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STAFF PAPER

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IASB Meeting

Project	**Goodwill and impairment project**		
Paper topic	Improving the impairment test		
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Objective of this paper

1. The purpose of this agenda paper is to ask the Board to consider a possible modification to the impairment test to address users' concerns about late recognition of impairment losses and overstatement of goodwill (for example because of an overpayment).

Structure of this paper

2. This paper includes the following sections:

    (a) What issue is the staff addressing in this paper?

    (b) Staff analysis:

        (i) Approaches that we could consider.

        (ii) Explanation of the day zero impairment test approach.

    (c) Staff recommendation and questions for the Board.

    (d) Appendix: Example to illustrate the difference between the current requirements in IAS 36 *Impairment of Assets* and the day zero impairment test approach.

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What issue is the staff is addressing?

3. An overpayment or underpayment may occur in a business combination. For example:

   (a) An overpayment may occur if the price is driven up in the course of bidding for the acquiree.

   (b) An underpayment may occur in a forced sale in which the seller is acting under compulsion.

   (c) An apparent overpayment or underpayment may also arise when an acquirer uses its own equity as consideration for an acquisition and the share price fluctuates between the date of fixing the quantity of shares used as consideration and the acquisition date.

4. The staff think that acquired goodwill is comprised of some or all of the following components (based on considering paragraph BC313 of IFRS 3 *Business Combinations*):

   (a) The fair value of the expected synergies and other benefits from combining the acquirer's and acquiree's net assets and businesses.

   (b) The fair value of the going concern element of the acquiree's existing business, ie the ability of the established business to earn a higher rate of return on an assembled collection of net assets and employees than would be expected if those net assets had to be acquired separately.

   (c) Assets that are not recognised separately because they are not identifiable.

   (d) Differences that arise because some assets and liabilities acquired in a business combination are not measure at fair value, for example income taxes and employee benefits.

   (e) Overvaluation of the consideration paid by the acquirer, particularly when estimates are made in valuing any non-monetary consideration—for example when equity instruments are used as consideration.

   (f) Overpayment by the acquirer.

5. The staff note that conceptually, overpayments and underpayments should not be part of goodwill. Conceptually they represent either a gain (in the case of underpayment) or a loss (in the case of overpayment) to the acquirer. Taking each of these scenarios in turn:

    (a) In the case of an underpayment, where the fair value of the net assets acquired exceeds the consideration transferred (a bargain purchase), IFRS 3 requires a gain to be recognised at the acquisition date, after a reassessment of the amounts recognised (paragraphs 34-36 of IFRS 3).

    (b) However, overpayments are addressed only through subsequent impairment testing. Even if an acquirer knows it has overpaid for an acquisition and can estimate the overpayment, IFRS 3 does not permit the overpayment to be recognised as a loss immediately. Nevertheless, IFRS 3 would permit an impairment test to be performed in accordance with IAS 36 immediately after recognition.

6. For the purpose of impairment testing, paragraph 80 of IAS 36 requires goodwill acquired in a business combination to be allocated, from the acquisition date, to each of the acquirer's cash-generating units (CGU), or groups of CGUs, that are expected to benefit from the synergies of the combination. Consequently, if acquired goodwill is allocated to an existing CGU and the recoverable amount of the CGU exceeds its carrying amount (for example because the CGU contains (unrecognised) internally generated goodwill at the acquisition date), the excess of the recoverable amount over the carrying amount will provide a buffering effect against recognition of an impairment loss.

7. In other words, if an overpayment is made, it has the same effect as if the entity had taken its own internally generated goodwill and reclassified it as acquired goodwill (even though internally generated goodwill is not a permissible component of goodwill—identified in paragraph 4 of this paper). In addition, as time passes, more internally generated goodwill may arise in the CGU and increase the buffering effect.

8. The staff note that this buffering effect would only apply if goodwill is allocated to existing CGUs of the acquirer and not if goodwill arising on the acquisition is allocated only to the acquiree.

9. Example: An acquirer purchases an acquiree for CU50 and recognises an amount of CU15 for goodwill in accordance with IFRS 3.[1] The acquirer estimates that it has overpaid by CU7 and so goodwill includes an estimated CU7 overpayment (ie goodwill is overstated by CU7). Assume, for simplicity, that goodwill is allocated to a single existing CGU, or a single group of CGUs. Assume also that the CGU (or group of CGUs) contains internally generated goodwill that contributes an amount of more than CU7 to the recoverable amount of the CGU.

   For the purposes of impairment testing, that internally generated goodwill would fully support the carrying amount of the recognised goodwill and no impairment loss would be recognised when testing the CGU. This buffering effect could prevent overpayments being recognised as impairment losses on a timely basis, thereby increasing concerns that goodwill is overstated and that impairments are being recognised too late.

10. The following paragraphs of the Basis for Conclusions accompanying IFRS 3 provide the Board's reasoning for the current requirements for overpayments:

> BC331 Because business combinations are generally exchange transactions in which knowledgeable, unrelated willing parties exchange equal values, the boards continue to believe that the acquisition-date fair value of the consideration transferred provides the best evidence of the acquisition-date fair value of the acquirer's interest in the acquiree in many, if not most, situations. However, that is not the case if the acquirer either makes a bargain purchase or pays more than the acquiree is worth at the acquisition date if the acquirer underpays or overpays. The revised standards provide for recognising a gain in the event of a bargain purchase, but they do not provide for recognising a loss in the event of an overpayment (paragraph BC382). Therefore, the boards concluded that focusing directly on the fair value of the consideration transferred rather than on the fair value of the acquirer's interest in the acquiree, with a presumption that the two amounts are usually equal, would be a more straightforward way of describing how to measure goodwill. (The same conclusion applies to measuring the gain on a bargain purchase, which is discussed in paragraphs BC371–BC381.) That change in focus will also avoid unproductive disputes in practice about whether the consideration transferred or another valuation technique provides the best evidence for measuring the acquirer's interest in the acquiree in a particular situation.
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> BC382 The boards considered whether the revised standards should include special provisions to account for a business combination in which a buyer overpays for its interest in the acquiree. The boards acknowledged that overpayments are possible and, in concept, an overpayment should lead to the acquirer's recognition of an expense (or loss) in the

[1] Monetary amounts are denominated in 'currency units' (CU)

period of the acquisition. However, the boards believe that in practice any overpayment is unlikely to be detectable or known at the acquisition date. In other words, the boards are not aware of instances in which a buyer knowingly overpays or is compelled to overpay a seller to acquire a business. Even if an acquirer thinks it might have overpaid in some sense, the amount of overpayment would be difficult, if not impossible, to quantify. Thus, the boards concluded that in practice it is not possible to identify and reliably measure an overpayment at the acquisition date. Accounting for overpayments is best addressed through subsequent impairment testing when evidence of a potential overpayment first arises.

Staff analysis

Approaches that we could consider

11. As noted by the Board in paragraph BC382 of IFRS 3, even if an acquirer knows it has overpaid for an acquisition, in practice the overpayment may be difficult to quantify. The staff think that an acquirer may also be reluctant to admit to making an overpayment or may be unsure if it has overpaid. Consequently, the staff do not think requiring the overpayment to be quantified at the date of acquisition and written off immediately would be a feasible approach.

12. Instead the staff have identified three other approaches that the Board may wish to consider to address concerns that impairment losses may be recognised too late and goodwill may be overstated:

    (a) Incorporate into the impairment test calculation any excess of the recoverable amount over the carrying amount of the existing CGUs (or groups of CGUs) to which goodwill is allocated. This approach would remove the buffering effect explained in paragraphs 6-9.

    (b) After the purchase price allocation has been completed, at the end of the measurement period, require any identified overpayment to be quantified and written off. Such an approach could be coupled with a list of situations where an overpayment may be more likely to occur to assist this assessment. For example:

        (i) a bidding war between two or more investors;

        (ii) a takeover bid that succeeds only after several unsuccessful proposals;

        (iii) consideration paid mostly by exchange of shares;

(iv) an unusually high amount of acquired goodwill; and

(v) an acquirer has a history of impairments recognised shortly after past acquisitions in the absence of specific causes.

(c) Measuring acquired goodwill on a stand-alone basis against the assumptions that gave rise to it at acquisition. The staff envisage that this would require a comparison of the actual performance of the acquisition against the key performance targets supporting the price paid for the acquisition and hence supporting the goodwill recognised (this would involve similar considerations as explained in Disclosure D2 in Agenda Paper 18B for this meeting).

If the key performance targets have not been met, the shortfall between the expected targets and the actual results would form a basis for quantifying the overpayment. For example, an entity could estimate the amount that would have been paid for the acquisition had the actual performance been used as the expected targets on acquisition. The difference between this amount and the actual amount paid would provide a basis for the write down of goodwill.

13. The staff have developed the approach in paragraph 12(a) in this paper. The staff think the approach in paragraph 12(a), together with the disclosure recommendations in Agenda Paper 18B, would address the main concerns expressed by users without significantly increasing the costs and complexity for preparers.

14. The staff do not support the approaches in paragraphs 12(b) and 12(c) for the following reasons:

(a) In paragraph 12(b), the amount that could be written off as a loss, resulting from an overpayment, would be left to management's discretion and could be open to abuse. Furthermore, the staff think it would be difficult to quantify what part of goodwill relates to an overpayment, even after the purchase price allocation has been completed.

(b) The detailed calculation required to measure any impairment of goodwill in paragraph 12(c) would add cost and complexity to the impairment test, particularly if an acquiree has been integrated into the business. The staff think these costs would outweigh the benefits to users because the test would still be subjective. Instead, the staff think that it is reasonable to require entities to perform a basic comparison of the performance of the acquisition against the key performance targets for disclosure purposes, subject to field testing (as described in Agenda Paper 18B).

15. Nevertheless if Board members are supportive of either of the approaches in paragraphs 12(b) and (c), the staff can develop the approaches for a future meeting.

Day zero impairment test (paragraph 12(a) approach)

16. The staff envisage that the approach in paragraph 12(a) could be applied as follows:

(a) Step One: on the date of acquisition, determine which of the acquirer's CGUs, or groups of CGUs, are expected to benefit from the synergies of the combination and determine how the acquired goodwill will be allocated (as is currently required by IAS 36). For example, assume goodwill is expected to be allocated to units A, B and C of the acquirer (the units could be an individual CGU or a group of CGUs).

(b) Step Two: before allocating goodwill or any other assets of the acquiree, calculate the recoverable amount of each of units A, B and C, at the date of acquisition, using pre-acquisition assumptions in the calculation. ‘Pre-acquisition assumptions’ would be the assumptions for those units excluding the effects of the acquisition (ie the assumptions for the unit immediately before the acquisition, assuming the acquisition will not take place).

The excess of a unit’s recoverable amount over its carrying amount, at the acquisition date using pre-acquisition assumptions, would be

considered to be the notional amount of pre-existing internally generated goodwill in that unit. However, if the carrying amount of a unit exceeds its recoverable amount, this would indicate that the unit is impaired prior to the acquisition, and therefore no amount would be assigned to internally generated goodwill for that unit. Note, the amount of pre-existing internally generated goodwill is calculated purely for the purposes of testing the unit for impairment (ie it is never recognised as an asset).

(c) Step Three: allocate the acquired goodwill and any other assets (if the acquired business is being integrated into the acquirer's existing business) from the acquiree to units A, B and C, as required by IAS 36.

(d) Step Four: because acquired goodwill is allocated to them, those units would need to be tested for impairment before the year-end (and on an annual basis) under the requirements in IAS 36. The impairment test would be performed for each of units A, B and C as follows:

 (i) The recoverable amount of each unit would be determined as normal in accordance with IAS 36 (ie post-acquisition assumptions and after the allocation of goodwill or any other assets of the acquiree).

 (ii) The recoverable amount of each unit determined in (i) would be compared to the total of:

  1. the carrying amount of that unit (including the allocated acquired goodwill and any other allocated assets of the acquiree); plus

  2. the notional amount of pre-existing internally generated goodwill associated with that unit determined in step 2.

 (iii) If the recoverable amount of a unit exceeds the total of 1 and 2, no impairment loss is recognised for that unit.

 (iv) However, if the total of 1 and 2 exceeds the recoverable amount of a unit, that excess would be recognised as an impairment loss.

(v) Any impairment would be allocated, in accordance with IAS 36, first to reduce the carrying amount of the acquired goodwill allocated to the unit and then to the other assets of the unit on a pro-rata basis.

Ideally, step four would be performed as close to the acquisition date as is practicable, because this is when the notional pre-existing internally generated goodwill is calculated.

17. Steps one, three and four are already required by IAS 36. Consequently, the only differences between the approach in paragraph 16 and the existing approach in IAS 36 are:

(a) the inclusion of an additional step, step two; and

(b) the requirement to consider a notional amount of pre-existing internally generated goodwill in step four.

The staff further note that these differences would only apply if some goodwill is allocated to existing CGUs of the acquirer. They would not apply if goodwill arising on the acquisition is allocated only to the acquiree.

18. The amount of pre-existing internally generated goodwill at the date of acquisition (determined in step two) would continue to be incorporated in future impairment tests of the unit. The staff note that, conceptually, it would be appropriate to remeasure the internally generated goodwill each time the impairment test is performed. However, the staff are concerned that requiring remeasurement for each subsequent impairment test might add cost and complexity that would outweigh the benefits of updating that measurement.

19. However, if, in a future period, the entity makes another acquisition that gives rise to further acquired goodwill, and that acquired goodwill is allocated to the same unit, the entity would be required to perform a new calculation to determine the amount of internally generated goodwill existing in the unit at the time of the second acquisition. The internally generated goodwill measured in this revised calculation would incorporate the originally calculated amount of internally generated goodwill. The single revised amount would be used from then on for the purposes of impairment testing of that unit.

20. The staff have provided an example in the Appendix to help to illustrate the steps in paragraph 16 using a very basic fact pattern. If the Board would like to develop this approach further, the staff would test it out against more complex fact patterns. For example, if the CGUs are subsequently restructured or recombined in some way, consideration would have to be given as to how to allocate and track the internally generated goodwill. The staff think one such method in that case might be to attach it to the acquired goodwill from the business combination that led to its calculation, and to follow the existing guidance in IAS 36 for the reallocation of acquired goodwill.

Staff recommendation and questions for the Board

21. The staff think that the day zero impairment test approach (as described in paragraphs 12(a) and 16-20) together with the staff's recommended disclosures in Agenda Paper 18B would provide significantly better, and more timely, information to users. Plus, the staff do not think this approach would add significant cost/complexity to preparers, particularly if the impairment test is made less burdensome to apply in other ways (for example by introducing an indicator-only impairment test for goodwill, rather than a required annual test).

Questions for the Board
(1) Do Board members have any comments or suggestions on the day zero impairment test approach in this paper?
(2) Do Board members want the staff to develop this approach further?
(3) Do Board members want the staff to develop either of the other two approaches in paragraphs 12(b)and(c) further?

Appendix: Example to illustrate the difference between the current requirements in IAS 36 and the day zero impairment test approach.

Fact pattern

A1. Company X has a 31 December year-end. On 1 September 2016, Company X purchases 100 per cent of Company Y for CU150 and measures the goodwill acquired at CU55 in accordance with IFRS 3.

A2. Company X has three CGUs, A, B and C, with carrying amounts of CU100, CU200 and CU300 respectively at the date of acquisition of Company Y.

A3. Company X determines the following allocations of the goodwill and assets of Company Y between its CGUs for impairment testing (as required by IAS 36):

	CGU A	CGU B	CGU C	Total
Identifiable net assets of Company Y	CU35	CU60	-	CU95
Acquired goodwill arising on acquisition of Company Y	CU20	CU35	-	CU55

A4. Assume for simplicity that in this example there is no change in the carrying amount of Company X's net assets and Company Y's net assets between the date of acquisition and the date of performing the impairment test.

A5. Assume that the recoverable amounts of CGU A and CGU B at the date of the impairment test are CU190 and CU300 respectively (determined based on value in use and pre-acquisition assumptions, ie including Company Y).

Current requirements in IAS 36

A6. CGU A and CGU B would need to be tested for impairment before the year-end (and on an annual basis), because goodwill is allocated to those CGUs.

A7. At the date of the impairment test the carrying amounts of the CGUs are as follows:

	CGU A	CGU B
Identifiable net assets (includes Company Y allocation)	CU135 (=100+35)	CU260 (=200+60)
Acquired goodwill arising on acquisition of Company Y	CU20	CU35
Carrying amount	**CU155**	**CU295**

A8. Outcome of the impairment test:

(a) CGU A: Recoverable amount (CU190) > Carrying amount (CU155). No impairment

(b) CGU B: Recoverable amount (CU300) > Carrying amount (CU295). No impairment.

Day zero impairment test approach (paragraph 12(a) approach)

A9. The recoverable amounts of CGUs A and B would need to be estimated at the date of acquisition of Company Y, based on the pre-acquisition assumptions and before allocation of Company Y goodwill and other assets. Assume the recoverable amounts determined on this basis are CU140 and CU220 respectively. The carrying amounts of CGUs A and B are CU100 and CU200 respectively (before allocations of Company Y).

A10. Consequently, for the purposes of the impairment test, pre-existing internally generated goodwill of CU40 (=140-100) is allocated to CGU A and CU20 (=220-200) is allocated to CGU B.

A11. CGU A and CGU B would need to be tested for impairment before the year-end (and on an annual basis), because goodwill is allocated to those CGUs.

A12. At the date of the impairment test, the amounts relating to CGUs A and B are as follows:

	CGU A	CGU B
Identifiable net assets (includes Company Y allocation)	CU135	CU260
Acquired goodwill arising on acquisition of Company Y	CU20	CU35
Carrying amount	**CU155**	**CU295**
Pre-existing internally generated goodwill at the date of acquisition of Company Y (not recognised)	CU40	CU20
Total of the carrying amount of the CGU plus the internally generated goodwill	**CU195**	**CU315**

A13. Outcome of the impairment test:

(a) CGU A: Recoverable amount (CU190) < Carrying amount of CGU plus pre-existing internally generated goodwill (CU195). Impairment of CU5 allocated to the acquired goodwill arising on acquisition of Company Y.

(b) CGU B: Recoverable amount (CU300) < Carrying amount of CGU plus pre-existing internally generated goodwill (CU315). Impairment of CU15 allocated to the acquired goodwill arising on acquisition of Company Y.

A14. Consequently, the carrying amounts of CGUs A and B after the impairment test are as follows:

	CGU A	CGU B
Identifiable net assets	CU135	CU260
Acquired goodwill arising on acquisition of Company Y (after allocation of impairment)	CU15 (=20-5)	CU20 (=35-15)
Carrying amount of CGU	**CU150**	**CU280**