Point of View

Recommendations on Accounting for Goodwill, issued by the International Organisation of Securities Commissions

January 2024

Foreword

In the aftermath of the financial crisis, easing of monetary policies provided financially strong companies with access to funding more easily and at a lower cost, which in turn allowed them to scale up their businesses and finance their merger and acquisition ("M&A") activities . As a result, there had been a significant surge in the carrying value of accumulated goodwill among major corporations across the world. This surge in goodwill has been particularly evident during active M&A periods, where acquisition prices tend to be higher.

As per the current global accounting standards, International Financial Reporting Standard ("IFRS") as well as US Generally Accepted Accounting Policies ("US GAAP"), goodwill is not amortized instead tested for impairment at least annually. However, concerns have emerged among stakeholders and regulatory authorities regarding the potential misuse of optimistic assumptions by management during impairment testing, possibly to downplay the impact of impairment losses on profitability.

This issue has led to the phenomenon known as "too little, too late," where impairment losses are only recognized when a company's financial performance significantly deteriorates. In some instances, the decline in performance may occur gradually, leading to "close call" scenarios where the excess of the recoverable amount over the carrying amount diminishes over time, triggering goodwill impairment recognition.

Considering the dynamic economic environment, it is imperative that management conducts a careful and objective assessment of the current economic landscape and is balanced in use of assumptions which are used for goodwill impairment assessment.

This Uniqus Point of View publication provides an overview of the existing challenges / expectation gaps and key considerations of the proposed amendments issued by the International Accounting Standards Board ('IASB').

In summary, maintaining a fair presentation of a company's financial position, performance, and cash flows is paramount for the benefit of investors. Addressing concerns related to goodwill accounting, both in terms of disclosure enhancements and improvements to impairment tests, is essential to ensure that financial reporting standards support transparent and accountable business practices.

We sincerely hope you find the enclosed publication informative, offering insights into the key concerns expressed by the stakeholders and regulatory bodies, as well as delving into nuances of the proposed amendments. We will be happy to engage in discussions and provide clarifications on our views enclosed in the attached publication. We look forward to hearing from you.

Thank you.

For Uniqus India Private Ltd.

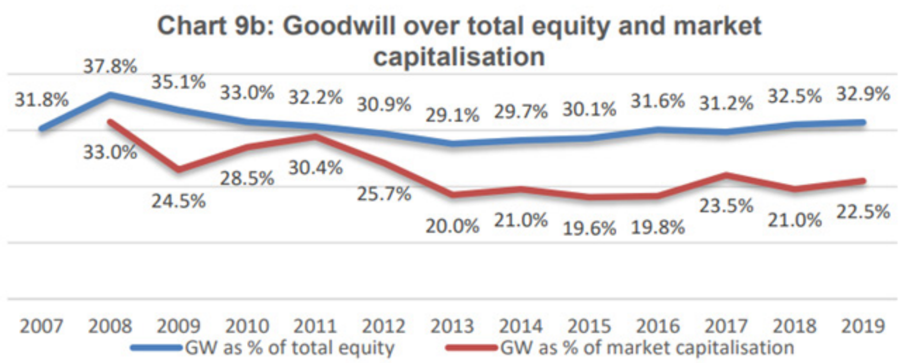
17 January, 2024

Sandip Khetan
Global Head of
Accounting & Reporting
Consulting

Overview

Goodwill is an asset arising from a business combination when a company obtains control over a business paying an acquisition purchase price that is greater than the value assigned to the identifiable net assets of the acquired business. Although it is recognized as an asset that represents future economic benefits arising from an acquisition, goodwill is not separable from other assets of the business unlike identifiable assets. Under IFRS, goodwill is not subject to amortization but is instead subject to an annual (or more frequent) impairment test when there are indications of potential impairment.

In the wake of the financial crisis, a noteworthy trend has emerged in the realm of corporate finance with an exponential growth of accumulated goodwill balances. Specifically, within the S&P 500, the total goodwill balance has more than doubled, soaring from USD 1.6 trillion in 2008 to USD 3.7 trillion in 2021. This surge is not exclusive to the United States, as a parallel pattern is evident in the European Union, where the total reported goodwill from 1,477 listed companies witnessed a nearly 50% increase, climbing from EUR 1.1 trillion in 2013 to EUR 1.6 trillion in 2019. This observation calls for a careful examination of the factors driving the persistent growth in goodwill, whether such balances align with the economic realities and whether these reported values are supportable.



[Source: Download (efrag.org)]

The matter has also been the focus area of regulators currently. Notably, the International Forum of Independent Audit Regulators ("IFIAR") and the European Securities and Markets Authority ("ESMA") are actively working to enhance the stringency of global and European practices, respectively. In the U.S., the Securities and Exchange Commission ("SEC") and the Public Company Accounting Oversight Board ("PCAOB") has remained steadfast in their focus on this critical and highly subjective accounting estimates.

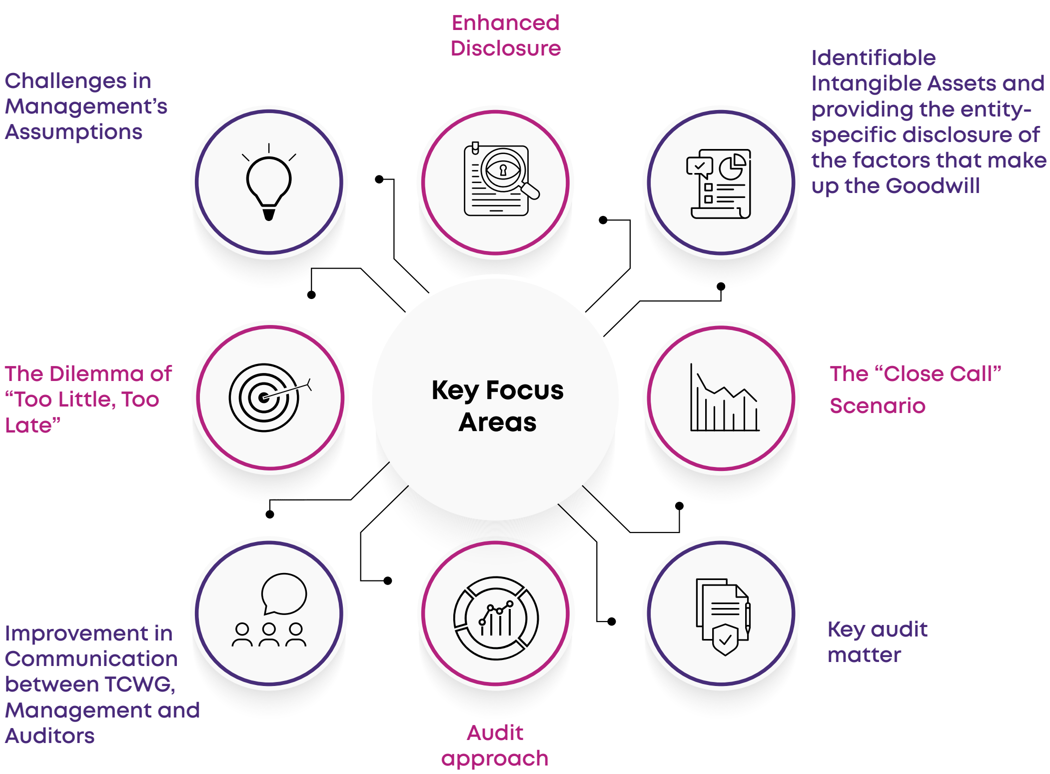
As the landscape of financial reporting evolves, addressing the challenges associated with goodwill impairment becomes imperative. By acknowledging and scrutinizing these concerns, stakeholders can contribute to fostering a more transparent and reliable reporting outcome.

Key Concerns

International Organization of Securities Commissions ("IOSCO"), being an international body that brings together securities regulators from around the world, collaborates with standard-setting bodies such as the IASB to promote consistency and transparency in financial reporting.

In addition to IASB's initiatives towards proposed amendments to IAS 36 and IFRS 3, there is a call for the IASB to explore opportunities to enhance the impairment tests themselves. IOSCO is actively monitoring how issuers, audit committees, and external auditors address the challenge of "too little, too late." Moreover, it is crucial for the IASB to consider how anticipated changes in standards will address and mitigate this problem.

Under IFRS, goodwill impairment occurs when the recoverable amount of a cash-generating unit (CGU) or a group of CGUs, to which goodwill is allocated, falls below its' carrying amount. The recoverable amount is determined as higher of the fair value less costs of disposal and its value in use. However, the intricacies lie in the inherent subjectivity of these assessments, relying heavily on significant management judgments and estimates.



Let's delve into some of the key focus areas voiced by the stakeholders and regulators regarding the recognition, measurement, and impairment assessment of Goodwill.

Identifiable Intangible Assets and providing the entity-specific disclosure

A significant portion of the consideration paid is reflected as goodwill, suggesting the possibility that not all distinct intangible assets were adequately identified and/or measured. Investors need disclosure of these assets to fully understand the nature of the acquisition and to better understand the subsequent performance of the acquisition.

While Paragraph B64(e) of IFRS 3 requires a qualitative description of the factors that make up the goodwill recognised, such as expected synergies from operational integration, intangible assets that do not qualify for separate recognition and other relevant factors, it has been noted through surveys that entities presently refrain from disclosing aforementioned entity-specific information. The information disclosed currently by most entities on the initial recognition of goodwill and the subsequent impairment tests of goodwill is boilerplate and does not include entity-specific information.

Challenges in Management's Assumptions

Some of the key challenges expected are:

- Risk associated with management adopting optimistic assumptions during the estimation of the recoverable amount driven by a reluctance to acknowledge impairment losses that could adversely impact profitability or alternatively, "shielding" created by other operations in same CGU which generate internal goodwill that is unrecognized.
- IFRS necessitate issuers to place greater weight on external evidence when establishing assumptions. Reporting entities may encounter limitations in accessing such external evidence—such as industry data, peer data, or investors' analyses to substantiate key assumptions.
- Adequacy of internal controls over the goodwill impairment process. For example, management's failure to assess whether forecasts were appropriately adjusted for potential risks.
- Disparities between statements in the management commentary and the assumptions used in goodwill impairment tests. For example, assumptions about the potential effect of sustainability risk (e.g., climate risk), economic trends and uncertainties, or potential changes in regulatory requirements.

The Dilemma of "Too Little, Too Late"

From the viewpoint of investor protection, it is crucial that financial reports fairly represent the financial position, performance and cash flows of an reporting entity.

Referred to as "too little, too late," the delayed recognition of impairment losses underscores the presence of "hidden losses" within goodwill. These losses remain concealed until a significant decline in profitability or cash flows occurs, despite earlier indications of diminishing expectations for future performance. This phenomenon calls attention to the need for a more proactive approach to identify and address potential impairments.

The "Close Call" Scenario

Further complexity arises in situations termed as a "close call," where a company's performance is on a declining trajectory, yet the recoverable amount still exceeds the carrying amount of a CGU or a group of CGUs. Investors should receive information that allows them to better understand whether any of the issuer's goodwill is "at risk" of impairment in the near term i.e., where there is a close call, but management has determined that goodwill is not impaired as of the financial statement date.

This nuanced scenario prompts a critical examination of the adequacy of the current accounting framework and related disclosures.

Enhanced Disclosure

As the securities regulators and market participants advocate for enhanced disclosure practices, the disclosure of key assumptions in goodwill impairment assessments stands out as a key area for improvement. One of the IOSCO principles for the listed companies is that there should be full, accurate and timely disclosure of financial results, risk and other information that is material to investors' decisions such as:

- How key assumptions are determined, including whether such assumptions that reflect past experience or external sources of information?
- If it differs, how and why it differs from past experience or external sources of information?
- Reasonably possible changes in a key assumption that could cause a subsequent impairment.

Regulators also commented on lack of sensitivity analysis provided even when a reasonably possible change in the key assumptions on which management based its determination of the recoverable amount would cause the carrying amount to exceed the recoverable amount.

Improvement in Communication between those charged with governance ("TCWG"), Management and Auditors

Interaction between Audit committees (or TCWG) and external auditors needs enhancement with respect to goodwill impairment tests. TCWG's involvement should encompass:

- Gaining insight into time, skills and resources employed by external auditors to evaluate the adequacy of goodwill impairment tests conducted by management's;
- Establishing an internal process to identify important issues and understand the basis for external auditors' conclusions about whether the goodwill impairment tests are conducted in a timely manner; and
- Discuss critical judgements and estimates made in relation to goodwill impairment tests with the external auditor and whether there was consistency between the assumptions and those used in other accounting estimates.

There is need to strengthen the internal audit and control process and institute programmes that allows for regular testing to identify and recognise impairment of goodwill.

Audit approach and Key audit matter

- Stakeholders assert that external auditors should exhibit a more robust approach in challenging management's assumptions and disclosures. Auditors should carefully question and scrutinize these assumptions, drawing on their industry knowledge of comparable asset impairments and valuations.
- Lack of specificities in the descriptions of Key Audit Matters as to why the matter was one of the most significant areas in the audit and how the matter was addressed in the audit. Members noted that key audit matters are frequently reported in a boilerplate manner.

IASB Initiatives in Response to Stakeholder Concerns

In March 2020, the IASB issued the Discussion Paper Business Combination – Disclosures, Goodwill and Impairment (the Discussion Paper) which outlined issues identified through the Post-Implementation Review of IFRS 3 Business Combinations (PIR of IFRS 3) and provided the IASB's preliminary views on how to address these issues.

IASB is in process of developing an exposure draft that would propose amendments to IFRS 3 and IAS 36.

Glance at key considerations by the IASB

	Implementation matters	Key considerations by IASB
01	Disclosure objectives and requirements in IFRS 3	Aim to improve the information provided to investors about an acquisition and its subsequent performance
02	Impairment test	The IASB is exploring improvements to and simplification of the impairment test as discussed by the IASB
03	Amortisation of goodwill	Amortisation of goodwill should not be reintroduced and decided to retain the impairment-only approach to accounting for goodwill
04	Future uncommitted restructuring - cash flow projections	Proposals/comments would be explored to reduce complexity of the impairment test by removing the restriction on including cash flows from a future uncommitted restructuring

Feedback and Recommendations

The IOSCO has published feedback from stakeholders and recommendations for standard setters that will be useful as they pursue initiatives to enhance business combination disclosures and related matters of impairment testing.

Identifiable Intangible Assets and providing the entity-specific disclosure

To address the concern of recognition of all identifiable intangible assets and providing entity-specific disclosure on business combination, the IOSCO has recommended that:

- Disclosure to satisfy the requirement to disclose a qualitative description of the factors that make up the goodwill.
- Decision-useful information regarding the specific benefits that a company expects from acquisition.

Challenges in Management's Assumptions

In response to the challenges encountered in management assumptions, the IOSCO has put forth the following key recommendations:

Disclosure

Adequate disclosure for understanding of users of financial statements

Monitoring of Synergies

Close monitoring of synergies (both revenue and cost) by management and TCWG

Budget vs Actual

Close monitoring of budgeted versus actual results by management and TCWG

External Experts

To determine/ validate complex assumptions like fair value of non-listed entities, significant impairment triggers, significant negative changes in macro- economic factors and unobservable inputs used

Corroboration

Use of assumptions that are corroborated by reliable external sources

Robust Governance Processes and Controls

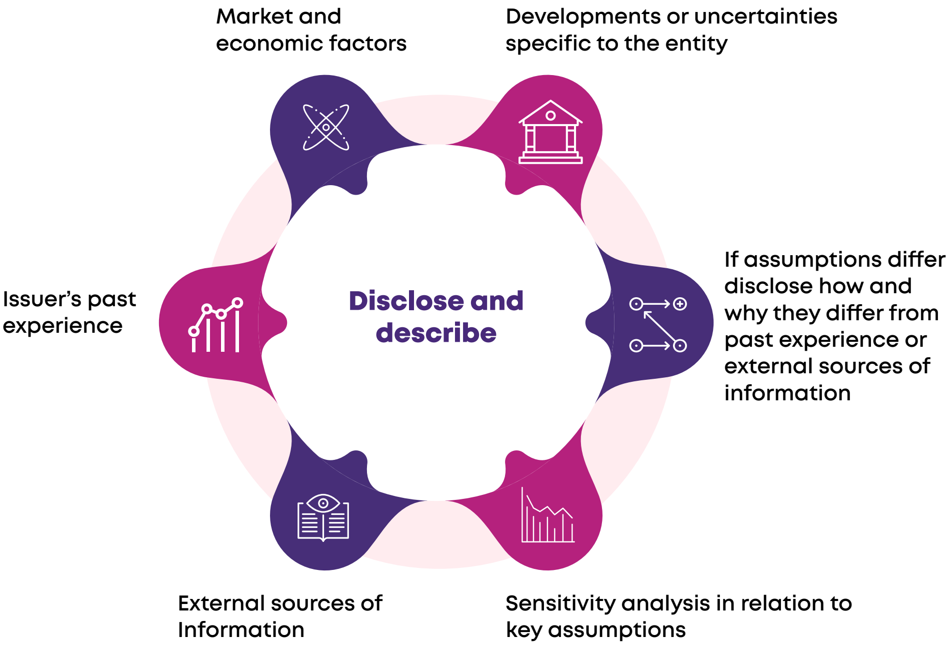
Focus on the material assumptions used in the goodwill impairment testing, including an appropriate level of involvement of the audit committee or TCWG

Clear Documentation

- Processes and controls
- Rationale behind key judgements
- Identification of significant assumptions within the estimates
- Estimation uncertainty like sensitivity
- Consideration of multiple data sources

Addressing the Dilemma of "Too Little, Too Late" and the "Close call" Scenario through enhanced disclosures

The IOSCO has recommended that issuers should clearly disclose impairment tests of a CGU or a group of CGUs to which goodwill is allocated, including how key assumptions are determined.



Recommended good practises by the IOSCO include disclosure of:

- The percentage by which the fair value or the value in use exceeds the carrying amount of a CGU or a group of CGUs.
- A discussion of the degree of uncertainty associated with the key assumptions. The discussion regarding uncertainty should provide entity-specific considerations and conditions to the greatest extent possible (e.g., uncertainty regarding assumptions within a valuation model that may involve future expectations for economic recovery from a business downturn that may have uncertain time horizons).
- Potential events and/or changes in circumstances that could reasonably be expected to negatively affect the key assumptions.

Improvement in Communication between TCWG, Management and Auditors

The IOSCO believes that Audit committees (or TCWG) should exercise effective governance over goodwill impairment tests, by implementing practices in the IOSCO Report on Good Practices for Audit Committees in Supporting Audit Quality and recommended certain chapters of the report. Furthermore, the IOSCO has recommended sample questions from Audit committees (or TCWG) to management/external auditors, aiming to facilitate more effective communication.

Audit approach and Key audit matter

Validating Reasonable and Supportable Assumptions

External auditors should adequately challenge management on their determination of reasonable and supportable assumptions used in impairment tests in accordance with the applicable financial reporting standards. The IOSCO requires external auditors to exercise an appropriate level of professional scepticism.

As a good practice, the IOSCO recommends following work should be performed to maintain and demonstrate professional scepticism when auditing management's estimates used in goodwill impairment tests:

01 Assessing management's assumptions by comparing them to reliable external sources or benchmarks such as industry reports or economic forecasts

02 Performing stress tests based on market-based information or "shadow calculations"

03 Performing independent sensitivity or scenario analyses

04 Engaging with external auditors' experts to support the audit of complex assumptions

05 Comparing past projections with actual results to identify patterns of overly optimistic assumptions

06 Testing whether the forecasts used for goodwill testing are consistent with other forecasts applied by management. Documenting contradictory evidence if it exists

07 Reporting the results of procedures to the audit committee or TCWG

Key audit matter

When reporting a key audit matter, the language employed should reflect the entity's specific circumstances, steering clear of generic or standardized language.

In the context of the key audit matter associated with goodwill impairment tests, an auditor should consider on whether to emphasize the disclosure of key assumptions, the disclosure of the range of possible outcomes and additional qualitative and quantitative disclosures linked to key sources of estimation uncertainty or critical accounting estimates. This is essential in elucidating why the matter was one of the most significance in the audit and how the matter was addressed in the audit.

Uniqus Point of View

Embracing a commitment to transparency not only aligns with regulatory principles but also serves to empower investors with the information necessary for prudent decision-making in the dynamic landscape of financial markets. This could help investors to more effectively hold management to account for its acquisition and subsequent reporting decisions. Providing greater transparency and improved disclosures regarding the following aspects would be beneficial for investors and other stakeholders:

- **Initial Recognition -** On initial recognition disclose how the acquired business is (or is not) incorporated into the existing business; how the results of performance and cash flows of the acquired business are included in each operating segment or CGU of the acquirer; and the future cash flows (including synergies), weighted average cost of capital (WACC) and growth rates for each business segment or CGU as assumed at the time of the acquisition.
- **Subsequent Assessment -** For periods subsequent to the acquisition, disclose aforementioned information to help investors confirm the subsequent performance of the business combination and identify the indication of goodwill impairment.
- **Valuation Models and Related Estimates and Assumptions –** Granular disclosures on the valuation models employed along with greater transparency on the related inputs and outputs.
- **Sensitivity analysis -** Information regarding the sensitivity to change of the significant estimates and assumptions.
- **Performance of Acquisitions -** Quantitative information on how an acquisition performs including TCWG's assessment, and disclosure of the key common performance metrics that management is using to monitor the performance of the acquisition.

While financial statement users would benefit from the disclosure of entity-specific factors that make up the goodwill recognized in a business combination and subsequent changes to these factors, reporting entities may face challenges in empirically identifying and verifying the items and amounts of synergies within the combined business. Additionally, information regarding goodwill is often commercially sensitive and the potential public disclosure of such details may, in some cases, lead to competitive disadvantages for the reporting entity.

Conversely, disclosing information about the performance of an acquisition might be more effectively addressed as a mandated aspect of management disclosure as disclosure in financial statements would pose challenges in the context of its acceptability under the existing accounting standards.

The publication of the IOSCO's recommendations on accounting for goodwill marks a significant development in the ongoing effort to refine financial reporting standards and is a step toward achieving greater transparency and reliability in financial reporting along with benefiting the global investment community.

In conclusion, the success of these recommendations lies not only in their theoretical soundness but also in their practical applicability. Achieving an equilibrium between the potential risks of boilerplate disclosure against divulging sensitive information poses a delicate challenge for standard setters, requiring careful navigation of the fine line between providing meaningful insights for financial statement users and safeguarding sensitive information of reporting entities.

A TEAM THAT
YOU CAN TRUST TO DELIVER

Sandip Khetan
Co-Founder, Global Head of ARC
sandip.khetan@uniqus.com

Avinash Ramkumar
Partner, ARC
avinash@uniqus.com

Huy Tran
Partner, ARC
huytran@uniqus.com

Sagar Lakhani
Partner, ARC
sagarlakhani@uniqus.com

Sharad Chaudhry
Partner, ARC
schaudhry@uniqus.com

Shashikant Shenoy
Partner, ARC
sshenoy@uniqus.com

Venkateswaran Narayanan
Partner, ARC
vn@uniqus.com

Karan Chopra
Associate Partner, ARC
karanchopra@uniqus.com

Purvi Shah
Director, ARC
purvishah@uniqus.com

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