

GOODWILL IMPAIRMENT: CAN IT BE IMPROVED?

JOINT INVESTOR OUTREACH EVENT IN MILAN

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European Financial Reporting Advisory Group

DISCLAIMER

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OVERVIEW

- WHY A DISCUSSION PAPER (DP) ON GOODWILL IMPAIRMENT?
- WHAT IS THE STRUCTURE OF THE DP?
- WHAT IS THE SCOPE OF THE DP?
- WHAT HAS EFRAG CONSIDERED IN THE DP?



WHY A DP ON GOODWILL IMPAIRMENT?

- When responding to the Discussion Paper *Should Goodwill still not be amortised?* (2014) many noted that the impairment test was a challenge and that there was room to improve it.
- EFRAG has not taken any final position on the treatment of goodwill. It agreed to focus its Research activities on potential improvements to the impairment test.
- The objective of the DP is to gather European constituents' views on what aspects of the impairment test need to be improved and how this could be achieved.

WHAT IS THE STRUCTURE OF THE DP?

- **Chapter 1** focuses on the objective of the DP, different goodwill accounting approaches and scope of the DP.
- **Chapter 2** describes the issues that arise in practice and discusses possible ways to address them.
- **Appendix 2** provides some additional quantitative analysis on market-to-book ratio and goodwill.

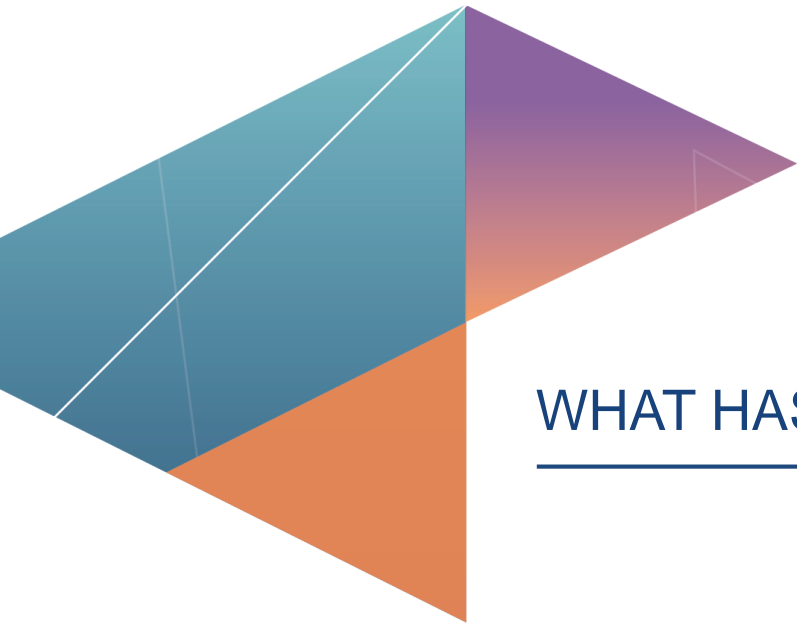


WHAT IS THE SCOPE OF THE DP?

- The DP illustrates some possible amendments to the impairment test. These are exposed for discussion and do not necessarily represent an EFRAG recommendation.
- EFRAG considered that the objectives of the amendments should be to:
 - enhance the application and effectiveness of the impairment test; and
 - reduce complexity and achieve a better balance between costs and benefits.

WHAT IS THE SCOPE OF THE DP?

- This DP does not address:
 - the identification and measurement of intangible assets in a business combination;
 - advantages and disadvantages of reintroducing annual amortisation; and
 - improvements to the disclosure requirements (already considered in a previous EFRAG Discussion Paper *Should Goodwill still not be amortised?*).



WHAT HAS EFRAG CONSIDERED IN THE DP?

HOW TO ALLOCATE GOODWILL TO CGUS?

WHAT ARE THE ISSUES?

- Allocation process is highly subjective and there is only limited guidance in IAS 36 on how to perform it.
- Entities have an incentive to allocate goodwill to CGUs with pre-acquisition headroom in order to 'shield' goodwill from impairment.
- When goodwill has been repeatedly re-allocated, the information is difficult to explain and understand.

HOW COULD THEY BE ADDRESSED?

- Additional guidance on the allocation of goodwill to CGUs. For example, fall-back methods and allocation ceiling.
- Disclosure of information on composition of goodwill. More specifically, reconciliation of total goodwill allocated to each CGU.
- Illustrative examples included in the DP and in the appendix to the presentation.

WHEN TO DETERMINE THE RECOVERABLE AMOUNT?

WHAT ARE THE ISSUES?

- An entity is required 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 with no real practical benefit.
- Some pointed out that US GAAP includes the option to perform first a qualitative assessment of the likelihood of an impairment.

HOW COULD THEY BE ADDRESSED?

- Introduce a 'Step Zero' in the impairment test: allow an entity to perform a qualitative assessment of the likelihood of an impairment loss.
- An entity would not be required to determine the recoverable amount when, and only when, the likelihood of an impairment is assessed to be remote.

SINGLE CALCULATION APPROACH TO DETERMINE THE RECOVERABLE AMOUNT?

WHAT ARE THE ISSUES?

- There is some confusion around the interaction between Value in Use (VIU) and Fair Value Less Cost of Disposal (FVLCD).
- Some claim that users may not understand the different assumptions used under the two methods. Others noted that it was more difficult to challenge management assertions in relation to VIU.

HOW COULD THEY BE ADDRESSED?

- Requiring or allowing only one method (VIU or FVLCD) could simplify the impairment test as both preparers and users will not have to consider whether there is a difference in terms of assumptions and inputs used in the DCF model when calculating the VIU and FVLCD.

VALUE IN USE AND FUTURE RESTRUCTURINGS

WHAT ARE THE ISSUES?

- Some claim 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.

HOW COULD THEY BE ADDRESSED?

- Allow the effect of planned future restructurings (inflows and outflows) to be incorporated in the cash flow projection, even when the threshold to recognise a provision for restructuring costs has not yet been met.

VALUE IN USE AND DISCOUNT RATES

WHAT ARE THE ISSUES?

- In many cases, entities can only observe post-tax rates and it is difficult to calculate an appropriate pre-tax rate.
- Academic books often estimate future cash flows on a post-tax basis using a corresponding post-tax discount rate.
- Not clear why a pre-tax calculation provides superior information to users.

HOW COULD THEY BE ADDRESSED?

- Allow entities to use a pre-tax or a post-tax calculation.
- Entities would need to disclose the basis chosen.

TARGETING INTERNALLY GENERATED GOODWILL

WHAT ARE THE ISSUES?

- Many argue that goodwill acquired in a business combination is being consumed and replaced by internally generated goodwill provided that the entity is able to maintain the overall level of goodwill (by, for instance, expending resources on advertising and customer service).
- This creates a perceived conflict with IAS 38 *Intangible Assets* that does not allow capitalisation of internally generated goodwill.

HOW COULD THEY BE ADDRESSED?

- Entities should be required to eliminate the effect of internally generated goodwill by deducting an accretion amount from the recoverable amount.
- An entity would determine the accretion amount by applying a rate to the opening balance of goodwill.
- Illustrative examples included in the DP.

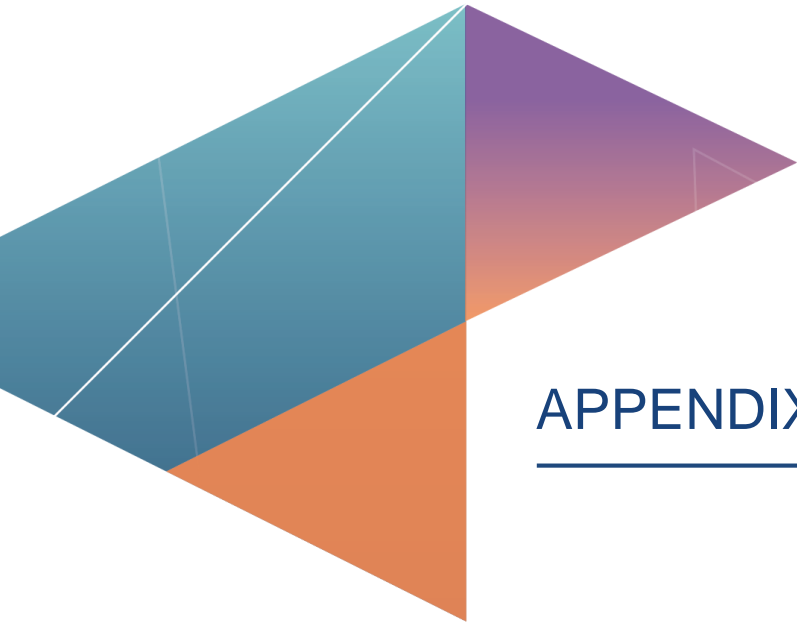


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APPENDIX – ILLUSTRATIVE EXAMPLES

ILLUSTRATIVE EXAMPLES

ALLOCATION BASED ON THE PRE- AND POST-ACQUISITION FAIR VALUE OF EACH CGU

Company A acquires company B for CU 2.100.

The net identifiable assets recognised by Company A amount to CU 1.800.

Company A recognises CU 300 of goodwill.

COMPANY A	PRE-ACQUISITION FAIR VALUE	NET ASSETS ALLOCATED	POST-ACQUISITION FAIR VALUE	DIFFERENCE
CGU A	2.000	1.700	3.985	285
CGU B	3.100	100	3.215	15

The difference can be used as a basis for allocation of goodwill.

ILLUSTRATIVE EXAMPLES

ALLOCATION BASED ON THE FAIR VALUE OF THE BUSINESSES ACQUIRED AND THEIR NET ASSETS

Company A acquires company B for CU 2.100.

The net identifiable assets recognised by Company A amount to CU 1.800.

Company A recognises CU 300 of goodwill.

COMPANY B	FAIR VALUE	NET IDENTIFIABLE ASSETS AT FAIR VALUE	DIFFERENCE
Position A	1.500	1.300	200
Position B	600	500	100

The difference is allocated to the CGUs to which the net identifiable assets have been allocated.

Regardless of the basis of allocation, in principle the method should not result in a decrease of the pre-acquisition headroom (an allocation ceiling).