STAFF PAPER

October 2017

IASB® Meeting

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

Purpose

1. The purpose of this paper is to set out the staff's current thoughts on possible approaches that might improve effectiveness of the model for impairment testing of goodwill and to seek the Board's feedback on those approaches. The Board is not being asked to make any decisions.

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 investors' concern that of impairment of goodwill is not recognised on a timely basis.

Structure of the paper

3. The paper is structured as follows:

   (a) background and introduction (paragraphs 4–6)

   (b) a single method for determining recoverable amount (paragraphs 7–36)

      (i) background (paragraphs 7–9)

(ii) adopting one method as the sole basis for measuring recoverable amount (paragraphs 10–35)

(iii) selecting a method that reflects the manner of recovery of the asset (paragraph 36)

(c) headroom approach (paragraphs 37–64)

(i) issue that the staff is trying to address (paragraphs 37–40)

(ii) buffering effect of headroom (paragraphs 41–48)

(iii) updated headroom approach (paragraphs 49–54)

(iv) example to illustrate updated headroom approach (paragraph 55–62)

(v) ASAF feedback on PH approach (paragraphs 63–64)

(d) question for the Board

(e) Appendix A—PH approach

(f) Appendix B—Examples to illustrate the PH approach

Background and introduction

4. In past Board meetings, the staff presented:

(a) a preliminary analysis of a possible approach to 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) a detailed analysis of pre-acquisition headroom (PH) approach, including numerical illustrations of application of that approach.

5. The staff analysis of the PH approach is included in *Appendix A* of this paper. The numerical illustrations of application of the approach are included in *Appendix B* of this paper.

6. In this paper, the staff:

(a) complete the analysis of the single method approach (paragraphs 7–36); and

(b) analyse a variant of the PH approach, described as the 'updated headroom' approach (paragraphs 37–64).

A single method for determining recoverable amount

Background

7. 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) 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.

8. 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 fair value (ignoring the costs of disposal) 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.

9. The Board could either:

   (a) adopt only one of the two methods (value in use or fair value) 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

10. 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

11. 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.

12. 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.

13. 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.

14. 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.

15. 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.

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. 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).

18. There is an important fact to be noted in assessing whether the IASC's considerations (set out in paragraphs 11–17) are still relevant today—there was no comprehensive Standard on fair value measurement when IAS 36 and IFRS 5 were issued.

19. 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 allows 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 shall adjust those data if reasonably available information indicates that other market participants would use different data or there is something particular to the entity that is not available to other market participants.

Similarities and differences between value in use and FVLCD

20. For 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 fair value. 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

21. 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.

22. 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, except for the specific exclusions that IAS 36 requires in

calculating value in use (see paragraph 23 of this paper). 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).

23. 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 fair value.

24. If an asset has alternative uses and an entity has the ability to put the asset to an alternative use, the value in use of the asset would reflect the value from the current use of the asset and, arguably, the value of the option to put the asset to a different use. However, fair value would reflect the highest and the best use.

Unit of account and synergies

25. 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.

26. 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.

27. 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.

28. Another difference in relation to unit of account is that synergies (a) between the asset being measured and other assets; or (b) from grouping of assets that would not be available to market participants are considered in calculating value in use but not in fair value. Arguably, this is inconsistent with the assumption in IFRS 13 that in measuring fair value of an asset that is used in combination with other assets or other assets and liabilities (a) any complementary assets and associated liabilities; and (b) synergies from using assets as a group in an ongoing business are available to market participants.

29. However, in the context of impairment testing of goodwill, there may not be a difference in the unit of account for measuring value in use or 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

30. The basic discount rate input for both value in use and fair value measurement 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. This discount rate is usually a post-tax rate because it incorporates market participant's assumption of tax effects. However, in calculating VIU, an entity should make adjustments to derive a pre-tax rate. However, the staff believe that, in practice, entities generally use a post-tax rate because pre-tax rates are not available. (See paragraphs 35–41 in Agenda Paper 18C for this meeting.)

Staff's preliminary conclusions on adopting a single method

31. In the context of impairment testing of goodwill, on the basis of the analysis in paragraphs 11–30 of this paper, the staff conclude that the concepts of value in use as adopted in IAS 36 and fair value consider and reflect a similar set of factors and the biggest single difference that causes 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. 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. (See paragraphs 42–47 in Agenda Paper 18C for this meeting.)

32. At the recent meeting of the Accounting Standards Advisory Forum (ASAF), some members commented that moving to a single method cannot be restricted to just impairment testing of goodwill and that the Board should consider this approach for all other assets within the scope of IAS 36. Some ASAF members thought that this would be a big change.

33. The staff think that considering fair value as the sole basis for determining recoverable amount would not result in a significant change because the first step in IAS 36 when testing an individual asset that may be impaired is to measure its fair value less costs of disposal.

34. 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 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 compared to fair value 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 value in use is when the current use of an asset is not its highest and best use.

35. Irrespective of whether the Board prefers moving to a single method, the Board could consider gathering more feedback and evidence through the Discussion Paper about whether the entity-specific nature of value in use allows an entity to manipulate the impairment test to avoid recognising an impairment.

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

36. Paragraph 9(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. The staff think that the considerations explained in paragraph 34 of this paper are relevant for this approach.

Headroom Approach

Issue that the staff is trying to address

37. Goodwill does not generate cash flows independently of other assets or groups of assets, and often contributes to the cash flows of more than one cash-generating unit. In addition, goodwill is measured as a residual as direct measurement of goodwill is not possible.

38. Paragraph 80 of IAS 36 requires that for the purpose of the goodwill impairment test, goodwill acquired in a business combination should be allocated to the acquirer's cash-generating units (or groups of units) that are expected to benefit from the synergies of the combination.

39. One of the main causes for the current impairment test failing to capture impairment of purchased goodwill at the right time and in the right amounts is the so-called buffering effect of the following within a unit (or group of units) to which purchased goodwill is allocated:

    (a) any pre-acquisition headroom in a unit (group of units) that was already held before the acquisition; and

    (b) any headroom that is internally generated after the acquisition, regardless of whether the unit (or group of units) was already held before the acquisition or was acquired in the business combination.

40. The headroom is the amount by which the recoverable amount of a unit(s) exceeds the carrying amount of the unit(s). Headroom, the components of which are never recognised in an entity's financial statements, consists of:

    (a) internally generated goodwill in the unit;

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

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

Buffering effect of headroom

41. The headroom provides a shelter to the purchased goodwill by absorbing any negative movements in the recoverable amount. Any impairment of purchased goodwill, under the current impairment model, is recognised only when all of the unrecognised headroom in the unit (group of units) is wiped out.

42. According to the EFRAG (2016), the market to book ratio for European companies is approximately 1.6 in 2014. Based on an S&P survey, the market to book ratio for American companies exceeds 2 on average. Therefore, if the market value of the entity is approximately equal to the aggregate of recoverable

amounts of all units in the entity, there is a significant unrecognised headroom in many entities.

43. The current impairment testing of goodwill does not include any adjustment for the headroom in the unit (group of units). The staff think that if some measure of headroom is incorporated into the impairment testing model, it will be possible to achieve more timely recognition of impairment losses on goodwill, at least in some cases. If an entity is able to achieve or outperform the metrics (such as growth rate, rate of return etc) that it assumed at the time of the business combination, the headroom is likely to either remain constant or increase. If the entity is not able to achieve those metrics, the headroom is likely to decline. By including a measure of headroom in testing goodwill for impairment, an entity would recognise impairment of goodwill when the actual performance is worse than expected.

44. The measure of headroom could be either a static amount or a continuously updated amount. A static measure of headroom determined at the date of the acquisition has some meaning only for pre-combination[1] units (or group of units) to which any purchased goodwill is allocated. A continuously updated measure of headroom has some meaning in all situations.

45. On the basis of the above analysis, the staff have developed two approaches:

    (a) pre-acquisition headroom approach (static measure of headroom, determined at the date of the acquisition); and

    (b) updated headroom approach (continuously updated measure of headroom).

46. Both those approaches do not increase the complexity in the current impairment testing model because there is just one additional input into the model. The headroom information is generally available from the calculations performed in the current impairment test. In situations in which an entity allocates purchased goodwill to a pre-combination unit (or group of units) that does not contain any goodwill, the entity may have to incur some additional costs in calculating the

[1] By pre-combination, we mean held before the acquisition.

headroom of that pre-combination unit (or group of units) in order to apply the headroom approaches.

47. As noted above, the Board has already discussed the pre-acquisition headroom approach. The mechanics of the approach and examples illustrating the application of the approach are included in the Appendices to this paper.

48. This is the first time the staff have analysed the updated headroom approach in this project. Depending upon the feedback of the Board on this approach, the staff plan to bring illustrations of application of the approach in various situations to a future Board meeting.

Updated headroom approach

49. In the PH approach, an entity adds the headroom of a pre-combination unit (or group of units) just before the business combination to the carrying amount of the post-combination unit when testing for impairment. The updated headroom approach is a variant of the PH approach. The only variation from the PH approach is that the headroom that is used as an input is the headroom of the unit (group of units) as at the immediately preceding impairment testing date.

50. The basis for using the headroom at that date is that businesses are dynamic and the composition of assets could change significantly over time because of enhancements, improvements, restructuring etc. Over time:

    (a) a static pre-combination headroom may become too small to make the impairment test significantly more effective; and

    (b) the headroom generated internally after the acquisition may become much more significant.

51. 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. The staff think it would be consistent with this to have a single headroom for each unit (giving rise to goodwill in that unit), rather than a separate headroom for each acquisition.

52. As a result, the staff think, a continuously updated headroom is more likely than a static headroom approach to help achieve the effectiveness objective.

53. The staff think any impairment loss should be first allocated to purchased goodwill in full before reducing the headroom, for the following reasons:

    (a) The primary objective of introducing the headroom approach is to remove the buffering effect arising from headroom before and after acquisition. Allocating impairment losses to purchased goodwill before the headroom would provide an earlier signal of impairment to the market and is consistent with this objective.

    (b) Unless the headroom is analysed into its components based on IFRS 3 to enable a meaningful allocation, any allocation of an impairment loss between the headroom and acquired goodwill would be arbitrary. The staff think requiring an entity to distinguish between the components of the headroom 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 headroom and goodwill would at least require the internally-generated goodwill component of the headroom to be identified. As noted in (b) the staff think componentisation of the headroom would be subjective, and unnecessarily costly and complex.

    (d) It may be clear that the headroom 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 headroom, before first reducing the recognised goodwill to zero, would be inappropriate.

    (e) The headroom 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 estimates of its useful life and pattern of consumption. If the impairment loss was allocated proportionately between goodwill

and the headroom, the amount allocated to goodwill would be likely to be arbitrary.

54. Nevertheless, one might argue that if the recoverable amount of a unit declines in value during the post-acquisition period, the decline could be caused by a decrease in the headroom of existing unit and not by the newly acquired business combination. Therefore, the staff think that the Board could consider following possible methods for allocating the impairment loss:

(a) in full to acquired goodwill before the headroom (the staff's current thought)

(b) in full to the headroom before acquired goodwill (which is same as the effects of the current impairment testing model);

(c) proportional allocation between the headroom and acquired goodwill; or

(d) in full to acquired goodwill unless the entity can demonstrate that a different allocation is appropriate.

Example to illustrate updated headroom approach

55. Company X acquires 100 per cent of Company Y for CU200 on 1 January 20X0. Company Y's net identifiable assets have a fair value of CU100. Consequently, Company X recognises goodwill of CU100. Company X concludes that the assets of Company Y will generate cash flows together with an existing unit, Z, and all of the acquired goodwill is allocated to the larger unit Z.

56. The carrying amount and the recoverable amount of unit Z just before the acquisition of Company Y were CU300 and CU400 respectively. As a result, pre-acquisition headroom of unit Z is CU100.

57. Company X tests goodwill for impairment regularly at the annual reporting date. The carrying amount (excluding goodwill) and the recoverable amount of the larger unit Z (post-acquisition) at subsequent annual reporting dates are as follows:

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

	31 December			
	20X0 CU	20X1 CU	20X2 CU	20X3 CU
Carrying amount excluding goodwill	500	525	510	540
Recoverable amount	720	730	695	715

58. The 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.

59. For the purposes of the impairment testing of goodwill at 31 December 20X0, the pre-acquisition headroom of unit Z is added to the carrying amount of unit Z at 31 December 20X0. The total amount is then compared with the recoverable amount of unit Z at that date. Similarly, for impairment testing of goodwill at 31 December 20X1, the headroom of unit Z at 31 December 20X0 is added to the carrying amount of unit Z at 31 December 20X1. The total amount is then compared to the recoverable amount of unit Z at that date. The staff assumed that any impairment loss is first offset against acquired goodwill.

60. The calculations are as follows:

	31 December			
	20X0 CU	20X1 CU	20X2 CU	20X3 CU
Carrying amount excluding goodwill	500	525	510	540
Goodwill	100	100	85	80
Carrying amount (a)	600	625	595	620
Headroom at previous test date	100	120	105	100
Carrying amount + headroom (b)	700	745	700	720
Recoverable amount (c)	720	730	695	715
Impairment loss [b – c]	**-**	**15**	**5**	**5**
Headroom at this date [c – a]	120	105	100	95
Goodwill less impairment, if any	100	85	80	75

61. In the current impairment model, because headroom is not used as an input, there will be no impairment loss of goodwill in the above example.

62. In the PH approach, the headroom that is added to the carrying amount is a static amount of CU100. This will result in recognition of an impairment loss of CU15 and CU10 at 31 December 20X2 and 31 December 20X3 respectively.

ASAF feedback on PH approach

63. The staff recently consulted ASAF on the PH approach. At the same meeting, EFRAG representative sought feedback of ASAF on an approach developed by EFRAG Secretariat, a 'goodwill accretion' approach, that aims to achieve timely recognition of impairment of goodwill.

64. ASAF members generally expressed concerns that both goodwill accretion and the PH approach would add complexity to the current impairment testing model. They thought that accountants might find it very difficult to explain the goodwill accretion approach to managements.

Question for the Board

Do you have any feedback or comments on the single method approach and the headroom approaches?

Appendix A
Pre-acquisition headroom approach

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:

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

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

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

(d) 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.

(e) 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.[2]

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.

[2] 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
Examples to illustrate the PH approach

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[3] after the impairment test are as follows:

[3] 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.

(a) 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).

(b) 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:

(a) 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.

(b) 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)