IASB Research project on goodwill and impairment

Issues Paper

Purpose of this paper

1 This paper discusses the following developments on the IASB's Research project (the project) on goodwill and impairment:

(a) the updated headroom approach;

(b) separate recognition of identifiable intangible assets acquired in a business combination; and

(c) IASB tentative decisions on other matters related to the project.

2 The above developments form the basis for a collective package of considerations/proposals that aim to improve the effectiveness of the goodwill impairment test and simply its application, to be included in a forthcoming consultation document.

A. The updated headroom approach

3 Research conducted by the IASB Staff identified that management optimism and the shielding effect created by unrecognised headroom of a cash-generating unit (CGU) were the main causes for the delay in the recognition of goodwill impairments under the current model in IAS 36 *Impairment of Assets*.

4 Management optimism relates to overly optimistic future cash flows associated with the CGU to which goodwill is allocated. The IASB considered this to be an issue of discipline and enforcement and not a conceptual matter that can be solved through standard-setting. At its meeting in December 2017, the IASB tentatively decided to use the unrecognised headroom of a CGU as an additional input in the impairment testing of goodwill in order to address the delay in goodwill impairment created by unrecognised headroom within a CGU – referred to as the updated headroom approach.

The shielding effect of unrecognised headroom

5 The unrecognised headroom is the excess of the recoverable amount over the carrying amount of a CGU. This headroom provides a buffer that shields acquired goodwill from impairment and consequently delays recognition of goodwill impairment. The shielding effect arises at the acquisition date (pre-acquisition headroom) and subsequently (post-acquisition):

(a) *pre-acquisition headroom* - when acquired goodwill is allocated to an existing business, the pre-existing headroom of that existing business provides a shield protecting acquired goodwill from impairment at the date of the business combination; and

(b) *post-acquisition headroom* - headroom generated after the date of the business combination also provides a shield against impairment of goodwill. This is the case regardless of whether the acquired goodwill is merged into a pre-existing CGU or is kept separate, in case the entity builds up self-generated goodwill and other intangible assets that are not recognised under IFRS Standards.

6 The unrecognised headroom comprises internally-generated goodwill, any unrecognised assets and any difference between carrying amounts and recoverable amounts of other assets in the CGU that are not measured at a current value.

7 In many cases, the overall shield could be significant, resulting in a potential significant delay in goodwill impairment recognition.

8 In paragraph 135 of the Basis of Conclusion of IAS 36, the IASB acknowledged that the carrying amount of goodwill will always be shielded from impairment by the internally generated goodwill. However, at that time the IASB concluded that it is not possible to measure separately goodwill generated internally and to factor that measure into the impairment test for acquired goodwill.

9 The IASB is now considering that a possible way to solve this problem is to incorporate the unrecognised headroom as an input in the goodwill impairment test (updated headroom approach).

Applying the updated headroom approach

10 The updated headroom approach requires that the unrecognised headroom is added to the carrying amount of the relevant CGU when performing the goodwill impairment test. The amount of headroom is recalculated (updated) every time the impairment test is performed. An impairment will happen when the headroom decreases.

11 The IASB considered ways to attribute an impairment:

(a) allocate it in full to acquired goodwill; or

(b) apply a presumption that the impairment is fully allocated to acquired goodwill *unless* the entity rebuts that presumption when there is specific evidence that all or part of the decrease is not attributable to acquired goodwill.

12 The fact that the unrecognised headroom and acquired goodwill are combined means they become largely indistinguishable and changes in estimates of inputs such as growth rate, expected returns or discount rate may affect both.

13 Under option (b), an entity may rebut the presumption if there is specific evidence that all or part of the decrease in total headroom is not attributable to acquired goodwill. This would occur for example, when the decrease in total headroom is due to an increase in risk-free component of discount rate or a significant decline in the current value of an asset within the CGU measured on a historical cost basis.

14 At this stage the EFRAG Secretariat understands that the IASB will include the rebuttable presumption - either as an option or a requirement or simply as an alternative - in the upcoming consultation document. Assuming the document will be a discussion paper, there is no need for the IASB to take a conclusive view on the attribution as will ask constituents for views and other suggestions.

Updated headroom approach compared to current requirements

15 Consider the following simple example - Company X has a CGU Z that includes goodwill acquired in a past business combination. The recoverable amount and the carrying amount of the net assets of CGU Z at three reporting dates are as follows (assume that there is no change in the level of business activity):

In currency units (CU's)	**T0**	**T1**	**T2**
Acquired goodwill	100	100	100
Other net assets	525	510	500
Carrying amount in the IFRS accounts (a)	**625**	**610**	**600**
Recoverable amount (b)	**730**	**695**	**680**
Unrecognised headroom (a-b)	**105**	**85**	**80**
Carrying amount including unrecognised headroom (c)	**730**	**715** **(610+105)**	**685** **(600+85)**
Impairment loss to be allocated (c-b)	**-**	**20**	**5**

16 Under the current goodwill impairment test, no goodwill impairment arises in the above example as the recoverable amount is higher than the carrying amount (excluding the unrecognised headroom). For instance, the impairment loss of CU20 in T1 would be absorbed entirely by the unrecognised headroom.

17 Under the updated headroom approach, the unrecognised headroom brought forward from the **previous period** is added to the carrying amount. In T1, the decrease in the unrecognised headroom of CU 20 represents an impairment loss in CGU Z and is deducted from acquired goodwill to the extent that it is attributable to the acquired goodwill. The same reasoning applies to the impairment of CU5 in T2. In both cases, **it is assumed that the entity does not 'rebut the presumption' that the impairment relates entirely to goodwill**.

Costs of applying the approach

18 The information on the recoverable amount would generally be available as it is already calculated annually for testing of impairment. However, an entity would need to determine the recoverable amount with more precision as it would be used as an input in the impairment test calculation. Furthermore, the recoverable amount will need to be determined in the following cases:

(a) when newly acquired goodwill is allocated to a CGU for the first time, the entity would need to determine the recoverable amount of the unit just before the business combination;

(b) when a CGU is partially disposed of (and for which not all previously acquired goodwill is derecognised), the entity would need to determine the recoverable amount of the unit immediately after the disposal; and

(c) for a restructured CGU, the entity would need to determine the recoverable amount of the unit immediately after the restructuring.

19 Although an entity will be able to use previous calculations of recoverable amount or update them as necessary, they will still incur some costs to update and refine the calculations.

Discussion at CMAC meeting (March 2018)

20 Members of the IASB Capital Markets Advisory Committee (CMAC) expressed mixed views on the updated headroom approach. Some CMAC members supported the approach because it removes the shielding effect of any unrecognised headroom. However, CMAC members said that they would be concerned if an entity would be required to always allocate the impairment to goodwill. The rebuttable presumption could work although some members thought it might not as it would result in significant judgement.

21 A few CMAC members supported amortisation of goodwill. Some members indicated a preference for disclosure of the unrecognised headroom amount instead of using it as an input for impairment testing.

Discussion at the GPF meeting (March 2018)

22 Most members of the Global Preparers Forum (GPF) said that the updated headroom approach is likely to add significant costs mainly for two reasons:

(a) more precise measurement of recoverable amount required even in years in which the unrecognised headroom is large; and

(b) the need for extensive debate with auditors and possibly regulators to rebut the presumption that the full impairment is allocated to the acquired goodwill.

23 One GPF member supported the headroom approach but thought that any decrease in the total headroom should not be attributed to acquired goodwill if the unrecognised headroom was in excess of the pre-acquisition headroom.

EFRAG TEG member views from past discussions

24 EFRAG TEG-CFSS discussed the pre-acquisition headroom approach in September 2017 and EFRAG TEG discussed the updated headroom approach in March 2018. EFRAG TEG members were in general critical of the updated headroom approach but noted that its practical outcome would largely depend on the allocation of impairments between recognised and unrecognised goodwill. It was acknowledged that the approach would accelerate impairment losses and might therefore address the 'too little too late concern'. However, the usefulness of the resulting information was questioned. Nonetheless, the approach merited further investigation. Some members preferred to reintroduce amortisation of goodwill which, in their view, was less costly and shared the accounting objective to reflect goodwill consumption over time.

Questions for EFRAG TEG and EFRAG CFSS members

25 Do you think the updated headroom approach could improve the effectiveness of the impairment test? What are your initial views on the potential costs that may have to be incurred to apply the approach in the goodwill impairment test?

26 Do you think that disclosure of the basis used for attributing the decrease in headroom would provide useful information for users of financial statements? Please explain your response.

27 At this stage, do you have any comments or suggestions on improving the mechanics of the updated headroom approach?

B. Separate recognition of identifiable intangible assets

28 Findings from the IASB's post-implementation review of IFRS 3 highlighted that many respondents did not support separate recognition of all identifiable intangible assets acquired in a business combination for various reasons. Specifically:

(a) preparers and auditors – valuation of intangible assets such as brands and customer relationships is costly and complex (lack of sufficient reliable and observable data, highly subjective and high level of judgement required, and arbitrary allocation of future cash flows);

(b) investors – separate recognition of acquired intangibles has limited utility (if any) except if there is a market for intangibles (significant arbitrage opportunities in accounting for an acquisition, little trust is placed on the value of intangible assets such as brands and customer lists, and amortisation of some intangibles conveys no useful information about potential replacement cost).

Approaches identified by the IASB Staff for the IASB's consideration

29 To respond to the above concerns, the IASB Staff identified the following possible approaches for the IASB to consider at a future meeting:

(a) approach A - retain the current requirements of IFRS 3;

(b) approach B – require disclosures similar to those in IFRS 13 *Fair Value measurement* for intangible assets acquired in a business combination;

(c) approach C – allow indefinite-lived intangible assets to be included within goodwill; and

(d) approach D – segregate intangible assets into wasting and organically-replaced assets and require only wasting intangibles to be recognised separately from goodwill.

30 The above approaches have been discussed with the CMAC and GPF and will be discussed with the IASB at its meeting in April 2018. Some of the pros and cons of each of the approaches are discussed below.

<u>Approach A – retain current requirements</u>

31 Separate recognition of intangible assets acquired in a business combination provides useful information, as they have characteristics that are different from goodwill and have predictive value and will be useful to users.

32 Separate recognition encourages management to better analyse the acquisitions and the intangibles it has acquired. Furthermore, some academic research establishes value relevance of separate recognition of intangible assets acquired in a business combination.

<u>Approach B – IFRS 13 disclosures</u>

33 Many investors question the usefulness of the information provided by all (some) recognised intangibles assets acquired in a business combination and would like to better understand how the intangibles are valued.

34 The IASB could consider expanding the disclosure requirements in IFRS 13 to include information about intangibles acquired in a business combination in order to enhance the information about valuation techniques and inputs used in measuring the fair value of those intangible assets. Such disclosure could include:

(a) the level of fair value hierarchy within which the fair value measurements are categorised in their entirely (Level 1, 2 or 3);

(b) for fair value measurements categorised within Level 2 and Level 3, a description of the valuation technique(s) and the inputs used;

(c) other information for fair value measurements categorised within Level 3 of the fair value hierarchy.

Approach C - indefinite-lived intangible assets included within goodwill

35 This could be the easiest and most cost effective approach as it would not involve a fundamental change in the way indefinite-lived intangibles are currently accounted for (they are similar to goodwill).

Approach D - Segregate intangible assets into wasting and organically-replaced assets

36 Approach D would require assessing whether an intangible asset acquired in a business combination is a wasting asset or an organically-replaced asset.

37 Some argue that recognising and amortising wasting assets provides useful information to users about potential future cash flows for replacing the asset (capital maintenance information). In addition, valuing wasting intangibles is considered less subjective than valuing organically-replaced intangibles. The potential drawback of this approach is that it would require judgement to decide whether an intangible is a wasting asset or an organically-replaced asset.

38 Research conducted by the UK's Financial Reporting Council[1] indicated that investors would find it useful to distinguish between wasting and organically-replaced intangible assets. Wasting intangibles (such as patents and licences) have a finite useful lives and lead to identifiable future revenue streams and therefore should be recognised. In contrast, organically-replaced intangibles (such as customer lists and brands) are replenished on an ongoing basis through marketing and promotional costs, and should be included in goodwill and subsequently tested for impairment.

Discussion at CMAC meeting (March 2018)

39 CMAC members had mixed views on separate recognition of intangibles assets acquired in a business combination. Some supported the current requirements. However, others noted that the significant level of judgement in valuing some of these intangibles reduced the usefulness of the information. There was also the inconsistency with internally generated intangibles that are not recognised under IAS 38 *Intangible Assets.* It may therefore be preferable to subsume some intangibles into goodwill.

40 However, it was noted that not recognising acquired intangibles in a business combination would create a different disconnect with the accounting for acquired intangible assets outside of a business combination. Some CMAC members thought that only wasting intangibles should be separately recognised in a business combination. Some members covering the banking sector said that they ignored

[1] In March 2014, the UK's Financial Reporting Council published the results of research it had carried to understand investor views on accounting for intangible assets *Investor Views on Intangible Assets and their Amortisation*.

intangibles assets acquired in a business combination because those assets are deducted from equity in determining regulatory capital.

Discussion at the GPF meeting (March 2018)

41 Members of the GPF generally supported the current requirements in IFRS 3 to recognise all identifiable intangible assets, with some members stating that valuation costs were one-off costs on the date of the acquisition and preparers had become accustomed to using valuation techniques and practices. Some commented on the interaction with the headroom approach being discussed by the IASB and did not support putting all intangible assets acquired within goodwill. There was not much support for the approaches B-D.

Questions for EFRAG TEG and EFRAG CFSS members

42 Do you think that separate recognition of all intangible assets acquired in a business combination provides useful information? If not, why not?

43 Do you agree with the feedback that valuing certain intangible assets like brands and customer relationships is costly and complex? Are you aware of any other intangible assets that are difficult to value?

44 At this stage, what are your views on each of the possible approaches identified by the IASB Staff in paragraph 29 above?

C. IASB tentative decisions on other matters

45 At its meetings in December 2017 and January 2018 the IASB also tentatively decided to:

a) not to reintroduce amortisation of goodwill;

b) retain the current requirement of using the higher of value in use (VIU) and fair value less costs of disposal as the basis for determining recoverable amount under IAS 36 *Impairment of Assets*;

c) remove the requirement to exclude a future restructuring or a future enhancement from the value in use calculation;

d) remove the explicit requirement to use pre-tax inputs to calculate value in use and to disclose the pre-tax discount rates used. Instead an entity would be required to use internally consistent assumptions about cash flows and discount rates, and disclose the discount rate(s) used; and

e) consider additional disclosures to improve information about goodwill and impairment testing (for example disclose the headroom amount and require a breakdown of the carrying amount of goodwill by business combination and an explanation of why management considers that the goodwill is recoverable).

46 EFRAG's Discussion Paper *Goodwill impairment test: can it be improved?* discusses similar issues to those being considered by the IASB in its project. Many constituents to EFRAG's discussion paper expressed the view that goodwill impairment test can be improved in certain areas (for example, simplifications to the way value-in-use is determined and aligning the calculation with management budgets and forecast).

47 EFRAG TEG generally supported the direction of the tentative decisions in paragraph 45. However, EFRAG TEG members noted a potential need for safeguards on including future restructuring effects in the value in use calculation

and raised some questions regarding the practical application of a post-tax discount rate and in particular possible interactions with deferred tax and unrecognised deferred tax assets.

Question for EFRAG TEG and EFRAG CFSS members

48 At this stage, do you have any comments or feedback on the tentative decisions in paragraph 45 above?