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 to inform the FASB about:
   (a) feedback from stakeholders during and after the IASB's Post-implementation Review (PIR) of IFRS 3 *Business Combinations* in relation to the costs of testing goodwill for any impairment; and
   (b) the possible approaches that the IASB considered for simplifying the impairment test without making it less robust.
2. This paper is mostly a reproduction of Agenda Paper 18E for the December 2017 IASB meeting.

The IASB's tentative decisions

3. The IASB tentatively decided not to consider further the following possible simplifications to the impairment testing model:
   (a) relief from the mandatory annual quantitative impairment testing of goodwill, ie relief from performing that test when there are no indicators of possible impairment.

(b) allowing goodwill to be tested at an entity-level or at the level of a reportable segment.

4. The IASB tentatively decided to pursue making some changes to the value in use calculation that are expected to contribute moderately to simplifying the impairment testing model in IAS 36. This paper does not include a discussion of those changes because the concept of value in use does not exist in US GAAP.

Structure of the paper

5. The paper is structured as follows:

   (a) summary of current requirements in IFRS Standards (paragraphs 6–10)

   (b) stakeholder feedback during and after the PIR of IFRS 3 (paragraphs 11–15)

   (c) relief from the mandatory annual quantitative impairment testing of goodwill (paragraphs 16–36)

   (d) allowing goodwill to be tested at the entity-level or at the level of a reportable segment (paragraphs 37–42)

Summary of current requirements in IFRS Standards

6. For impairment testing, an entity is required to allocate, from the acquisition date, the goodwill acquired in a business combination to each of its cash-generating units, or groups of units, that is expected to benefit from the synergies of the combination.[1]

7. Each unit to which the goodwill is so allocated should:

   (a) represent the lowest level within the entity at which the goodwill is monitored for internal management purposes; and

[1] In the context of impairment testing of goodwill, any reference to a unit should be read as referring also to a group of units.

(b) not be larger than an operating segment as defined by paragraph 5 of IFRS 8 *Operating Segments* before aggregation.

8. A unit to which goodwill has been allocated should 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 with its recoverable amount. If the carrying amount of the unit exceeds its recoverable amount, an impairment loss is recognised in the manner specified in the Standard.

9. That 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. 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.

10. Recoverable amount of a unit is the higher of its value in use and fair value less costs of disposal.

Stakeholder feedback during and after the PIR of IFRS 3

11. The PIR identified concerns from preparers that the current impairment testing requirements are costly and complex to apply and there are some shortcomings in the information provided to investors. Consequently, some think the benefit of the information provided to investors does not justify the costs of applying the current impairment requirements in IAS 36.

12. The main challenges in applying the current impairment requirements identified during the PIR were:

(a) the overall costs involved in performing the impairment test, including the requirement to perform it annually;

(b) limitations of the value in use calculation, including the restriction that excludes cash flows arising from a future restructuring or a future performance enhancement and the requirement to use a pre-tax discount rate; and

(c) the high degree of subjectivity in the assumptions used in the impairment test, and in allocating (and reallocating) goodwill to cash-generating units for impairment testing purposes.

13. Some stakeholders question the current requirements in IAS 36 about the frequency of the quantitative impairment testing of a cash-generating unit. Applying the current requirements (a) for a unit that contains goodwill, that test must be performed annually; but (b) for a unit that does not include goodwill, the test is required only when there is an indication that the unit may be impaired. Those stakeholders think that because goodwill is currently tested for impairment as part of a unit (or group of units), the focus of the test, in reality, is not to assess whether the carrying amount of goodwill is overstated but to assess whether the carrying amount of net assets of the unit (that includes goodwill) is overstated. If the focus of the test is on the carrying amount of the net assets of the unit, rather than on the carrying amount of goodwill, it is unclear why the requirements for the frequency of the quantitative impairment test depend on whether the unit contains goodwill. Consequently, they think that a unit, whether or not it includes goodwill, should be tested only when there is an indication that the unit may be impaired.

14. Some stakeholders think that for the impairment testing of goodwill to be effective, goodwill should be tested at the lowest possible levels of cash-generating units without grouping the units. To be able to do that, an entity would need to further componentise goodwill, especially to identify the synergies paid for, and allocate the synergies on a reasonable basis to the individual units that benefit from the synergies. However, other stakeholders think that imposing such a requirement would make the impairment testing of goodwill even more costly.

15. The IASB discussed the feedback and set its research project the objective of assessing whether the application of the requirements in IAS 36 can be improved by simplifying the impairment test without making it less robust.

Relief from the mandatory annual quantitative impairment testing of goodwill

16. As explained in paragraph 8 of this paper, IAS 36 requires a unit to which goodwill has been allocated to be tested for impairment annually.

17. According to some feedback from preparers in the PIR of IFRS 3, when there are no indicators of possible impairment, removing the requirement to perform the quantitative impairment test may reduce complexity. Removing that requirement would also be consistent with the impairment testing requirements in IAS 36 for assets within the scope of IAS 36, other than goodwill and intangible assets with indefinite life. For those assets, an entity is required to assess at the end of each reporting period whether there is any indication that the asset may be impaired. If any such indication exists, the entity shall perform an impairment test. IAS 36 provides a non-exhaustive list of indicators that an asset may be impaired.

18. To respond to that feedback from preparers, the IASB considered providing relief from the mandatory annual quantitative impairment testing of goodwill, using one of the following four approaches:

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

    (b) *Approach 2*—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*—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*—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.

19. The IASB considered the factors discussed in paragraphs 20–31 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 IASB also considered the work of the FASB—see paragraphs 32–35 of this paper.

Current requirements and considerations in IAS 36

20. As explained in the Basis for Conclusions on IAS 36, the IASB required an annual quantitative impairment test for intangible assets with indefinite useful life and goodwill because not amortising those assets increases the reliance that must be placed on impairment reviews to ensure that their carrying amounts do not exceed their recoverable amounts.

21. For goodwill, the existence of a rigorous and operational impairment test was seen as a precondition for removing the requirement to amortise it in all cases. The International Accounting Standards Committee (IASC), the IASB's predecessor, introduced the requirement to carry out an annual quantitative impairment test for goodwill and intangible assets with indefinite life at the same time as it removed a previous requirement that amortisation of goodwill should be over a period not exceeding 20 years.

22. These considerations continue to be relevant.

Cost of performing the annual quantitative impairment testing of goodwill

23. 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 each year involved in ensuring that those inputs and assumptions are accurate.

24. 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 some diligence review in the process of restructuring the units or undertaking the new business combinations and that review would provide some inputs to the subsequent impairment testing.

Annual impairment test—a good governance mechanism

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

26. However, some stakeholders think that measuring recoverable amount is a valuation concept; and that management is not likely to perform valuations annually (or more frequently) for any purpose other than to satisfy a prescriptive requirement to carry out impairment testing of goodwill.

Concerns about robustness of impairment testing and loss of disclosures

27. 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, 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 Global Preparers Forum (GPF) members preferred Approach 4, (mandatory quantitative test less frequently than annually, with indicator-based approach in intervening years) 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.

28. IAS 36 requires an entity to disclose the estimates used to measure recoverable amounts of units containing goodwill or intangible assets with indefinite useful life. 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 need to 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 intangible assets with indefinite useful life, 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 intangible assets with indefinite life is to provide investors with information for evaluating the estimates used by management to support the carrying amounts of goodwill and those intangible assets.

Possible additional indicator for assessing impairment

29. In relation to the first few years after a business combination, the IASB considered 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. 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. 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 automatically mean that the acquired assets are impaired. Entities generally take a long-term view of the benefits from the business combination.

30. 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.

31. A few Capital Markets Advisory Committee (CMAC) members supported removing the requirement for an annual quantitative impairment test, together with introducing a disclosure of the indicators that triggered the quantitative impairment test. Currently, IAS 36 does not require disclosure of indicators that triggered the quantitative impairment test. 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

32. In 2011, the Financial Accounting Standards Board of the US (FASB) 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 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.

33. 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.

34. Based on informal discussions with the FASB staff, the staff understood that many companies did not immediately use the qualitative test because the macro-economic environment in the US then 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.

35. If Approach 1 is pursued, the IASB thought that the audit and enforcement framework in a jurisdiction would affect the robustness of application of the indicator-based impairment testing.

The IASB's conclusion

36. The IASB tentatively decided not to consider providing relief from the mandatory annual quantitative impairment testing of goodwill mainly because doing so could exacerbate concerns about timely recognition of goodwill impairment.

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

37. 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.)

38. 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.

39. 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 IASB's considerations are clearly explained in paragraphs BC137–BC150B of the Basis for Conclusions on IAS 36.

40. One possible simplification is to allow impairment testing of goodwill at the entity-level or at the reportable-segment level. As explained in paragraph 37 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 IASB specifically concluded that requiring goodwill to be allocated down 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 that 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.

41. 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.

The IASB's conclusion

42. The IASB tentatively decided not to consider testing goodwill for impairment at the entity-level or at the level of a reportable segment. This is because it could lead to loss of information about impairment by making the recognition of impairment losses less timely of goodwill, through aggregation with headroom in other units.

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[2] 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.

[2] 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[3] 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.

[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.