ON THE IFRS DISCUSSION PAPER BUSINESS COMBINATIONS: DISCLOSURES, GOODWILL AND IMPAIRMENT

O DISCUSSION PAPER DE COMBINAÇÕES DE NEGÓCIOS DAS IFRS: DIVULGAÇÕES, GOODWILL E TESTE DE IMPAIRMENT

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RESUMO

Em 2020, a *IFRS Foundation* divulgou o documento *Discussion Paper* DP/2020/1: *Business Combinations - Disclosures, Goodwill and Impairment* (de agora em diante: DP), seguindo a Revisão de Pós-Implementação da IFRS 3. O objetivo do artigo é analisar, criticar e apresentar propostas a partir da literatura prévia sobre as sugestões do IASB no que diz respeito às mudanças na contabilização do *goodwill*. Para isso, um grupo de trabalho formado por nove acadêmicos brasileiros elaborou uma carta-comentário em resposta ao DP. Diferentemente de um artigo tradicional da área contábil, a investigação desta pesquisa baseou-se na utilização de literatura para observar as propostas de alterações do DP. Este artigo também fornece revisões de estudos anteriores, avaliações, discussões, sugestões de definições e princípios, e sugestões para pesquisas futuras relacionadas a: divulgações sobre aquisições, eficácia do teste de redução ao valor recuperável, amortização do *goodwill*, simplificação do teste de redução ao valor recuperável, apresentação em separado de intangíveis e *goodwill*, e práticas convergentes ao US GAAP. Os resultados indicaram: i) a divulgação sobre aquisições deve focar no monitoramento do sucesso ou fracasso da aquisição; ii) a norma de *impairment* não apresenta problemas técnicos de eficácia; iii) o *goodwill* deveria ser amortizado ao longo do tempo em que o gestor espera recuperar esse investimento; iv) um teste de impairment deve ser realizado quando ocorre um evento adverso e não anualmente; v) os intangíveis devem continuar a ser reconhecidos separadamente do *goodwill*; vi) e a mudança no modelo de amortização provavelmente convergirá com o US GAAP. Além disso, do ponto de vista do conhecimento científico, é possível observar que, algumas dificuldades levantadas pela literatura são consideradas nos problemas apontados no DP; sendo que, o gerenciamento do teste de impairment do *goodwill* é o principal, sendo amplamente investigado na literatura em diversos aspectos, como tempestividade, relevância e comportamento dos gestores. Por fim, os resultados fornecem insights que podem contribuir para o processo de elaboração de normas do IASB, e para a literatura sobre divulgação de *goodwill*.

Palavras-chave: Combinações de negócios. Goodwill. Teste de redução ao valor recuperável. Divulgação. Normatização.

ABSTRACT

In 2020, the IFRS Foundation released the document Discussion Paper DP/2020/1: Business Combinations—Disclosures, Goodwill and Impairment (hereafter DP), according to the Post-Implementation Review of IFRS 3. The objective of the paper is to analyze, criticize and make propositions from the previous literature on the IASB's proposals for changes to goodwill accounting. For that, a working group of nine Brazilian academics built on a comment letter in response to the DP. Unlike a traditional article in the accounting area, the investigation of this research was based on the use of previous literature to observe the proposals for changes of the DP. This paper also provides reviews of prior research, assessments, discussions, suggestions for definitions and principles, and suggestions for further research related to disclosures about acquisitions, the effectiveness of the impairment test, the amortization of goodwill, the simplification of the impairment test, the separation of intangibles from goodwill, and the converging practices with the US GAAPs. The results indicated: i) the disclosure about acquisitions should focus on the monitoring of the success or failure of the acquisition; ii) the impairment standard does not present technical problems of effectiveness; iii) the acquired goodwill should be amortized over the time in which the manager expects to recover that investment; iv) an impairment test should be run when an adverse event happens and not annually; v) intangibles should continue to be recognized separately from goodwill; vi) and the change to the amortization model will probably converge with the US GAAPs. Moreover, from the point of view of previous scientific knowledge, it is possible to observe that some problems raised by the literature are considered in the problems pointed out by the standard-setter in the DP; the management of goodwill impairment results is the main one, widely reported in the literature in several aspects, such as timeliness,

relevance and manager behavior. Finally, the results provide insights that can contribute to the IASB's standard-setting process and to the literature on goodwill reporting.

Keywords: Business combinations. Goodwill. Impairment test. Disclosure. Standard-setting.

1 INTRODUCTION

Goodwill is a controversial issue in accounting regulation (POWELL, 2010) since the standard setters around the world have adopted different principles over the years. IAS 22 Business Combinations required goodwill to be amortized over 20 years, but it was superseded by IFRS 3 Business Combinations with the requirement for an annual impairment test. In the United States, the amortization was for 40 years, but it also changed to the impairment test. Before the IFRS adoption, goodwill was amortized at most in 10 years in Brazil and in 5 years in Germany. In the case of England, companies recognized goodwill losses directly in equity (MARTINS, 2020). The International Accounting Standards Committee - IASC (predecessor standard setter of IASB) itself accepted the application of the pooling of interests when two independent companies combined without the characterization of acquisition and thus without the recognition of goodwill (RAYBURN; POWERS, 1991).

Currently, IFRS 3 deals with mergers and acquisitions and contains requirements for the recognition and measurement of identifiable assets and liabilities as well as goodwill. IAS 36 Impairment of Assets requires assets to be reported at no more than their recoverable amount, which includes goodwill. In the United States, SFAS 142—Goodwill and Other Intangible Assets offers the accounting practice for goodwill, which is subject to the impairment test. Despite the similarity of the accounting practice for goodwill between the US GAAPs and the IFRSs, the subject has been debated with great intensity. Zeff (2002, p. 51) argues on the basis of evidence that the periodic impairment test of goodwill was introduced in the USGAAP as a result of strong lobbying.

In 2020, the discussion of the accounting practice of goodwill received more attention due to the Post-Implementation Review of IFRS 3 led by the IFRS Foundation, which resulted in the publication of the document Discussion Paper DP/2020/1: Business Combinations—Disclosures, Goodwill and Impairment. The Board expects to improve the disclosure of subsequent performance of acquisitions, allowing investors to be informed about the performance of the acquired business. According to the DP, the main incentives to return to the discussion of goodwill are the poor disclosure regarding business combinations, the shielding effect due to headroom in the consolidated balance sheets-, and finally managers' over-optimism, resulting in a possible time lag between the economic loss event and the accounting recognition of the impairment loss (IFRS FOUNDATION, 2020).

In addition, there is a wide literature about the negative implications of the current goodwill accounting practice, such as poor disclosure (ANDRÉ; DIONYSIO; TSALAVOUTAS, 2018; CARLIN; FINCH, 2011), doubts about the efficacy of the goodwill impairment test (CARLIN; FINCH, 2009, 2010; HOOGENDOORN, 2006), the possibility of earnings management (CAPPELLESSO; RODRIGUES; PRIETO, 2017; GINER; PARDO, 2015; LI; SLOAN, 2017; SANCHIDRIÁN; PÉREZ GARCÍA; GONZALO-ANGULO, 2021), and the low relevance of the information about goodwill for the capital market (BENS; HELTZER; SEGAL, 2011; CAPPELLESSO; ROCHA; DANTAS, 2018). The scientific evidence has been collected in different regulatory and legal environments, which reminds us that the IFRSs' adoption is influenced by legal and institutional aspects (HOLTHAUSEN, 2009; SODERSTROM; SUN, 2007; WALKER, 2010). The DP provides an opportunity for academics to revisit the literature and gain new insights.

This paper takes advantage of the opportunity offered by the DP by providing the views of nine Brazilian academics on the issues surrounding goodwill accounting. The DP lists a series of questions arising from the proposed changes, which in turn were prepared based on requests arising from problems

in the information disclosed by companies and the natural evolution of capital markets. Thus, there is a gap in knowledge arising from the need for change observed by the accounting standard setters regarding the accounting treatment of goodwill.

This paper addresses the following research problem: can the previous scientific evidence predict and contribute to the assessment of normative alternatives raised by the international standard-setter for changing the current accounting for goodwill? Based on this problem, the authors decided to establish the following objective of the paper: to analyze, criticize and make propositions from the previous literature on the IASB's proposals for changes to goodwill accounting.

Unlike a traditional article in the accounting area, the empirical investigation of this work is based on the use of previous literature to observe these proposals for changes in the accounting standard as an economic phenomenon, which contains the standard-setter's view of problems and possible solutions, and that can impact the information and decision of economic agents. The paper is not limited to a review of prior research but includes assessments, discussions, suggestions for definitions and principles, opinions, and suggestions for further research. We expect to contribute to the IASB's standard-setting process and to the literature on goodwill reporting.

The authors decided to form a working group to answer the questions in the DP via a comment letter, which was submitted to the IASB on December 20, 2020. This paper builds on the comment letter and discusses the proposals set out by the Board regarding the DP. The DP contains six sections and includes questions for comment letter submitters and the Board's preliminary views on most issues.

The current paper's structure corresponds to that of the DP and has one additional concluding section. Section 2 of the DP discusses the Board's preliminary view that new disclosures about the subsequent performance of acquisitions should be required and that the Board should make targeted improvements to the disclosure objectives and requirements of IFRS 3. Section 3 deals with the reintroduction of the amortization of goodwill or the preservation of the impairment-only model for the subsequent accounting for goodwill. Section 4 of the DP discusses whether the Board should simplify the impairment test for goodwill and intangible assets. The Board's preliminary view is that it should develop proposals to remove the requirement to perform a quantitative impairment test every year. Section 5 concerns the criteria for recognizing the intangible assets acquired in a business combination. The preliminary opinion of the Board is that it should not make any changes and therefore its proposal is not to allow some intangible assets to be included in goodwill. Section 6 addresses the divergences between the IASB and the FASB standards because many aspects of IFRS 3 converge with those of the US Generally Accepted Accounting Principles (US GAAPs).

2 IMPROVING DISCLOSURES ABOUT ACQUISITIONS

Section 2 of the DP discusses the Board's preliminary view that new disclosure issues about the subsequent performance of acquisitions should be required and that the Board should make targeted improvements to the disclosure objectives and requirements of IFRS 3. This view is a possible response to investors' assertions that companies do not provide enough information to help investors to understand the subsequent performance of an acquisition and to determine whether the acquisition's objectives have been achieved. The DP asks whether the new disclosure requirements would resolve this issue and whether investors' needs for better information on the subsequent performance of an acquisition would be met. The question is accompanied by a set of six disclosure proposals.

We believe that investors should receive inputs about the ex-post performance of combined companies ('synergies' or another explanation for expected abnormal profits); otherwise, they will not know whether the management is generating or destroying wealth through acquisitions. Hence,

disclosing the metric used by the management to evaluate the ex-post performance of combined companies will help investors to make better investment decisions.

Regarding the six specific disclosure proposals, we disagree with the proposal to disclose information about the strategic rationale and the management's objectives for an acquisition on the acquisition date. We understand that disclosing information about the strategic rationale and objectives of the acquisition may jeopardize the management's acquisition strategy by making commercially sensitive information available to competing companies. It must be pointed out that there are economic consequences of increasing disclosure, as mentioned by Leuz and Verrecchia (2000).

We believe that the most important point for investors is to be able to evaluate the success or failure of an acquisition. Accordingly, they need to know which metrics are used by the management to monitor the acquisition and what the follow-up period is. Empirical evidence about the information content of the business combination disclosure level can be found in the article by Shalev (2009). Therefore, company managers should be required to disclose only the metrics that they used and the follow-up period.

Regarding the concerns that information about the management's objectives for an acquisition along with detailed targets could, in some jurisdictions, be considered to be forward-looking information, the DP asks whether are there any constraints in a jurisdiction that could affect a company's ability to disclose this information. In Brazil, according to the capital market regulations in force, any information that implies an indication of future performance is qualified as projection and as such is subject to certain requirements (Brazilian SEC Regulation).

Nonetheless, we agree that a company should be required to disclose information about whether it is meeting those objectives. Ex-post performance is critical information for investors and may enhance corporate governance. The requirement to disclose information about how a company monitors an acquisition and determines whether it is meeting its objectives may force managers to negotiate the price of the target company better.

The management should also be required to disclose the monitoring period. It is trivial for investors to evaluate the post-acquisition performance of a business combination. It is of great relevance to disclose information regarding the management's decision to stop monitoring the performance post-acquisition before the end of the second full year after the acquisition as well as the fact that it has done so and the reasons behind the decision. Otherwise, investors will make bad decisions through misguidance.

As documented in the literature, agency costs may arise from free cash flows (Jensen, 1986) because free cash flows may be consumed against shareholders' interest (for instance, in acquisitions that destroy wealth). Thus, when a business combination takes place, there is a risk of 'hubris' and overpayments, as investigated by Hietala, Kaplan and Robinson (2003).

Moreover, we agree with a mandatory disclosure regarding the fact that the management does not monitor an acquisition. A possible consequence will be an increase in the cost of capital of the company (considering uncertainties due to the lack of information regarding the allocation of capital). This requirement may result in a positive externality: enforcing the management to monitor future acquisitions. Moreover, market participants monitor the ex-post performance of combined companies using their own metrics. Evidence can be obtained from Healy, Palepu and Ruback (1992).

If the management (Chief Operating Decision Maker—CODM) changes the metrics used to monitor the objectives of the acquisition to determine whether they are being met, there should be a requirement to disclose the new metrics and the reasons for the change. It is of great relevance to disclose information regarding the management's decision to change the metrics to evaluate and monitor performance post-acquisition as well the fact that it has done so and the reasons for doing so.

Then, the DP addresses issues regarding the scope of the required disclosures, the cost of disclosing the information, its materiality, and the commercial and legal sensitivity of the disclosure. We believe that information on all material monitored acquisitions ('relevant ones') should be disclosed regardless of the volume of disclosures. The benefits for investors and for the company justify the cost incurred in producing the information. We think that this may reduce the opportunity for managers to engage in 'cherry picking.'

After discussing these issues, the DP explains the Board's preliminary view that setting more specific disclosure objectives would clarify why investors need particular information to understand why a company has acquired a business and what assets, synergies, and other benefits it has bought. The Board considered whether the generic nature of the disclosure objectives in IFRS 3 could be the reason for stakeholders suggesting that companies often use the current disclosure requirements of IFRS 3 mechanically as a checklist. The reason that the Board is considering amending the disclosure objectives of IFRS 3 is to explain investors' main needs for the information that companies are required to disclose. We believe that a kind of framework focusing on the disclosure objectives of IFRS 3 should be considered by the Board.

3 GOODWILL IMPAIRMENT AND AMORTIZATION

3.1 The impairment test and its effectiveness

The DP asks whether it is feasible to make the impairment test for cash-generating units containing goodwill significantly more effective at recognizing impairment losses on goodwill on a timely basis than the impairment test set out in IAS 36 Impairment of Assets. To answer this question, we present some empirical evidence below.

André, Dionysio and Tsalavoutas (2018) investigated the disclosure regarding IAS 36 and observed that many companies do not disclose the actual impairment loss or a reversal of impairment loss across reportable segments. In addition, many firms do not disclose the main events and circumstances that led to the recognition of impairment losses or the reversal of impairment losses. Then, the impairment test can be a fundamental input for the stakeholders' decision-making process, and poor disclosure may result in doubts about the quality of goodwill impairment testing (CARLIN; FINCH, 2009, 2010; HOOGENDOORN, 2006).

Carlin and Finch (2009) commented that the discussion regarding the recognition, measurement, and disclosure of goodwill is not recent and that the subject has received substantial attention from accounting practitioners and academics since the first half of the 20th century, which explains the discrepancy in the accounting practice for goodwill between countries and over time. Considering the requirements of IAS 36, the authors studied the application of the impairment test to Australian companies, focusing on evidence concerning the selection of discount rates for the purposes of goodwill impairment testing. The results indicated that 70% of the cases analyzed were outside the reasonable expected range and thus not consistent with the notion of bias in the selection of discount rates. In their second study, Carlin and Finch (2010) applied a similar methodological approach to New Zealand. According to the authors, there is evidence of the opportunistic exercising of discretion to avoid unwanted impairment losses. In their third study, on the disclosure of the estimated recoverable amount in the context of goodwill impairment testing, Carlin and Finch (2011) found evidence of systematic non-compliance with the disclosure requirements of the IFRS goodwill impairment testing regime on the part of large listed Australian firms.

In Spain, Giner and Pardo (2015) investigated whether the goodwill impairment test is used to fulfill opportunistic motivations and manage earnings or whether, as argued by the accounting standard setters, it works as a mechanism to provide private information about the underlying economics of a firm.

The results confirmed that opportunism explains both the decision to recognize impairment loss and the decision about the amount of loss.

More recently, Sanchidrián, Pérez García and Gonzalo-Angulo (2021) investigated the application of the impairment test between 2005 and 2015 in the main European banks. The results obtained showed that systematic amortization has been replaced by opportunistic impairment, which does not reflect the economic conditions underlying the financial activity of the main European banks, giving rise to less relevant financial information and possible harmful pro-cyclical effects.

In short, the literature about the impairment test has highlighted poor disclosure, the impairment losses on goodwill not being value relevant, the opportunistic exercise of discretion to avoid impairment losses. We cannot ignore the managers' relevant discretionary power in the context of IFRS adoption (CHRISTENSEN; HAIL; LEUZ, 2013). We should also remember that the IFRS literature has revealed that the adoption of international standards is influenced by legal and institutional aspects (HOLTHAUSEN, 2009; SODERSTROM; SUN, 2007; WALKER, 2010).

The literature (ANDRÉ; DIONYSIO; TSALAVOUTAS, 2018; BENS; HELTZER; SEGAL, 2011; CAPPELLESSO; RODRIGUES; PRIETO, 2017; CARLIN; FINCH, 2009; GINER; PARDO, 2015; HOOGENDOORN, 2006; LI; SLOAN, 2017; SANCHIDRIÁN; PÉREZ GARCÍA; GONZALO-ANGULO, 2021) has provided evidence that the impairment test itself is not the problem but that judgment and subjectivity in applying the impairment test can be used by the management to achieve optimism about the business. This allows for the late recognition of an impairment loss. The IAS 36 already has requirements aimed at reducing the risk of a very optimistic forecast, and it is known that the presence of headroom can jeopardize the timeliness of accounting information. However, it is the role of audits, and regulators, to verify the correct application of the test, resulting in an enforcement issue.

The DP also asks about any other aspects of IAS 36 that could be considered in the Post-Implementation Review (PIR) of IFRS 3. We do not agree that there are other aspects of IAS 36 in this project as a result of concerns raised in the Post-Implementation Review (PIR) of IFRS 3. However, the removal of the requirement to perform a quantitative impairment test every year can be compensated for by the disclosure of the metrics that reveal the performance of the acquired business. Thus, investors would have access to information of a qualitative and quantitative kind that they could use to assess possible losses in the acquired business.

3.2 Amortization of goodwill versus the impairment model

Section 3 also discusses the reintroduction of the amortization of goodwill or the retaining of the impairment-only model for the subsequent accounting for goodwill. The Board proposes not to reintroduce the amortization of goodwill.

Goodwill impairment is a mechanism of conditional conservatism, according to the approach of Basu (1997), who found that earnings are more timely or concurrently sensitive in reflecting publicly available 'bad news' than 'good news.' The 'bad news' is evaluated by the negative unexpected annual stock returns. As a consequence, goodwill impairment loss recognition can be value relevant (LI; AMEL-ZADEH; MEEKS, 2010). These characteristics represent good information quality.

However, there is evidence that the goodwill impairment loss recognition may be not timely because managers manage earnings with goodwill impairment (FRANCIS; HANNA; VINCENT, 1996; VINTEN; SEVIN; SCHROEDER, 2005), including a big bath (JORDAN; CLARK, 2004). Goodwill impairment losses are more frequent and larger in magnitude if there has been a recent change in management or the industry has taken write-offs in the past (HILTON; O'BRIEN, 2009).

The current principles may incentivize managers not to send signals to the capital market. Goodwill impairment serves as a leading indicator of a decline in future profitability. Thus, managers will avoid recognition of goodwill impairment losses (Li et al. 2011). CEOs with longer tenures are more

likely to have been involved in the acquisitions that generated that goodwill. To avoid reputation costs, such long-tenured CEOs are less likely to take goodwill write-offs (BEATTY; WEBER, 2006). As a consequence, the current principles have raised doubts about the faithful representation of acquired goodwill. The goodwill amounts on the balance sheets of companies are large and increasing. There are doubts as to whether these amounts faithfully represent the benefits initially expected from the business acquisition (BETANCOURT; IRVING, 2019).

To develop a new proposal for the accounting of acquired goodwill, we think that the nature and the definition of acquired goodwill should be revisited to allow a proper interpretation of the relevance and faithful representation of the asset, the amortization expense, and the impairment loss of goodwill.

Managers usually decide to acquire a business by assessing a visible time horizon of synergy benefits. Managers (and often analysts) frequently estimate the benefits of acquiring a business in amounts, such as amounts of synergy gains, an approach that presupposes a visible time horizon. In our view, the expected economic benefits at the date of the business combination can be measured in this visible time horizon, given the objective of the combination. Thus, the goodwill can be amortized during the time when the managers expect to recover this investment. Managers' assessment can provide useful information about their performance on the acquisition over time. Despite being able to choose the useful life of acquired goodwill, the presentation of the information about the objectives of the combination and its useful life on the date of acquisition will reduce managers' ability to bias the information.

This proposal to require managers to define the useful life is in line with the Board's proposal to increase the disclosure about the acquisition. However, if a manager is unable to make a reasonable estimate of the useful life, the Board should arbitrate a useful life. In our view, the definition of the useful life of the acquired goodwill can provide investors and creditors with an estimate of the recovery time of the investment made.

Like any other investment, the acquired goodwill is not capable of generating perpetual economic benefits without reinvestments. The cost savings made through the business combination, such as administrative costs, could be perpetual if no change happens over time in the strategy, labor relations, technology, and so on, which is not feasible. The initial expectations are only maintained or increased if there is reinvestment or growth of the acquired business, which is internally generated goodwill. The entity can obtain new abnormal benefits that were not initially foreseen, generating internal goodwill, which cannot be confounded with the acquired goodwill.

The economic benefits of the goodwill acquired may not be apparent from the date of acquisition but may take time. Thus, the amortization of goodwill should start when the acquired business is ready to provide these economic benefits, similar to the principle of depreciation of PPE and amortization of intangible assets. However, this could open an opportunity for earnings management by delaying the recognition of expenses. If abnormal earnings are not generated in the first 2 or 3 years, it seems likely that there has been an overpayment. Therefore, it is necessary to start the amortization from the acquisition date.

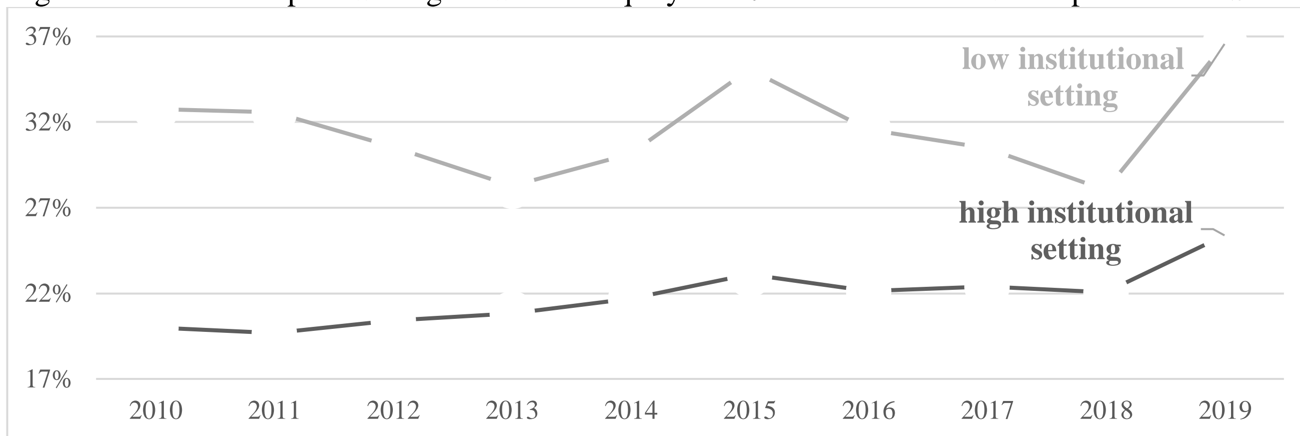
The amortization of goodwill may represent the move from conditional to unconditional conservatism. However, it can avoid some kinds of earnings management that the literature has empirically identified and can provide relevant information about the recovery of investment in the acquisition of a business over time. The amortization expense can provide relevant information about the consumption and return of investment on acquired goodwill. It can also be useful for earnings prediction (JENNINGS; LECLERE; THOMPSON, 2001; STEVENSON; MCPHEE, 2005).

3.3 Disclosure of total equity excluding goodwill

The last paragraphs of the DP explain the Board's preliminary view that it should develop a proposal to require companies to present the amount of total equity excluding goodwill on their balance

sheets. We agree that the Board should develop such a proposal because there is no consensus on the accounting practice of goodwill due to the incentives that influence managers' decisions (BAKER; WEARING, 2001; LAPOINTE-ANTUNES; CORMIER; MAGNAN, 2008; SEETHARAMAN; BALACHANDRAN; SARAVANAN, 2004). In addition, the DP presents some statistics that reveal the increase in goodwill in recent decades. To reinforce this, we collected the book values of goodwill and total equity for 18,905 firms belonging to 49 countries.

Figure 1 - Relationship between goodwill and equity for 49 countries that have adopted the IFRSs



Note: Data were obtained from the Standard & Poors® Capital IQ database. Countries with a low institutional setting: Argentina, Austria, Brazil, Chile, Croatia, the Czech Republic, Finland, Greece, Hungary, Jordan, Mexico, Pakistan, Peru, the Philippines, Poland, Portugal, Romania, the Russian Federation, Singapore, Slovenia, South Africa, South Korea, Sweden, Turkey, and Ukraine; countries with a high institutional setting: Australia, Belgium, Canada, Denmark, France, Germany, Hong Kong, Ireland, Israel, Italy, Malaysia, the Netherlands, New Zealand, Norway, Spain, and the United Kingdom. The classification between high and low institutional settings was based on Brown, Preiato and Tarca (2014). March 2021

Figure 1 allows us to observe the growth in the goodwill and equity ratio, which indicates that goodwill may be relatively inflated on balance sheets, especially in countries with a low institutional setting. In a study conducted by the Board, this ratio was 18% on average, with goodwill amounting to $8 trillion for all listed companies worldwide, and the data were extracted from Capital IQ (IFRS FOUNDATION, 2020). This result can be explained by the incorrect application of the impairment test, as the literature has indicated (ANDRÉ; DIONYSIO; TSALAVOUTAS, 2018; BENS; HELTZER; SEGAL, 2011; CAPPELLESSO; RODRIGUES; PRIETO, 2017; CARLIN; FINCH, 2009; GINER; PARDO, 2015; HOOGENDOORN, 2006; LI; SLOAN, 2017; SANCHIDRIÁN; PÉREZ GARCÍA; GONZALO-ANGULO, 2021).

4 SIMPLIFYING THE IMPAIRMENT TEST

Section 4 of the DP discusses whether the Board should simplify the impairment test for goodwill and intangible assets. The Board's preliminary view is that it should develop proposals to remove the requirement to perform a quantitative impairment test every year. A quantitative impairment test would not be required unless there is an indication of impairment.

We consider that an annual impairment test would not make managers provide more relevant information than a significant event-based impairment test since they are delaying information when following the current principles. We have not identified any empirical evidence to support the assertion that the maintenance of the required annual impairment test would reduce or eliminate the earnings manipulation. Thus, we agree with the proposal to remove the requirement of the annual impairment test

considering that an assessment to determine whether there is an indication that there may be an impairment is required at the end of each reporting period.

The Board's preliminary view would reduce costs. The impairment test requires a valuation assessment of the acquired business, and companies usually contract external services or appoint their own group of experts, or both, to provide a reliable calculation. This cost would decrease if the test was performed only when a significant event occurs. However, the internal costs are not observable and no empirical evidence was identified to support any decision based on cost reduction.

The Board also questions whether the proposals make the impairment test significantly less robust. The robustness of the impairment test depends on the way in which the management deals with the significant event that indicates possible impairment losses. It probably will not be different if the test does not run every year. A robust test will be required only when there are impairment indicators. This proposal will make the IFRSs closer to the two-step approach of the US GAAPs. No empirical evidence was identified to support the idea that a less robust impairment is associated with untimely recognition of impairment. The current empirical evidence, as mentioned before, shows exactly the opposite as the impairments are recognized 'too little too late' under the current requirements for a robust impairment test: performing an annual impairment test cannot remove the shielding effect resulting from unrecognized headroom.

The Board's preliminary view is that it should develop proposals to remove the restriction in IAS 36 that prohibits companies from including some cash flows when estimating value in use—cash flows arising from a future uncommitted restructuring or from improving or enhancing the asset's performance—and to allow companies to use post-tax cash flows and post-tax discount rates in the estimation of value in use. The Board expects that these changes would reduce the cost and complexity of impairment tests and provide more useful and understandable information.

We think that the Board should develop such proposals because distinguishing the maintenance capital expenditure (CAPEX) from the expansion CAPEX and excluding the restructurings from the value in use (VIU) constitute a significant challenge. The elimination of this restriction would align the VIU with the fair value less costs of disposal (FVLCD), which also incorporates the future restructuring plan of the market participants. This decision will narrow the difference between the VIU and the FVLCD. As a result, the standard can be simplified to use the FVLCD, where available, or the VIU. This will eliminate the need to use the higher of the two to determine the recoverable amount.

Nevertheless, we must point out what it is already known about the post-tax discount rate. Firstly, implicit in the approach based on discounting the pre-tax cash flow at a pre-tax discount rate is the presumption that the pre-tax cash flow can be obtained by grossing up the post-tax cash flow at a rate equal to one less the marginal corporate tax rate or, conversely, that the post-tax cash flow is simply the pre-tax cash flow multiplied by a factor equal to one less the marginal corporate tax rate. This presumption is not always correct because it ignores the divergence between the pre-tax income, which is used for tax assessment, and the pre-tax cash flow. Secondly, the market rates for equity (cost of equity) are usually stated post-tax while the market rates for liabilities are usually stated pre-tax (cost of debt).

5 IMPROVING DISCLOSURES ABOUT ACQUISITIONS

IFRS 3 guides the disclosure of information that enables users to evaluate the nature and the financial effect of a business combination. The current standard requires a qualitative description of the factors that set the recognized goodwill, such as expected synergies and unqualified intangible assets, to be recognized separately and to refer to disclosures of fair value from other intangible asset types on the acquisition date. The DP, in Section 5, argues that the Board should change the criteria for recognizing intangible assets acquired in a business combination. The Board's preliminary view is that it should not

make any changes and therefore its proposal is not to allow some intangible assets to be included in goodwill.

A survey realized by the Financial Reporting Council (FRC) from April 2013 to January 2014 stated that recognizing intangible assets separately from goodwill would be useful because that disclosure would provide a basis on which to understand what a company has paid. Most investors have agreed that intangible assets acquired in a business combination should always be included in the statement of financial position or should have alternative treatments (FINANCIAL REPORTING COUNCIL, 2014).

Some investors have argued about the information on those assets mentioned above because they believe that their measurement could be limited due to the level of uncertainty in their estimation of fair value, especially when they do not have an active market or face difficulties in evaluating assets using the separability criterion. However, when a company is acquired, its intangible assets—separated from goodwill—must already have been measured or identified. Therefore, those difficulties are related to internal goodwill, not to acquired goodwill, as mentioned in Section 3 (regarding Question 7 of the DP).

The answers in that survey suggest that there is a problem with non-compliance in the current standard establishing the disclosure of intangible assets acquired in a business combination (FINANCIAL REPORTING COUNCIL, 2014). Furthermore, those assets included in goodwill might generate a loss of useful information for some investors as goodwill would be mixed with identifiable intangible assets and with different characteristics. Considering the mentioned context, we agreed that the Board should not make any changes and not allow some intangible assets to be included in goodwill.

In our view, separating those assets from goodwill generates relevant information for investors in their valuations and decision making. When intangible assets are capitalized and disaggregated out of goodwill, R&D, and other identifiable intangible assets (IIAs), both goodwill and other IIAs provide relevant valuation information incremental to other balance sheet items (GODFREY; KOH, 2001). Accordingly, IIAs are perceived by investors as relevant.

We understand that, if goodwill and intangible assets are separated, the disclosure will become more understandable, will become less complex and opaque (considering the information needs of capital providers), and could reduce accounting opportunism and overpayment. In the pre-IFRS period, there was evidence of Australian firms recognizing IIAs in business combinations with higher acquisition premiums, a relationship emerging between these two events (SU; WELL, 2018), and the authors presented evidence that the association ceased after the IFRS adoption. Thereby, we believe that a higher level of disclosure and compliance would signify better governance.

The compliance will improve if those items are disclosed separately. Research has established that these companies do not make sufficient efforts to identify and disclose the intangible assets acquired in business combinations individually (CARVALHO; RODRIGUES; FERREIRA, 2016). Therefore, by implementing mandatory disclosure of goodwill separately from intangible assets, the Board encourages compliance in companies. Moreover, investors could differ in a firm that makes efforts to improve its governance.

6 CONSISTENCY WITH THE US GAAPS

Section 6 of the DP states that 'the IFRS 3 is converged in many respects with the US generally accepted accounting principles (US GAAP). For example, under both IFRS 3 and US GAAP for public companies, companies do not amortize goodwill.' In addition, it questions whether we would change any of our comments if there were divergences between the IASB and the FASB standards.

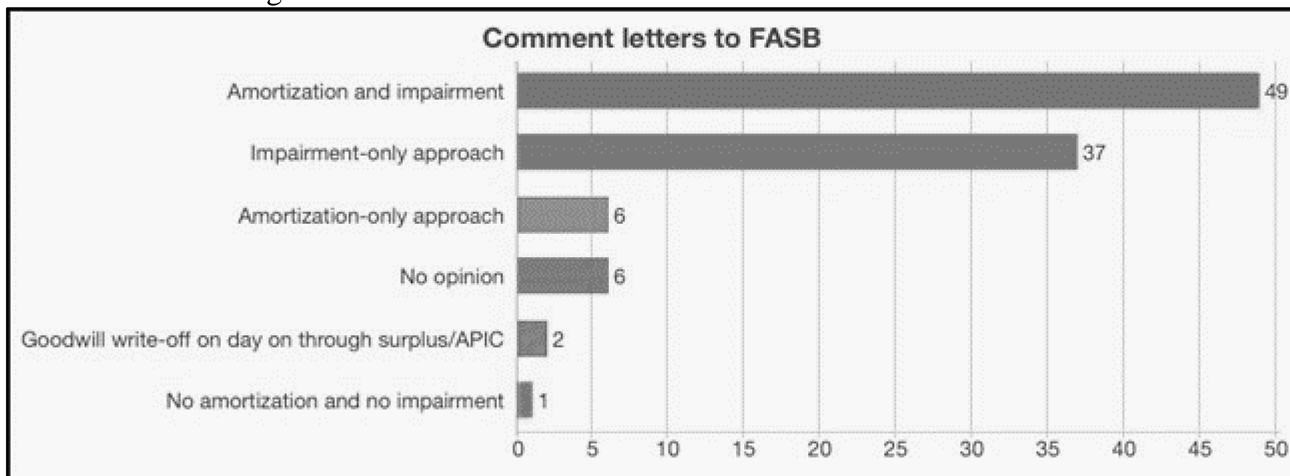
When adopting a hybrid model with goodwill amortization and the impairment test, when there are impairment indicators, the amendment to IFRS 3 published by the IASB will not be in line with other FASB standards.

The literature provides evidence that the lack of goodwill amortization distorts the accounting information and increases the risks for investors. Analyzing the sample with all the US listed firms during the period of 1983–2017, containing stock returns, the number of outstanding shares, and standard industrial classification (SIC) codes obtained from the Center for Research in Security Prices (CRSP), along with the firm-level annual accounting data from COMPUSTAT, Wu and Lai (2020, p. 21) concluded, among other aspects, that:

> Our findings call on portfolio managers and retail investors to be wary of excessive crash risk associated with intangible-intensive firms. Our findings also provide policy implications for regulatory agencies, the academia, and capital market participants to address the issues of managers' discretionary accounting choices and information disclosure on intangible assets and goodwill. Future policies should protect investors from stock price crashes caused by the fragility of goodwill.

Our opinion, expressed through this comment letter, is aligned with the majority of the comment letters sent to the FASB (as exhibited in figure 2) related to the ongoing Project: 2019-720 Identifiable Intangible Assets and Subsequent Accounting for Goodwill. We acknowledge that there are differences in the approach to the impairment test between the FASB and the IASB. Despite the differences, the majority of the comment letters support the hybrid model that we are advocating in our response: amortization along with an impairment test when there is an indication of impairment.

Figure 2 - Number of comment letters by opinion—Project 2019-720 Identifiable Assets and Subsequent Accounting for Goodwill



Source: Comment letters retrieved from https://www.fasb.org/jsp/FASB/CommentLetter_C/CommentLetterPage&cid=1218220137090&project_id=2019720&page_number=1. October 2019

We also present evidence of goodwill in publicly traded companies in the Brazilian capital market and its proportion of the total assets. See Table 1 and Table 2 below.

The Brazilian market for mergers and acquisitions, according to the Economatica database, had 41 companies that presented goodwill in a separate line item in the statement of financial position in 2010, out of a total of 592 public companies (6.92%). In 2019, 32 companies had presented goodwill out of a total of 610 public companies (5.24%), and the relative percentage of goodwill values recorded to total assets declined from 0.99% to 0.79% from 2010 to 2019.

Table 1 - Goodwill ratio (goodwill divided by total assets)

Year	Total Number of Companies	Companies with Goodwill	Assets	Booked Goodwill Value of All Companies	% Goodwill/ Total Assets (General)	% Goodwill/Total Assets of Companies with Goodwill
Amounts in Thousands of Reais						
2010	592	41	6,496,963,589	64,628,889	0.99%	6.02%
2011	607	45	7,293,672,991	77,443,863	1.06%	3.51%
2012	615	41	8,176,988,491	71,097,046	0.87%	6.44%
2013	625	34	8,418,078,367	80,192,652	0.95%	7.59%
2014	637	33	9,257,124,716	94,833,730	1.02%	11.93%
2015	624	33	9,936,418,350	112,490,820	1.13%	24.76%
2016	616	31	9,904,152,810	97,350,549	0.98%	19.31%
2017	615	26	10,118,555,655	81,413,284	0.80%	17.08%
2018	617	30	10,765,521,035	94,411,822	0.88%	19.46%
2019	610	32	11,633,907,703	91,928,635	0.79%	17.65%

Source: Economatica database. Reais: Brazilian currency. October 2020

When analyzing only the data of companies that have goodwill accounted for and exhibited in a separate line item in the statement of financial position, on December 31, 2019, the relative percentage of goodwill to total assets is 17.65%, including companies with more than 50% of their total assets accounted for as goodwill. The goodwill of the five largest companies (Saber, Ambev, JBS, Gerdau, and Gerdau Met) represents 89.74% of the total amount of goodwill accounted for and exhibited in a separate line item in the statement of financial position out of the 32 largest companies in 2019 (R$82,499,357/R$91,928,635), according to the data exhibited in Table 2.

Table 2. Largest companies with a relative percentage compared with total assets

Publicly Traded Company Name	Assets	Book Value of Goodwill	Goodwill/Total Assets
Amounts in Thousands of Reais (Brazilian currency)			
Saber Serviços Educacionais S/A	7,610,252	4,053,076	53.26%
Alper S.A.	261,125	133,773	51.23%
Qualicorp	3,380,063	1,516,342	44.86%
Quality Soft	108,263	43,778	40.44%
Alliar	2,401,121	844,768	35.18%
Ambev S/A	101,742,944	35,009,909	34.41%
Anima	2,400,023	760,733	31.70%
Linx	2,563,943	727,558	28.38%
Technos	676,091	155,520	23.00%
Nutriplant	58,409	12,828	21.96%
Ambipar	622,622	135,128	21.70%
JBS	126,339,387	24,497,750	19.39%
Totvs	3,535,927	622,331	17.60%
Gerdau	54,002,970	9,469,311	17.53%
Gerdau Met	54,048,736	9,469,311	17.52%
Metal Leve	2,327,651	407,372	17.50%
Lupatech	504,628	82,166	16.28%
Flex S/A	420,171	49,187	11.71%
Bbmlogistica	664,116	60,271	9.08%
Weg	15,687,641	1,118,315	7.13%
Marcopolo	5,193,678	245,796	4.73%
Duratex	10,714,688	472,704	4.41%
Tim	40,348,924	1,527,219	3.79%
Cinesystem	208,883	7,637	3.66%
Eternit	545,587	16,538	3.03%
Statkraft	2,203,515	46,595	2.11%

Publicly Traded Company Name	Assets	Book Value of Goodwill	Goodwill/Total Assets
Wilson Sons	4,639,629	56,792	1.22%
Lojas Renner	11,791,735	116,679	0.99%
Tupy	5,124,167	41,226	0.80%
Sul America	28,412,451	173,889	0.61%
Argo Energia Empreend e Part S/A	4,718,104	24,487	0.52%
Energias BR	27,489,069	29,646	0.11%
	520,746,513	91,928,635	17.65%

Source: Economatica database, http://economatica.com.br/ October 2020

This evidence corroborates that, although there is a greater movement in the mergers and acquisitions market in Brazil, as in other emerging and developed markets worldwide, the problem of accounting for the goodwill generated from business combinations is likely to grow as well as the percentage of the total assets.

CONCLUDING REMARKS

The DP sheds light on issues involving goodwill acquired in a business combination: disclosure, timeliness, the shielding effect due to headroom, and information relevance. There are many possible problems for a large asset. As mentioned in the DP, the amount of $8 trillion of goodwill of all listed companies worldwide really deserves special attention. The literature has reinforced the concern about this asset by presenting considerable evidence of problems of disclosure, the timeliness of impairment loss recognition of goodwill, and the value relevance of information.

The questions from the DP raise thoughts. The discussion among the authors led us to a broader understanding of the problem. This article sought to contribute new insights. We assessed the implications of the alternatives raised by the DP and discussed information quality based on the empirical evidence provided by the previous literature, and we tentatively take positions, although these positions may be a result of a limited view on the issues. We also provide a new suggestion for the definition of acquired goodwill and new arguments for the amortization of goodwill combined with impairment tests, as well as suggestions on disclosure principles.

In general, we agree with the board about the main questions, as shown in Table 3.

Table 3 - Synthesis of the discussion paper's answers

Question	Key Themes	Item	Answer	Alternatives Proposed?
2	Disclosure	a)	Affirmative	No
		b) (i)	Negative	No
		b) (ii)	Affirmative	No
		b) (iii)	Affirmative	No
		b) (iv)	Affirmative	No
		b) (v)	Affirmative	No
		b) (vi)	Affirmative	No
		c)	Negative	No
		d)	Affirmative	Yes
		e)	Affirmative	No
3	New disclosure requirements	a)	Affirmative	No
4	Requirement specific to disclosure	a)	Affirmative	No
5	Pro-forma information	a)	Affirmative	No
		b)	Affirmative	No
		c)	Affirmative	No
6	Impairment test	a)	Affirmative	No
		b)	Not applicable	--------
		c)	Affirmative	No
		d)	Negative	No
7	Amortization of goodwill	a)	Negative	Yes
		b)	Affirmative	No
		c)	Affirmative	No
		d)	Affirmative	No
		e)	Not applicable	--------
		f)	Affirmative	Yes
8	Total equity without goodwill	a)	Affirmative	No
		b)	Negative	No
9	Quantitative annual impairment test	a)	Affirmative	No
		b)	Affirmative	No
		c)	Negative	No
10	Estimate of value in use	a)	Affirmative	No
		b)	Negative	No
11	Impairment test simplification	a)	Negative	No
		b)	Negative	No
12	Inclusion of intangible assets in goodwill	a)	Affirmative	No
		b)	Not applicable	No
		c)	Negative	No
13	Convergence with US GAAPs	a)	Negative	No

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The main positions of the authors are as follows: the disclosure about acquisitions should focus on the monitoring of the success or failure of the acquisition; the impairment test has no technical problems of effectiveness; the acquired goodwill should be amortized over the time in which the manager

expects to recover that investment; an impairment test should be run when an adverse event happens and not annually; intangibles should continue to be recognized separately from goodwill; and the change to the amortization model will probably converge with the US GAAPs.

Our positions expressed in this work were the result of discussions by the group of authors about the issues raised in the DP. There was not always immediate consensus from the group, as there is no right answer to each of these questions. Our position represents only one possible answer and is not intended to be the only answer that could be given based on scientific evidence. Thus, we understand that providing a position to the reader would be better than not offering it, as this allows him to have a reference so that he can make his own assessment and agree or disagree. More than that, we understand that this allows the reader to perceive the richness of the process of formulating an accounting standard through an academic discussion based on empirical evidence.

From the point of view of previous scientific knowledge, it is possible to observe that some problems raised by the literature are considered in the problems pointed out by the standard-setter in the DP. The management of goodwill impairment results is the main one, widely reported in the literature in several aspects, such as timeliness, relevance and manager behavior. On the other hand, the headroom problem reported by the IASB has little empirical evidence in the literature, even though it is a phenomenon that can be deduced from the actual application of the current standard. Theories produced and empirically verified by the literature are capable of predicting the effects of the proposed changes.

This paper is limited to the proposed objective and its methodological choices. The article does not contain new empirical evidence as a traditional paper in accounting, but it may motivate future quantitative or qualitative research. We suggest future research, before or after the issue of a possible new accounting standard on the subject, involving the amortization and impairment of goodwill, the manager's ability to manage earnings in relation to the expected time for recovery of the investment in acquisitions, the shielding effect due to headroom in consolidated balance sheets, in addition to behavioral research involving the manager's over-optimism in the expected results of the acquisition and in his accounting choices.

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