Goodwill and Impairment - Amortisation of goodwill, a single method for recoverable and other issues.

Issues Paper

Purpose of this paper

1 The purpose of this paper is to obtain EFRAG TEG members views' on the following IASB's tentative decisions on its Research project on goodwill and impairment:

(a) Amortisation of goodwill - not to reintroduce amortisation of goodwill.

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

(c) Restructuring - remove the requirement to exclude a future restructuring or a future enhancement from the value in use calculation.

(d) Post-tax versus pre-tax inputs - 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:

(i) to use internally consistent assumptions about cash flows and discount rates; and

(ii) to disclose the discount rate(s) used.

Amortisation of goodwill

Background

2 The feedback received on the IASB's post-implementation review (PIR) of IFRS 3 *Business Combinations* indicated some support for amortisation of goodwill together with an indicator-based impairment test (views were generally mixed).

3 At the March 2017 meeting of the IASB Global Preparers Forum (GPF), some GPF members confirmed support for goodwill amortisation because: a) the measurement of recoverable amount is often highly sensitive to unverifiable assumptions about the terminal growth rate: b) the impairment testing methodology could be 'gamed' by manipulating the recoverable amount, and consequently the timing of recognition of impairment loss; c) amortisation of goodwill would better reflect the economics in some situations.

4 To address the feedback received, the IASB considered whether it should reintroduce goodwill amortisation.

Work performed by some national standard-setters including EFRAG

5 In July 2014, a Research Group from the European Financial Reporting Advisory Group (EFRAG), the Organismo Italiano di Contabilità (OIC), and the Accounting Standards Board of Japan (ASBJ) (collectively, the EFRAG/OIC/ASBJ Research Group) published a discussion paper *Should Goodwill Still Not Be Amortised?*. Most respondents agreed that the impairment-only approach for acquired goodwill was not the most appropriate solution for subsequent measurement and therefore supported reintroducing amortisation of goodwill.

6 The ASBJ published two research papers — one on amortisation of goodwill in May 2015, and another on analyst views on financial information regarding goodwill in June 2017. As part of the research, the ASBJ performed surveys seeking investors' views on amortisation of goodwill. Investors had mixed views on whether they preferred the impairment only approach or a combination of amortisation and impairment.

7 The ASBJ also presented an agenda paper titled *Possible Approach for addressing the "Too Little, Too Late"* at the July 2017 ASAF meeting which proposed an accounting policy choice between an impairment only model and an amortisation and impairment approach. This paper was considered by EFRAG TEG and EFRAG CFSS members at their joint meeting in June 2017. There was not much support for an optional approach, because of the effect on comparability and the general view that there was not a convincing conceptual basis for amortisation.[1]

8 In June 2017 EFRAG issued a *Discussion Paper Goodwill Impairment Test: Can it be improved?* ('EFRAG DP') discussion paper with the objective to expose potential amendments to the goodwill impairment test which could contribute to the IASB Research project. Although the EFRAG DP did not address the issue whether the amortisation of goodwill should be reintroduced some respondents suggested that the IASB explore the reintroduction of amortisation of goodwill. The responses to EFRAG DP are discussed in session 7 for today's meeting.

IASB Staff analysis and recommendation

9 At the IASB meeting in December 2017, the IASB Staff presented a paper on amortisation of goodwill. The analysis was based on the findings from research conducted by national standard-setters (discussed above) and on the IASB's considerations when developing the impairment-only approach in IAS 36 (referred to in paragraph BC131D of the Basis for Conclusions on IAS 36). The arguments for and against amortisation of goodwill are summarised in Appendix 1 of this paper.

10 The IASB Staff concluded that the arguments in support of amortising goodwill are not new and are not strong enough to support reintroducing it.

IASB tentative decisions

11 At its meeting in December 2017, the IASB tentatively decided not to consider reintroducing amortisation of goodwill. Some IASB members also noted that in case the updated headroom approach was not accepted the other alternative would be to develop additional disclosure rather than reintroducing annual amortisation.

[1] Under Japanese GAAP an entity is required to amortise acquired goodwill on a systematic basis, using the straight line method or other reasonable method, over the period for which goodwill is expected to have an effect, which shall not exceed 20 years, while requiring an entity to recognise impairment losses when a specified threshold is met.

Recoverable amount – single method or dual method?

Background

12 Under IAS 36 *Impairment of Assets*, 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).

13 VIU is the present value of the future cash flows expected to be derived from an asset or cash-generating unit (CGU), 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.

14 However, in FVLCD calculations, an entity is required to use assumptions that market participants would use when pricing the asset or liability, assuming that market participants act in their economic best interest.

15 Some investors have reported concerns about the entity-specific nature of value in use and about possible scope for management to manipulate the impairment test to avoid recognising an impairment. Similarly, a few auditors have reported concerns about challenging management's best estimates used in calculating VIU. Some argue that management optimism is a key reason for delays in goodwill impairment.

16 To respond to the concerns noted in paragraph 15, the IASB Staff analysed whether moving to a single method, ie either FVLCD or value in use, could help improvement the effectiveness of impairment testing and reduce application costs.

IASB Staff analysis and recommendation

17 The IASB Staff analysis identified that:

(a) the concepts of value in use as adopted in IAS 36 and fair value consider and reflect a largely similar set of factors;

(b) the biggest single difference that sometimes causes value in use to be lower than fair value are the restrictions in IAS 36 regarding cash flow projections used to calculate VIU. When these restrictions cause value in use to be less than FVLCD, VIU would not capture all of the goodwill of the unit; and

(c) the requirements in IAS 36 are designed with the intention of not allowing unwarranted management optimism to creep into value in use. In projecting the cash flows that management expects to derive, IAS 36 includes requirements that should, in principle, be sufficient to restrict an entity from using cash flow projections that are very different from the marketplace without justification. For example, an entity is required to use reasonable and supportable assumptions giving greater weight to external evidence when projecting cash flows. If there is any ineffectiveness in practice in impairment testing because of management optimism, it is very likely that this is because of entities misunderstanding the requirements in IAS 36.

IASB tentative decision

18 At its December 2017 meeting, the IASB tentatively decided to retain the current 'higher of' requirement to determine recoverable amount.

19 The IASB noted that both methods (VIU and FVLCD) were appropriate in different sets of circumstances. Some members also observed that the management

optimism represents an enforcement issue that cannot be solved by a single method.

EFRAG Secretariat observations and analysis

20 The IASB tentative decision is consistent with views provided by EFRAG TEG and EFRAG CFSS members in previous discussions. It is also consistent with views provided by respondents to EFRAG's DP on the topic.

21 EFRAG TEG and EFRAG CFSS considered a single method approach at its joint meetings in June and September 2017. 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. Therefore, they supported having both methods. This view was consistent with the view shared by most ASAF members who observed that in some industries (such as mining) there were significant differences between fair values and VIU.

The EFRAG DP

22 The EFRAG DP discusses identifies advantages and disadvantages with eliminating one of the methods to determine recoverable amount, without expressing a view on which method is preferable.

23 The majority of respondents disagreed with a single calculation approach for several reasons, such as: a) the benefits would not be obvious, b) it would lead to a too narrow approach for the calculation of the recoverable amount, c) the fair value, although is not always available, can be an alternative value to be used as a reasonableness test of the VIU.

Restructuring and enhancements to an asset's performance

Background

24 The concept of VIU under IAS 36 focuses on the current condition of the asset. For that reason, IAS 36 states that estimates of future cash flows shall not include estimated future cash inflows or outflows that are expected to arise from:

(a) a future restructuring to which an entity is not yet committed; or

(b) from improving or enhancing the asset's performance.

25 Some argue that excluding cash flows that relate to an uncommitted restructuring is necessary for consistency with the requirements in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* on restructuring provisions. Under IAS 37, an entity recognises a restructuring provision only when it is committed to the restructuring.

26 Several respondents (mainly preparers) to the IASB's PIR of IFRS 3 expressed concerns about costs and complexity arises from the restriction to exclude cash flows that would arise from future performance enhancement when determining VIU, since it meant adjusting their financial budgets/forecasts, and asked the IASB to remove this restriction.

IASB Staff analysis and recommendation

27 The IASB Staff agreed with the concerns of preparers and supported removing the requirement in IAS 36 to exclude restructuring and enhancement from the VIU calculation for the following reasons:

(a) Use of the asset -The underlying principle of VIU under IAS 36 is that the measurement reflects all cash flows expected to arise from the use of the asset and from its subsequent disposal. If the asset already contains the potential for future restructuring or future enhancement, VIU would appropriately reflect, among other things, all cash flows expected to result from that potential in line with management budgets and forecasts.

(b) Unit of account - The current condition of some assets (or cash generating units) contains a potential to restructure or enhance the asset, which market participant purchasing such an asset would be willing to pay for. Similarly, a market participant selling such an asset would demand to be paid for selling that potential. The fair value of such an asset would therefore include value attributable to that potential at the measurement date.

(c) Concept of VIU - The VIU of an asset (and its fair value) reflects, among other things, many expected future cash outflows for which the reporting entity has no liability at the measurement date. However, that does not mean that those cash outflows should be excluded from value in use. Whether the entity already has a liability determines whether the resulting cash flows should be included in the measurement of a liability, rather than in the measurement of the recoverable amount of the asset and consequently the VIU calculation.

28 The IASB Staff concluded that removing the restriction that excludes cash flows from future restructuring and from future performance enhancements would remove an inconsistency in IAS 36 (unit of account for VIU) and enhance faithful representation of information without a significant change in the concept of value in use. It would also add simplicity to the impairment testing by adopting the same unit of account for both approaches and reduce costs for preparers.

IASB tentative decision

29 At its January 2018 meeting, the IASB tentatively decided to remove the requirement to exclude from the VIU calculation cash flows resulting from a future restructuring or a future enhancement. In particular, members supported aligning the VIU calculation with an entity's budgets and forecasts for the reasons provided in the IASB Staff analysis above.

EFRAG Secretariat observations and analysis

30 The IASB tentative decision is consistent with views provided by EFRAG TEG and EFRAG CFSS members in previous discussions. It is also consistent with the majority view provided by respondents to EFRAG's DP on the issue.

EFRAG Discussion paper

31 Most of the respondents to the EFRAG DP generally agreed to include cash flows from would result from a future restructuring or from a future enhancement in the calculation of the value in use for the following reasons: a) the current guidance in IAS 36 is too restrictive and needs to be improved; b) it would be beneficial if entities could use their business plans and forecasts for impairment testing without corrections; c) the inclusion of future restructuring enhances the relevance of the impairment test, which would be based on how the entity intends to run the business; d) it is useful to take the dynamic management of the business into consideration and the limitation on capital enhancements complicates the value in use calculation.

Using pre-tax inputs to calculate value in use

Background

32 Under IAS 36, VIU is determined based on pre-tax cash flows and a pre-tax discount rate (which an entity also needs to disclose). However, in practice the pre-tax discount rate is a number derived from discounted cash flow calculations that are performed using post-tax inputs.

33 The issue of pre-tax versus post-tax cash flows to determine VIU is long-standing accounting issue. In issuing IAS 36, the International Accounting Standards Committee (IASC), required the use of pre-tax inputs mainly because it observed that using post-tax inputs without specifying the tax attribute that an entity should reflect in value in use (ie the basis for computing the future tax cash flows), would cause double counting of future tax consequences of temporary differences. It was noted that specifying a tax attribute might add complexity.

34 Based on the IASB's PIR of IFRS 3 and subsequent outreach, several stakeholders reported that a pre-tax discount rate when calculating VIU was hard for users and others to understand, and unable to provide useful information. This is because that rate is not observable and is generally not used for valuation purposes. Many stakeholders asked to be able to use a post-tax rate.

IASB Staff analysis and recommendation

Double counting effect

35 At the IASB meeting in January 2018, the IASB Staff provided an analysis of the possible double counting effect from using post-tax inputs.

36 The paper focused on the tax cash flows considered in fair value measurement and VIU were the same. In the view of the IASB Staff, this would depend on whether the asset being valued is a separate taxable entity. If the asset being valued is not a separate entity, it is *unlikely* that future tax related cash flows will be computed in the same manner. This is because:

(a) Measuring fair value - The entity-specific tax base of the asset on the date of measurement is ignored when measuring fair value because, in most situations, that tax base differs from the tax base that would be available to a market participant acquiring the asset. Therefore the tax base of the asset to the market participant is normally equal to its cost (its fair value).

(b) Measuring VIU - The measurement of VIU would be based on the actual entity-specific tax base of the asset using post-tax inputs that reflect the tax consequences of any temporary difference between tax base of the asset and its value in use. In addition, according to IAS 12 *Income Taxes* the entity should recognise deferred tax thus causing a double counting related to the recognition of temporary difference in VIU and also as a deferred tax asset or liability.

37 If the asset being value is a separate entity, in most situations, the tax bases of the assets within that entity remain unchanged when the entity is bought. This means that the tax base of assets would be the same for both a market participant and the reporting entity holding the asset. Consequently, it is *likely* that the future tax cash flows would be computed in the same manner when measuring fair value as when measuring VIU.

Possible approaches for the IASB to consider

38 The IASB Staff proposed the following approaches:

(a) retaining the current requirement to use pre-tax inputs;

(b) removing the explicit requirement in IAS 36 to use pre-tax inputs in calculating VIU; or

(c) removing the explicit requirement in IAS 36 to use pre-tax inputs and specify what tax attribute should be reflected in VIU.

39 The IASB Staff concluded that the current requirement for pre-tax inputs may not be helpful because:

(a) in practice, the current value of an asset is generally regarded and understood as a post-tax measure; and when valuing an asset using discounted cash flow techniques, post-tax cash flows are discounted using a post-tax discount rate.

(b) pre-tax discount rate is not generally observable; in fact it is the post-tax discount rate adjusted to reflect the specific amount and timing of the future tax cash flows;

(c) using pre-tax inputs does not necessarily help in resolving the double counting issue unless the definition of VIU is made sufficiently precise to identify what tax attribute an entity should reflect in value use.

40 The IASB Staff noted that a requirement to specify the tax attribute (in order to avoid the double counting issue discussed in paragraphs 35 - 37) would require an extensive analysis of the interaction between IAS 36 and IAS 12. Furthermore, such a requirement was likely to increase the costs and complexity of determining recoverable amount, rather than simplifying it. It was better to keep it simple and focus on post-tax inputs to determine VIU.

IASB tentative decisions

41 At its January 2018 meeting, the IASB tentatively decided to remove the explicit requirement to use pre-tax inputs to calculate VIU and to disclose the pre-tax discount rates used. An entity would be required: a) to use internally consistent assumptions about cash flows and discount rates; and b) to disclose the discount rate used.

EFRAG Secretariat observations and analysis

42 The IASB tentative decision is consistent with views expressed by EFRAG TEG in previous discussions and with the majority view expressed by respondents to EFRAG's DP on this topic.

EFRAG Discussion paper

43 The majority of respondents generally agreed with the proposal to use a post-tax discount rate to determine VIU because it would reduce complexity and costs and increase consistency with internal practices and the business model.

44 Some respondents expressed additional considerations on this issue and in particular: a) no clear advantage of one or the other method because both calculations (pre-tax and post-tax) should lead to the same value in use; b) needed additional guidance to ensure consistency between the discount rate and the cash flows used.

Question for EFRAG TEG

45	What are your views on the IASB's tentative decisions discussed above?

Appendix 1 – Arguments for and against amortisation of goodwill

46 The table below presents the arguments for and against amortisation of goodwill presented at the IASB meeting December 2017 when discussing whether amortisation of goodwill should be reintroduced.

Arguments for supporting amortising goodwill	Arguments for not reintroducing amortising goodwill
Acquired goodwill is an asset that is consumed and replaced by internally generated goodwill. Therefore, amortisation ensures that the acquired goodwill is recognised in profit or loss and no internally generated goodwill is recognised as an asset in its place.	By its nature, goodwill (or core goodwill) is often considered to have an indefinite life. If there is no foreseeable limit on the period during which an entity expects to consume future economic benefits embodied in goodwill. Therefore amortisation over an arbitrarily determined period would not faithfully represent the substance of the consumption of the goodwill.
Conceptually, amortisation is a method of allocating the cost of acquired goodwill over the periods in which it is consumed, and is consistent with the approach taken to other intangible and tangible fixed assets that do not have indefinite useful lives. Therefore there is no conceptual reason for treating acquired goodwill differently. If goodwill is amortised, the amortisation would capture the gradual consumption of goodwill and impairment would capture losses from bad investment decisions.	Reintroducing amortisation may not significantly reduce cost and complexity. Straight-line amortisation of goodwill is very likely to be viewed as arbitrary and not useful. A more robust amortisation model may have to be developed to make the amount of amortisation useful. That could be perceived as complex because estimating the primary inputs (useful life of goodwill and the pattern in which acquired goodwill is consumed) is very judgemental.
The useful life of acquired goodwill cannot be predicted with a satisfactory level of reliability, nor can the pattern in which that goodwill diminishes be known. However, systematic amortisation over an albeit arbitrary period provides an appropriate balance between conceptual soundness and operationality at an acceptable cost.	There is a risk that reintroducing amortisation would divert attention from the problems of poor impairment testing. It would help to avoid overstatement of goodwill, but would not focus on the underlying problem which is the need to improve how the impairment test is being performed to ensure that impairment of goodwill is properly recognised.
Amortising goodwill is likely to be seen by many preparers as the only way to reduce significantly the costs and complexity of subsequent accounting for goodwill. This is consistent with the IASB reasoning during the	The conceptual debate between amortising goodwill and only testing goodwill for any impairment is never ending. On issues for which views have always been so polarised, and may perhaps always remain polarised, it

development of the IFRS for SME's, and its conclusion that for cost-benefit reasons, rather than conceptual reasons, goodwill and other indefinite-lived intangible assets should be amortised.	would not be appropriate to change the accounting model every few years unless significant new evidence has emerged indicating that previous conclusions are no longer valid.
	Only a small minority of investors support amortising goodwill. A majority of investors have consistently maintained that amortisation of goodwill, and even intangible assets, is generally disregarded or ignored in their analysis. They think that unlike depreciation of tangible assets, amortisation of goodwill or many intangible assets does not provide information about potential future cash outflows. If investors disregard or ignore amortisation, preparers' concerns about the cost and complexity of the impairment test would not be sufficient reason to reintroduce amortisation of goodwill.