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GOODWILL IMPAIRMENT TEST: COULD IT WORK BETTER?

EFRAG

Short Discussion Series Paper

[MONTH 2017]

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The paper invites comment on its proposals via the 'Questions for Respondents' at the end of each section (which are summarised in the Invitation to Comment). Such comments should be submitted by using the 'Express your views' page on EFRAG website by clicking [[here-insert hyperlink](#)] or should be sent by post to:

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B-1000 Brussels
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so as to arrive no later than [[Comment Deadline Date](#)]. All comments received will be placed on the public record unless confidentiality is requested.

EFRAG Research activities in Europe

This paper is part of EFRAG's research work. EFRAG aims to influence future standard-setting developments by engaging with European constituents and providing timely and effective input to early phases of the IASB's work. Four strategic aims underpin research work:

- engaging with European constituents to ensure we understand their issues and how financial reporting affects them;
- influencing the development of global financial reporting standards;
- providing thought leadership in developing the principles and practices that underpin financial reporting; and
- promoting solutions that improve the quality of information, are practical, and enhance transparency and accountability.

More detailed information about our research work and current projects is available on the EFRAG website.

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Executive Summary

[To be finalised in a more advanced version]

ES1 [Text within the second heading]

QUESTIONS TO CONSTITUENTS

EFRAG invites comments on all matters in this Short Discussion Series Paper, particularly in relation to the questions set out below. Comments are more helpful if they:

- a) address the question as stated;
- b) indicate the specific paragraph reference, to which the comments relate; and/or
- c) describe any alternative approaches EFRAG should consider.

Before replying, please consider the scope and objective of the paper as described in paragraph 1.16; topics like identification of acquired intangible assets in a business combination; the advantages and disadvantages of reintroducing annual amortisation; and the improvements to the disclosure requirements are out of the scope of this paper.

All comments should be received by [Submission date].

Chapter 1: [A question on any of the topics?]

[To be finalised in a more advanced version]

[To be finalised in a more advanced version]

Chapter 2: Improving IAS 36

[To be finalised in a more advanced version]

- when the entity should determine the recoverable amount;
- how the entity should identify a CGU and allocate goodwill;
- how the entity should determine the recoverable amount;
- which cash flows should be included in the calculation;
- how the entity should determine the discount rate; and
- determining the recoverable amount.

Chapter 1: Background

Introduction

- 1.1 On 30 January 2014, the IASB began its Post-implementation review of IFRS 3 *Business Combinations* (IFRS 3 PIR) by publishing a Request for Information on experience with, and the effect of, implementing the Standard.
- 1.2 Respondents to the IFRS 3 PIR raised a number of issues in relation to different aspects of business combinations accounting. Some of these concerns relate to how entities are required to perform the impairment review.
- 1.3 In July 2014, EFRAG together with the ASBJ and the OIC published a Short Discussion Series Paper [*Should Goodwill still not be amortised?*](#) ('2014 DP'). The paper reflected the views of a Research Group and addressed the following topics:
- d) initial and subsequent accounting for goodwill, including the advantages and disadvantages of reintroducing annual amortisation;
 - e) areas of complexity in IAS 36 *Impairment of Assets*; and
 - f) possible improvements to the disclosures on goodwill impairment.
- 1.4 Following the replies from constituents and the publication of a [feedback statement](#), in January 2015 the EFRAG Board agreed that work should be continued on the project, in particular on second topic, potential improvements to the impairment model.
- 1.5 EFRAG considered the main issues raised by constituents and is publishing this Short Discussion Series Paper with a view to make some tangible suggestions to address them. EFRAG will use the feedback received on this paper to react to any proposals coming out of IASB *Goodwill and Impairment* research project.
- 1.6 Since the launch of its research project, the IASB has discussed:
- a) whether changes should be made to the existing impairment test for goodwill and other non-current, non-financial assets;
 - b) the subsequent accounting for goodwill (including the relative merits of an impairment-only approach and an amortisation and impairment approach); and
 - c) the extent to which other intangible assets should be separated from goodwill.
- 1.7 The IASB has not yet made tentative decisions on its research project at publication date of this paper and expects to continue its discussion until the end of 2017. The IASB will decide the form of public consultation (i.e. Discussion Paper or Exposure Draft) by then.
- 1.8 The Financial Accounting Standards Board ('FASB') has also active projects on its agenda for identifiable intangible assets in a business combination, accounting for goodwill and accounting for goodwill impairment. The two boards have been monitoring each other's work and having regular joint meetings to discuss the projects summaries and progress reports.

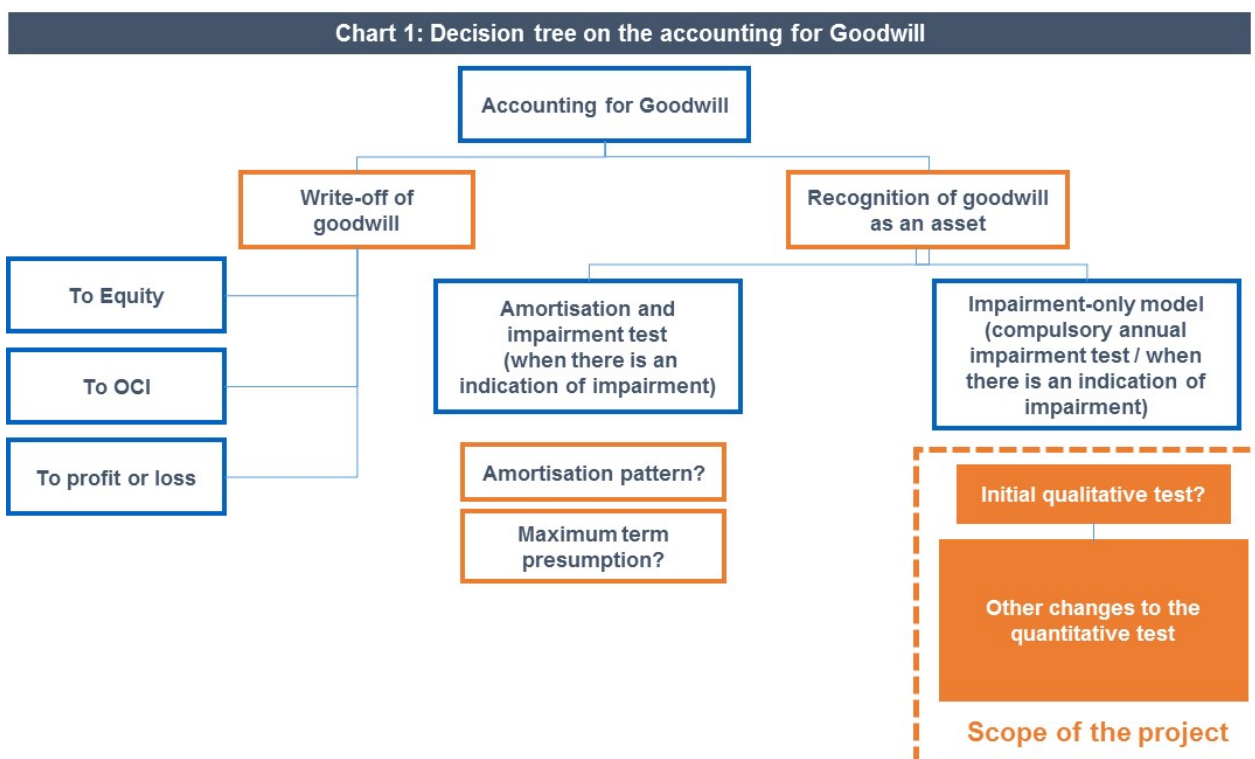
Understanding the problem

- 1.9 The accounting for goodwill and goodwill impairment is a complex and controversial topic in accounting. Goodwill arises when an entity purchases a business. Goodwill is recognised as an asset and measured as the difference between the purchase consideration and the value assigned to the identifiable assets and liabilities of the acquiree, which is the fair value at the acquisition date (with a few exceptions), and the value assigned to any non-controlling interest.
- 1.10 Before the introduction of IFRS 3, goodwill was subject to an annual amortisation with a rebuttable presumption that its useful life could not exceed 20 years. After IFRS 3, goodwill is not amortised and is subject to an impairment review.
- 1.11 Goodwill should represent the present value of the going concern element and synergies expected from the business acquisition. However, it does not generate independent cash flows, cannot be transferred independently and cannot be measured directly. For these reasons, there are different views on how goodwill should be accounted for, how an impairment test should be performed and some even question that it qualifies as an asset.
- 1.12 For example, IFRS Standards, US GAAP, IFRS Standards for small and medium-sized entities ('IFRS for SMEs') and the Directive 2013/34/EU have different requirements in relation to the impairment test of goodwill:
- a) **IFRS Standards:** In accordance with IAS 36, goodwill acquired in a business combination shall be tested for impairment at least annually and whenever there is an indication of impairment. The Standard also clarifies that an entity shall test goodwill for impairment at the level of a cash-generating unit or group of cash-generating units ('CGU') and that an entity records the excess of the carrying amount over the recoverable amount as an impairment loss. For other assets that are subject to annual depreciation or amortisation, IAS 36 requires to assess if an impairment loss may have occurred, based on a number of indicators. If there is an indication of impairment loss, an entity is required to determine the recoverable amount of that asset;
 - b) **US GAAP:** In accordance with ASC 350 *Intangibles – Goodwill and Other* impairment is the condition that exists when the carrying amount of goodwill exceeds its implied fair value. An entity may first assess whether the fair value of a reporting unit is more likely than not to be lower than its carrying amount, in which case a two-step quantitative impairment test is required only if the fair value is likely to be lower than the carrying amount; or go directly to the quantitative impairment test. The FASB has recently published an Accounting Standards Update with a view to simplify the requirements and has removed a second step of the calculation that required to determine the implied fair value of goodwill;
 - c) **IFRS for SMEs:** IFRS for SMEs requires goodwill to be amortised. An entity reporting under IFRS for SMEs is required to assess, based on qualitative factors, whether there is any indication that goodwill may be impaired at each reporting date. Although the wording has been simplified and adapted to SMEs, the indications included in IFRS for SMEs are practically the same as those in full IFRS Standards. If there is an indication of impairment loss, an entity is required to determine the recoverable amount of that asset; and

- d) **Accounting Directive 2013/34/EU:** The Directive 2013/34/EU requires that goodwill shall be written off over its useful economic life. In exceptional cases where the useful life cannot be assessed, the Directive requires an amortisation period no shorter than five years and no longer than 10 years. A value adjustment must be made for a loss in value that is deemed permanent.

Decision tree on accounting for goodwill

- 1.13 As referred above, there are different views on how to account for goodwill. The following table provides a summarised illustration of the different possibilities, both in relation to initial and subsequent accounting.



Scope and objective of the Short Discussion Series Paper

- 1.14 The objective of this Short Discussion Series Paper is to propose some suggestions for amendments to the goodwill impairment test. While some constituents consider that more fundamental changes are needed, EFRAG considers that addressing some practical difficulties could be beneficial to:

- a) enhance the application and effectiveness of the impairment review, which should mitigate concerns that recognition of impairment losses may not be timely; and
- b) address some of the complexity and achieve a better balance between cost and benefits.

- 1.15 EFRAG notes that the two objectives in the previous paragraph may sometimes be in conflict. The paper illustrates what objective each suggestion is meant to achieve, and what are the potential drawbacks.

Outside the scope of the Short Discussion Series Paper

- 1.16 This Short Discussion Series Paper does not address the following:
- a) the identification and measurement of intangible assets in a business combination nor the extent to which intangibles assets should be separated from or subsumed into goodwill;
 - b) advantages and disadvantages of reintroducing annual amortisation; and
 - c) improvements to the disclosure requirements.

For a discussion on these topics, please refer to the 2014 DP.

Chapter 2: Potential improvements to the impairment testing requirements on goodwill

In this chapter, EFRAG describes some of the issues raised by its constituents on the existing impairment testing requirements and discusses possible ways to address them.

Identification of the issues

- 2.1 Many respondents to the 2014 DP considered that the impairment was a challenge in practice and that there was room to improve the guidance in IAS 36. Respondents expressed concerns about:
- a) the late recognition of impairment losses and the overstatement of goodwill;
 - b) the cost and complexity of performing an impairment test for goodwill; and
 - c) a number of practical difficulties related to the current impairment test.
- 2.2 The most common issues and areas of potential improvement were the following:
- a) impairment testing involves significant judgement, which may result in lack of transparency and allow for earnings management;
 - b) entities should be required to determine the recoverable amount only if there is an indication of an impairment loss, similar to what is allowed under US GAAP;
 - c) the requirements to identify the cash-generating units to which goodwill is allocated should be improved, particularly in relation to the effects of organisational changes;
 - d) the IASB should clarify the interaction between the two methods to determine the recoverable amount (e.g. the use of the concept 'highest and best use' only for fair value calculations) or consider that the calculation of recoverable amount should be based on the expected manner of recovery;
 - e) the requirement to perform discounted cash flow calculations on a pre-tax basis was problematic; and
 - f) some aspects of the value in use calculation were problematic, particularly in relation to:
 - (i) the exclusion of future restructurings;
 - (ii) how to distinguish between investments that maintain the assets in their current conditions and investments that improve or enhance the assets' performances; and
 - (iii) how to determine an appropriate terminal growth rate.
- 2.3 Finally, there was also general support for further research on the value relevance of the goodwill impairment and cost-benefit analysis.

Improving IAS 36

- 2.4 In the following paragraphs, EFRAG will illustrate some suggestions to address the concerns in the areas of:
- a) when the entity should determine the recoverable amount;
 - b) how the entity should identify a CGU and allocate goodwill;
 - c) how the entity should determine the recoverable amount;
 - d) which cash flows should be included in the calculation;
 - e) how the entity should determine the discount rate; and
 - f) determining the recoverable amount.

When the entity should determine the recoverable amount: the 'Step Zero'

Guidance in IAS 36

- 2.5 In accordance with IAS 36, an entity is required to determine the recoverable amount of a CGU to which goodwill has been allocated at least annually and whenever there is an indication of impairment. For other assets that are subject to annual depreciation or amortisation, IAS 36 requires an entity to assess if an impairment loss may have occurred based on a number of indicators. If there is an indication of impairment loss, an entity is required to determine the recoverable amount of that asset.

Issues identified

- 2.6 There have been practical concerns that IAS 36 results in an entity having to determine the recoverable amount of a CGU even when the likelihood of an impairment is remote. This is perceived as a time-consuming and costly exercise that has no real practical benefit.
- 2.7 Paragraph 99 of IAS 36 allows entities to use the most recent detailed calculation of the recoverable amount as a test for the current period, but subject to strict conditions:
- a) there have been no significant changes in the assets and liabilities of the CGU;
 - b) the most recent detailed calculation showed a significant headroom; and
 - c) based on an analysis of facts and circumstances, the likelihood of an impairment loss is remote.
- 2.8 Some of these respondents pointed out that US GAAP includes the option to perform first a qualitative assessment of the likelihood of an impairment.

Suggestion: introduce a 'Step Zero'

- 2.9 The Step Zero, similarly to US GAAP guidance, would allow an entity to perform a qualitative assessment of the likelihood of an impairment loss. A separate review would

be required at least annually for each CGU to which goodwill has been allocated. An entity would not be required to determine the recoverable amount when, and only when, it is highly probable that the recoverable amount exceeds the carrying amount (i.e. the likelihood of an impairment is remote).

2.10 The introduction of a Step Zero would require developing more specific indicators for goodwill. A tentative list would include:

a) Macroeconomic conditions:

- (i) a decline in general of economic conditions (e.g. equity and credit markets) or limitations on accessing capital;
- (ii) industry and market considerations such as a deterioration in the environment in which an entity operates or increased competitive environment; and
- (iii) cost factors such as significant increases in raw materials, labour, or other costs that have a negative effect on earnings and cash flows.

b) Conditions specific to the entity/CGU:

- (i) observable prices for the CGU, such as price paid by the acquirer or a third party to buy non-controlling interest, vesting or non-vesting of performance-based put/call option on non-controlling interest and outcome of contingent consideration clauses;
- (ii) significant decline in actual and planned earnings when compared with projected earnings of prior periods;
- (iii) whether the reasons for undertaking the business combination transaction have been met, for example in relation to expected technological innovation, access to markets or realisation of expected synergies from the combination;
- (iv) information from previous impairment calculations, such as whether the most recent calculations have indicated that the recoverable amount of the CGU is significantly greater than its carrying amount;
- (v) changes in the way the acquired business is managed or changes in plans, such as restructuring or discontinued operations of the business acquired;
- (vi) restructuring costs are significantly higher than initially expected; and
- (vii) other relevant entity-specific events such as changes in key personnel or customers, contemplation of bankruptcy or litigation.

2.11 An entity would always need to consider all facts and circumstances that could affect the recoverable amount of the CGU.

2.12 It could be possible to add also a quantitative component to the Step Zero in the form of an 'acid test'. For example, a market capitalisation lower than the carrying amount of the net assets (for listed entities) or a decline in the revenues of the CGU of more than a

defined threshold would automatically require an entity to determine the recoverable amount.

- 2.13 To increase transparency, an entity would have to disclose how it reached a conclusion on its qualitative assessment for each CGU to which a significant amount of goodwill has been allocated. The disclosure could include a description of the significant factors evaluated.

Advantages and disadvantages of the suggestion

- 2.14 The introduction of the Step Zero would allow entities to avoid the calculation of the recoverable amounts in those circumstances where an impairment is unlikely, and result in a reduction of cost. It may increase complexity, but its optional nature would allow entities to assess when to apply it.
- 2.15 The introduction of the Step Zero does not reduce – and possibly increases – the judgment inherent in the impairment assessment.
- 2.16 Firstly, it requires to set up and assess a likelihood threshold; in paragraph 2.9 it was assumed that an entity would assess if an impairment loss is ‘highly probable’ but alternative thresholds would be possible – such as ‘more likely than not’ or ‘probable’. Concerns have been expressed on the potential diverging application of likelihood thresholds in IFRS Standards.
- 2.17 Secondly, judgment could be objectively difficult when some indicators provide conflicting evidence. It would not be possible to define a precise hierarchy among the indicators.
- 2.18 Thirdly, it may be argued that management would have an incentive to conclude that there is no likelihood of impairment. The disclosure in paragraph 2.13 would mitigate but not eliminate the risk. EFRAG also acknowledges that requiring an annual calculation of the recoverable amount may benefit management and be an effective tool to monitor the performance of an acquisition.

How the entity should identify a CGU and allocate goodwill

Guidance in IAS 36

- 2.19 Goodwill does not generate independent cash flows, therefore an entity is required to identify CGU or groups of CGU that are expected to benefit from the synergies of the combination, and allocate goodwill to them. Each identified CGU shall represent the lowest level within the entity at which the goodwill is monitored for internal management purposes, and not be larger than an operating segment determined in accordance with IFRS 8 *Operating Segments*.
- 2.20 If an entity disposes an operation within a group of CGUs to which goodwill has been allocated, the goodwill associated with that operation shall be included in the carrying amount of the operation when determining the gain or loss on disposal. It should be measured based on the relative values of the operation disposed of and the portion of the CGU retained, unless the entity can demonstrate that some other method better reflects the goodwill associated with the operation disposed of.

- 2.21 If an entity reorganises its reporting structure in a way that changes the composition of one or more cash-generating units to which goodwill has been allocated, the goodwill shall be reallocated to the units affected. This reallocation shall be performed using a relative value approach similar to that used when an entity disposes of an operation within a cash-generating unit, unless the entity can demonstrate that some other method better reflects the goodwill associated with the reorganised units.
- 2.22 In practice, entities often rely on the pre-acquisition analysis (e.g. M&A due diligence made by the acquirer) to identify which synergies are expected to arise from the business combination and which parts of the group are expected to benefit from them, for instance through cost savings and revenue synergies

Issues identified

- 2.23 Constituents expressed the following concerns:
- a) the identification of CGU and allocation of goodwill involve a high degree of subjectivity and there is only limited guidance in IAS 36 on how to perform it;
 - b) if there are pre-existing CGUs with a recoverable amount that exceed their carrying amount ('headroom'), entities have an incentive to allocate goodwill regardless of whether they are actually affected by the new acquisition; and
 - c) after a number of reorganisations the final structure of the group (and CGUs) may have little or no similarities with the structure at the time of the acquisition. When goodwill has been repeatedly re-allocated, the information is difficult to explain and understand. Moreover, some noted that re-allocation of goodwill could be used to hide potential impairment losses.

Suggestion: additional guidance on identification and allocation

- 2.24 EFRAG agrees that the main driver to identify CGU and allocate goodwill should be the entity's reporting structure and the management's analysis of the expected synergies. However, the Standard could indicate some fall-back methods to be used when the entity cannot determine reliably the amounts to be allocated.
- 2.25 For instance, an 'allocation ceiling' could be introduced, under which the entity would determine the headroom both before and after the allocation. If the headroom post-allocation is lower than the pre-acquisition headroom, the entity would reduce (at least by the same amount) the portion of goodwill allocated to the CGU. After testing all CGUs affected by the acquisition, any remaining goodwill should be allocated to the purchased business – assuming it constitutes an independent CGU – or written off.
- 2.26 An acceptable allocation method might be based on the pre- and post-combination fair value of each CGU (or group of CGUs) that the entity monitors. More specifically, an entity would determine both values and the difference obtained for each CGU (or group of CGUs) could be used as a basis for allocation of goodwill.
- 2.27 Alternatively, as a practical expedient, entities could be allowed to allocate the goodwill on the basis of the difference between the fair value of the portion of the acquired business to be included in a CGU and the fair value of the net assets of the acquired

business that have been assigned to a CGU. In most cases, this method would result in goodwill being allocated based on where the net assets of the acquiree have been assigned and exclude other CGU that might be affected indirectly by the combination. For example, if Company A acquires company B that has two different businesses (e.g. beverages and soft drinks), Company A would calculate the fair value of the beverage business acquired and the fair value of the net assets associated. The difference between the two (implicit goodwill of the beverage business) would be allocated to the CGU of Company A that is focused on the beverage business (where the acquired business has been integrated).

Advantages and disadvantages of the suggestion

- 2.28 The proposed allocation methods would ensure that entities have an objective alternative when they cannot apply the IAS 36 requirements reliably. This would have the benefit of bringing more transparency and consistency into the application of the allocation principles defined in IAS 36, particularly when there is an incentive to shield the goodwill from future impairments.
- 2.29 The 'allocation ceiling' test would increase cost, since companies are not currently required to measure the headroom in pre-existing CGU. However, EFRAG notes that the IASB has discussed the introduction of a pre-acquisition headroom test.

Suggestion: adding information on composition of goodwill

- 2.30 Impairment losses often trigger questions from users about the origin of the goodwill that has been impaired. Since impairment may occur years after the acquisition, and in the meantime the Group organisation may have been modified, it may be unclear to relate losses (or residual amounts of goodwill) to the original acquisitions. There is no current requirement to track goodwill by individual acquisition.
- 2.31 This information gap may be filled by a requirement to disclose a reconciliation of the total goodwill allocated to each CGU. An illustrative example is shown below:

Goodwill is allocated to the Group's CGU according to business segments.

The carrying amounts of goodwill by CGU at 31 December 201x are summarised below:

	CGU 1	CGU 2	CGU 3	Group
Goodwill related to acquisition of A	6 500	1 500	1 265	9 265
Goodwill related to acquisition of B	1 265	1 200	1 500	3 965
Goodwill related to acquisition of C	1 200	1 260	1 211	3 671
Goodwill related to acquisition of D	1 200	6 500	15 200	22 900
Total	10 165	10 460	19 176	39 801

- 2.32 The reconciliation could also include a breakdown of the major changes over the reporting period (new acquisitions, reallocations, impairment and disposals).

Advantages and disadvantages of the suggestion

- 2.33 The introduction of the reconciliation would provide a clearer picture of the changes in the allocation and the historical origin of goodwill and would assist users in better assessing its recoverability.
- 2.34 The suggestion does not address the complexity in reallocating goodwill after group reorganisation and introduces some additional cost; entities may not have the information to apply the disclosure retrospectively.

How the entity should determine the recoverable amount: a single calculation approach

Guidance in IAS 36

- 2.35 In accordance with IAS 36, a CGU to which goodwill has been allocated is impaired when the carrying amount of that CGU exceeds its recoverable amount. The recoverable amount of the CGU is the higher of its:
- a) **fair value less costs of disposal ('FVLCD')** which reflects the assumptions of market participants; and
 - b) **value in use (VIU)** which reflects the effects of factors that may be specific to the entity and not applicable to entities in general.
- 2.36 In practice, many companies use a discounted cash-flows calculation (DCF) to determine the recoverable amount, the difference being that a FVLCD uses a market participant perspective and the VIU uses a management. A report published by ESMA¹ in 2013 showed that most entities use VIU in a DCF calculation. In a 2013 survey among entities included in the STOXX Europe 600 Index², 69% of the respondents that used both FVLCD and VIU indicated that the latter is often higher because the market under-priced the company.

Issues identified

- 2.37 Respondents indicated that there was some confusion around the interaction between VIU and FVLCD. It was claimed that users may not understand the different assumptions used under the two methods. Others noted that it was more difficult to challenge management's assertion in relation to VIU.

Suggestion: a single calculation approach

- 2.38 From a practical standpoint, requiring or allowing only one method could simplify the impairment test. This could be achieved by:

¹ European enforcers review of impairment of goodwill and other intangible assets in the IFRS financial statements, ESMA (January 2013).

² European Goodwill Impairment Study, Duff & Phelps (December 2013)

- a) simply eliminating one of the two methods (i.e. entities would be required to use only one method);
 - b) requiring entities to choose one of the two methods as an accounting policy to determine recoverable amounts; or
 - c) requiring an entity to choose the method that reflects the intended manner of settlement. In this case, an entity would apply only FVLCD to a CGU that management expects to sell in the foreseeable future, and would apply only VIU when it expects to hold the investment.
- 2.39 Under alternatives b) and c), entities would be required to disclose and describe the approach used in the impairment test.

Advantages and disadvantages of the suggestion

- 2.40 The elimination of one method would simplify the application of the requirements in those instances where an entity is required to apply both methods, which happens when the first method results in a recoverable amount lower than the carrying amount. This applies to all alternatives.
- 2.41 Each method has its own advantages. FVLCD can be based on observable prices, when available, which enhances its reliability. It also has the benefit of allowing an entity to consider cash flows expected to arise from a future restructuring to which a preparer is not yet committed or from asset enhancements.
- 2.42 VIU allows entities to consider factors that are more entity-specific, including synergies. This would also be aligned with fact that most business acquisitions are largely driven by large synergies and not by a future sale (exit strategies are typically related to investment companies). Nonetheless, such an approach is often criticised due to the subjectivity of the assumptions used by preparers. It is often argued that value in use model can be prepared in a way that could delay the recognition of impairment value.
- 2.43 Alternative c) in paragraph 2.38 has the advantage to reflect the intended manner of recovery. This would be consistent with other IFRS Standards. For instance, IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* requires to measure a disposal group at the lower of its carrying amount and FVLCD, which reflects the fact that the disposal group is expected to be sold. IAS 12 *Income Taxes* states that the measurement of deferred taxes shall reflect the tax consequences that would follow from the manner in which the entity expects to recover the carrying amount of assets.
- 2.44 The elimination of one of the methods is a change in the notion of recoverable amount applied and may be seen to reduce the relevance of the calculation. The IASB would need to consider if this change would be extended to all assets in scope of IAS 36.
- 2.45 All alternatives would likely result in recognition of more impairment losses compared to the existing requirements. This would be the case when the method applied results in a recoverable amount lower than the carrying amount, and the other method would have resulted in an amount higher than the carrying amount. EFRAG has not investigated how frequent these cases are.

Which cash flows should be included in the calculation: future restructurings

Guidance in IAS 36

- 2.46 In accordance with IAS 36, estimating VIU involves estimating the future cash flows to be derived from continuing use of the CGU and from its ultimate disposal. The cash flow projections should be based on reasonable and supportable assumptions and the most recent budgets and forecast.
- 2.47 The cash flow projections should relate to the asset in its current condition. Thus, the value in use should not reflect cost saving or benefits that are expected to arise from enhancements or future restructurings but to which an entity is not yet formally committed.

Issues identified

- 2.48 It has been claimed that the exclusion of the effect of future restructurings does not reflect how acquirers price the business. Typically, a buyer would incorporate future restructurings and changes in the processes when determining the maximum purchase price to be paid.

Suggestion: allow consideration of future restructurings

- 2.49 The requirements for the VIU measurement should be changed to allow considering the impact of expected restructurings even when these do not meet the recognition threshold.

Advantages and disadvantages of the suggestion

- 2.50 The suggestion would increase the relevance of the calculation because it would take into consideration the dynamic management of the business. It would simplify it, as it allows entities to use directly their budgets and forecast, which are likely to include the impact of future restructurings. It would also eliminate one of the sources of confusion between the VIU and the FVLCD method.
- 2.51 If an acquirer has incorporated the effects of future restructurings in pricing the acquisition, the exclusion of these effects may result in recognition of an impairment loss, which according to IAS 36 cannot be reversed. The suggested change would avoid this.
- 2.52 The suggestion would increase the level of judgment inherent in the test and create some application issues:
- a) it may be difficult to identify the unit of account, if the restructuring is expected to modify the existing Group reporting structure;
 - b) it may require long-term projections (in some cases exceeding the 5-year usual term). When the restructuring process takes a number of years to be completed, its final outcome may differ significantly from the original expectations; and

- c) the inclusion would make the projections even more judgmental and it would be more difficult to assess if the assumptions are reasonable, as users would not have detailed information about plans that have not yet been made public.
- 2.53 To mitigate these risks, an entity could be allowed to take into account future restructurings only if it has a formal plan (although not yet made public) and/or the restructurings is expected to be completed in the foreseeable future. In addition, an entity may be required to demonstrate the technical feasibility of completing the restructuring plan and the availability of adequate financial and other resources to complete the plan (similar to the guidance in paragraph 57 of IAS 38 to recognise an intangible arising from development).

How the entity should determine the discount rate

Guidance in IAS 36

- 2.54 IAS 36 requires the use of a pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the asset/CGU. The discount rate should not reflect risks for which future cash flows have been adjusted and should equal the rate of return that investors would require if they were to choose an investment that would generate cash flows equivalent to those expected from the asset/CGU, in terms of amount, timing and risk profile. Since the discount rate is determined on a pre-tax basis, future cash flows are also estimated on a pre-tax basis.
- 2.55 The discount rate is estimated from the rate implicit in current market transactions for similar assets or from the weighted average cost of capital of a listed entity that has a single asset (or a portfolio of assets) similar in terms of service potential and risks to the asset under review. When an asset-specific rate is not directly available from the market, an entity uses surrogates to estimate the discount rate.
- 2.56 When the basis used to estimate the discount rate is post-tax, that basis is adjusted to reflect a pre-tax rate. In accordance with paragraph BCZ85, the pre-tax discount rate is best determined by an iterative computation and not by grossing up the post-tax discount rate by a standard rate of tax. A simple gross-up does not usually work because it ignores the timing of creation and reversal of future temporary differences. That is, the simple gross up is only the correct pre-tax discount rate if the specific amount and timing of the future tax cash flows are reflected in this rate.

Issues identified

- 2.57 Determining the discount rate is often mentioned as a problematic area. In particular, it has been claimed that in many cases, entities can observe only post-tax rates and it is difficult to calculate an appropriate pre-tax rate. In addition, the use of pre-tax discount rate could be challenged. These respondents did not see the benefit of using a pre-tax rate (on pre-tax cash flows) when compared to a post-tax rate (on post-tax cash flows) and did not understand why a pre-tax calculation would provide superior information to users. These respondents also noted that academic books often estimated future cash flows on a post-tax basis using a corresponding post-tax discount rate.
- 2.58 In many cases the test is conducted on a post-tax basis with an additional iteration performed simply to derive a pre-tax discount rate.

Suggestion: allow the use of a post-tax rate

- 2.59 The requirements should be changed to allow entities an election between a pre-tax or post-tax calculation. Entities would need to disclose the basis chosen.

Advantages and disadvantages of the suggestion

- 2.60 The inclusion of a choice would simplify the calculation and reduce the cost when entities only have observable post-tax discount rates for an asset/CGU. Entities usually use WACC as a starting point for determining the discount rate, and the WACC is typically a post-tax rate.
- 2.61 The relevance of the calculation would not be affected, because the two basis should result in the same recoverable amount when the pre-tax rate is adjusted to reflect the timing of creation and reversal of temporary differences.
- 2.62 However, allowing a post-tax basis could raise some issues. For example it is unclear if this would have implications on the composition of the CGU and calculation of the amount of tax that should be allocated to the different CGUs. Also, since the estimates of future cash flows should include cash inflows or outflows from income tax receipts or payments, a number of practical questions would arise (as noted in paragraphs BCZ81 to BCZ84 of the basis for conclusions of IAS 36). For example, how should deferred taxes be reflected in the future cash-flows? How should the carrying amount of the CGU be equally adjusted? In this process, entities will have to ensure that the carrying amount of a cash-generating unit shall be determined on a basis consistent with the way the recoverable amount of the cash-generating unit is determined.

Determining the recoverable amount: goodwill accretion approach

Issues identified

- 2.63 In theory, the objective of the goodwill impairment test would be to ensure that the goodwill purchased is not carried at an amount higher than its recoverable amount. However, goodwill is not directly measurable - its initial carrying amount is a residual difference after all the identifiable net assets and non-controlling interests have been measured.
- 2.64 Goodwill can only be tested for impairment together with other assets in a CGU and it can be allocated either to pre-existing CGU that benefit from the acquisition or to purchased business.
- 2.65 Due to this, there are a number of 'shielding effects' that can potentially offset an impairment loss on the purchased goodwill.
- 2.66 The first is referred to as pre-acquisition headroom. When goodwill is allocated to a pre-existing CGU, at acquisition date the recoverable amount of that pre-existing CGU may be higher than its carrying amount due to:
- a) some assets being carried at amortised cost; and
 - b) unrecognised internal goodwill.

- 2.67 All things remaining equal, as long as the pre-existing headroom exceeds the cumulated impairment of the purchased goodwill allocated, the recoverable amount of the CGU will be higher than its carrying amount and no impairment loss will be recognised.
- 2.68 The second may be referred to as post-acquisition internally-generated goodwill. After the business combination, the acquirer may generate additional goodwill through its efforts and investments. Conceptually, this is not part of the purchased (and paid for) goodwill.
- 2.69 The BC of IAS 36 acknowledges that the purchased goodwill is shielded by the post-acquisition internally-generated goodwill but concludes that it is not possible to measure them separately.
- 2.70 Critics of the current model point out that this shielding effect creates a conflict with IAS 38 *Intangible Assets* that does not allow capitalisation of internally generated goodwill. It is claimed that this creates an accounting arbitrage – entities have an accounting incentive to grow through mergers and acquisitions rather by internal growth.
- 2.71 This Short Discussion Paper does not include suggestions to address the pre-acquisition headroom. EFRAG notes however, that the suggestion in paragraph 2.25 above (the ‘allocation ceiling’) would contribute to avoid this shielding effect. The IASB may also put forward a proposal in this regard.

Suggestion: the goodwill accretion approach

- 2.72 IAS 36 should require entities to include an accretion of the value of goodwill. The accretion would be determined only for the purpose of the impairment test with no recognition in the financial statements.
- 2.73 Each year, the entity would determine an accretion by multiplying the opening balance of goodwill by the discount rate at the end of the prior period. It would then be added to the carrying amount of the CGU or deducted from the recoverable amount.
- 2.74 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 balance of the accretion would be correspondingly reduced. The entity would continue to determine the accretion until the goodwill is fully written off.
- 2.75 Appendix 2 illustrates how the approach is applied in different circumstances.

Advantages and disadvantages of the suggestion

- 2.76 The inclusion of the accretion attempts to mitigate the shielding effect of the creation of post-acquisition internally-generated goodwill. Since no direct measurement is possible, EFRAG considers that an essential feature of the approach should be its cost effectiveness and simplicity.
- 2.77 The approach is meant to reflect that the acquirer consumes the purchased benefits over time. In other words, the useful life of the purchased goodwill is finite, although not determinable.

- 2.78 In practice, it can be observed that the recoverable amount of a business is maintained or even increased over time. However, any increases in value generated long after the acquisition are more likely to be related to the actions taken and investments made by the acquirer rather than to the acquisition itself.
- 2.79 The approach assumes a rate of creation of internally generated goodwill equal to the return expected on the acquisition. For an acquisition to be successful, the return earned annually by the acquirer should be at least equal to the discount rate, which reflects the time value of money, the variability of the expected future cash flows and the risk inherent in the business acquired.
- 2.80 From a conceptual standpoint, it could be argued that purchased goodwill represents a present value of expected future cash flows in excess of identifiable assets, measured at the date of acquisition. All things being equal, with the passage of time the present value of these cash flows should increase by the unwinding of the discount. Again, this argument assumes that the purchased goodwill has a limited useful life.
- 2.81 EFRAG believes that the goodwill accretion approach does not create a new conflict with the general objective in IAS 36. The stated objective is that an asset should not be carried at an amount higher than its recoverable amount, but the Basis for Conclusions of IAS 36 states that, given the residual nature of goodwill, the starting point in any goodwill impairment test would have to be the recoverable amount of the unit it has been allocated. The approach is compatible with an objective to measure the whole CGU at its recoverable amount, net of the unrecognised internally generated goodwill.
- 2.82 The approach is cost-effective because it only needs input that are already available to the entity (the carrying amount of the goodwill and the discount rate). Its application is relatively simple, as in substance it is a calculation of a notional interest. In addition, the approach is effective regardless of whether the goodwill is allocated to pre-existing CGU or the purchased business.
- 2.83 EFRAG acknowledges that the accretion is only an indirect measure of the creation of internally generated goodwill, which cannot be measured directly, and as such, it cannot be proved precise. It is however neutral and without bias.
- 2.84 EFRAG also notes that, although the goodwill accretion implicitly is based on the assumption that the purchased goodwill is being consumed, its application does not necessarily lead to an annual amortisation. We acknowledge that some disagree with the promise, while others may consider that the outcome is inconsistent with the implicit premise.

Summary of identified potential solutions

Issue	Suggestion	Reference (paragraph)
When to determine the recoverable amount	Introduce a 'Step Zero' (qualitative assessment of the likelihood of an impairment loss)	2.5 - 2.18

Identification of CGUs and allocation of goodwill	<ul style="list-style-type: none"> • Additional guidance on identification and allocation (e.g. fall-back methods) • Disclosure of information on composition of goodwill 	2.19 - 2.34
Ways to determine the recoverable amount	<p>Single calculation approach (FVLCD or VIU):</p> <ul style="list-style-type: none"> • Eliminate one of the two methods; • Accounting policy choice; or • Require the use of method reflecting the intended manner of recovery. 	2.35 - 2.45
Cash flows to take into account in the recoverable amount	Allow consideration of cash flows from future restructurings	2.46 - 2.53
Discount rate to be used in the recoverable amount	Allow the use of a post-tax rate	2.54 - 2.62
Acquired goodwill shielded by post-acquisition internally generated goodwill	Add an accretion amount to the recoverable amount	2.63– 2.84

Appendix 1 – Goodwill accretion approach: illustrative example

- 1 The appendix includes an illustrative example on the application of the approach and discusses some specific application issues.

Illustrative example

- 2 During Year 0, Entity A acquires Business B. After completing the purchase price allocation, goodwill is measured at CU 100. Entity A determines that Business B is a CGU and allocates 100% of the purchased goodwill to it. At the end of Year 0, Entity A determines a discount rate of 7%.
- 3 Each year, the entity would determine an accretion by multiplying the opening balance of goodwill by the discount rate at the end of the prior period. It would then be added to the carrying amount of the CGU or deducted from the recoverable amount.
- 4 The following table illustrates the application of the approach in Years 1, 2 and 3 and the way the cumulated accretion balance would change.

	Year 1	Year 2	Year 3
Recoverable amount of CGU	320.0	284.0	275.0
Opening balance of accretion	0.0	7.0	13.0
Accretion of the year	7.0	6.0	7.3
Adjustments due to impairments	0.0	0.0	-9.0
Cumulated accretion	7.0	13.0	11.3
Adjusted recoverable amount	313.0	271.0	263.7
Carrying amount of net assets	200.0	180.0	168.0
Carrying amount of goodwill	100.0	100.0	91.0
Total CGU	300.0	280.0	259.0
Impairment losses	0.0	-9.0	0.0
CA of goodwill less impairment	100.0	91.0	91.0

- 5 At the end of Year 1, the entity does not recognise an impairment loss and carries forward the balance of CU 7. The entity updates the discount rate to 6%.
- 6 At the end of Year 2, the entity recognises an impairment loss of CU 9 and updates the discount rate to 8%. The closing balance of goodwill is CU 91.
- 7 In Year 3, the entity decreases the cumulated accretion by CU 9 and calculates an accretion for the period equal to CU 91*8%. The entity does not recognise any impairment loss and carries forward the cumulated balance of CU 11.3.

Original or revised accretion rate?

- 8 EFRAG has considered whether the accretion should be computed based on the original discount rate (that is, the discount rate used for the first impairment test) or an updated rate.

- 9 Updating the accretion rate is more consistent with the overall impairment test model. However, it would imply that a decrease in the discount rate leads both to an increase in the recoverable amount (assuming no changes in the nominal cash flows) and to a decrease in the accretion. Both these effects would make the recognition of an impairment less likely.
- 10 This could be seen as counterintuitive, because a decrease in discount rates makes credit cheaper and allows entities to invest more in the purchased business, which may be conducive to a higher rate of creation of internally generated goodwill.
- 11 If the accretion rate were not updated, this would create an application issue when goodwill from a new acquisition is added to a CGU that already includes some from a prior business combination. In that case, the entity would have to test separately the two portions.
- 12 The approach attempts to simulate the rate of creation of internally generated goodwill. The original rate represents the return that the investor is willing to accept on the investment and the revised rate represents the current expected return. EFRAG does not hold strong views on the issue. An approach based on an updated rate seems to be simpler to apply.

How do partial disposals or distributions affect the approach?

- 13 Paragraph 86 of IAS 36 indicates that if the entity disposes an operation within a cash-generating unit to which goodwill has been allocated, (part of) the goodwill should be included in the operation disposed and derecognised.
- 14 The paragraph addresses disposals, which is not a defined term under IFRS. However, IFRS 5 *Non-current Assets Held for Sale and Discontinued Group* includes the notion of disposal groups – and disposal groups can be classified as either held for sale or held for distribution to owners. It may therefore be concluded that paragraph 86 of IAS 36 also applies to non-monetary distribution to owners.
- 15 In the context of the goodwill accretion approach, EFRAG suggests that after a partial sale or distribution, the cumulated balance of the accretion is reduced in the same proportion of the portion of the goodwill that has been de-recognised, unless the entity can demonstrate that another basis is more appropriate.
- 16 The rationale is that the operation disposed is likely to include a portion of internally generated goodwill after the acquisition. Therefore, the shielding effect is likely to be reduced, which should result in a reduction of goodwill accretion included in the impairment test after the disposal.
- 17 A cash distribution should not influence the goodwill accretion approach. The approach attempts to incorporate the consumption of the benefits from the business combination, not its distribution to owners.

Appendix 2 – Some background data

EFRAG's quantitative study on goodwill and goodwill impairment

- 1 In September 2016, EFRAG published a quantitative study on goodwill and goodwill impairment. The objective of the study was to provide some evidence on how goodwill and goodwill impairment have evolved over time. The study presented an analysis of approximately 300 major European companies from 2005 to 2014 on:
 - a) absolute amounts of goodwill and goodwill impairments;
 - b) relative weight of goodwill compared to total assets and equity;
 - c) distribution of goodwill and impairment losses across the entities in the sample;
 - d) comparison of the trend of impairment losses and market capitalisation; and
 - e) a breakdown of the overall data by industry.
- 2 The full study can be found [here](#). A summary of the key findings in Europe can be found below:
 - a) from 2005 to 2014 the total amount of goodwill recognised increased from 935 billion euros to 1.341 billion euros, representing an increase of 43%;
 - b) a small number of companies accounted for a large share of the carrying amount of goodwill and impairment losses recognised;
 - c) the ratio goodwill to total assets had remained stable over the years at approximately 4%. The ratio was significantly higher when entities in Financials industry are excluded but had been gradually decreasing since 2009;
 - d) the ratio goodwill to net assets had been decreasing since 2008, but it was still significant in 2014 (29%);
 - e) the amount of impairment losses recognised was at the highest level in 2008 and 2011, years when the performance of the financial markets was negative. On average, companies with goodwill at the beginning of the year impaired 3% of their opening balance of goodwill. Companies that recorded an impairment, impaired, on average, 6% of their opening goodwill; and
 - f) absolute and relative levels of goodwill and impairment losses varied significantly across industries.

Analysis of market-to-book ratio of the S&P 350 Europe sample

- 3 Based on the feedback received, EFRAG further analysed the data and added some findings on the relationship between the market-to-book ratio and goodwill.

What is the market-to-book ratio and why is it important?

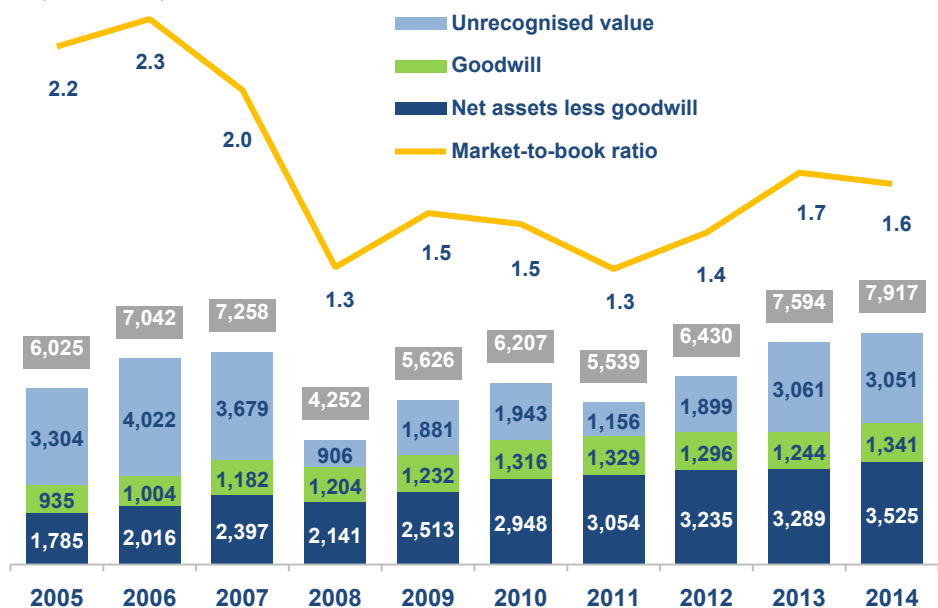
- 4 *The Conceptual Framework for Financial Reporting* defines equity as the residual interest in the assets of an entity after deducting all its liabilities; it is also called the **book value of equity** and represents an accounting measure of the net worth of the firm.
- 5 The **market value of equity** or market capitalisation is calculated by multiplying the number of shares outstanding by the market price per share.
- 6 The relation of the book value of equity and its market value, typically expressed in the form of the market-to-book ratio, is a topic of longstanding interest in finance. This ratio is often used by investors and analysts to explain patterns in stock returns.
- 7 When the ratio is higher than one, it means that the market assigns a higher value to an entity than its book value. This market premium can depend on various factors such as the entity's industry, the nature of the entity's assets and liabilities, and the entity's specific attributes. The following explanations for such a premium are possible:
 - a) many assets are measured based on their historical cost rather than their fair value or what investors expect those assets to produce in the future (e.g. intangible assets, such as brands and property, plant and equipment and intangible assets); and
 - b) many of the company's assets are not recognised in the statement of financial position (e.g. quality of the management team, value of research and innovation, relationships with customers and suppliers, entity's reputation, etc.).
- 8 IAS 36 indicates that a market capitalisation lower than the carrying amount of equity (i.e. a market-to-book ratio lower than 1) is one of the external sources of information that suggest likelihood of impairment, because the market perceives that the book value of equity is not recoverable. On the other hand, IAS 36 requires determining the recoverable amount as the higher of the fair value less costs of disposal and value in use. Therefore, a market capitalisation lower than the book value of equity does not need to result in recognition of an impairment loss, if the management assumptions are more optimistic than the market participants' are.

Quantitative data

- 9 The following graph illustrates the trends in the year-end market capitalisation, disaggregated into the following three components:
 - a) goodwill;
 - b) net assets other than goodwill; and
 - c) unrecognised value (that is, the difference between the year-end market capitalisation and net assets including goodwill). This difference represents the value that the market assigns to the companies but that is not recognised in the financial statements.
- 10 The unrecognised value is a large portion of the market capitalisation and it is mostly driven by market fluctuations rather than changes in recognised goodwill.

Market capitalisation, goodwill, net assets less goodwill and market-to-book ratio - S&P 350 Europe

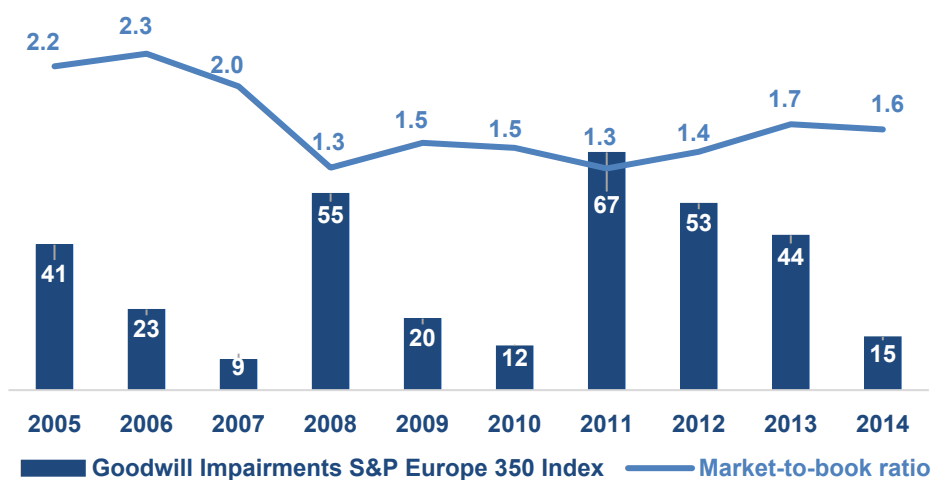
(EUR billion)



Note: Figures in grey boxes represent the market capitalisation, which is equal to the sum of the market premium (light blue), goodwill (green) and net assets less goodwill (dark blue).

- 11 The following graph shows that the average market-to-book ratio for the sample at its lowest levels in 2008 and 2011, despite the significant goodwill impairment losses that were recorded in those two years.

Market-to-book ratio and goodwill impairments (goodwill impairments are in billion euros)



- 12 EFRAG further investigated the frequency and intensity of goodwill impairment losses in entities having a market-to-book ratio lower than one.

13 On average during the period:

- a) of all companies in the sample reporting goodwill, 20% had a ratio lower than 1 at year-end (34% of those with ratio lower than 1, had a ratio of goodwill over net assets higher than 30%); and
- b) out of these companies, 40% reported a goodwill impairment loss during the period (or 60% did not). These companies impaired 4% of the opening balance of goodwill, which is lower than the average 6% of the sample (see paragraph 3e).

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Number of companies with goodwill [a]	295	298	289	291	290	297	299	295	300	306
How many of these have market-to-book ratio lower than 1? [b]	17	12	26	99	67	67	99	81	56	61
% [b] / [a]	6%	4%	9%	34%	23%	23%	33%	28%	19%	20%
How many of these with market-to-book ratio lower than 1 recorded goodwill impairment [c]?	5	2	6	50	31	31	42	40	28	26
% [c] / [b]	29%	17%	23%	51%	46%	46%	42%	49%	50%	43%
How much of their opening goodwill they impaired?	N/A	1%	2%	7%	3%	2%	8%	6%	7%	2%
What was the year-end market-to-book ratio of companies under [c]?	0.7	0.9	0.8	0.6	0.7	0.7	0.5	0.6	0.7	0.7
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Market-to-book ratio of companies with no goodwill	1.9	1.4	2.2	1.2	1.7	2.0	1.8	2.3	2.0	2.6
Market-to-book ratio of companies with goodwill over net assets lower than 30%	2.3	2.4	2.0	1.2	1.2	1.2	1.0	1.1	1.2	1.1
Market-to-book ratio of companies with goodwill over net assets higher than 30%	2.1	2.4	2.1	1.4	1.8	1.7	1.6	1.8	2.5	2.5



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