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Goodwill and Impairment – Improving effectiveness of the goodwill impairment testing model

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Objective

- 1 The objective of this session is to seek input from EFRAG CFSS and EFRAG TEG on the following in preparation for the September 2017 ASAF meeting:
 - (a) IASB Staff proposals to simplify and improve the effectiveness of the goodwill impairment testing model; and
 - (b) Presentation from EFRAG on the mechanics of the ‘Goodwill accretion’ approach.
- 2 The Appendix in this paper provides a comparison between the IASB Staff proposals to be discussed during this session and suggestions considered in the EFRAG discussion paper to address similar and/or complementary issues.

Background

IASB developments

- 3 The IASB has a research project on goodwill and impairment that aims to explore whether it is possible to simplify and improve the application of the impairment test, improve the disclosures about impairment of goodwill and simplify separation of specified identifiable intangible assets from goodwill in a business combination. So far, no decisions have been taken. The IASB also plans to discuss whether amortisation of goodwill should be reintroduced and possible approaches to simply identification of intangible assets separately from goodwill in a business combination.
- 4 The IASB’s work plan states that the IASB expects to publish a discussion paper in H1 2018.

Feedback from previous discussions with EFRAG TEG-CFSS, ASAF and other IASB consultative groups

- 5 EFRAG TEG discussed the pre-acquisition headroom approach at its meeting in May 2016. Many thought that the approach was a step in the right direction; however several questions were raised about practical implications of the approach, including concerns around complexity.

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- 6 At its meeting in June 2017, EFRAG TEG-CFSS discussed progress on the IASB project and considered an ASBJ draft proposal allowing a choice between amortisation and impairment model and impairment only model. EFRAG TEG-CFSS members did not support this proposal mainly because of comparability concerns.
- 7 Like EFRAG CFSS-TEG, ASAF members generally did not support an accounting policy choice between an impairment-only approach versus an amortisation and impairment model. The preference is to find ways to improve the impairment test, because an improvement would be required regardless of the approach for accounting for goodwill. The focus should be on what information users want versus the costs to preparers of producing this information.
- 8 The project has also been discussed at the IASB's consultative groups including the Capital Markets Advisory Committee (CMAC) and the Global Preparers Forum (GPF). Feedback from the CMAC reported mixed views about amortisation of goodwill, with a number of analysts noting that the impairment test provides useful information, and suggesting that the impairment model should be made more robust rather than introducing other approaches. Members of the GPF generally cautioned against introducing further complexity in the goodwill impairment test and requiring disclosure that is difficult to provide.

EFRAG Research project

- 9 EFRAG has a research project to provide input to any future IASB proposals on its goodwill and impairment project. In September 2016, EFRAG published a quantitative study on Goodwill and Impairment.
- 10 In June 2017 EFRAG published a discussion paper that includes similar issues to those being considered by the IASB project. These are addressed in Appendix 1. The EFRAG discussion paper is open for comment until 31 December 2017.

Agenda Papers

- 11 In addition to this paper, the following papers are provided for background only:
 - (a) agenda paper 13-02 ASAF paper 5 – EFRAG Goodwill accretion approach;
 - (b) agenda paper 13-03 ASAF paper 5A – EFRAG Goodwill and Impairment DP;
 - (c) agenda paper 13-04 Issues paper on improving effectiveness of goodwill impairment testing model; and
 - (d) agenda paper 13-05 ASAF paper 5B – Presentation on improving effectiveness of goodwill impairment testing model.

Appendix A – Relevant issues in the EFRAG discussion paper compared to IASB Staff proposals on improving the effectiveness of the goodwill impairment test

ISSUES ON EFFECTIVENESS OF THE IMPAIRMENT TEST	IASB STAFF PROPOSAL	EFRAG DISCUSSION PAPER PROPOSAL
<p>Adjusting the goodwill included in the impairment test</p> <p>Some argue that one of the causes for the current impairment test failing to capture impairment losses at the right time for the correct amount is the so-called shielding effect of unrecognised internally generated goodwill of a CGU.</p> <p>This could happen when:</p> <ul style="list-style-type: none"> • an entity allocates acquired goodwill to a pre-acquisition CGU that is expect to benefit from the synergies of the business combination; • the unrecognised internally generated goodwill of the pre-acquisition CGU shields, in that case, the acquired goodwill from impairment by absorbing any negative movements in the recoverable amount of the CGU; and 	<p>PH approach (calculated at inception)</p> <p>The PH is the excess of a cash generating unit’s recoverable amount over its carrying amount at the date of acquisition using pre-acquisition assumptions. The PH is not recognised in the financial statements. The PH has the potential to shield goodwill in that it might include:</p> <ul style="list-style-type: none"> • any unrecognised assets of the pre-combination CGU, • any differences between the carrying amounts and recoverable amounts of the assets of the pre-combination CGU; and • any internally generated goodwill. <p>The approach works as follows:</p>	<p>The goodwill accretion approach (calculated throughout the life of the goodwill)</p> <p>The goodwill accretion approach aims at targeting the shielding effect of internal goodwill generated by the acquirer after the acquisition.</p> <p>The approach works as follows:</p> <ul style="list-style-type: none"> • the entity would determine an accretion amount by applying a rate to the opening balance of goodwill; • this amount would be added to the carrying amount of the CGU (only for the purpose of the impairment test); • if no impairment loss is recognised, the balance of accretion would be carried forward; • when the inclusion of the accretion results in the recognition of an impairment loss, the

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<ul style="list-style-type: none"> as consequence the acquired goodwill is not impaired or is impaired by a lesser amount. 	<ul style="list-style-type: none"> the PH is added to the carrying amount of the CGU (only for the purpose of the impairment test calculation), and the aggregate of the carrying amount of the CGU (including the PH) is compared with the recoverable amount of the CGU in identifying any impairment loss. <p>Any impairment loss would be allocated:</p> <ul style="list-style-type: none"> first to reduce the carrying amount of the recognised goodwill allocated to the CGU; secondly against the PH (this is a notional allocation because the PH is not recognised in the financial statements); and Finally, to other assets of the CGU in accordance with the existing requirements of IAS 36. <p>The PH approach will be most effective in the first impairment test following an acquisition. This is because the PH is not updated for changes in the shielding effect of newly generated goodwill after acquisition. It is essentially a 'frozen' amount that is carried forward to future periods.</p>	<p>balance of the accretion would be correspondingly reduced.</p> <ul style="list-style-type: none"> the entity would continue to determine the accretion until the goodwill is fully written off. <p>One main issue around the approach is the selection of the appropriate accretion rate and whether it should be updated.</p> <p>The EFRAG Discussion Paper notes that since it is not possible to directly measure internally generated goodwill, the accretion method is based on assumptions.</p> <p>However, the method has the following advantages: i) the application of the method is relatively simple; ii) if the accretion rate was assumed to be the same as the discount rate, the method would not require the determination of any additional input; iii) it does not create a conflict with the general objective in IAS 36 (the accretion is compatible with an objective to measure the whole CGU at its recoverable amount, net of the unrecognised internally generated goodwill).</p> <p>The accretion method is complementary to the PH approach being discussed by the IASB because each address a different buffer or</p>

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	Overall, the IASB Staff think that the PH approach would improve the effectiveness of the impairment test, and help to address inventors' concerns that impairment losses are being recognised 'too little too late'.	shielding effect, and could be potentially combined.
Single calculation approach		
<p>IAS 36 defines recoverable amount as the higher of an asset's (or cash-generating unit's (CGU's)) fair value less costs of disposal (FVLCD) and its value in use (VIU).</p> <p>VIU is the present value of the future cash flows to be derived from continuing use and disposal of the asset, based on reasonable and supportable assumptions that represent management's best estimate.</p> <p>FVLCD is based on assumptions that market participants would use when pricing the asset or liability.</p> <p>Some feedback from the PIR of IFRS 3 indicated that requiring the use of a single method, rather than the higher of the two methods, might reduce complexity without causing a loss of information for users of financial statements.</p> <p>It is not always necessary to determine both FVLCD and VIU of a CGU. However, if an entity determines that one of these amounts</p>	<p>The IASB Staff provide two proposals on a single method:</p> <p>a) retain only one of the two methods (VIU or FVLCD) as the sole basis for measuring recoverable amount; or</p> <p>b) retain both methods and require an entity to select a method that reflects the manner in which the entity expects to recover the asset:</p> <p>i. FVLCD if the entity expects to recover the asset through sale, and</p> <p>ii. VIU if the entity expects to recover the asset primarily through use</p> <p>The IASB Staff think that method (b) will result in the impairment testing model being based mostly on VIU use. If an entity decides to sell the asset and the criteria in IFRS 5 <i>Non-current Assets Held for Sale and Discontinued Operations</i> are met, then</p>	<p>The EFRAG discussion paper considers that a single calculation approach may simplify the impairment test, and discusses the advantages and disadvantages of doing so.</p> <p>The discussion paper also illustrates the strengths and weaknesses of both VIU and FVLCD.</p> <p>FVLCD can be based on observable input which enhances its reliability. VIU allows entities to consider factors that are more entity-specific, including entity-specific synergies. This would also be aligned with fact that many business acquisitions are motivated by expected synergies and not by a future sale. However VIU is often criticised due to the subjectivity of the assumptions used by preparers.</p> <p>It should be noted that a single method approach:</p> <ul style="list-style-type: none"> • would change the notion of recoverable amount and may be seen to reduce the

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<p>is less than the CGU's carrying amount, the entity has to determine the other amount before it concludes on the recoverable amount of the CGU.</p> <p>Some argue that when an entity has to determine both amounts there is complexity and possible confusion because of the need to consider the difference between the inputs for calculating value in use (management's best estimates) and those used for calculating FVLCD (market participant assumptions).</p>	<p>recognition of impairment losses and reversals are based on FVLCD.</p>	<p>relevance of the calculation. The IASB would also need to consider if this change should be extended to all assets in scope of IAS 36; and</p> <ul style="list-style-type: none">• would likely result in more frequent impairment losses compared to the existing requirements. This would occur when the single method retained would result in a recoverable amount lower than the carrying amount, and the removed method would have resulted in an amount higher than the carrying amount.