Will goodwill under IFRS be amortized again?

The plans of the International Accounting Standards Board

BOARD LEADERSHIP NEWS
EDITION 03/2020

In the event of a business combination, International Financial Reporting Standards ("IFRS") require the acquirer to allocate the purchase price on the acquisition date. Goodwill itself is a residual value in the purchase price allocation and is defined in its simplest form as the difference between the (higher) purchase price and the (lower) net assets of the acquired business (see Figure 1).

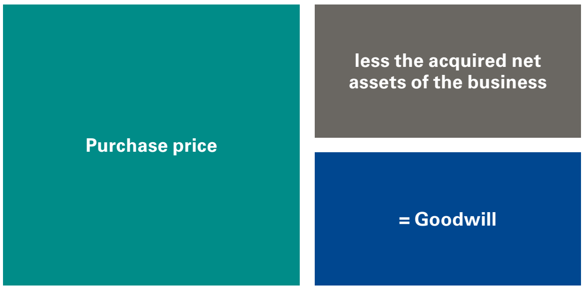

Figure 1: Simple derivation of goodwill in accordance with IFRS

A purchase price higher than the value of the acquired net assets may be paid because the business being acquired has, for example, a highly specialized workforce or it can in the future be used to achieve synergies with the acquiring company's existing business activities or allow it to gain access to a new market.

Under IFRS, goodwill is capitalized on the acquisition date in the acquirer's balance sheet. In contrast to many other non-current assets, goodwill is not systematically amortized over a period of time, but must instead be subjected to an impairment test carried out by the acquirer at least once a year (impairment-only approach). As goodwill does not itself generate independent cash inflows, the acquirer must assess the goodwill together with other related net assets for impairment testing purposes. In practice, the testing of the impairment of these cash-generating units of a company is often carried out using discounted cash flow models. At a minimum, the result of the testing must support the carrying amount of the combined net assets of the respective unit so that goodwill does not have to be impaired. Besides actually selling parts of the company to which goodwill has been allocated, such an impairment is the only way for an entity

applying IFRS to derecognize this particular asset. The application of the impairment-only approach is also mandatory for entities applying US GAAP.

How important is goodwill when reporting under international accounting standards?

Our analysis of the financial reports of SMI[1] companies for 2018 shows that all 19 entities using IFRS or US GAAP reported goodwill in their balance sheets. The highest proportion of goodwill to equity under the accounting standard applied is 83% for a US GAAP company, whereas the lowest proportion for an IFRS company is just 3%. For all SMI companies together, the average goodwill/equity ratio is a remarkable 43%, which proves the paramount importance of this asset for the preparers of financial statements under international accounting standards. We have observed this finding not only at a national level, but also in other parts of the world.

What are the points of criticism regarding goodwill accounting under IFRS?

As IFRS is the accounting standard[2] most frequently used by companies with a primary listing of shares on the SIX Swiss Exchange, in this section we will only cover the criticism of the impairment-only approach[3] under IFRS.

Many observers, particularly financial analysts, believe that currently too little goodwill is being impaired and that this amount is being impaired too late ("too little, too late"). In the past, one of the first official acts of a new management team would often be to partially or completely eliminate the goodwill positions created by its predecessors.

Although the IFRS stipulate detailed disclosure requirements for business combinations as well as for impairment tests, a further shortcoming is that the factors used to determine the purchase price for a business are not clear from the investor's perspective. Users of financial statements also want to ensure that the buyer accounts for the subsequent performance of the businesses it has acquired, in order to assess in retrospect whether the acquisition was successful. These points are not adequately addressed by the current disclosure requirements.

Some entities using IFRS say that recognizing different intangible assets separately is a challenge, because it is often difficult for an acquirer to identify and measure the value of those assets in the purchase price allocation. They also complain that the impairment test for goodwill is expensive and complicated.

Certain investors and users would simply like to see goodwill amortized on a scheduled basis reintroduced under IFRS – in other words, a return to the situation prior to the introduction of the impairment-only approach. This would, according to certain voices, better address the consumption of the asset than a one-off adjustment.

---

1 SMI (Swiss Market Index) is the blue-chip index of the SIX Swiss Exchange and contains the 20 largest stocks from the SPI (Swiss Performance Index, overall index for the Swiss equity market). Source: https://www.six-group.com/exchanges/indices/data_centre/shares/smi_en.html

2 As of January 24, 2020, 56% of the companies with participation rights that have their primary listing on the SIX Swiss Exchange apply IFRS. Source: https://www.six-group.com/exchanges/shares/companies/issuer_list_en.html

3 Source: https://cdn.ifrs.org/-/media/project/goodwill-and-impairment/in-brief-goodwill-and-impairment-factsheet.pdf?la=en

What is the standard-setting body planning for IFRS companies now?

The above-mentioned points of criticism are, of course, well-known to the International Accounting Standards Board (IASB or Board) – the IFRS standard-setting body – as they are not new. In March 2020, the IASB published a discussion paper on disclosures, goodwill and impairment related to business combinations[4]. A discussion paper is a document that is available at an early stage in the IASB's standard-setting process and does not have binding effect. The Board is interested in a substantive discussion, the aim of which is to indicate the direction of any future activities.

The views of the standard-setting body contained in the discussion paper are as follows:

- The IASB is aiming for an improvement in the information that is made available to users about an acquired business and its subsequent performance;
- It does not appear to be possible for the IASB to make the impairment test for goodwill much simpler than it is today;
- In the Board's opinion, the reintroduction of a systematic goodwill amortization would not provide users with significantly better information;
- The IASB is considering dispensing with the mandatory annual impairment test for goodwill in order to reduce costs and complexity;
- In order to increase transparency, companies will in the future have to record a "equity excluding goodwill" subtotal in their balance sheets.

In conclusion, the IFRS standard-setting body does not intend to reintroduce systematic goodwill amortization, but promises the benefit of improved disclosures to both preparers and users.

Our recommendations to you

In your capacity as a member of the Board, we recommend that you ask yourself the following questions about your company's goodwill accounting:

- Can you identify the value underlying the goodwill through the disclosures made in the financial statements, especially in the case of new acquisitions or impairment testing?
- How important is goodwill for the company and is this importance taken into account accordingly in the financial statements? If goodwill is one of the main assets in the consolidated financial statements, we expect the notes on goodwill to play a prominent role.
- How does the company measure whether past acquisitions have been successful or not? Does your company use specific benchmarks to assess the success of an acquisition and if so, are they appropriate?
- How does the company account for past acquisitions externally?

Goodwill accounting is a good opportunity to discuss value drivers and their accounting with your financial managers.
It is also a good starting point to streamline and improve systems, processes and disclosures in the financial report.

We would also like to invite you to read the IASB discussion paper on business combinations-disclosures, goodwill and impairment and, in particular, to provide your opinions on the subject until 31 December 2020, as the IASB is looking to engage in an exchange with key stakeholders such as yourself, as a representative of the preparer community.

---

[4] Source: https://www.ifrs.org/news-and-events/2020/03/iasb-publishes-goodwill-discussion-paper/

Side note: Goodwill in accordance with Swiss GAAP FER / Revision of Swiss GAAP FER 30

In contrast to IFRS and US GAAP, Swiss GAAP FER offers buyers an important accounting policy choice in an acquisition: They can either capitalize the goodwill in the balance sheet and amortize it on a systematic basis over a limited useful life – usually five years, but up to a maximum of 20 years in justified cases – or offset it directly against Swiss GAAP FER equity at the time of acquisition. In the latter case, shadow accounting with theoretical capitalization and amortization as well as impairment must be disclosed in the consolidated financial statements. In addition, preparers of Swiss GAAP FER must, in the event of a sale of parts of a company, include the goodwill historically offset against equity at its original cost value when determining the result of the sale recognized in the income statement.

A project is currently underway at the standard-setting body to revise FER 30 Consolidated financial statements. The aim of this project is to determine the need to review the rules on the treatment of goodwill according to Swiss GAAP FER, among other things. However, at this stage, no reliable information on the project status is available[5]. In our opinion, however, it is unlikely that Swiss GAAP FER will switch to an impairment-only approach in the future, too – like international accounting standards.

[5] Source: https://www.fer.ch/projekte/swiss-gaap-fer-30-konzernrechnung/

The current situation is therefore as presented in illustration 2.

Topic	Swiss GAAP FER	IFRS and US GAAP
Initial recognition	Accounting policy choice: • Capitalization in the balance sheet; or • Offsetting against equity	Capitalization in the balance sheet
Amortization on a systematic basis	Usually over five years, but up to a maximum of 20 years with justification	No
Impairment loss	Yes – in addition to amortization on a systematic basis. Test via cash-generating unit	Yes – impairment only. Test via cash-generating unit

Illustration 2: Goodwill treatment per accounting standard

Martin Stevka
Director, Co-Head Accounting Advisory Services
KPMG Switzerland

+41 58 249 41 14
mstevka@kpmg.com

This article is part of KPMG's Board Leadership News. To receive this newsletter three times per year, please register here.

About the KPMG Board Leadership Center

The KPMG Board Leadership Center offers support and guidance to board members. We equip you with the tools and insights you need to be highly effective in your role, enabling you to focus on the issues that really matter to you and your business. In addition, we help you to connect with peers and exchange experiences.

Learn more at kpmg.ch/blc