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International Organization of Securities Commissions (IOSCO)
Calle Oquendo 12
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**Comments on the Consultation paper *Consultation on Goodwill***

To the IOSCO Board Members:

The Japanese Institute of Certified Public Accountants (JICPA) appreciates the continued efforts of the International Organization of Securities Commissions (IOSCO) to support consistent application and enforcement of high-quality reporting standards and disclosure regulations, and welcomes the opportunity to comment on the Consultation paper *Consultation on Goodwill.*

Please see our comments to each Question for Independent Auditors in the following pages.

**Question 20:** How can the impairment test for goodwill in IAS 36 be improved to address the concerns around the timely identification and recognition of an impairment charge?

**Comment:**
As already considered in the IASB project, it is not feasible to design a different impairment test for goodwill that is significantly more effective than the impairment test in IAS 36. We understand that the IASB is mainly discussing about ways to improve disclosures at the moment. However, we do not think the 'too little, too late' issue can be solved through modifying accounting standards, unless amortisation of goodwill is reintroduced. In other words, we strongly believe there are no realistic options that would be able to address the issue other than reintroducing amortisation. We think that reintroducing amortisation is a practical and effective approach to address the concern arising from impairment losses not being recognised on a timely basis, instead of directly tackling fundamental flaws underlying the impairment test.

The impairment test for goodwill requires significant management judgements and estimates, which can be hard for auditors to assess in some cases. As we responded to Questions 22 and 24, assumptions underlying future estimates are largely dependent on subjective judgements made by management and unconscious management bias may be present in making of such estimates, which could cause difficulties for auditors in assessing the reasonableness of assumptions and projections. Considering this nature of accounting estimates, the issue of 'too little, too late' would be solved by applying the amortisation and impairment approach (i.e. the reintroduction of amortisation), not the impairment-only model.

Regardless of the reintroduction of amortisation, though, we should keep making an effort to take practical solutions, including urging on management the importance of applying prudence to accounting estimates, enhancing the quality of audit to assess management's estimates, and providing investors with transparent enough disclosures about the process of impairment testing, in order to address the issue of 'too little, too late.'

That being said, we hope the following adjustments to IAS 36 might be able to improve the recognition of impairment losses on a more timely basis, although they would not represent fundamental changes to the impairment test.

- In IAS 36, goodwill is allocated to cash-generating units, or groups of cash-generating units, expected to benefit from the synergies of the business combination. It is required under the standard that each unit or group of units shall represent the lowest level within the entity at which the goodwill is monitored for internal management purposes and shall not be larger than an operating segment as defined by paragraph 5 of IFRS 8 *Operating Segments* before aggregation. However, there are many cases in practice where the unit subject to monitoring for internal management purposes represents an operating segment, indicating the requirement is failing to work as a constraint to appropriately narrow down the level of unit for goodwill allocation purposes. This can be the reason why impairment losses are not recognised on a timely basis.

For example, we may suggest adding the following constraints to the requirement in order to clarify the relation between benefits expected from synergies due to business combinations and cash-generating units (or groups of cash-generating units), which could contribute to lower the highest level to which goodwill is allocated.

- ➢ The benefits expected at the acquisition date from synergies due to business combinations should be anticipated for the unit(s).
- ➢ The unit(s) should represent the lowest level in which specific factors generating synergies are identified at the time of business combination.

Adding the above-mentioned constraints to IAS 36 and enhancing disclosures for goodwill may encourage preparers to make a careful consideration before determining that a cash-generating unit or group of cash-generating units is represented by an operating segment. Further, more detailed information can be provided to users about goodwill allocated to cash-generating units, or groups of cash-generating units, and the nature of synergies.

**Question 21:** What good practices have you observed of management applying IAS 36 to timely identify and recognize goodwill impairment charges?

**Comment:**

We have seen certain good practices, including the following:

- An indication of impairment is identified not when it is determined that an event occurs, such as a withdrawal or sale of business, but when a plan arises for those withdrawals or sales, when the market environment deteriorates, or when other objective external factors are observed. Consideration is made accordingly throughout the period whether to recognise impairment losses and the consideration process is disclosed in the footnotes related to accounting estimates or impairment losses.

- Premises and assumptions for estimating future cash flows are not just based on subjective management projections, but also developed using external data, past performance, and other objective source of information that is available. Also, internal controls for examining the reasonableness of such assumptions are designed and operating.
- When projecting future cash flows, an entity breaks down sales, growth rates, cost ratios and other inputs forming the projection into key components or assumptions, which are analysed individually (e.g. sensitivity analysis).

> **Question 22:** The evaluation of whether goodwill is impaired requires significant management judgment and is subject to significant estimation uncertainty.
>
> What challenges have you experienced in executing audit procedures to test the reasonableness of management's assumptions used in the impairment tests of goodwill?
>
> How do you maintain and demonstrate your professional scepticism when auditing management's estimates used in the goodwill impairment tests?

**Comment:**

When management projects future cash flows, their premises underlying projected economic trends as well as their estimates on market information, such as exchange rates and crude oil prices, are largely dependent on judgements made by management. Further, when considering revenue growth rates or cost reduction plans for new businesses, such information usually cannot be corroborated directly with external data or historical results, which may cause difficulties in assessing the reasonableness of assumptions and projections used by management. We especially encounter these difficulties for new businesses and startups.

That said, the following are some examples of how we demonstrate our professional scepticism when auditing significant management judgements for accounting estimates: compare management's estimates with external objective data, such as competitors' publicised information, industry average ratios, and forward-looking information published by specialists; and run a sensitivity analysis on management's assumptions to analyse the impact on impairment test results when the assumptions change within a reasonable range.

**Question 23:** Does management's documentation adequately support the reasonableness of their assumptions and judgments made?

**Comment:**
For the purpose of documenting the process of impairment testing, management may use qualified external experts or specialised employees within the entity who are capable of preparing such information. In those cases, audits can often be conducted efficiently because the reasonableness of premises and judgements used by management for their estimation methods, assumptions, and data for the impairment testing is appropriately documented.

On the other hand, when management fails to use qualified external experts or when employees with little expertise are preparing information, adequate documentation may not exist within the entity.

Although internal controls are usually in place to some extent throughout the process of impairment testing, including a review by qualified personnel and an approval from management, it is our understanding that they are not always sufficiently supporting the reasonableness of management’s assumptions and judgements in an objective manner, and as such, auditors have to look into each case.

**Question 24:** In your experience, does management give objective consideration to both corroborative and contradictory information when setting assumptions? If not, please explain areas within the estimate where unconscious bias may be present.

**Comment:**
We encounter cases where it is doubtful whether management has given objective consideration to both corroborative and contradictory information when setting assumptions. Unconscious bias may particularly exist in the following areas:

- An objective outlook and management’s hope or pursuit could be mixed up in projected amounts of sales and costs consisting of the budget on which a cash flow projection is based.
- Despite having a downside risk in future cash flows, the projection of future cash flows remains to be based on historical trends.
- An entity that does not expect any direct impacts of economic uncertainties arising from COVID-19 pandemic, the current international situation surrounding Ukraine, or other events is projecting its future cash flows without considering indirect impacts that are yet to be seen, such as the global supply disruption causing price

hikes or shortages of certain products.

**Question 25:** Would additional educational material on auditing management's estimates be useful? If yes, which educational material would be relevant and useful?

**Comment:**

We understand that the audit practice for impairment testing has been prevalent to a certain degree and matured over time. Accordingly, we do not expect the audit practice to significantly improve regardless of whether or not we have additional educational material on auditing management's estimate.

That being said, we may suggest developing additional educational material on auditing management's estimate may enable management to obtain a better understanding about our audit procedures and their importance, if management can also read and understand such material.

Yours faithfully,

Eriko Otokozawa
Executive Board Member — Business Accounting Standards and Practice/Corporate Disclosure
The Japanese Institute of Certified Public Accountants