STAFF PAPER

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Project	Goodwill and Impairment research project		
Paper topic	Improving effectiveness of the impairment testing model in IAS 36 *Impairment of Assets*		
CONTACT(S)	Woung Hee Lee	wlee@ifrs.org	+44 (0)20 7246 6947
	Raghava Tirumala	rtirumala@ifrs.org	+44 (0)20 7246 6953

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Purpose

1. The purpose of this paper is to:

   (a) provide some context to the Board about the causes of ineffectiveness in the IAS 36 impairment testing model;

   (b) explain whether moving from (i) the current requirement of higher of value in use and fair value less costs of disposal; to (ii) a single method (either value in use or fair value less costs of disposal) as the sole basis for determining recoverable amount would make impairment testing more effective and to explain why this move would not mean a fundamental reconsideration of IAS 36; and

   (c) further analyse the updated headroom approach, to (i) respond to comments from Board members at the October 2017 meeting about the costs of applying the approach; and (ii) illustrate application of this approach in complex situations.

Objective of improving effectiveness of impairment testing of goodwill

2. The objective of considering possible approaches to improve the effectiveness of impairment testing of goodwill is to address stakeholders' concern that

impairment of acquired goodwill is not being recognised by entities on a timely basis.

Structure of the paper

3. The paper is structured as follows:

   (a) background and introduction

      (i) causes of ineffectiveness in the IAS 36 impairment testing model (paragraphs 4–11)

      (ii) staff research so far (paragraphs 12–16)

   (b) a single method for determining recoverable amount

      (i) would adopting a single method make impairment testing more effective? (paragraphs 17–21)

      (ii) would this approach mean a fundamental reconsideration of IAS 36? (paragraphs 22–25)

   (c) updated headroom approach

      (i) introduction (paragraphs 26–29)

      (ii) mechanics of the approach (paragraphs 30–37)

      (iii) cost of applying the updated headroom approach (paragraphs 38–44)

   (d) question for the Board

   (e) *Appendix A*—analysis of the approach of using a single method for determining recoverable amount

   (f) *Appendix B*—examples illustrating application of the updated headroom approach

Background and introduction

Causes of ineffectiveness in the IAS 36 impairment testing model

4. Investors have consistently stated that recognition of impairment losses in an entity's financial statements only confirms, and never precedes, investors'

assessment and consideration of those losses in their analysis of the entity. That leads to a question about what an acceptable delay is between the events that trigger impairment (which investors 'know' and consider in their analysis) and the recognition of the impairment loss in the entity's financial statements.

5. Some stakeholders think that an entity should recognise impairment losses in the next financial statements, whether interim or annual, immediately after the events triggering impairment have occurred. However, there could be delays in recognition of impairment losses for various reasons. In the context of goodwill, there could be a delay in recognition of losses for one or both of the following reasons:

   (a) the entity's management might conclude that market participants overreacted to the circumstances. Consequently, the entity might not reduce the recoverable amount and, as a result, might recognise no impairment of goodwill. In some circumstances, this might be a result of unwarranted management optimism, as discussed in paragraphs 6–9.

   (b) if part of acquired goodwill was allocated to an existing cash-generating unit that benefits from the business combination, the unrecognised assets of that unit absorb the first layer of decreases in the recoverable amount of the unit, thereby shielding that allocated acquired goodwill against the recognition of impairment losses.[1] Similarly, goodwill generated internally after a business combination also shields acquired goodwill from impairment. See paragraphs 10–11.

Management's optimism

6. In any conversation about effectiveness of the IAS 36 impairment testing model, investors and auditors have always flagged management's optimism as a main reason for delays in recognising impairment of goodwill.

7. A few investors have reported concerns about the entity-specific nature of value in use and about possible scope for management's optimism to creep into the impairment test to avoid recognising an impairment. Similarly, a few auditors

[1] In this paper, any reference to a cash-generating unit or a unit should be read as also referring to groups of units to which the goodwill relates.

have reported concerns that it may be more difficult to challenge management's best estimates used in calculating value in use, than to challenge management's estimates of the assumptions market participants would use.

8. On the basis of informal discussions with a few individuals from large accounting firms, the staff understand that management is generally motivated to make optimistic cash flow forecasts and that the level of optimism might be somewhat lower if management were estimating what cash flows other market participants would derive from the asset(s). If this effect occurs, it could result in value in use being higher than fair value less costs of disposal. This effect might sometimes be offset by restrictions that IAS 36 imposes on cash flow projections used in calculating value in use (see paragraph A17).

9. One of the possible reasons for management's optimism creeping into the impairment test is the requirement in paragraph 33(b) of IAS 36 that the estimates of future cash flows should be based on the most recent financial budgets/forecasts approved by management. Management's budgets/forecasts may tend to be set at a level that is challenging, rather than at a level that provides a realistic prediction of what will ultimately happen.

Shielding effect of internally-generated goodwill

10. Internally-generated goodwill provides a shielding effect for acquired goodwill in two ways:

    (a) when acquired goodwill is allocated to an existing business, the already existing internally-generated goodwill of that existing business provides a shield at the date of the business combination.

    (b) in periods after the business combination, goodwill generated after the date of the business combination provides a shield. This is the case regardless of whether the acquired goodwill is merged into a pre-existing unit or is kept separate.

11. The fact that internally-generated goodwill has a shielding effect for acquired goodwill is not new information for the Board. When revising IAS 36 in 2004 to remove amortisation of goodwill, the Board concluded that acquired goodwill will always be shielded from impairment by internally generated goodwill because it is

not possible to measure separately goodwill generated internally after a business combination and to factor that measure into the impairment test. Therefore, the Board took the view that the objective of the goodwill impairment test could at best be to ensure that the carrying amount of goodwill is recoverable from future cash flows expected to be generated by both acquired goodwill and goodwill generated internally after the business combination. (See paragraph BC135 of the Basis for Conclusions on IAS 36.)

Staff research so far

12. With the background explained in paragraphs 4–11, the staff have been analysing (a) whether any changes to the measurement basis in IAS 36 for determining recoverable amount could improve effectiveness of impairment testing; and (b) whether the shielding effect of goodwill, which is inherent in the impairment testing of goodwill, can be removed.

13. The staff have developed the following possible approaches:

    (a) using a single method, ie either fair value (less costs of disposal) or value in use, as the sole basis for determining recoverable amount instead of the current measurement basis of higher of fair value less costs of disposal and value in use—with the objective of understanding whether there are any problems that make the impairment test less effective and whether unwarranted management's optimism can be eliminated;

    (b) the pre-acquisition headroom (PH) approach—with the objective of removing the shielding effect of the already existing internally-generated goodwill of an existing unit; and

    (c) the updated headroom approach—with the objective of removing the shielding effect of internally-generated goodwill, regardless of whether the acquired goodwill is merged into a pre-existing unit or is kept separate.

14. In past Board meetings, the staff presented:

(a) a detailed analysis of a possible approach of using a single method, ie either fair value less costs of disposal or value in use, as the sole basis for determining recoverable amount;

(b) a detailed analysis of the PH approach, including numerical illustrations of application of that approach; and

(c) a preliminary analysis of the 'updated headroom' approach.

15. The past discussions of the Board indicated that the PH approach is not likely to be the Board's preferred approach mainly because it does not remove the shielding effect of goodwill generated internally after the business combination. Consequently, analysis of the PH approach is not included in this paper. See Appendices A and B of Agenda Paper 18B for the October 2017 Board meeting for analysis of the PH approach.

16. In this paper, the staff:

(a) explain whether using a single method (either value in use or fair value) as the sole basis for determining recoverable amount would improve the effectiveness of impairment testing and why moving to this approach would not mean a fundamental reconsideration of IAS 36; and

(b) further analyse the updated headroom approach.

A single method for determining recoverable amount

Would adopting a single method make impairment testing more effective?

17. The staff analysed this possible approach (ie a single method for determining recoverable amount):

(a) to identify whether there are any problems with the measurement basis in IAS 36 for determining recoverable amount; and

(b) to determine whether moving to a single method would help remove the ineffectiveness in impairment testing arguably caused by management's optimism.

18. The Board considered a detailed analysis of this approach at its October 2017 meeting. See *Appendix A* of this paper for the analysis. The following conclusions may be drawn from the analysis:

    (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 cause value in use to be lower than fair value is the restriction that IAS 36 imposes on cash flow projections used in calculating value in use. In those situations in which the restrictions cause value in use to be less than fair value less costs of disposal, value in use would not capture all of the goodwill of the unit.

    (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, in the staff's view, 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, in the staff's view, it is very likely that this is because of entities misunderstanding the requirements in IAS 36.

19. On the basis of the conclusions in paragraph 18, it is not clear whether using a single method for determining recoverable amount in itself would make impairment testing more effective.

20. Moving to a single method for determining recoverable amount might be worth considering as part of some other approaches being considered in the research project. For example, paragraph 41 discusses briefly whether moving to a single method might mitigate some possible concerns about the updated headroom approach.

Other suggestions from a few stakeholders

21. In relation to unwarranted management optimism, some individuals from large accounting firms think that redrafting the requirements in IAS 36 on cash flow projections could help in improving the application of the Standard. For example, the requirement in paragraph 33(b) of IAS 36 that cash flow projections should be based on the most recent financial budgets/forecasts receives more focus than the subsequent guidance in the Standard that an entity should give greater weight to external evidence. Management's budgets are one of the sources of information for projecting cash flows. Redrafting the requirements to state that management's budgets are one of the sources of information might help to avoid optimism in budgets being carried through into value in use. The Board could consider making such drafting changes if it concludes that such changes would help improve the application of IAS 36.

Would this approach mean a fundamental reconsideration of IAS 36?

22. At the October 2017 meeting, a few Board members suggested that this approach (moving to a single method) could not be adopted without a fundamental reconsideration of IAS 36. The following paragraphs explain why the staff think that this approach would not mean a fundamental reconsideration because it does not contradict the objective of IAS 36.

23. The objective of IAS 36 is that an asset is carried at no more than its recoverable amount. The recoverable amount is the amount to be recovered through use or sale of the asset. In developing IAS 36, the Board's predecessor (the IASC) decided that the recoverable amount should be the higher of value in use and fair value less costs of disposal. Nevertheless, in the staff's view, the decision that the objective of IAS 36 involves determining a recoverable amount, does not necessarily dictate a particular method for determining recoverable amount. In assessing how best to determine recoverable amount, it would be acceptable (and, indeed, appropriate) to consider various factors, including the degree of relevance to users of financial statements, the degree of subjectivity involved and cost-benefit considerations. It would be perfectly possible, without contradicting

the overall objective of IAS 36, for the Board to adopt other ways of determining recoverable amount, for example:

(a) fair value less costs of disposal in all cases, if the Board felt that adopting a market-participant perspective, rather than an entity-specific perspective, would reduce subjectivity and measurement uncertainty.

(b) value in use in all cases, if the Board felt that the most relevant information would result from a measurement that reflects what management actually expects will happen.[2]

(c) some simplified basis, if this would reduce implementation costs without significantly reducing the usefulness of the resulting information to users of financial statements.

24. At the last Board discussion, some Board members noted that US GAAP treats the recognition of an impairment loss as creating a new cost basis. Thus, in US GAAP, impairment losses are typically not reversed if circumstances change. On the other hand, under IFRS Standards, impairment loss are typically reversed (except for goodwill, because it is not feasible to separate reversal of an impairment loss on acquired goodwill from the internal generation of unrecognisable goodwill). Those Board members asked the staff whether changing the basis for determining the recoverable amount of goodwill could conflict with the overall approach in IAS 36 (ie the measurement basis is recoverable amount, not a new cost, and impairment losses are typically reversed).

25. In the staff's view, no such conflict exists. Selecting one particular approach to determining recoverable amount would not dictate whether impairment losses should be reversed if circumstances change.

[2] In the staff's view, for an asset that management expects to sell in the short term, it would be reasonable to expect value in use to be approxinately equal to fair value less costs of disposal.

Updated headroom approach

Introduction

26. Just as a reminder, goodwill is tested for impairment at the level of a cash-generating unit because:

    (a) goodwill does not generate cash flows independently of other assets (or of other groups of assets); and

    (b) the unit represents the level with which goodwill would naturally be associated.

27. As explained in paragraphs 10–11, the shielding of acquired goodwill from impairment by internally-generated goodwill is inherent in testing goodwill for impairment. Moreover, it is not just the internally-generated goodwill that shields the acquired goodwill from impairment, but also:

    (a) any unrecognised assets such as internally generated intangibles that do not meet the recognition criteria; and

    (b) any difference between carrying amounts and recoverable amounts of other assets in the unit that are not measured at a current value.

    For convenience, internally-generated goodwill together with the other components set out in (a) and (b) is here after referred to as ‘unrecognised headroom’. The term ‘total headroom’ refers to the sum of unrecognised headroom and acquired goodwill, or in other words excess of recoverable amount over the carrying amount of recognised assets, less liabilities (excluding acquired goodwill).

28. To remove the shielding effect, the updated headroom approach would introduce the amount of unrecognised headroom as an additional input into the impairment testing model. The unrecognised headroom is a proxy for a measurement of internally-generated goodwill and is measured as the difference between (a) the recoverable amount of the unit and (b) the carrying amount of the unit including acquired goodwill. This measurement is consistent with the notion that goodwill can only be measured as a residual amount.

29. In principle, information about unrecognised headroom is generally available from the current impairment testing model for goodwill. This is because recoverable amount is calculated annually for testing goodwill for any impairment. (See paragraphs 38–44.)

Mechanics of the approach

30. Consider the following example—Company X tests goodwill for impairment regularly at the annual reporting date. Company X has a cash-generating unit Z that includes goodwill acquired in a past business combination. The recoverable amount and the carrying amount of the net assets of unit Z at two reporting dates are as follows (assume that there is no change in the level of business activity)

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

	31 December	
	T0	T1
Carrying amount		
– acquired goodwill	*100	#100
– other recognised assets, less liabilities	525	510
Recoverable amount	730	695

* after recognising impairment loss, if any, as at T0

before recognising impairment loss at T1

31. Applying the updated headroom approach at T1:

(a) an entity compares:

(i) the recoverable amount of the unit at the current impairment testing date (T1) CU695; with

(ii) the sum of:

1) the carrying amount of the unit at the current impairment testing date (T1) CU610; and

	CU
Acquired goodwill (which is the same amount of goodwill, less impairment, at T0 if there are no changes between T0 and T1 because of new business combinations or disposals or restructuring)	100
Other recognised assets, less liabilities	510
Total	610

2) *unrecognised headroom of the unit at the previous impairment testing date (T0) CU105*

	CU
Recoverable amount	730
Acquired goodwill, less impairment	(100)
Other recognised assets, less liabilities	(525)
Unrecognised headroom	105

(b) the calculation in (a) is, in effect, a comparison of total headroom at the previous impairment testing date (T0) with the total headroom at the current impairment testing date (T1).

Calculation in (a)	→	$RA_{t1} – (CAA_{t1} + \mathbf{GW_{t1}} + UHR_{t0})$
	≡	$RA_{t1} – (CAA_{t1} + \mathbf{GW_{t0}} + UHR_{t0})$
	≡	$(RA_{t1} – CAA_{t1}) – (GW_{t0} + UHR_{t0})$
	≡	$THR_{t1} – THR_{t0}$

RA_{t1} = Recoverable amount of the unit at time T1

CAA_{t1} = Carrying amount at time T1 of all assets[3] of the unit other than acquired goodwill

GW_{t1} = Carrying amount of acquired goodwill before impairment at time T1 (generally equal to the carrying amount of acquired goodwill, less impairment at time T0 except for any adjustments between T0 and T1 for any disposal, restructuring or new business combination)

UHR_{t0} = Unrecognised headroom at time T0

THR_{t1} = Total headroom at time T1

THR_{t0} = Total headroom at time T0

		31 December	
		T0	T1
Recoverable amount	(a)	730	695
Carrying amount of other recognised assets, less liabilities	(b)	(525)	(510)
Total headroom	(a–b)	205	185

[3] Less liabilities. For simplicity, we mention only assets

(c) if the sum in (a)(ii) (CU610 + CU105 = CU715) is greater than the amount in (a)(i) CU695 (in other words, there is a net decrease in the total headroom [CU205–CU185]), that excess of CU20 [CU715–CU695] is deducted from acquired goodwill as an impairment loss, to the extent that it is attributable to the acquired goodwill. See paragraphs 32–37 for further discussion on possible approaches for attribution of loss.

$THR_{t1} - THR_{t0} < 0$	indicates impairment
$THR_{t1} - THR_{t0} > 0$	No impairment

Attribution of impairment

32. The current impairment testing model results in impairment being absorbed entirely by the unrecognised headroom first. In the example in paragraph 30, applying IAS 36, Company X will not recognise any impairment of goodwill because recoverable amount is higher than the carrying amount of unit Z at both T0 and T1. However, the total headroom of unit Z, for which IAS 36 currently does not require any tracking, decreased from CU205 at T0 to CU185 at T1. Applying IAS 36, all of that decrease of CU20 is, in effect, attributed to unrecognised headroom and none is attributed to acquired goodwill.

33. On the other hand, the updated headroom approach aims to attribute at least some of a decrease in total headroom to acquired goodwill. Therefore, the main difference between the current impairment testing model and the updated headroom approach is in the sequence applied in attributing the decrease in total headroom. The rationale for changing the attribution of loss (ie decrease in total headroom) is that (a) decreases in total headroom arising from changes in estimates of inputs such as growth rate, expected returns, discount rate etc not only affect the unrecognised headroom but also acquired goodwill; and (b) the fact that they are combined means they become largely indistinguishable.

34. The decrease in total headroom could be attributed in one of the following ways:

(a) the decrease is always attributed to acquired goodwill, ie all decreases in total headroom are recognised as an impairment loss on acquired goodwill; or

(b) the decrease is presumed to be attributable in full to acquired goodwill unless the entity rebuts that presumption on the basis of specific evidence that the all or part of the decrease is not attributable to acquired goodwill.

35. Offsetting decreases in total headroom always to acquired goodwill first would accelerate impairment. However, in situations in which acquired goodwill and (or) acquired assets are allocated to an existing unit, this attribution method is likely to draw a criticism that losses with no relation to acquired goodwill are recognised as impairment of goodwill, and thus this attribution approach may not provide relevant information and may not faithfully represent the extent of the loss (may overstate it).

36. The second approach described in paragraph 34(b) may result in reasonable attribution of decreases in total headroom.

(a) For example, if the decrease in total headroom is mainly because of an entity not being able to realise the expected synergies from a business combination, it would be appropriate to offset all the decrease in total headroom against acquired goodwill.

(b) If the decrease in total headroom is mainly because of an increase in discount rate, a reasonable allocation (perhaps pro rata) of the decrease in total headroom between acquired goodwill and unrecognised headroom of the previous impairment testing date might be appropriate.

(c) In some situations, it may be clear that the total headroom consists primarily of components other than internally generated goodwill. For example, suppose that the unit contains land that is measured at historical cost but has a much greater fair value. Any decrease in total headroom could arise mainly from a decrease in the fair value of land, in which case attributing all of the decrease to the unrecognised headroom would be appropriate.

37. If the Board adopts the second attribution approach, the Board could also consider requiring disclosure in notes about how decreases in the total headroom have been attributed, including specific (not just generic) disclosure of the evidence that the

entity relied on in rebutting the presumption that all losses should be attributed to acquired goodwill. This would enhance the decision usefulness of this approach.

Costs of applying the updated headroom approach

38. At the October 2017 meeting, Board members directed the staff to assess whether this approach would significantly increase the cost and complexity of impairment testing.

39. The staff do not think that the approach adds complexity to the impairment testing because it only adds one input to the existing equation of impairment testing. Information about unrecognised headroom or total headroom is generally available from the current impairment testing model for goodwill because recoverable amount is calculated annually for testing goodwill for any impairment. However, an entity may have to perform some additional tasks to apply this approach, which would add to the cost of impairment testing.

40. The additional tasks, and consequently the costs, would arise because:

    (a) the current measurement basis for determining recoverable amount, (which is higher of value in use and fair value less costs of disposal) may not always produce a single point estimate of recoverable amount—a precise single value for recoverable amount would normally be determined only when the bottom-end of the recoverable amount range is less than a unit's carrying amount; and

    (b) there would be situations in which the measure of unrecognised headroom or total headroom will not be readily available—this is because IAS 36 does not require an entity to determine the recoverable amount of a unit annually if the unit does not contain acquired goodwill and no indicators of impairment are present.

41. When revising IAS 36 in 2004, the Board proposed to require an entity to disclose the unrecognised headroom of a unit that includes goodwill. The Board did not finalise that proposal because the Board was sympathetic to feedback from preparers that the measurement basis in IAS 36 does not produce a single point estimate of recoverable amount. These concerns, and consequently the need for any additional tasks, can be reduced by either:

(a) pursuing the approach of using a single method as the sole basis for determining recoverable amount; or

(b) retaining the current measurement basis in IAS 36 and removing the restrictions that IAS 36 imposes on cash flow projections used in calculating value in use.

42. In the following cases, an entity would have to carry out additional tasks for calculating the unrecognised headroom:

(a) for an existing unit that does not contain goodwill and to which newly acquired goodwill has been allocated for the first time, the entity would need to determine the recoverable amount of the existing unit just before the business combination—the pre-combination unrecognised headroom would be used as the input when performing impairment testing of goodwill of the unit for the first time after the business combination.

(b) for a unit that 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—the post-disposal unrecognised headroom would be used as the input at the next impairment testing.

(c) for a restructured unit, the entity would need to determine the recoverable of the unit immediately after the restructuring—the post-restructuring unrecognised headroom would be used as the input at the next impairment testing.

43. The additional tasks explained in paragraph 42 are one-time tasks. They would arise in circumstances when it is not possible to roll forward previous calculations of recoverable amount. Consequently, there will be additional one-time costs for applying the updated headroom approach in those circumstances.

44. The Board could consider not requiring these additional tasks (perhaps on cost-benefit grounds), in which case the updated headroom approach would not be available for that unit in that period. The recoverable amount calculations at the first impairment testing date after the event provide the headroom information for the subsequent impairment testing.

Examples illustrating application of the updated headroom approach

45. See *Appendix B* of this paper.

Question for the Board

Do you have any comments or feedback on the analysis of the two approaches?

Appendix A
A single method for determining recoverable amount

Background

A1. The objective of IAS 36 is to prescribe procedures that an entity applies to ensure that its assets are carried at no more than their recoverable amount. IAS 36 defines recoverable amount as the higher of an asset's (or cash-generating unit's) fair value less costs of disposal (FVLCD) and its value in use. Value in use is the present value of the future cash flows expected to be derived from an asset or cash-generating unit. The cash flow projections used in calculating value in use are required to be 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. 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.

A2. A few 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 difficulty in challenging management's best estimates used in calculating value in use. To respond to those concerns, the Board could consider whether moving to a single method, ie either FVLCD or value in use, could:

(a) make the impairment testing of goodwill more straight forward, simple and easy to understand and apply; and

(b) reduce concerns that the current model makes it too easy to delay and (or) conceal impairment losses.

A3. The Board could either:

(a) adopt only one of the two methods (value in use or FVLCD) as the sole basis for measuring recoverable amount; or

(b) retain both methods and require an entity to select a method that reflects the manner in which the entity expects to recover the asset—FVLCD if

the entity expects to recover the asset through sale, and value in use if the entity expects to recover the asset primarily through use.

Adopting one method as the sole basis for measuring recoverable amount

A4. The following considerations would help in deciding the method to adopt:

(a) are the considerations of the International Accounting Standards Committee (IASC), the Board's predecessor, when developing the principle for measuring recoverable amount still relevant today?

(b) what are the similarities and differences between value in use and FVLCD?

Considerations of the IASC

A5. In developing a principle for measuring recoverable amount, the IASC considered what a rational entity will do on discovering that an asset is impaired. The IASC reasoned that the entity will either (a) sell the asset if the net proceeds from the sale exceed the benefits from continuing to use the asset; or (b) continue to use the asset even if its service potential is lower than originally expected.

A6. The IASC (a) concluded that the resulting decision from the entity is, in substance, an investment decision based on estimated net future cash flows expected from the asset; and (b) decided that measuring the recoverable amount at the higher of value in use and net selling price would best reflect that conclusion.

A7. The term 'net selling price' was replaced with FVLCD in 2004 when the Board issued IFRS 5 *Noncurrent Assets Held for Sale and Discontinued Operations*. When an entity decides to sell its assets and those assets (or cash-generating units) meet the criteria in IFRS 5 to be classified as held for sale, IFRS 5 specifies when and how the entity would use fair value less costs to sell.

A8. The IASC considered and rejected measuring recoverable amount based only on fair value for the following reasons:

(a) no preference should be given to the market's expectation. An entity may have superior information about future cash flows and may plan to use an asset in a manner different from the market's view of the best use.

(b) market values are a way to estimate fair value but only if they reflect the fact that both parties, the acquirer and the seller, are willing to enter a transaction.

(c) if an entity can generate greater cash flows by using an asset than selling it, it would be misleading to base recoverable amount on the market price because a rational entity would not be willing to sell.

(d) recoverable amount of an asset is the amount that an entity expects to recover from an asset, including the effect of synergies with other assets.

A9. If no deep and liquid market exists for an asset, IASC considered that value in use would be a reasonable estimate of fair value. This is likely to happen for many assets within the scope of IAS 36: observable market prices are unlikely to exist for goodwill, most intangible assets and many items of property, plant and equipment. Therefore, it is likely that the recoverable amount of these assets, determined in accordance with IAS 36, will be similar to the recoverable amount based on the fair value of these assets.

A10. The IASC considered and rejected measuring recoverable amount based only on value in use for the following reasons:

(a) if an asset's FVLCD is higher than its value in use, a rational entity will dispose of the asset. In this situation, it is logical to base recoverable amount on the asset's FVLCD to avoid recognising an impairment loss that is unrelated to economic reality.

(b) if an asset's FVLCD is greater than its value in use, but management decides to keep the asset, the extra loss (the difference between FVLCD and value in use) properly falls in later periods because it results from management's decision in these later periods to keep the asset.

A11. As originally issued, IAS 36 stated that sometimes it will not be possible to measure net selling price because there is simply no basis for making a reliable estimate of the price at which an orderly transaction to sell the asset would take place between market participants at the measurement date under current market conditions. In those situations, the entity may use the asset's value in use as its

recoverable amount. The current version of IAS 36 continues to make this observation in the context of FVLCD (see paragraph 20 of IAS 36).

A12. There is an important fact to be noted in assessing whether the IASC's considerations (set out in paragraphs A5–A11) are still relevant today—there was no comprehensive Standard on fair value measurement when IAS 36 and IFRS 5 were issued.

A13. IFRS 13 *Fair Value Measurement* provides a deeper analysis of the characteristics of a fair value measurement than was available to the IASC when it developed IAS 36. For example:

(a) in the context of non-financial assets, IFRS 13 discusses what assumptions a rational market participant buying the asset would make about *how to use* the asset in its *highest and best use* (such as in a productive process and not simply as scrap). That highest and best use of the asset establishes the valuation premise used in measuring the fair value of the asset. An entity's current use of a non-financial asset, which is the basis for determining value in use, could be its highest and best use unless market or other factors suggest that a different use by market participants would maximise the value of the asset.

(b) in situations in which there are no quoted prices in active markets or observable inputs for an asset, IFRS 13 requires the use of unobservable inputs (Level 3 inputs) and provides guidance on how an entity should develop unobservable inputs. In developing unobservable inputs, an entity may begin with its own data, but it is required to adjust those data if reasonably available information indicates that other market participants would use different data or if there is something particular to the entity that is not available to other market participants.

Similarities and differences between value in use and FVLCD

A14. In analysing and understanding the differences between value in use and FVLCD, the staff considered the following background:

(a) on the basis of feedback from the Global Preparers Forum and other stakeholders, the staff believe that entities generally need to use Level 3

inputs in measuring FVLCD of a unit because of the absence of observable inputs. The staff also believe that discounted cash flow techniques are commonly used in measuring FVLCD. Fair values derived using discounted cash flow techniques are often corroborated using multiples-based valuation. Value in use, by definition, is a discounted cash flow amount.

(b) the measure of value in use adopted in IAS 36 is not a pure 'entity-specific' measure. Although the cash flows used as the starting point in calculation are entity-specific cash flows (they are derived from the most recent financial budgets/forecasts approved by management and represent management's best estimate of the set of economic conditions that will exist over the remaining useful life of the asset), their present value is required to be determined using a discount rate that reflects current market assessments of the time value of money and the risks specific to the asset. In other words, an asset's value in use reflects how the market would price the cash flows that management expects to derive from that asset. (See paragraph BC60 of the Basis for Conclusions on IAS 36.)

Cash flow projections

A15. At a high level, the main difference is that value in use is based on management's best estimate of cash flow projections whereas FVLCD is based on assumptions that market participants would use. Nevertheless, paragraph BCZ20 of the Basis for Conclusions on IAS 36 explains that IASC believed that IAS 36 included sufficient requirements to prevent an entity from using assumptions different from the marketplace without justification. For example, an entity is required to determine value in use using cash flow projections based on reasonable and supportable assumptions and giving greater weight to external evidence.

A16. If the requirements in IAS 36 are correctly applied, the cash flow projections used in calculating value in use should not be very different from those used in calculating FVLCD, except for the specific exclusions that IAS 36 requires in calculating value in use (see paragraph A17). On the other hand, on the basis of informal discussions with a few individuals from large accounting firms, the staff

understand that management is generally motivated to make optimistic cash flow forecasts and that the level of optimism might be somewhat lower if management were estimating what cash flows other market participants would derive from the asset(s).

A17. Another difference in relation to cash flow projections is that the concept of value in use adopted in IAS 36 is 'value in use for the asset in its current condition'. In calculating value in use, IAS 36 requires an entity to exclude estimated cash flows that are expected to arise from (a) a future restructuring to which an entity is not yet committed; or (b) improving or enhancing the asset's performance. In contrast, fair value measurement reflects the highest and best use of the asset. These exclusions would sometimes result in value in use being lower than FVLCD.

A18. However, some might question whether the difference caused by those exclusions is a result of a necessary difference between the two concepts or mainly a result of detailed application guidance. (See paragraphs A9–A14 of *Appendix A* in Agenda Paper 18E for the December 2017 Board meeting.)

Unit of account and synergies

A19. The default unit of account for impairment testing applying IAS 36 is an individual asset. On the basis of requirements in paragraph 22 of IAS 36, the first step in testing an individual asset that may be impaired is to determine its FVLCD. If FVLCD of the asset is lower than the carrying amount, the next step is to assess whether value in use of the asset (a) can be determined; and (b) if determinable, can be estimated to be close to its FVLCD. If not, the entity would then start determining recoverable amount for the cash-generating unit to which the asset belongs.

A20. Value in use for an individual asset can be determined only if the asset generates cash flows that are largely independent of those from other assets or groups of assets. If the asset does not generate independent cash flows, value in use is determined for the cash generating unit to which the individual asset belongs. A cash-generating unit is defined as the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets.

A21. In contrast, fair value of an individual asset can be measured irrespective of whether the asset generates independent cash flows. IFRS 13 does not contain guidance on the unit of account because the unit of account is determined in each case in accordance with the particular IFRS Standard that requires fair value measurement in that case. IFRS 13 contains guidance on measurement of fair value of an asset whose highest and best use is through use in combination with other assets as a group (as installed or otherwise configured for use) or in combination with other assets and liabilities (eg a business). The objective of providing this guidance is to ensure that fair value is not based on the assumption that the asset would be sold for scrap if the only observable price in the market is for a scrap sale of the asset.

A22. Another difference in relation to unit of account is that synergies that would not be available to market participants are considered in calculating value in use but not in FVLCD. On the basis of informal discussions with individuals of large accounting firms, the staff understand that in practice it is rare to observe a difference arising between the two measures because of such synergies.

A23. However, in the context of impairment testing of goodwill, there may not be a difference between the unit of account used in measuring value in use and the unit of account used in measuring FVLCD. Paragraph 80 of IAS 36 identifies the unit of account for measuring recoverable amount. Applying that paragraph an entity allocates acquired goodwill to each of its cash-generating units (or groups of units) that is (are) expected to benefit from the synergies of the business combination. Each unit or group of units to which goodwill is so allocated (a) represents the lowest level within the entity at which goodwill is monitored for internal management purposes; and (b) must not be larger than an operating segment as defined by IFRS 8.

Discount rate

A24. The basic discount rate input for both value in use and FVLCD is the rate that reflects *current market assessments* of the time value of money and the risks specific to the asset. In other words, it is a market participant assumption and not an entity-specific assumption.

A25. This discount rate is usually a post-tax rate because it incorporates market participant's assumption of tax effects. However, in calculating value in use, an entity is required make adjustments to derive a pre-tax rate. Nevertheless, the staff believe that, in practice, entities generally use a post-tax rate because pre-tax rates are not available. (See paragraphs A1–A8 of *Appendix A* in Agenda Paper 18E for the December 2017 Board meeting.)

Staff's preliminary conclusions on adopting a single method

A26. In the context of impairment testing of goodwill, on the basis of the analysis in paragraphs A5–A25, the staff conclude that the concepts of value in use as adopted in IAS 36 and fair value consider and reflect largely a similar set of factors and the biggest single difference that causes value in use to be lower than FVLCD is the restriction that IAS 36 imposes on cash flow projections used in calculating value in use. However, as explained in paragraph A18, some might question whether that difference is a result of a necessary difference between the two concepts or mainly a result of detailed application guidance.

A27. At the recent meeting of the Accounting Standards Advisory Forum (ASAF), some members commented that if the Board moves to a single method for goodwill, the Board would need to consider adopting this approach for all other assets within the scope of IAS 36. Some ASAF members thought that this would be a big change.

A28. The staff think that using FVLCD as the sole basis for determining recoverable amount for all assets (and units) within the scope of IAS 36 would not result in a significant change in practice because the first step in IAS 36 when testing an individual asset that may be impaired is to measure its FVLCD.

A29. Using value in use as the sole basis for determining recoverable amount could pose some problems because the default unit of account in IAS 36 would no longer be an individual asset, but an asset (or group of assets) that generates independent cash flows. There would be knock-on consequences on allocating any impairment loss to individual assets within an asset group. The staff have not assessed those consequences at this stage. A possible argument in support of value in use is that some investors may find value in use more useful than FVLCD because value in use reflects the manner in which an entity expects to use the

asset. However, preparers are likely to argue that IAS 36 imposes on cash flow projections restrictions that make value in use less meaningful than FVLCD. If the Board were to remove those restrictions, the only helpful information that investors would get from using value in use (rather than FVLCD) is when the current use of an asset is not its highest and best use.

Selecting a method that reflects the manner of recovery of the asset

A30. Paragraph A3(b) mentions another possible approach—retaining both methods and requiring an entity to use the method that reflects how the entity expects to recover the asset. The staff think that the considerations explained in paragraph A29 are relevant for this approach as well.

A31. The staff think that this approach would result in the impairment testing model for all non-financial assets within the scope of IAS 36 being based mostly on value in use. For an asset that management expects to sell in the short term, it would be reasonable to expect value in use to be approximately equal to FVLCD. When the entity decides to sell the asset and the criteria in IFRS 5 are met, IFRS 5 requires recognition of impairment losses and reversals based on FVLCD.

Appendix B
Examples illustrating application of the updated headroom approach

Example 1—First acquisition

Fact pattern

B1. The financial year of Company X ends on 31 December. On 1 July 20X0, Company X acquires 100 per cent of Company Y for CU300 and 100 per cent of Company Z for CU450. Company Y and Z's net identifiable assets have a fair value of CU200 and CU300 respectively at that date. Consequently, Company X recognises goodwill of CU250 (CU100 for Company Y and CU150 for Company Z).

B2. Company X concludes that the business of Company Y will generate cash flows together with Company X's existing cash-generating unit (CGU) A, and thus the goodwill CU100 from acquiring Company Y is allocated to the larger unit A. The carrying amount and the recoverable amount of existing unit A just before the acquisition of Company Y were CU200 and CU350 respectively.

B3. On the other hand, the assets of Company Z will generate cash flows independently of other assets of Company X. Therefore, the business of Company Z constitutes a new cash-generating unit (unit B) of Company X and goodwill CU150 from acquiring Company Z is allocated to new unit B.

B4. Company X tests goodwill for impairment regularly at the annual reporting date. The carrying amounts (excluding goodwill) and the recoverable amounts of units A and B at subsequent annual reporting dates are as follows:

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

	31 December		
	20X0 CU	20X1 CU	20X2 CU
Unit A			
Carrying amount excluding goodwill	420	410	430
Recoverable amount	680	640	650
Unit B			
Carrying amount excluding goodwill	310	320	325
Recoverable amount	480	495	460

Applying the updated headroom approach

B5. The unrecognised headroom of a unit at any given date is calculated as the difference between the recoverable amount and the carrying amount (including goodwill) of the unit at that date. The updated headroom approach uses the unrecognised headroom at the immediately preceding impairment testing date as an input for impairment testing calculation.

B6. Unit A has unrecognised pre-acquisition headroom of CU150 (CU350–CU200). The table below summarises the various amounts as at the date of acquisition:

	CGU A	CGU B
Carrying amount before acquisition (a)	200	-
Identifiable net assets from acquisition (b)	200	300
Carrying amount after acquisition excluding goodwill (a + b)	400	300
Acquired goodwill (c)	100	150
Pre-acquisition unrecognised headroom (d)	150	-
Total headroom on the date of acquisition (c + d)	250	150

B7. The calculations used in the impairment test of goodwill allocated to unit A are as follows:

	31 December		
Unit A	20X0 CU	20X1 CU	20X2 CU
Carrying amount excluding goodwill (a)	420	410	430
Acquired goodwill before impairment at this date (b)	100	100	70
Carrying amount [a+b]	520	510	500
Unrecognised headroom at previous test date	***150**	**160**	**160**
Carrying amount + Unrecognised headroom (c)	670	670	660
Recoverable amount (d)	680	640	650
Impairment loss [c–d]	**-**	**30**	**10**
Goodwill after impairment (e)	100	70	60
Unrecognised headroom at this date [d–(a+e)]	**160**	**160**	**160**

* Pre-acquisition unrecognised headroom

B8. Company X concludes that all of the loss is attributable to acquired goodwill because the synergies expected from the acquisition have not been realised. Consequently, it recognises an impairment loss on goodwill of CU30 and CU10 for the years ended 31 December 20X1 and 31 December 20X2 respectively.

B9. The calculations used in the impairment test of goodwill allocated to unit B are as follows:

Unit B	31 December 20X0 CU	20X1 CU	20X2 CU
Carrying amount excluding goodwill (a)	310	320	325
Acquired goodwill before impairment at this date (b)	150	150	150
Carrying amount [a+b]	460	470	475
Unrecognised headroom at previous test date	**-**	20	25
Carrying amount + Unrecognised headroom (c)	460	490	500
Recoverable amount (d)	480	495	460
Impairment loss [c–d]	**-**	**-**	**40**
Goodwill after impairment (e)	150	150	110
Unrecognised headroom at this date [d–(a+e)]	**20**	**25**	**25**

B10. Company X concludes that all of the loss is attributable to acquired goodwill because the actual revenue growth is less than the expected growth. Consequently, it recognises an impairment loss on goodwill of CU40 in the year ended 31 December 20X2.

Example 2—Reorganisation

Fact pattern

B11. Company X decides to reorganise unit A, dividing unit A into two CGUs, which are smaller unit A and new unit C, to actively sell a product that was earlier used only as an input.

B12. On 1 July 20X3, Company X splits the assets between unit A and new unit C and determines the recoverable amount of the two units. The table below summarises the various amounts

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

	CGU A	CGU C
Carrying amount after reorganisation excluding goodwill (a)	300	120
Acquired goodwill (b)	40	20
Carrying amount of the unit (c = a + b)	340	140
Recoverable amount (d)	440	190
Unrecognised headroom (d – c)	100	50

B13. The carrying amounts (excluding goodwill) and the recoverable amounts of the smaller unit A and new unit C at subsequent annual reporting dates are as follows:

	31 December		
	20X3 CU	20X4 CU	20X5 CU
Unit A			
Carrying amount excluding goodwill	300	290	280
Recoverable amount	420	415	385
Unit C			
Carrying amount excluding goodwill	130	140	145
Recoverable amount	210	225	240

Applying the updated headroom approach

B14. The calculations used in the impairment test of goodwill allocated to unit A are as follows:

	31 December		
Unit A	20X3 CU	20X4 CU	20X5 CU
Carrying amount excluding goodwill (a)	300	290	280
Acquired goodwill before impairment at this date (b)	40	20	20
Carrying amount [a+b]	340	310	300
Unrecognised headroom at previous test date	***100**	**100**	**105**
Carrying amount + Unrecognised headroom (c)	440	410	405
Recoverable amount (d)	420	415	385
Impairment loss [c–d]	**20**	**-**	**20**
Goodwill after impairment (e)	20	20	-
Unrecognised headroom at this date [d–(a+e)]	**100**	**105**	**[#]105**

* Unrecognised headroom on reorganisation.

[#] This information is no longer required because the carrying amount of goodwill is now zero, and so Company X will no longer be required to calculate recoverable amount on an annual basis

B15. Company X concludes that all of the loss is attributable to acquired goodwill. Consequently, it recognises an impairment loss on goodwill of CU20 and CU20 for the years ended 31 December 20X3 and 31 December 20X5 respectively.

B16. The calculations used in the impairment test of goodwill allocated to unit C are as follows:

CGU C	31 December 20X0 CU	20X1 CU	20X2 CU
Carrying amount excluding goodwill (a)	130	140	145
Acquired goodwill before impairment at this date (b)	20	20	20
Carrying amount [a+b]	150	160	165
Unrecognised headroom at previous test date	***50**	**60**	**65**
Carrying amount + Unrecognised headroom (c)	200	220	230
Recoverable amount (d)	210	225	240
Impairment loss [c–d]	**-**	**-**	**-**
Goodwill after impairment (e)	20	20	20
Unrecognised headroom at this date [d–(a+e)]	**60**	**65**	**75**

* Unrecognised headroom on reorganisation

Example 3—Additional acquisition

Fact pattern

B17. On 1 July 20X3, Company X acquires 100 per cent of Company Q for CU400. Company Q's net identifiable assets have a fair value of CU200. Consequently, Company X recognises goodwill of CU200.

B18. Company X concludes that the assets of Company Q will generate cash flows together with Company X's existing unit B. Consequently, all of the acquired assets and goodwill are allocated to the larger unit B. The following table summarises the various amounts before and after the acquisition of Company Q.

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

Unit B	Before acquisition	Added on acquisition	After acquisition
Carrying amount excluding goodwill	320	200	520
Acquired goodwill	110	200	310
Carrying amount of the unit	430	400	830

B19. The carrying amount (excluding goodwill) and the recoverable amount of the larger unit B at subsequent annual reporting dates are as follows:

	31 December		
	20X3 CU	20X4 CU	20X5 CU
Carrying amount excluding goodwill	530	520	525
Recoverable amount	870	865	840

Applying the updated headroom approach

B20. The calculations used in the impairment test of goodwill allocated to unit B are as follows:

	31 December		
	20X3 CU	20X4 CU	20X5 CU
Carrying amount excluding goodwill (a)	530	520	525
Acquired goodwill before impairment at this date (b)	310	310	310
Carrying amount [a+b]	840	830	835
Unrecognised headroom at previous test date	***25**	**30**	**35**
Carrying amount + Unrecognised headroom (c)	865	860	870
Recoverable amount (d)	870	865	840
Impairment loss [c–d]	**-**	**-**	**30**
Goodwill after impairment (e)	310	310	280
Unrecognised headroom at this date [d–(a+e)]	**30**	**35**	**35**

* Unrecognised headroom as at 31 December 20X2 (see the table in paragraph B9)

B21. Company X concludes that all of the loss is attributable to acquired goodwill. Consequently, it recognises an impairment loss on goodwill of CU30 for the year ended 31 December 20X5.