevant.

1. Financial position

A7 Goodwill is a significant balance for UK IFRS reporters and potential changes to the subsequent accounting for goodwill are likely to have material impacts. In 2020, goodwill for FTSE 350 and AIM entities totalled £391.3bn, representing 50.9% of net assets. Goodwill exceeded net assets for 57, or 5%, of FTSE 350 and AIM entities.[9]

A8 The growth in goodwill balances in absolute and relative terms since the introduction of the impairment-only model in 2005 was highlighted in the UK Endorsement Board Secretariat's response to the IASB's Discussion Paper 2020/1 *Business Combinations: Disclosures, Goodwill and Impairment*. We support the IASB's current exploration of different approaches to the subsequent measurement of goodwill given the continued significance of goodwill balances for UK IFRS reporters, in both absolute and relative terms.

[9] Source: UKEB calculations based on Eikon data.

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2. Covenants

A9 Our public survey[10] included questions on financial loan covenants. The objective of these questions was to establish whether potential changes to the subsequent measurement of goodwill could lead to breaches of such covenants.

A10 15 respondents completed the covenants section of our public survey for UK IFRS preparers, compared to 23 respondents overall. Several respondents stated that they did not complete the covenants section because the information requested was confidential. Respondents who completed the covenants section of the survey have a combined market capitalisation of £290bn, representing 11% of FTSE 350 market capitalisation. Their combined goodwill totals £49bn, representing 13% of FTSE 350 combined goodwill.[11]

A11 Of the respondents to the covenants section, 87% (13 respondents) affirmed that covenants use IFRS-based measures.

A12 Of these 13 respondents: eight stated that the IFRS-based measures in covenants include goodwill and are taken directly from the financial statements, one stated that the IFRS-based measures in covenants are derived from the financial statements but adjusted to exclude goodwill, and four stated that covenants used both types of IFRS-based measure.

A13 We asked whether IFRS-based measures in covenants were based on frozen GAAP. Of the respondents to the covenants section, 47% (seven respondents) stated that IFRS-based measures in covenants were based on frozen GAAP. Another 47% (seven respondents) stated that IFRS-based measures in covenants were not based on frozen GAAP. 6% (one respondent) did not answer this question.

A14 We further asked whether covenants allow for re-negotiation when there are changes to financial reporting standards. Of the respondents to the covenants section of our survey, 80% (12 respondents) stated that covenants do not allow for renegotiation when there are changes to financial reporting standards. 20% (three respondents) stated that covenants allow for re-negotiation when there are changes to financial reporting standards. These three respondents were not a subset of those respondents who stated that IFRS-based measures in covenants were not based on frozen GAAP.

A15 Based on our survey results, potential changes to the subsequent measurement of goodwill are associated with an increased risk of breach of covenants. The impact cannot be quantified without further information on current headroom and more comprehensive data on specific covenant terms. However, follow-up discussion with respondents identified that in practice, covenants which did not use frozen GAAP would be likely to be renegotiated in the event of changes to IFRS.

[10] Our public survey was open from 15 November 2021 to 26 November 2021

[11] Source: UKEB calculations based on Eikon data

A16 Some respondents noted that changes to credit ratings may impact loan covenants. Since ratings agencies typically exclude goodwill in their rating methodologies, we do not anticipate that this would typically impact loan covenants.

A17 Several respondents from the banking and insurance sectors noted that loan covenants are typically based on their Solvency II position rather than on IFRS-based measures. There were no other discernable trends by sector, size of entity, reported goodwill or number of acquisitions in the responses to our survey questions on covenants.

3. Management compensation schemes

A18 Some survey respondents highlighted that potential changes to the subsequent measurement of goodwill could impact management compensation schemes. Through follow up discussion with survey respondents, we identified that remuneration committees will typically discuss and agree on any necessary adjustments to IFRS-based performance measures in management compensation schemes if there are changes to IFRS Standards. Given lead-times for the implementation of new Standards, there is sufficient time for adjustments to be made. We do not foresee significant impact on management compensation schemes arising from potential changes to the subsequent measurement of goodwill.

4. Distributable profits

A19 Under the UK Companies Act 2006 and UK common law, distributions are made by individual companies and not by groups. The group accounts are therefore not relevant for the purpose of determining a company's profits available for distribution, dividend payments or capital maintenance. Amortisation or impairment of goodwill arising on consolidation has no direct impact on distributable profits, dividend payments or capital maintenance. However, goodwill arising on the acquisition of an unincorporated business is reported in the acquiring entity's separate financial statements and therefore its amortisation would directly impact distributable profits and dividend payments for that entity.

A20 Our survey revealed that 39% of respondents (nine respondents) had acquired at least one unincorporated entity in the last five years. 26% (six respondents) had acquired between one and five unincorporated entities during the last five years. 9% (two respondents) had acquired between six and 10 unincorporated entities during the last five years and 4% (one respondent) had acquired more than 10 unincorporated entities during the last five years. Acquisitions of unincorporated businesses took place in the technology, information services, banking and FMCG sectors. However, an initial review of their financial statements revealed that acquisitions of unincorporated entities did not typically result in material goodwill balances.

A21 However, we are continuing to gather evidence on the prevalence and size of goodwill balances arising from trade and assets business combinations in single entities and their potential impact on distributable profits.

5. Tax implications

A22 Transitioning to a hybrid model for the subsequent measurement of goodwill under IFRS would not directly impact tax payable by UK IFRS reporters and their UK-based subsidiaries.

A23 This is because for UK companies corporation tax payable is computed under tax legislation and is not directly derived from accounting profits. For non-UK based subsidiaries, different tax regimes may apply.

6. Market regulations

A24 Our outreach and desk-based research have not identified an increased risk of failing to meet market regulations if there were changes to the subsequent measurement of goodwill.

A25 Where market regulations include tests of gross assets, capital and profits to determine whether additional disclosure is required[12] these tests are applied to asset and profit values at the time the test is required. Therefore, retrospective application of potential changes to the subsequent measurement of goodwill would not increase the risk of compliance failure. Prospective application may lead to increased disclosures relating to these types of transaction in future.

A26 Several respondents to our public survey for IFRS preparers from the banking and insurance sectors noted that changes to the subsequent measurement of goodwill would not impact Solvency II compliance, since goodwill is already excluded from Solvency II ratios.

7. Operational implications

A27 The majority (71% / 16 responses) of responding organisations said that they would not anticipate significant operational changes if there were a transition to a hybrid model for the subsequent measurement of goodwill. These respondents identified that they would expect some change in the following operational areas if the potential transition to a hybrid model were to go ahead: processes and procedures, audit, staff training, and investor relations. One respondent commented that, 'There would also be a need to train / educate investors and users of our financial reports on the change in our reporting, given the non-cash nature of the charge.'

A28 The remaining respondents (39% /seven responses) said that they anticipated significant operational changes if there were a transition to a hybrid model. These respondents identified that significant changes would be needed to the following areas: processes and procedures, audit, data, staff training, and systems and technology.

[12] For example, Listing Rules Class tests for transactions Listing Rules 13.5.33b; Disclosure Guidance and Transparency Rules Related Party tests.

A29 Respondents anticipating significant operational changes if there were a transition to a hybrid model did not report higher numbers of acquisitions in the last five years or higher goodwill.

8. Cost implications

A30 When asked about the anticipated cost impact of a potential transition to a hybrid model, 39% of respondents anticipated either a substantial reduction, a minor reduction, or minimal or no impact on costs. The respondent who anticipated a substantial reduction in costs cited ongoing cost reductions in processes and procedures as the underlying reason.

A31 48% of respondents anticipated a minor increase in costs and 13% of respondents anticipated a significant increase in costs. Approximately one third of the respondents anticipating a minor increase in costs attributed this to implementation costs rather than ongoing costs. Respondents anticipating a significant increase in costs cited audit, staff training and additional expert resource as underlying reasons. Two thirds of these respondents anticipated increases in implementation costs and ongoing costs. The implementation costs related to developing a model for estimating useful life of goodwill and a methodology for revising it for future acquisitions.

A32 Respondents anticipating cost increases did not report higher numbers of acquisitions in the last five years or higher goodwill.