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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting:	**June 2008, London**
Project:	**Annual improvements process**
Subject:	**IAS 36 – Unit of accounting for goodwill impairment test (Agenda paper 6B)**

Proposed amendments

1. When IFRS 8 *Operating Segments* was issued in 2006, some consequential amendments were made to IAS 36 *Impairment of Assets* to reflect that decision. However, the staff has been notified of an additional clarification that is needed to reflect the Board's intention when it revised IAS 36. Paragraph 80 of IAS 36 refers to an operating segment determined in accordance with IFRS 8 as the largest unit permitted for the goodwill impairment test.

   The staff believes that this issue would be most appropriately resolved by the annual improvements process.

Staff recommendation

2. The staff recommends that the Board should:

   - add this issue to the annual improvements project;

- amend paragraph 80(b) of IAS 36 so that it states clearly the largest unit of accounting for the goodwill impairment test.

Background

3. Paragraph 80 of IAS 36 requires goodwill arising from a business combination to be allocated to a cash-generating unit (CGU) or groups of CGUs that are expected to benefit from the synergies of the business combination. These units to which goodwill is allocated should be the lowest level within the entity at which the goodwill is monitored for internal management purposes, but not 'larger than an operating segment determined in accordance with IFRS 8'.[1]

4. Entities adopting IFRS 8 effective 1 January 2009 (or earlier for early adopters) will have to reconsider the allocation of goodwill and whether any goodwill needs to be allocated to different CGUs based on the new largest unit permitted by the new segment definition introduced by IFRS 8.

5. The following views have developed about the new largest unit (or 'ceiling') permitted by IAS 36 when determining the unit of accounting for goodwill impairment test:

   - View A - the operating segment level *as defined* in paragraph 5 of IFRS 8 **before** the aggregation permitted by paragraph 12 of IFRS 8

   - View B – the operating segment level determined by IFRS 8 **after** the aggregation permitted by paragraph 12 of IFRS 8.

   The staff discusses the rationales for each of the two views below.

6. Regardless of which of the two 'ceilings' the Board intended when revising IAS 36 at the time IFRS 8 was issued, the reference to operating segments determined by IFRS 8 could result in goodwill being allocated to a different CGU (or a group of CGUs) than the previous version of IAS 36, which referred to the primary or secondary format of IAS 14 (see footnote 1).

[1] The previous version of paragraph 80 of IAS 36 referred to a unit not 'larger than a segment based on either the entity's primary or the entity's secondary reporting format determined in accordance with IAS 14 *Segment Reporting*.'

7. Entities in all industries make business acquisitions frequently, which generate goodwill that is required to be assessed for impairment and the related accounting is a significant part of their financial reporting. A common interpretation of the requirements for impairment testing is important to the consistent application of the standard.

8. This is a sufficiently narrow issue that does not relate to a current or planned IASB project, and could be addressed through a clarification of the Board's intent.

Alternative views

View A – IAS 36 permits the largest unit of accounting for the goodwill impairment test to be the operating segment level *as defined* in paragraph 5 of IFRS 8 <u>before</u> the aggregation permitted by paragraph 12 of IFRS 8

9. Paragraph 5 of IFRS 8 describes the three characteristics that identify an operating segment before any permitted aggregation. The wording of this paragraph is identical to the defined term 'operating segment' in Appendix A of IFRS 8.

10. Supporters of View A believe the lowest level of management responsible for the monitoring of goodwill as described in paragraph 80(a) of IAS 36 and the lowest level that the chief operating decision maker (CODM) regularly reviews the operating results of operating segments, (i.e., *as defined* in paragraph 5(b) of IFRS 8 <u>before</u> permitted aggregation) are equivalent.

11. They also believe that this interpretation avoids masking impaired goodwill by aggregating two operating segments that are financially and operationally separate but are aggregated in accordance with IFRS 8 on the basis of similar economic characteristics.

12. In addition, the aggregation test permitted in paragraph 12 of IFRS 8 is under the heading 'Reportable Segments' and not under the heading 'Operating Segments'.

13. Supporters of View A also believe that the ceiling in View A will be the same as that permitted by US GAAP goodwill impairment guidance in SFAS 142 *Goodwill and Other Intangible Assets*.[2]

14. In contrast, they think that View B permits aggregation for goodwill impairment testing at a level explicitly prohibited by US GAAP. For the goodwill impairment test, US GAAP prohibits the aggregation of reporting units that share similar economic characteristics but are related to different individual operating segments, as clarified in EITF D-101: *Clarification of Reporting Unit Guidance in Paragraph 30 of FASB Statement No. 142*.

View B – IAS 36 permits the largest unit of accounting for the goodwill impairment test to be the operating segment level determined by IFRS 8 <u>after</u> the aggregation permitted by paragraph 12 of IFRS 8.

15. Paragraph 12 of IFRS 8 discusses the criteria for the aggregation test permitted (not required) by that standard to determine reportable segments. It states that ‘Two or more operating segments may be aggregated into **a single operating segment** if aggregation is consistent with the core principle of this IFRS, the segments have similar economic characteristics, and the segments are similar in each of the following respects: …’[Emphasis added]

16. Supporters of View B point out that paragraph 80(b) of IAS 36 refers to operating segments as *determined in accordance with* IFRS 8 rather than *as defined by* IFRS 8 and that paragraph 12 of IFRS 8, taken in isolation, could suggest that individual operating segments may be aggregated to form ‘a single operating segment’ as the CGU for the purposes of goodwill impairment test in IAS 36.

17. From reviewing the Basis for Conclusions of IFRS 8, they also believe that the Board distinguished between the qualitative aggregation criteria in paragraph 12 of IFRS 8 and the quantitative aggregation thresholds in paragraphs 13-19 of IFRS 8, viewing the former as determining an operating segment while the latter as determining which operating segments are reportable segments. When

[2] See footnote 17 of paragraph 30 in SFAS 142. It clearly refers the reporting unit for goodwill impairment test to be an operating segment as defined in paragraph 10 of SFAS 131 *Disclosures about Segments of an Enterprise and Related Information*, which is identical to the definition of operating segment in paragraph 5 of IFRS 8 and before any permitted aggregation.

redeliberating ED 8, the Board inserted the word ‘operating’ into paragraph 12 of IFRS 8 where it refers to aggregation into a ‘single operating segment’ to address a respondent’s comment that the ranking of the qualitative and quantitative aggregation criteria is unclear in ED 8 and to make the wording of IFRS 8 and SFAS 131 for the aggregation paragraph identical (paragraph BC30 of IFRS 8).

18. View B supporters think that View A may potentially result in goodwill impairment testing at a lower (more detailed) level than that required by View B.

19. The previous version of IAS 36 referred to segments determined under IAS 14, which would generally result in segments larger than operating segments as defined in paragraph 5 of IFRS 8. Although uncommon, there may be situations when an entity monitors goodwill at a higher level than the lowest level of operating segments regularly reviewed by the CODM. View B could accommodate those situations more easily.

20. In addition, they believe that the determination of the monitoring level of goodwill in paragraph 80(a) of IAS 36 and the level of review by CODM of operating segments as defined in part (b) of paragraph 5 of IFRS 8 are different actions undertaken for different purposes.

Staff analysis

21. The staff supports View A.

22. The staff agrees that the lowest level of management for monitoring goodwill in IAS 36 and the lowest level of CODM who regularly reviews operating results of operating segments as defined in IFRS 8 are equivalent.

23. The staff notes that the Basis for Conclusions of IAS 36 documented the most frequent question from field visit participants to the Board during the exposure period of ED 3 was ‘what level of management’ is the lowest level that monitors goodwill. Paragraph BC141 of IAS 36 cited board of directors, chief executive officer, or segment management as possibilities. In comparison, paragraph 7 of IFRS 8 identified CODM as a function rather than a specific title but listed similar examples that included an entity’s CEO, COO, and a group of executive directors.

24. The staff also agrees that View A avoids masking of known impairment losses, creating a mismatch between the recognised amount of goodwill impairment (or lack thereof) and the economic reality of the business operations. Meeting the aggregation criteria of similar economic characteristics permitted in IFRS 8 does not automatically represent groups of cash-generating units that are expected to benefit from the synergies of the same identified goodwill. Similarly, the aggregated segments do not necessarily represent the separate business operations that are economically interdependent or work in concert to recover the identified goodwill being assessed for impairment.

25. Furthermore, the staff thinks that aggregating operating segments into a single unit for goodwill impairment testing larger than the unit at which goodwill is monitored contradicts the rationales previously considered by the Board when it redeliberated ED 3 before issuing IAS 36.

26. Some respondents on ED 3 asked the Board to consider converging with SFAS 142 on two aspects: (i) requiring the same level for the goodwill impairment test at the reporting unit level, i.e., one level below an operating segment; and (ii) aggregating CGUs with similar characteristics as a single unit for goodwill impairment testing notwithstanding that they may be monitored independently for internal purposes (paragraphs BC145(b)(c) of IAS 36).

27. The staff understands that, at the time, the Board decided not to converge on the basis that (i) the level of reporting unit in SFAS 142 places a limit on how far goodwill can be 'pushed down' for impairment testing, i.e., limited only to one level below an operating segment (paragraph BC148-BC149 of IAS 36); and (ii), aggregating CGUs with similar characteristics could mask an impairment loss that management *knows* exists in a CGU (paragraph BC150 of IAS 36).

28. On the other hand, with respect to arguments put forth by supporters of View B, the staff agrees that the wording in paragraph 80(b) of IAS 36 is ambiguous and not definitive in this respect. If the current wording was not deliberate, the Board can remove the unintended divergence easily through a simple amendment.

29. However, the staff believes that the order of the qualitative and quantitative aggregation in IFRS 8 cited by View B supporters is not relevant for goodwill

impairment purposes, and setting a ceiling at the aggregated operating segment level is undesirable for that purpose.

30. The staff thinks the qualitative aggregation test in IFRS 8 is two-pronged and both are optional (the use of ‘may’ in paragraph 12 and ‘if desired’ in the IG7 diagram). While one aggregation test requires that <u>all</u> qualitative criteria in paragraph 12 be met, the other aggregation test for individually immaterial operating segments only requires that <u>most</u> qualitative criteria in paragraph 12 be met (paragraph 14 of IFRS 8).

31. Aggregation arbitrarily when the operations are not integrated may result in an impairment being masked by aggregation with a business that does not share the recovery of the goodwill.

32. Although the staff agrees with supporters of View B that View A may potentially result in goodwill impairment testing at a lower (more detailed) level than that required by View B, the staff thinks that both View A and View B may result in different CGUs for impairment testing than the previous version of IAS 36 which referred to segments under IAS 14. The Board has already considered the situations when entities may have to arbitrarily allocate goodwill if goodwill is not monitored at or below the segment level, as described in paragraph BC140 of IAS 36.

33. Paragraph 80(b) of IAS 36 prevents entities from erroneously concluding that, when a business combination enhances the value of all of the acquirer’s pre-existing CGUs, the acquired goodwill identified can be tested for impairment at levels higher than those monitored by management.

34. The staff also disagrees with View B supporters that the determination of the level at which goodwill is monitored for impairment in paragraph 80(a) of IAS 36 and the level of review by CODM of operating segments as defined in part (b) of paragraph 5 of IFRS 8 are different actions undertaken for different purposes. The Board clearly communicated its intent to link the two actions in paragraph BC140 of IAS 36.

35. Based on its analysis, the staff believes that the Board’s intent when amending paragraph 80(b) of IAS 36 was to require goodwill to be tested for impairment at

the lowest level monitored by management, which is equivalent to the lowest level of CODM review of operating segments *as defined* in paragraph 5 of IFRS 8 and before permitted aggregation. That is, View A.

36. **Does the Board agree with the staff's conclusion that the Board's intent was to reflect View A when initially amending IAS 36 to refer to IFRS 8?**

37. **Does the Board agree that paragraph 80(b) of IAS 36 should be amended to clearly reflect that intent?**

Annual improvement considerations

38. Because this is a sufficiently narrow issue that does not relate to a current or planned IASB project, the staff thinks the Board could address it in the annual improvements process.

39. The staff also considered proposing a consequential amendment to paragraph 12 of IFRS 8 to remove the word 'operating' in the phrase 'a single operating segment' to remove the confusion that 'operating segment' might be defined in two paragraphs of IFRS 8 at two different levels, i.e., paragraph 5 and paragraph 12.

40. Because that word was specifically inserted when redeliberating ED 8 to achieve identical wording with SFAS 131 about aggregation, the staff believes that explaining the rationales in the proposal's basis for conclusion in IAS 36 should suffice and therefore, does not propose any consequential amendment to IFRS 8 at this time unless the Board concludes otherwise.

41. Consistent with the prospective application in paragraphs 138-139 of IAS 36 when the standard was revised in March 2004, the staff proposes to require an entity to apply this proposed amendment prospectively from its effective date.

42. The staff does not believe that it is appropriate to require retrospective application because the assessment of goodwill impairment might involve the use of hindsight in determining the fair values of the CGUs at the date of a past reporting period.

43. The staff does not believe that any relief for first-time adopters will be necessary.

44. The proposed amendment affects the size of units for the goodwill impairment test with potential implications for recognition and measurement of impairment losses. Therefore, if approved, this should be included in Part I of the next exposure draft for *Improvements to IFRSs*.

45. The staff does not believe that this proposed amendment requires any questions in addition to the standard questions in the ED's invitation to comment.

46. Appendix A includes the proposed drafting for the amendment if the Board agrees with the staff recommendation to adopt View A.

47. Appendix B includes the proposed drafting for the amendment if the Board decides to adopt View B.

48. Does the Board agree with the staff recommendations:

- **a. To address this issue in the annual improvements project;**
- **b. To propose no consequential amendment to IFRS 8 or its basis;**
- **c. To propose prospective application;**
- **d. To provide no relief for first-time adopters;**
- **e. To include the proposed amendment in Part I of the ED; and**
- **f. To solicit comments as part of the ED's standard invitation to comment.**

49. **Does the Board have any comments on the drafting proposed?**

Appendices A and B

[Appendices A and B omitted from Observer Notes].