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STAFF PAPER

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Project	**Goodwill and Impairment research project**
Paper topic	Possible simplifications to the impairment testing model in IAS 36 *Impairment of Assets*

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Purpose

1. The purpose of this paper is (a) to provide the Board with an (updated) analysis of possible simplifications to impairment testing of goodwill; and (b) seek the Board's feedback on whether these approaches could help in simplifying impairment testing.

Objective of simplifying the impairment testing model

2. The objective of considering possible simplifications to the impairment testing model is to investigate whether it is possible to reduce the cost of impairment testing without making the impairment test less robust.

Structure of the paper

3. The paper is structured as follows:
   - (a) background and introduction (paragraphs 4–11)
   - (b) relief from the mandatory annual quantitative impairment test (paragraphs 12–34)
   - (c) other possible simplifications

(i) pre-tax or post-tax inputs in calculating value in use (paragraphs 35–41)

(ii) future restructuring and future enhancements (paragraphs 42–47)

(iii) allowing goodwill to be tested at the entity-level or at the level of a reportable segment (paragraphs 48–52)

(d) question for the Board

(e) Appendix A— extracts from Topic 350-20 of FASB Codification relating to qualitative factors for goodwill impairment

Background and introduction

4. In its May 2017 and July 2017 meetings, the Board discussed the possible simplification of removing the requirement to perform an annual quantitative impairment test of goodwill when there are no indicators of possible impairment. This paper includes an updated analysis of the possible simplification considering the Board's discussion in July 2017 (paragraphs 12–34).

5. The Board could also consider other possible simplifications to the impairment testing model, such as:

(a) easing the value in use calculation by being less specific about whether inputs used should be pre-tax or post-tax (paragraphs 35–41).

(b) removing the requirement in paragraph 44 of IAS 36 to exclude from the calculation of value in use cash flows that would arise from future restructuring and from future performance enhancement (paragraphs 42–47).[1]

(c) allowing goodwill to be tested at an entity-level or at the level of a reportable segment (paragraphs 48–52).

[1] Paragraph 44 of IAS 36 states that 'Future cash flows shall be estimated for the asset in its current condition. Estimates of future cash flows shall not include estimated future cash inflows or outflows 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.

6. This paper includes the analysis of these other possible simplifications. The staff previously presented these other possible simplifications to the Board in October 2015. However, the Board had only a high-level discussion because the amortisation versus impairment debate dominated the Board's discussions.

7. In March 2017, the staff sought feedback from the Global Preparers Forum (GPF) on all possible simplifications listed in paragraphs 4–5 of this paper. In June 2017, the staff discussed removing the requirement to perform an annual quantitative impairment test with the joint group of members of Capital Markets Advisory Committee (CMAC) and GPF. See *Appendix C* of Agenda Paper 18A for this meeting for the minutes from the two meetings. The feedback from the two meetings has been considered in the staff analysis.

8. In past Board meetings, the staff discussed with the Board the following approach as a possible simplification of impairment testing—using a single method as the sole basis for determining recoverable amount, ie either value in use or fair value less costs of disposal, rather than the higher of those two amounts.

9. However, at its May 2017 meeting, the Board observed that the complexity argument put forth by stakeholders during the Post-Implementation Review (PIR) of IFRS 3 *Business Combinations* was not a persuasive argument for changing the basis for determining recoverable amount. This is because arguably an entity does not need to calculate both value in use and fair value less costs of disposal in all situations. It needs to do this only when calculating one of these amounts has shown that there may be an impairment.

10. Nevertheless, although moving to a single method might not make impairment testing simpler, the staff have concluded that it might help in making it more effective. A more straightforward impairment test using either value in use or fair value less costs of disposal might:

    (a) be easier to apply and understand; and

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

11. Consequently, this approach is being analysed as a possible approach for improving the effectiveness of impairment testing (see Agenda Paper 18B for this meeting).

Relief from the mandatory annual quantitative impairment test

12. IAS 36 requires a cash-generating unit to which goodwill has been allocated to be tested for impairment annually, and whenever there is an indication that the unit may be impaired, by comparing the carrying amount of the unit, including goodwill, with the recoverable amount of the unit.

13. The annual quantitative impairment test may be performed at any time during an annual period, provided it is performed at the same time every year. Different units may be tested for impairment at different times. However, if some or all of the goodwill allocated to a unit was acquired in a business combination during the current annual period, that unit must be tested for impairment before the end of the current annual period.

14. According to some feedback from the PIR of IFRS 3, removing the requirement to perform the quantitative impairment test when there are no indicators of possible impairment may reduce complexity. This would also be consistent with the approach for finite life assets in the scope of IAS 36.

15. IAS 36 requires that an entity shall assess at the end of each reporting period whether there is any indication that an asset may be impaired. If any such indication exists, the entity shall perform an impairment test. IAS 36 provides a list of indicators that an asset may be impaired. This list of indicators is not exhaustive and is required to be considered as a minimum.

Staff analysis

16. To respond to the feedback from preparers, the Board could consider providing relief from the mandatory annual quantitative impairment testing of goodwill, using one of the following four approaches:

    (a) *Approach 1*—the Board could require an entity to perform the quantitative impairment testing of goodwill only when there are indicators of possible impairment;

    (b) *Approach 2*—the Board could require an entity to perform the quantitative impairment testing of goodwill for the first year after a business combination; and in the later years, perform the quantitative impairment test only when there are indicators of possible impairment;

(c) *Approach 3*—the Board could require an entity to perform the quantitative impairment testing of goodwill at least annually (and more frequently whenever there are indicators of possible impairment) for the first few years after a business combination, perhaps 3–5 years; and in the later years, perform the quantitative impairment test only when there are indicators of possible impairment; and

(d) *Approach 4*—the Board could require an entity to perform the quantitative testing of goodwill less frequently than annually, for example every 3 years; and in the intervening periods, perform the quantitative impairment test only when there are indicators of possible impairment.

17. The Board may consider the factors discussed in paragraphs 18–30 of this paper in assessing whether the relief would meet the objective of simplifying the application of IAS 36 without making the model less robust. Furthermore, the Board could also consider the work of the FASB—see paragraphs 31–34 of this paper.

Current requirements and considerations in IAS 36

18. Assets within the scope of IAS 36 other than indefinite-lived intangible assets and goodwill need to be tested for impairment (ie recoverable amount is determined) only when there is an indication that the asset may be impaired. Arguably, there is no conceptual reason for treating indefinite-lived intangibles and goodwill differently.

19. As explained in the Basis for Conclusions on IAS 36, the Board required an annual quantitative impairment test for intangible assets with indefinite useful life because non-amortisation of an intangible asset increases the reliance that must be placed on impairment reviews of that asset to ensure that its carrying amount does not exceed its recoverable amount.

20. For goodwill, the existence of a rigorous and operational impairment test was seen as a precondition for removing the requirement to amortise in all cases. The

International Accounting Standards Committee (IASC), the Board's predecessor, introduced the requirement to carry out an annual quantitative impairment test for goodwill and indefinite life intangible assets at the same time as it removed a previous requirement to amortise those assets.

21. These considerations continue to be relevant.

Cost of performing the annual quantitative impairment testing of goodwill

22. A possible question is whether performing the quantitative impairment testing of goodwill annually is truly costly. Arguably, at least some of the cost of the quantitative test is in setting up the valuation model. Having set up a valuation model for a unit to which goodwill is allocated, an entity would run the valuation model with a fresh set of inputs and assumptions every year. However, there are incremental costs involved in ensuring that those inputs and assumptions are accurate.

23. An entity may have to amend the valuation model when there are events such as reorganisation of units or new business combinations etc. In those situations, the incremental costs incurred by an entity for performing the quantitative impairment test may not be considered significant because the entity would have undertaken a valuation exercise in the process of restructuring the units or undertaking the new business combinations.

Annual impairment test—a good governance mechanism

24. A few members of the Board's consultative groups viewed the annual quantitative impairment test as a good governance mechanism.

25. Measuring recoverable amount is a valuation concept; and management is not likely to perform valuations annually (or more frequently) for any purpose other than impairment testing of goodwill. Measuring recoverable amount of assets when they might be impaired is a good governance practice.

Concerns about robustness of impairment testing and loss of disclosures

26. There was feedback from investors that impairment losses are often recognised too late (even with an annual quantitative impairment test). They thought that without a mandatory annual test, concerns may arise that recognition of

impairment losses could be delayed even further. This could reduce investors' confidence in the carrying amount of goodwill and increase concerns that it may be overstated. Consequently, some GPF members preferred Approach 4, which they think would be more robust than other approaches. However, compared to the current requirement in IAS 36, Approach 4 is not likely to save significant costs because the saving in costs from not having to perform an annual impairment testing will be partially offset by loss of benefit of learning curve from a regular annual impairment test.

27. IAS 36 requires an entity to disclose the estimates used to measure recoverable amounts of units containing goodwill or indefinite-lived intangible assets. During the PIR of IFRS 3, some investors said that some of the current disclosures are useful; these included discount rates used, long-term growth rates, profit and capital expenditure assumptions and sensitivities. If the requirement to perform the annual quantitative impairment test is removed, an entity will disclose those estimates only when an impairment of goodwill is recognised. A few preparers argue that for units that do not contain any goodwill or indefinite-lived intangible assets, an entity discloses the estimates only when an impairment loss is recognised. However, the objective of requiring disclosures at annual intervals for units containing goodwill or indefinite-lived intangible assets is to provide investors with useful information for evaluating the reliability of the estimates used by management to support the carrying amounts of goodwill and indefinite-lived intangibles.

Possible additional indicator for assessing impairment

28. In relation to the first few years after a business combination, the Board could consider including another indicator of possible impairment—whether the actual performance is in line with key assumptions or targets supporting the purchase consideration in that business combination. (See also Appendix B of Agenda Paper 18D for this meeting.) If the actual performance is not in line with the key assumptions or targets, this indicator would trigger a requirement to determine the recoverable amount of the unit. The staff envisage this indicator would operate only over the first few years following a combination, for example 3 years. However, some GPF members thought that if the actual performance in the first few years is not in line with the key assumptions or targets supporting the

purchase price, that does not mean that the acquired assets are impaired. Entities generally take a long-term view of the benefits from the business combination.

29. In relation to Approaches 3 and 4, GPF members thought that requiring the quantitative test for the first few years after an acquisition is not useful because there is generally no impairment of goodwill during those initial years, especially if there is no significant change in circumstances.

30. A few CMAC members supported removing the requirement for an annual quantitative impairment test, together with a disclosure of the reasons that triggered the quantitative impairment test. Currently, IAS 36 does not require disclosure of indicators that triggered the quantitative impairment test. For assets within the scope of IAS 36 (other than units containing goodwill or intangible assets with indefinite useful life), IAS 36 requires disclosure of the events and circumstances that led to the recognition or reversal of an impairment loss.

Optional qualitative test in US GAAP

31. In 2011, the Financial Accounting Standards Board of the US introduced an optional qualitative test in US GAAP for testing goodwill for impairment. An entity that applies US GAAP has the option to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the goodwill impairment test. The more-likely-than-not threshold is defined as having a likelihood of more than 50 percent. See *Appendix A* for the qualitative factors from US GAAP. The staff think that the indicators in US GAAP are similar to those in IAS 36.

32. The staff reviewed publicly available information and had informal discussions with the FASB staff about how the optional qualitative assessment is being applied in practice. Publicly available survey reports indicate that there is a steady increase in the number of public companies that are electing to use the qualitative test as a first step. The percentage of public companies applying the qualitative test increased from 29 percent in 2012 to 59 percent in 2016.

33. Based on informal discussions with the FASB staff, we understand that many companies did not immediately use the qualitative test because the macro-economic environment in the US when the qualitative test was introduced

possibly made it difficult for companies to pass the more-likely-than-not threshold. The accumulation of evidence needed for a robust application of the qualitative test was probably more complex than performing the quantitative test. However, with the macro-economic environment improving, the application of the qualitative test is possibly becoming less complex, which is evidenced by more public companies using the qualitative test.

34. If the Board considers pursuing Approach 1, the staff think that the audit and enforcement framework in a jurisdiction affects the robustness of application of the indicator-based impairment testing.

Other possible simplifications

Pre-tax or post-tax inputs in calculating value in use

35. In calculating value in use, IAS 36 requires an entity to:

    (a) use a pre-tax discount rate (paragraph 55 of IAS 36); and

    (b) exclude income tax receipts or payments, ie estimate cash flows on a pre-tax basis (paragraphs 50 and 51 of IAS 36).

36. Consequently, IAS 36 requires an entity to disclose the discount rate(s) applied to the cash flow projections (paragraph 134(d)(v) of IAS 36).

37. In respect of discount rate, paragraph 56 of IAS 36 states that it is the return that investors would require if they were to choose an investment that would generate cash flows of amounts, timing and risk profile equivalent to those that the entity expects to derive from the asset. In other words, it is an asset-specific rate. When an asset-specific rate is not directly available from the market, IAS 36 allows an entity to use surrogates to estimate the discount rate. These surrogates might be the entity’s weighted average cost of capital, the entity’s incremental borrowing rate or other market borrowing rates.

38. In practice, entities generally estimate the discount rate because asset-specific rates are not typically available for the level (ie unit or groups of units) at which goodwill is monitored for internal management purposes. Weighted average cost of capital is generally used as the surrogate to estimate the discount rate.

39. As is the case for discount rates directly available from the market, weighted average cost of capital is a post-tax rate. Since IAS 36 requires the use of pre-tax rates in determining value in use, the staff understand that in practice entities use the post-tax rate and then translate it into a pre-tax rate. In theory, the pre-tax discount rate is the post-tax discount rate grossed up by a standard rate of tax. However, a simple gross up only works under a very simple scenario when no growth is assumed in future periods (see paragraph BCZ85 of the Basis for Conclusions on IAS 36).

40. Many academics and valuation professionals recommend using the post-tax rates available and converting pre-tax cash flows to post-tax cash flows. This has led to divergence in practice. Some companies use post-tax rates and post-tax cash flows, whereas others convert post-tax rates to pre-tax rates and apply these to pre-tax cash flows. Regulatory practice also differs; some regulators state that they now accept calculations on a post-tax basis, whereas others have taken regulatory action to require companies to use and disclose pre-tax discount rates[2]. Feedback during and after PIR of IFRS 3 also showed that calculating and using pre-tax rate has been challenged because the starting point for the calculation is usually the post-tax rate and it is difficult to find a benefit of using only pre-tax rates.

41. Consequently, the staff thinks that the Board should consider not requiring whether the discount rates used should be pre-tax rates or post-tax rates when determining value in use. This would be consistent with the requirements in IFRS 13 for determining FVLCD. It would also be consistent with the removal from IAS 41 *Agriculture* of a reference to pre-tax discount rates in 2008 (see paragraphs BC5–BC7 of the Basis for Conclusions on IAS 41).

Future restructuring and future enhancement

42. IAS 36 requires that future cash flows for value in use calculation are estimated for an asset in its current condition. Consequently, it states that estimates of future cash flows should not reflect estimated future cash inflows or outflows that

[2] Based on information provided to IASB staff by IOSCO's Committee 1 on Issuer Accounting, Audit and Disclosure, which comprises 28 members.

are expected to arise from a future restructuring to which an entity is not yet committed or from enhancing the asset's performance.

43. As explained in paragraph BC69 of the Basis for Conclusions on IAS 36, all else being equal, the value in use of a newly acquired unit would sometimes be less than the price paid for the unit because value in use would not include net benefits of a future restructuring to which the entity is not committed yet. Consequently, other things being equal, the unit's recoverable amount in those case would often be its FVLCD not value in use. The Board acknowledged that using FVLCD for a newly acquired asset seems inconsistent with the objective of recoverable amount measurement, which is to reflect the economic decisions that are made when an asset becomes impaired: is it better to sell the asset or to keep using it?

44. Nevertheless, the Board concluded that including these cash flows in the calculation of value in use would significantly change how the concept that value in use is determined for the asset in its current condition. The Board decided that the change to the concept of value in use should be reconsidered only if the Board addresses the broader question of the appropriate measurement objectives in accounting.

45. The Board has been considering measurement objectives as part of its Conceptual Framework project. The Exposure Draft of *Conceptual Framework for Financial Reporting* states that value in use, an entity-specific value, is the present value of the cash flows that an entity expects to derive from the continuing use of an asset and from its ultimate disposal. However, it does not specify that an application of the value in use measurement base would require the exclusion of cash flows that result from future restructuring of the asset or future enhancement to the asset.

46. The staff think the Board should reconsider whether to retain the IAS 36 requirement to exclude from the calculation of value in use those cash flows that would result from a future restructuring or future enhancement. In reaching that conclusion, the staff considered the following:

    (a) the current condition of some assets contains a potential to restructure or enhance the asset. A market participant purchasing such an asset would be willing to pay for that potential. Similarly, a market participant selling such an asset would demand to be paid for selling that potential. Thus, the fair value of such an asset would include value attributable to that potential. That value would reflect the potential that exists at the measurement date. It would not assume that the restructuring or enhancement has already occurred.

(b) in principle, there seems to be no reason why the value in use of an asset would exclude value attributable to the existing potential to restructure or enhance the asset. Arguably, the IAS 36 exclusion of cash flows resulting from that potential arises from one or more of the following:

(i) a wish to exclude cash flows that, arguably, are subject to an unusually high risk that management will make unjustifiably optimistic assumptions.

(ii) the adoption of one unit of account for fair value (including the potential for restructuring or enhancement) but a different unit of account for value in use (excluding that potential).

(iii) a failure to distinguish clearly between the existing potential for restructuring or enhancement and the possible future outcome of that restructuring or enhancement.

(c) in some cases, it may be difficult to distinguish between an existing potential, already contained within an asset, to enhance that asset, and the possible future acquisition of a different asset.

47. IAS 36 anchors the estimates of future cash flows in management's budgets and forecast. The IAS 36 restriction on the cash flows means that the budgeted or forecast cash flows need to be split into two components. Arguably, that exclusion is arbitrary, produces information that is less likely to be useful to users of financial statements and imposes costs on preparers.

Allowing goodwill to be tested at the entity-level or at the level of a reportable segment

48. For impairment testing, IAS 36 requires that goodwill should be allocated from the acquisition date to each of the units that are expected to benefit from the synergies of the business combination. This is because goodwill does not

generate cash flows independently. Each unit represents the lowest level within the entity at which the goodwill is monitored for internal management purposes and must not be larger than an operating segment. (See paragraph 80 of IAS 36.)

49. Some respondents to the PIR of IFRS 3 thought that one of the main challenges of the current impairment test is identifying units and allocating goodwill to units because this task can be judgemental and difficult to apply in practice. The staff have had some feedback that IAS 36 does not provide sufficient guidance in this area.

50. IAS 36 explains that applying the requirements in paragraph 80 of IAS 36 results in goodwill being tested for impairment *at a level that reflects the way an entity manages its operations* and with which the goodwill would naturally be associated. The considerations of the Board have been clearly explained in paragraphs BC137–BC150B of the Basis for Conclusions on IAS 36.

51. One of the possible simplifications is to allow impairment testing of goodwill at the entity-level or at the reportable-segment level. As explained in paragraph 48 of this paper, the level at which goodwill is tested for impairment must not be larger than an operating segment identified in accordance with IFRS 8 *Operating Segments*. When revising IAS 36 in 2004, the Board specifically concluded that requiring goodwill to be allocated to at least the segment level is necessary to avoid entities erroneously concluding that, when a business combination enhances the value of all of the acquirer's pre-existing cash-generating units, any goodwill acquired in that combination could be tested for impairment only at the level of the entity itself. The staff do not think that an entity should be given an option to test goodwill at the entity-level or at the level of a reportable segment because it could lead to loss of information about impairment. For example, if goodwill impairment exists at the lower level at which the goodwill is monitored, that impairment might not be recognised if a unit that contains goodwill is aggregated with other units that contain sufficient headroom to offset the impairment loss.

52. The staff also thought about the possibility of providing additional guidance on allocation of goodwill for impairment testing. The staff think that it is difficult to provide any additional guidance that applies to all entities because the factors that make up the acquired goodwill are not likely to be the same across business

combinations. Furthermore, how existing units of an entity benefit from a business combination are specific to the entity.

Question for the Board

Do you have any feedback or comments on the analysis and any other factors that the staff should consider?

Appendix A
Extracts from Topic 350-20 of FASB Codification relating to qualitative factors for goodwill impairment

35-3C In evaluating whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount, an entity shall assess relevant events and circumstances. Examples of such events and circumstances include the following:

a. Macroeconomic conditions such as a deterioration in general economic conditions, limitations on accessing capital, fluctuations in foreign exchange rates, or other developments in equity and credit markets
b. Industry and market considerations such as a deterioration in the environment in which an entity operates, an increased competitive environment, a decline in market-dependent multiples or metrics (consider in both absolute terms and relative to peers), a change in the market for an entity's products or services, or a regulatory or political development
c. Cost factors such as increases in raw materials, labor, or other costs that have a negative effect on earnings and cash flows
d. Overall financial performance such as negative or declining cash flows or a decline in actual or planned revenue or earnings compared with actual and projected results of relevant prior periods
e. Other relevant entity-specific events such as changes in management, key personnel, strategy, or customers; contemplation of bankruptcy; or litigation
f. Events affecting a reporting unit such as a change in the composition or carrying amount of its net assets, a more-likely-than-not expectation of selling or disposing of all, or a portion, of a reporting unit, the testing for recoverability of a significant asset group within a reporting unit, or recognition of a goodwill impairment loss in the financial statements of a subsidiary that is a component of a reporting unit
g. If applicable, a sustained decrease in share price (consider in both absolute terms and relative to peers).

…

35-3F[3] The examples included in paragraph 350-20-35-3C(a) through (g) are not all-inclusive, and an entity shall consider other relevant events and circumstances that affect the fair value or carrying amount of a reporting unit in determining whether to perform the quantitative goodwill impairment test. An entity shall consider the extent to which each of the adverse events and circumstances identified could affect the comparison of a reporting unit's fair value with its carrying amount. An entity should place more weight on the events and circumstances that most affect a reporting unit's fair value or the carrying amount of its net assets. An entity also should consider positive and mitigating events and circumstances that may affect its determination of whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If an entity has a recent fair value calculation for a reporting unit, it also should include as a factor in its consideration the difference between the fair value and the carrying amount in reaching its conclusion about whether to perform the quantitative goodwill impairment test.

[3] ASU 2017-04 (referred to in paragraph A24 of Agenda Paper 18A for his meeting) amended paragraphs 350-20-35-3F and 350-20-35-3G. The text reproduced in this Appendix is the amended text.

35-3G[4] An entity shall evaluate, on the basis of the weight of evidence, the significance of all identified events and circumstances in the context of determining whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount. None of the individual examples of events and circumstances included in paragraph 350-20-35-3C(a) through (g) are intended to represent standalone events or circumstances that necessarily require an entity to perform the quantitative goodwill impairment test. Also, the existence of positive and mitigating events and circumstances is not intended to represent a rebuttable presumption that an entity should not perform the quantitative goodwill impairment test.

[4] ASU 2017-04 (referred to in paragraph A24 of Agenda Paper 18A for his meeting) amended paragraphs 350-20-35-3F and 350-20-35-3G. The text reproduced in this Appendix is the amended text.