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Comments on Consultation on Goodwill

1. The Accounting Standards Board of Japan (the “ASBJ” or we) are pleased to provide our comments on *Consultation on Goodwill* (hereinafter referred to as “the Consultation Paper”). The ASBJ is a private-sector organisation that develops accounting standards to be authorised by the Financial Services Agency, the Japanese securities regulator, as part of Japanese generally accepted accounting principles (GAAP).
2. In this comment letter, we would like to comment on Question 1 of the Consultation Paper. We share the concern in the Consultation Paper that the balance of goodwill has accumulated over the years. We conducted quantitative surveys of the balance of goodwill twice in our Research Papers in 2016 and in 2020¹. We observed the trend of steady increase in the amount of goodwill from before the global financial crisis. As indicated in the Consultation Paper, we think that it is likely that the “too little, too late” issue exists under the existing impairment-only approach, that is, expense related to goodwill has not been recognised in a timely manner and the amount of expense has been insufficient. We are concerned that this accumulating balance of goodwill would undermine the usefulness of information provided in the financial statements, in particular in the statement of financial position. During the period of Covid-19 Pandemic, the accumulation of goodwill may have stopped or the

¹ Research Paper No. 2, *Quantitative Study on Goodwill and Impairment*
<https://www.asb.or.jp/en/discussions/papers/2016-1003.html>
Research Paper, *Goodwill: Improvements to Subsequent Accounting and an Update of the Quantitative Study*
<https://www.asb.or.jp/en/discussions/papers/2020-0324.html>

balance may have decreased, but the balance may grow again as the economy recovers from the Pandemic.

3. The impairment-only approach for the subsequent accounting for goodwill is currently adopted in IFRS Accounting Standards and U.S. GAAP. Goodwill is not subject to amortisation but is instead subject to an annual (or when there are indications of potential impairment, a more frequent) impairment test. In its Discussion Paper *Business Combinations-Disclosures, Goodwill and Impairment* published in 2020, the International Accounting Standards Board (IASB) has identified two reasons for its concerns about the possible delay in recognising impairment losses on goodwill: management over-optimism and shielding. Similar to the description in the Consultation Paper, stakeholders tend to focus on the optimistic estimate made by management, but the ASBJ believes that the main reason is the accounting mechanics that leads to shielding. The IASB acknowledged that the existing impairment-only approach may give rise to shielding when it initially developed IFRS 3 *Business Combinations*, but after many years of application, the shielding has proved to be more problematic than it was initially expected. For example, under the impairment-only model, the carrying amount of goodwill could be considered recoverable, even when the acquisition fails to meet its initial expectations because of the headroom created by the acquirer within the same cash-generating unit. Therefore, the ASBJ thinks that it is inappropriate to maintain the existing approach and that the amortisation of goodwill should be reintroduced.
4. We believe that goodwill should be amortised and be subject to impairment. Our primary reasons are:
 - (a) Goodwill constitutes the cost paid to acquire the assets and liabilities of the acquiree in a business combination. Because the acquirer's profit after the business combination should be viewed as the excess recovered beyond the cost invested, goodwill should be amortised from the viewpoint of appropriately recognising in each period the income and the corresponding cost of the investment.

- (b) Assuming that certain portions of goodwill represent excess earning power, the value of such power normally diminishes due to the competitive environment. Non-amortisation of goodwill neglects to account for such phenomenon.
- (c) An entity should generally be able to estimate the useful life of goodwill because an acquirer typically decides to undertake the acquisition after diligent analysis of the acquiree. In addition, although some may argue that the pattern in which goodwill diminishes cannot be predicted reasonably, it would be more reasonable to amortise goodwill on a systematic basis over a certain period rather than adopting an approach that may not recognise the decrease in the value of goodwill at all in certain periods. Furthermore, the difficulty in estimating the useful life or the pattern of amortisation or depreciation exists not only in accounting for goodwill, but also in accounting for tangible fixed assets. In fact, determining the useful life of a tangible fixed asset requires the consideration of many factors, including the expected physical wear as well as technical obsolescence arising from changes or improvements in production. Moreover, the determination of the depreciation method also requires an entity to reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity.
- (d) Paragraph 1.7 of the *Conceptual Framework for Financial Reporting* issued by the IASB states that general purpose financial reports are not designed to show the value of a reporting entity, which implies that the recognition of internally generated goodwill is not relevant for general purpose financial reporting (See paragraph 5(a) of this comment letter).
- (e) The impairment test for goodwill cannot be considered a substitute for the amortisation of goodwill because they differ in their objectives in that the amortisation of goodwill focuses on the periodical allocation of costs whereas the impairment test of goodwill focuses on recoverable amounts. In addition, because the recoverable amount would inevitably include the value of internally generated goodwill arising after the business combination, impairment tests would sometimes fail to represent the decrease in the value of goodwill originally acquired in a business combination.

5. We are aware that there are criticisms against the amortisation of goodwill. Regarding our views to these criticisms, we emphasise the following points:

- (a) Regarding the criticism that it is questionable whether goodwill is always a wasting asset with a finite useful life

We do not think that goodwill continues to have effect indefinitely because the sources of competitive advantages in the market that are represented by goodwill erode in their effects over time, assuming there is healthy competition and that improvements and adjustments to the knowledge and the processes that generate the entity's future returns would be needed as the surrounding environment changes and the workforce is replaced. In our view, acquired goodwill and goodwill internally generated from the reinvestment of cash flows produced subsequently are separate items.

- (b) Regarding the criticism that the useful life and amortisation pattern of goodwill generally cannot be predicted and that straight-line amortisation of goodwill over an arbitrary period fails to provide useful information

We think that the difficulty in predicting the useful life or the pattern of amortisation is not limited to goodwill – it also applies to other assets that should be depreciated or amortised. In addition, we think that it is possible to estimate the useful life of goodwill because, whenever an entity acquires a business, such an entity usually collects various types of information and conducts sufficient analyses before making the decision to acquire that business.

- (c) Regarding the criticism that users of financial statements would add back the amortisation expense because the amortisation expense would not help them assess performance

The survey of Japanese analysts' views we conducted in 2017² revealed that the method of analyses varied among analysts and that there were some analysts who focused on both cash flow information and accounting profit information. It follows that users of financial statements may use information about amortisation depending on the objective of their analyses and thus it cannot

² Research Paper No. 3, *Analyst Views on Financial Information Regarding Goodwill*
<https://www.asb.or.jp/en/discussions/papers/2017-0612.html>

simply be concluded that information about amortisation is unnecessary because analysts focus on cash flows. In addition, users of financial statements who added back amortisation expense also added back impairment losses, both of which are non-cash expenses. The fact that users of financial statements added back amortisation in itself neither indicates the superiority of the impairment-only approach nor the inferiority of the amortisation with impairment approach. Considering that those users of financial statements can adjust the amortisation expense without incurring significant costs, we think that a larger number of users of financial statements would benefit from the amortisation with impairment approach that would enhance the relevance of financial information. Under this approach, the financial performance for each period includes the amortisation expense of goodwill, and management would be held accountable for the acquisition in light of this financial performance.

6. We acknowledge the discussion that resulted in the tentative decision that would retain the impairment-only approach at the IASB meeting in November 2022 described in the Consultation Paper. Our understanding is that the IASB concluded as to whether there is a compelling case for change from the existing impairment-only approach to the amortisation with impairment approach, and not about which approach is superior. Although current efforts made by the IASB such as the potential improvements in the disclosures and in the impairment requirements may result in more relevant information, these efforts will have limited effects on mitigating shielding and, accordingly, we think that it is unlikely that they will directly help resolve the “too little, too late” issue. Accordingly, we continue to think that it is necessary to consider the reintroduction of the amortisation with impairment approach.

We expect that our comment will contribute to the objectives of the Consultation Paper and future discussion in this area.

Yours sincerely,

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Yasunobu Kawanishi
Chair
Accounting Standards Board of Japan