Regulation and Supervision at a glance
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Goodwill Accounting under IFRS

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The value of goodwill positions recognised globally amounts to 7000 billion dollars[1] already – and it keeps rising, even though US companies are estimated to have a higher impairment risk than their European counterparts.[2] German DAX 30-listed companies alone reported goodwill positions of 260 billion euros by the end of 2017.[3] On average, goodwill now accounts for 44.83 % of the balance sheet equity of DAX 30 companies.[4]

→ The current goodwill accounting requirements according to the International Financial Reporting Standards (IFRS) create a **threat to global financial stability**.

→ A goodwill bubble of considerable proportions is clearly emerging – its bursting risks entailing **procyclical effects** in an economic downwards scenario.

1 Source: Wirtschaftswoche 20/11 May 2018, p. 68–71 (69).
2 Findings of the current study: Deutsche Bank Research, The goodwill barometer of 19 July 2018.
3 Source: Own calculations based on data in: WirtschaftsWoche 20/11 May 2018, p. 68–71 (70).
4 The company-specific relative share of goodwill in Equity ranges from 1 % to 116 %. The respective share of DAX 30-listed insurers amounts to 17 % (Allianz) and 9 % (Munich Re). Source: ibidem.

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Key Positions

→ The regulatory measures (e.g. Solvency II) implemented over the last years have made the **insurance industry more resilient to crises.** Goodwill positions are not recognised in the supervisory reporting of assets and liabilities (i.e. Solvency II Balance Sheet).

→ While we have clearly entered a state of overregulation by now, especially in the insurance industry, the efforts made over the last years are undermined by inadequate IFRS provisions on **goodwill accounting**. For this reason, it is vital to **reconsider goodwill accounting provisions under IFRS** and re-introduce systematic amortisation.

→ It is an encouraging sign that the global standard-setter – the International Accounting Standards Board (IASB) – has agreed, in its meeting on 18 July 2018, to explore the **re-admission of systematic goodwill amortisation** as an alternative approach.

Goodwill accounting problem

The ban on systematic goodwill amortisation under IFRS is considered to be the **reason** behind the inflated amount of goodwill accounted for. Goodwill is only subject to a (discretionary) impairment test (so-called **Impairment Only Approach, IOA**). Therefore, it is of key importance for the IASB to rectify the current provision. The continuously growing global goodwill bubble must be deflated before the global economy falls into a self-reinforcing downward spiral. To illustrate the accounting problem of recognising acquired goodwill, we will first explain the accounting treatment of internally generated goodwill.

Internally generated goodwill

Internally generated goodwill is a combination of value-increasing elements that cannot be recognised in the balance sheet under current accounting conventions. Examples include the good reputation of a company, the quality of its products and its management, the know-how of its employees, the expected loyalty of its clients, operational and organisational structure in production and distribution etc. These positions are hard to be separately identified, not reliably measurable and potentially not controlled by the entity. However, they have one thing in common – the hope that their advantages can be used for the benefit of the company. Recognising their expected values as an asset item in the balance sheet would mean recognising **items based on hope alone,** resulting in an inflated equity of the reporting entity. For this reason, goodwill internally generated by the companies themselves is **not recognised** in the balance sheet.

Goodwill acquired in a business combination/acquired goodwill

Acquired goodwill can be interpreted as "internally generated goodwill acquired through purchase". Moreover, in corporate transactions between external third parties there is often a difference between the price paid by the purchaser and the sum of assets and liabilities of the purchased company that are recognised at fair value. In terms of the balance sheet, acquired goodwill is a **residual value** that remains after the purchase price has been allocated to the individual assets and liabilities.

Each business combination has a different economic background – some are intended to improve the competitive position, others are initiated in the hope of creating synergies between the purchasing and the purchased company. The payment of **takeover premiums** can also have different motivations: Some are paid in the hope of benefitting from the success of the purchased company's technologies, others are quite simply overpayments caused by poor negotiating and/or the dynamics of the negotiation process. Hence, goodwill resulting from price allocation is based on diverging motivations.

How is goodwill accounted for under the German Commercial Code (HGB), IFRS and Solvency II?

Chart I presents the accounting principles for the recognition of internally generated and acquired goodwill under HGB, IFRS and Solvency II. As illustrated therein, the **main difference** between the recognition of acquired goodwill under HGB and IFRS lies in its **subsequent measurement.**

- According to **HGB, straight-line amortisation** over a period of **ten years** is compulsory where the expected useful life cannot be estimated in a reliable manner. Thereby, the recognition of acquired goodwill is systematically adjusted downwards until it disappears from the balance sheet – the system **prevents the risk of exaggerated measurements** and artificially inflated HGB balance sheets.

- According to **IFRS,** acquired goodwill shall **not be subject to systematic amortisation,** but only to annual impairment tests. The **IOA** is based on the assumption that **acquired goodwill** is an **asset with an indefinite useful life.**

Goodwill accounting as a problem of IFRS balance sheets

Chart I **· Similarities and differences in goodwill accounting under HGB, IFRS and Solvency II**

	HGB (German Commercial Code)	IFRS	Solvency II
Recognition of internally generated goodwill	**No recognition** (Not an asset according to German GAAP)	**No recognition** (IAS 38.48)	**No recognition**
Recognition of acquired goodwill			
- Recognition	**Obligation to recognise** (Definition as asset based on legal fiction, Sect. 246 (1) sentence 4 HGB)	**Obligation to recognise**	**No recognition**[5]
- Measurement at recognition	Recognised at the **difference** by which the price paid for purchasing a company exceeds the value of the individual assets of the company minus the liabilities at the time of takeover (Section 246 (1) sentence 4 HGB)	Similar to HGB: **Residual figure** calculated based on allocation of company purchase price (more details under IFRS 3.32)	**Not applicable**
- Measurement after recognition	**- Obligation to perform systematic straight-line amortisation;** - Obligation to perform extraordinary adjustments in case of probably permanent impairments; - **Prohibition of reversal of impairment losses** (Section 253 (5) sentence 2 HGB)	**- Prohibition of systematic amortisation;** - Impairment test to be performed at least annually; - **Prohibition of reversal of impairment losses** (IAS 36.124)	**Not applicable**

Source: GDV chart

Why has the systematic amortisation of acquired goodwill been prohibited under IFRS?

The prohibition of goodwill amortisation under IFRS has been introduced in the context of the revision of US GAAP by US standard-setter Financial Accounting Standards Board (FASB). Prior to that, systematic goodwill amortisation had been common IFRS accounting practice for many years. Under US GAAP, acquired goodwill had also been amortised for more than 30 years (starting from 1970) before it was prohibited in 2001.[6]

US standard-setter FASB had been critical of the co-existence of two different accounting procedures for the recognition of company mergers, which led to different accounting results.[7] In addition to the purchase method, the pooling-of-interests method could also be applied under certain circumstances. The ban of the latter in 2001 gave rise to a **political controversy** on the necessity of protecting the interests of the US economy. In an attempt to resolve the controversy, it was decided to put an end to the systematic amortisation of goodwill created through the application of the purchase method. Since then, acquired goodwill has only been subjected to impairment tests. The IASB has adopted this approach – which has been politically motivated, but face-saving for the FASB – because of its increased harmonisation attempts in the field of IFRS accounting at the time.

Outcome of the ban on systematic goodwill amortisation

Following the ban on goodwill amortisation (with effect from 2005) under the IFRS, recognised goodwill amounts have increased, e.g. in German Dax 30 companies. Similar developments have taken place at the global level. At the same time, the IASB's "Post Implementation Review" on the functioning of IFRS 3 *Business Combinations* came to the conclusion that the cost-benefit ratio of this IFRS provision is widely perceived as a significant issue. According to the results of the Review, the IOA approach "is complex, time-consuming and expensive and involves significant judgements".[8]

5 According to Art. 12 Commission Delegated Regulation (EU) 2015/35 of 10 October 2014, Goodwill is valued at zero for Solvency II purposes, which implies a non-recognition.
6 For a short historical overview, cf. FASB, Agenda Paper 18B, FASB/IASB June 2018 Meeting, paragraph 3–10.
7 Cf. FASB, Agenda Paper 18B, FASB/IASB June 2018 Meeting, paragraph 3.

8 Cf. IASB's Report and Feedback Statement of June 2015, p. 6 and 22.

This undesirable development is due to the fact that the impairment test required by the IOA under IFRS entails the implicit recognition of internally generated goodwill (despite the prohibition under IAS 38.48!)[9], inevitably resulting in the **"too little, too late"** problem: Impairment losses on acquired goodwill are recognised too late and their volume is far too small.[10] Therefore, the recoverability of recognised goodwill amounts must be seen in a critical light, despite the only seemingly precise, costly calculations needed for the IOA. The **lack of amortisations on acquired goodwill** is due to its blending with internally generated goodwill, which shall not be recognised. IFRS balance sheets risk becoming even less reliable if the lack of systematic amortisations of acquired goodwill continues to exist.

Will goodwill amortisation under IFRS be reintroduced?

The IASB has been discussing how to overcome the negative effects of the IOA and reduce its costs for some time now. It is an encouraging sign that recently presented ideas that would have made the IOA even more complicated have been dropped.[11] In the Board meeting on 23 May 2018, the course of debate has changed directions. The Board acknowledged the fact that the current treatment of goodwill might put the IASB's reputation at risk. In its meeting on 18 July 2018, the Board decided to explore the re-admission of systematic goodwill amortisation as a next step. Hence, the recent discussions have contributed to the insight that it will not be enough to address the effects of the IOA, but that the underlying reason – the ban on goodwill amortisation – must be dealt with, too. In its analyses performed so far, the IASB concluded that **the IOA itself is the root of the problem.**

9 The comparison between the carrying amount of a cash-generating unit and its recoverable amount (higher of value in use and fair value less costs to sell), which must be performed in the context of the impairment test, takes into account the value-enhancing effects of internally generated goodwill, even though the latter is not eligible for recognition in principle.

10 In 2015, average annual goodwill amortisations have fallen to the level of only 1.8 %. Cf. Robert Braun's warning in: Praktische Erfahrungen zum Werthaltigkeitstest gemäß IAS 36, Die Wirtschaftsprüfung 12/2008, p. 749–754 (749 f.).

11 As regards the so-called pre-acquisition/updated headroom approach, cf. IASB, Agenda Paper 18C, IASB December 2018 Meeting.

Positions of the German insurance industry

The German Insurance Association takes the position that the ban on goodwill amortisation under IFRS should be reconsidered. The following reasons speak in favour of abandoning the IOA and quickly reinstating the straight-line amortisation of goodwill:

- The different accounting treatment of internally generated goodwill (which shall not be recognised) and acquired goodwill (which must be recognised) leads to an **asymmetry**, which is creating a disadvantage for organically growing companies.

- Admitting systematic amortisation of goodwill under IFRS would **eliminate** the incentive created by the IOA with regards to company takeover activities.

- Returning to straight-line goodwill amortisation would not only have a **disciplinary effect** on future takeover activities, but also **reduce operational costs** to the benefit of companies, auditors and market supervisors.

- Maintaining the IOA would entail the risk of **procyclical effects** exacerbating future economic regressions, given that goodwill amounts accumulated in company balance sheets might have to be impaired at the same time, with corresponding implications for the companies' equity position and the capital market.

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