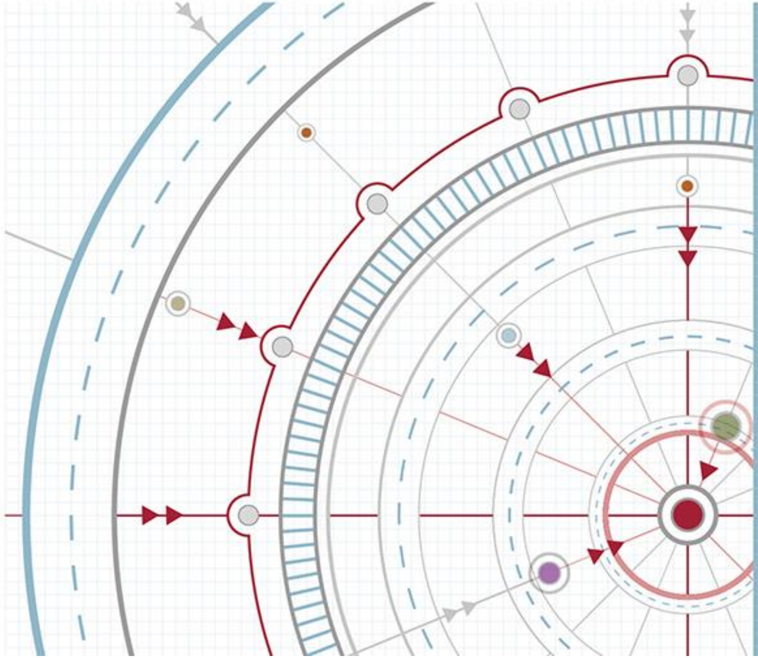
IFRS® Foundation



Accounting Standards Advisory Forum

April 2018

ASAF Agenda Paper 5

Goodwill and Impairment

THIS PAPER IS CLEARER IF PRINTED IN COLOUR

The views expressed in this presentation are those of the presenter, not necessarily those of the International Accounting Standards Board (the Board) or IFRS Foundation.

Objective of the meeting

To seek views about:

- an approach to the impairment testing of goodwill that considers movements in headroom [headroom is the excess of the recoverable amount of a cash-generating unit (or group of units) over the carrying amount of that unit]; and
- the requirement in IFRS 3 *Business Combinations* to recognise identifiable intangible assets acquired in a business combination.

Contents of the paper

Brief background

Brief background (1/3)

2009

Entities started implementing revised version of IFRS 3 *Business Combinations*

2013

The Board sought stakeholder feedback on specified matters as part of the Post-implementation Review of IFRS 3

2015

Having reviewed the stakeholders' feedback and academic research, the Board identified issues/topics for further research and follow-up (see pages 6–7)

2017

The Board made tentative decisions on some topics (see pages 6–7)

2018

The Board will soon decide the next stage of the research project

Brief background (2/3)

Feedback received	Topic for research	Current status of Board's research
There are delays in recognition of impairments of goodwill.	**Topic 1**—Can the impairment testing model for goodwill be improved? *(Focus of this ASAF meeting)*	The Board tentatively decided to consider using the unrecognised headroom as an additional input in the impairment testing of goodwill. Headroom is the excess of the recoverable amount of a cash-generating unit (or group of units) over the carrying amount of the unit(s).[1]
Impairment testing of goodwill is a costly process.	**Topic 2**—Can impairment testing be simplified without making it less robust?	The Board tentatively decided to consider simplifying the value in use calculation.[2]
Financial statements do not include information to assess performance of an acquired business.	**Topic 3**—Can the quality of information provided to the users of financial statements be improved without imposing costs for preparers that outweigh the benefits?	The Board tentatively decided to consider requiring entities to disclose: (a) the unrecognised headroom; (b) breakdown of goodwill by past acquisition; and (c) information about value creation from new acquisitions.[1]

1. Members may refer to Agenda Papers 18C and 18F for the December 2017 Board meeting for more information.
2. Members may refer to Agenda Papers 18–18B for the January 2018 Board meeting for more information.

Brief background (3/3)

Issue identified	Topic for research	Current status of Board's research
Testing goodwill only for impairment without amortising it is not appropriate.	**Topic 4**—Are there any new conceptual arguments or new information in support of amortising goodwill?	The Board tentatively decided not to consider reintroducing amortisation of goodwill.[3]
Valuing some intangible assets on an acquisition is a costly process and does not provide useful information to investors.	**Topic 5**—Can an entity be allowed to include some acquired identifiable intangible assets within goodwill arising on an acquisition? *(Focus of this ASAF meeting)*	• No decisions made • This topic is scheduled for discussion at the April 2018 Board meeting

3. Members may refer to Agenda Paper 18B for the December 2017 Board meeting for more information.

Question to ASAF

1. Do you have any comments or feedback about the Board's tentative decisions on Topics 2, 3 and 4 listed on pages 6–7?

IFRS Foundation

Improving effectiveness of impairment testing of goodwill using headroom approach

Frequently used terms

For the benefit of members, terms and acronyms frequently used in this section of the paper are defined or commented on below.

Cash-generating unit (unit)	Smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets. References to a 'unit' should also be read as referring to groups of units.
Recoverable amount (RA) of a unit	Recoverable amount is higher of fair value less costs of disposal (FVLCD) and value in use (VIU).
Carrying amount (CA) of a unit	Carrying amount includes the carrying amount of only those assets that can be attributed directly, or allocated on a reasonable and consistent basis, to the unit. This also includes carrying amount of acquired goodwill allocated to the unit.
Unrecognised headroom (UH)	Difference between the recoverable amount of a unit and its carrying amount. This difference mainly comprises internally generated goodwill and unrecognised intangible assets, if any.
Total headroom (TH)	Sum of the unrecognised headroom of a unit and the carrying amount of acquired goodwill allocated to that unit.

Why improve the impairment test? (1/2)

IAS 36 requirements

- Goodwill tested for impairment at the level of a unit to which goodwill relates
- RA of the unit to be measured every year
- No impairment if RA > CA

Investors’ concerns

- Entity-specific nature of VIU gives scope for management’s optimism to creep into impairment test to avoid recognising any impairment
- Impairments of goodwill are not recognised at the right time and in the right amounts

Staff research

Likely causes—

- Unwarranted management optimism
- Shielding effect of internally generated goodwill

Why improve the impairment test? (2/2)

What is the shielding effect?	Is it possible to remove the shielding effect?
• In the current model, RA of a unit is compared with its CA. • Impairment of goodwill is recognised only if RA < CA • If there is a decrease in RA for reasons such as an acquisition not giving rise to synergies as expected, such decrease is not reflected in performance so long as RA of the unit is higher than its CA • This is because, *the unrecognised headroom ([RA - CA] which mainly comprises internally generated goodwill)* always absorbs the first layer of decreases in RA; thus, it shields the acquired goodwill.	• A possible simple solution would be to make a rebuttable presumption that the first layer of decreases in RA is attributable to acquired goodwill • For this purpose, an entity might be required to specifically consider the headroom information when testing goodwill for impairment as explained and illustrated in pages 13–18

How to improve the impairment test?

Current requirement	Headroom approach
Compare recoverable amount (RA) of a unit with its carrying amount (CA) at the current impairment testing date T1	Compare total headroom of a unit at the current impairment testing date T1 (ie TH_{T1}) with the total headroom of the unit at the immediately preceding impairment testing date T0 (ie TH_{T0})
Goodwill is impaired only if recoverable amount of the unit is less than its carrying amount (ie $RA_{T1} < CA_{T1}$)	If the total headroom decreases (ie $TH_{T1} < TH_{T0}$), it is presumed that there is an impairment of acquired goodwill amounting to $TH_{T1} – TH_{T0}$ unless that presumption is rebutted.
	If the entity rebuts that presumption, it should disclose the reasons why part or all of the decrease should not be attributed to acquired goodwill.

Members may refer to Agenda Paper 18C for the December 2017 Board meeting for detailed analysis of the headroom approach.

Headroom approach (1/5)

Consider the following facts

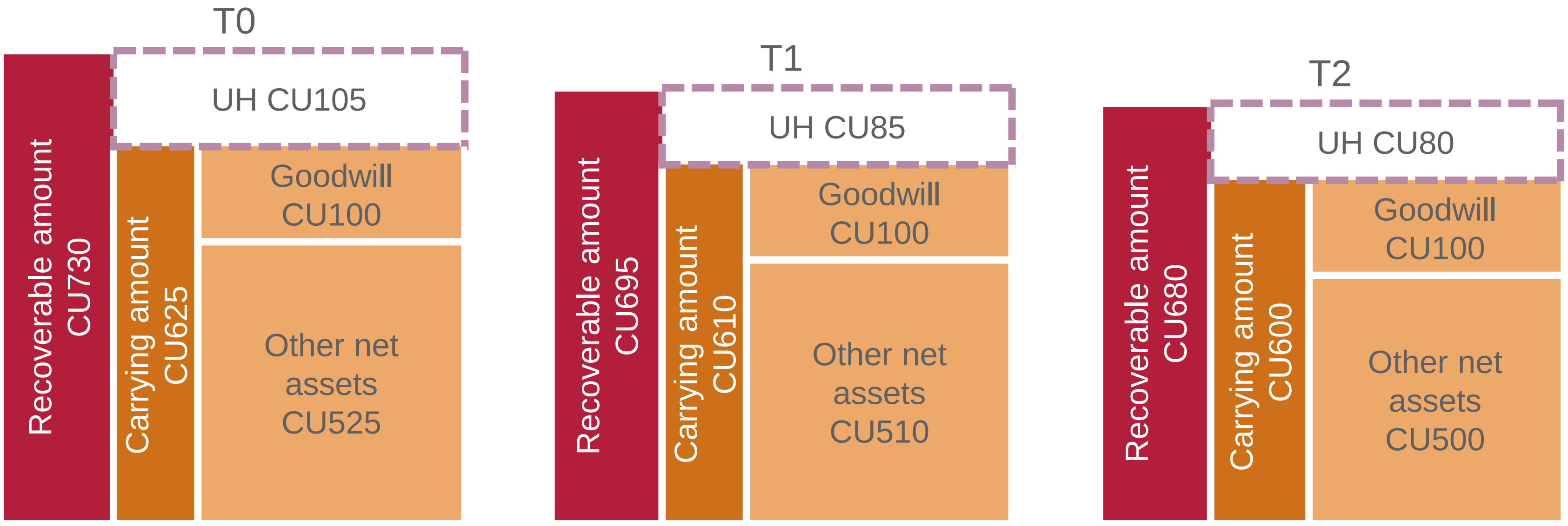
- Company X tests goodwill for impairment regularly at the annual reporting date
- Company X has a cash-generating unit Z that includes acquired goodwill from a recent past acquisition
- See table for the recoverable amount and the carrying amount of unit Z at three reporting dates T0, T1 and T2
- Assume that there is no change in the level of business activity
- Monetary amounts are denominated in ‘currency units’ (CU)

Unit Z	T0 CU	T1 CU	T2 CU
Carrying amount			
– acquired goodwill	*100	#100	#100
– other recognised assets, less liabilities	525	510	500
Recoverable amount	730	695	680

* after recognising impairment loss, if any, at T0
# before recognising impairment loss at T1 and T2

Headroom approach (2/5)

Impairment testing of unit Z applying the current requirements in IAS 36



No impairment of goodwill
$RA_{T0} > CA_{T0}$

No impairment of goodwill
$RA_{T1} > CA_{T1}$

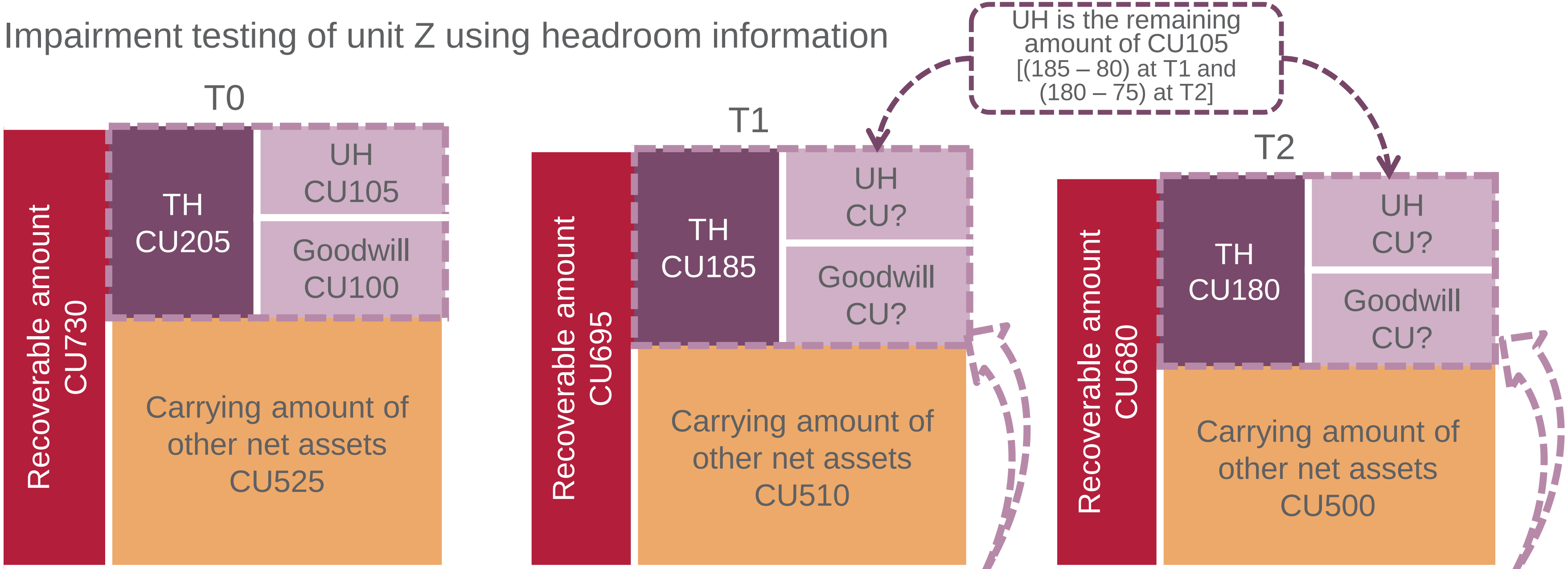
No impairment of goodwill
$RA_{T2} > CA_{T2}$

Disclosure of the unrecognised headroom (UH) is currently required in financial statements only if a reasonably possible change in a key assumption used in measuring RA would cause CA to exceed RA

IFRS

Headroom approach (3/5)

Impairment testing of unit Z using headroom information



Comparing TH at two dates	$TH_{T1} < TH_{T0}$ by CU20 (205-185)	$TH_{T2} < TH_{T1}$ by CU5 (185-180)
Recognised as goodwill impairment*	CU20	CU5
Goodwill after impairment	CU80 (100 - 20)	CU75 (80 - 5)

* It is assumed in this example that all decreases in total headroom are attributed to acquired goodwill. See pages 17–18 for the staff's current thoughts on attribution of decreases in total headroom.

Headroom approach (4/5)

Attribution of loss to acquired goodwill and (or) unrecognised headroom

- In the current impairment testing model, the first layer of decreases in total headroom is all absorbed by the unrecognised headroom
  - In the example on page 15, the decrease in total headroom of CU20 from T0 to T1 is absorbed by unrecognised headroom
  - Similarly, the decrease in total headroom of CU5 from T1 to T2 is absorbed by unrecognised headroom
- This might not reflect the economics especially if the decrease in total headroom is for reasons such as the entity not being able to realise the expected synergies from an acquisition etc
- Consequently, in the headroom approach, there is a rebuttable presumption that any decrease in total headroom is attributed first to acquired goodwill (as illustrated on page 16)
- The decrease in total headroom attributed to acquired goodwill is recognised as impairment loss in the entity's financial statements.
- However, an entity may rebut the presumption if there is specific evidence that all or part of the decrease in total headroom is not attributable to acquired goodwill

(continued)

Headroom approach (5/5)

Attribution of loss to acquired goodwill and (or) unrecognised headroom

- The presumption could be rebutted if the decrease in total headroom is for reasons such as:
  - increase in risk-free component of discount rate; or
  - significant decline in the current value of an asset within the unit that is measured in the financial statements on a historical cost basis
- In such a situation, the entity would attribute the decrease in total headroom either all to the unrecognised headroom or pro-rata to acquired goodwill and the unrecognised headroom depending upon the reason for the decrease
- As in the case today, the decrease in total headroom attributed to the unrecognised headroom is NOT recognised in the entity's financial statements [Today, all of the first layer of the decrease is attributed to unrecognised headroom]
- The entity would be required to disclose the basis of attribution of decrease in total headroom

Pros and cons of the headroom approach

- Shielding effect of internally generated goodwill is removed
- Entities would need to think carefully about factors affecting acquired goodwill
- Management is discouraged from making over-optimistic projections of cash flows because any difficulty in maintaining the over-optimism year after year reduces the total headroom, potentially resulting in impairment of acquired goodwill
- Recognition of impairments of goodwill may become more timely
- Investors benefit from the disclosure of basis used for attributing decrease in total headroom

- Costs of applying the impairment testing model would increase because of the need for:
  - more precise measurement of recoverable amount in year in which unrecognized headroom is large; and
  - application of the rebuttable presumption

Recent feedback from Capital Markets Advisory Committee (CMAC)

- A good majority of CMAC members supported the headroom approach because it removes the shielding effect of any unrecognised headroom
  - Some members highlighted the importance of the accompanying narrative that a company should be required to disclose in its financial statements
  - Some members indicated a preference for disclosure of headroom instead of using the headroom approach for impairment testing
- Other feedback
  - One member cautioned that using a rebuttable presumption could lead to decreases in total headroom being attributed to acquired goodwill even if the decrease was caused by reasons not connected to the acquired goodwill
  - A couple of members supported amortisation of goodwill
  - One member supported componentising goodwill on initial recognition and then, depending on the nature of the component, either amortising the component, writing it off against equity or only testing it for impairment

Recent feedback from Global Preparers Forum (GPF)

- Staff asked GPF about the nature and extent of costs likely to be incurred in applying the updated headroom approach
- Most of the members said that the headroom approach is likely to add significant costs to the impairment testing of goodwill mainly for two reasons:
  - more precise measurement of recoverable amount required even in years in which unrecognised headroom is large; and
  - rebutting the presumption that all decreases in total headroom are attributable to acquired goodwill would cause significant incremental debate with auditors and also would attract questions from regulators
- Some GPF members said that there would be there would be costs involved in tracking actual performance versus the assumptions made in support of the consideration paid for the business combination
- One member supported the headroom approach but thought that any decrease in total headroom should not be attributed to the acquired goodwill so long as the unrecognised headroom is in excess of the pre-acquisition headroom
- Another member said that introducing the headroom approach would create an inconsistency with the prohibition in IAS 36 on reversal of impairment losses for goodwill. The headroom approach attributes part or all of a decrease in total headroom to acquired goodwill, but the prohibition in IAS 36 means that no part of any subsequent increase in total headroom can be attributed to acquired goodwill.

Questions to ASAF

2. Could you highlight the nature and extent of costs that entities may have to incur in applying the headroom approach?
3. Do you think disclosure of the basis used for attributing the decrease in headroom would provide useful information to users of financial statements?

IFRS Foundation

Separate recognition of identifiable intangible assets acquired in a business combination

Feedback from Post-implementation Review of IFRS 3

Feedback from preparers and auditors			Feedback from investors		
Valuation of intangible assets such as brands and customer relationships is costly and complex			Separate recognition of acquired intangibles is of limited (if any) utility except if there is a market for the intangibles		
Lack of sufficient reliable and observable data	Highly subjective and high level of judgement required	Arbitrary allocation of future cash flows	Significant arbitrage opportunities in accounting for an acquisition	Little credence placed on value of intangible assets such as brands or customer lists	Amortisation of some intangible assets conveys no useful information about potential replacement cost

After reviewing academic research and feedback from other outreach activities, the Board decided to consider whether some intangible assets could be included within goodwill acquired in a business combination

Possible approaches for Board’s consideration (1/8)

Retain current requirements of IFRS 3 (Approach A)

Require disclosures similar to those in IFRS 13 *Fair Value Measurement* for intangible assets acquired in a business combination (Approach B)

Allow indefinite-lived intangible assets to be included within goodwill (Approach C)

Segregate intangible assets into wasting assets and organically-replaced assets and require only wasting assets to be recognised separately from goodwill (Approach D)

Possible approaches for Board’s consideration (2/8)

Approach A— Retain current requirements of IFRS 3	Usefulness of financial statements would be enhanced if intangibles acquired in a business combination were separated from goodwill
	To have predictive value, financial information should be segregated into reasonably homogenous groups—many intangibles have characteristics that distinguish them from goodwill
	Some academic research establishes value relevance of separate recognition of intangible assets acquired in a business combination
	The requirement to account separately for intangible assets encourages management of an entity to better analyse the acquisitions

Possible approaches for Board’s consideration (3/8)

Approach B— Requiring disclosures similar to those in IFRS 13 for intangible assets acquired in a business combination	Investors question the credibility of the value of recognised intangibles. One possible reason for those questions is attributed to inadequate disclosure about the valuation techniques and inputs used in measuring fair value of those intangibles
	Some investors requested the Board to consider expanding the scope of the disclosure requirements in IFRS 13 to include information about fair value of intangible assets recognised in a business combination
	Together with the disclosures, separate recognition of intangible assets could provide decision useful information to investors

Continued…

Possible approaches for Board's consideration (4/8)

Approach B—Requiring disclosures similar to those in IFRS 13 for intangible assets acquired in a business combination

- The staff could ask the Board to consider requiring the following disclosures for intangible assets recognised in a business combination, which are along the lines of the requirements in IFRS 13
  a. The level of fair value hierarchy within which the fair value measurements are categorised in their entirety (Level 1, 2 or 3).
  b. For fair value measurements categorised within Level 2 and Level 3 of the fair value hierarchy, a description of the valuation technique(s) and the inputs used in the fair value measurement.
  c. For fair value measurements categorised within Level 3 of the fair value hierarchy:
     i. quantitative information about the significant unobservable inputs used in the fair value measurement.
     ii. a narrative description of the sensitivity of the fair value measurement to changes in unobservable inputs if a change in those inputs to a different amount might result in a significantly higher or lower fair value measurement.
     iii. if there are interrelationships between the significant unobservable inputs and other unobservable inputs used in the fair value measurement, a description of those interrelationships and of how they might magnify or mitigate the effect of changes in the unobservable inputs on the fair value measurement.

Possible approaches for Board's consideration (5/8)

Approach C— Allow indefinite-lived intangible assets to be included within goodwill	The easiest possible course of action
	This is not a fundamental change in accounting for those assets because subsequent accounting for indefinite-lived intangible assets and goodwill is similar
	Likely to reduce the cost of applying IFRS 3
	May not provide useful information especially if any of the acquired indefinite-lived intangible assets are already generating independent cash flows, say by way of licensing income

Possible approaches for Board's consideration (6/8)

Approach D— Segregating intangible assets into wasting assets and organically-replaced assets and requiring only wasting assets to be recognised separately from goodwill	Valuing wasting intangibles assets is less subjective than valuing organically-replaced intangible assets
	Amortisation of a wasting asset provides useful information about potential future cash outflows for replacing the asset
	A fundamental change to the relevant IFRS Standards
	Judgement required in assessing whether an intangible asset is a wasting asset or an organically-replaced asset; some assets may not neatly fall into one of the two categories

Continued…

Possible approaches for Board's consideration (7/8)

Approach D—Segregating intangible assets into wasting assets and organically-replaced assets and requiring only wasting assets to be recognised separately from goodwill

- The Accounting and Reporting Policy team of the UK's Financial Reporting Council carried out research to understand investor views on accounting for intangible assets
- The results of the research were published in March 2014 in a report *Investor Views on Intangible Assets and their Amortisation*
- In relation to intangible assets acquired in a business combination, more than half of respondents preferred accounting requirements different from IAS 38
- A majority of those respondents, explained the following distinction that they make:
  - wasting intangible assets
  - organically replaced intangible assets

Continued…

Possible approaches for Board's consideration (8/8)

Approach D—Segregating intangible assets into wasting assets and organically-replaced assets and requiring only wasting assets to be recognised separately from goodwill

- Investor views about the distinction are as follows:

Wasting intangible assets	Organically-replaced intangible assets
These are separable from the entity, have finite useful lives and lead to identifiable future revenue streams	Investors raise doubts about whether these intangible assets are capable of being separated from the entity, are likely to have reliably determined useful lives, or be a source of future economic benefits that could be distinguished from the business as a whole. They stated that such intangible assets are replenished on an ongoing basis through the marketing and promotional expenditure of the company.
Examples—wireless spectrum, patents	Examples—customer lists, brands.
Should be separately recognised	Should not be separately recognised
Subsequently amortised	Subsequently tested for impairment

Recent feedback from CMAC (1/2)

Does recognition of identifiable intangible assets acquired in a business combination provide useful information?

- Mixed feedback
- One member supported the current requirement in IFRS 3 as providing useful information
- Another member said that extreme level of judgement in valuing some intangibles makes that information not useful
- Some members were indifferent because detailed information about values of intangible assets is not generally available when an acquisition is announced, which is when they assess whether the acquisition is a good or a bad deal
- Some members with experience covering banking sector said that they ignore intangible assets acquired in a business combination because those assets are deducted from equity in determining regulatory capital

Would extending the scope of IFRS 13 disclosures to intangible assets acquired in a business combination remove investors' concerns about credibility of fair value

- The discussion did not produce a clear view

Recent feedback from CMAC (2/2)

Are there ways of allowing some identifiable intangible assets acquired in a business combination to be included within goodwill without losing useful information that is currently provided?

- One member did not support allowing any intangible assets to be included within goodwill.
- One member said that an acquiring entity should recognise only those intangible assets that have already been recognised as assets by the acquired entity.
- One member supported segregating intangible assets into wasting assets and organically replaced assets, and requiring recognition of only wasting intangible assets acquired in a business combination—because amortisation of wasting intangible assets provides useful information about potential future cash outflows required for replacing those assets.
- One member with experience covering the banking sector thought that allowing indefinite lived intangible assets to be included within goodwill may not result in saving costs for preparers—because not many indefinite lived intangible assets being recognised in acquisitions.

Recent feedback from GPF

- Staff sought feedback from GPF on the same questions that CMAC was asked
- GPF generally supported the current requirement in IFRS 3 to recognise all identifiable intangible assets—the discussion did not produce a clear view about the usefulness of that information
- There was not much support for any of the possible approaches for allowing some identifiable intangible assets to be included within goodwill
- Similarly, there was not much support for requiring disclosures similar to those in IFRS 13 for intangible assets acquired in a business combination

Questions to ASAF

4. Do you think separate recognition of all identifiable intangible assets acquired in a business combination provides useful information? If not, why not?
5. Do you agree with the feedback that valuing brands and customer relationships is costly and complex? Are you aware of any other intangible assets that are difficult to value?
6. Do you have any comments or feedback on each of the possible approaches that the staff have identified for the Board's consideration?

IFRS Foundation

Appendices

Past discussions with ASAF

Appendix A

Feedback from ASAF (1/4)

Month	Question asked	Summary of feedback
December 2015	ASAF members were asked for feedback on the Board's initial discussions and for any advice on the way forward with the project.	• Mixed views with some members supporting impairment-only approach to goodwill whereas others supported amortisation and impairment of goodwill. • Consider what information users want; focus on the benefits for users of the current information versus the costs to preparers of applying the requirements. • Focus primarily on improving the impairment test, because such an improvement would be required regardless of the approach for accounting for goodwill. • Some ASAF members thought it necessary to retain a robust impairment test if the impairment-only approach is maintained.
		Click the links for agenda papers 5–5F, full meeting summary and recording.

Feedback from ASAF (2/4)

Month	Question asked	Summary of feedback
July 2016	ASAF members were asked for views on the quantitative study presented by staff of EFRAG and ASBJ staff on trends in goodwill, intangible assets and impairment charges over ten years.	ASAF members: • suggested the objective and research question need to be specified clearly. • questioned whether the study provides sufficient information about internally generated intangible assets. • emphasised that it is difficult to analyse goodwill on an average basis because goodwill is concentrated among a small number of companies. • suggested reviewing goodwill on a case by case basis and performing further analysis of goodwill by industry.
		Click the links for agenda papers 6–6app, full meeting notes and recording.

Feedback from ASAF (3/4)

Month	Question asked	Summary of feedback
July 2017	ASAF members were asked for feedback on the IASB staff's and ASBJ's current thoughts on simplifying and improving the effectiveness of the impairment testing model for goodwill.	• ASAF members generally did not support the ASBJ's idea of allowing a choice between amortisation and impairment model and impairment-only model mainly because of deteriorating comparability and other concerns. • Mixed views on single method approach and indicator-only approach to simplify and improve goodwill impairment testing.
		Click the links for agenda papers 3–3B, full meeting notes and recording.

Feedback from ASAF (4/4)

Month	Question asked	Summary of feedback
September 2017	ASAF members were asked for feedback on possible approaches developed by the IASB staff (pre-acquisition headroom) and by the EFRAG staff (goodwill accretion) for improving the effectiveness of the impairment testing model for goodwill.	• ASAF members generally expressed concerns that both goodwill accretion approach and the pre-acquisition headroom approach would add further complexity. • Some members thought that the goodwill accretion approach would be difficult to understand or explain. • In relation to using a single method as the sole basis for determining recoverable amount, there was no clear support for using either fair value less costs of disposal or value in use as the sole basis.
		Click the links for agenda papers 5–5B, full meeting notes and recording.

Keep up to date

www.ifrs.org

@IFRSFoundation

IFRS Foundation, IASB

IFRS Foundation

IFRS Foundation