



Research Paper

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Goodwill: Improvements to Subsequent Accounting and an Update of the Quantitative Study

Staff of Accounting Standards Board of Japan
Staff of Hong Kong Institute of Certified Public Accountants

The observations and views presented in this Research Paper are those of ASBJ Staff and HKICPA Staff and do not necessarily reflect views of the ASBJ or the HKICPA.

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EXECUTIVE SUMMARY

Quantitative study

1. The updated quantitative study in this Research Paper shows a steady increase in the amount of acquired goodwill presented in the financial statements. Considering this increasing trend, it is unlikely that the impairment-only model for acquired goodwill is working as intended. This has led to a “too little, too late” issue, which has been noted as a concern among some stakeholders.

Scope of the Research Paper and the measurement basis for acquired goodwill

Scope of the Research Paper

2. The scope of this Research Paper is the subsequent measurement of acquired goodwill. Both the ASBJ Staff and the HKICPA Staff consider that acquired goodwill is a distinct unit of account independent from internally generated goodwill.

Measurement basis for acquired goodwill

3. Acquired goodwill is an asset that should be measured at historical cost. The historical cost should be updated to depict its consumption over time. Acquired goodwill should also be subject to the impairment test. When conducting the impairment test, future cash flows would be discounted to determine the recoverable amount of the cash generating unit (CGU).

Arguments for reintroducing amortisation in addition to impairment

4. Both the ASBJ Staff and the HKICPA Staff think that acquired goodwill should be amortised over time on a systematic basis, and the CGU(s) to which acquired goodwill is attributed should be tested for impairment when there is an indication of impairment.

ASBJ Staff view

5. The ASBJ Staff think acquired goodwill is a “wasting asset” (that is, an asset that diminishes in value over time) and, to faithfully represent this nature, financial statements need to reflect the reduction in value.
6. As a result of this wasting nature and due to other factors, the ASBJ staff propose

that acquired goodwill be amortised in addition to being tested for impairment. Impairment serves to signal the lack of recoverability of the carrying amount of acquired goodwill and amortisation signals the consumption of acquired goodwill. Both are necessary.

HKICPA Staff view

7. The HKICPA Staff consider that goodwill may be described as the difference between the fair value of an entity and its identifiable net assets recognised under prevailing accounting standards (book value), and we term this “economic goodwill”. The value of economic goodwill constantly changes over time. We think that acquired goodwill is a static snapshot of economic goodwill as of an acquisition date.
8. Over time, the amount recognised as acquired goodwill becomes increasingly less reflective of the current fair value or current book value of the entity, and therefore more meaningless as a balance sheet item.
9. The HKICPA Staff think that amortisation (with indicator-based impairment) better reflects the nature of acquired goodwill than an impairment-only regime as:
 - (a) It better reflects the fact that acquired goodwill becomes increasingly less representative of the acquiree and the consolidated entity.
 - (b) It provides a better opportunity to show how an acquisition is utilised.
 - (c) It improves comparability between entities that grow organically and through acquisitions.
10. The HKICPA Staff also think amortisation ensures that increasingly large goodwill balances supported by the impairment-only model, which can contribute negatively to management incentives and misrepresent risks, will be allocated to expense on a timely basis.

Amortisation period and method

11. Both the ASBJ Staff and the HKICPA Staff think that acquired goodwill should be amortised using a single amortisation period for the entire acquired goodwill amount recognised for each business combination, rather than disaggregating acquired goodwill into components and using different amortisation periods for each

component.

ASBJ Staff view

12. The ASBJ Staff think that the amortisation period should be based on the period that management expects to generate incremental cash inflows arising from the acquisition. In addition, the ASBJ Staff think that a maximum number of years should be established by the standard-setter for the amortisation period to strike a balance between the provision of relevant information and the need to respond to the concerns over the “too little, too late” issue.

HKICPA Staff view

13. The HKICPA Staff think that:
 - (a) The amortisation period of acquired goodwill should be determined in terms of the expected utilisation of an acquisition. Entities should apply judgement to determine what amortisation period and pattern is expected to best reflect the expected utilisation of an acquisition.
 - (b) The process of determining an amortisation period based on the principle of reflecting expected utilisation of an acquisition will benefit both (a) management, as it will be required to think critically about its post-acquisition plans before acquisition date, and (b) users, as they will gain insight into management’s expected timeline for an acquisition.

INTRODUCTION

Objective of this Research Paper

- IN1 The subsequent accounting for goodwill has been a subject of debate for many years. As of the issuance of this Research Paper ('RP'), the International Accounting Standards Board ('IASB') has an ongoing research project on goodwill and impairment. The United States Financial Accounting Standards Board ('FASB') has also been undertaking a project on identifiable intangible assets and subsequent accounting for goodwill.
- IN2 The objective of this RP is to contribute relevant and timely analyses and arguments to the global research project, and to present the views of the staff of the Accounting Standards Board of Japan ('ASBJ Staff') and the staff of the Hong Kong Institute of Certified Public Accountants ('HKICPA Staff').
- IN3 This RP aims to accomplish the following:
- (a) Share new findings from an updated quantitative study based on work previously conducted in 2016 by the European Financial Reporting Advisory Group ('EFRAG') secretariat and the ASBJ Staff.
 - (b) Analyse the existing requirements for goodwill under IFRS.
 - (c) Explore alternative views on the subsequent accounting for goodwill.
- IN4 This RP is a collaboration between the ASBJ Staff and the HKICPA Staff (collectively, 'the Staffs').

Existing requirements and two concepts of goodwill

- IN5 IFRS 3 *Business Combinations* defines goodwill as "*An asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognised.*"
- IN6 Applying IFRS 3, goodwill is initially recognised at the acquisition date as a residual – the excess of the consideration transferred over the identifiable net assets acquired (ignoring non-controlling interest and step-acquisitions for simplicity). Thereafter, goodwill is measured at historical cost and written down under the requirements of IAS 36 *Impairment of Assets* in the event of

impairment. This subsequent measurement approach may be referred to as the ‘impairment-only’ approach.

- IN7 What is defined as goodwill under IFRS 3 can be described as *acquired goodwill* (‘AGW’), and we shall label it as such in this RP.
- IN8 There is additionally a concept of *internally generated goodwill* (‘IGGW’), which is clearly distinguished from AGW in this RP. This concept will be discussed in Part 3.

History of the project on goodwill

- IN9 The IASB issued IFRS 3 in 2004, superseding IAS 22 *Business Combinations*. This eliminated the pooling of interests method and mandated that all business combinations within the scope be accounted for using the acquisition method. IFRS 3 followed the issuance of FASB Statement No.141, *Business Combinations*, in 2001, and resulted in the convergence of U.S. GAAP and IFRS. This meant that any entity paying consideration for an acquisition in excess of the fair value of the acquiree’s identifiable net assets would be required to recognise the residual difference as goodwill (which would be subsequently subject to impairment).
- IN10 The IASB completed its Post-implementation Review (‘PIR’) of IFRS 3 in June 2015. Following the PIR, the IASB has undertaken a research project on goodwill and impairment, with the aim of investigating how companies can provide users with better information about business combinations at a reasonable cost. In addition, the FASB published an Invitation to Comment *Identifiable Intangible Assets and Subsequent Accounting for Goodwill* on July 9, 2019, as part of its project on subsequent accounting for goodwill.
- IN11 One of the findings of the PIR is that stakeholders have mixed views on the subsequent accounting for goodwill. In particular, while some stakeholders support the existing requirements (impairment-only), others support the amortisation of goodwill. Additionally, some stakeholders have expressed the view that goodwill impairment is not always recognised in a timely fashion (this is known as the “too little, too late” issue), and some investors have stated that disclosures required by IFRS do not provide enough information to enable them

to understand whether an acquired business is performing as expected. Some companies have also stated that the impairment test required for goodwill under IAS 36 is costly and complex.

Structure of this Research Paper

IN12 Recognising the issues in the previous paragraph, the RP discusses the subsequent accounting for goodwill. The structure of this paper is as follows:

(a) Quantitative study

This part shows recent results of quantitative studies on goodwill and explains that timely discussion about the subsequent accounting for acquired goodwill is still needed.

(b) Scope of the RP and measurement basis for acquired goodwill

This part explains the scope of the RP and the measurement basis for acquired goodwill to provide context for later discussions.

(c) Arguments for reintroducing amortisation in addition to impairment

This part discusses the subsequent accounting for acquired goodwill, especially whether amortisation should be reintroduced.

(d) Amortisation period and method

This part discusses the amortisation period and the amortisation pattern.

PART 1: QUANTITATIVE STUDY

Background information and summary of the study

- 1.1 The objective of the quantitative study is to provide quantitative data and illustrate the trends in the amounts of goodwill and impairment in major jurisdictions. The aim is to facilitate the technical and conceptual discussions related to the subsequent accounting for goodwill by accounting standard setters around the world.
- 1.2 In 2016, the ASBJ Staff conducted a quantitative study on goodwill and impairment together with the EFRAG secretariat, and as a result, issued Research Paper No. 2 *Quantitative Study on Goodwill and Impairment* in October 2016 ('Research Paper No. 2')¹. This quantitative study was conducted based on data from 2005 to 2014. Observing the results, the ASBJ expressed its view that Research Paper No. 2 implied that there was an increasing risk that impairment of goodwill would have a significant impact on the financial position of an entity when it was recognised.
- 1.3 The Staffs conducted updated quantitative studies on goodwill for the data from 2014 to 2018 to show the recent trend in goodwill balances. The methodology of this updated study is described in detail in Appendix A. The update of the study includes the following figures or ratios for stock market indices of the United States (the S&P 500 index), Europe (the S&P Europe 350 index), Hong Kong (the Hang Seng Composite index) and Japan (the Nikkei 225 index – companies that apply IFRS)²:
 - (a) Total amount of goodwill
 - (b) Amount of goodwill per company

¹ Please refer to the following website:

<https://www.asb.or.jp/en/discussions/papers/2016-1003.html>

² As mentioned in Appendix A, for the stock market index of Japan, the following companies that apply IFRS were included in the population considering that there were companies that have transitioned from either Japanese GAAP or U.S. GAAP to IFRS between 2014 and 2018:

- (a) Regarding (a)-(e), companies that applied IFRS in 2018 were included in the population. For the financial figures for the periods in which the companies applied Japanese GAAP, no adjustments were made regarding the effects of amortisation charges.
- (b) Regarding (f) and (g), companies that applied IFRS throughout 2014-2018 were included in the population.

- (c) Ratio of goodwill to net assets
- (d) Ratio of goodwill to market capitalisation
- (e) Number of companies that present high goodwill ratios
- (f) Amount of goodwill expensed
- (g) Intensity of goodwill expensed

1.4 The study found that the amount of goodwill generally increased steadily over the period of 2014 to 2018. Specifically:

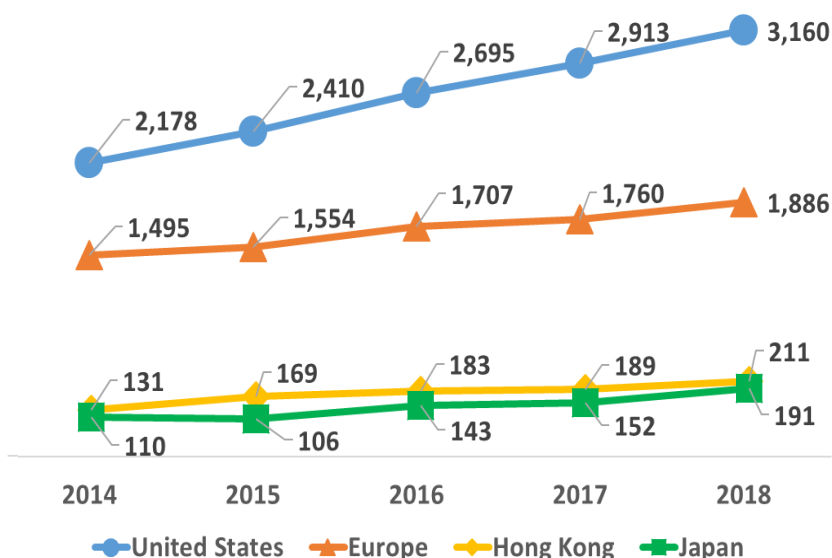
- (a) From 2014 to 2018, total goodwill and total goodwill per company tended to increase steadily in all stock market indices.
- (b) A number of companies that constituted the stock market indices of the United States and Europe recognised goodwill that exceeded 100% of their net assets. For example in 2018, regarding the United States, 18.8% of companies that constituted the stock market index had goodwill that exceeded 100% of their net assets, while in Europe that number was 10.1% of companies. Some companies even recognised goodwill that exceeded 100% of their market capitalisation, though the number of those companies was relatively small.
- (c) The implied time to fully expense goodwill based on the impairment losses recognised from 2014 to 2018 resulted in 122 years for the stock market index of the United States, 78 years for the stock market index of Europe, 64 years for the stock market index of Hong Kong and 64 years for the stock market index of Japan.

Results of the updated study

Total amount of goodwill

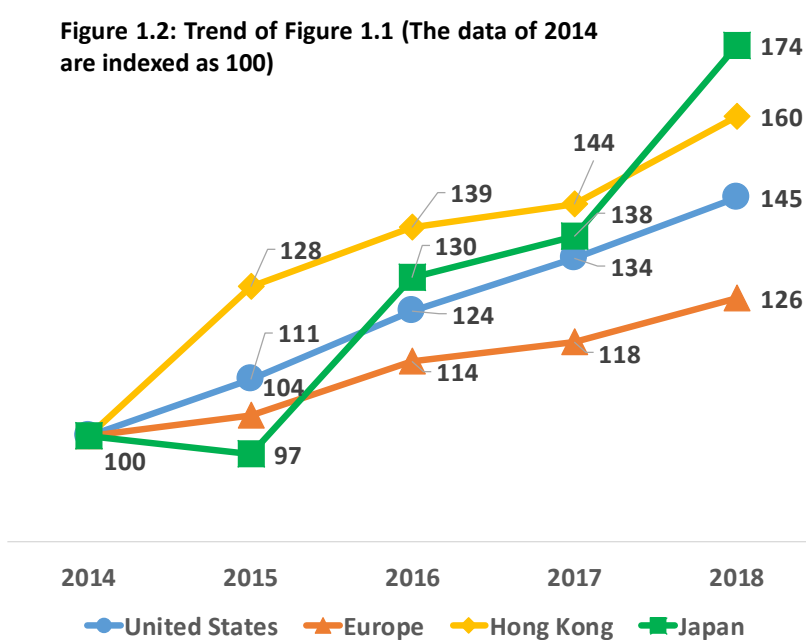
1.5 Figure 1.1 shows the trends in the total amount of goodwill from 2014 to 2018.

Figure 1.1: Trends in the amount of total goodwill (in USD billion)



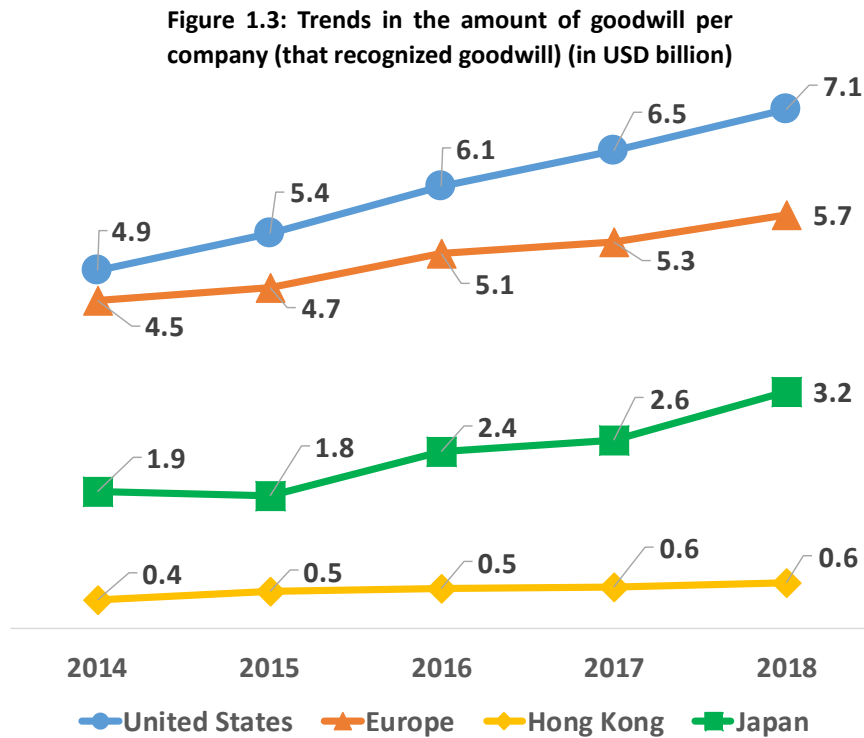
1.6 From 2014 to 2018, total goodwill tended to increase for all stock market indices. Comparing the amounts in 2014 and in 2018 (Figure 1.2), total goodwill increased by 45% for the stock market index of the United States, 26% for the stock market index of Europe, 60% for the stock market index of Hong Kong, and 74% for the stock market index of Japan.

Figure 1.2: Trend of Figure 1.1 (The data of 2014 are indexed as 100)



Amount of goodwill per company

- 1.7 Figure 1.3 shows the trends in the amount of goodwill per company that recognised goodwill from 2014 to 2018.



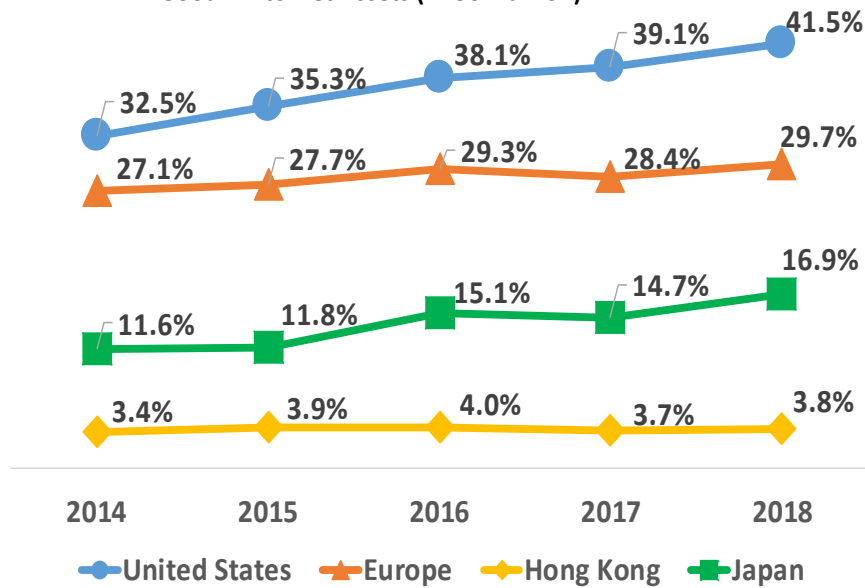
- 1.8 The amount of goodwill per company for the stock market indices of the United States and Europe was larger than that for the stock market indices of Japan and Hong Kong. From 2014 to 2018, the amount of goodwill per company for the stock market indices of the United States, Europe and Japan increased steadily year by year.

Ratio of goodwill to net assets³

- 1.9 Figure 1.4 shows the trends in the ratio of goodwill to net assets. The objective of Figure 1.4 is to illustrate the significance of goodwill compared to the book value of net assets.

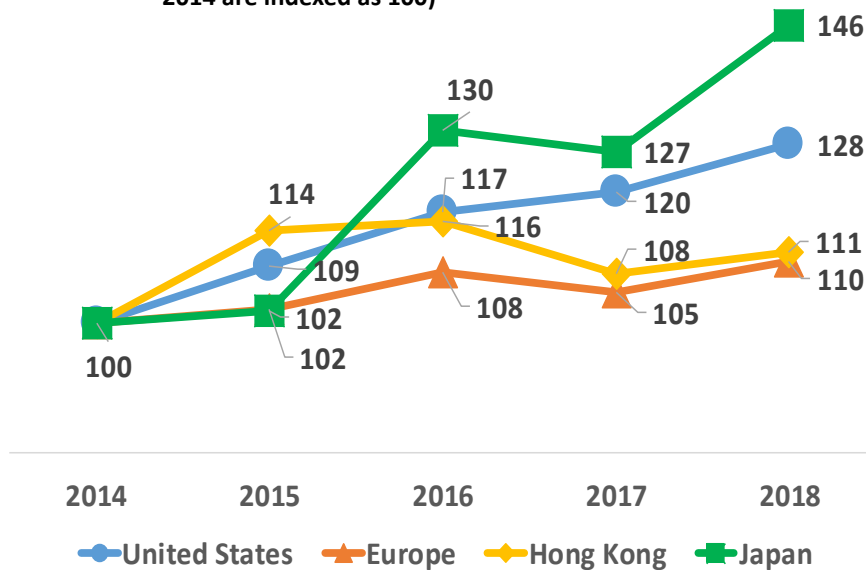
³ Net assets means the book value of equity.

Figure 1.4: Trends in the ratio of the amount of Goodwill to Net Assets (in USD billion)



1.10 The average ratio of goodwill to net assets from 2014 to 2018 was higher for the stock market indices of the United States and Europe. In addition, the ratio steadily increased for the stock market indices of the United States and Japan. Figure 1.5 shows this increasing trend more clearly.

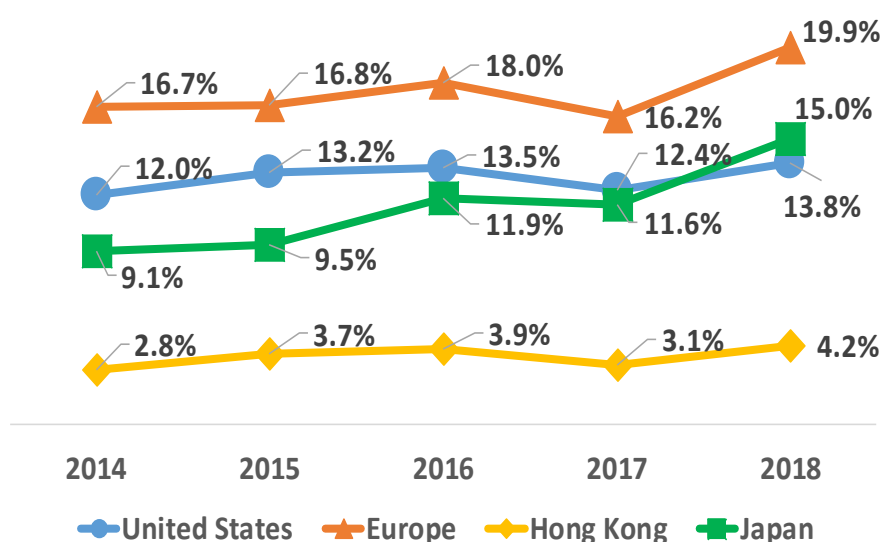
Figure 1.5: The trend of Figure 1.4 (The data of 2014 are indexed as 100)



Ratio of goodwill to market capitalisation⁴

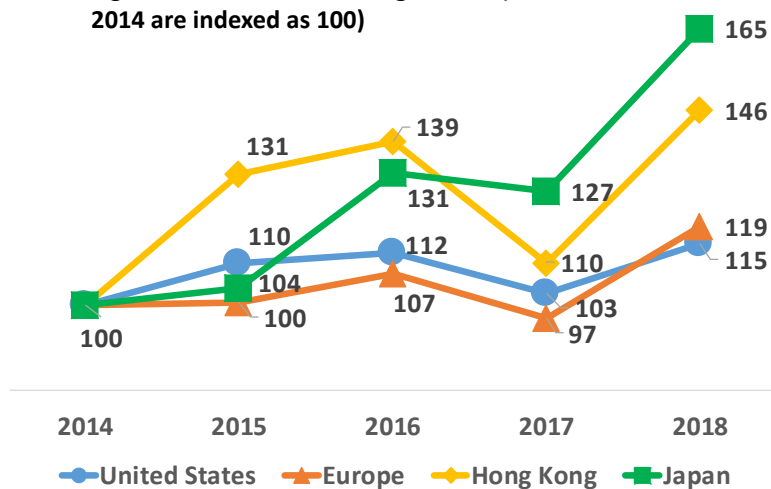
1.11 Similar to the trends in the ratio of goodwill to net assets, Figure 1.6 shows the trends in the ratio of goodwill to market capitalisation.

Figure 1.6: Trends in the ratio of the amount of Goodwill to the Market Capitalisation



1.12 The average ratios of goodwill to market capitalisation in the stock market indices of the United States and Europe were relatively high but were lower than the ratio of goodwill to net assets in Figure 1.4. Figure 1.7 shows this trend by rescaling the figures of all market indices as 100 in 2014.

Figure 1.7: The trend of Figure 1.6 (The data of 2014 are indexed as 100)



⁴ Market capitalisation means market value of equity.

Number of companies that present high goodwill ratios

1.13 The following data shows the number of companies whose goodwill ratios (the ratio of goodwill to net assets and the ratio of goodwill to market capitalisation) are high. This shows the extent to which the amount of goodwill was concentrated in certain number of companies that constitute stock market indices. Tables 1.8 and 1.9 show the number of companies that recognised goodwill that exceeded 50% and 100% of their net assets and their market capitalisation, respectively, from 2014 to 2018.

Table 1.8: Trends in the number of companies that exceed certain ratios of the amount of Goodwill to Net Assets

Stock Market Index	The number of companies analysed	2014		2015		2016		2017		2018	
		share		share		share		share		share	
US 50%+	489	169	34.6%	181	37.0%	192	39.3%	201	41.1%	201	41.1%
		(71)	(14.5%)	(73)	(14.9%)	(83)	(17.0%)	(82)	(16.8%)	(92)	(18.8%)
EUR 50%+	346	112	32.4%	119	34.4%	120	34.7%	119	34.4%	117	33.8%
		(39)	(11.3%)	(45)	(13.0%)	(41)	(11.8%)	(35)	(10.1%)	(35)	(10.1%)
HK 50%+	464	13	2.8%	11	2.4%	18	3.9%	18	3.9%	18	3.9%
		(7)	(1.5%)	(8)	(1.7%)	(8)	(1.7%)	(6)	(1.3%)	(8)	(1.7%)
JPN 50%+	62	4	6.5%	4	6.5%	6	9.7%	7	11.3%	5	8.1%
		(0)	(0.0%)	(1)	(1.6%)	(0)	(0.0%)	(0)	(0.0%)	(0)	(0.0%)

*Share: Ratio of the number of applicable companies to the number of companies analysed.

Table 1.9: Trends in the number of companies that exceed certain ratios of the amount of Goodwill to Market Capitalisation

Stock Market Index	The number of companies analysed	2014		2015		2016		2017		2018	
		share		share		share		share		share	
US 50%+	489	10	2.0%	19	3.9%	16	3.3%	24	4.9%	39	8.0%
		(0)	(0.0%)	(2)	(0.4%)	(1)	(0.2%)	(2)	(0.4%)	(4)	(0.8%)
EUR 50%+	346	24	6.9%	23	6.6%	21	6.1%	19	5.5%	38	11.0%
		(3)	(0.9%)	(3)	(0.9%)	(5)	(1.4%)	(3)	(0.9%)	(9)	(2.6%)
HK 50%+	464	6	1.3%	11	2.4%	12	2.6%	12	2.6%	15	3.2%
		(2)	(0.4%)	(1)	(0.2%)	(4)	(0.9%)	(3)	(0.6%)	(6)	(1.3%)
JPN 50%+	62	1	1.6%	1	1.6%	1	1.6%	2	3.2%	4	6.5%
		(1)	(1.6%)	(1)	(1.6%)	(1)	(1.6%)	(1)	(1.6%)	(1)	(1.6%)

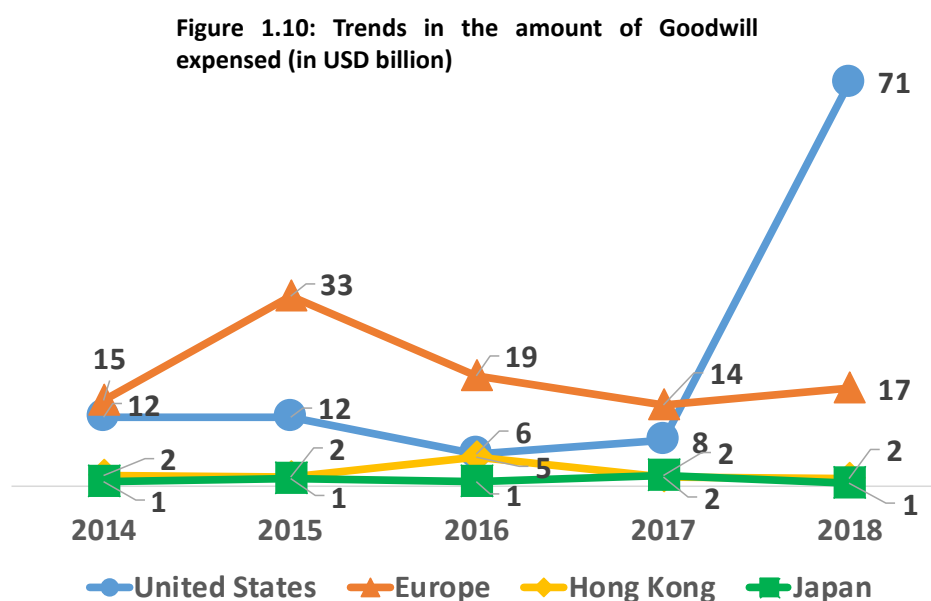
*Share: Ratio of the number of applicable companies to the number of companies analysed.

1.14 18.8% of companies constituting the stock market index of the United States, and

10.1% of companies constituting the stock market index of Europe, recognised goodwill that exceeded 100% of their net assets in 2018. Some companies even recognised goodwill that exceeded 100% of their market capitalisation.

Amount of Goodwill Expensed

1.15 Figure 1.10 shows the trends in the amount of goodwill expensed (that is, impairment losses) from 2014 to 2018.



1.16 The impairment was relatively higher for the stock market indices of the United States and Europe, and was largest in 2018 for the stock market index of the United States.

Intensity of Goodwill Expensed

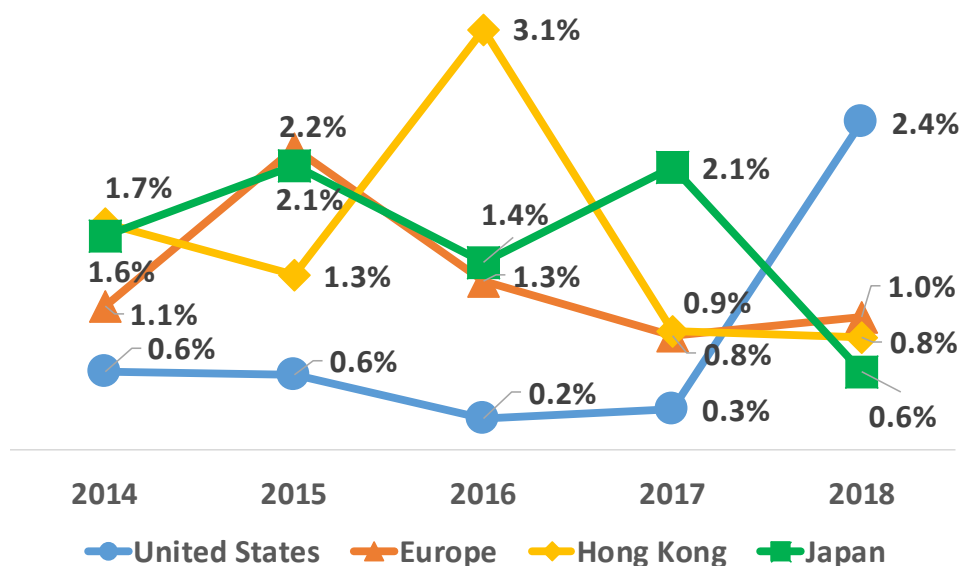
1.17 The intensity of goodwill expensed shows the extent of reductions of the goodwill balance during the year. Figure 1.11 shows the trends in the ratio of the amount of goodwill expensed in the year to the amount of goodwill as of the previous year-end⁵. For this analysis, the reductions do not include expenses or losses

⁵ The intensity of goodwill expensed is calculated as follows:

$$\text{The intensity of goodwill expensed} = \frac{\text{the amount of goodwill expensed in the year}}{\text{the balance of goodwill as of the previous year-end}}$$

recognised from the disposal of businesses.

Figure 1.11: Trends in the intensity of Goodwill expensed (in USD billion)



- 1.18 The inverse of this ratio implies the time to fully expense goodwill. The inverse of the average of the ratios from 2014 to 2018 resulted in 122 years for the stock market index of the United States, 78 years for the stock market index of Europe, 64 years for the stock market index of Hong Kong and 64 years for the stock market index of Japan.

Does the “too little, too late” issue exist?

- 1.19 As summarised in paragraph 1.4, the amount of acquired goodwill in the statement of financial position tended to increase steadily over time. In addition, as mentioned in the previous paragraph, the implied average time to fully expense acquired goodwill for each stock market index largely exceeds 40 years. We note that 40 years was the maximum amortisation period of acquired goodwill prescribed in APB Opinion No.17 *Intangible Assets*, which was applied before U.S. GAAP were revised in 2001. We also note that 20 years was the maximum amortisation period prescribed in IAS 22, which was applied before IFRS was revised in 2004.
- 1.20 We observe that, together with the increasing trend of the amount of acquired

goodwill and the time to fully expense acquired goodwill, it is likely that the “too little, too late” issue exists with respect to the expensing of acquired goodwill under the existing impairment-only model. If this is the case, it may be questionable whether the existing impairment test is sufficiently “rigorous and operational” to justify the non-amortisation of acquired goodwill⁶ and provide relevant information to users of financial statements.

- 1.21 On the other hand, some have questioned our observation claiming that the increasing trend in the amount of acquired goodwill does not justify the existence of the “too little, too late” issue. For example, the growth in the economy and the increase in M&A activity in recent years may have contributed to the increase in the amount of acquired goodwill.
- 1.22 However, we do not think that such a claim undermines our observation in paragraph 1.20. This is because it would be difficult to define and obtain data that represents the relationship between the growth in the economy or the frequency of acquisitions and the amount of acquired goodwill. Under this data constraint, we conducted some rough data analyses but could not obtain any clear implications from the analyses⁷. Accordingly, in the following parts, we will discuss the subsequent accounting for acquired goodwill assuming that it is likely that the “too little, too late” issue exists.

⁶ Please refer to paragraph 2.7.

⁷ We conducted simplified quantitative data analyses by the following comparison, but we could not confirm clear relationships.

- (a) A comparison between the amount of acquired goodwill and the stock price indices.
- (b) A comparison between the amount of acquired goodwill and GDPs.
- (c) A comparison between the amount of acquired goodwill and the number of M&A cases.

The amount of acquired goodwill used in these analyses is based on the data of the companies that have been in the scope of analyses this time, and differs from the scope of the companies on which comparative data such as GDP is based. These analyses were conducted under such data constraints, and the implications of the results are extremely limited. More sophisticated analyses may produce different results.

PART 2: SCOPE AND MEASUREMENT BASIS FOR ACQUIRED GOODWILL

Scope of this Research Paper

2.1 As mentioned in the Introduction, we refer to what is recognised as goodwill under IFRS 3 as *acquired goodwill* (AGW). This RP considers the subsequent accounting for acquired goodwill.

2.2 IFRS introduces another concept of goodwill, which is *internally generated goodwill* (IGGW). Paragraph 49 of IAS 38 *Intangible Assets* provides following explanation:

In some cases, expenditure is incurred to generate future economic benefits, but it does not result in the creation of an intangible asset that meets the recognition criteria in this Standard. Such expenditure is often described as contributing to internally generated goodwill. Internally generated goodwill is not recognised as an asset because it is not an identifiable resource (ie it is not separable nor does it arise from contractual or other legal rights) controlled by the entity that can be measured reliably at cost.

2.3 When considering the accounting for AGW, it is relevant to assess the unit of account. We think that AGW is a distinct unit of account that is independent from IGGW. This can be demonstrated by the fact that, under the existing requirements:

(a) Only AGW is recognised as an asset. IGGW is not recognised, and under IFRS is dealt with separately in accordance with IAS 38. AGW can be recognised given the existence of an exchange transaction to refer to for measurement, and it is a unique accounting construct.

(b) AGW is a static concept measured at historical cost as mentioned later in this part. It is not updated to track the changes attributable to IGGW⁸. The carrying amount of AGW is only updated when a cost allocation method is

⁸ Some may note that the carrying amount of AGW can be supported by IGGW when performing the impairment test (the “impairment shield” problem, discussed below); however, this is due to the inability to separate AGW and IGGW after a business combination and reflects a “best solution” for the impairment model, which we do not think should be interpreted as affecting AGW’s unit of account.

applied (for example, impairment).

- (c) The Staffs think that, under the concept of historical cost accounting, the impact of consideration transferred at the acquisition date (that gives rise to AGW) should be distinguished from the impact of expenditures subsequent to the business combination (that give rise to IGGW).

Measurement basis for AGW - existing requirements

- 2.4 AGW is measured at historical cost under the existing requirements. When a Cash Generating Unit ('CGU') to which AGW is attributed is subsequently tested for impairment, any impairment losses would first reduce the carrying amount of AGW followed by the carrying amount of the other assets within the CGU.

- 2.5 Paragraph BC131B of IAS 36 explains that, when introducing non-amortisation of AGW, the IASB considered (a) straight-line amortisation with an impairment test when there is an indication of impairment, and (b) non-amortisation with an impairment test at least annually.

- 2.6 In its considerations, the IASB noted the following (paragraph BC131E of IAS 36):

...the Board agreed that achieving an acceptable level of reliability in the form of representational faithfulness while striking some balance with what is practicable was the primary challenge it faced in deliberating the subsequent accounting for goodwill. The Board observed that the useful life of acquired goodwill and the pattern in which it diminishes generally are not possible to predict, yet its amortisation depends on such predictions. As a result, the amount amortised in any given period can be described as at best an arbitrary estimate of the consumption of acquired goodwill during that period. The Board acknowledged that if goodwill is an asset, in some sense it must be true that goodwill acquired in a business combination is being consumed and replaced by internally generated goodwill, provided that an entity is able to maintain the overall value of goodwill (by, for example, expending resources on advertising and customer service). ...

- 2.7 Ultimately, the IASB concluded on an approach of non-amortisation on the basis that more useful information would be provided if a rigorous and operational

impairment test could be devised (paragraph BC131G of IAS 36).

Measurement basis for AGW - historical cost or current value?

- 2.8 The IASB's *Conceptual Framework for Financial Reporting* revised in March 2018 ('Conceptual Framework') identifies historical cost and current value as the two categories of measurement bases in IFRS. The Staffs consider historical cost, the measurement basis currently required, to be the more relevant measurement basis for AGW. This is because the entity's business activities usually do not involve selling AGW (indeed AGW itself can't be transferred), which is calculated as a residual from the costs incurred to achieve a business combination, and the entity retains it for use (paragraph 6.53 of the *Conceptual Framework*), and because AGW is used in combination with other economic resources to produce indirect cash flows for the entity (paragraphs 6.54-6.56 of the *Conceptual Framework*).
- 2.9 Historical cost measurement does not reflect changes in values (paragraph 6.4 of the *Conceptual Framework*), but is updated over time to depict, for example, the consumption of part or all of the economic resource that constitutes the asset, or the effect of events that cause part or all of the historical cost of the asset to be no longer recoverable (paragraph 6.7 of the *Conceptual Framework*). As considered in the development of IFRS 3 (please refer to paragraphs 2.5 and 2.6), amortisation is one way to depict such consumption of the asset.

PART 3: ARGUMENTS FOR REINTRODUCING AMORTISATION IN ADDITION TO IMPAIRMENT

- 3.1 The Staffs support reintroducing amortisation in addition to impairment as a superior method for the subsequent measurement of acquired goodwill.

The Staffs propose an amortisation plus indicator-based impairment regime for AGW, under which AGW would be allocated to profit or loss on a systematic basis over its amortisation period. Amortisation reflects the utilisation of AGW. While amortisation would be a mandatory and prominent aspect of this regime, the Staffs also support retaining indicator-based impairment to reflect situations where there has been a substantive decline in the recoverable amount of the CGU(s) to which the AGW is assigned within the amortisation period.

- 3.2 In the following paragraphs of Part 3 the Staffs explain this common view from bilateral perspectives, reflecting the Staffs' respective ways of looking at the nature of acquired goodwill.

PART 3A: ASBJ Staff view

What is the issue?

- 3.3 The ASBJ Staff think that there are diverse views on the subsequent accounting for AGW because there are diverse views on various issues related to AGW, including the disagreement on whether the "too little, too late" issue exists (considered in Part 1) and the disagreement on how to determine the amortisation period (considered in Part 4A). Part 3A discusses the following three issues mainly related to the nature of AGW:

- (a) Stakeholders have different assumptions on the scope of "goodwill".

Some stakeholders do not clearly distinguish goodwill arising from business combinations (AGW) from goodwill arising from expenditures made after the business combinations (IGGW).

- (b) Stakeholders have different views on the nature of AGW.

Stakeholders have different views on whether AGW is of a wasting nature.

- (c) Stakeholders have different views on how to reflect that nature in the

subsequent accounting for AGW.

Among those who think that AGW is of a wasting nature, stakeholders have different views on whether amortisation should be applied.

The scope of “goodwill”

- 3.4 When considering whether goodwill is of a wasting nature, an important starting point is the scope of “goodwill”. A lack of consensus on this point is likely to lead to differing views on the accounting for goodwill⁹.
- 3.5 Some stakeholders do not clearly distinguish AGW from IGGW. These stakeholders typically are interested in assessing the value of an entity, and consider goodwill to be one of its major contributors. They are more interested in how goodwill contributes to the current value of an entity, and are less interested in whether goodwill has arisen from a business combination.
- 3.6 In contrast, the ASBJ Staff consider that only AGW should be within the scope of the discussion, because it would result in providing relevant information about performance subsequent to the business combination. In this regard, the ASBJ Staff note that general purpose financial reports are not designed to show the value of an entity, but rather to provide useful information that is helpful for users of financial statements to estimate the value of an entity¹⁰. The ASBJ Staff think that this concept is not necessarily shared by such stakeholders in terms of what kind of financial information should be provided. The success or failure of a business combination should be assessed by the profit earned after deducting its cost over the periods subsequent to the business combination. The ASBJ Staff think that information about such profit is relevant to users of financial statements. For this reason, the ASBJ Staff think that it is important to clearly distinguish AGW from IGGW.

⁹ This repeats the discussion in paragraph 2.3, but this is important for discussing the next issue of a wasting nature of goodwill.

¹⁰ Please refer to paragraph 1.7 of *the Conceptual Framework*.

The nature of AGW - Is AGW a wasting asset?

3.7 The excess of the consideration of the acquisition over the fair value of the identifiable net assets is allocated to AGW. AGW arises from an exchange of values that actually occurred, but by definition it has no physical substance, nor can it be separated from the entity. For these reasons, its condition cannot be directly observed, and stakeholders have different views and expectations on what would be its benefit and how long such benefit would last.

The six components

3.8 When developing IFRS 3, the IASB considered six components that could potentially form part of AGW (see Table 3.1)¹¹. The IASB concluded that Components 1, 2 and 5 should not be subsumed into the amount initially recognised as AGW.

Table 3.1: The six potential components of AGW (quoted from related descriptions from paragraphs BC313 and BC316 of IFRS 3)

Component 1	The excess of the fair values over the book values of the acquiree's net assets at the date of acquisition.
Component 2	The fair values of other net assets that the acquiree had not previously recognised.
Component 3	<p>The fair value of the <i>going concern</i> element of the acquiree's existing business. The going concern element represents the ability of the established business to earn a higher rate of return on an assembled collection of net assets than would be expected if those net assets had to be acquired separately. That value stems from the synergies of the net assets of the business, as well as from other benefits (such as factors related to market imperfections, including the ability to earn monopoly profits and barriers to market entry – either legal or because of transactions costs – by potential competitors).</p> <p>The third component relates to the acquiree and reflects the excess assembled value of the acquiree's net assets. It represents the pre-</p>

¹¹ These six components were originally discussed in FASB's Proposed Statement of Financial Accounting Standards: *Business Combinations and Intangible Assets*, issued September 7, 1999.

	existing goodwill that was either internally generated by the acquiree or acquired by it in prior business combinations.
Component 4	<p>The fair value of the expected synergies and other benefits from combining the acquirer's and acquiree's net assets and businesses. Those synergies and other benefits are unique to each business combination, and different combinations would produce different synergies and, hence, different values.</p> <p>The fourth component relates to the acquiree and the acquirer jointly and reflects the excess assembled value that is created by the combination – the synergies that are expected from combining those businesses.</p>
Component 5	Overvaluation of the consideration paid by the acquirer stemming from errors in valuing the consideration tendered.
Component 6	Overpayment or underpayment by the acquirer.

3.9 Under IFRS 3, Components 3, 4 and 6 are recognised as AGW, and Components 3 and 4 collectively are referred to as “core goodwill”. Consistent with IFRS 3, this RP focuses on Components 3 and 4 and discusses these Components in the following paragraphs¹². The ASBJ Staff would not discuss Component 6 because it would not be an asset from a conceptual standpoint but nonetheless would be considered to be of a wasting nature.¹³

3.10 Examples of the Components 3 and 4 include the following:

Component 3 (Going concern element)	Reputation, know-how, human resources
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¹² The identification of these components is for discussion purposes and the ASBJ Staff understand that it is not practically easy to separate these components. As noted later in paragraph 4.6, the FASB explains in its exposure draft issued in 1999 that it abandoned the discernible-element approach, which would determine the amortisation period of AGW based on the multiple discernible elements of AGW, because the FASB found decomposing AGW into elements highly subjective.

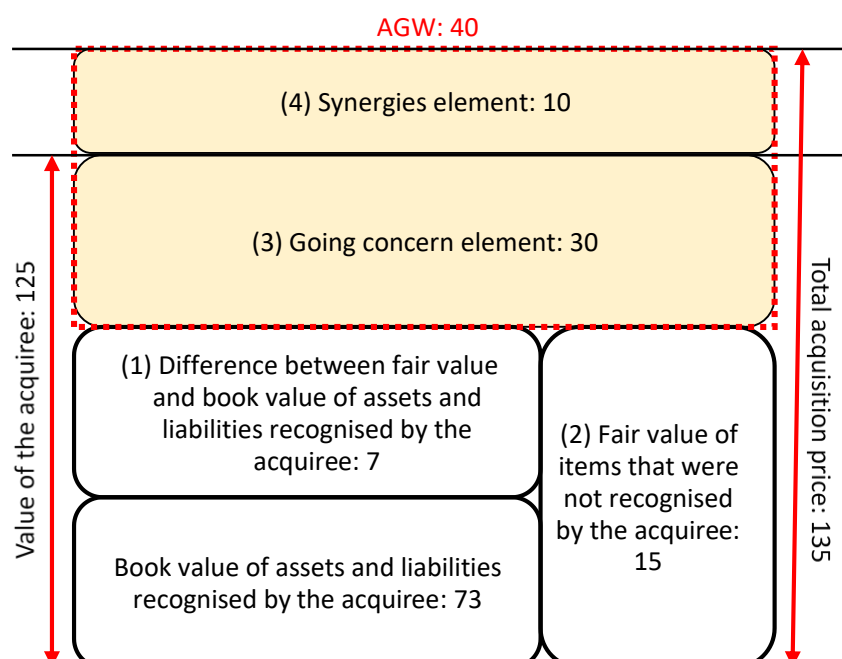
¹³ The IASB acknowledged that the sixth component is not an asset but conceptually is a loss (in the case of overpayment) or a gain (in the case of underpayment) to the acquirer. Nevertheless, the IASB concluded that in practice it is not possible to identify and reliably measure an overpayment at the acquisition date. Accordingly, the IASB decided to recognise the sixth component as part of acquired goodwill and to address the accounting for overpayments through subsequent impairment testing.

Component 4 (Synergies element)	Eliminating redundant work, creating new revenue streams by combining know-how
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3.11 Figure 3.2 illustrates the relationship between the acquisition price and Components 1-4¹⁴. This example assumes the following:

- (a) The total acquisition price was 135.
- (b) The book value of identifiable assets and liabilities that were previously recognised by the acquiree was 73 and the fair value of such assets and liabilities was 80.
- (c) The fair value of identifiable assets and liabilities that were not previously recognised by the acquiree was 15.
- (d) The value of the acquiree as a whole was 125, implying that the going concern element was valued at 30.

Figure 3.2: Relationship between the acquisition price and Components 1-4



¹⁴ This example assumes that the acquisition price does not include Components 5 and 6.

Going concern element

- 3.12 The going concern element represents the ability to combine the identifiable items of the acquiree to generate a return that exceeds the return that would be generated by using those items individually. In other words, the going concern element is the value inherent in the acquiree, and stems from the synergies between identifiable items of the acquiree and from other benefits such as those related to the ability to earn monopoly profits and legal or other barriers to market entry by potential competitors as described in Table 3.1.
- 3.13 Some stakeholders claim that the going concern element may include the entity's reputation with customers, technology and know-how, and an assembled workforce. These stakeholders think that these factors are not of a wasting nature. In other words, the entity's reputation with customers generates cash flows to the entity continuously, technology and know-how that supports the business creates value continuously¹⁵, and the knowledge required to utilise the workforce is maintained in the entity continuously.
- 3.14 The ASBJ Staff take an opposing view, and think that the going concern element is of a wasting nature for the following reasons:
- (a) The ASBJ Staff think that it is difficult to differentiate the factors in paragraph 3.13 clearly, and difficult to quantify their value. This is because those factors interact with each other, and thus their value develops as a whole. If those factors could be separated, they should already have been identified separately as an identifiable asset. Thus, considering the going concern element as a whole, AGW represents something that the acquirer is willing to pay to earn a return higher than the market expectation. These excess returns will decrease over time assuming there is healthy competition.

¹⁵ Perspectives Paper issued by International Valuation Standards Council (IVSC), "Business Valuation – Is Goodwill a Wasting Asset?" (<https://www.ivsc.org/files/file/view/id/1599>) claims that the going concern goodwill comprises of reputation, future intangible value, and workforce, which are not wasting in nature. Regarding future intangible value, the in-place assets such as workforce, knowhow and foundational platform technology are leveraged for future ideation and technologies and continuously create new intangible value. However, such assets seem to evolve over time to respond to the changes in the surrounding environment, which will likely make obsolete the original assets acquired at the business combination. When assuming that what is acquired at the business combination is distinguished from what is generated afterwards as mentioned in paragraph 3.6, it is unclear how such assets can continue to create new value.

Certain advantages over other entities due to legal or other economic reasons may continue indefinitely, but such cases are rare.

- (b) Even if it were possible to consider those individual factors as claimed in paragraph 3.13, the effects of the entity's reputation with customers, and the effects of technology and know-how would decrease as the surrounding environment changes and the workforce is replaced. Therefore, improvements or adjustments would be needed to ensure that those factors continue to be effective. In this way, the going concern element of AGW would be replaced by updated reputation with customers or updated technology and know-how. The ASBJ Staff think that these updated factors form part of IGGW, which is distinct from the original AGW. Accordingly, the advantages provided by the factors that were originally recognised as part of AGW would not continue for long.

Synergies element

- 3.15 The synergies element represents synergies and other benefits expected from combining the net assets and businesses of both the acquirer and the acquiree. Those benefits include cost reduction through the use of economies of scale or generating incremental revenue such as by jointly producing better products or providing better services.
- 3.16 Some stakeholders think that factors such as higher margins due to cost reduction or higher revenue from enhancing the business of the acquirer or the acquiree (or both) are the manifestation of the synergies element. Similar to the going concern element, some argue that the synergies element is not of a wasting nature because, when estimating the value of an entity, such factors are assumed to exist indefinitely¹⁶ in the estimated future cash flows.
- 3.17 The ASBJ Staff take an opposing view, and think that, though the acquirer expects to achieve higher margins or higher revenue as the manifestation of the synergies element, the synergies element is of a wasting nature for two reasons. One is that, if the synergies element is expected to generate excess returns, similar

¹⁶ IVSC Perspectives Paper cited in footnote 15 claims that the synergies include higher margins through realising economies of scale (costs synergies) and higher revenue (revenue synergies). The paper states that synergies are implicitly assumed to exist indefinitely but it is not clear why such an assumption should be posed.

behaviors aiming to achieve such excess returns would be enhanced in the industry, and such excess returns would decrease over time assuming there is healthy competition. This is similar to the discussion on the going concern element. The other reason is that acquirers hold the view that many business combinations do not meet their expectations¹⁷ and that this may imply that there are many instances where the synergies element does not contribute to performance subsequent to the business combination as expected.

Goodwill as a whole

- 3.18 As described above, the ASBJ Staff think that both the going concern element and the synergies element are of a wasting nature, and that AGW is as a whole of a wasting nature.
- 3.19 Some stakeholders argue against this view from different perspectives without distinguishing the going concern element from the synergies element. These stakeholders typically claim that, even if those elements are diminishing in nature, the period or pattern in which those elements diminish is not generally known and that the elements may continue as long as the business is considered to be a going concern.

The ASBJ Staff do not agree with this view because the question of how to

¹⁷ There are following surveys available on the Internet and are mainly based on the responses from entities that experience business combinations.

Global PMI Partners, Success and Failure in M&A Execution – An Empirical Study,
<https://gpmip.com/success-and-failure-in-ma-execution-an-empirical-study/>

This study examines whether the value of the transaction is higher than the price actually paid for the target and concludes that the evolution of the market capitalisation of publicly listed companies following an acquisition generally points to a destruction of shareholder value.

From Buying Growth to Building Value, The Boston Consulting Group

http://image-src.bcg.com/Images/BCG-From-Buying-Growth-to-Building-Value-Oct-2015_tcm9-88324.pdf

The report states that companies can grow through acquisition, but that inexperienced acquirers typically destroy value for their shareholders.

The Survey on M&A by Deloitte Tohmatsu Consulting in 2013 (Japanese only)

<https://www2.deloitte.com/content/dam/Deloitte/jp/Documents/about-deloitte/news-releases/jp-nr-nr20131008-2.pdf>

36% of companies that responded to the survey met their standards of M&A success. Most of those standards determine their M&A success based on whether they have achieved more than 80% of their objectives.

Please also refer to footnote 36.

estimate the diminishing period or pattern and the question of whether AGW is of a wasting nature are two separate issues. In addition, considering that an entity is required to estimate the period and the pattern in which the benefits of property, plant and equipment (PPE) and intangible assets with a finite useful life are expected to be consumed, the ASBJ Staff expect that the same would apply to AGW. It may be true that more information is available in estimating the diminishing period and pattern for PPE or finite-lived intangible assets because those assets are exposed to physical wear and tear or may have legal limits on the use of assets. However, their useful lives are defined in terms of the assets' expected utility to the entity¹⁸ and technical or commercial obsolescence are considered. In this regard, AGW is essentially no different from PPE or intangible assets. Accordingly, there is little justification that AGW should be treated otherwise.

- 3.20 In relation to the wasting nature, academic studies have repeatedly shown that returns or rate of returns derived from accounting information, such as return on assets (ROA) or return on equity (ROE), tend to revert to their industry mean¹⁹. Some researchers in Japan have considered this tendency of mean reversion of ROA or ROE to be compatible with the argument that AGW is of a wasting nature. Palepu and Healy (2013)²⁰ noted the reason we can observe this tendency as follows:

... rate of return on investment (ROEs) tend, over several years, to move from abnormal to normal levels – close to the cost of equity capital – as the forces of competition come into play. Profit margins also tend to shift to normal levels, but for this statistic “normal” varies widely across firms and industries, depending on the level of asset turn over and leverage. ...

- 3.21 In addition, some academic studies have analysed to determine whether the entity's performance has improved subsequent to business combinations. Some of these studies reported results that do not support the argument by observing lower rates of return for several years subsequent to business

¹⁸ IAS 16 *Property, Plant and Equipment*, paragraph 57.

¹⁹ The ASBJ Staff reviewed academic papers mentioned in paragraphs C.1 to C.4 of Appendix C.

²⁰ Palepu, Krishna G. and Paul M. Healy (2013) *Business Analysis and Valuation Using Financial Statements*, PART 2, 6-16, 5th edition, South-Western Cengage Learning

combinations at a statistically significant level²¹. The ASBJ Staff acknowledge that those studies do not directly study the synergies element, but the ASBJ Staff observe that combining the business and net assets of the acquirer and the acquiree do not necessarily lead to improved performance. This seems to imply that it is unlikely that there is positive support for the view that the synergies element continue to exist.

- 3.22 The ASBJ Staff note that, even if AGW is of a wasting nature and its value diminishes over time, this does not necessarily mean that the estimated future cash flows to the entity would decline over time. This is because cash flows generated by the entity are reinvested. In other words, an entity has various resources that contribute to its prospects for future cash flows, many of which have finite useful lives. The reduction in resources due to their consumption usually results in the collection of other resources, which would be reinvested in the entity's business. This reinvestment cycle will continue as long as the entity lasts as a going concern.

Some stakeholders claim that, if goodwill is of a wasting nature, there would be a large portion of cash flows that are unexplained after the entity's finite-lived resources are consumed. However, the cash flows generated from the finite-lived resources originally acquired in a business combination will be reinvested into new finite-lived resources and additional cash flows will be generated from these new resources. Accordingly, future cash flows will continue to be generated, far beyond the useful lives of the finite-lived resources originally acquired in a business combination. This process allows the value of an entity to appear to be stable even if AGW is of a wasting nature.

Accounting for acquired goodwill as a wasting asset

Whether acquired goodwill should be amortised

- 3.23 In the previous section, we concluded that AGW is of a wasting nature.
- 3.24 One approach to depict the wasting nature of AGW in the financial statements is the amortisation approach. This approach would allocate the cost of AGW

²¹ Please refer to paragraph C.5 of Appendix C.

over its useful life as expenses on a systematic basis, and the carrying amount after amortisation would be tested for impairment²². The carrying amount of AGW under the amortisation approach is not intended to directly reflect the current value of AGW. Rather, amortisation would represent the consumption of AGW, and amortisation would represent the decline in the benefits represented by AGW.

- 3.25 Another approach to depict the wasting nature of AGW in the financial statements is the non-amortisation approach. Under this approach, it is assumed that it would not be a problem that entities may recognise IGGW up to the initial historical cost of AGW. Accordingly, the carrying amount of AGW would not be revised and thus expenses would not be recognised unless the total value of AGW and IGGW becomes lower than the initial historical cost of AGW. Impairment losses should be recognised when the total value of AGW and IGGW becomes lower than the initial historical cost of AGW.

This non-amortisation approach focuses on the inseparability of AGW and IGGW. In other words, an entity cannot observe AGW separately from IGGW subsequent to the business combination; an entity can only observe the integrated unit of AGW and IGGW. Accordingly, under this approach, as long as IGGW compensates the wasting of AGW, an entity would report that the value of goodwill is maintained.

- 3.26 Considering these two approaches, the ASBJ Staff support the amortisation approach for the following reasons:
- (a) The amortisation approach would not directly reflect the current value of AGW in its carrying amount, but would allow an entity to represent its declining trend over time separately from IGGW by reflecting the consumption of AGW.
 - (b) The ASBJ Staff think that the amortisation approach would reflect the consumption of AGW, which forms part of investment of the business combination, in profit or loss in each period. This would result in expensing AGW in a timelier manner and would provide useful information about

²² Please refer to footnote 8 regarding the unit of account that should be subject to impairment.

financial performance subsequent to the business combination.

- (c) When the impairment test is conducted at the CGU level, the carrying amount of AGW is shielded by the acquirer's IGGW before the business combination and any IGGW of the combined business generated after the business combination²³. This would obscure the impairment of AGW. As a result, when relying only on the impairment test, it is less likely that the wasting nature of AGW would be faithfully represented in the financial statements. In this regard, the amortisation would be applied regardless of such shielding, and the amortisation approach could avoid this disadvantage of the non-amortisation approach.
- (d) The non-amortisation approach would raise again the discussion of the scope of the accounting discussed in paragraphs 3.4-3.6. In addition, the non-amortisation approach would effectively allow an entity to recognise IGGW, up to the initial historical cost of AGW, which results in treating IGGW differently, depending on whether it relates to AGW. The amortisation approach could avoid this disadvantage of the non-amortisation approach.

²³ The IASB is aware of the issue of the so-called shielding effect and made efforts to improve the effectiveness of the impairment test of goodwill, such as by developing an approach that could address the buffer created by the unrecognised headroom. However, the IASB did not continue the efforts due to various reasons including the complexity of the developed approach.

PART 3B: HKICPA Staff view

Introduction

3.27 Since the introduction of the impairment-only model, AGW balances have been rising globally²⁴. The HKICPA Staff think that such a trend, along with recent high-profile goodwill write-offs, gives rise to a number of questions about the nature of goodwill, its place on the balance sheet and its subsequent accounting.

3.28 The HKICPA Staff think an amortisation plus impairment approach (which we refer to in short as an amortisation approach) for the subsequent accounting of AGW is superior to the existing impairment-only approach. In this section, we explain:

(a) The HKICPA Staff view on the nature of goodwill and its treatment under IFRS.

(b) Why amortisation plus impairment is a better choice than impairment-only.

The nature of goodwill and its treatment under IFRS

3.29 It is challenging to come to consensus on the nature of goodwill due to the fact that it is not separately identifiable and cannot be directly measured. Various attempts have been made to set out the components of goodwill, but none come to a definitive list.²⁵

3.30 As discussed in Part 2 of this paper, IFRS has two established accounting concepts for goodwill: (a) acquired goodwill, or AGW, which IFRS 3 requires to be recognised as an asset; and (b) internally generated goodwill, or IGGW, which IAS 38 prohibits from being recognised as an asset.

3.31 For discussion purposes, the HKICPA Staff think that it is helpful to compare the

²⁴ Refer to Part 1 of this paper for an updated quantitative study on this phenomenon.

²⁵ In October 2015, IASB staff considered an approach to apply different accounting treatments for the separate components of goodwill. In February 2016 (Agenda Paper 18B), that approach was excluded from deliberations on the basis that it would be extremely complex and subjective, and if there are any components that can be accounted for separately then they'd presumably meet the IAS 38 criteria for separate recognition. The IFRS 3 Basis for Conclusions acknowledges that goodwill may include components such as a trained workforce, loyal customers (reputation), as well as market imperfections and barriers to entry, but a conclusive list of components was not provided.

IFRS concepts of AGW and IGGW with goodwill in a broader sense, which we term “economic goodwill” to provide a reference point independent of the accounting regime.

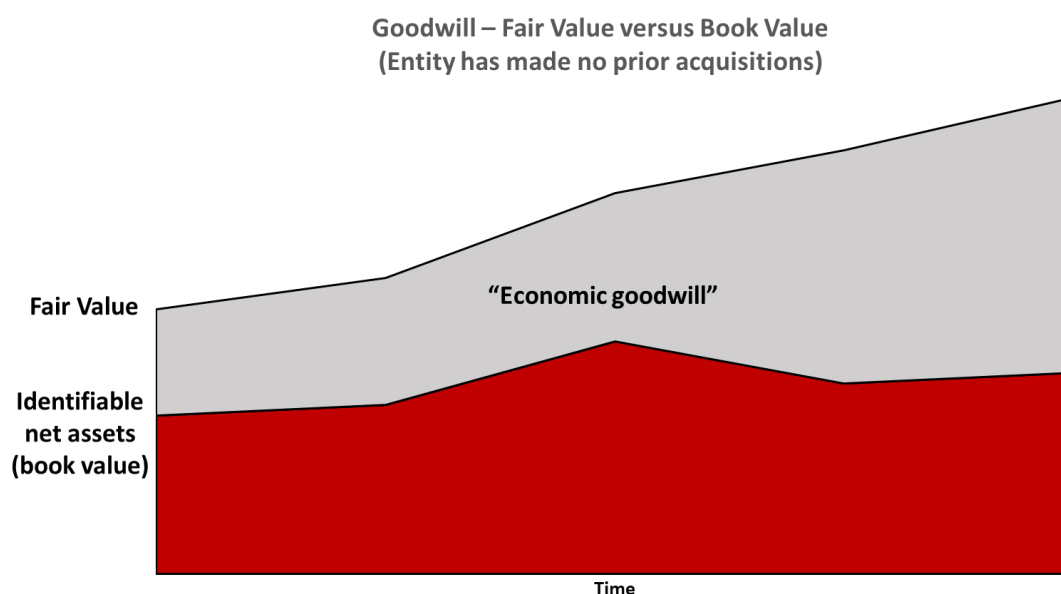
Economic goodwill

3.32 The HKICPA Staff describe economic goodwill as follows:

Economic goodwill is the difference between the fair value of an entity and its identifiable net assets (book value) recognised under prevailing accounting standards.

3.33 The fair value of an entity refers to the market value or enterprise value of an entity as a whole. As the unit of account we refer to is the entity as a whole, this includes all elements that make up that whole including the ability to control the entity (control premium). There are various methods and a multitude of inputs to determine a fair value for control of entity, which is an economic matter independent of the given accounting regime. The HKICPA Staff consider acquisition price to be the best representation of the fair value of an entity at the time of acquisition.

3.34 Economic goodwill can be illustrated as such for an entity that has made no prior acquisitions (and hence has no AGW on its balance sheet):



- 3.35 The purpose of goodwill in accountancy is to represent the divergence between what can be recognised and measured for financial reporting purposes (identifiable net assets, whose carrying amount is commonly referred to as “book value²⁶”), and what cannot (all components of the total fair value of an entity).
- 3.36 A multitude of items and factors may contribute to the difference between an entity’s fair value and the book value of identifiable net assets²⁷. The fact is that financial reporting cannot identify, recognise and measure every component that makes up the fair value of an entity (and indeed it is not the purpose of general purpose financial reports to show the value of an entity, but rather to provide information to help users estimate the value). Hence, there is a need for the concept of goodwill to act as a balancing amount.
- 3.37 It should be noted that the concept behind our description of economic goodwill is considered in IAS 38.50, which when describing IGGW states “*Differences between the fair value of an entity and the carrying amount of its identifiable net assets at any time may capture a range of factors that affect the fair value of the entity.*” However, IFRS does not directly define IGGW and the concept is primarily used as a differentiator from AGW within the accounting framework.

Acquired goodwill

- 3.38 The relationship between economic goodwill and AGW is that AGW is a point-in-time “snapshot” of an acquiree’s economic goodwill as of the acquisition date of a business combination²⁸. AGW is the difference at the acquisition date between the identifiable net assets of the acquiree, and the acquirer’s estimation of fair value of the acquiree (the acquisition price).
- 3.39 The concept of goodwill hence exists not only in the case of a business

²⁶ HKICPA Staff use the term “book value” to represent the net amount recognised on the balance sheet of an entity under prevailing accounting standards. This amount may fluctuate from period to period due to the subsequent measurement of assets and liabilities, and recognition or derecognition events.

²⁷ In line with the IASB’s rationale for rejecting an approach that accounts for separate components of goodwill, HKICPA Staff do not think it is possible to attempt a definitive list of components so long as those remain sufficiently unidentifiable and unmeasurable.

²⁸ HKICPA Staff acknowledge AGW will be affected by any uplift in the book value of the acquiree’s net assets when they are fair valued under the acquisition method, and the fair value of any identifiable net assets the acquiree had not previously recognised.

combination, but so long as an entity's fair value exceeds the book value of its identifiable net assets. The business combination simply provides a situation in which the economic goodwill of an acquiree can be measured as a balancing amount from the exchange transaction. The HKICPA staff think the ability to obtain this residual measurement is one of the primary reasons recognition of AGW is tenable under prevailing accounting standards.

- 3.40 As a snapshot, AGW is a static and distinct historical accounting artefact. Barring the application of any subsequent accounting regime to update its carrying amount, AGW cannot be re-measured after acquisition, nor can changes in AGW be directly tracked (hence why the impairment test depends on assessing the recoverable amount of CGU(s)). This is in contrast to economic goodwill, which is dynamic and will vary in amount as the fair value of an entity fluctuates from day to day, or the book value of the entity's identifiable net assets changes from reporting period to reporting period.

Why amortisation plus impairment is a better choice than impairment-only

- 3.41 The HKICPA Staff are of the view that an amortisation regime (together with indicator-based impairment²⁹) is the best approach to subsequently accounting for AGW. There are two key points as to why:
- (a) Amortisation better reflects the nature of AGW, in particular:
 - (i) It better reflects the fact that AGW becomes increasingly less representative of the acquiree and the consolidated entity.
 - (ii) It provides a better opportunity for entities to show how an acquisition is utilised.
 - (iii) It improves comparability between entities that grow organically and through acquisitions.
 - (b) Amortisation ensures that increasingly large goodwill balances supported by the impairment-only model, which may contribute negatively to management incentives and misrepresent risks, will be allocated to expense on a timely basis.

²⁹ Please refer to Part 4 for detailed discussion on our proposed method of amortisation plus impairment.

3.42 These points are addressed in turn.

Key Point 1: Amortisation better reflects the nature of AGW.

Better reflects how AGW becomes increasingly less representative of the acquiree and consolidated entity

- 3.43 Goodwill is always a residual amount. It cannot be directly measured or directly valued because it is only the difference between an entity's fair value and the book value of its identifiable net assets, and would not exist as a concept without those data points. In this sense, goodwill itself is not an item subject to "valuation", and it could be said that goodwill is only a part of an asset (that asset being the entity as a whole) rather than a stand-alone asset itself.
- 3.44 Over time, the amount recognised as AGW will become increasingly less reflective of the current fair value or current book value of the entity, and therefore increasingly meaningless as a balance sheet item. Unlike something such as a financial asset that can be measured at fair value, AGW cannot be re-measured and so cannot be updated to reflect any value creation.
- 3.45 As such, a situation in which AGW has not yet been impaired does not demonstrate that an acquisition has been a success, or even that it has met expectations. The impairment test is asymmetric and cannot reflect increases in value. As long as the fair value of its CGU(s) remains sufficient, AGW's carrying amount will be supported (shielded) by IGGW and any other unrecognised 'headroom', and hence economic goodwill, in the CGU³⁰. This is because the impairment test compares a historical AGW balance against a current fair value, the latter which will reflect a dissimilar state of economic goodwill from that at the acquisition date. Effectively, AGW becomes a ceiling for the indirect recognition of IGGW. This can be referred to as the "impairment shield" issue.
- 3.46 This impairment shield issue obscures the reality of goodwill, because what the financial statements purport to be an asset arising from a historical acquisition may be shielded from expense recognition by cash flows of an entity significantly

³⁰ Specifically, this will be the recoverable amount (higher of value in use and fair value less costs of disposal) of the CGU(s) to which AGW is assigned over the respective carrying amount. Though there are differences between value in use and fair value, the argument is the same.

different from those of the entity that the asset was established for. The consolidated entity and its acquisition may continue to perform for years after recognising AGW. Over time, the acquisition may be integrated, and the overall entity enhanced and transformed in myriad ways to the point where the originally recognised AGW becomes largely meaningless. At such a point, e.g. years or decades after an acquisition, any impairment charge would be equally as meaningless and also confusing, particularly if that acquisition had been successfully monetised many years prior.

- 3.47 Noting the above, we disagree with the argument made by some constituents that AGW should not be amortised because it can be linked to and supported by the cash flows used to value the acquisition (and is hence indefinitely lived or “non-wasting” in nature)³¹. Firstly, AGW simply cannot be directly measured (directly valued) and hence cannot be directly linked to any cash flows. As noted above, AGW acts more as a *part* of the asset of the overall entity rather than a stand-alone asset. Secondly, what is being assessed is acquired goodwill, which is a snapshot of economic goodwill, and hence a static picture of an historical amount. To assert that AGW is linked to or supported by the entity’s cash flows becomes therefore even more tenuous, as AGW increasingly bears no relation to the fair value of the entity and its cash flows to which, some constituents argue, the AGW is supposed to relate.
- 3.48 The HKICPA Staff think that amortisation plus impairment better reflects the fact that AGW becomes increasingly less representative of the economics of the underlying entity than impairment-only. Amortisation ensures that the necessary function of cost allocation will be applied in a systematic and understandable manner to an asset that becomes increasingly meaningless in relation to its entity over time. This will help to resolve the issue that an impairment-only approach creates by enabling AGW balances to remain on balance sheets irrespective of changes in the underlying entity, potentially to the point of those AGW balances being nonsensical.

³¹ In particular, some constituents argue that AGW’s value is linked to the terminal value used to value an acquisition, and that is subject to a perpetual growth assumption. These constituents argue that as a result, goodwill is “non-wasting”, i.e. assumed to be an indefinite life asset, and therefore disagree with amortisation approaches. We disagree with this view for the reasons presented in this paper.

Better opportunity to show how an acquisition is utilised

- 3.49 One of the functions of accountancy is to represent the utilisation of economic resources over time. This is why there are concepts such as depreciation for property, plant and equipment, regardless of an entity's expectation of increases in economic value of those items. The purpose of such depreciation is not to show a decline in the fair value of an item, which would be better represented by a current value measurement, but to show the utilisation of that item.
- 3.50 AGW represents a part of the historical fair value of an entity at the acquisition date (although as noted in the section above this link cannot be directly measured). After the acquisition, if expectations are realised and the value of that acquisition is monetised, the cash flows associated with that acquisition will be accounted for as income that increases assets (cash, accounts receivable, etc.) and equity (retained earnings). If the AGW does not have an appropriate cost allocation method applied to it, the entity effectively starts double counting cash flows (first as AGW, then again as income). Such a situation results in an artificial and accounting-driven inflation of assets and equity, and no information whatsoever on the utilisation of the amount paid for the acquisition.
- 3.51 The HKICPA Staff think amortisation with impairment is preferable to impairment-only because it provides a mechanism to show the utilisation of AGW. Under amortisation, users will be able to see the timeframe in which an acquisition is expected to be utilised (via the amortisation period³²), and be able to observe a systematic cost allocation of AGW versus the income earned by the entity. This would better tie AGW to the performance of the acquisition. For successful acquisitions, this would provide a superior representation of the monetisation of the acquisition. For unsuccessful acquisitions, amortisation plus impairment would also reflect the destruction of value in a timelier manner.
- 3.52 Amortisation is criticized by some constituents as an "artificial" charge. Some also rightly note it is challenging to link the amount recognised as AGW to specific future benefits, given AGW can't be directly measured or separately identified, and does not produce independent cash flows. The HKICPA Staff consider that

³² Refer to Part 4 for discussion on amortisation period.

this problem exists under both an amortisation and an impairment-only model, and will exist so long as AGW is recognised as an asset.

- 3.53 Both amortisation and impairment of AGW are non-cash expenses, and as such both are “artificial” insofar as they are subsequent measurement mechanisms for accounting purposes. The impairment model is an asymmetric mechanism to indirectly allocate AGW’s cost by reference to associated CGU(s) which cannot be disentangled from IGGW. The HKICPA Staff consider that it is more artificial to let goodwill remain un-expensed over time (e.g. if an entity performs or if AGW is otherwise shielded from impairment) to the point where, as noted in the prior section, it ceases to reflect any economic reality of the underlying firm.
- 3.54 The HKICPA Staff propose retaining an indicator-based impairment test as part of an amortisation approach. This would ensure that significant declines in value of CGU(s) indicative of a failed acquisition would be recognised in early years, when the un-amortised amount of AGW is still of a substantial size. As such, impairment would still play a significant role in our approach, but that role would be more relevant. This is because impairment tends to be most relevant in the early years after an acquisition where the acquiree can be clearly distinguished within the consolidated entity. The HKICPA Staff think that the current level of information provided about management’s capital allocation decisions, and the success or failure of acquisitions, will not deteriorate under an amortisation with impairment approach. Our approach does not eliminate the recognition of AGW as an asset or otherwise hide the acquisition’s performance. The HKICPA Staff think that concerns for additional insight into the performance of acquisitions are best served by disclosures (including potential new disclosures about business combinations developed through the standard setting process³³).

Improves comparability between entities that grow organically and through acquisitions

- 3.55 When AGW is recognised as an asset, a problem that immediately arises is that the financial reporting of entities who primarily grow organically begins to diverge from that of entities who primarily grow through acquisitions. This is because some of what constitutes organic growth is required to be expensed (as

³³ We note that better disclosures for business combinations has been under consideration by the IASB and its staff, for example in Agenda Paper 18A of the June 2019 IASB meeting.

IGGW), whereas acquisitive growth allows for amounts not recognised as part of identifiable net assets to be capitalised as AGW. In this way, accounting is biased towards entities depending on their growth strategy.

- 3.56 Amortisation would ensure that AGW balances will eventually be expensed in a systematic manner, and this will serve to improve comparability between organic and acquisitive growth. This is illustrated in further detail in **Appendix B**.

Key Point 2: Impairment-only supports increasingly large goodwill balances that may negatively incentivise management and misrepresent risks.

- 3.57 As noted in Part 1, we acknowledge that there may be multiple reasons for increasing goodwill balances. However, the HKICPA Staff think it is difficult to deny that an impairment-only model has contributed to such increases.

Why does the impairment-only model allow for increasing goodwill balances?

- 3.58 The absence of a regular amortisation charge will naturally result in higher goodwill balances so long as impairment is avoided. Problematically, the current regime provides the opportunity to avoid recognising impairment. This is because AGW is tested for impairment by allocating it to cash generating units (CGU(s)) and testing those against their current recoverable amount. This current recoverable amount will inevitably include IGGW and headroom, and hence changes in economic goodwill that both existed before, and was created after, the acquisition date. This is the impairment shield issue³⁴.
- 3.59 The impairment shield issue is exacerbated by a high level of management judgement in determining how the impairment test is performed, including the ability to determine the level of CGU(s). Management can potentially allocate goodwill to a CGU that is sufficiently large (with sufficient headroom) such that a decline in the value of the operations that the AGW relates to is shielded by the broader CGU³⁵.

³⁴ This was acknowledged by the IASB in the development of IAS 36 (IAS 36.BC134-BC135).

³⁵ For example, a large multinational entity could purchase a relatively small subsidiary in one country, and then allocate the AGW of that subsidiary to a global business division. In doing so, the entity could avoid recognising any impairment even if the subsidiary performed poorly, because that AGW would be shielded by the much larger recoverable amount of the global business division.

What is the problem with increasing goodwill balances?

3.60 The HKICPA Staff think that growing and un-expensed AGW balances may result in distorted and weakened balance sheets, and lead to concerns about the role accountants are playing in allowing risks to develop without appropriate representation. Consider the following:

- (a) Current goodwill accounting is arguably pro-cyclical. An environment of low interest rates, easy credit, and aggressive deal making may drive a larger number of acquisitions and higher acquisition prices. This in turn will result in higher AGW balances. In such an environment, entities may then avoid recognising any expense with regard to that AGW for an extended period of time as conditions remain positive and discount rates (used in the calculation of recoverable amount) low. However, when economic conditions turn negative or interest rates rise, entities may start to experience “impairment shocks” and sudden large losses.
- (b) Increasing AGW creates situations where more of entities’ liabilities and equity are supporting a highly nebulous asset, which cannot be identified, separated, transferred or liquidated. This can result in management leveraging against an increasingly more speculative asset side of the balance sheet. Synergies, which some argue are a significant component of AGW, don’t always manifest. Research from McKinsey & Company and Bain & Company³⁶ has found that nearly 70 percent of mergers assessed failed to achieve expected revenue synergies, and two thirds of acquisitions fail to create meaningful shareholder value.

3.61 The HKICPA Staff are also concerned that the impairment-only regime may exacerbate undesirable management incentives as follows:

- (a) It may incentivise “big bath” accounting practices due to the subjective nature of the impairment assessment and the impairment shield. Entities

³⁶ <https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/where-mergers-go-wrong>.
https://www.bain.com/contentassets/a13fb5f396e348cc84699f4c7fe89d05/bsr_masteringmergerintegration.pdf.

may elect to take a large impairment charge all at once (e.g. to coincide with a change in management).

- (b) It may incentivise management to value acquisitions more highly, given that any payment over identifiable net assets can be reflected as AGW and management can ignore subsequent expense for a foreseeable future.
- (c) It may incentivise management to lever against an inflated and speculative asset-side of the balance sheet.
- (d) To maximise financial reporting metrics, and given the market often views impairment negatively, management may be incentivised to delay impairment as long as possible.
- (e) Sticky AGW balances, resulting in inflated assets and equity and suppressed expenses, can influence management's decisions and affect the ability to proceed with certain corporate actions. For example, the ability to pay dividends out of distributable reserves can be affected.

- 3.62 The fact that some sophisticated stakeholders already make adjustments for goodwill indicates that they view goodwill as it currently exists a speculative financial reporting item.

How amortisation would improve this

- 3.63 Amortisation would help to address the issues noted above, as it would ensure AGW balances are brought down over the period the acquisition is utilised in a systematic manner. This would reduce the potential risks noted that are not currently being addressed by the impairment-only model. It would also help to mitigate the "impairment shield" problem and the ability of management to apply questionable judgement to impairment testing.
- 3.64 The HKICPA Staff think that amortisation would improve management discipline and better hold management accountable for acquisitions because it would require entities to consider the expected utilisation of the cost of their acquisitions, and would not enable AGW to remain on balance sheet for undue amounts of time. This is unlike the current impairment model, which can contribute to expense avoidance for a lengthy period of time. In this way, the negative management incentives noted above would be alleviated.
- 3.65 The HKICPA Staff disagree with the argument that amortisation of AGW would

allow management to “hide” failed acquisitions. We are of the view that amortisation, plus impairment, will improve transparency as it will ensure the real economic cost of an acquisition is brought through the financial statements in a timely and systematic manner.

Goodwill and corporate stability

A contribution to the HKICPA Staff by Professor Adam Leaver, Chair in Accounting and Society at Sheffield University Management School, United Kingdom.

As noted in paragraph 3.50, the impairment-only model effectively ‘double counts’ assets because a) AGW values are a capitalised measure of the acquirer’s expected future cash flows at the point of acquisition and b) cash flows which then result from that acquisition are accounted for as income that increases assets (cash, accounts receivable, etc.) or equity (retained earnings) without incurring any corresponding costs or reductions to AGW. The benefits of an acquisition are, in other words, monetized first as AGW, then again as income. The resulting inflation of assets and equity that are an artefact of this accounting treatment may distort managerial incentives.

First, CEOs may be incentivised to grow inorganically rather than organically. This may encourage amalgamations driven by financial engineering rather than operational efficiency motives. The resulting amalgamations may lead to increased operating inefficiencies at the aggregate. Worse, they may introduce ponzi-like dynamics if the disappointing operating outcome/cash flow performance of one merger leads managers to seek a second merger for the asset uplift. In such situations, one poorly thought through merger may beget another.

Second, given the option of either capitalising or distributing this double-counted income many managers will choose to distribute. This may lead to an ‘acquire and distribute’ strategy which may again displace other investment-led, productivity-focused sources of shareholder value creation. Remuneration structures tied to shareholder value measures or measures that underpin the creation of shareholder value may exacerbate this problem.

Third, the benefits of double counting may encourage managers to over-estimate the true economic value of corporate assets. Acquiring companies may therefore be

willing to pay a rising multiple of a target firm's average annual income to acquire it. Paying higher multiples of average annual income may then have a corresponding effect on the goodwill booked.

Fourth, the double counting of goodwill may have implications for corporate stability. If acquisitions are financed with large amounts of debt, and cash flows from the acquisition fall below the level expected to justify AGW valuations, double counting goes into reverse. Falling cash flows may lead to real-time losses and those real-time losses may lead to a goodwill impairment test. If the recoverable value of CGU assets are deemed to be lower than their carrying amount, that may lead to an impairment charge on top of the real-time losses. If firms are highly levered, there may be inadequate equity redundancies to accommodate the operating and impairment losses; or, firms will be forced to recapitalise through share issue at precisely the point that the market doesn't want to buy shares. Firms may even be reluctant to impair their goodwill, despite weakening economic performance – incentivising accounting fraud.

In this sense goodwill accounting might be thought of as a form of leverage. And these processes might be thought of as 'pro-cyclical', echoing some of the problems witnessed in financial firms during the 2007/8 crisis. Furthermore, this may erode the decision-usefulness of accounts for investors if the logic of it is greater balance sheet volatility, which is difficult to predict.

PART 4: AMORTISATION PERIOD AND METHOD

- 4.1 The Staffs think that amortisation should be applied to the AGW arising from each individual business combination as a whole (that is, the AGW asset arising from a particular acquisition should not be disaggregated into components with different amortisation schedules). This is because AGW cannot be separately identified or directly measured³⁷. In addition, management should make a reasonable estimate of the amortisation period utilising reasonably available information.
- 4.2 The Staff's respective proposals, based on their core arguments, are presented below.

PART 4A: ASBJ Staff view

Unit of amortisation

- 4.3 As already discussed in paragraphs 3.23-3.26, the ASBJ Staff think that the amortisation approach should be applied to depict the wasting nature of the AGW in the financial statements. The ASBJ Staff do not think the amortisation approach can be rejected merely because some consider it difficult to estimate the amortisation period.
- 4.4 As discussed in paragraphs 3.8-3.11, AGW can conceptually be analysed based on several components, including the going concern element and the synergies element. However, the ASBJ Staff think that a single amortisation period should be used for AGW as a whole.
- 4.5 The ASBJ Staff acknowledge that AGW itself is a residual of the consideration of the business combination after deducting the fair value of identifiable net assets and do not generate independent cash flows. Accordingly, the ASBJ Staff understand that it is practically not easy to identify those individual components. Even if those components were to be individually identified, it would not be easy to quantify how those components contribute to the amortisation period

³⁷ If it were possible for components of AGW to be separately identified for amortisation, we think that would presume such component should have been considered for recognition as an IAS 38 intangible asset.

because those components interact with each other.

- 4.6 In the Proposed Statement of Financial Accounting Standards, *Business Combinations and Intangible Assets* published in 1999 ('1999 Exposure Draft'), the FASB noted that it had considered the discernible-elements approach. This approach assumes that goodwill is composed of multiple discernible elements, and identifies the useful life of each component and amortises AGW using a weighted average amortisation period of the discernible elements. No further consideration was undertaken, as field testing found the approach to be highly subjective.
- 4.7 For this reason, that approach was not proposed in the 1999 Exposure Draft. Instead, the FASB proposed an amortisation period for the entire AGW based on management estimates, up to a maximum of 20 years. Considering the history of such discussions, the ASBJ Staff think that it is reasonable to apply a single amortisation period to AGW as a whole, rather than to apply multiple amortisation periods to individual components.

Possible approaches to determining the amortisation period

- 4.8 Possible approaches to determining the amortisation period for AGW as a whole include the following:
- Approach 1: Require management to estimate the amortisation period, taking into account the nature of AGW.
- Approach 2: As there is too much uncertainty in estimating the amortisation period, the accounting standard setter should determine the amortisation period (that is, "pick a number").
- 4.9 Approach 1 takes into account the fact that business combinations are diverse and that they can vary in nature. The ASBJ Staff think that what the acquirer expects from goodwill and when the acquirer expects goodwill to become wasted (or alternatively, how long the acquirer expects goodwill to have an effect) vary depending on the business combination in question. In many cases, the ASBJ Staff think that such expectation would be consistent with management expectation that future net cash inflows would increase due to the business combination, when incremental cash flows arising from reinvested assets are

excluded³⁸. However, Approach 1 may be costly compared to Approach 2.

4.10 Approach 2 ignores the different natures of AGW that arises from each business combination. Accordingly, this approach would treat AGWs with different economics in the same manner, which may fail to represent the wasting of AGW in a timely manner and which may lead to false comparability. On the other hand, the amortisation period for AGW has been controversial in the international debates, and some claim that a default period for the amortisation period should be considered as a viable alternative, given that addressing the “too little, too late” issue is of high priority. However, Approach 2 could only be justified in the context of eliminating subjectivity inherent in estimating the amortisation period and in the context of addressing cost concerns.

4.11 Regarding Approach 1 and Approach 2, the Agenda Paper “Possible approach for addressing ‘too little, too late’ issue” (‘ASBJ Paper’)³⁹ which the ASBJ submitted to the Accounting Standards Advisory Forum in July 2017 discussed the amortisation period as follows:

(a) The ASBJ Paper basically supported Approach 1, with an amendment that sets a cap on the amortisation period discussed below. In other words, the ASBJ Paper argued that it was important to clarify the principle of the concept of amortisation period, and in developing that principle, the views of users of financial statements on the amortisation period and information provided by amortisation should be emphasised. In addition, users of financial statements who supported amortisation thought that information based on management’s estimate was useful. The ASBJ Paper suggested, as the essence of their views, that the amortisation period be “based on the management's estimate of the period in which the future net cash inflows would increase due to the business combination.” Though acknowledging the concerns over relying on management estimate, the ASBJ Paper emphasised more its advantage.

(b) On the other hand, the ASBJ Paper did not provide a positive view on

³⁸ Paragraph 3.22 discusses that cash flows from reinvestment should not be considered when discussing the wasting nature of AGW.

³⁹ Please refer to following website:

<https://www.asb.or.jp/en/discussions/papers/2017-0612-2.html>

Approach 2. In other words, for users of financial statements the information about amortisation period based on the management's estimate was useful, whereas information based on the default amortisation period set by the accounting standard setter was unlikely to be useful, and would not necessarily result in faithful representation because all AGWs are assumed to have the same amortisation period.

- 4.12 The ASBJ Staff's understanding is that the views of users of financial statements are not significantly different from those expressed in 2017. In addition, management would be in the best position to estimate the amortisation period because various information about the business combination is required to estimate the amortisation period. Accordingly, the ASBJ Staff think that the discussion in the ASBJ Paper in the previous paragraph still holds, and Approach 1 should be given priority, emphasising the views of users of financial statements who consider the information based on the management's estimate to be useful.

Maximum amortisation period in applying Approach 1

- 4.13 Setting a cap on the amortisation period would narrow management's discretion beyond the cap in estimating the amortisation period and might affect the relevance of information. The ASBJ Staff acknowledge that this is inconsistent with the objective of Approach 1. However, assuming that there are growing concerns over the "too little, too late" issue described in Part 1, such a measure would likely be helpful to strike a balance between the provision of relevant information and the need to respond to such concerns. That is, setting such a maximum period would ensure that the amount of AGW decreases to zero within that maximum period, and is helpful to address the "too little, too late" issue. Accordingly, the ASBJ Staff think that it would be appropriate to set a maximum amortisation period.
- 4.14 Although it was not easy to logically establish the appropriate maximum number of years, the ASBJ Paper suggested 10 years. 10 years seemed to be acceptable to most stakeholders in light of (a) the maximum amortisation period set for the amortisation option provided for private companies under U.S. GAAP⁴⁰, (b) the amortisation requirement under the IFRS for SMEs⁴¹, and (c) the results of some

⁴⁰ FASB Accounting Standards Codification Paragraph 350-20-35-63.

⁴¹ Paragraph 19.23 (a) of IFRS for SMEs.

academic studies.

- 4.15 In this regard, the ASBJ Staff proposes a 10 year period similar to the ASBJ Paper. However, unlike the ASBJ Paper, the ASBJ Staff think that rebutting the maximum period of 10 years should not be permitted from the viewpoint of reaching international consensus. This is because (a) in international discussions so far, some have noted that it is unlikely to expect the effects of a business combination to continue more than 10 years, and (b) the amortisation option provided for private companies under U.S. GAAP and the amortisation requirement under the IFRS for SMEs set 10 years as the maximum number of years and do not permit longer years (even as a rebuttable presumption). The ASBJ staff also confirmed the results of academic studies that could be additionally referenced (Please refer to Appendix C). As a result, the ASBJ Staff think that setting the maximum amortisation period at 10 years will be acceptable to most stakeholders.

Discussion of Approach 2

- 4.16 As explained in Part 1, the amount of AGW has been increasing steadily over time, and this RP discusses the “too little, too late” issue assuming that this trend is likely to exist. In addition, as was observed during the recent discussions in the United States, stakeholders have serious concerns over the costs incurred in relation to the subsequent accounting for AGW. Considering these situations, the ASBJ Staff think that some variation to Approach 2 is still worth consideration as the second best alternative to gain international consensus. In this case, considering the balance between eliminating subjectivity in estimating the amortisation period and ensuring a certain level of relevance, if the entity can justify an amortisation period that is shorter than the default amortisation period, such amortisation period should be permitted.
- 4.17 The ASBJ Staff consider that the discussion of the maximum amortisation period in Approach 1 can also apply to the discussion to set the default period in Approach 2, considering that a variation to Approach 2 would permit an amortisation period shorter than the default period if the entity could justify it. Accordingly, the ASBJ Staff proposes that the default period in Approach 2 be 10 years.

PART 4B: HKICPA Staff view

Amortisation period

- 4.18 One of our reasons for proposing amortisation of goodwill is to reflect the utilisation of AGW. As such, the HKICPA Staff think that the amortisation period of AGW should be determined in terms of the expected utilisation of an acquisition⁴². Entities should apply judgement to determine an amortisation period that reflects the entity's expectations for utilisation of the acquiree, including the duration over which integration and monetisation of the acquiree is expected to take place as of the acquisition date.
- 4.19 The HKICPA Staff view is that there are a variety of approaches and information sources that can be used for determining the amortisation period for AGW in line with this principle. When entering into an acquisition, it is good practice for management to analyse and have a business plan for the acquired entity post-acquisition. Questions that may be asked to inform the determination of the amortisation period include:
- (a) What is the objective and strategic rationale of the acquisition? What are the key business goals or priorities and their expected timeframe?
 - (b) What are the most important sources of value from the acquisition, and how and when will they be realised?
 - (c) What are the financial results expected from the acquisition and when are these expected? Is there an expected return on investment (consideration transferred) based on forecast cash flows?
 - (d) What is the integration plan for the acquisition? How long will the integration process last? What are the key milestones for the integration team and when are they expected to be met?
 - (e) Are there any limiting factors that would indicate a minimum or maximum amortisation period, for example any legal, compliance, or other similar

⁴² The reader may note this is analogous to the principles in IAS 16 for determination of useful life.

factors that impact the ability to fully integrate or operationalise an acquisition?

- 4.20 We consider that much of this information should be able to be sourced from internal reporting. Entities may also consider factors already noted in paragraph 90 of IAS 38 for determining the useful life of intangible assets. Determination of the amortisation period will require management judgement. However, the process of determining an amortisation period based on the principle of reflecting expected utilisation of an acquiree will benefit both (a) management, as it will need to think critically about its post-acquisition plans, and (b) users, as they will gain more insight into management's expectations for an acquisition. The HKICPA Staff note that this would be further enhanced by disclosure of the significant judgements used in determining the amortisation period of AGW⁴³.
- 4.21 Setting such an approach based on the principle of expected utilisation of the acquisition also reflects our view that AGW is a historical snapshot of the difference between fair value and book value as of the acquisition date. Being a historical residual amount that cannot be directly measured, AGW is not subject to valuation per se, and as an accounting construct does not have an "economic life".
- 4.22 In addition to the principle above, we think that:
- (a) There should not be a mandatory floor or ceiling for the amortisation period, as such a requirement would not be in line with the principle-based nature of IFRS and may fail to reflect an entity's particular situation, industry and economic environment, which would diminish the value of the information provided to users. It may also incentivise entities to select the standard period as a matter of operational convenience or to minimise amortisation expense.
 - (b) The HKICPA Staff nevertheless would support a rebuttable presumption that the amortisation period should not exceed a specified number of years (e.g. 10 years). This is to avoid entities estimating an exceptionally long

⁴³ The need to disclose significant judgements would be captured by the disclosure requirements in IAS 1.

amortisation period that fails to reflect the nature of AGW and results in similar concerns as already noted under the impairment-only approach.

Determination of amortisation period for AGW - other possible approaches

At the International Forum of Accounting Standard Setters (IFASS) in October 2019, participants suggested a number of approaches for determining the amortisation period. Among those, we noted a suggestion that an entity could, in considering the synergies arising from the business combination and the expected utilisation of the underlying acquired assets, apply a method based on the average useful lives of the identifiable underlying assets acquired. Another suggestion was to reference the industry or business life cycle of the entity.

Amortisation method

- 4.23 The HKICPA Staff view is that entities should be required to apply judgement to determine what amortisation pattern is expected to best reflect the expected utilisation of an acquisition.
- 4.24 Analogising to the depreciation or amortisation requirements of IAS 16 or IAS 38, we may note that the cost allocation method used shall reflect the pattern in which an asset's future economic benefits are expected to be utilised. The HKICPA Staff think that, similar to IAS 16 and IAS 38, a variety of amortisation methods may be used to allocate AGW on a systematic basis over its amortisation period. The method used should however reflect the expected utilisation of the acquiree, and be applied consistently from period to period. We think that, similar to IAS 38, entities should be required to use the straight-line method if the pattern of utilisation cannot otherwise be determined reliably.
- 4.25 Entities could consider a variety of questions to help inform the amortisation method. The information used to determine the amortisation period should also be considered when determining the amortisation method (e.g. expected financial results, integration plan, key milestones, etc.).
- 4.26 The HKICPA Staff think that the residual value of the AGW should be zero for amortisation purposes. AGW does not generate independent cash flows and

cannot be transferred or disposed of. Additionally, AGW becomes increasingly less representative of the acquiree and the consolidated entity over time.

Applying amortisation – too difficult or too arbitrary?

Some stakeholders argue that an amortisation approach for AGW is too difficult and judgemental or too arbitrary to implement.

The HKICPA Staff disagree, particularly when comparing an amortisation approach to the existing impairment-only approach. The impairment-only regime is judgemental (e.g. in terms of allocation of AGW to CGU(s) and application of the impairment test) and operationally burdensome. Applying depreciation or amortisation, on the other hand, has been present in accountancy at its most basic levels for much of modern history.

Amortisation with indicator-based impairment will further reduce the burden of an annual valuation process (which is complex and time-consuming and may require costly engagement of external valuation firms).

This paper presents a principle-based method by which to amortise AGW, and illustrates some of the methods and thought processes that could be used to determine both the amortisation period and the amortisation method. The HKICPA Staff think that determining an amortisation period and amortisation method based on expected utilisation of an acquisition is both practical and reasonable because entities should have basic answers to questions such as (1) what are the objectives for the acquisition and the timeframe for meeting them; (2) what are the financial expectations for the acquisition; and (3) what is the integration plan for the acquisition. We furthermore consider that much of this information should be based on internal reporting, and hence utilising that for external reporting will help minimise costs.

Answers to such questions can help to inform a reasonable estimate of how an entity expects to utilise an acquiree. Judgement will certainly be required, however the use of judgement is present in many areas of IFRS and does not undermine the usefulness of the resulting information⁴⁴.

⁴⁴ Paragraph 2.19 of the *Conceptual Framework* notes the use of reasonable estimates is an essential part of the preparation of financial information and does not undermine the usefulness of the

Answers to such questions will also help enforce management discipline and accountability around acquisitions, which is something we think an amortisation regime supports in many respects. In order to determine an amortisation period and amortisation method, and disclose how those were determined, entities will need to consider and answer important questions about their acquisitions and post-acquisition plans. This will help further support good practice and management stewardship.

Appendix A: METHODOLOGY OF THE QUANTITATIVE STUDY

The scope of companies analysed

A1. The quantitative study collected data of more than 1,000 listed companies that constituted the following four major stock market indices in the United States, Europe, Hong Kong and Japan:

- (a) the S&P 500 index of the United States ('the stock market index of the United States');
- (b) the S&P Europe 350 index of Europe ('the stock market index of Europe');
- (c) the Hang Seng Composite Index of Hong Kong ('the stock market index of Hong Kong') ; and
- (d) the Nikkei 225 index of Japan ('the stock market index of Japan').

A2. Companies that have constituted the stock market indices as of the starting date of the study (July 2019) were included in the population, but the following adjustments should be noted:

- (a) Companies which had no net assets in any of the years between 2014 and 2018 were excluded from the population;
- (b) Companies with duplications (for example, a group and a listed subsidiary within the group) were excluded from the population⁴⁵, except for companies that constituted the stock market index of Hong Kong because data to track such group relationships were not available for Hong Kong; and
- (c) For the stock market index of Japan, only the following companies were included in the population, considering that there were companies which have transitioned from either Japanese GAAP or U.S. GAAP to IFRS during 2014-2018⁴⁶:
 - (i) Companies that applied IFRS in 2018 regarding the following figures:

- Figure 1.1: Trends in the amount of total goodwill;

⁴⁵ We identify such group relationships by the information provided by the Bloomberg database labelled as the "Ultimate Parent" under the category of "Company Overview".

⁴⁶ The adjustments (a) and (b) were also considered to determine the companies included in the population.

- Figure 1.2: The trend of Figure 1.1 (The data of 2014 are indexed as 100.)
- Figure 1.3: Trends in the amount of goodwill per company (that recognised goodwill);
- Figure 1.4: Trends in the ratio of the amount of Goodwill to Net Assets;
- Figure 1.5: The trend of Figure 1.4 (The data of 2014 are indexed as 100.)
- Figure 1.6: Trends in the ratio of the amount of Goodwill to the Market Capitalisation;
- Figure 1.7: The trend of Figure 1.6 (The data of 2014 are indexed as 100.)
- Table 1.8: Trends in the number of companies that exceed certain ratio of the amount of Goodwill to the Net Assets;
- Table 1.9: Trends in the number of companies that exceed certain ratio of the amount of Goodwill to the Market Capitalisation.

For the financial figures for the periods in which the companies applied Japanese GAAP, no adjustments were made regarding the effects of amortisation charges.

(ii) Companies that applied IFRS throughout 2014-2018 regarding the following figures:

- Figure 1.10: Trends in the amount of Goodwill expensed;
- Figure 1.11: Trends in the intensity of Goodwill expensed.

A3. With the adjustments mentioned in the previous paragraph, the number of companies analysed for each stock market index was as follows:

Stock market index	Number of companies constituting the stock market index	Number of companies analysed in the quantitative study	Number of companies that recognised goodwill
United States	500	489	445
Europe	351	346	333
Hong Kong	485	464	339
Japan	225	62*(29#)	59*(27#)
Total	1,561	1,361	1,176

* Number of companies that applied IFRS in 2018. The data of

applicable companies are used for Figures 1.1 - 1.7 and for Tables 1.8 and 1.9.

Number of companies that applied IFRS throughout 2014-2018. The data of applicable companies are used for Figures 1.10 and 1.11.

A4. It should be noted that this sample is not a representative sample and should not be used for statistical inference.

Years covered

A5. We gathered data from 2014 to 2018.

A6. Most companies had a year-end of 31 December. However, some companies had a year-end other than 31 December. For the stock market indices of the United States, Europe, Hong Kong and Japan, the financial data of those companies were classified in the year with the year-end that was closest to 31 December. For example, financial data of companies with the year-ends of 1 July 2018, 31 December 2018 and 30 June 2019 were all presented as data for 2018.

Data collected

A7. The following data were collected for each company analysed:

- (a) Goodwill;
- (b) Goodwill impairment;
- (c) Net assets (that is, the book value of total equity); and
- (d) Market capitalisation (that is, the market value of total equity).

A8. In this RP, all amounts were translated into U.S. dollars (USD) for the readers' convenience. A single exchange rate as of the end of June 2019 was used for this translation, as shown in the following table:

1 EUR = 1.13699	USD
1 JPY = 0.00926	USD
1 CNY = 0.14562	USD
1 HKD = 0.12797	USD
1 GBP = 1.26935	USD
1 CHF = 1.02494	USD
1 DKK = 0.15239	USD
1 NOK = 0.11721	USD

1 SEK = 0.10773 USD

A9. The data of companies that constitute stock market indices were collected and analysed using the Bloomberg database. However, the following adjustments were made:

- (a) Regarding the stock market index of Japan, the Bloomberg data for 'goodwill impairment' were replaced with the equivalent data from annual reports for all companies analysed if the data from two sources were inconsistent.
- (b) Regarding the stock market indices of the United States, Europe and Hong Kong, the Bloomberg data for 'goodwill impairment' were replaced with the equivalent data from annual reports for companies which decreased goodwill balance by more than USD 1 billion compared to the previous year-end if the data from two sources were inconsistent.
- (c) Other minor adjustments include using the data from annual reports in the years for which the equivalent data are not available in the Bloomberg database because of a change of accounting period.

Appendix B: COMPARABILITY BETWEEN ORGANIC GROWTH ENTITIES AND ACQUISITIVE GROWTH ENTITIES

- B1. The IFRS *Conceptual Framework*, when describing the qualitative characteristic of comparability, states that the faithful representation of similar economic phenomenon should possess some degree of comparability. The current accounting regime results in AGW being recognised as an asset only at the time of a business combination. This creates deviations between entities that grow through acquisitions versus those that grow organically.
- B2. To illustrate, consider the following example. Bank X has been mainly providing investment banking services. Management decides to set up a new wealth management ('WM') division to expand and realise synergies by marketing some investment banking services to wealthy individuals. Management is considering two options:
- (a) Option A: Build-up a new WM division internally. This will cost \$20m in expenses, of which \$5m are identifiable assets and \$15m relates to expenses that do not meet the recognition criteria in IAS 38 (and hence contribute to IGGW).
 - (b) Option B: Acquire an existing private bank in the market and integrate it as a new business division. This will also cost \$20m, of which \$5m will be allocated to identifiable net assets and \$15m recognised as goodwill.
- B3. Management determines that it will take one year to fully establish the WM business under both options. Assume that for purposes of our example, Bank X will be in substantially the same economic position after one year under either option. Also assume that the fair value of each resulting iteration of Bank X will be the same, and will be largely impacted by the costs used to build the WM business. We may illustrate how this will be accounted for under both options.

Option A (organic growth):

- B4. Bank X will expense \$15m of costs that do not meet IAS 38 recognition criteria, and capitalise \$5m of other identifiable assets. At the end of the year, that expense will reduce equity via retained earnings.

Debit		Credit	
Expense	15m	Cash	20m
Other Assets	5m		
Overall effect			
<ul style="list-style-type: none">• Cash of \$5m is transformed into other assets• Decrease of assets (cash) by \$15m• Expenses increase by \$15m• Equity (retained earnings) decrease by \$15m			

Option B (acquisitive growth):

- B5. Bank X will capitalise \$15m of AGW as required by IFRS 3, and capitalise \$5m of other identifiable assets. Assuming no impairment, there will be no impact to retained earnings. The cash has been transformed into other non-cash assets for accounting purposes.

Debit		Credit	
AGW (Asset)	15m	Cash	20m
Other Assets	5m		
Overall effect			
<ul style="list-style-type: none">• Cash of \$20m is transformed into AGW and other assets			

- B6. The post-build up balance sheet position of Bank X will hence differ depending on the option selected. Assume that Bank X started the year pre-build up with gross assets of \$120m, split evenly between liabilities and equity. After the build-up, the balance sheets (assuming no impairment and ignoring all other elements and transactions for simplicity) would be as follows:

Option A	
Assets 105m	Liabilities 60m
	Equity 45m

Option B	
Assets 120m	Liabilities 60m
	Equity 60m

- B7. The example above illustrates that current accounting regime leads to differences in

financial reporting depending on whether entities grow organically or through acquisitions, even in cases where the cost of growth and economic substance of the entity after the growth is theoretically identical. This negatively impacts the qualitative characteristic of comparability. Some might argue that it is additionally 'unfair' to entities that grow organically, given they are subject to a relatively less benign accounting model than acquisitive entities when it comes to accounting for goodwill.

- B8. Introducing amortisation to the subsequent measurement of AGW would ensure that AGW balances will eventually be expensed in a systematic manner, and will serve to improve comparability between organic and acquisitive growth.

Appendix C: ACADEMIC STUDIES REFERENCED BY THE ASBJ STAFF

Analyses cited in the comment letter of the American Accounting Association regarding the relevance of amortisation

- C.1 The comment letter of the Financial Accounting and Reporting Section of the American Accounting Association in response to FASB's Invitation to Comments, *Identifiable Intangible Assets and Subsequent Accounting for Goodwill* notes that there are some academic studies that suggests that the expected benefit of goodwill decays rapidly and that investors view goodwill as a wasting asset, including:

Bugeja, M., and N. Gallery. (2006). Is older goodwill value relevant? *Accounting & Finance* 46 (4): 519–535.

The comment letter also notes that following studies examine more closely the length of the amortisation period of goodwill and suggest that shorter amortisation periods better reflect the short-lived benefits of AGW:

Henning, S. L., and W. H. Shaw. (2003). Is the selection of the amortization period for goodwill a strategic choice? *Review of Quantitative Finance and Accounting* 20 (4): 315–333.

Ojala, H. (2007). The value relevance of accounting goodwill – Does the abandonment of systematic amortisation make sense to investors? *Finnish Journal of Business Economics* 1: 9–34.

- C.2 The comment letter, on the other hand, notes following academic studies that suggest that amortisation would unlikely provide useful information.

Jennings, R., M. LeClere, and R. B. Thompson. (2001). Goodwill amortization and the usefulness of earnings. *Financial Analysts Journal* 57 (5): 20–28.

Moehrle, S. R., J. A. Reynolds-Moehrle, and J. S. Wallace. (2001). How informative are earnings numbers that exclude goodwill amortization? *Accounting Horizons* 15 (3): 243–255.

Analyses regarding mean reversion of rate of returns

- C.3 One of the most notable academic papers that presented this tendency of mean reversion is as follows:

Fama, E.F. and K.R.French (2000). Forecasting Profitability and Earnings, *Journal of Business*, 73(2): 161-175

In addition, the ASBJ Staff reviewed following academic papers when drafting the ASBJ Paper:

Healy, P., Serafeim, G., Srinivasan, S. and Yu, G. (2011). Market competition,

government efficiency, and profitability around the world. Working paper, Harvard Business School. Available at SSRN 1865878.

Nissim, D. and Penman, S. H. (2001). Ratio analysis and equity valuation. *Review of Accounting Studies*, 6: 109– 154.

Obinata, T. (2013). Sustainability and mean reversion of profitability. Chuokeizai-sha, Inc. (the title of the book is not official translation but tentative one by the ASBJ Staff.)

Palepu, K. G. And Healy, P. M. (2012). Business analysis and valuation 5th edition – International edition, Cengage learning.

Palepu and Healy (2012) showed the empirical research results that excess operating returns on equity diminished within five to ten years. Nissim and Penman (2001) explored the period of the mean reversion for decile portfolios formed on excess operating profit and found that excess operating profit for the highest decile remained over 10 years.

C.4 The ASBJ Staff additionally reviewed following papers and confirmed that there are no significant difference in the trend of mean reversion of rate of returns.

Muramiya, K. (2010). Characteristic analysis of financial ratios that constitute residual income model. In Sakurai, H. ed., *Empirical analysis of enterprise valuation*, Section 9, 230-269, Chuokeizai-sha, Inc. (the titles of the paper and the book are not official translations but tentative ones by the ASBJ Staff.)

Similar analyses to Nissim and Penman (2001) were conducted using samples of Japanese companies for fiscal years ending between January 1977 and March 2007. Time series analyses for nine years were conducted for residual earnings and residual operating income. The trend of mean reversion were observed.

Sakurai, T. (2010). Persistence of residual income and enterprise valuation. In Sakurai, H. ed., *Empirical analysis of enterprise valuation*, Section 10, 270-315, Chuokeizai-sha, Inc. (the titles of the paper and the book are not official translations but tentative translations by the ASBJ Staff.)

The paper demonstrated that the adjustment speed of residual income per year was 0.6271 for the sample Japanese companies for fiscal years ending between March 2002 and March 2007. Based on this, ROE is estimated to be reduced to the cost of equity in about five years.

Analyses regarding performance subsequent to business combinations

C.5 Following academic paper refers to several studies that analyses performance subsequent to business combinations:

Obinata, T. (2012). The Origin of the Study of Accounting Standards, 364-365,

Chuokezai-sha, Inc. (the titles of the paper and the book are not official translations but tentative translations by the ASBJ Staff.)

Studies that support improved performance referred to in Obinata (2012) include:

Healy, P.M., K.G.Palepu and R.S.Ruback (1992). Does Corporate Performance Improve after Mergers?, *Journal of Financial Economics*, 31(2): 135-175

Bruner, R.E.(2001). Does M&A Pay? A Survey of Evidence for the Decision-Maker, working paper, University of Virginia

Kallunki, J.-P., E. Pyykkoe and TI Laamanen (2009). Stock Market Valuation, Profitability and R&D Spending of the Firm: The Effect of Technology Mergers and Acquisitions, *Journal of Business Finance & Accounting*, 36(7-8): 838-862

Studies that do not support improved performance referred to in Obinata (2012) include:

Ghosh, A. (2001). Does Operating Performance Really Improve Following Corporate Acquisitions? *Journal of Corporate Finance*, 7(2): 151-178

Ma, Q., D.A.Whidbee and A.W.Zhang (2011). Value, Valuation, and the Long-run Performance of Merged Firms, *Journal of Corporate Finance*, 17(1): 1-17