STAFF PAPER

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Project	**Goodwill and Impairment research project**		
Paper topic	Improving the effectiveness of the impairment testing model in IAS 36		
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Purpose

1. The purpose of this paper is to provide a high-level analysis of the following possible approaches that might improve effectiveness of the impairment testing model:

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

   (b) the pre-acquisition headroom (PH) approach.

2. This paper is for information only and provides the necessary context for the staff's oral update of the feedback from ASAF. Consequently, the Board is not being asked any questions on this paper.

3. The analysis in this paper is a reproduction of the analysis in agenda papers of past Board meetings.

Structure of the paper

4. The paper is structured as follows:

(a)	a single method for determining recoverable amount	paragraphs 5–24
(b)	PH approach;	paragraphs 25–27
(c)	mechanics of the PH approach; and	Appendix A
(d)	examples to illustrate the PH approach.	Appendix B

A single method for determining recoverable amount

5. 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 (CGU's)) FVLCD and its value in use. Value in use is the present value of the future cash flows to be derived from continuing use and disposal of the asset. The cash flow projections used in calculating value in use should 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.

6. It is not always necessary to determine both FVLCD and value in use of a CGU. However, if an entity determines that one of these amounts is less than the CGU's carrying amount, the entity has to determine the other amount before it concludes on the recoverable amount of the CGU. Consequently, when an entity has to determine both amounts and if the entity determines FVLCD using a discounted cash flow calculation, there is complexity and possible confusion because of the need to consider whether there is in fact a difference between the inputs for calculating value in use (management's best estimates) and those used for calculating FVLCD (market participant assumptions).

7. There was some feedback from PIR of IFRS 3 that requiring the use of a single method, rather than the higher of two methods, might reduce complexity without causing a loss of information for users of financial statements.

Staff analysis

8. The Board could either:

   (a) retain 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.

9. The staff received some feedback from a few stakeholders that the complexity described in paragraph 6 of this paper is not a persuasive argument for changing the basis for determining recoverable amount. This is because an entity does not need to calculate both value in use and FVLCD of a CGU in all situations. It needs to do this only when calculating one of these amounts has shown that there may be an impairment.

10. However, moving to a single model might help in improving the effectiveness of the impairment testing model. A more straightforward impairment test using one model could:

    (a) be easier to apply and understand; and

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

11. The following considerations would help in deciding the method to retain:

    (a) are the considerations of the International Accounting Standards Committee (IASC), the predecessor of the Board, 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

12. 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.

13. 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.

14. The term net selling price was replaced with FVLCD in 2004 when the Board issued IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*. When an entity decides to sell its assets and those assets (or CGUs) meet the criteria in IFRS 5 to be classified as held for sale, the entity would use fair value less costs to sell as, and in the manner, required by IFRS 5.

15. 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.

16. 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.

17. An important fact to be noted in assessing whether the IASC's considerations are still relevant today is that there was no comprehensive Standard on fair value measurement when IAS 36 or IFRS 5 were issued. 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, IFRS 13 discusses what assumptions a rational market participant buying an asset would make about how to use the asset (such as in a productive process, or simply as scrap). For a future Board meeting, the staff will analyse whether that deeper analysis in IFRS 13 provides any reason to rethink the arguments considered by the IASC.

Similarities and differences between value in use and FVLCD

18. On the basis of feedback from GPF and other stakeholders, the staff believe that entities generally use Level 3 inputs in measuring FVLCD of a CGU because of the absence of observable inputs. The staff also believe that discounted cash flow techniques are commonly used in measuring fair value. Fair values derived using discounted cash flow techniques are corroborated using multiples-based valuation. Value in use, by definition, is a discounted cash flow amount. This background helps in analysing and understanding the differences between value in use and FVLCD.

19. At a high level, the main difference is that VIU 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:

(a) cash flow projections based on reasonable and supportable assumptions and giving greater weight to external evidence; and

(b) a discount rate that reflects current market assessments of the time value of money and the risks specific to the asset.

20. 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 fair value. 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).

21. Another difference is that in calculating value in use, estimates of cash flows are required 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. There is no such restriction in fair value measurement.

22. Paragraph 53A of IAS 36 highlights a few factors that are not reflected in fair value but reflected in value in use.

> 53A Fair value differs from value in use. Fair value reflects the assumptions market participants would use when pricing the asset. In contrast, value in use reflects the effects of factors that may be specific to the entity and not applicable to entities in general. For example, fair value does not reflect any of the following factors to the extent that they would not be generally available to market participants:
>
> (a) additional value derived from the grouping of assets (such as the creation of a portfolio of investment properties in different locations);
>
> (b) synergies between the asset being measured and other assets;

(c) legal rights or legal restrictions that are specific only to the current owner of the asset; and

(d) tax benefits or tax burdens that are specific to the current owner of the asset.

23. The staff will further analyse the similarities and differences between value in use and fair value and present the analysis to the Board at a future meeting.

24. Paragraph 8(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 this method will result in the impairment testing model being based mostly on value in use. However, 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.

PH approach

25. One of the causes for the current impairment test failing to capture impairment losses at the right time and in the right amounts is the so-called shielding effect of unrecognised internally generated goodwill of a CGU. In situations in which an entity allocated acquired goodwill to a pre-combination CGU that is expected to benefit from the synergies of the combination, the unrecognised internally generated goodwill of the pre-combination CGU shields the acquired goodwill from impairment by absorbing any negative movements in the recoverable amount of the CGU. Consequently, the acquired goodwill is not impaired or is impaired by a lesser amount. To address this issue, the staff developed the PH approach that was presented to the Board at its March and April 2016 meetings.

26. The difference between the carrying amount of the CGU and its recoverable amount immediately before the combination is referred to as the ‘pre-acquisition headroom’ or ‘PH’. The PH includes any unrecognised assets of the pre-combination CGU, any differences between the carrying amounts and recoverable amounts of the assets of the pre-combination CGU and any internally generated goodwill. The pre-acquisition headroom (PH) approach aims to prevent the shielding effect of internally generated goodwill of existing CGU(s). The basic

mechanics of the PH approach is that the PH measured at the acquisition date is added to the carrying amount of the CGU for the purpose of the impairment test calculation and then the aggregate of the carrying amount and the PH is compared with the recoverable amount of the CGU in measuring any impairment loss.

27. The mechanics of the PH approach are set out in *Appendices A and B* of this paper.

Appendix A
Mechanics of the PH approach

(This is a reproduction of Appendix C of Agenda Paper 18B of the June 2016 joint Board meeting)

Basic mechanics in the period of acquisition

A1. The staff suggest the approach should be applied as follows:

(a) Step One: 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 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' are the assumptions for those units excluding the effects of the acquisition (ie the assumptions for the unit immediately before the acquisition, assuming that the acquisition would not take place).

The excess of a unit's recoverable amount over its carrying amount at the date of acquisition using pre-acquisition assumptions is the 'pre-acquisition headroom' ('PH') in that unit. The PH is calculated purely for the purposes of testing the unit for impairment (ie it is never recognised as an asset).

If a unit's carrying amount exceeds its recoverable amount at the date of acquisition using pre-acquisition assumptions, this indicates that the unit is impaired prior to the acquisition (and that there is no PH for that unit). This would be an indicator some of the existing assets in the unit are impaired.

(c) Step Three: allocate the 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 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 and 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 goodwill and other allocated assets of the acquiree); plus
2. the PH existing in that unit determined in step two.

(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, that excess would be recognised as an impairment loss.

(v) Any impairment loss would be allocated

1. first to reduce the carrying amount of the recognised goodwill allocated to the unit;
2. then secondly against the PH (this is a notional allocation because the PH is not recognised in the financial statements); and
3. then to other assets of the unit by applying the existing requirements of IAS 36.

Comparison with existing approach

A2. Steps one, three and four are required by IAS 36. Consequently, the only differences between the PH Approach in paragraph A1 and the existing approach in IAS 36 are:

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

(b) the requirement to consider the PH in step four.

Once no further goodwill remains in the unit, the PH would no longer be considered by the entity.

A3. These differences would only apply if some goodwill is allocated to the acquirer's existing CGUs. They would not apply if goodwill arising on the acquisition is allocated only to the acquiree. This is not a shortcoming of the PH Approach, because if goodwill is only allocated to the acquiree, there would be no buffering effect from the acquirer's existing assets against recognising an impairment loss.

Other methods for allocating the impairment loss (paragraph A1(d)(v))?

A4. A PH could arise for a combination of several reasons and so may consist of different components, including:

(a) internally generated goodwill in the unit arising from the existing synergies in the business and the management team;

(b) other internally generated intangible items in the unit that do not meet the recognition criteria;

(c) differences between carrying amounts and recoverable amounts on other assets in the unit, which will be affected by the entity's accounting policies and by the assumptions used in measuring recoverable amount. For example, the recoverable amount of the entity's property may be higher than the carrying amount of the property measured under the cost model; and

(d) management's assumptions in measuring the recoverable amount of the unit. For example if recoverable amount is based on VIU, it will depend on management's assumptions about expected cash flows, discount rate, growth rates etc.

A5. In paragraph A1(v) the staff have proposed to allocate the impairment loss in full to goodwill before the PH for the following reasons:

(a) the primary objective of introducing the PH Approach is to remove the buffering effect of the acquirer's pre-existing assets to respond to concerns that impairment losses are being recognised too slowly and in

too small amounts ('too little, too late'). Allocating impairment losses to goodwill before the PH would provide an earlier signal of impairment to the market and is consistent with this objective.

(b) unless the PH is analysed into its components (see paragraph A6) to enable a meaningful allocation, any allocation of an impairment loss between the PH and the recognised goodwill would be arbitrary. The staff think requiring an entity to distinguish between the components of the PH would be subjective, and unnecessarily costly and complex.

(c) IAS 36 requires an impairment loss to be allocated first to goodwill and then to other assets. To be consistent with this requirement, any allocation of impairment between the PH and goodwill would at least require the internally-generated goodwill component of the PH to be identified. As noted in (b) the staff think componentisation of the PH would be subjective, and unnecessarily costly and complex.

(d) it may be clear that the PH primarily consists of components other than internally generated goodwill. For example the unit may contain land measured at historical cost that has a much greater fair value. In this case, allocation of the impairment loss to the PH, before first reducing the recognised goodwill to zero, would be inappropriate.

(e) the PH will be affected by the entity's accounting policies for assets and liabilities in the unit and by management's assumptions in measuring recoverable amount of the assets and of the unit. For example, the carrying amount of an item of machinery will depend on management's assumptions regarding its useful life and pattern of consumption. If the impairment loss was allocated proportionately between goodwill and the PH, the amount allocated to goodwill would likely be arbitrary.

A6. Nevertheless, the staff think there are several methods that could be considered for allocating the impairment loss:

(f) in full to goodwill before the PH (used in paragraph A1(d)(v));

(g) in full to the PH before goodwill (essentially the existing allocation method in IAS 36);

(h) proportional allocation between the PH and goodwill; or

(i) in full to goodwill unless the entity can demonstrate that a different allocation is appropriate. For example, assume there is a significant increase in the discount rate after the PH is calculated, but there are no other significant changes in the unit. The recoverable amount of a unit would fall but it may be clear that it does not relate primarily to an impairment of the acquired goodwill. In such a circumstance adjustment of the PH, to reflect the subsequent change in discount rate, might be appropriate.

(j) another more sophisticated method. However, unless the components of the PH are analysed to enable a meaningful allocation, any allocation of an impairment loss between the PH and the recognised goodwill would likely be arbitrary. Furthermore, requiring an entity to distinguish between the components of the PH may be subjective, costly and complex.

Future impairment tests

A7. Conceptually, it would be appropriate to remeasure the PH every time an impairment test is performed because over time the unit's assets and liabilities (upon which the PH was calculated) could change significantly. However, the staff note that this would result in remeasurement of any internally generated goodwill included in the PH amount. This would be inconsistent with the accounting treatment of the recognised goodwill, which is being tested for impairment.

A8. Nevertheless, the staff think that if the Board wishes to consider remeasurement of the PH this could be done in one of two ways:

(a) Method one: Stripping out the effect of the acquisition, ie determining the difference between the unit's recoverable amount and its carrying amount on the date of each impairment test as if the acquisition never happened. This would give the revised headroom in the unit for the existing business.

(b) Method two: Stripping out the effect of the goodwill in the unit, ie determining the difference between the unit's recoverable amount and its carrying amount on the date of each impairment test, excluding the goodwill. This would give the total revised headroom in the unit, including any assets allocated from the acquiree (except for the goodwill).

A9. The staff think requiring remeasurement of the PH for each impairment test would add cost and complexity that would outweigh the benefits of updating that measurement. The staff note the following:

(a) Method one would require the entity to make artificial assumptions about the existing business of the acquirer, ie assumptions as if the acquisition never happened. Over time it would be very difficult for an entity to distinguish the effects of the acquisition from the effects of the existing business of the unit. The staff think that this calculation would be extremely subjective, particularly when performed a significant time after the acquisition and when the entity undertakes multiple acquisitions.

(b) Method two would effectively be requiring the entity to determine the recoverable amount of the goodwill in the unit. In developing IFRS 3, the Board observed that goodwill cannot be measured other than as a residual, and that measuring the fair value of goodwill directly would not be possible.[1]

A10. In addition to concerns from investors about impairments being recognised 'too little too late', some preparers say that the impairment test is already costly and complex. The staff think that incorporating the PH, without remeasurement, would go a long way towards addressing investors' concerns without adding significant cost and complexity to the impairment test.

[1] See paragraph BC202 of the Basis for Conclusions accompanying IFRS 3 (2008).

Future acquisitions

A11. The staff do not think that the PH should be remeasured every time an impairment test is performed. Nevertheless, the staff suggest that an entity should be required to perform a revised calculation of the unit's PH if it makes a second acquisition and further goodwill is allocated to the same unit. The revised calculation would determine the PH existing in the unit at the time of the second acquisition. The revised PH would replace the original PH from the first acquisition. The single revised PH amount would be used from then on for the purposes of impairment testing of that unit.

A12. When calculating the unit's revised PH on the date of the second acquisition (ie prior to incorporating any goodwill/assets from the second acquisition), the goodwill and assets from the first acquisition would be included in the unit. In other words, the staff suggest this should be a calculation of the PH of the unit at the date of the second acquisition, not a remeasurement of the PH associated with the assets held prior to the first acquisition.

A13. IAS 36 does not require goodwill allocated to a unit to be tracked by individual acquisition for impairment testing. In other words, IAS 36 effectively treats all goodwill allocated to the same unit as one asset. Consistent with this, the staff think it is appropriate to have a single PH for each unit, rather than a separate PH for each acquisition giving rise to goodwill in that unit.

Future disposals/restructurings

A14. Paragraph 86 of IAS 36 requires that if goodwill has been allocated to a CGU and the entity disposes of an operation within that CGU, the goodwill associated with the operation disposed of is measured on the basis of the relative values of the operation disposed of and the portion of the CGU retained, unless the entity can demonstrate that some other method better reflects the goodwill associated with the operation disposed of.

A15. The staff suggest it would be appropriate to apply the same requirement to the PH. Therefore, the PH should be allocated on the basis of the relative values of the operation disposed of and the portion of the CGU retained unless the entity can demonstrate another basis is more appropriate. An example of another basis might

be if the entity can demonstrate that the PH mainly relates to the difference between the carrying amount and recoverable amount of a significant piece of land retained in the CGU. In this case the entity may be able to demonstrate that it is more appropriate to keep the PH within the portion of the CGU retained, rather than eliminate part of it.

A16. Paragraph 87 of IAS 36 requires that if an entity reorganises its reporting structure in a way that changes the composition of one or more CGUs to which goodwill has been allocated, the goodwill shall be reallocated to the CGUs affected. This reallocation is also performed using a relative value approach similar to that used when an entity disposes of an operation within a CGU, unless the entity can demonstrate that some other method better reflects the goodwill associated with the reorganised units. The staff suggest it would be appropriate to apply the same requirement to the PH for consistency with our proposals for allocating the PH on disposal.

A17. Under the proposals in paragraphs A14–A16, the unit's PH would not necessarily be allocated on the same basis as the unit's goodwill in the case of a disposal or restructuring. For example, the staff suggest an entity could allocate goodwill based on relative values and the PH on some other basis, or vice versa.

Should a PH be used in any other cases?

A18. The staff does not think that a PH should be incorporated into the impairment test for other assets tested at the CGU (or group of CGUs) level, such as corporate assets.

A19. The staff think that using a PH for testing goodwill for impairment is an appropriate additional safeguard to respond to a unique issue:

(a) unlike other assets, goodwill is not a distinct asset that can be separately and reliably measured on acquisition. Consequently, it is measured as a residual amount. This means there is potentially a greater risk of overstatement of goodwill on initial recognition than other assets.

(b) goodwill comprises several different, often difficult to distinguish components. Consequently allocating goodwill to CGUs, or groups of CGUs, for the purpose of impairment testing is likely to be a more

subjective process than allocating other assets, such as corporate assets, to CGUs/groups of CGUs.

(c) goodwill often contributes to the cash flows of multiple CGUs. Requiring the PH of each unit to which goodwill is allocated to be incorporated into the impairment test of goodwill removes the incentive to allocate more goodwill to a unit in which the recoverable amount greatly exceeds the carrying amount (ie has a significant buffer against impairment).

(d) goodwill is often a significant number in an entity's balance sheet in comparison with other assets. During the post-implementation review of IFRS 3 we received concerns from investors that goodwill impairment losses are being recognised 'too little, too late'.

Costs versus benefits of step two

A20. The staff do not think adding step two to the impairment test would add significant cost or complexity. Determining the PH would require an additional calculation of recoverable amount for units to which goodwill is allocated. This would be a one-time cost at the time of acquisition. The staff think this calculation would be no more onerous than the calculation involved in the current goodwill impairment test, which is required at least annually.

A21. Furthermore, the staff note that if an entity allocates goodwill to a unit that already contains goodwill, the entity will have already calculated the recoverable amount of that unit within the last twelve months (because of the annual impairment test requirement). If there have been no significant changes in the assumptions used in that calculation, the entity may be able to update its recent calculation rather than calculating recoverable amount from scratch.

Strengths and weaknesses of the PH Approach

A22. The staff think the strengths of the PH Approach are:

(a) responding to investors' concerns that impairment losses are being recognised 'too little, too late' by removing the buffering effect against

recognising an impairment loss from the acquirer's existing assets. Removal of the buffer existing on acquisition means that an impairment of goodwill will be more likely under the PH Approach than under the current approach. Hence, the PH Approach is likely to result in recognition of earlier, larger impairment losses.

(b) measurement of the PH would be a one-time cost at the time of acquisition. The staff think this calculation would be no more onerous than the calculation currently required by the goodwill impairment test.

(c) the PH will be most effective in the first impairment test following an acquisition, because this test will take place soon after the PH is determined. However because the 'frozen' PH would be used in future tests it will also help accelerate impairment losses after the first year.

(d) applying IAS 36, management cannot recognise an immediate loss even if it determines soon after the acquisition date that the assumptions used in setting the purchase price were too optimistic, and it can estimate the overstatement of goodwill. The staff think it would be difficult, and subjective, to quantify what part of goodwill relates to an overpayment or overstatement even after the purchase price allocation. Consequently, the staff agree with this restriction in IAS 36. Nevertheless, this treatment may be partially responsible for investors' concerns that goodwill may be overstated. The staff think that the PH Approach is an effective way of addressing this concern. Under the PH Approach any overstatement of goodwill on acquisition would likely be caught by the first impairment test after the acquisition. This is because the buffering effect on acquisition, that might provide a shield against the impairment loss, would be removed.

A23. The staff think the weaknesses of the PH Approach are:

(a) the PH is determined on acquisition and not updated at the time impairment tests are carried out. Consequently, while the PH would remove the buffering effect from the acquirer's existing assets in the unit at the date of acquisition, it would not remove any increase in the buffering effect of those assets over time.

(b) similarly, the approach would not take into account any potential decline in the buffering effect of the acquirer's existing assets over time. This means it also has the potential to result in 'over impairment' of goodwill.

A24. Although the PH Approach is not perfect, the staff think that the PH Approach would improve the effectiveness of the impairment test, and help to address inventors' concerns that impairment losses are being recognised 'too little too late'. Furthermore, the staff do not think this approach would add significant cost or complexity to the impairment test for preparers.

Appendix B
Example to illustrate the PH approach

(This is a reproduction of Appendix D of Agenda Paper 18B of the June 2016 joint Board meeting)

Illustration 1 (first acquisition)

Fact pattern

B1. 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.

B2. 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.

B3. 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
Goodwill arising on acquisition of Company Y	CU20	CU35	-	CU55

B4. 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.

B5. Assume that the recoverable amounts of CGU A and CGU B at the date of the impairment test are CU190 and CU300 respectively (determined in accordance with IAS 36 as normal, ie after including Company Y allocations of net assets and goodwill, and using the assumptions for the CGUs post acquisition of Company Y).

Applying the PH Approach

B6. In order to determine the PH, the recoverable amounts of CGUs A and B would need to be determined at the date of acquisition of Company Y, based on the pre-acquisition assumptions and before allocation of Company Y. Assume the recoverable amounts of CGUs A and B determined on this basis are CU140 and

CU220 respectively. As noted in paragraph D2, the carrying amounts of CGUs A and B are CU100 and CU200 respectively (before allocation of Company Y).

B7. Consequently, for the purposes of the impairment test, a PH of CU40 (=140-100) exists for CGU A and a PH of CU20 (=220-200) exists for CGU B.

B8. IAS 36 requires CGU A and CGU B to be tested for impairment before the year-end (and on an annual basis), because goodwill is allocated to those CGUs.

B9. At the date of the impairment test, amounts relating to CGUs A and B are:

	CGU A	CGU B
Identifiable net assets excluding goodwill (includes Company Y allocation)	CU135 (=100+35)	CU260 (=200+60)
Goodwill arising on acquisition of Company Y	CU20	CU35
Carrying amount	**CU155**	**CU295**
PH (not recognised as an asset)	CU40	CU20
Total of the carrying amount of the CGU plus the PH	**CU195**	**CU315**

B10. Outcome of the impairment test:

(a) CGU A: Recoverable amount (CU190) < Carrying amount of CGU plus PH (CU195). Impairment of CU5 allocated to the goodwill recognised on acquisition of Company Y.

(b) CGU B: Recoverable amount (CU300) < Carrying amount of CGU plus PH (CU315). Impairment of CU15 allocated to the goodwill recognised on acquisition of Company Y.

B11. Consequently, the carrying amounts of the CGUs of Group X[2] after the impairment test are as follows:

[2] Group X consists of Company X and its subsidiaries (currently only Company Y).

	CGU A	CGU B	CGU C
Identifiable net assets excluding goodwill	CU135	CU260	CU300
Goodwill (after allocation of impairment)	CU15 (=20-5)	CU20 (=35-15)	CU0
Carrying amount of CGUs	**CU150**	**CU280**	**CU300**

Illustration 2 (second acquisition)

Fact pattern

B12. Same fact pattern as illustration 1. On 1 July 2017 the carrying amount of Group X's CGUs A, B and C are as follows:

	CGU A	CGU B	CGU C
Identifiable net assets excluding goodwill	CU145	CU240	CU250
Goodwill	CU15	CU20	CU0
Carrying amount of CGUs	**CU160**	**CU260**	**CU250**

B13. On 1 July 2017 Group X purchases 100 per cent of Company Z for CU200 and measures the goodwill acquired at CU61 in accordance with IFRS 3. Company X allocates Company Z in full to its existing CGU A.

B14. Assume for simplicity that in this example there is no change in the carrying amount of the net assets of the companies between the date of acquisition of Company Z and the date of performing the impairment tests of CGUs A and B. Assume also that the annual impairment test of CGUs A and B is performed after the acquisition of Company Z takes place.

B15. CGU A and CGU B would need to be tested for impairment during the year, because goodwill is allocated to those CGUs.

(c) Assume the recoverable amount of CGU A after allocation of Company Z at the date of the impairment test is CU400 (determined in accordance with IAS 36 as normal, ie after including Company Z

allocations of net assets and goodwill, and using the assumptions for CGU A post acquisition).

(d) Assume that the recoverable amount of CGU B is CU250 at the date of the impairment test.

Applying the PH Approach

CGU A

B16. The allocation to CGU A of goodwill from the acquisition of Company Z will require measurement of a revised PH for CGU A. The recoverable amount of CGU A would need to be determined at the date of acquisition of Company Z, based on the pre-acquisition assumptions and before allocation of Company Z goodwill and other assets. These pre-acquisition values and assumptions would nevertheless include the Company Y allocations

B17. Assume the recoverable amount of CGU A on 1 July 2017 based on the pre-acquisition assumptions and before allocation of Company Z is CU196. Consequently, a revised PH of CU36 (=196-160) exists for CGU A.

B18. At the date of the impairment test, the amounts relating to CGU A are as follows:

	CGU A
Identifiable net assets excluding goodwill (includes Company Z allocation)	CU284 (=145+139)
Goodwill	CU76 (=15+61)
Carrying amount	**CU360**
Revised PH (not recognised as an asset)	CU36
Total of the carrying amount of the CGU plus the PH	**CU396**

B19. Outcome of the impairment test of CGU A: Recoverable amount (CU400) > Carrying amount of CGU plus the PH (CU396). No impairment.

CGU B

B20. At the date of the impairment test, the amounts relating to CGU B are as follows:

	CGU B
Identifiable net assets excluding goodwill	CU240
Goodwill	CU20
Carrying amount	**CU260**
PH (not adjusted as no goodwill allocated from Company Z)	CU20
Total of the carrying amount of the CGU plus the PH	**CU280**

B21. Outcome of the impairment test: CGU B: Recoverable amount (CU250) < Carrying amount of CGU plus pre- acquisition headroom (CU280). Impairment of CU20 allocated to the goodwill arising on acquisition of Company Y. The remaining CU10 is allocated against the PH, not the other assets of CGU B.

B22. As there is no goodwill remaining in CGU B, the PH allocated to CGU B will be disregarded for future impairment tests.

B23. Note: If the recoverable amount of CGU B had been CU230, CU20 would have been allocated to goodwill, CU20 would have been allocated against the PH and CU10 would have been allocated to other assets of the unit in accordance with IAS 36.

Illustration 3 (disposal of part of an operation)

Fact pattern

B24. Same fact pattern as illustrations 1 and 2. On 1 February 2018 the carrying amount of CGU A is as follows:

	CGU A
Identifiable net assets excluding goodwill	CU260
Goodwill	CU76
Carrying amount of CGU	**CU336**

B25. On 1 February 2018 Group X sells for CU100 an operation that is part of CGU A. The carrying amount of the net assets in the operation excluding goodwill at the time of sale is CU70. Assume the goodwill associated with the operation is

measured on the basis of the relative values of the operation disposed of and the portion of CGU A retained in accordance with paragraph 86(b) of IAS 36. The recoverable amount of the portion of CGU A retained is CU300.

Allocation of goodwill and PH between operations disposed and retained

B26. Assuming goodwill and PH are both allocated on the basis of relative values:

(e) The portion of the CGU disposed of is 25% of the CGU based on relative value (=100/(300+100)). Hence, 25% of the goodwill in CGU A is included in the operation sold.

(f) 25% of the PH would be removed from future impairment calculations.

B27. Consequently:

(a) Goodwill of CU19 (=0.25x76) is allocated to the operation disposed of.

(b) A PH of CU9 (=0.25x36) would be allocated to the operation disposed of, leaving a PH of CU27 in CGU A for use in future impairment tests.

B28. Immediately following disposal of part of CGU A, amounts relating to CGU A are:

	CGU A
Identifiable net assets excluding goodwill (includes Company Z allocation)	CU190 (=260-70)
Goodwill	CU57 (=76-19)
Carrying amount	**CU247**
Remaining PH	CU27 (=36-9)