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Dear Mr Marshall,

On behalf of the Austrian Financial Reporting and Auditing Committee (AFRAC), the privately organised standard-setting body for financial reporting and auditing standards in Austria, we appreciate the opportunity to comment on the joint ASBJ, EFRAG, and OIC Discussion Paper (DP) *Should goodwill still not be amortised? Accounting and disclosure for goodwill*.

Principal authors of this comment letter were Max Eibensteiner, Klemens Eiter, Erich Kandler, Alfred Wagenhofer, and Christian Gross. In order to provide a balanced Austrian view on the DP, the professional background of these authors is diverse (two auditors, one preparer, and two academics).

General remarks and Summary

We welcome the efforts of ASBJ, EFRAG, and OIC to discuss the merits of different accounting treatments of goodwill. What is the 'right' accounting method to portray goodwill in financial reports has been heavily debated amongst accounting professionals, preparers, and academics for decades. We take it that the aim of the DP is to summarise this long-lasting debate and agree to major conclusions. This discussion also provides important input into the post-implementation review of IFRS 3 undertaken by the IASB.

AFRAC recognises that goodwill is – due its residual nature – a very special asset. Nevertheless, it is an asset and we agree with the DP that goodwill satisfies the criteria for an asset under the current Framework (and under the proposed Conceptual Framework) of the IASB. The same special nature of goodwill warrants an accounting treatment that differs from the treatment of other intangible assets. While we believe that in general most intangible assets have a definite useful life, we acknowledge that it may be difficult to determine. We can imagine that there are circumstances in which goodwill has a very long useful life. In other circumstances, a relatively short useful life may be justified. Despite the large variation in useful lives of goodwill in practice, we believe that the standard accounting treatment for goodwill should hold for the majority of cases. However, exceptions for special cases should be possible.

We agree with the DP that goodwill should be amortised in a systematic way. When it comes to the factors that should determine the length of the amortisation period, we agree with the criteria in paragraph 84(c) of the DP: the expected period in which the acquirer expects to earn excess return over the theoretical case of a standalone business; the expected payback period of the investment on a business combination; and the useful life of the primary asset (or the weighted-average useful life of a group of assets).

We differ from the DP in thinking that a standard setter should explore the possibility of stating a range of useful lives (a 'corridor') that suits most situations in which goodwill arises. This corridor should span a period from, say, five to 20 years. The purpose of such a corridor of useful lives should serve as a rebuttable presumption from which entities can deviate if their situation is special. In such a case, they should be required to explain and substantiate the selection of a shorter or a longer useful life with specific facts in the notes. However, an indefinite useful life should be prohibited. An immediate impairment, on the other hand, could reasonably be required in case the value of the acquired entity declines between the signing and the closing date.

When it comes to impairment tests for goodwill, we suggest linking the required proceedings to the general corridor of useful lives that we propose. When a preparer uses an amortisation period that lies within the general range, impairment tests will only be required when triggering events occur. When a preparer selects a useful life that is longer than the maximum threshold of the corridor, an annual impairment test (similar to the one that is currently prescribed by IAS 36) should be required.

FURTHER AREAS WORTH REVISITING

In addition to this fundamental issue examined in the DP, we have further suggestions for related topics that could be revisited:

- We have noticed that in the integration phase, i.e., the first few years after an acquisition, the expected benefits of an acquisition in cost-benefit terms seldom arise immediately, because additional expenditures are often required. Standard setters could therefore usefully discuss whether (and under which conditions) such additional expenditures (such as integration expenses) incurred after the date of acquisition but closely related to it could be capitalised as subsequent costs of acquisition if they are expected to give rise to future benefits stemming from the acquisition.
- Accounting for badwill, a topic that is inevitably linked to goodwill and is currently not dealt with in the DP, should be revisited in the light of the discussion in the DP, as several considerations with respect to goodwill may also affect the treatment of badwill.
- It would also be useful to discuss how a transition from the current impairment-only (IFRS 3) to a mandatory amortisation approach for goodwill could work.
- Finally, in the Appendix we list three academic research papers that reveal the scope for earnings management under the impairment-only approach and provide evidence that the approach is indeed used for this purpose.

SPECIFIC REMARKS

1. Do you agree that there should be a requirement to recognise goodwill as an asset and amortise it over subsequent periods? If so, do you support amortisation because:

(a) goodwill existing at acquisition date is consumed and replaced with internally generated goodwill over time, thus it should be allocated to subsequent periods as part of the cost of acquiring an entity;

(b) an impairment-only model is not sufficiently reliable due to the large use of assumptions in the impairment test (future cash flows, terminal growth rate and discount rate); or

(c) amortisation of goodwill, in addition to the impairment test, achieves an appropriate cost-benefit balance.

Yes, we agree that goodwill should be recognised and regularly amortised over time and an impairment test should be required only if there is an indicator for impairment (as specified in IAS 36.12 *et seqq.*).

We think that this accounting treatment better reflects economic reality, where the benefits of an acquisition over and above the benefits that could have been internally generated last only for a limited period of time. In cases where a potential acquirer decided not to engage in an acquisition but to set up a new business or expand an existing one, similar benefits to the acquired ones could be internally generated. This organic growth would require more time than the acquisition. After this time has passed, however, the two cases – acquisition and organic growth – could lead to very similar outcomes. Thus, without regular goodwill amortisation, comparability between similar businesses would be hampered. This argument is similar to the one provided under (a) above.

We also think that argument (c) is an important one. An impairment-only approach is costly, as – with acquired goodwill being one of the major intangible assets that is currently not amortised – it triggers an annual impairment test. An argument in favour of regular goodwill amortisation is that it lessens the need for goodwill impairments that are not only costly to the entities but also subject to errors (which means that (b) can also be considered a valid argument). Moreover, the major potential benefit of the impairment-only approach for goodwill amortisation is questionable. Even though goodwill impairment potentially acts as an early warning signal of an unfavourable situation, analysts and investors often claim that these impairments are not timely enough. With this informational benefit in doubt, goodwill impairment often only worsens the reported earnings of entities that are already experiencing losses, which results in a pro-cyclical effect from the impairment of goodwill as a non-recurring item.

The regular amortisation of goodwill can mitigate or prevent accounting arbitrage in the purchase price allocation, as preparers might otherwise have an incentive to leave as many items in the residual goodwill position as possible to avoid amortisation, which is usually

required for other intangibles. With a regular goodwill amortisation requirement, this incentive would be reduced or disappear (depending on the useful life determined for goodwill), and the results of the purchase price allocation would probably be more meaningful.

Reintroduction of goodwill amortisation reduces another potential incentive for managers: they should be less tempted to prefer growth via acquisitions to organic growth. If goodwill is not amortised increases in revenue due to acquired synergies would not be matched with corresponding costs in profit or loss. The absence of regular goodwill amortisation would therefore increase reported operating profits compared to a similar situation under organic growth.

Although we are in favour of goodwill amortisation, we are aware that an approach that allows for both definite and indefinite useful life of goodwill under appropriate circumstances also has conceptual merits. The major advantage of such a 'mixed' approach would lie in improving financial statement comparability. Due to its residual nature goodwill can be composed of different components (as noted in the DP). A treatment that does not account for these differences could make dissimilar things look alike. If, e.g., one entity's goodwill mainly consists of the value of the employees, while another entity's goodwill mainly consists of a brand asset, comparability will decrease if both are required or neither is allowed to amortise goodwill.

2. Assuming that there was a requirement to amortise goodwill, do you think that the IASB should:

(a) indicate what the amortisation period should be?

(b) indicate a maximum amortisation period?

(c) provide guidance on how entities should assess the amortisation period (for instance, by referring to the expected payback period or the useful life of the primary asset)?

(d) allow entities to elect the amortisation period that they consider appropriate?

Providing flexibility in determining the amortisation period is key to reflecting different economic realities in financial reporting. If the allowable amortisation periods are too constrained by a standard, in particular if a fixed maximum useful life is mandated, comparability may decrease, as firms with different economic realities would be forced to report in the same way. Similar things would certainly look more alike, but so too would dissimilar things. For the determination of the amortisation period, we agree with the factors in paragraph 84(c) of the DP.

As mentioned in our general remarks above, we suggest introducing a corridor as a rebuttable presumption of 'normal' useful lives for goodwill. If an entity wishes to select a useful life outside the corridor, it should be required to explain and substantiate the selection of a shorter or a longer useful life with specific facts in the notes. These explanations should

then be grounded on specific circumstances as well as management intentions with respect to the expected useful life. As the expected value of acquisitions is generally calculated at the time of acquisition, the assumptions in these valuations could be crucial to justifications for deviations from the standard range. Though we suggest permitting deviations from the standard range, we would still prohibit immediate write-offs of goodwill as well as goodwill positions with indefinite useful lives.

Also, if an entity selects a useful life for goodwill that is higher than the maximum threshold of the corridor, it should be required to make an annual impairment test.

3. The DP suggests the need for improved guidance in a number of areas in IAS 36. Do you think that the IASB should improve and/or provide additional guidance in relation to:

(a) the methods to determine the recoverable amount of the goodwill;

(b) the application of the value-in-use method;

(c) the identification of cash-generating units and allocation of goodwill to each unit; and

(d) the choice of the discount rate.

If not, please indicate why. Please state any specific suggestions for improvements if you have.

Although it might be worthwhile to consider potential shortcomings of the existing model for goodwill impairment in IAS 36, we think that this should be a separate exercise from the question as to whether a regular amortisation of goodwill is appropriate.

IAS 36 is a standard that is conceptually appealing but – due to its heavy reliance on forward-looking information requiring estimates – hard to apply in practice. Goodwill impairments pose a particular challenge to preparers and auditors of financial statements, which is reflected in the survey results cited in the DP. Hence, we would welcome additional guidance in most of the areas mentioned above, especially on estimates that are needed to compute the value in use and on the allocation of goodwill to different CGUs.

A specific issue that we would like to see clarified is the discount rate calculation in IAS 36. We observe that in practice many firms use the weighted average cost of capital (after tax) and rely on a peer group to estimate this cost of capital. However, IAS 36 specifies the pre-tax discount rate and an estimate of the value in use to the entity. In our opinion, developments in applying IAS 36 have led to a blurring of the line between fair value and value in use. Clarification of this and other issues would be welcome (e.g., in the IASB research project on discount rates).

4. The DP suggests a number of possible new disclosures about impairment testing for

goodwill. Do you think that the IASB should consider improving requirements to:

(a) assist users in understanding the robustness of the modelling and the entity's current assumptions;

(b) provide confirmation of the 'reasonableness' of the entity's past assumptions; and

(c) assist users in predicting future impairment.

We agree with paragraph 131 of the DP that it is imperative to avoid unnecessary disclosures. Thus, existing disclosures in IAS 36 and IFRS 3 should be reviewed with respect to their usefulness. The same holds true in general for the newly proposed disclosures in the DP. We feel that current disclosures on impairment are already too extensive, and adding further disclosures is not the way to improve the situation. This is in line with the current disclosure framework discussions.

From the disclosure proposals set out in the DP, we find the ones related to the robustness of an entity's modelling decisions (particularly the ones related to the computation of the value in use) potentially helpful, as they convey the assumptions underlying estimates to users of financial statements. However, we do not find disclosures aimed at assisting users to predict future impairments particularly useful, as most of them remain speculative and are linked to questionable reporting incentives for preparers.

5. IAS 38 requires that intangible assets with indefinite useful lives are not amortised but tested for impairment at least annually. Assuming that there was a requirement to amortise the goodwill, do you think that the same requirement should be extended to other intangible assets with indefinite useful lives? In addition, assuming that there was a requirement to amortise goodwill, do you think that the current requirements of identifying intangible assets separately from goodwill should be reconsidered? If so, how?

We maintain that goodwill is, due to its residual nature, different from other intangible assets. So we do not think that the subsequent measurement of intangible assets with an indefinite useful life needs to be changed if goodwill amortisation is reintroduced.

Kind regards,

Romuald Bertl

Chairman

APPENDIX: Interesting academic studies on the topic that are not currently cited in the DP

Beatty, A., and J. Weber (2006): Accounting discretion in fair value estimates: An examination of SFAS 142 goodwill impairments, Journal of Accounting Research 44, 257–288.

Abstract: This study examines Statement of Financial Accounting Standards 142 adoption decisions, focusing on the trade-off between recording certain current goodwill impairment charges below the line and uncertain future impairment charges included in income from continuing operations. We examine several potentially important economic incentives that firms face when making this accounting choice. We find evidence suggesting that firms' equity market concerns affect their preference for above-the-line vs. below-the-line accounting treatment, and firms' debt contracting, bonus, turnover, and exchange delisting incentives affect their decisions to accelerate or delay expense recognition. Our study contributes to the accounting choice literature by examining managers' use of discretion when adopting a mandatory accounting change and by developing and testing explicit cross-sectional hypotheses of the determinants of firms' preferences for immediate below-the-line versus delayed above-the-line expense recognition.

Henning, S. L., Lewis, B. L., and W. H. Shaw (2000): Valuation of the Components of Purchased Goodwill, Journal of Accounting Research 38, 375–386.

First paragraph of introduction: This paper examines whether investors distinguish among identifiable components of goodwill for valuation purposes, in the year of acquisition. Similar to Barth, Beaver, and Landsman's [1992] analysis of the value relevance of the components of pension expenses under Statement of Financial Accounting Standards No. 87, we use contemporaneous stock price and returns regressions to examine investors' valuation of the components of goodwill and their amortizations. Although current accounting practice does not require firms to disclose components of goodwill – Accounting Principles Board Opinion No. 16: Accounting for Business Combinations [1970] requires firms to record only the total excess of the purchase price over the fair value of identifiable assets and to amortize this asset over a period not to exceed 40 years – market participants can readily calculate goodwill components from publicly available data.

Ramanna, K., and R.L. Watts (2012): Evidence on the use of unverifiable estimates in required goodwill impairment, Review of Accounting Studies 17, 749–780.

Abstract: SFAS 142 requires managers to estimate the current fair value of goodwill to determine goodwill write-offs. In promulgating the standard, the FASB predicted that managers will, on average, use the fair-value estimates to convey private information on future cash flows. The current fair value of goodwill is unverifiable because it depends in part on management's future actions (including managers' conceptualization and implementation of firm strategy). Agency theory predicts managers will, on average, use the unverifiable discretion in SFAS 142 consistent with private incentives. We test these hypotheses in a sample of firms with market indications of goodwill impairment. Our evidence, while consistent with some agency-theory based predictions, does not confirm the private information hypothesis.