COVID-19 as a Triggering Event in the Goodwill Impairment Testing

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Abstract

The purpose of this article is to review and analyze the existing regulation of the accounting impairment of goodwill in the financial statements of enterprises in the light of the COVID-19 pandemic, answering the question of whether COVID-19 can be considered as a "triggering event" in the performance of the impairment test. As a result of the study it was concluded that the assessment of whether COVID-19 is a "triggering event" with material impact on goodwill impairment should be made on the basis of enterprise-specific indicators and should be performed holistically.

Keywords: goodwill impairment, indicators, COVID-19, triggering event, IAS 36

JEL Code: M41

Introduction

Subsequent measurement of an entity's assets is critical to their value in the entity's financial statements and is critical to the ways in which financial information will be perceived. In addition, adequate and correct valuation of assets is a prerequisite for improving the quality characteristics of the disclosed accounting information in the financial statements of enterprises. Information about the accounting impairment of goodwill is often perceived as a signal of a problem in the functioning of the acquired business due to the requirements and specifics of the tests. The COVID-19 pandemic, which has been around for two years, has not only affected public health but also created serious financial, social and economic problems for businesses by changing the way companies structure and manage their businesses. We have witnessed a collapse in market prices of listed companies, layoffs, closure of retail outlets, reorganization of entire production facilities, etc., which inevitably affects the accounting estimates that companies use to represent the various accounting outlets in its financial statements.

The purpose of this article is to review and analyze the existing regulation of the accounting impairment of goodwill in the financial statements of enterprises in the light of the COVID-19 pandemic, answering the question of whether COVID-19 can be considered "triggering" event in the performance of the impairment test. In the present study, we do not aim to critically analyze the existing regulations regarding the subsequent reporting of the goodwill and the adoption of only the "model of impairment", as well as the possible difficulties and effects that arise from this.

Legal regulation of the subsequent assessment of the goodwill according to IAS / IFRS

As required by IFRS 3 Business Combinations, recognized goodwill is treated as a specific asset that is not depreciated but is subject to annual impairment testing only. The impairment test is performed in accordance with the requirements of IAS 36 Impairment of Assets. According to the requirements of the standard (IAS36, 2010) in order for impairment to occur, the carrying amount of the asset should exceed its recoverable amount. In this case, the asset is considered to be impaired and the entity shall reduce its carrying amount by recognizing an impairment loss. The requirement has also been introduced that the goodwill acquired in a business combination be tested for impairment at least once a year, clarifying that the loss from impairment of goodwill cannot be reversed. For the purpose of impairment testing, goodwill should be allocated to the cash-generating unit (CGU) or groups of CGUs that are expected to benefit from the synergy resulting from the business combination, whether or not other assets or liabilities of the acquiree are attributable to these units or groups of units, i.e. which will derive economic benefit from goodwill.

The allocation of goodwill to CGU or to a group of CGUs arises from the fact that goodwill does not in itself generate cash flows separately from other assets of the enterprise. In addition, unlike many other non-current assets, it is not possible to determine directly the fair value of goodwill or its value in use. In our view, in many cases, goodwill may be related to the results and cash flows of more than one cash-generating unit. This also leads to the requirement "the lowest level in the enterprise at which goodwill is observed for internal management purposes sometimes covers several cash-generating units to which goodwill is linked but to which it cannot be allocated". (IAS36, 2010)

One of the challenges that companies face in testing for goodwill impairment is determining the recoverable amount of CGU . The very definition of recoverable amount is not under discussion. This is considered to be the higher of the fair price less costs to sell and value in use. A basic valuation principle is that the valuation of each asset can be considered as a function of (1) the future cash receipts for the asset owner, (2) the time to receive that income, and (3) the risk associated with the realization of the estimated income. for the allotted time. (Deloitte, 2004)

It is important to note that the provisions of the applicable standards do not allow for the recovery of recognized impairment losses on goodwill like other non-current assets. We consider this regulation to be quite correct, as we believe that otherwise the company's management will have to be able to clearly determine the extent to which the subsequent increase in the recoverable amount of goodwill may be related and due to the restoration of goodwill in within the CGU or an increase in the internal goodwill of the CGU, which is practically impossible in practice. Because of these arguments, we share the views of regulators and accept them as an expression of reasonable judgment, taking into account the peculiarities of the nature of goodwill and how to maintain it - the relationship between acquired and internally generated goodwill over time. The opposite would create conflict and a lack of comparability between companies that have recognized goodwill as a result of an acquisition and those that have not.

Factors (determinants) for the impairment of goodwill.

Understanding the concept of goodwill impairment should be subject to clarifying the factors (determinants) that underlie this concept. In the last fifteen years, a significant part of the publications on the topic of "business combinations and goodwill" are directly or indirectly related to the clarification of these factors. To be considered as a triggering event in goodwill impairment testing it needs to have a material impact on the goodwill value.

Various studies in this area point to some of the main factors that are important in the impairment of goodwill (Glaum, et al., 2015) (Verriest & Gaeremynck, 2009):

- ✓ The form and structure of ownership;
- ✓ The quality of corporate governance;
- ✓ The financial and economic condition of the enterprise.

As a result of their study Verriest and Gaeremynck found that only 53% of the companies surveyed depreciated their goodwill, although the authors expected a much higher percentage of companies to do so. The results give the authors reason to believe that "the interpretation of IAS 36 may differ materially from entity to entity". (Verriest & Gaeremynck, 2009, p. 119) These results should be perceived in the context of other indicators for measuring the economic performance (condition) of the enterprise, such as the authors' return on assets (ROA = 5.9%), the ratio of market value to the book value of capital (MV / BV = 1.45) and the debt -to-assets ratio (66%) .

Derived by Andre et al. (André, et al., 2016) three main indicators of the existence of impairment of goodwill aim to reveal the circumstances that lead to the existence of economic impairment of goodwill. In the role of such indicators, they determine what we already know: the ratio of market value to book value of capital, EBITDA and the negative value of the difference between market and book value of capital. One of the authors' ideas is to use the indicators of economic impairment indicated by them as a starting point for the analysis of the level of accounting impairment of goodwill in the context of their time adequacy (timeliness). To these indicators the authors of another study conducted on the basis of 91 public companies in Brazil for the period 2011 - 2014, Vogt and others. (Vogt, et al., 2016) add a change in management, the number of EGPs, the change in the return on assets (ΔROA) and the amount of goodwill recognized in the financial statements. One of the most important conclusions made by the authors is that along with the economic indicators related to the recognition of impairment losses on assets, the role of management decisions in this process stands out.

The management of the company, which can be found in the research of Zang (Zang, 2008), Lemans (Lemans, 2010), Šapkauskienė and Leitonienė (Šapkauskienė & Leitonienė, 2014) is also considered as a key factor playing a key role in reporting impairment of goodwill. One of the main conclusions, based on these studies, shows that the change of management is related to the reporting of impairment of goodwill by companies. According to the authors, new financial managers tend to write off their goodwill in the name of better results in the future. In addition, the goodwill of the executive directors, their behavior, the bonuses and bonuses they receive based on the results achieved, etc. are mentioned, as according to Šapkauskienė and Leitonienė managers are reluctant to recognize impairments in the financial statements when this would lead to a reduction in their premiums, deterioration of their goodwill, lowering the ratings of their work on the basis of the profitability they provide to investors, etc.

Regardless of the relative objectivity of financial indicators, we believe that those non-financial measures that are often directly related to the motives for the acquisition and may have a significant impact on the value of goodwill should not be excluded from the scope of the analysis. As we have mentioned before, such indicators can be considered: information on corporate management and enterprise strategy, information on corporate social commitment of the company, the environment in which it operates, market share, number of customers, staff turnover, information on formed corporate cultural values, set development strategies, etc. (Atanasov, 2012)

Mavrinac and Siesfeld (Mavrinac & Siesfeld, 1998) attempt to analyze the importance of non-financial factors in the investment decision-making process of financial market participants and conclude that non-financial information has a significant impact on investment decisions. In this context of non-financial indicators, it should be noted that the corporate culture factor is also important for a merger and acquisition transaction. In many cases, it is cultural differences and cultural compatibility or incompatibility that are the factors that can change the financial plans of managers beyond recognition in a merger or acquisition.

Undoubtedly, corporate culture is reflected in the behavior of the human factor in enterprises. So according to Wyatt (Wyatt, 2008) certain industries are highly dependent on intellectual capital and in particular on human capital. She points out that the use of non-financial measures, such as staff skills, is very important for companies and they can be associated with different levels of growth in individual companies. Wyatt believes that the approaches adopted for the management of "human capital" are related to the financial performance of the company. In her conclusions, she relies on Hand 's study , according to which financial measures such as equity growth, realized profits, operating income, value of sales, dividends paid and more can explain about 70% of the market price of company shares. These findings become even more important in the context of COVID-19 impairment testing, as very often intellectual capital is heavily affected by the pandemic, but the assessment of this impact cannot be directly seen in the financial statements of companies.

From the above, we believe that it is possible that the factors influencing the impairment of assets can be divided into two groups depending on their scope and characteristics:

According to their scope: internal and external indicators;

Internal indicators	External indicators
➢ ***Financial*** ➢ Amount of goodwill in the annual financial statements ➢ Market value of capital (market capitalization) ➢ Book value of capital / net assets / ➢ Profit management policies ➢ Return on assets ➢ The level of indebtedness ➢ Data from internal reports of internal audit ➢ Other events specific to the enterprise or EGP, etc.	***Economically*** ➢ The level of productivity in the country, measured by GDP ➢ Level of saturation of the market in which the company operates.
Management ➢ The change of executive management ➢ The goodwill of executive management ➢ Ways to form management remuneration ➢ The ownership structure	
Organizational ➢ Size of the enterprise ➢ Number of operating segments / EGPP	

According to their characteristics: financial and non-financial indicators

Financial indicators	Non-financial indicators
➢ Amount of goodwill in the annual financial statements ➢ Market value of capital (market capitalization) ➢ Book value of capital / net assets / ➢ Profit management policies ➢ Return on assets ➢ The level of indebtedness ➢ Number of EGPP ➢ Data from internal reports of internal audit ➢ Other enterprise- or EGP-specific events	➢ Market share of the enterprise ➢ Company culture ➢ Staff / staff characteristics ➢ Motivation of staff to work after the transaction ➢ Number of customers ➢ Capital / ownership structure ➢ The motives of the management related to the formation of its remuneration ➢ Other events specific to the enterprise or EGP, etc.

It should be noted that impairment of goodwill is more specific than impairment of tangible assets, where it is much easier to determine the value in use or the net fair value of assets. Therefore, when performing an analysis for the presence of impairment, we believe that these indicators are essential, and should be considered rather as basic and be interpreted on the basis of the characteristics of the activities of a particular enterprise. In addition, the principle of consistency should be observed by regularly reviewing circumstances that have occurred in previous periods and whose existence has led to the recognition of impairment losses on goodwill. If a triggering event or indicator exist it request a deep analysis and imapairment test performing at the CGU level.

COVID-19 and its impact on goodwill impairment

The complex nature of goodwill as an accounting object and the specifics of its impairment testing require a very careful review of the factors that indicate that a CGU may be impaired. We believe that in general they include the following circumstances:

- ✓ During the period there have been significant adverse changes in the technological, market, economic or legal environment that affect the company, which shows that the economic results are or will be worse than expected.
- ✓ Market interest rates or other market rates of return on investment have increased over the period, and these increases are likely to significantly reduce the asset's recoverable amount.
- ✓ The carrying amount of the net assets of the enterprise is greater than its market capitalization.

In the last two years, the COVID-19 pandemic has led to significant changes in the economies of countries around the world. A significant part of the industries were affected as the results were reduced sales, reduced revenue, staff reductions, closures, increased indebtedness, delayed payments, etc. All this had an impact on the accounting estimates used in the financial statements of enterprises. In this regard, company managements are faced with various issues related to determining the effects of COVID-19 on their business. For example, the temporary breaking of activities or the decline in demand, prices and profitability are obviously events that may indicate impairment. But at the same time, management must assess how and to what extent the pandemic would affect the particular business.

What has been said so far requires answering a few basic questions: *Can it be assumed that the adverse economic effects of COVID-19 could be a triggering in goodwill impairment process? Do external or internal indicators matter more? And what are the challenges that business executives need to address in order to present true and fair goodwill information in the financial statements?*

Impairment indicators may be presented in material changes that have an adverse effect on the enterprise that occurred during the period or will occur in the near future in the market or economic environment in which the enterprise operates as a result of COVID-19. In this context, the consulting and auditing company PwC states that management should assess whether COVID-19 and the measures taken to control it are likely to reduce future cash flows or increase operating and other costs, and whether these events (including for example, lowering the company's share price so that the market capitalization is lower than the transfer value) are an indicator of impairment that requires goodwill and intangible assets with indefinite life to be tested outside the annual cycle or other assets to be tested. (PwC, 2020)

Caution should be exercised with regard to cash flow assumptions and projections used for impairment testing. They should reflect both the existing and the potential impact of the pandemic, as far as foreseeable at the enterprise level. In estimating future cash flows, an entity should consider available external information and, as indicated by KPMG due to the high degree of uncertainty and the resulting cash flow forecasting challenges, it may be useful to base these estimates on external sources, such as economic forecasts from reputable central banks and other international organizations. (KPMG, 2020)

It is extremely important to study the nature of the activity and the business sector in which the company operates. It is known that different sectors of the economy have been affected to varying degrees by the COVID-19 pandemic. In this regard, management should assess whether their business is affected by declining demand for their products or services or by restrictions imposed by governments.

Dependence on supply chains or the availability of production facilities in countries significantly affected by COVID-19, as well as trade relations with partners in countries significantly affected by COVID-19 are also some of the factors mentioned in the literature that should be carefully analyzed. (KPMG, 2020)

General budgets, forecasts and other assumptions previously made by the entity in connection with impairment testing, for example in the previous quarter, should not be used. All assumptions used to determine the recoverable amount of CGU should be revised to reflect economic conditions at the balance sheet date and in particular to address the increased risk and uncertainty resulting from COVID-19.

Careful consideration of the growth rates set, as well as the discount rate used, may be crucial in an environment of uncertainty caused by COVID-19. Discount rates should include the risk associated with COVID-19, and it is very important for management to ensure that the relevant risk is reflected in the cash flow forecast and the discount rate. In this regard, we believe that it is important to develop different scenarios (optimistic, pessimistic, realistic) for business development and to monitor and control their implementation and timely change, which in turn would make forecasts dynamic and more realistic.

A Deloitte study cites factors stemming from the COVID -19 pandemic, which the authors say show that the book value of CGU may not be restored. These may include (1) reduced demand for the enterprise's products or services; (2) increased costs / business interruptions due to supply chain problems; (3) cancellation or postponement of customer orders; (4) the need to provide significant discounts to customers; (5) significant customers experiencing financial difficulties or cash flow difficulties.(Deloitte, 2020) The analysis also points out that given the recent declines in stock market prices, the carrying amount of the company's net assets may exceed its market capitalization.

In its report, Grant Thorton also identified certain indicators by which COVID-19 could affect the value of goodwill in the financial statements: loss of key non-temporary staff (eg death); testing for the write-off or impairment of a significant group of assets; the recognition of impairment loss in the separate financial statements of the invested person; a significant decline in the entity's share price, which may cause the carrying amount of the entity's net assets to exceed its market capitalization. (Grant Thorton, 2020)

The indicated features of the impairment test in the conditions of COVID- 19 allow us to construct the following logical scheme of the testing process:

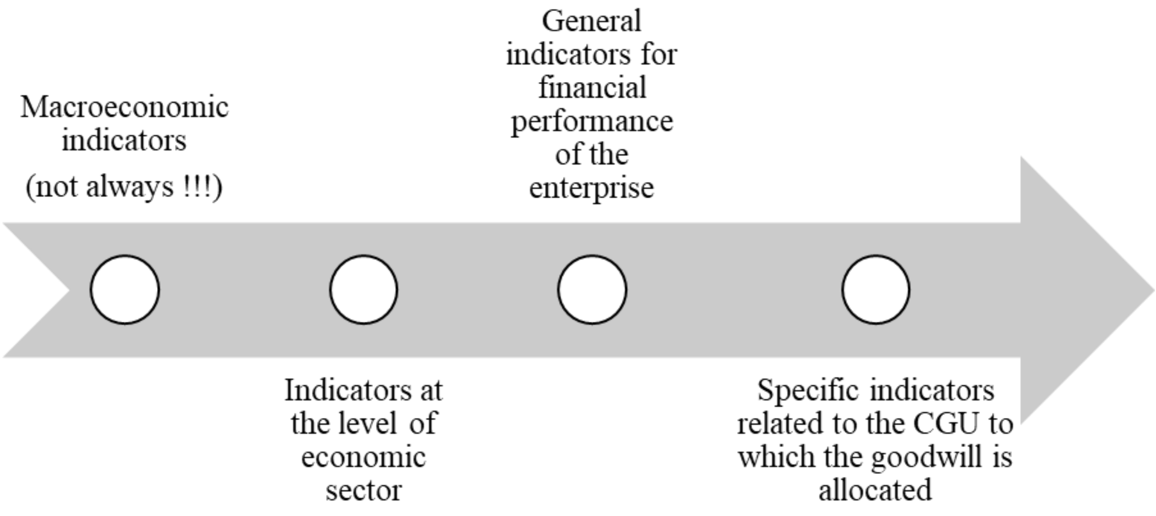

Figure 1. Impairment testing process in COVID-19 conditions

We believe that only after a comprehensive and in-depth assessment of a set of indicators and circumstances such as those described above can an entity determine whether or not the fair value of a reporting item is less than its carrying amount. We pay special attention to macroeconomic indicators, which we believe do not always show the "full picture" because they do not take into account the importance of the specific business segment in which the company operates. For example, an enterprise located in a country that is relatively weakly affected by COVID-19, but whose activity is highly dependent on the supply chain of the supply of components, raw materials, etc. from companies that are in countries that are heavily affected by the pandemic, there will be no macroeconomic indicators, but there will be specific ones for the specific business.

With regard to public companies, the problems that should be the focus of management are related to fluctuations in market share prices, declining market capitalization of enterprises, as well as the reduction of investment interest in companies. The reduction of the market capitalization itself should be the subject of a specific analysis, as it may be temporary and the prospects for the company's development may be positive and upward. Disclosure of specific information in this regard is of particular importance to users of financial statements. However, when such circumstances exist, they should be disclosed in a timely manner in the interim financial statements prepared by the entity. it cannot be recovered at the end of the reporting period.

These issues are also part of a public statement by the International Organization of Securities Commissions (IOSCO), which states that disclosures should not limit to a standard discussion of COVID-19 itself, but should explain; (i) how COVID-19 has affected and / or is expected to affect the issuer's financial performance, financial condition and cash flows, (ii) how issuers' strategy and objectives have been changed to address the effects of COVID-19 and (iii) measures taken to address and mitigate the impact of the pandemic on the issuer.(IOSCO, 2020)

As a result of the analysis, we believe that COVID-19 can be considered as the so-called. “Triggering event”, but an in-depth analysis of all specific factors and circumstances specific to the industry, region and current enterprise must be performed. For some companies, the negative effect of COVID-19 may indicate the need for impairment of goodwill in the interim financial statements, but this type of impairment should be approached with extreme caution and in regard of future business development forecasts, as such impairment can’t be recovered in the annual financial statements, and on the other hand is a signal to investors that the value of the acquired business is developing in a negative direction.

Of course, the fact that all this is subject to assessment by the company's management should not be eliminated. For these reasons, goodwill impairment is often subject to deliberate manipulation by management. With regard to impairment under COVID-19 Laxminarayan notes that this element (goodwill) is likely to affect companies with significant competitive acquisitions in the past. According to the author, if the amount of goodwill in the statement of financial position of the businesses affected by COVID-19 is high, there is likely to be greater management control over the presentation of significant impairments in the income statements of such companies, as similar something could affect profitability for next years. (Lakshminarayan, 2020) Sharing this thesis with concern, we believe that goodwill may be the "possible buffer" for many companies in deciding how much to reduce their key financial performance indicators based on their financial statements.

Conclusion

COVID-19 has significantly changed the way individual economies around the world function. Both people and individual businesses need to get used to the change brought about by the pandemic and readjust their businesses in a way that is adequate to the conditions. Governments need to rethink their spending policies in order to focus on a speedy recovery and the creation of a new competitive business environment.

Understanding the circumstances underlying the impairment of goodwill as a specific intangible asset is crucial in testing it for impairment. We believe that the complex nature of goodwill poses a serious dilemma for companies to achieve relevant and at the same time reliable information that takes into account non-financial indicators and risks that exist in the conditions of uncertainty resulting from COVID-19. All this gives us confidence to believe that the assessment of whether COVID-19 is a " triggering event" with material impact on goodwill impairment should be made on the basis of enterprise-specific indicators and be done holistically.

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