Keidanren
Policy & Action

Summary of Results of Questionnaire Survey on Goodwill Accounting

Subcommittee on Corporate Accounting
Committee on Finance and Accounting
Keidanren

Survey Background

✓The acquirer of M&As shall recognize "goodwill" measured as the excess of the paid amount over the fair value of the identifiable assets acquired and the liabilities assumed.

✓Japanese GAAP requires that goodwill is amortized over time within 20 years and is impaired when the value of goodwill is diminished at a faster speed than what is originally expected.

On the other hand, IFRS and US GAAP require the acquirer of M&As shall test for impairment annually, without regular amortization.

✓Keidanren has repeatedly called on the IASB and FASB to reintroduce goodwill amortization, because we believe that goodwill amortization would enable companies to accurately assess financial performance subsequent to M&As and to well discipline corporate management.

✓Keidanren asked the member companies for response to a survey on the accounting for goodwill (including whether to amortize goodwill over time) to hear those companies' voice.

Survey Overview (I)

- Participants: Member companies of the Subcommittee on Corporate Accounting of the Committee on Finance and Accounting

  Of the 58 companies to which the questionnaire was sent, 31 responded (response rate: 53.4%)

- Breakdown of the 58 companies by accounting standard applied [numbers in brackets indicating that of the 31 respondent companies]

  Japanese GAAP: 31 [15]
  IFRS (including those planning to adopt): 20 [13]
  US GAAP: 7 [3]

- Breakdown of the 58 companies by industry [numbers in brackets indicating that of the 31 respondent companies]

  - ♦ Manufacturing industry: 26 [15]
    Machinery 3 [2], chemical 6 [3], glass 1 [1], food 2 [1], paper 1 [1], pharmaceutical 1 [1], steel 2 [1], electronics 8 [4], transport equipment 2 [1]

  - ♦ Financial industry: 16 [10]
    Banking 4 [4], securities 1 [1], insurance 7 [2], leasing 4 [3]

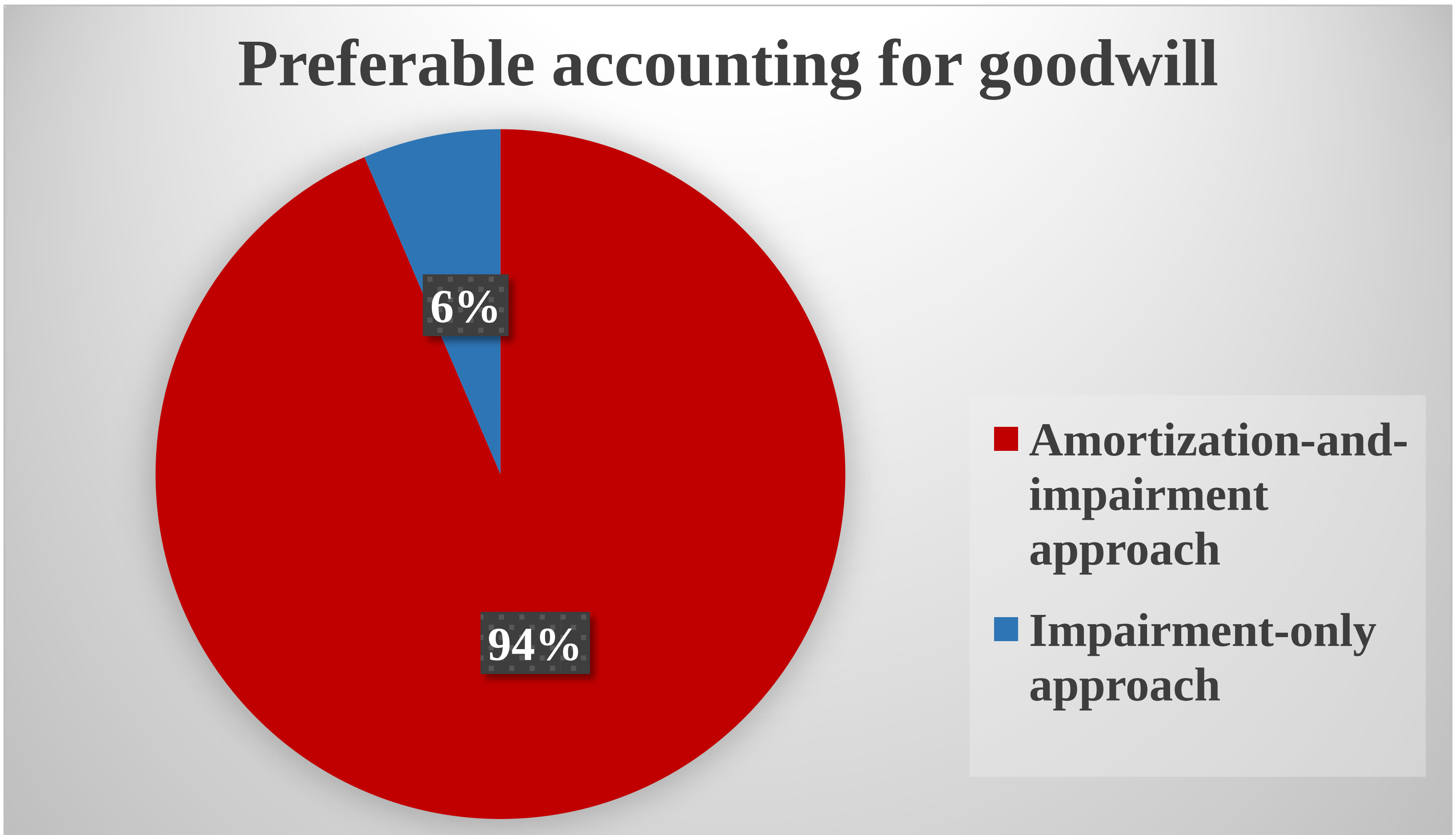
  - ♦ Other: 16 [6]
    Wholesale 5 [3], maritime transport 2 [1], construction 1 [0], retail 1 [0], information and communications 2 [0], petroleum 1 [0], electric power 1 [1],
    real estate 2 [0], land transport 1 [1]

Survey Overview (II)

- Questions asked:
  1. Characteristics of goodwill
  2. Post-business combination accounting for goodwill
  3. Estimating goodwill amortization periods
  4. Improving impairment test

Survey Conclusions (I)

1. Almost all respondent companies, whether they have adopted (or plan to adopt) IFRS or comply with US GAAP, support the amortization of goodwill. We should continue to call on the IASB to reintroduce amortization.



Survey Conclusions (II)

2. Reasons for supporting the amortization of goodwill are as listed below.

   Amortizing goodwill would enable companies to:

   - ✓ Accurately assess financial performance subsequent to M&As
   - ✓ Ensure steady and well-disciplined corporate management;
   - ✓ Appropriately reflect in financial statements a decrease in the value of goodwill over time, making it possible to avoid the recognition of internally generated goodwill
   - ✓ Recognize an impairment loss in a more timely manner (at the time of the investment proving a failure), which might also be useful to determine whether the investment has succeeded or failed.

3. Reasons for supporting the impairment-only approach include difficulty in estimating the pattern of consumption of goodwill.
4. Companies estimate goodwill amortization periods in a rational manner after sufficient consultation with the auditors, which indicates that the criticism of such periods being arbitrarily determined is unjustifiable.
5. Views on the maximum amortization period for goodwill are divided mainly into two groups: some advocate 10 years in order to ensure a certain level of accuracy in economic assessments of investments and demonstrate the soundness of amortization to the IASB; and others insist that a 20-year period is a conceivable option in light of Japanese GAAP.
6. Respondents do not support the pre-acquisition headroom (PH) approach advocated by the IASB to improve impairment accounting, as the approach is problematic both theoretically and practically.

Contents

1. Characteristics of Goodwill

◎ Companies supporting the amortization-and-impairment approach and those supporting the impairment-only approach differ in their views on characteristics of goodwill.

♦ Companies supporting the amortization-and-impairment approach

- Whereas goodwill is an investment cost to obtain excess earning power and synergies, its value cannot be maintained without additional investments as long as every product and business has a life cycle.
- Goodwill represents the excess earning power that consists of management mechanisms and personnel: the former will eventually cease to be effective as the market environment changes and the latter will be replaced by successors.
- We cannot think of any components of goodwill that never diminish in value permanently. Whereas it may be the case for a brand, a certain cost is probably paid to prevent its value from diminishing. Because the components of goodwill whose value never diminishes are very limited, special attention to them is not needed when considering accounting treatments.
- Although corporate image does not diminish in value over time, the value of the portions arising from the fair value measurement of assets and liabilities does diminish with the passage of time.

♦ Companies supporting the impairment-only approach

- Such goodwill as corporate image, along with a production-sales synergy resulting from a business combination between a sales company and a manufacturing firm, may maintain its value subsequent to the M&As.

2. Post-Business Combination Accounting for Goodwill
(1) Outline of survey results

◎Almost all respondent companies, whether they have adopted (or plan to adopt) IFRS or comply with US GAAP, call for the reintroduction of amortization.

(Unit: companies)

	Supporting the amortization-and-impairment approach	Supporting the impairment-only approach	Total
Japanese GAAP	15	0	15
IFRS (Of which those planning to adopt)	11 (5)	2 (0)	13 (5)
US GAAP	3	0	3
Total	29 [93.5%]	2 [6.5%]	31 [100%]

2. Post-Business Combination Accounting for Goodwill

(2) Arguments for amortization-and-impairment approach (I)

◎ Amortization is needed to accurately assess post-M&A financial performance.

- Amortization would result in profit being recognized if gains from the acquisition exceed the cost of investment, or loss if the gains are less than the cost. This would enable them to <u>accurately assess post-business combination financial performance</u>. (Japanese GAAP, IFRS, US GAAP)

- From the perspective of recovering invested capital through business operations, it is desirable to recover invested capital including goodwill through recurring income and to <u>use amortized assets and recurring income (including goodwill amortization expense) for the management of indicators such as return on assets(ROA) and return on equity(ROE)</u>. (IFRS)

- From the corporate management viewpoints, in assessing post-business combination performance as recovery of investments, allocating the investments systematically and regularly as expenses over the expected payback period would make decision-making on the consolidated basis easier. (IFRS)

- Under the amortization-and-impairment approach, a decrease in value of goodwill would be recognized in the same manner as that of noncurrent assets. This enables companies to <u>assess performance after M&As using the same yardstick as for internal capital investments</u>. (Japanese GAAP, IFRS)

Note: <u>On slides 9 to 12, the accounting standard of the company(ies) providing the response is indicated in parentheses.</u>

2. Post-Business Combination Accounting for Goodwill
(2) Arguments for amortization-and-impairment approach (II)

◎ The amortization-and-impairment approach would contribute to steady and well-disciplined corporate management.

- The impairment-only approach tends to lead to large onetime losses and greater volatility in financial performance, undermining management stability. By contrast, <u>periodic amortization would contribute to sound corporate management</u>. (Japanese GAAP, IFRS, US GAAP)

- The value of an asset recognized on the balance sheet should be measured from the <u>perspective of prudence (conservatism)</u>. Unless the perpetuity of the asset value under normal circumstances can be clearly explained, the asset should not be treated as non-amortizable. (IFRS)

- Non-amortization of goodwill entails the <u>risk of encouraging corporate executives to actively pursue M&As without fully considering the costs thereof—that is, the risk of encouraging irresponsible M&As</u>. (Japanese GAAP, IFRS)

- The amortization-and-impairment approach would be more conducive to corporate management that gives comprehensive consideration to earnings, expenses, and future impairment risk with a focus on recovering the investment. This would <u>discipline management to a certain degree, thereby helping the company achieve sustained growth</u>. (US GAAP)

2. Post-Business Combination Accounting for Goodwill
(2) Arguments for amortization-and-impairment approach (III)

◎ Goodwill, which diminishes in value over time and is replaced by internally generated goodwill, should be regularly amortized.

- Goodwill will eventually diminish in value. Even if the excess earning power is maintained, that is simply made up for by the company's additional efforts and investments. <u>Non-amortization is nothing less than the recognition of those additional efforts and investments as internally generated goodwill</u>. (Japanese GAAP, IFRS)

- <u>Goodwill derives primarily from technological capabilities, customer bases, and personnel. These resources change as technology advances, market transforms, and employees resign or retire</u>, presumably in accordance with the passage of time in general. Thus, it is logical to consider that, subsequent to a business combination, goodwill diminishes in value. (IFRS)

- While the excess earning power and acquisition synergies that goodwill represents reflect generally the financial value of operational know-how and technological superiority, <u>such value is expected to diminish over time as long as there are competitors. Furthermore, sources of operational know-how and technological superiority (e.g., human resources) continue to change from the time of initial measurement of goodwill and are replaced by internally generated goodwill</u>. Hence, it is reasonable to recognize a decline in the value of goodwill. (IFRS, US GAAP)

2. Post-Business Combination Accounting for Goodwill

(2) Arguments for amortization-and-impairment approach (IV)

◎ Amortization would enable companies to recognize an impairment loss on goodwill in a more timely manner (at the time of the investment proving a failure), which might also be useful to determine whether the investment has succeeded or failed.

- Under the amortization-and-impairment approach, an impairment loss would be recognized if the amortized carrying amount of goodwill is more than its recoverable amount. In other words, the need to recognize an impairment loss would be assessed by comparing the recoverable amount with the carrying amount of goodwill that reflects a decrease in value over time. This would make it possible to recognize a more appropriate amount of impairment loss in a more timely manner, that is, at the time of the investment proving a failure. (IFRS)

- The impairment-only approach dictates that goodwill be stated on the balance sheet in the amount measured at the time of investment. Consequently, even a slight decrease in value, which would not matter if goodwill is amortized, leads to recognition of an impairment loss. This suggests the possibility that an impairment loss may have to be recognized even in cases where the investment is not necessarily deemed a failure. (Japanese GAAP)

- The amortization-and-impairment approach would allow a post-acquisition company to, as part of its business operations, regularly check whether the investment is being recovered as planned, by comparing the earnings generated by the business with a decrease in the value of goodwill that represents the excess earning power and acquisition synergies measured at the time of decision-making. Furthermore, the approach would require an impairment loss to be recognized when the company judges the investment to be unrecoverable, enabling the company to clearly indicate that the investment has succeeded or failed. (Japanese GAAP, IFRS)

2. Post-Business Combination Accounting for Goodwill

(3) Arguments for impairment-only approach

- Goodwill is considered to contain components that do not diminish in value. Hence, it is not logical to amortize all components of goodwill.
- Even with regard to the components of goodwill that diminish in value, it is difficult to estimate the pattern of their consumption. Amortization would therefore not provide useful information that reflects economic substance.
- The adoption of the impairment-only approach allows an acquirer to clearly show investors any deviation from the estimate made at the time of acquisition, helping the investors evaluate the acquirer’s investment decision.
- Recognizing both goodwill amortization expense and the expense related to personnel and other resources used to prevent goodwill from diminishing in value might constitute the double recognition of expense, distorting income for the period.

2. Post-Business Combination Accounting for Goodwill

(4) Decisions to adopt IFRS and goodwill accounting

◎ Many companies had discussed the effect of non-amortization of goodwill when examining the adoption of IFRS, but eventually decided to adopt the IFRS standard considering overall benefits therefrom, such as the international comparability ensured.

- We had debated the impact of non-amortization on corporate management, such as larger fluctuations in financial performance, but started preparing for IFRS adoption in expectation of greater international comparability, the government's policy of increasing companies voluntarily adopting IFRS, and the IASB advancing discussions on goodwill amortization.
- While we prefer the amortization-and-impairment approach, we have confirmed that the non-amortization of goodwill resulting from IFRS adoption has a limited impact on us due to the amount of goodwill currently recognized being small and to our practice of accurately evaluating the acquiree's enterprise value based on business plans.
- We believe that it is a logical and sound method to expense a gradual decrease in the value of goodwill with the passage of time. Accordingly, since we started applying US GAAP, we have classified goodwill arising from a business combination as an identifiable intangible asset (amortizable asset) to the greatest extent reasonable.

3. *Estimating Goodwill Amortization Periods*
(1) Current practice under Japanese GAAP (I)

Factors considered in deciding estimates

◎When estimating an amortization period, many companies make decisions considering the expected payback period of investment in a business combination as well as the period over which synergies from the business combination will be realized. Some companies take into account the useful lives of the associated intangible assets. Another also allows for risks (future uncertainty) that might arise over the period for which goodwill is expected to have an effect.

Internal rules

◎Some companies have established internal rules that set benchmarks for amortization periods. Such rules are considered to help reduce arbitrariness in estimates for those periods.

[Examples:]

- In principle, a goodwill amortization period is to be 10 years (when performing purchase price allocation).
- According to the importance of goodwill in monetary terms, the following measures are to be taken: goodwill of less than ¥50 million to be immediately amortized; goodwill worth ¥50 million or more but less than ¥500 million to be amortized over five years using the straight line method; and, for goodwill of ¥500 million or more, the payback period to be determined based on medium-term plans and the like.

3. Estimating Goodwill Amortization Periods
(1) Current practice under Japanese GAAP (II)

Arbitrariness in estimates for amortization periods

◎Some criticize that goodwill amortization periods are arbitrarily estimated. However, companies estimate them rationally after sufficient consultation with the auditors to reduce room for arbitrariness as much as possible, which indicates that the criticism is unjustifiable.

- It is our practice to estimate a goodwill amortization period according to rational criteria of factors such as earnings forecasts made at the time of deciding the investment and the expected payback period of the investment. We also have sufficient prior consultation with the accounting auditor. In these ways, we endeavor to reduce room for arbitrariness to the extent possible.
- When it is possible to estimate a period over which goodwill is expected to have an effect, the amortization period is determined based on the payback period; otherwise, goodwill is amortized over five years. In projecting future free cash flows for an economic assessment of the investment, we limit the projection period to 10 years to ensure a certain level of accuracy. We believe it appropriate to set the maximum goodwill amortization period at 10 years as well.
- An amortization period can be rationally estimated in accordance with the characteristics of the acquiree’s business and merchandise (e.g., product life cycles). Similar estimates are needed for estimating depreciation periods for property, plant and equipment. Contrary to popular belief, the impairment-only approach has more room for arbitrariness.
- More rational estimates would become possible by developing formal guidance on the methods of determining useful lives (e.g., calculations based on the period over which goodwill is expected to contribute to future cash flow generation, or projections based on the useful lives of identifiable intangible assets).

3. Estimating Goodwill Amortization Periods

(2) Maximum goodwill amortization period (I)

◎ View on the maximum amortization period in the event of amortization being reintroduced are divided mainly into two groups: one advocates 10 years in order to enable companies to conduct economic assessments of investments with a certain level of accuracy and strongly demonstrate the soundness of amortization to the IASB; and the other insists that a 20-year period is a conceivable option in light of Japanese GAAP.

<u>Either 10 years or 10 years plus a rebuttable presumption</u>

- Given that a period over which companies can project future cash flow is generally 10 years, the maximum amortization period should also be 10 years. <u>To strongly demonstrate the soundness of amortization to the IASB, a rebuttable presumption should not be incorporated</u>.
- <u>The maximum length of time over which projections can be made with a certain degree of accuracy is 10 years, which should therefore be the maximum amortization period. However, in view of there being some cases where the payback period is longer (for example, an investment in an interest in raw materials), a rebuttable presumption should be included</u>.
- In these days, market environment changes and technology advances rapidly, so assets are generally expected to become obsolete within 10 years. Yet, as some business models can remain in effect for more than 10 years, a rebuttable presumption may as well be added.
- Given that goodwill represents the excess earning power arising from a combination of the acquired assets, <u>the maximum amortization period of 10 years or less is appropriate in view of the useful lives of identifiable property, plant and equipment, and intangible assets</u>. Still, it is desirable to establish a rebuttable presumption taking into account business characteristics and other elements.

3. Estimating Goodwill Amortization Periods

(2) Maximum goodwill amortization period (II)

Either 20 years or 20 years plus a rebuttable presumption

- In a large-scale M&A, the decision to invest is made in anticipation of long-term benefits. <u>In fact, there were some investments in which excess earnings were realized after the passage of more than 10 years</u>.
- <u>As a certain difference exists among companies concerning the way they see industry characteristics and investment paybacks</u>, it is appropriate to set the maximum amortization period at 20 years and have individual companies make the best possible estimate.
- The maximum amortization period should be set at the longest possible term, on the grounds that the maximum amortization period under the superseded IAS 22 was 20 years and that some large-scale acquisitions require the investment to be evaluated using 20-year or longer projections. At the same time, as making accurate projections over a horizon of more than 20 years is extremely difficult, we suggest that the maximum period be 20 years as a rule and a rebuttable presumption be included.

Other

- Considering that the effects of some M&As continue for an extremely long period of time and that the provisions in other IFRS do not set numerical criteria in principle, it may be desirable to allow individual companies to make the best possible estimate, without introducing any numerical criterion.

4. Improving Impairment Test (I)

◎ No respondent supports the PH approach as it entails serious theoretical and practical problems.

- PH contains unrealized gains from the acquirer's land and internally generated goodwill. The value of these assets, however, is unrelated to the acquisition. As such, it is irrational to include these in a measurement of the value of goodwill arising from the acquisition.
- The PH approach would not only increase the burden on preparers but also add complexity and arbitrariness because accounting for PH would require measuring the internally generated goodwill of cash-generating units. This would make the meaning of the computed amount of impairment loss unclear and render it much less understandable to the users of financial statements.
- Because a company considering an acquisition rarely draws up a business plan or cash flow plan that excludes the effect of the acquisition, additional works would be needed. When the existing business has property, plant and equipment, and intangible assets, an expert appraisal and other processes would also be necessary. Given the need for audit arrangements as well, the PH approach would demand considerable human and financial resources and time.
- For a company which acquires a diverse range of business, the effects of business combinations are wide-ranging and hence it would have to identify the cash-generating units of the related existing business and measure the PH of each cash-generating unit. However, this would not work in the real world because of its complexity in practice and heavy burdens on preparers.
- The PH approach is theoretically faulty in that it disregards post-acquisition changes in PH. Further, estimates for PH run counter to the current efforts to simplify the impairment test.

4. Improving Impairment Test (II)

◎ Respondents also call for the improvements to the impairment test as listed below. Many argue that consideration should be given to reintroducing amortization in order to address the “too little, too late” issue regarding impairment losses and simplify the impairment test.

- The “too little, too late” issue should be addressed, rather than by introducing the PH approach that would place heavy burdens on preparers, but by less burdensome measures, such as expansion of items included in intangible assets to reduce the amount of goodwill, and/or adoption of the amortization-and-impairment approach.
- Reintroducing amortization to deal with the “too little, too late” issue would enable goodwill to be expensed every period, presumably allowing companies to perform impairment testing not annually but only in the case of there being indications of impairment as dictated by Japanese GAAP. This would contribute to simplifying the impairment test as well.
- Testing all components of goodwill for impairment at least annually on an ongoing basis places heavy burdens on preparers. We request that consideration be given to the development of a simplified testing method and other measures to reduce the frequency of impairment testing. Calculations of the value in use of goodwill also entail problems: as those calculations involve many estimates, the company and the auditor often differ in the views of the calculation method. The publication of formal guidance needs to be considered.