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

### **Issues Paper**

#### **Purpose of this paper**

- 1 This paper discusses the following IASB Staff proposals on possible ways to improve the effectiveness of impairment testing model under IAS 36 *Impairment of Assets*:
  - (a) the pre-acquisition headroom (PH approach); and
  - (b) single method for determining recoverable amount.
- 2 The PH approach has not been discussed with ASAF members. EFRAG TEG briefly discussed the approach at its meeting in May 2016. The single method for determining recoverable amount was briefly discussed with ASAF members at its July 2017 meeting and considered by EFRAG TEG-CFSS at its June meeting.

#### **The pre-acquisition headroom approach (PH approach)**

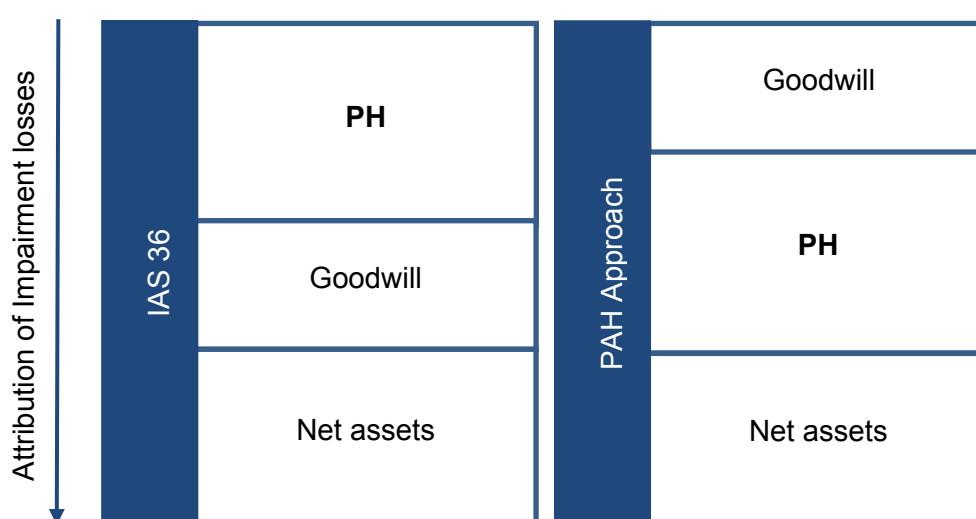
- 3 IAS 36 requires goodwill to be allocated to a cash-generating unit (CGU) or groups of CGUs that are expected to benefit from the synergies of the business combination.
- 4 In a business combination, the acquired entity can either be (1) a separate CGU or (2) grouped with an existing CGU (or group of CGUs). Some argue that one of the causes for the current impairment test failing to capture impairment losses at the right time and in the right amounts is the so-called shielding effect.
- 5 The shielding effect is created when goodwill is allocated to a CGU that contains unrecognised internally generated goodwill or other unrecognised internally generated intangible assets, because these assets have the potential to shield goodwill impairment losses and therefore delay the recognition of impairment. This combination of unrecognised items is referred to as the pre-acquisition headroom or PH.

#### *Mechanics of the PH approach*

- 6 The PH approach tries to prevent the shielding effect from delaying goodwill impairment losses, by requiring an entity to determine the PH of a CGU (or group of CGUs) to which goodwill is allocated at the date of a business combination. The PH is calculated purely for the purpose of testing the CGU for impairment and is not recognised in the financial statements.

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- 7 The PH approach requires an entity to determine the PH of the related CGU (or group of CGUs) on the date of the acquisition. The excess of a CGU's recoverable amount over its carrying amount at the date of acquisition using pre-acquisition assumptions is the PH of that CGU.
- 8 The entity then compares the carrying amount (including the PH) with the recoverable amount of the CGU (or group of CGUs). If the total of carrying amount (including the PH) exceeds the recoverable amount of the CGU (or group of CGUs), that excess would be recognised as an impairment loss.
- 9 Under IAS 36, an impairment loss is allocated first to the PH and thus does not affect the carrying amount of goodwill until the PH is used up. Under the PH approach, any impairment loss would first be allocated to the recognised goodwill, then to the PH and finally to the other assets of the CGU, as shown in the illustration below:



- 10 The PH that is measured at the acquisition date is added to the carrying amount of the CGU for the purpose of the impairment test calculation and then the aggregate of the carrying amount (including the PH) is compared with the recoverable amount of the CGU in measuring any impairment loss.
- 11 The difference between the carrying amount of the CGU and its recoverable amount immediately before the business combination is referred to as the PH.

*The PH is not remeasured*

- 12 The PH is determined on acquisition, and not updated after acquisition. In other words, the PH determined at the date of acquisition is carried forward to future periods and used in the impairment test each year.
- 13 Conceptually, the IASB Staff acknowledge that the PH should be remeasured every time an impairment test is performed, in order to consider changes in the PH due to changes in the shielding effect of goodwill generated internally after acquisition or other effects. However, the IASB Staff note that remeasurement of the PH would significantly increase cost and complexity as this would require entities to isolate the effect of the acquisition in subsequent periods. Over time this exercise would become extremely subjective, particularly when performed a significant time after the acquisition or when the entity undertakes multiple acquisitions.

- 14 Overall, the IASB Staff believe that the PH approach will go a long way towards addressing investors' concerns without adding significant cost and complexity to the impairment test.

*The pros and cons of the PH approach*

- 15 The IASB Staff summarise the pros and cons of the PH approach as follows:

<b>PROS</b>	<b>CONS</b>
Leads to earlier recognition of impairment losses	As the PH is determined on acquisition and not updated after acquisition, the approach cannot remove any increase in the shielding effect of newly internally-generated goodwill after acquisition
Measurement of the PH would be a one-off cost at the time of acquisition	The PH approach adds complexity to the impairment test
Will be most effective in the first impairment test after an acquisition because this test will be performed soon after the PH is measured	

- 16 Appendix 1 provides an illustrative example of the PH approach and how it compares to IAS 36.

*EFRAG TEG meeting in May 2016*

- 17 EFRAG TEG had an initial discussion on the PH approach at its meeting in May 2016. EFRAG TEG had mixed views on the approach.
- 18 Some members saw conceptual merits with the approach and what it was trying to achieve and thought theoretically it may be the right solution to eliminate the risk of overpayments being recorded.
- 19 However, several members considered that the approach seemed complex and costly for preparers. The additional layer of calculation required by the approach would add complexity to the impairment test. Some members noted that the lack of remeasurement of the PH meant that it would address the shielding effect only at the date of acquisition.

*EFRAG Secretariat analysis and observations*

- 20 The EFRAG Secretariat observes that the removal of the shielding effect that might exist on acquisition when goodwill is allocated to an existing CGU (or group of CGUs) means that impairment of goodwill is more likely to be recognised under the PH approach than under the current IAS 36 impairment approach. Hence, the PH approach is likely to result in recognition of earlier impairment losses.
- 21 The PH approach will be most effective in the first impairment test following an acquisition, because this test will take place soon after the PH is determined and thereafter is not remeasured or updated for changes. This has the benefit of making

the PH calculation a one-off cost but has the disadvantage of ignoring any increase in the shielding effect of newly generated goodwill after the acquisition.

- 22 If the IASB were to 'freeze' the PH as proposed in the IASB Staff paper (ie no remeasurement in subsequent periods), a possible solution to address any increase in the shielding effect might be the goodwill accretion approach proposed in the EFRAG discussion paper. As explained in the discussion paper, the goodwill accretion approach aims at targeting the shielding effect of goodwill internally-generated by the acquirer after the acquisition. The goodwill accretion approach is explained in agenda paper 13-02 for this session (ASAF paper 5).

**Questions for EFRAG CFSS and EFRAG TEG**

- 23 Do you think the PH approach could improve the effectiveness of the impairment test?
- 24 Do you have any comments or suggestions on improving the mechanics of the PH approach?

**Single method for determining recoverable amount**

- 25 The objective of IAS 36 is to prescribe procedures that an entity applies to ensure that its assets are carried at no more than their recoverable amount. Recoverable amount is defined as the higher of:
- (a) an asset's (or cash-generating unit's (CGU's)) fair value less costs of disposal (FVLCD); and
  - (b) its value in use (VIU).
- 26 The IASB Staff consider that moving to a single method might help in improving the effectiveness of the impairment testing model. A more straightforward impairment test using one model might be easier to apply and understand, and reduce concerns that the current model makes it too easy to delay and (or) conceal impairment losses.

*Value in use (VIU) versus fair value less costs of disposal (FVLCD)*

- 27 VIU is the present value of the future cash flows to be derived from continuing use and disposal of the asset. The cash flow projections used in calculating VIU should be based on reasonable and supportable assumptions that represent *management's best estimate* of the range of economic conditions that will exist over the remaining useful life of the asset.
- 28 In contrast, in FVLCD calculations, an entity is required to use assumptions that *market participants* would use when pricing the asset or liability.
- 29 It is not always necessary to determine both FVLCD and VIU of a CGU. However, if an entity determines that one of these measures is less than the CGU's carrying amount, the entity has to determine the other measure before it concludes on the recoverable amount of the CGU.
- 30 Consequently, when an entity has to determine both amounts, and if the entity determines FVLCD using a discounted cash flow calculation, there is complexity because of the need to consider the extent of difference between the inputs for calculating VIU and those used for calculating FVLCD.
- 31 Although some support the use of a single method, there are conflicting views about which of the two methods should be required. While some investors argue that a

fair value based impairment model would be more objective, preparers seem to prefer VIU on the basis that it better reflects the fact that an entity holds the assets for continued use in the business. VIU reflects a range of economic conditions for different entities and not just a market-based scenario.

*IASB Staff analysis*

- 32 The IASB Staff think that the IASB could consider either:
- (a) retaining only one of the two methods (value in use or FVLCD) as the sole basis for measuring recoverable amount; or
  - (b) retaining both methods and requiring an entity to select the method that reflects the manner in which the entity expects to recover the asset—FVLCD if the entity expects to recover the asset through sale, and VIU if the entity expects to recover the asset primarily through use.
- 33 If the IASB decides to retain only one method, the following considerations would help in deciding the method to retain:
- (a) are the considerations of the International Accounting Standards Committee (IASC), the predecessor of the IASB, when developing the principle for measuring recoverable amount still relevant today?
  - (b) what are the similarities and differences between VIU and FVLCD?

*Considerations by the IASC when developing a dual model approach*

- 34 The IASC considered and rejected measuring recoverable amount based only on fair value for the following reasons:
- (a) no preference should be given to the market's expectation. An entity may have superior information about future cash flows and may plan to use an asset in a manner different from the market's view of the best use.
  - (b) market values are a way to estimate fair value but only if they reflect the fact that both parties, the acquirer and the seller, are willing to enter a transaction.
  - (c) if an entity can generate greater cash flows by using an asset than selling it, it would be misleading to base recoverable amount on the market price because a rational entity would not be willing to sell.
  - (d) recoverable amount of an asset is the amount that an entity expects to recover from an asset, including the effect of synergies with other assets.
- 35 The IASC considered and rejected measuring recoverable amount based only on VIU for the following reasons:
- (a) if an asset's FVLCD is higher than its VIU, a rational entity will dispose of the asset. In this situation, it is logical to base recoverable amount on the asset's FVLCD to avoid recognising an impairment loss that is unrelated to economic reality.
  - (b) if an asset's FVLCD is higher than its VIU, but management decides to keep the asset, the extra loss (the difference between FVLCD and value in use) properly falls in later periods because it results from management's decision in these later periods to keep the asset.
- 36 An important fact to be noted in assessing whether the IASC's considerations are still relevant today is that IFRS 13 *Fair Value Measurement* had not been issued when IAS 36 or IFRS 5 were issued.

- 37 In some cases, differences might arise between cash flows projections used in calculating VIU and those used to determine FVLCD. For example, IAS 36 requires estimates of cash flows to exclude estimated cash flows that are expected to arise from (a) a future restructuring to which an entity is not yet committed; or (b) improving or enhancing the asset's performance. There is no such restriction in fair value measurement. On the other hand, paragraph 53A of IAS 36 highlights a few factors that are not reflected in fair value but reflected in value in use.

*EFRAG Secretariat observations and analysis*

- 38 The EFRAG discussion paper also suggests a single method as a means to simplify the requirements. The paper identifies a number of advantages and disadvantages with eliminating one of the methods, without expressing a view on which method is preferable.
- 39 EFRAG TEG and EFRAG CFSS considered a single method approach at its joint meeting in June 2017 and noted that IAS 36 did not always require both tests to be done. Some members considered that the important factor was the intended use of the CGU being tested for impairment and the selection of the method had to fit that business purpose.
- 40 ASAF members considered a single approach at the ASAF July 2017 meeting. Some members noted that in some industries (such as mining) there were significant differences between fair values and VIU. Members also observed that the two methods served different purposes and thus cautioned against requiring a single method approach. Some members supported retaining both methods and requiring an entity to select the method that reflects the manner in which the entity expects to recover the asset or CGU.

**Questions for EFRAG CFSS and EFRAG TEG**

- 41 Do you think using a single method, ie FVLCD or VIU, to determine recoverable amount could improve the effectiveness of the impairment test?
- 42 In most situations, do you think FVLCD and VIU measurements produce significantly different values? If so, why?

## **Appendix 1 – Illustrative example of the PH approach**

This example is taken from Appendix A of Agenda Paper 18D of the July 2017 IASB meeting.

### **Applying the PH approach to a new acquisition (year 1)**

- 1 Company X has a 31 December year-end. On 1 September 2016, Company X purchases 100 per cent of Company Y for CU 150 and measures the goodwill acquired at CU 55 in accordance with IFRS 3.
- 2 Company X has three CGUs, A, B and C, with carrying amounts of CU 100, CU 200 and CU 300 respectively at the date of acquisition of Company Y. The identifying net assets of Company Y are CU 35 for CGU A and CU 60 for CGU B.
- 3 Company X determines the following allocations of the goodwill and assets of Company Y between its CGUs for impairment testing (as required by IAS 36):

	<b>CGU A</b>	<b>CGU B</b>	<b>CGU C</b>	<b>Total</b>
Identifiable net assets of Company Y	CU35	CU60	-	CU95
Goodwill arising on acquisition of Company Y	CU 20	CU35	-	CU55

- 4 Assume for simplicity that there is no change in the carrying amounts of Company X's net assets and Company Y's net assets between the date of acquisition and the date of performing the impairment.
- 5 Assume that the recoverable amounts of CGU A and CGU B at the date of the impairment test are CU190 and CU300 respectively (determined in accordance with IAS 36 as normal, ie after including Company Y allocations of net assets and goodwill, and using the assumptions for the CGUs post acquisition of Company Y).

#### *Applying the PH Approach*

##### Step 1: Determine to which CGUs goodwill will be allocated

- 6 Company X determines that the CGUs A and B will benefit from the synergies of the combination.

##### Step 2: Calculate the recoverable amount of the CGUs and its PH

- 7 In order to determine the PH, the recoverable amounts of CGUs A and B would need to be determined at the date of acquisition of Company Y, based on the pre-acquisition assumptions and before allocation of Company Y. Assume the recoverable amounts of CGUs A and B determined on this basis are CU140 and CU220 respectively. As noted in paragraph D2, the carrying amounts of CGUs A and B are CU100 and CU200 respectively (before allocation of Company Y).
- 8 Consequently, for the purposes of the impairment test, a PH of CU40 (=140-100) exists for CGU A and a PH of CU20 (=220-200) exists for CGU B.

##### Step 3: Goodwill and asset allocation

- 9 IAS 36 requires CGU A and CGU B to be tested for impairment before the year-end (and on an annual basis), because goodwill is allocated to those CGUs.

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Step 4: Impairment test

- 10 At the date of the impairment test, amounts relating to CGUs A and B are:

	<b>CGU A</b>	<b>CGU B</b>
Identifiable net assets excluding goodwill (includes Company Y allocation)	CU135 (=100+35)	CU 226 (=200+60)
Goodwill arising on acquisition of Company Y	CU 40	CU 35
<b>Carrying amount</b>	<b>CU155</b>	<b>CU295</b>
PH (not recognised as an asset)	CU40	CU20
<b>Total of the carrying amount of the CGU plus the PH</b>	<b>CU 195</b>	<b>CU 315</b>

- 11 Outcome of the impairment test:
- (a) CGU A: Recoverable amount (CU190) < Carrying amount of CGU plus PH (CU195). Impairment of CU5 allocated to the goodwill recognised on acquisition of Company Y.
- (b) CGU B: Recoverable amount (CU300) < Carrying amount of CGU plus PH (CU315). Impairment of CU15 allocated to the goodwill recognised on acquisition of Company Y.
- 12 Consequently, the carrying amounts of the CGUs of Group X after the impairment test is as follows:

	<b>CGU A</b>	<b>CGU B</b>	<b>CGU C</b>
Identifiable net assets of Company Y	CU135	CU160	CU300
Goodwill (after allocation of impairment)	CU15 (=20-5)	CU20 (=35-15)	CU0
<b>Carrying amount of CGUs</b>	<b>CU150</b>	<b>CU280</b>	<b>CU300</b>

**Comparison to IAS 36**

- 13 Steps 1, 3 and 4 are already required by IAS 36. Consequently, the only differences between the PH approach and the existing approach in IAS 36 are the inclusion of an additional step to calculate the PH (step two) and the requirement to consider the PH in step four.
- 14 If the current requirements in IAS 36 are applied to the example above, the following results would be obtained for the CGUs:

	<b>CGU A</b>	<b>CGU B</b>
Post-acquisition recoverable amount	CU 190	CU 300



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Post-acquisition carrying amount	CU 155	CU 295
Impairment loss	CU 0	CU 0

- 15 As the impairment loss would be allocated first to the “buffer”, it would not affect the carrying amount of the goodwill. Impairment losses would therefore only be recognised when there is no “buffer” left. The “buffer” is therefore impacted as follows:

	<b>CGU A</b>	<b>CGU B</b>
<b>PH before impairment</b>	<b>CU 40</b>	<b>CU 20</b>
Impairment loss	CU -5	CU -15
<b>PH after impairment</b>	<b>CU 35</b>	<b>CU 5</b>